For release on delivery
(Approximately 6 p.m. CST)
Wednesday, April 13, 1966

Floors and Ceilings: Guidelines and Understandings in Commercial Banking

Remarks of George W. Mitchell

Member, Board of Governors of the Federal Reserve System

at the

Annual Executive Forum

of the

American Institute of Banking
(St. Louis Chapter)

St. Louis, Missouri

April 13, 1966

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Floors and Ceilings: Guidelines and Understandings in Commercial Banking

Commercial banks are perhaps the oldest surviving business institutions whose product and method of manufacture has been relatively unchanged over the years. They have continuously been a highly important and integral part of our economic system, attracting and allocating or reallocating credit resources among a broad spectrum of needs. But commercial banking has not remained static. In particular, during our generation banks have had to cope with an environment in which two discordant--and interrelated--trends have been at work.

First, they have found themselves facing more intense competition from new financial institutions--as well as from the money and capital markets and nonfinancial businesses. Second, mainly as a heritage from historical experience--especially, but not solely in the 1930's--banks have been subject to detailed regulation by the States and the Federal Government. And, as competition has come increasingly to substitute for regulation in promoting and protecting the public interest, the confining effect of regulation has been intensified.

It is the inhibitions on competitive behavior of banks, self-imposed and super-imposed, that I should like to discuss with you today: the rules, the guidelines, and the informal understandings that condition the way banks behave in the market place. These factors not only influence portfolios and profits of banks, but also how much and how well banks contribute to the effectiveness and efficiency of our economic system.

Banking history for the past decade or so demonstrates that commercial banks can and have used competitive methods to grow and to prosper. The earlier disdain many of them had for small depositors, consumer instalment credit, and residential mortgages has disappeared but not before it provided the opportunity

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for specialized financial intermediaries and credit-granting institutions to become well established. Today banks have become large in the consumer credit field, where they show signs of spectacular innovation. On occasion they enter the mortgage market quite vigorously.

The new spirit of competition has not been limited to the asset side of the balance sheet. Early in this decade, in addition, banks saw the demand for their deposits declining because consumers and businesses found other financial assets more attractive. Eventual awareness of this attrition has caused banks latterly to aggressively seek deposits of all types and sizes by offering a variety of attractive claims. They--and the public--are better off, and the new spirit of competition and innovation is spreading.

This new competitiveness is, when carried out with sense, all to the good. But there are still many areas where custom, practice, and regulation dull the edge of bank competition, making the life of bankers and bureaucrats more comfortable, to be sure, but reducing the contribution of banks to the well-being of society. These factors, it seems, feed on themselves. The bankers and Government officials who keep saying that banks are different and hence need certain regulations and policies may really mean that these regulations and policies have made the banks different. Moreover, the ghosts of past problems and previous economic environments still haunt the modern banker long after the body of the original problem--if it ever truly existed--has turned to dust And, what is perhaps even worse, too often it is assumed that the rule, policy, or regulation is successful in alleviating the problem to which it was directed, when study suggests this is just not so.

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Present day usury laws are a case in point. These statutes were established in the late 19th and early 20th centuries to prevent the exploitation of small and weak borrowers. The thrust of these legislative actions was liberalizing in a degree. The older usury laws simply had made it impossible for most legitimate lenders to supply funds to certain borrowers, and many credit demands were diverted to illegal lenders. But rather than repudiating the usury mores of the Middle Ages, the thrust of legislative action was to exempt certain kinds of loans on a regulated basis. Moreover, there was no recognition of the role of competition in protecting consumers; instead, regulation proliferated with separate laws for each type of lender or borrower.

Has the effect of these laws been to protect the consumer and other borrowers who are the supposed beneficiaries of usury regulations? The evidence suggests the contrary. Take the case of consumer credit, an area where the original laws were supposed to work their protection, and where most of the "controlled" exemption from usury laws has taken place.

The first thing we observe is that in most consumer instalment credit markets actual rates are below the ceilings--which for commercial banks in the various States range between 12 and 16 per cent simple interest. This seems to suggest that most consumer credit markets are operating under competitive market forces. Only at small loan companies, which face greater risks and higher costs, do actual rates tend to be at their ceilings of 24 to 48 per cent.

Despite surface appearances, the usury laws do interfere with competition. And they do so because widely different ceiling rates for essentially the same transaction exist between lender groups, such as banks and sales finance companies. Part of this difference, of course, reflects the different types

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of credit risks that the various lenders face, but the point is that multiple rate ceilings essentially allow each lender group to stake out part of the market for itself free of any competition from a group with rate ceilings below its own. Thus, the superficial appearances of competition is just that: appearance. The public--and banks, whose rate ceilings are among the lowest--would be much better off if there were either no ceiling or a uniform ceiling for all loans, both of which would permit lenders to attempt to penetrate other markets.

Second, what has been called the "6 per cent myth"--that is, the indoctrination that 6 per cent is a "right" or "fair" rate--has been reinforced by rate ceilings. As a result, legitimate lenders quote rates on a basis that disguises the true, simple interest rate and the consumer finds it impossible to compare costs among alternative borrowing sources. I realize fully that calculating simple interest is not simple, but lenders, including banks, are clearly muddying the water when they quote automobile instalment loan rates at 5 per cent when they know full well that they are charging 10 per cent on the unpaid balance. Perhaps repeal of usury laws would further efforts to devise uniform methods of rate quotation--which would contribute importantly to effective and fair competition.

While consumers are immediately brought to mind when rate ceilings are discussed, the various State laws regarding interest rate ceilings also extend to business borrowing. It has recently been estimated, you may be surprised to hear, that over 40 per cent of all business credit, and almost 60 per cent of farm credit, are subject to some interest rate ceiling. And here, too, usury laws are hostile to their announced purpose, for while many

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States exempt corporate businesses, most States that have usury laws do not exempt unincorporated enterprises and this fact may deny bank credit to the very enterprises that the usury laws seek to protect.

Consider a bank, which, given today's credit conditions and demand, charges 5-1/2 per cent on loans to its highest quality customers, but cannot charge in excess of 6 per cent on a high-cost, high-risk loan to the corner retailer. Doesn't it stand to reason that the bank must recoup a high enough margin over the rate charged its highest quality customers to compensate for the greater risks and costs of the poorer credit. If usury laws prevent this, the poorer risk loans will not be made even though the would-be borrower is prepared to pay a higher rate rather than forego the funds. Of course, banks can find ways to overcome ceilings--such as requiring relatively larger compensating balances and imposing relatively greater service charges on deposit accounts--but the point is clearly that such ceilings interfere with the market process by putting a real constraint on the freedom of banks to make loan and portfolio decisions in both the public and private interest.

Ceilings on asset returns are paralleled by ceiling rates that banks may pay for deposits. As you all know, banks are prohibited from paying interest on demand balances--because of legislation enacted in the 1930's on the basis of claims that such payments had led to destructive competition in the twenties--and the Federal Reserve, the FDIC, and some States set maximum rates that banks may pay on time and savings balances.

The public policy issues raised by ceiling rates on deposit balances involve difficult practical questions affecting savings institutions, savers and investors, and the allocation of credit among the competing demands for it.

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Few economists approve ceilings on rates, especially on time and savings deposits, because they interfere with the market adjustment mechanism. Yet the market mechanism which inevitably involves financial institutions whose assets have a longer maturity than their liabilities, can be quite destabilizing.

If maturities of depositors' claims matched loan repayment schedules, changes in financial market conditions would have roughly comparable effects on rates for both deposits and loans. Under these conditions the close alignment of ceilings with market rates would not be disruptive to the liquidity position of the financial intermediary. But when commitments on the deposit side are short--even on demand--loan runoff from term loans or mortgages cannot cope with withdrawals stimulated by higher returns offered by competitors that are not similarly exposed in their deposit-loan relationships. Thus, an important advantage of relatively stable rate ceilings is that they permit intermediaries to offer savers liquidity and a reasonable return from the higher yields of longer term loans.

But near-instant liquidity of time deposits is a privilege that cannot be widely shared with those whose withdrawals are stimulated by rate incentives when such incentives are pervasive among time depositors. A predictable, even though large, turnover in savings accounts is one thing--a mass withdrawal to take advantage of rising yields is quite another. To meet this problem, many banks are attempting to stratify their time accounts, according the rate conscious-investment type money a more competitive yield but on a fixed maturity and with interest penalties for earlier withdrawal. And other types of savings institutions are beginning to do the same. But the plans of some institutions only amount to changing the name of the game, and

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others are either unwilling or legally constrained from doing anything.

There is also a statutory responsibility involved in the fixing of rate ceilings. The Federal Reserve Board and the FDIC have no choice under the spirit of the present law but to establish rate maxima. But, doing so under the law does not change the fact that such ceilings are a competitive inhibition, even though such inhibitions may be justified by the real possibility of serious damage to other financial intermediaries. True, the ceilings may make life easier for policymakers, banks, and other financial institutions, but they may also protect the best of all possible worlds for the small- and medium-sized saver.

Even with ceilings, market pressures are always at work to narrow or circumvent rate differentials. Shorter maturities on certificates of deposit and more frequent compounding, just to mention two examples, are used in lieu of higher nominal offering rates. Even the prohibition of interest payments on demand deposits is partially breached--quite legally. Competing for balances through additional services, or reduced service charges, or varying compensating balances are a kind of substitute for explicit interest payments.

Not all prohibitions are expressed in terms of rate, for example, while member banks may absorb the cost of numerous services to demand depositors they do not have the option of absorbing exchange charges as the result of non-par remission of checks. This prohibition denies member banks the use of yet another competitive tool. Would the loosening of constraints here, intensify the pressure on nonpar banks to remit the face value of checks? Would competition be able to achieve par clearance, something regulation cannot accomplish, or at least has not accomplished over the years?

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Ceiling rates on loans and deposits are established by law. But floors on rates are set by the policy of bankers. The prime rate, for example, establishes the rate at which loans are made to the "best" customers of banks--that is, the large, well established firms, which have the least risk of default. On the surface, this policy--adopted by most banks as an operating convention--seems a rational way to differentiate loan rates on the basis of risk to the lender. However, the history of this policy suggests that it may be neither in the interests of the public nor banks.

The establishment of a nationwide prime rate came in the 1930's when a very liquid banking system faced a greatly reduced loan demand. The combination of banks seeking loans and of customers who were well aware of the large number of available banking alternatives kept downward pressure on loan rates. In an effort to protect themselves from erosion of yields by these competitive forces, banks began to follow the lead of a few large banks who simply announced a floor rate below which they would not lend. Rates were scaled up from this minimum for less prime customers and stability in yields was thus assured. Borrowers were supposed to be happy because they knew that they were paying the lowest rate available. Lenders were supposed to be content since they knew they competitively could not charge more than the going rate, and if they charged less they would simply cause all other banks to join them and, hence, they would "spoil the market." The similarities between the logic of the prime rate and the pricing procedures suggested under the NRA are clear, but there is no evidence that banks displayed the blue eagle when discussing the prime rate.

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This anachronistic, inflexible policy is still with us today. To be sure, banks tend to vary the definition of a prime customer as supply and demand conditions change, but the basic inflexibility remains--to the detriment of the public and bank stockholders.

A properly functioning market mechanism should not only foster flexible yields but also permit reasonably stable differentials between the cost of funds and the price of uses. The prime rate convention does little for either objective. Consider the period from 1961 to 1965. The prime rate was unchanged at 4-1/2 per cent, despite two upward changes in the discount rate, an almost 200 basis point increase in short-term yields, a 60 basis point increase in long-term yields, and a 225 basis point rise in the price paid for time deposits. The fixed prime rate over these years clearly suggests that bank loan rates were in a changing relationship to market forces.

Since late 1965, two increases in the prime rate have occurred as market yields have risen sharply and bank liquidity has declined. But the inflexibility of the prime rate convention still shines through. And its rigidity is very much reinforced by the companion convention that a borrower must pay all his creditor banks the same interest rate. Banks themselves are among the most insistent advocates of this latter rule; but they have sacrificed some of their own freedom in the process.

Not all banks experience the same loan demands, face the same portfolio problems, or have the same deposit costs. Bank managements ought to have the flexibility to vary their lending prices accordingly, if they are to produce optimal results. The way banks are pricing CDs, for instance, provides an instructive example. Market competition does create a tendency for the CD rates

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within a banking market to move toward uniformity, but within that market uniformity, individual bank CD pricing is freely adjusted to the circumstances at each bank. This kind of price flexibility has a dynamism in it that can serve the best interests of both the individual bank and its customer, and the community at large. The kind of price fixing inherent in the prime rate, on the other hand, contravenes some of the key virtues that we associate with competitive market enterprise.

Furthermore, in the present era of monetary restraint the rigidity of the prime rate structure also hinders the transition of monetary restraint from banks to many of the largest users of bank credit. The best customers, those with the largest balances over the longest period of time, have a powerful claim on banks' loanable resources. Past policies and understandings make it extremely difficult, if not impossible, for those customers to be turned away, or even scaled down. The only really impersonal inhibition to their borrowing is price, and the prime rate convention inhibits the reasonable use of that alternative. One could almost say it is downright discriminatory to fight inflation with monetary restraint so long as the prime rate is holding the credit door invitingly open to the biggest borrowers in the business.

To summarize, floors and ceilings on interest rates set by law and understandings inhibit the competitive stance of banks. So do a whole host of other laws and agreements--chartering, branching, limits on mortgage loans, the voluntary foreign credit restraint program, correspondent bank arrangements, etc. Some of these are necessary ad hoc or long-run compromises with the philosophy of a free market society. But even the cursory review of a few of the concessions that I have discussed today should remind us that too often reconsideration

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suggests that the costs of intervention in the market outweigh the benefits--real or imagined. Somehow, it is always necessary for someone to point out that the Emperor is now wearing no clothes.

Banking has an old and honorable tradition, and in recent years has demonstrated anew its ability to change, innovate, and compete. Competition--like progress--helps some and hurts some, has good and worrisome implications. Banks in the last five or so years have learned the benefits of competition and in their own self-interest, as well as the public interest, should be intensifying their efforts to widen the scope within which they can compete. Not all the unfettering called for, however, depends on getting Congress or some regulatory authority to give up the key to a shackle. Some of the keys are deep in bankings' own vest or trouser pockets; these keys should be used too.

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