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Regulation Q--Ten Years Later

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In reviewing materials for my presentation before you today, it occurred to me that this past September marked the tenth anniversary of the extension of our present system of regulatory interest rate ceilings to the deposits of all major types of savings institutions. Since financial markets are quiet at the moment, and savings inflows generally have been quite ample for an extended period, this seems a good time to step back and take stock of how the savings institutions have fared over these years. More generally, we need to take the opportunity for reviewing how the evolution of Regulation Q in the last decade has affected the competitive position of the thrift industry.

In the fall of 1966, when Regulation Q-type ceilings were extended by law to savings and loan associations and mutual savings banks, our country had experienced close to a full year of sharply rising market interest rates, following several years of relatively low and stable rates. Commercial banks were even then competing directly with alternative money market outlets for large deposit balances, so that it had been necessary at the end of 1965 to raise rate ceilings on the time deposit structure of these institutions. Savings deposit rate ceilings had not been changed, but the competition for smaller savings balances--both from the banks and the market--nevertheless intensified greatly. As a result, many of the savings institutions had suffered losses of deposit funds during the spring and summer of 1966--an experience for them that was unprecedented over the post-war period.

The earning assets of thrift institutions at that time were locked mainly into mortgage portfolios with low fixed yields, slow turnover and thin secondary markets. Without substantial amounts of marketable short-term assets or a large borrowing capability, many mutual savings banks and savings and loan associations were ill-equipped to handle either heavy drains on their resources or to make new mortgages unless they could continue to attract net inflows over time in savings funds. Indeed, many observers feared that these institutions could not compete effectively in an environment of escalating interest rates, and that some might not even be able to survive. Thus, in an effort to maintain orderly financial markets in general, and to encourage a continued flow of funds into mortgage markets in particular, the Congress authorized a more flexible rate setting authority for the bank regulators and extended the system of deposit rate ceilings to the thrift institutions as well. From the outset, the ceiling rate relationships established by the regulatory agencies were designed to give thrifts an advantage over the more versatile commercial banks.

Interest rate ceilings on deposits have long been regarded by most economists as anticompetitive measures which amount to price-fixing for depositary institutions. But when the new system of rate ceilings was authorized, the Congress believed that such protection was essential to the short-run viability of the thrift industry--necessary at the time, though intended only as a temporary measure. The Regulation Q-type structure was supposed to tide the thrift institutions over until they could adapt in more fundamental ways to the new regime of higher and potentially more volatile interest rates. In this spirit, both the initial legislation and the subsequent renewals have been of short duration, never more than two years. Hence, every Congress since 1966 has reconsidered the question of continuing deposit rate regulation in its present form, and the current authority, renewed a year ago for 14 months, expires on March 1.

Under the protection of deposit rate ceilings, our thrift institutions have weathered four episodes of exceptionally tight credit, beginning with the conditions that led to the introduction of the ceiling differentials back in 1966. Each credit cycle has produced higher peak market interest rates than the one before. In 1966, for example, we thought that a 5-3/8 per cent 3-month bill rate was high. A little more than 3 years later, this same interest rate stood at 7-7/8 per cent, and in the summers of 1973 and 1974 it moved to 8-5/8 and 9 per cent respectively. Over the past two years, however, short-term interest rates have declined substantially, and the current bill rate--at around 4-1/2 per cent--is below all segments of the institutional rate ceiling structure.

The decade from 1966 to 1976 was also characterized by higher and more variable rates of inflation than the earlier postwar period. During the early 1960's, the consumer price index had advanced by less than 1-1/2 per cent per year. With the higher public spending of the Vietnam War period, the rate of inflation accelerated to an average annual rate of about 4 per cent. And, of course, we all remember vividly the price explosion that erupted in 1973 and 1974, partly as a result of food shortages and the oil cartel, the depreciation of the dollar in foreign exchange markets and the ending of domestic price controls. Over those two years, consumer prices rose by more than twenty per cent--the first experience for our nation, at least in modern times, with double digit inflation. The inflationary expectations that accompanied our deteriorating price performance were undoubtedly a major influence in bringing the successive waves of higher and higher interest rates we experienced in the decade through 1974. Since then, both inflation and interest rates have moderated considerably. I am hopeful that this marks a basic change in trend, though it is too early yet to say so with confidence.

With these observations on market interest rates and inflation in mind, let us turn to a parallel examination of Regulation Q developments over the same ten-year period. Since the inception of the new rate ceiling structure in 1966, thrift institutions and commercial banks have been permitted to offer progressively higher rates of interest, usually in a lagged and muted response to market developments. This is reflected to some extent in the maximum rates permitted on traditional account forms, but more importantly by the introduction and development of new account categories. The ceiling on passbook deposits at savings banks, for example, is only a little higher now than it was in late 1966, while ceilings on shorter-term certificate accounts have been raised only by a percentage point or less. But the introduction of new account categories to include longer-term consumer CD's has been the major means of increasing the rates payable on deposits. As a result of these new accounts, the highest interest rate available on time deposits at savings banks has risen from 5 per cent on 6-month money back in 1966 to 7-3/4 per cent on 6-year certificates beginning in late 1974--a change that more closely parallels the movements in open market rates over the 10-year period.

The evolution of the longer-term certificates deserves considerable emphasis, because this not only has provided the key to maintaining the competitive viability of the regulated institutions, but has made possible also an important improvement in the deposit structure of the thrift industry. Ten years ago, the maximum interest rate that any depositary institution could offer varied between 4 and 5-1/2 per cent, depending on the type of institution and account. But at that time, virtually all deposits were subject to withdrawal within 6 months, and the vast majority was held in passbook accounts offering immediate access to the funds.

In 1970, the first effort to encourage lengthening the maturity of deposits got underway as higher rate ceilings were introduced for 1- and 2-year certificates. In a second major revision to Regulation Q, 2-1/2 and 4-year accounts with still higher ceilings were established in 1973, a change which allowed thrifts to attract funds into the new maturity categories at a time when open market rates were at all-time highs and passbook balances were declining. In 1973, also, we all remember the brief experiment with long-term, no ceiling certificates, which was cut short by excessive competition for funds among the various institutions in the circumstances of the time. And finally, there was the introduction of 6-year certificates and Individual Retirement Accounts in 1974. These developments have had a major impact on the maturity distribution of thrift institution liabilities. Savings banks now have more than 20 per cent of their deposits in accounts with original maturities of 4 years or longer; at S&L's, the proportion is slightly above 30 per cent. The resulting better match between assets and liabilities of thrift institutions, I believe, has materially improved their structural integrity.

Recognizing the increased ability of thrifts to compete with commercial banks, as well as the need of all institutions to compete with the rates available on market instruments, there has been a narrowing over time in the differential between the rate ceilings on deposits among the various types of institutions. In 1966, ceiling rates on passbooks were set initially 1 percentage point higher at mutual savings banks and 3/4 point higher at savings and loan associations, relative to commercial bank rates, reflecting the distressed situation in which many of the thrifts found themselves. By 1970, the mortgage portfolio yields of thrift institutions had begun to respond to the higher interest rates on new mortgages booked, and the newly established certificates were expected to help materially in drawing interest-sensitive money. Accordingly, the differential on certificates was set at 1/4 per cent and the passbook ceiling was narrowed to 1/2 per cent. The differentials were narrowed further in 1973--to 1/4 per cent on all deposit categories except for 1-year certificates--but it does not appear that thrift institutions have been at a disadvantage in attracting funds, perhaps in part because of the new powers gained in recent years. As evidence of the rough parity in the competitive situation, the growth rates in consumer-type time and savings deposits at the two types of institutions have been quite similar over the past three years, averaging 13.8 per cent, at an annual rate, for the commercial banks and 13.4 per cent for the thrift institutions.

In recent years, moreover, various legislative changes and industry innovations have added to the capability of thrifts to compete for deposits. On the asset side of the balance sheet, greater diversification in investment opportunities has reduced the dependence of thrifts--and savings banks in particular--on long-term mortgages, the yields on which adjust only sluggishly to changing market conditions. I might note also that these mortgage portfolios, once a serious earnings problem for thrifts, have become progressively less disadvantageous as more and more of the outstanding mortgages have come to reflect the higher interest rates prevailing over the past 7 or 8 years. Borrowers may be expected to refinance if rates should drop significantly, of course, so that there is some exposure to the risk that average portfolio yields could adjust downward again. But the widespread use of prepayment penalties protects mortgage lenders against moderate rate declines.

And mortgage assumptions are not the hazard they once were, partly because of the declining use of assumption clauses and partly because the rapid inflation in existing home prices has made the outstanding low-rate loans too small a proportion of purchase price to be of use to most buyers.

On the liability side, a thrift institution's balance sheet can seem rather cluttered, reflecting the greater flexibility of new sources of funds and the offering of new financial services over recent years. In addition to regular passbook savings, there are at least five separate categories of time certificates available, ranging in maturity from 3 months to 6 years. Savings banks were instrumental in the introduction of NOW accounts in Massachusetts and New Hampshire in 1972, and in the subsequent broadening of this market to the entire New England area. Also, demand deposit powers for thrifts are spreading. They were introduced in Maine and Connecticut in 1975, at least for consumer-type accounts, and similar legislation was enacted for state-chartered savings banks and S&L's in New York State this past May. It is regrettable that these new money transfer powers do not call for the provision of the cash reserve requirements that would help in achieving effective monetary control, but that is a topic for another speech on another day.

In sum, the trend among institutions at which consumers keep their funds is evidently toward more and more similarity on the deposit side. And with the better matching of asset and liability maturities, as well as the greater flexibility for maneuver on both sides of the balance sheet, I believe that the position of the thrift institutions is significantly more resistant to interest rate cycles than was the case a decade ago. Today the thrifts are again strong entities, quite able to compete effectively with other depositary institutions in a variety of consumer savings markets.

There remains, however, one lurking threat to the viability of thrift depositaries, including consumer-oriented commercial banks. This is the threat that, in some future period of high and rising interest rates, there may again be a substantial or protracted shift in savings flows away from the institutions. Savers have become more sophisticated over the years and, therefore, accumulated savings balances are increasingly interest-sensitive. In spite of the innovations of the thrifts in longer-term certificates, the non-institutional market has also been adept at devising instruments to tempt savers into becoming "investors." These alternatives to deposits are unconstrained by arbitrary interest rate ceilings, and if there should be another period like 1973-74, when market interest rates soared to unprecedented highs, I believe that we might well face a flood of market-type instruments designed to attract the relatively small saver.

Part of the problem is that the size of the funds over which a "small" saver has discretion has been growing, while the denominations of the market alternatives to deposits have not. The minimum denomination Treasury bill was increased from $1,000 to $10,000 in 1970, and partly countered the movement of small savers into these instruments. But

Treasury bonds and notes, Federal agency securities, corporate and municipal obligations are widely available in units of $1,000 or less, and will offer very attractive yields during periods of credit stringency. With account sizes at savings banks exceeding $4,000 on average, the markets for these securities will offer a tempting alternative to savers who undertake the rather small effort to search out the attractive issues. And once they have done so,the second time will be much easier.

Recently, also, financial innovations have provided attractive new outlets for the funds of interest-sensitive small investors. The issuance of variable-rate notes in 1974 by Citicorp and other bank holding companies generated great interest at the time. Though many of these notes have been redeemed in recent months, they are certain to reappear again should market conditions dictate. Another development of significance was the rapid evolution of money market mutual funds early in 1974. This handful of funds grew by $3.5 billion in little more than one year's time, and they have held their own in the subsequent period of relatively low interest rates. We can be sure that these innovations--and others as well--will do a thriving business in drawing funds away from depositary accounts whenever thrifts and commercial banks are unable to pay interest rates that are reasonably commensurate with open market alternatives.

From the record of the decade, it seems to me abundantly clear that Regulation Q is becoming an increasingly ineffective device in protecting depositary institutions when market rates rise appreciably above whatever ceilings prevail. This ineffectiveness is particularly acute at the short end of the maturity spectrum, where the largest gaps between open market rates and deposit rate ceilings typically occur. Thus, it is in providing alternatives to passbook and other short-term deposits that the process of financial innovation has been most effective. Regulation Q may successfully restrict the competition between one type of depositary institution and another, but it cannot keep the institutions as a group from losing increasingly large parts of their savings business to the market when times are ripe. This is most likely to occur precisely when credit conditions generally are the tightest, so that the corollary objective of maintaining adequate flows of mortgage funds at such times must necessarily be frustrated.

In order to counter effectively the threat of disintermediation, I believe that we need to make further progress in loosening the grip of Regulation Q. Such progress would be consistent with the Hunt Commission recommendations and subsequent legislative proposals for financial reform, all of which seek to free up the institutions so that they can compete in any market environment. The phasing out of Regulation Q must take place cautiously and prudently, of course, and I would think it desirable to retain standby authority for use in the event that destructive inter-institutional competition should again develop. But we should be working steadily toward the conditions that will make possible such a phase-out. For example, the industry should be working now on proposals for new deposit instruments, designed especially to hold short-term deposits in the face of fluctuating short-term market rates. Or perhaps we should consider raising rate ceilings in small systematic steps at regular intervals, so that all institutions will have an opportunity to adust gradually. Whatever the specific proposals, it would be better to make progress gradually, I believe, than to wait and be forced to make hasty adjustments in a period of crisis. Although such liberalizations as I have mentioned may seem unnecessarily costly, especially at a time when savings inflows are ample in any event, they would help to prepare the thrift industry to better defend its position when it again finds itself in direct competition with market forces.

In keeping with what I regard to be a necessary and desirable movement in the direction of greater competitive freedom, I want to state also that I find the maintenance of a required rate differential subject to serious criticism from the standpoint of equity and increasingly dubious as a matter of competitive equality. Certainly, the differential is questionable in case of IRA and Keogh Accounts, which represent the investment of long-term retirement funds and have little or nothing to do with the convenience concept of one-stop banking. But even for regular deposit business, it seems to me that the supposed disadvantages of thrifts are rapidly being narrowed to the vanishing point. Demand deposit powers, NOW accounts, facilities for automatic or directed transfers of funds, and the wide array of savings and time certificate options are serving to make more and more thrifts like commercial banks on the liability side. And for consumer customers, the same trends toward similarity in service are evident on the asset side of the ledger.

The other basic rationale for the rate differential, as I understand it, is that this will help to maintain flows of funds to the mortgage market and hence support a healthy volume of homebuilding. But this is not the case, as I have noted, when all of the institutions combined are losing competitive position vis a vis the open market. And it may not be true even in normal times if the institutions are diversifying into other types of investments. Over the last decade, for example, the proportion of total financial assets invested directly by the mutual savings banks in 1-4 family mortgages has dropped from 58 per cent to 39 per cent. Even if indirect mortgage investments, in the form of mortgage-backed bonds, are included,the decline in portfolio concentration has amounted to 14 percentage points over this period. The importance of home mortgage loans in the portfolios of savings and loan associations has remained much greater--precisely, I would imagine, because they do not have the same latitude to diversify into other investment outlets.

These comparisons point up an essential difficulty with the differential as a support for the mortgage market--that is, its potential inefficiency in achieving this purpose. The inefficiency results because the differential is expected to work indirectly through a distinction between types of institutions that may not be closely related to the use of funds generated by the rate advantage. There has never been a guarantee that the additional funds would be used to make mortgages--only an expectation based on past portfolio composition. If we want to encourage more investment in housing as a matter of national social priority, it would be more efficient and more certain to do so by rewarding the activity directly through the market mechanism of a higher interest return.

In further search of means to counter the threat of disintermediation, we need to reconsider and remove inflexibilities on the asset side of institutional balance sheets as well. Broader investment powers represent one way to achieve this, and such asset diversification is already underway, as I have noted. Returns on mortgage portfolios should be made to reflect more nearly broad movements in open market rates, whether up or down. In this connection, I believe that variable rate mortgages--which have had some success recently in California and other states--should be made available as an option on the national level also. I recognize that there are many complexities in marketing variable rate mortgages, but the fact that they have been well received in some areas should encourage us to try them in others.

Usury ceilings provide another example of non-market rigidity on the asset side. Indeed, the 8-1/2 per cent New York State ceiling has been a major impediment to profitable investment by mutual savings banks in local mortgage markets there. A substantial part of their mortgage activity has had to focus instead on mortgage-backed securities and the acquisition of loans from out of State. Restrictive usury ceilings on loans are sometimes cited as an argument for maintaining ceiling controls on deposit rates. But such an argument cannot be persuasive except on a very superficial level, since the result is simply to match an unavailability of mortgage finance at a non-competitive rates with an unavailability of funds, as savings are diverted to the open market.

I recognize that removal of such impediments is not an easy task, but we must continue to work at it. And even if returns on assets do not become as flexible as we might like them to be, there is hope now for financial conditions favorable to a movement away from dependence on the constraints of Regulation Q. Interest rates have declined considerably over the past two years, as inflation rates and the expectations of continuing rapid inflation have eased. This tendency may be extended, if we can make further meaningful progress in curbing inflation and if credit demands on our markets are not excessive. But even if this is not achieved, it seems to me very unlikely that we will witness the kind of increase in mortgage interest rates in the decade to come that we had in the decade past, when they nearly doubled. Therefore, I think it reasonable to believe that much of the extraordinarily slow and difficult adjustment in mortgage portfolios of the thrifts to the higher prevailing market rate structure is behind us. If so, the issue of Regulation Q constraint may simply disappear over time because of market circumstances.

I noted earlier that the Regulation Q-type structure of interest rate ceilings was from the outset intended as an interim measure; and, in just a few weeks, the rate ceilings will be reconsidered once again by the Congress. In the evaluation of the place that Regulation Q-type authority should occupy in our financial regulatory system, I believe that three basic considerations should be kept firmly in mind. First, Regulation Q is essentially anticompetitive and protective, since it places ceilings on the price that may be offered and earned for the accumulated funds of relatively small savers. Second, the Regulation Q-type structure of rate ceilings cannot prevent a draining away of savings into more rewarding uses when open market interest rates are high. And finally, the evolution of thrift institutions over the past ten years has done a great deal to prepare them for the restoration of fully competitive conditions. I hope and trust that such conditions can be acheived in the not too distant future.