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Statement by

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before the

Subcommittee on Financial Institutions

of the

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I am pleased to testify this morning on behalf of the Federal Reserve Board concerning measures that would increase the rates of return available on small-denomination deposit accounts. The Board has long advocated the gradual removal of deposit rate ceilings, recognizing that they are an impediment to free competition and that they have had a particularly inequitable impact on small savers. The two resolutions before this Subcommittee would help alleviate these problems, but the Board cannot at this time support a proposal that would lower the minimum denomination on money market certificates to $1,000, for reasons that I will explain shortly.

The Federal financial regulatory agencies have recently been exploring ways that would reduce the burden of deposit rate controls on small savers, and, at the same time, comply with the intent of Congress in establishing and renewing these controls. We believe that the regulatory actions proposed last week would significantly improve the depositary options available to small savers without threatening the viability of the thrift industry.

Before discussing these proposals and the two resolutions in detail, I believe it appropriate to review briefly the institutional, economic, and legislative constraints that impinge on regulatory decisions concerning deposit rate ceilings. Although market developments are rapidly undermining the efficacy of these ceilings, many of the factors that initially led Congress to establish this regulatory framework are still at work. A review of these constraints is there-

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fore necessary to an understanding of the regulatory decisions that are currently at issue.

The fundamental constraint is that thrift institutions still cannot pay market-oriented rates of return on all their deposit liabilities during periods of high interest rates. Their inability to do so results from restrictions which limit their investments principally to long-term, fixed-rate mortgages. Because of slow turnover in these mortgage portfolios, the average yield on thrift assets responds sluggishly to changes in market conditions. For example, average returns on mortgage portfolios have risen only 2-1/2 percentage points since 1966, when deposit rate controls first were introduced, while inflation-induced increases in short- and intermediate-term market interest rates have averaged 3-1/2 to 4 percentage points over the same period. As a result, the earnings of thrift institutions are still squeezed whenever they try to compete for funds by paying market rates during periods of credit stringency. Before thrifts can be expected to pay market rates on all their deposits, reform of their asset powers will be necessary. Otherwise, the financial solvency and stability of many individual institutions may be jeopardized.

It should be emphasized that commercial bank earnings have never been a limiting factor in the regulatory decisions on deposit rate ceilings. Banks hold a more diversified portfolio of assets whose maturities are, on average, considerably shorter than those of the thrifts. The rates of return on commercial bank portfolios have thus been more responsive to market yields and have given them greater flexibility to pay competitive rates on deposits.

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In enacting and subsequently extending the authority for coordinated deposit rate controls, Congress has repeatedly made it clear that protection of the thrift institutions and concern for the mortgage market should be dominant considerations in establishing the structure of deposit rate ceilings on the small-denomination time and savings deposits for which banks and thrifts are in direct competition. At the time deposit rate controls first were enacted in 1966, this legislation was viewed as a temporary but necessary measure to protect the short-run viability of the thrift industry. In this spirit, both the initial legislation and the subsequent renewals have been for short periods, never more than two years. Thus, every Congress since 1966 has had to reconsider the need and justification for deposit rate controls, as will this Congress when the current authority expires at the end of 1980. In all, 13 votes have been taken to renew deposit rate control authority.

In two instances, moreover, Congressional actions were taken to increase the protection of the thrift industry beyond the scope originally envisioned in the 1966 legislation. The first such action followed the suspension in July 1973 of deposit rate ceilings on 4-year accounts with denominations of $1,000 or more. Barely four months later a Congressional resolution mandating ceilings on all deposits under $100,000 brought an end to this experiment, and with it the only period since 1966 when the institutions were free to offer a market-oriented rate of return to small savers.

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Two years later the Congress again strengthened the protection of thrifts from the possibility of regulatory actions that might unduly threaten their competitive positions, when it passed a law (P.L. 94-200) requiring approval by both Houses of Congress prior to any reduction in ceiling rate differentials on accounts then in existence. In short, whenever the Congress has acted in the past on deposit rate controls, the objectives of protecting the thrift industry and sustaining mortgage credit flows appear to have overshadowed the desire to provide small savers with a market-oriented rate of return.

Meanwhile, small savers have become increasingly aware of alternative investments that pay returns well in excess of deposit rate ceilings when market yields are high. The public has learned the relative ease with which market securities--particularly Treasury issues--can be purchased. Moreover, innovative instruments, such as money market mutual funds and unit investment trusts, have emerged to attract the deposits of small savers. Shares in these funds are ordinarily quite liquid, bear market rates of return, and often are available in minimum denominations of $1,000 or less. In the last six months, these mutual funds have attracted over $10 billion, and it is a reasonable presumption that a sizable share of this flow might have gone to or remained in depositary institutions if the rates they could pay were more competitive.

These developments make it clear that some action needs to be taken to provide relief to the small saver and thereby to reduce the exposure of the institutions to disintermediation by this group of

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depositors. Yet it is also clear that such action cannot unduly threaten the earnings of thrift institutions during a period of high market rates. One of the resolutions being considered today (S. Con. Res. 5) calls upon the agencies to provide promptly "an appropriate method under which the interest rate on small savings deposits.. is increased equitably." We believe that the actions proposed last week meet this requirement within the constraints I have noted. Recognizing the complexity and novelty of some of the proposals, the agencies have solicited comments for a 30-day period; the comments we receive should help us judge whether an appropriate balance has been struck between the needs of small savers and the necessity of maintaining a viable thrift industry and mortgage market. The Board fully expects that action on these proposals can be taken shortly after the period for public comments ends in early May.

In advancing this set of proposals, the agencies are seeking to provide savers with instruments that bear higher returns with reasonable liquidity, while limiting the increases in thrift institution costs to manageable proportions. The floating-ceiling certificate would provide a market-oriented rate of return to savers who are willing to commit as little as $500 for the 5-year period specified; depositors withdrawing funds after a year or so would be subject to a premature withdrawal penalty that is considerably less severe than the existing requirement. For savers with an uncertain investment horizon, the rising-rate certificate would offer more flexibility in gaining access to their funds, albeit

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at some sacrifice in yield. After the first year, there would be no penalty for premature withdrawal from rising-rate certificates; the penalty would be replaced by an incentive to earn a higher yield by keeping funds on deposit. Finally, for savers whose main desire is a better return on liquid deposits, the bonus savings account plan would offer a moderately higher yield on whatever portion of their accounts happens to remain on deposit for a period of one year or more.

This set of proposals represents the end product of intensive study and discussion by the financial agencies of a wide variety of alternatives. Among the options that received careful consideration was the possibility of reducing the $10,000 minimum denomination on existing money market certificates. We also considered introducing a new money market certificate with a lower minimum and a lower ceiling. Although these alternatives were appealing for their simplicity and equity, they had to be rejected because of the potentially severe cost impact on thrift institutions. These cost increases would result mainly from the shifting of funds into money market certificates that the institutions otherwise would retain in lower-cost passbook and short-term time accounts.

Similar reasoning leads the Board to believe that it would be unwise for the Congress to approve a resolution like S. Res. 59, which requires regulatory minimum denominations of no more than $1,000 on any deposit whose ceiling rate of interest is tied to yields on U.S. Government securities. This resolution would not only mandate a reduciton in existing minimum denomination requirements on money market certificates, but it would also limit the range of options that might need to be considered in future deliberations on interest rate ceilings.

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When the money market certificate was introduced last June 1, a minimum denomination of $10,000 was established on the grounds that depositors with relatively large amounts at stake would be most likely to shift into open-market instruments during a high rate period. The choice of $10,000 seemed particularly appropriate since that is the minimum denomination of six-month Treasury bills, to which the rate ceiling on money market certificates is tied. Even with this restriction, the new certificate has attracted a huge volume of funds and provided many savers with their first deposit instrument bearing a market rate of return. But it has also been a very costly source of funds for the institutions. The Board's staff estimates that about half of the $116 billion of money market certificates outstanding at the end of February represented funds that otherwise would have remained in lower-cost passbook or fixed-ceiling time accounts. Indeed, the mounting earnings pressures on savings and loan associations and mutual savings banks resulting from the transfer of such funds was a major reason for the recent regulatory action reducing somewhat the maximum yields available on money market certificates.

Lowering the minimum denomination on money market certificates would, of course, expose the thrifts to greater adverse earnings effects and could create serious problems of solvency and liquidity for some institutions. If such action were taken, those institutions choosing to offer money market certificates in smaller units would

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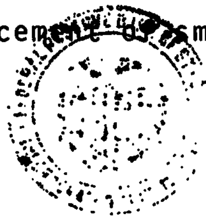
probably experience large transfers from existing accounts. This would directly increase their costs of funds, and--since no additional funds for high-yielding investments are provided by such transfers--earnings would be squeezed more than at present. On the other hand, those institutions electing not to offer smaller money market certificates would face the prospect of large outflows of small-denomination accounts to other institutions, which could create serious liquidity problems. Given the large number of passbook accounts with deposits of $1,000 or more, as well as the large volume of small-denomination certificates scheduled to mature in the next few quarters, the risks of institutional dislocation associated with a low minimum denomination on money market certificates seem too large to bear.

The Board, however, recognizes the pressing need for a deposit instrument offering a market-determined yield that would be available to small savers. We believe the proposed 5-year, floating-ceiling certificate meets this need without endangering the short-run viability of the thrift institutions. The relatively long maturity, coupled with the still significant penalty for premature withdrawal, should limit the potential for massive transfers from lower-cost passbook and short-term time accounts. At the same time, ceiling rates of interest somewhat below yields on Treasury issues of like maturity are warranted by the simplicity and convenience of dealing with local institutions rather than going into the market for the placement of small saving balances.



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Of course, all of the proposals that have been advanced during the deliberations of the agencies represent only patchwork solutions to the basic problem, which results from the fact that thrift institutions, by law and by regulation, invest mainly in long-term fixed-rate assets. Regardless of what actions the regulatory agencies may take in the period just ahead, these portfolio characteristics still constrain the ability of thrift institutions to pay substantially higher rates on deposits without seriously jeopardizing the viability of some institutions. When inflationary pressures subside and market rates decline, thrifts will be in a much better position to compete. Over the longer run, however, any depositary institution specializing in fixed-rate mortgages will be vulnerable to the pressures of disintermediation and the attendant risks of illiquidity, insolvency, and possible forced merger.

In the Board's view these problems can be solved only if Congress acts to liberalize the asset powers of thrift institutions. Such action would make possible a more flexible return on investments. Increasingly in recent years, banks and other financial intermediaries have insisted that their long-term loan contracts include provisions for rate adjustments keyed to some index of market rates. This stance reflects their desire to avoid the risks associated with extending fixed-rate, long-term credit when their cost of funds fluctuates. Most savings and loan associations and mutual savings banks are prohibited currently from offering variable-rate mortgages. The Board believes that Congressional authorization of nationwide VRMs,

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with provisions to assure that the mortgage rate varies with market rates in such a way as to protect consumer interests, would allow thrift and other institutions to build up mortgage portfolios providing earnings more flexibly attuned to market developments. Over time, this would eliminate the major constraint facing the financial regulatory agencies in providing more equitable returns to all savers.

In addition, the Board recommends that the Congress consider exempting Federally insured depositary institutions from anachronistic State usury ceilings on residential mortgage rates in view of the compelling circumstances which currently prevail. In 13 States, usury ceilings are currently below free-market mortgage yields. In place of these restrictions, the Congress might wish to consider a usury ceiling for Federally insured institutions tied to an interest rate that is sensitive to market conditions. Without some relief from existing usury restrictions, it seems unreasonable to expect our institutional lenders to pay market rates of return on deposits when they are prevented at the same time from earning market yields on their assets.

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