For release on delivery
Expected 9:30 A.M. E.D.T.

Statement by

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before the

Subcommittee on Financial Institutions

of the

Committee on Banking, Housing and Urban Affairs

United States Senate

June 27, 1979

I am pleased to appear today on behalf of the Federal Reserve Board to discuss S.1347, the Depository Institutions Deregulation Act of 1979. The Board supports strongly the principles underlying each of the major provisions of the bill. Indeed, we believe that S.1347 provides a workable framework for accomplishing desired, gradual changes in the structure of our financial system, although we would propose several minor amendments to help ensure achievement of the bill's objectives. Before turning to our specific concerns, however, I would like to review briefly the reasons for the Board's support of the broad thrust of S.1347; these arguments have been developed in greater detail in my testimony of May 15, 1979 before the Subcommittee on Financial Institutions of the House Banking Committee.

Our endorsement of the principle of interest payments on transactions balances at all depository institutions is based on considerations of equity and economic efficiency. Many well informed larger depositors already earn something approaching market rates of return on their transactions balances, either through implicit returns in the form of banking services provided below cost or by placing some of their funds in interest-bearing short-term investments that can be mobilized quickly for transactions purposes. As a matter of equity, it is only proper that smaller, less sophisticated depositors have similar opportunities. Moreover, authorization of the payment of interest on transactions accounts would enable financial institutions to compete directly for funds and to charge for services on the basis of costs incurred. This environment should promote a more efficient use of resources by both consumers and producers of financial services.

Although the Board thus favors the principle of permitting interest on all transactions accounts, we believe that progress toward such an environment should be gradual. Orderly change might best be achieved by extending an activity with which experience has already been gained; thus, nationwide NOW accounts would be a logical extension of existing programs in New England and New York. Moreover, our concern with transitional problems in the move to interest on transactions accounts suggests that NOW's be subject to a deposit rate ceiling in the short run. Staff analysis at the Board suggests that, without deposit rate ceilings set by coordinated action of the regulatory agencies, the actual cost of NOW account funds to financial institutions might rise temporarily by several percentage points above the long run sustainable rate in those states gaining NOW powers for the first time. While resulting earnings reductions would not pose major problems for most commercial banks, they would be serious for some individual institutions. The impact could be especially marked for thrift institutions, which could be expected to compete vigorously with banks for the new interest-bearing transactions account business. The Board therefore supports the interest rate ceiling on NOW's contained in S.1347--a ceiling that would be phased out gradually in concert with all deposit rate ceilings.

The Board has long advocated the gradual removal of deposit interest rate ceilings. Most economists believe that these ceilings are anticompetitive--and that they have a particularly inequitable impact on the small saver. Moreover, by reducing depository institutions' ability to compete for funds, ceilings subject such institutions to significant periods of disintermediation whenever market interest rates are cyclically high. However, while the elimination of deposit rate ceilings is by itself highly desirable, this process must be a gradual one. Many of the factors that caused Congress to establish the framework for coordinated rate ceilings in 1966 are still at work. Thrift institutions, because of constraints on the kinds of assets they hold, still are unable to pay market-oriented rates of return on all deposit liabilities when those rates are high. Before the thrifts can compete in such an environment--without jeopardizing the financial solvency and stability of individual institutions--reform of thrift asset powers is necessary.

In light of these considerations, the Board agrees that the plan for phasing out deposit rate ceilings should proceed in tandem with expansion of the asset powers of thrift institutions. We support those provisions of S.1347 that would accomplish this, including the temporary federal preemption of existing state usury ceilings on mortgage rates, which would oblige the states to reconsider such ceilings in light of existing economic realities. We also endorse the recent regulatory move authorizing federally chartered savings and loans to issue variable rate mortgages, and thereby achieve a more flexible return on part of their loan portfolios. And, allowing thrifts to hold up to 10 percent of assets in consumer loans and various money market instruments, as provided in S.1347, would help thrifts to shorten the effective maturity structure of their assets, so that portfolio returns could rise and fall more nearly in unison with market rates. At the same time, this limited expansion in portfolio possibilities would not likely have a significantly adverse impact on mortgage flows, given the expanding range of sources of mortgage credit and the increasing experience of thrifts in the packaging of mortgages for sale through such devices as pass-through securities.

Let me turn now to the Board's strong endorsement of the provisions of S.1347 requiring NOW accounts at all financial institutions to be subject to Federal Reserve reserve requirements. The setting of reserve ratios on transactions balances is an important tool of monetary policy and, as such, needs to be controlled by the nation's central bank. Further, it is essential that required reserves on all transactions balances be held in the form of vault cash or in balances held at (or passed through to) Federal Reserve Banks; otherwise, the System's ability to control reserve availability is compromised. Finally, in order to exercise control over transactions balances, the central bank must have reasonable control over the total amount of reserves supporting these balances. In our view, universal reserve requirements on NOW's are a step in the right direction toward universal reserve requirements on all transactions balances. However, passage of S.1347 would leave unresolved serious problems--both in terms of monetary control and institutional equity--which I will note later in my testimony.

I turn now to some particular difficulties we have with S.1347. I will note only our major concerns and have asked Board staff to communicate other minor, technical suggestions to the Committee's staff.

First, while the Board strongly supports the phasing out of deposit rate ceilings, we believe that the regulatory agencies should be able to respond flexibly to circumstances created by the transition to a ceiling-free environment. For example, it is conceivable that, even with broadened asset powers, portfolio returns at thrifts might not rise as rapidly as deposit costs--leading to serious earnings squeezes at a sizeable number of individual institutions. Prudence could suggest delaying an increase in ceiling rates at one or more points in the transition period to give portfolio returns a chance to catch up to deposit costs. Under our interpretation of the bill, however, any delay in implementing the scheduled phase-out would have to be fully "made-up" within 12 months. Thus, following such a delay, the bill would seem to require ceiling rates to jump 50 basis points, possibly at a time when the viability of thrift institutions might be particularly strained. For this reason, the Board prefers that the "catch-up" provision of the bill be deleted so as to allow more flexibility in dealing with the problems of transition. As an alternative, we recommend that the Board, after consultation with other regulatory agencies, be permitted to waive scheduled half-yearly rate increases up to three times during the 8 year phase-out without need to reinstate the scheduled increases. This added flexibility to the phase-out schedule would, we believe, reduce the chances that earnings problems during the transition period might become crippling to financial institutions. And, even if the scheduled 25 basis point increases need to be foregone for the maximum number of times, ceiling rates at the conclusion of the phase-out still would be 325 basis points above current rates.

A second concern we have is that the scheduled increases in ceiling rates appear to apply to money market certificates and to the new savings certificate with a variable rate ceiling tied to the yield on four-year government securities. These instruments are broadly designed to key permissible deposit rates of return to the market and the Board sees no reason for including them under the proposed legislation. Indeed, under the scheduled phase-out, ceilings on MMC's would quickly rise <u>above</u> the rates on corresponding Treasury instruments--which is tantamount to removing ceilings on these deposits and ignoring the problems of the transition period which otherwise have been so carefully addressed in the bill. The Board recommends instead that the existing variable-rate instruments be exempted from the scheduled phase-out; of course, ceilings on such instruments should be eliminated, along with those on other deposit categories, by 1990.

Finally, the Board believes that the range for the reserve ratio on NOW accounts as proposed in the bill--3 to 22 percent--is much wider than is necessary. It seems highly unlikely that anything like a 22 percent reserve ratio would be needed for the effective conduct of monetary policy, and we would suggest instead a range of 4 to 12 percent (which is the same range as is proposed in H.R.7).

In closing, I would like to return to the issue of reserve requirements and the exposure to rapid attrition in the number of Federal Reserve member banks--a subject on which the Board has testified with some frequency in recent months. The introduction of NOW accounts, the phase out of deposit rate ceilings, and the expansion of asset powers for thrifts all will serve to increase competition in the financial sector. The resulting downward pressure on institutional earnings, at least during an interim period, seems likely to make member banks even more acutely aware of the costs of membership and could sharply accelerate the rate of membership attrition. This outcome is suggested by our experience of recent years in

New England--where the introduction of NOW's placed particular pressure on bank earnings, and membership withdrawals in that region increased dramatically. Thus, the Board strongly urges prompt action by the Committee on S.85 and related bills in the recognition that Congressional passage of S.1347 would exacerbate the Fed membership problem and thereby hamper the Federal Reserve's conduct of monetary policy.