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**Statement of J. L. Robertson, Vice Chairman,
Board of Governors of the Federal Reserve System,
before the
Committee on Banking and Currency
of the
House of Representatives
on
H. R. 14026
and related bills**

May 24, 1966

It is my purpose to express the views of the Board of Governors on the two bills (H.R. 14026 and H.R. 14422) that are the subject of these hearings. It might be helpful to begin with a summary of recent developments in banking, attempting to place those developments in historical perspective.

As this Committee is well aware, the commercial banking system has become more active in recent years in seeking longer term savings funds. This has not been an isolated phenomenon, but rather an integral part of a major change in the character of commercial banking. Banks have become increasingly ready to challenge traditional or outmoded practices. They have become more aggressive not only with respect to bidding for deposits, but also in finding ways to put funds to profitable uses, in opening new facilities, in providing new services for bank customers, and in reducing costs by adopting more efficient techniques of production, especially through automation.

In addition, the increased activity of banks in bidding for time deposits appears to reflect a response to the declining trend of bank liquidity over the postwar years. Under the conditions of high liquidity and limited loan demand that prevailed from the mid-1930's through the early years of the postwar period, banks showed little

interest in competing for time and savings deposits. As loan-to-deposit ratios advanced over the postwar years, banks came to be increasingly concerned about their ability to meet their customers' loan demands. This concern increased in late 1959, when soaring credit demands and monetary restraint put many banks under pressure.

Shortly thereafter, banks increased their efforts to attract time and savings deposits, especially for corporate time deposits through the issuance of negotiable certificates of deposit. The emergence of the negotiable certificate as a money market instrument began in early 1961, when a large New York City bank announced that it would issue certificates of this kind to both corporate and noncorporate customers and that a large Government security dealer was establishing a secondary market for those instruments. Since 1961, outstanding negotiable certificates in denominations of \$100,000 or more--certificates large enough to be traded readily in the secondary market--have increased to more than \$17 billion. Growth in outstandings has been relatively slow since the fall of 1965, however, and it may be that the period of rapid growth of these deposits is largely behind us.

Pressure on banks to find lendable funds has intensified since 1961, as loan demands of customers have continued to outstrip the growth of deposits. Consequently, banks have become increasingly alert to the possibilities of tapping new sources of funds, especially through issuance of negotiable and nonnegotiable certificates of deposit in smaller denominations, often called "savings certificates" or "savings bonds."

The two bills before the Committee would cut off commercial banks from important sources of funds through which they have been able to meet the rising financing needs of businesses, consumers, home buyers, and State and local governments. They would also prohibit banking practices of long standing. The earliest data available showing a detailed classification of time and savings deposits by type indicate that, in 1928, time certificates and open account time deposits comprised about one-fourth of all member bank time and savings deposits held by businesses and individuals. This is nearly as high as the current proportion. The issuance of certificates of deposit to small savers has been a common practice in some Midwestern and Southwestern States for many years. In 1928, country banks in the St. Louis and Kansas City Federal Reserve Districts held as large an amount of savings under time certificates of deposit as in savings accounts, suggesting that in those Districts, small-denomination time certificates were a leading channel for the placement of individual savings. Our most recent survey confirms that certificates of deposit in small denominations are still an important source of funds to small banks in the Midwest and Southwest.

The negotiability feature of certificates of deposit also has substantial legal precedent. The language used by many banks in their certificates is patterned after wording used in four examples published by the Board in 1933, to provide guidance to member banks in drawing up time certificate contracts that would be consistent with Federal Reserve Regulation Q. The suggested language was

widely adopted, and many banks presently issue certificates of deposit that are legally negotiable, even though little use is made of the negotiability feature. Many of these certificates are in small denominations and are issued by small banks, even though the largest part of the dollar volume of negotiable certificates consists of certificates issued by large banks with denominations in excess of \$100,000. Thus, a recent Federal Reserve survey indicated that three-fourths of the number of member banks with negotiable certificates of deposit outstanding to individuals and businesses on December 22, 1965, were banks with less than \$50 million in total deposits.

The changed attitude of banks toward bidding for time deposits, together with the increases in maximum rates payable on time and savings deposits under Regulation Q, has altered significantly the role of the commercial banks as an intermediary channeling funds from savers to borrowers. The proportion of total credit flows financed by expansion of commercial bank deposits has been considerably higher in recent years than in most postwar years. This increase in the financing of economic expansion through the banking system has been accompanied by some decline in the relative position of the banks' major institutional competitors in the savings field, although the absolute size of these nonbank intermediaries has continued to increase rapidly. Most recently, particularly in the period since year-end, the growth rate of all financial institutions has slowed, as more savings have tended to flow directly from savers to borrowers

rather than through financial intermediaries, reversing the pattern of savings flows that had persisted over the expansion of the previous five years.

With this background information in mind, let us turn now to more specific consideration of H.R. 14026 and H.R. 14422. There is every reason for Congress and the supervisory authorities to remain alert during periods of structural change in financial flows such as those now in process. There is always a possibility that changes in the competitive position of financial institutions may be accompanied by excessively zealous efforts to gain a short-run advantage, and to actions that might raise questions about the liquidity, solvency, and viability of financial institutions. In contemplating the need for supervisory or legislative action, however, it must be borne in mind that the forces of competition have great potential for promoting the interests of the consumer and for serving the public interest.

The two bills at issue represent, in the Board's judgment, efforts to circumscribe competitive processes in ways that are harmful to the public interest. H.R. 14026 would prohibit issuance of negotiable certificates of deposit and other similar negotiable instruments purely on the grounds of their negotiability. We can see no justification for a general prohibition of that kind. The legal status of the negotiability feature of time certificates has a long-standing historical precedent. On economic grounds, the

attribute of negotiability does not, in and of itself, impair the liquidity of the issuing bank nor of the banking system as a whole. The ability of the holder to sell these certificates in secondary markets increases the attractiveness of the instrument. Because the certificates bear stated maturities, bank portfolio managers are in a position to adapt the maturity structure of their assets to the scheduled maturities of their deposit liabilities. The emergence of new financial instruments, and the adjustments in financial markets that take place because of them, have to be taken into consideration in the formation of monetary policy. But the mere presence or absence of negotiability does not impair the ability of the monetary authorities to implement whatever policy is called for by the economic situation.

H.R. 14422 would prohibit insured banks from accepting time deposits in denominations of less than \$15,000. It would deny to banks the use of an instrument employed for many years in attracting savings of individuals. It would deny to the small saver a form of bank deposit to which he has been accustomed, but it would not prohibit the issuance of certificates of deposit in large denominations to individuals of substantial wealth or to businesses. Under the present structure of ceiling rates, small savers would obtain at most the maximum rate payable on passbook savings--4 per cent. Those fortunate enough to be large depositors could earn as much as 5-1/2 per cent. Such differential treatment of large and small savers on the basis of deposit size alone would be discriminatory.

The Federal Reserve Act now specifies four criteria the Board may use in setting the maximum rates payable on time and savings deposits: maturity of deposit, conditions respecting withdrawal or repayment, bank location, and the discount rates in the several Federal Reserve Districts. It has been suggested by the Secretary of the Treasury that the Act be amended to give the Board temporary authority to use an additional criterion for differentiating maximum permissible rates, namely, the extent to which a time deposit is afforded protection through insurance by the Federal Deposit Insurance Corporation. The rationale underlying this proposal is that returns on investment should be scaled according to the risk assumed by the investor. Accordingly, because a depositor's risk on the insured portion of the deposit is eliminated by the assumption of a contingent liability by the Federal Government, the maximum rate payable on that portion could be less than on the uninsured portion.

The Board welcomes consideration of measures aimed at increased flexibility in administering ceiling rates on time and savings deposits. But experience has taught us that this is a complicated field in which changes sometimes produce ramifications that are not anticipated. For this reason, the implications of a new legislative proposal should be thoroughly explored by Congress, and new powers should be exercised by regulatory agencies only after careful exploration of ultimate as well as immediate effects.

For example, in administering the proposed amendment, it may well prove difficult to achieve at one and the same time its stated objectives and equitable treatment as between small and large depositors. However, we wish to assure you that if the suggested amendment is enacted into law, the Board will conscientiously assume the responsibility for its use, in conjunction with its existing authority to regulate interest payments and its other policy instruments, as the public interest requires.

The amendment also raises questions concerning the principle of equity among competing financial institutions. Consequently, Congress might wish to consider whether parallel legislation is needed to authorize the application of a similar criterion with respect to rates of interest on Federally-insured deposits or shares at other savings institutions.

Changes in the competitive situation among financial intermediaries merit continuing close surveillance. The Board is watching developments closely for any indications that these competitive developments might be taking forms that are harmful to the public interest. The Board has ordered a new survey--which is now in the field--of changes since early 1966 in the rates banks are paying on various classes of time and savings deposits, and in the net flows of these deposits during this period. If regulatory actions seem to be needed, in the light of unfolding developments, the Board will not hesitate to take whatever action is called for. It also will not hesitate to request new legislative authority if this should seem necessary or desirable.