Statement of

J. L. Robertson, Vice Chairman,

Board of Governors of the Federal Reserve System,

before the

Committee on Banking and Currency

of the

United States Senate

on

Legislation to broaden authority
to prescribe maximum rates payable
on deposit-type savings,
and related proposals

August 4, 1966

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

On behalf of the Board of Governors of the Federal Reserve System, let me express my appreciation for your prompt consideration of legislation to provide flexible authority for supervisory agencies to prescribe maximum rates of return payable on deposit-type savings. The Board's proposals in this regard are incorporated in S. 3627. In addition, the Board recommends legislation to widen the range within which the Board may fix reserve requirements on time and savings deposits, and to authorize the Federal Reserve System to buy and sell in the open market obligations issued or guaranteed by agencies of the United States, such as the Federal Home Loan Banks or the Federal National Mortgage Association. The latter two proposals, along with the provisions of S. 3627 regarding rate ceilings, are embodied in a draft bill submitted to your Chairman on August 2.

The Board has already indicated the general nature of its support of these proposals to the Committee, in letters of July 15 and August 2 to your Chairman. My remarks this morning are intended to supplement those earlier communications, after which I shall be glad to try to answer any questions that the Committee members may have. Let me address my comments in turn to each of the major areas of authority provided for in the Board's legislative proposals, beginning with interest rates on deposits.

Maximum rates on deposit-type savings

As you know, the Board of Governors of the Federal Reserve System and the Board of Directors of the Federal Deposit Insurance

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Corporation are now required by statute to prescribe maximum limits on the rates that member banks and insured nonmember banks may pay on time and savings deposits. I understand that the Federal Home Loan Bank Board has implied authority to limit rates paid by Federal savings and loan associations on savings accounts, but not those paid by State-chartered associations. Until recently, however, the Federal Home Loan Bank Board endeavored to accomplish such regulation indirectly by restricting the amount of Federal Home Loan Bank credit extended to member associations that paid excessive rates.

S. 3627 contains uniform authority for regulation of maximum rates payable by these competing types of depositary institutions. For both banks and savings and loan associations, regulation of rates would be discretionary, so that it could be invoked under conditions of excessive rate competition, but could be suspended in less troublesome times, when regulation is not needed. The bill provides for consultation among the three regulatory agencies before any change is made in ceiling rates under their regulations.

Under existing law the Board may use only the following criteria in differentiating among deposits for rate ceiling purposes: (1) different maturities, (2) different conditions respecting withdrawal or repayment, (3) different conditions by reason of different locations of the banks, or (4) differences--if any--in Federal Reserve discount rates. The proposed legislation would broaden this authority to authorize differentiation on such reasonable bases as the responsible

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

agency deems advisable in the public interest, including authority to differentiate on the basis of the amount of the deposit.

A lower rate ceiling for smaller deposits is, of course, subject to the objection that it discriminates against the small saver. For this reason, the Board is requesting this authority with considerable reluctance. Neverhteless, we are faced with the fact that today there are roughly $18 billion outstanding in negotiable certificates of deposit in denominations of $100,000 or more, and the going rate on these money-market CD's--that is, the rate banks must pay to renew them, even for very short maturities--is 5-1/2 per cent. Competing instruments in the money market are being sold at higher yields. For example, commercial and finance company paper offers an alternative means of investing corporate funds for short periods. Most large finance companies have recently raised the rate they offer on such paper to 5-5/8 per cent. Rates on commercial paper marketed by smaller concerns through dealers have risen to a range of 5-3/4 per cent to 6-1/8 per cent. I am convinced that banks should be moderating their reliance on continued net sales of large negotiable certificates of deposit, for reasons of sound banking as well as monetary restraint, but I also believe it would be fruitless and disruptive in this kind of environment to attempt to roll back interest rates on these instruments.

In contrast to the 5-1/2 per cent rate on money-market CD's, available evidence indicates that relatively few banks are paying

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

more than 5 per cent on other time deposits. For some time a 4 per cent ceiling has been in effect on savings deposits, which may be withdrawn on demand. The bank must reserve the right to require at least 30 days' notice before withdrawal of a savings deposit, but in practice notice of withdrawal is waived, just as it is for share accounts at savings and loan associations. Member banks are prohibited, however, from paying other time deposits, except in an emergency, before maturity or an agreed-upon period of notice (which must be at least 30 days).

In the first half of 1966, partly due to the fact that other forms of investment attracted more of the limited supply of savings, all types of depositary savings institutions experienced a slower rate of growth. At the same time, credit demands were proving very strong. Commercial banks reacted to these developments by seeking a new type of time deposit at higher rates. The market for this kind of deposit differs from that for the money-market CD, which is issued in denominations of $100,000 up mainly to attract idle funds of corporations. In contrast, the consumer CD, as I will call it to distinguish it from the money-market CD, is sold mainly to individuals and other smaller investors. These consumer CD's cannot be thought of, however, as being held by small savers not particularly sensitive to interest rate differentials. A sizable portion of the funds in this area represents fairly large blocks, and we have abundant evidence that holders of these CD's have been prepared to shift their funds fairly

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

promptly to take advantage of attractive interest rate differentials. Thus, the rapid growth of consumer CD's at banks in the first half of 1966 was matched in good part by offsetting withdrawals from passbook savings deposits at these same banks (which, as you will recall, remain subject to a 4 per cent ceiling). In addition, the most aggressively merchandised consumer CD's seemed also to be drawing funds from other savings institutions, and perhaps in some cases even from cash balances and marketable securities.

The saver who chooses to move his funds into a consumer-type time certificate of deposit must give up some freedom of action in exchange for the attractive interest return. Smaller CD's cannot be readily sold, as can marketable securities. CD holders are compelled to wait at least 30 days, and often longer, to withdraw, rather than being repaid on demand, as they have come to expect of savings deposits. To overcome this drawback, banks in the first half of this year increasingly offered depositors an option: if they were willing to leave funds on deposit for longer periods, they were promised higher returns, but they were given the privilege of withdrawing earlier at lower rates of return. For example, a bank might offer a savings certificate with a one-year maturity at 5 per cent interest, but allow earlier withdrawals, on 30 days' notice, in which case interest at 4 per cent would be paid.

There is perfectly sound logic behind the idea of offering a higher return on longer-maturity deposits, but the attempt to combine

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

high returns with instruments that were nominally long-term but effectively payable on 30 days' notice posed a threat to bank liquidity. Furthermore, the apparent market appeal of this kind of double-barrelled promise to depositors threatened to accelerate shifts of funds from other savings institutions, thereby permitting greater expansion of bank credit in contravention of current monetary policy while at the same time generating further dislocations of an already seriously tight mortgage market. Accordingly, the Board, effective July 20, lowered the highest rate payable on multiple-maturity deposits to 5 per cent, and established a 4 per cent ceiling for those payable less than 90 days from deposit or from the last previous date on which the deposit was payable.

In part the Board settled upon this "multiple-maturity" ruling because present law limited the nature of regulatory amendments it could make without disrupting the market for negotiable CD's of $100,000 and over in the process. Admittedly, banks are still free to offer single-maturity CD's, even to the "consumer" market, at rates up to the current 5-1/2 per cent ceiling and with maturities as short as 30 days, with no restraints other than their own judgment as to what would be wise.

In these circumstances, we think it would be prudent to have more flexible authority to establish ceilings on other bases. I am hopeful that our present regulation will prove effective. However, if it does not, we should be in a position to take whatever action is appropriate in the circumstances prevailing.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The Board believes that it would be most unwise to attempt to fix specific rate ceilings by statute. Conditions in the market for savings can change rapidly, and small misalignments in rates can generate large-scale shifts of funds. Events during the last year give abundant evidence on this score. This is a time of great innovation among institutions as they explore means of attracting funds to meet powerful demands for credit. We urge that you arm the three regulatory agencies with discretionary authority to react to further changes as they develop.

In particular, we would counsel against an attempt by statute to roll back interest rates to levels appropriate to conditions other than those that exist today. The latest comprehensive information available on the market for consumer CD's comes from a survey of member banks that the Board undertook in May, copies of which have been furnished to your Committee. That survey showed that on May 11 roughly $18.4 billion in consumer CD's were outstanding at member banks. The following table indicates the dollar volume in each of four categories of these deposits, along with the dollar totals outstanding at banks that were offering more than 4-1/2 per cent on at least some deposits of that type:

	Amount Outstanding	Maximum Rate over 4-1/2%
Savings certificates	$ 9.5 billion	$3.3 billion
Savings bonds	.9 "	.5 "
Other non-negotiable CD's	4.8 "	2.9 "
Negotiable CD's under $100,000	3.2 "	1.8 "
	$18.4 "	$8.6 "

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

This does not mean that over 4-1/2 per cent was being offered on the entire $8.6 billion. Doubtless some of the older instruments outstanding bore lower rates. It does not even necessarily mean that the banks involved were then offering that high a rate on all new deposits of that type. But it does indicate that an attempt to roll back rates to 4-1/2 per cent would create very serious problems of adjustment.

Banks paying over 4-1/2 per cent are concentrated largely in growing and capital-short areas in States such as Arizona, California, and Texas, and in New York, where the strong upward push in money-market rates has pushed up rates on consumer-type accounts as well. Ceilings set too low could accelerate tendencies, already apparent, for some investors to move their funds out of banks, and out of other thrift institutions as well, to take advantage of the higher returns available on marketable instruments ranging from 5-1/4 per cent on the latest Treasury refunding issue to 6 per cent on medium-quality corporate bonds.

Maximum rates payable by savings and loan associations

Let me turn now to the provisions of the bill regarding regulation of rates payable by savings and loan associations and similar institutions that are members of the Federal Home Loan Bank System or are insured by the Federal Savings and Loan Insurance Corporation. With respect to such institutions, the bill would vest in the Federal Home Loan Bank Board regulatory authority with

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

respect to rates identical with that vested in the Federal Reserve and the FDIC insofar as commercial banks are concerned. It also would require consultation among the three agencies before this authority could be exercised with respect to either banks or savings and loan associations. From the points of view of assuring sound operations of both kinds of institutions, achieving equity among competing institutions, and avoiding massive and seriously disrupting shifts within savings and credit markets, it seems obvious that rate regulation should extend to savings and loan associations as well as banks.

Chairman Horne of the Federal Home Loan Bank Board is, of course, better qualified than I to testify as to the shortcomings of that body's limited authority in this area. But I would suggest that recent experience indicates that its present authority is liable to prove least effective at the time of greatest need.

And precisely because there are times when rate regulation is needed and times when it is not, the bill would permit each of the three agencies (again, after consultation with the others) to suspend ceilings altogether when they are not needed. The Board believes that under certain circumstances the rates paid by financial institutions to attract funds should be completely free to reflect market forces, and that healthy competition among financial institutions in this respect, as well as others, should be encouraged. We agree with the conclusion reached by the President's Committee on Financial Institutions in its report of April 11, 1963:

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

"On balance, the Committee believes that the case for continuous regulation [of interest rates on time deposits] has less force today than in 1933. Nevertheless, recognizing the possibility of a recurrence of the need for maximum rates, the Committee does not propose that interest rate regulation be completely abandoned. Rather, it should be placed on a standby basis and extended to other depositary-type institutions. The very existence of such standby authority would help to prevent excessive increases in rates paid.

"The Committee envisages that such standby authority would be invoked by the responsible supervisory agencies only when they deem it necessary either to prevent institutional practices in the payment of interest and extension of credit that were inconsistent with the safety and liquidity of a significant number of institutions or to supplement other governmental policies to promote the objectives of the Employment Act of 1946."

Expanded authority for changes in
time deposit reserve requirements

The Board also favors expanding the range within which the Board would be empowered to vary reserve requirements on time and savings deposits of member banks from the present 3-to-6 per cent to a range of 3-to-10 per cent. In the Board's view, this added dimension of flexibility in reserve requirements could prove helpful in dealing with some of the shifts in the role and structure of commercial bank time deposits that can develop in a dynamic economy.

Historically, the statutes have provided for a substantially lower level and range of reserve requirements against time and savings deposits than those applicable on demand deposits. Thus, the Federal Reserve Act initially specified reserve requirements of 3 per cent on time deposits as compared with demand deposit reserve requirements of 13, 10, and 7 per cent, applicable to central reserve city, reserve city, and so-called "country" banks, respectively. Subsequent

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

legislation adopted by the Congress in the 1930's empowered the Board to vary such requirements between these percentage levels as a minimum and double these percentages as a maximum. More recently, Congress has acted to consolidate the reserve classes of "central reserve city" and "reserve city" banks, and to broaden the bases on which the Board can classify banks between the two existing categories. As a consequence, the Board is currently empowered to vary reserve requirements on demand deposits between 10 and 22 per cent at reserve city banks and between 7 and 14 per cent at country banks, but still only between 3 and 6 per cent with respect to time deposits at any class of bank.

The reasons for prescribing lower reserve requirements against time deposits are historical; they were based essentially on the judgment that such deposits were less active and less subject to sudden transfer than were demand deposits that were utilized by the public to perform most money-payment functions. Member bank reserve requirements today serve more as a mechanism for implementing monetary policy than as a means of coping with deposit withdrawals. Moreover, recent changes in the forms of time deposit instruments and the kinds of purposes for which they are issued, serve to clothe some segments of time deposits with more of the attributes traditionally associated with money and money market instruments.

Very short-term money market funds are being attracted particularly into short-term large-denomination certificates of deposit.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

In addition, consumer CD's, combining relatively high interest rates and extremely attractive withdrawal or liquidation provisions at the option of the holder, have also been attracting considerable amounts of money that otherwise would have lodged in temporarily idle demand deposit balances or with other types of depositary institutions. Funds attracted to commercial banks in this way can prove highly volatile when cash needs or the attractiveness of interest rates or other terms available on other instruments shift adversely to banks--and it has to be recognized that such shifts will undoubtedly occur in the future.

In these circumstances, we believe that it would be desirable for the Board to have authority to alter reserve requirements on various forms of time deposits over a range more comparable with that now applicable to demand deposits. Several different effects of any increase in time deposit reserve requirements should be distinguished. First, it would raise the proportion of bank resources tied up in non-earning assets, and to that extent would produce a small increase in the cost of such time deposits to the banks. Second, the increased reserve balance held by each member bank to satisfy the higher reserve requirement would represent a small increase in what is effectively a restricted liquidity reserve of the bank. Finally, any change in time deposit reserve requirements could also serve to increase or decrease--as the case may be--the general availability of bank reserves, and could thereby assist, in coordination with other Federal Reserve instruments, in implementing general monetary policy. Properly

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

employed, judicious adjustments in time deposit reserve requirements could assist in altering the willingness of banks to issue time deposits and their capacity to withstand any subsequent liquidations thereof.

It is true that the Board of Governors currently possesses the power to act in this respect to a modest degree, by altering reserve requirements against various kinds of time deposits between 3 and 6 per cent. This power was used last month, when considerations such as those I have been citing led the Board to raise reserve requirements from 4 per cent to 5 per cent on time deposits (other than savings deposits) in excess of $5 million per bank. The present range within which such requirements can be changed, however, is so small that only the most marginal kind of influence on banking decisions can be exercised by alterations of requirements within these limits.

A substantial expansion of the range within which such adjustments could be made--for example, to the 3-to-10 per cent range recommended by the Board--would enlarge the marginal effectiveness of such reserve requirement changes on time deposits to the point where significant alterations in banking behavior might be attainable.

We would hope that over the long run time deposit reserve requirements could be kept at the lowest practicable level consistent with the aims I have cited, for we have no desire needlessly to handicap commercial banks in the competition for the saver's dollar. But appropriately-timed upward and downward adjustments in such reserve

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

requirements might dampen overaggressive interest rate competition for savings funds, moderate sudden large shifts of savings back and forth between banks and other kinds of savings institutions, and forestall major disruptions in credit markets.

Authority for System to operate in "Agency issues"

The Board also favors extending the range of securities which the Federal Reserve is empowered to buy and sell in the open market, to include all obligations issued or guaranteed by any agency of the United States.

At the present time, the Federal Reserve Banks have legal authority to purchase and sell a number of Federal Agency obligations either in the open market or directly from or to the United States. These include Agency obligations which are fully guaranteed by the United States by virtue of specific statutory provisions, including debentures and other such obligations of the Federal Intermediate Credit Banks due in six months or less or obligations guaranteed by the United States by operation of law in accordance with an opinion of the Attorney General of the United States (42 Op. A.G. No. 1 of April 14, 1961).

Examples of securities currently eligible for System open market operations under the above authority include certain obligations of the Export-Import Bank, D. C. Armory Board, Federal Housing Administration, Commodity Credit Corporation, and the Maritime Administration. The bulk of these and the other issues currently

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

eligible, however, are small in size and do not include the major Agency issues traded in the market.

The principal Agency issues in terms of aggregate size and market activity are Federal Intermediate Credit Bank debentures, Federal Home Loan Bank notes and bonds, Federal Land Bank bonds, Bank for Cooperatives debentures, and Federal National Mortgage Association debentures and certificates of participation. Aside from Federal Intermediate Credit Bank obligations previously mentioned, none of these issues are eligible for System transactions, even though from a "market" point of view there is little to distinguish them from those issues that are either explicitly guaranteed or covered by the Attorney General's opinion. In fact, these currently ineligible issues could probably be bought and sold by the System in substantial volume with less risk of disrupting market conditions than could the currently eligible issues.

The authority to make all Agency issues eligible for System purchase or sale would increase the potential flexibility of open market transactions and could also serve to make these securities somewhat more attractive to investors. The recent large volume of Agency issues was relatively well received in the market, and public acceptance and understanding of the issues has grown. But there is still a lingering public confusion because of the diverse and complex legal and administrative factors affecting varying issues. If all the issues were eligible for System operations, this could act as something of a common denominator of market acceptability and would tend to establish a better market background.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

It should be recognized that the authority requested does no more than permit System transactions in Agency issues. They would thereby be placed on the same footing as direct obligations of the U.S. Government insofar as System open market operations are concerned. And as with direct Federal debt, System decisions as to whether, when, and how much to buy or sell of Agency issues would have to be made with a view to the need for supplying or absorbing reserves as indicated by the stance of monetary policy, and in light of developments in the markets, including the need to cope with disorderly market conditions should they emerge. It would be important, however, to avoid any semblance of "rigging" the markets or "pegging" the interest rates for Agency issues, for such actions would give rise to official dominance of the markets that would run counter to many of the broader objectives of Federal financial policies.

If and as the market conditions surrounding Agency issues develop to the point where Federal Reserve operations would be appropriate, it might prove desirable for the System to conduct such operations in the form of repurchase agreements rather than, or in addition to, outright purchases and sales. The authority to undertake outright transactions in an issue is required in order for that issue to be eligible for repurchase agreements. The use of such agreements would tend to reduce the risk of undesired System market dominance associated with sizable outright transactions by the System, while at the same time it would enhance the development of markets in Agency issues by making it more attractive for dealers to position the securities.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Timeliness of the legislation

Finally, let me add a few words as to the timeliness of the proposed legislation. Events of the past year or so have made abundantly clear how quickly circumstances can change, and how important the consequences can be unless appropriately met by prompt corresponding changes in private and public policies. Our economy has expanded at a pace that has created considerable pressures upon both real and financial resources. Credit markets have tightened and interest rates have risen, and the processes of adjustment have been sufficiently uneven to place considerable strains on various parts of the financial mechanism.

Without intending in any way to forecast the future, I must say that no one can be sure when or whether recent trends will taper off. The powers embodied in the proposed legislation, I believe, would enable the authorities to take actions that could mitigate some of the most uneven credit pressures that have already emerged or could develop. Therefore, I urge the prompt enactment of these powers in order to permit the tailoring of public policies in this area in ways that can best contribute to orderly, prosperous, noninflationary growth of the economy.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis