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Statement by

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Subcommittee

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I am pleased to testify this morning on behalf of the Federal Reserve Board concerning the administration of deposit rate ceilings and their effects on the rate of return available to small savers. It has been nearly 13 years since Congress mandated the establishment of a coordinated set of deposit rate ceilings by the Federal financial regulatory agencies. Most economists believe that these ceilings are anticompetitive--amounting to price-fixing for the depositary institutions--and that they have a particularly inequitable impact on the small saver. Moreover, though deposit rate ceilings may successfully restrict competition among depositary institutions, when interest rates are high they cannot protect the institutions as a group from exposure to loss of a significant amount of savings business to open market instruments attractive to the small saver.

Even though market developments are rapidly undermining the efficacy of deposit rate ceiling regulations, many of the factors that caused the Congress to establish the framework for such regulations in 1966 are still at work. Savings and loan associations and mutual savings banks, because of constraints on the kinds of assets they hold, are still unable to pay market-oriented rates of return on all deposit liabilities during periods of high interest rates. Before the thrift institutions can pay such rates, without jeopardizing the financial solvency and stability of individual institutions, reform of their asset powers will be necessary. Nevertheless, the Board believes it important to make progress whenever possible to restore rate flexibility to the institutional deposit structure, and toward this end it has favored a phase-out of rate ceiling regulations over some reasonable period--say 5 years or so.

In considering the actions that can be taken by the Federal financial regulators to move toward a less constrained deposit ceiling rate structure, I believe it is necessary to understand the institutional and legislative framework in which the current structure was originally established. Developments over the past 13 years underscore the complexity of the conflicting issues surrounding Regulation Q-type ceilings, which include not only equity for the small saver, but also the adequacy of mortgage credit flows, competitive balance among various types of depositary institutions, and the financial strength and viability of some institutions. The financial regulatory agencies have been forced, both by law and economic necessity, to attempt to balance these conflicting goals, and hence have been required to make trade-offs.

In mid-1966, as interest rates rose sharply, many thrift institutions faced sizable deposit outflows for the first time in the postwar period, as consumers shifted their savings to higher-yielding market investments and commercial bank accounts. Savings and loan associations and mutual savings banks thus faced the difficult task of trying to meet the competition in deposit markets while their earnings were constrained by portfolios of long-term, slowly amortizing mortgate assets that, on average, provided a net return not much higher than the rates paid on deposits at some commercial banks. Commercial banks were not so hampered because their portfolios were diversified, with an average maturity considerably shorter than that of thrift assets. The rates of return on commercial bank portfolios were thus more responsive to market yields and gave them greater flexibility to pay competitive rates on deposits. With the slackening in deposit flows at thrifts, residential mortgage lending was sharply curtailed at these institutions, and some savings and loan associations and mutual savings banks faced the spectre of outflows that they could not readily meet. It was in this environment that the Congress enacted interest rate control legislation (P.L. 89-597) in the fall of 1966, authorizing the financial regulatory agencies to establish an interrelated structure of deposit rate ceilings.

Commercial bank earnings were not then--nor are they now--a limiting factor in the regulators' ability to set maximum rates payable on deposits. Thus, establishing the initial schedule of deposit rate ceilings in 1966, the financial regulatory agencies attempted to determine the maximum rates that thrift institutions could affort to pay, given their portfolio returns. This set the thrift institution ceilings. The maximum rates payable by commercial banks were then established at levels up to one percentage point below the thrift deposit ceilings. This was intended to give savings and loan associations and mutual savings banks a premium or differential to help offset their competitive disadvantage vis-a-vis commercial banks--a disadvantage that resulted, in part, from their inability to offer a full range of deposit and lending services to their predominantly consumer customers.

At the time of enactment, deposit rate control legislation was viewed as a temporary but necessary measure to protect the short-run viability of the thrift industry and to encourage an adequate flow of credit to the mortgage market. In this spirit, both the initial legislation and subsequent renewals have been of short duration, never more than two years. Thus, every Congress since 1966 has reconsidered deposit rate ceilings, as will this Congress when the present authority expires at the end of 1980.

Since 1966, the ceiling rate structure has been revised a number of times. Generally, such action was precipitated by periods of disintermediation when market interest rates rose well above the deposit rate ceilings. The pressure of higher market yields required upward adjustments in ceiling rates if the institutions were to be able to compete for deposits and sustain the flow of residential mortgage credit.

These upward adjustments followed periods during which thrift institution earnings had strengthened again, reflecting in large measure the increasing average return on assets as portfolios turned over and higher-yielding mortgages were acquired. The resultant improvement in the financial condition of thrifts permitted the regulatory agencies to increase deposit rate ceilings; however, thrift earnings remained a constraint on the magnitude of ceiling rate adjustments. Even though the individual increases in maximum rates payable on deposits were moderate, they were followed by significant reductions in the profitability of savings and loan associations and mutual savings banks. And, because the ceiling adjustments were moderate, growth of deposits subject to rate ceilings remained depressed as long as the yield on alternative market instruments continued high.

Changes in regulatory ceilings have taken two forms. Ceiling rates on existing account categories have been increased, and new deposit instruments have been introduced. Of these actions, new deposit instruments have been by far the most important. In 1970, 1973, 1974, and 1978 the Federal regulatory agencies introduced new longer-term time certificates with relatively modest minimum denominations, in each instance at ceiling rates above those prevailing on existing accounts. This approach limited the cost impact of ceiling rate increases. The higher rate on the new certificates was paid only to those depositors willing to give up some liquidity for additional yield. Cost increases occurred only as such deposits expanded, in contrast to passbook ceiling rate increases, which would apply to both new and existing accounts. The 1973 increase in the maximum rate payable on passbook accounts, for example, led to a sharp reduction in thrift earnings with little increase in deposit growth. Thus, the desire of small savers for a short-term deposit instrument paying market-oriented rates of return conflicts with the necessity to permit the institutions to maintain and attract deposits in an environment of high and rising market rates, without putting undue pressure on earnings.

The introduction of successively longer-term certificates has dramatically changed the maturity structure of thrift institution deposit liabilities. When rate ceilings went into effect in 1966, 85 to 90 per cent of thrift deposits were in passbook form. By mid-1978, only one-third to one-half of total deposits outstanding were in passbook accounts. Since savings and loan associations and mutual savings banks hold predominantly long-term assets, this maturity lengthening has been desirable. Substantial early withdrawal penalties have helped ensure the stability of these longer-term deposits in subsequent periods of rising rates, blunting potential disintermediation.

Since ceilings on thrift institution accounts were first imposed, there has been only one brief period in which small savers were able to earn a market-determined rate of return on a deposit instrument. In July 1973, the regulatory agencies suspended ceilings on 4-year time deposits with denominations of $1,000 or more. Reflecting grave doubts about the ability of thrifts to meet such market competition without severe financial difficulties, the Congress within three months passed a resolution terminating the experiment and mandating the reimposition of ceiling rates on any time account of less than $100,000. At the end of 1975, in order to protect thrift institutions against the possibility of other regulatory actions that might unduly threaten their competitive position, Congress enacted legislation (P.L. 94-200) prohibiting the financial regulatory agencies from reducing ceiling rate differentials on all account categories in existence at that time without the approval of both Houses of Congress. Both of these Congressional actions made it abundantly clear that protection of thrift institutions and concern for the mortgage market were still the dominant factors to be considered in determining the structure of ceiling rates.

Meanwhile, the small saver has 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 and agency issues--can be purchased. Moreover, innovative instruments have developed to attract the deposits of the small saver, such as money market mutual funds and unit investment trusts. Shares in these funds are ordinarily quite liquid, bear market rates of return, and are often available in minimum denominations of $1,000 or less. In the last six months, such mutual funds have attracted over $9.5 billion, and it is a reasonable presumption that a sizable share of this flow might have gone to or remained in depositary institutions if deposit rate ceilings had been more competitive.

In late 1977 and early 1978, deposit inflows began to slacken as market rates of interest moved above regulatory ceilings. Recognizing the threat of increasing disintermediation arising from the growing public awareness of deposit alternatives, the financial regulatory agencies on June 1, 1978 introduced the 6-month money market certificate. This instrument represented a significant change in the rate ceiling structure, providing institutions with a short-term instrument whose ceiling varied with market rates. The thrift institutions were thereby able to compete for funds during high interest rate periods and thus to sustain residential mortgage credit flows at relatively high levels.

A minimum denomination of $10,000 was established on the money market certificate--the same as is required on 6-month Treasury bills to which the rate ceiling is tied--since it was considered that depositors with relatively large amounts at stake would be the ones most likely to shift into open-market instruments. The new certificate has proven to be extraordinarily popular, providing many savers with their first investment bearing a market-determined rate of return. But this new instrument also has been a very costly source of funds for the institutions. Even with the $10,000 minimum denomination, the Board staff estimates that about half of the $116 billion of money market certificates outstanding at the end of February represented funds that would otherwise have remained in lower-cost passbook or fixed-ceiling time accounts. Indeed, the developing earnings pressure on savings and loan associations and mutual savings banks was a major motive underlying the recent regulatory action to reduce somewhat the ceiling rates paid on money market certificates. This was only the second time since 1966 that the regulatory authorities have reduced the ceiling rate on an account category, the first occurring in 1973 when Congress mandated an end to the "wild card" experiment.

Lowering the minimum denomination on the money market certificate or taking any other action to provide more attractive deposit instruments to the saver with less then $10,000, of course, would serve to heighten the earnings pressure on thrifts. After 13 years of deposit rate ceilings, the same set of problems prevailing in 1966 still constrain the options available to the regulators to increase rates of return paid to small savers. The earnings of thrift institutions are already being squeezed by their effort to compete for funds in a high interest rate period. Even though the average return on mortgage portfolios at thrifts is more than 2-1/2 percentage points higher than in 1966, inflation-induced increases in market rates have amounted to over 3-1/2 percentage points in short-term markets and about 4 percentage points in intermediate-term markets over the same period. And, with small savers' increased awareness of alternative market instruments, the potential threat of disintermediation is even greater today than when ceiling rates were first introduced.

Consumer groups and some members of Congress have correctly argued that the existing ceiling rate structure has placed the small saver at an increasing disadvantage. Growing sentiment for relief for the small saver has been voiced simultaneously with mounting pressure by thrifts to curb the rising cost of their deposit funds and concern that increasing deposit costs would be reflected in higher mortgage rates. Not only the consideration of equity for the small saver, but also the growing threat of disintermediation, indicates to us that some regulatory action is becomming imperative. A wide range of suggestions have been made to give the consumer more attractive deposit instruments. For example, some have suggested a reduction in the minimum denomination on the money market certificate, perhaps with a ceiling rate that floats at some fixed differential below the 6-month Treasury bill rate. Another alternative might be to introduce a small-denomination long-term certificate whose ceiling either floats with longer-term market rates, or is fixed a reasonably competitive level. Chairman Reuss of the House Banking Committee has recently suggested a small-denomination savings instrument, with attractive liquidity characteristics, whose maximum return to the saver would rise the longer it is held.

I want to assure you that the regulatory agencies in recent weeks have been analyzing and evaluating a large number of such alternatives in an effort to develop a more attractive deposit instrument for the small saver, without putting undue pressure on thrift institution earnings. It is the Board's hope that constructive action in this area can soon be taken.

The Chairman of this Subcommittee, in his letter inviting the Board to testify, asked what unilateral actions the Federal Reserve could legally take to give small savers a more nearly market-determined rate of return on their savings. The Board, after consultation with the other regulatory agencies, has the authority to create new deposit categories for member banks--bearing any deposit rate ceiling believed to be in the public interest--where unique characteristics or conditions exist. In 1977, the Board used such authority to create the new IRA/Keogh time deposit to accommodate the Congressional objective in the Employee Retirement Income Security Act of 1974. I am also advised that, after consultation, the Board could raise the ceiling rate for member banks on any deposit category created since the 1975 enactment of P.L. 94-200, or reduce the minimum denomination on any member bank account category. This would include the money market certificate. While the Board thus could take action on its own to create an attractive instrument for member banks to offer to the small saver, we are aware that such unilateral action would risk shifts of funds from thrift institutions, thereby threatening the flow of mortgage credit.

Regardless of what actions the regulatory agencies may take in the period just ahead, the asset characteristics of savings and loan associations and mutual savings banks will still constrain their ability to pay substantially higher rates on deposits without seriously threatening the viability of some institutions. When inflationary pressures moderate, and market interest rates decline, thrifts will be in a much better position to compete. Over the longer run, however, any depositary institution that specializes in fixed-rate mortgages is likely to remain vulnerable to the pressures of disintermediation, which include the risks of illiquidity, insolvency, and possible forced merger. As I have noted, these risks are being heightened by financial innovations facilitating the acquisition by small savers of nondeposit instruments bearing market rates of return.

In the Board's view, these problems can be eliminated only if the Congress acts to liberalize the asset powers of thrift institutions. 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. Restrictions prohibit most savings and loan associations and mutual savings banks from offering variable-rate mortgages. The Board believes that Congressional authorization of nationwide VRMs, 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 asset 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 14 States, usury ceilings are currently below free-market mortgage yields. If our institutional lenders are restricted from earning market rates of return on assets, then they cannot be expected to pay market rates of return on deposit liabilities. This is the fundamental problem that impedes progress toward unconstrained institutional competition for small-depositor funds--an outcome that the Board has long supported and continues to seek.

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Appendix Table

Maximum Rates Payable on Small-Denomination Deposits
at Federally Insured Depositary Institutions
September 1966 - March 1979
(in percent per annum)

Type of deposit	Effective date [1]					
	Sept. 26, 1966	Jan. 21, 1970	July 1, 1973	Nov. 1, 1973	Dec. 23, 1974	June 1, 1978
Commercial banks						
Savings [2]	4	4½	5	5	5	5
Money market certificates [3]	--	--	--	--	--	*
Other time deposits [4/5]						
90 days - 1 year		5	5½	5½	5½	5½
1 - 2 years		5½	6	6	6	6
2 - 2½ years						
2½ - 4 years	5		6½	6½	6½	6½
4 - 6 years		5¾			7¼	7¼
6 - 8 years			**	7¼	7½	7½
8 years or more						7¾
Thrift institutions [6]						
Savings						
Savings and loan assoc.	4¾	5	5¼	5¼ [7]	5¼ [7]	5¼ [7]
Mutual savings banks	5					
Money market certificates [3]	--	--	--	--	--	*
Other time deposits [4/5]						
90 days - 1 year		5¾	5¾	5¾	5¾	5¾
1 - 2 years		5¾	6½	6½	6½	6½
2 - 2½ years						
2½ - 4 years	4¾-5¼ [8]		6¾	6¾	6¾	6¾
4 - 6 years		6			7½	7½
6 - 8 years			**	7½	7¾	7¾
8 years or more						8

* Ceiling varies weekly with the 6-month Treasury bill rate. See following page for details.

** No ceiling. See following page for details

Detailed notes appears on the following page.

NOTES

* From June 1, 1978, through March 14, 1979, the ceiling rate on money market certificates at commercial banks was the discount rate on the most recently issued 6-month U.S. Treasury bills (auction average), and the ceiling rate for thrift institutions was 1/4 percentage point higher. Effective March 15, 1979, the compounding of interest on money market certificates was prohibited, and the ceiling rate for thrift institutions was set equal to the discount rate on 6-month bills whenever this rate is 9 percent or more. Thrift institutions may pay 9 percent on money market certificates when the 6-month bill rate is between 8-3/4 percent and 9 percent, and they may pay 1/4 percentage point more than the bill rate whenever the bill rate is 8¾ percent or less.

** No ceiling applied to deposits of $1,000 or more with maturities of 4 years or more during the period indicated, as long as the amount of such deposits at an individual institution did not exceed 5 percent of its total time and savings deposits. Certificates not meeting these requirements were subject to the ceilings prevailing on shorter-term time deposits.

1/ Effective dates vary slightly in some instances for different types of institutions. The dates shown are for commercial banks.

2/ The same ceilings applied to time deposits with maturities of 30 to 89 days at commercial banks throughout the period shown. There is no separate 30- to 89-day account category for thrift institutions.

3/ Must have a maturity of exactly 26 weeks and a minimum denomination of $10,000, and must be nonnegotiable.

4/ Minimum denomination requirements vary over time and among types of institutions. At present, a minimum denomination of $1,000 is required on certificates of deposit with maturities of 4 years or more at all institutions in order to qualify for the ceiling rates indicated. In addition, savings and loan associations must require a minimum of $1,000 on all deposits with maturities of 1 year or more, except in areas where mutual savings banks are permitted lower minimum denominations. These requirements do not apply to deposits representing funds contributed to an Individual Retirement Account (IRA) or to a Keogh (H.R. 10) Plan.

5/ Interest rate ceilings on time deposits of governmental units and ceilings on deposits representing funds contributed to an Individual Retirement Account (IRA) or to a Keogh (H.R. 10) Plan are not shown separately. Effective November 27, 1974, governmental units could receive interest rates on time deposits with denominations under $100,000 as high as the maximum rate permitted on any such fixed-ceiling deposit at any Federally insured depositary institution, regardless of maturity (currently 6 percent). Effective July 6, 1977, the same rule was adopted for IRA and Keogh deposits with maturities of 3 years or more.

6/ Savings and loan associations and mutual savings banks only.

Notes (contd.)

7/ Five percent for negotiable order of withdrawal (NOW) accounts effective January 1, 1974. This is the same ceiling in effect on such accounts at commercial banks, and applies only to institutions with home offices in New England States and New York State.

8/ Savings and loan associations were permitted to pay 4¾ percent on 90-day notice accounts and 5¼ percent on accounts with maturities of 6 months or more. A 5 percent ceiling for MSBs applied to all accounts with maturities of 90 days or more.