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Statement by

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before the

Subcommittee on Financial Institutions
Supervision, Regulation and Insurance

of the

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

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I am happy to appear today on behalf of the Federal Reserve Board to discuss the new savings instruments proposed last month by the financial regulatory agencies. I have also attached a supplement commenting on the questions contained in the Chairman's letter of May 1, but these are not covered directly in my statement.

At the outset let me emphasize that the agencies' recent proposals were constrained by our responsibilities to consider and balance three conflicting needs: namely, to provide more equitable rates of return to depositors, particularly small savers; to ensure an adequate flow of funds to the savings institutions and hence to mortgage markets; and to protect the viability of the thrift industry. The last two of these objectives were mandated by the Congress when it expanded the scope of deposit rate control authority in 1966, and they have been reaffirmed repeatedly in subsequent renewals of that legislation. The objective of providing equitable returns to small savers, while never specifically incorporated into legislation, has nonetheless emerged as an important factor. In view of the sharp increase in market interest rates and in the price level that have occurred over the past year or two, it is no wonder that small savers have become increasingly vocal about the disparities between market yields and the maximum rates available on deposits at thrift institutions and commercial banks.

Despite these developments, fundamental conflicts among the three regulatory goals persist and must be reckoned

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with in any responsible regulatory action. For example, policies designed to augment mortgage flows during periods of high market interest rates necessarily place pressure on the earnings of thrifts and may cause severe problems for some of the weaker institutions. Similarly, actions intended primarily to benefit small savers also squeeze the profitability of thrifts and may not generate any significant additional flow of funds for housing.

These conflicts, and the agencies' attempts to resolve them, are reflected in the three new account categories proposed for public comment last month. Consider, for example, the bonus savings account plan, which would authorize the payment of an extra one-half percentage point in interest on the minimum balance held in a savings account for one year or more. This plan is designed to provide some additional income to savers who prefer to keep their funds in very liquid deposits but nevertheless end up holding these deposits for a substantial period of time. Though the bonus increase in yield proposed is modest, it would raise costs significantly for depository institutions and, at present rates of interest, produce little or no new funds for investment in mortgages. It would be our hope, however, that the minimum maturity restriction would encourage depositors to maintain funds in their savings accounts for longer periods of time and, therefore, add stability to deposit flows, particularly for thrifts.

Creating an incentive to maintain funds on deposit was also an important consideration in developing the rising rate certificate proposal. This plan would provide depositors with an instrument whose yield increases gradually with the passage

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of time. Specifically, commercial banks could pay interest according to a schedule which starts at 6 per cent for the first year and rises in increments of one-half per cent, reaching 8 per cent for the sixth through the eighth year--the maximum specified maturity. Thrifts could pay one-fourth per cent more throughout. Three months' forfeiture of interest would be required for withdrawals during the first year, after which no penalty would apply.

The main attraction of this instrument to depositors would not be a higher return, since the yield for most given holding periods is at or somewhat below that available on fixed-term certificates of the same maturity. But by eliminating the early withdrawal penalty after one year, the rising-rate certificate offers passbook-type liquidity and the prospect of increasing returns to those savers who believe that they will keep their funds on deposit for at least one year. Under the proposed rate schedule, this instrument should not affect thrift earnings materially, nor would we expect it to augment mortgage flows significantly. Instead, the proposed instrument would be intended to serve a particular need for those whose plans are not sufficiently certain to warrant investment in fixed maturity deposit instruments.

Of the three new account categories, we think that the five-year floating-ceiling certificate probably has the greatest cost potential in the short run. It is certainly the most likely, in the Board's view, to augment deposit flows and mortgage credit availability. Patterned after the money market certificate, the instrument would provide a market-oriented rate of return to savers

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who are willing to commit as little as $500 for five years; moreover, depositors withdrawing funds prematurely after a year or so would face a penalty less severe than the existing requirement. Maximum rates of interest would be changed once each month and would be one percentage point below the yield on five-year U.S. Treasury securities for thrifts and 1-1/4 percentage points below for commercial banks.

In advancing this proposal, the agencies have recognized the desirability of permitting a deposit instrument offering a market-determined yield to small savers. We believe that the proposed five-year certificate meets this need without endangering the short-run viability of the thrift industry. The relatively large discount from market yields serves to reduce the cost to depository institutions, and is warranted by the simplicity and convenience of dealing with local institutions rather than going into the market for the placement of small savings balances. During the interagency deliberations leading to this proposal, careful consideration was given to the much simpler steps of either reducing the minimum denomination of the existing 6-month money market certificates or creating a new short-term market certificate with a lower rate ceiling and a lower minimum denomination. However, these alternatives were rejected because of their potential for inducing substantial transfers of funds from low-cost passbook and short-term time deposits and the resultant institutional cost implications. The relatively long maturity of the proposed instrument, coupled with the still

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significant penalty for premature withdrawals, should reduce these risks considerably.

Individually the proposed instruments strike a balance among conflicting objectives in different ways. Taken as a group, we hope that they would provide for greater liquidity and moderately higher returns to small savers and lead to a somewhat larger flow of funds to mortgage markets, all at a cost to the depository institutions that is manageable. Although the considerations motivating each element of the package seem diverse, at least two features are common to all components. First, the differential between the maximum rates payable by thrifts and commercial banks that characterizes each new instrument continues the competitive advantage for thrifts that has clearly been the intent of Congress in its legislative decisions on deposit rate ceilings. Second, all of the proposals, including the suggested reduction of the existing $1,000 minimum denominations on fixed-rate certificates to $500, enlarge the savings opportunities for depositors with moderate sums to invest.

It is too early to provide this Subcommittee and the public with a detailed evaluation of the comments that have been received on the proposals. The 30-day comment period ended just last Friday, and we are still receiving letters that were transmitted to our regional Reserve Banks. I understand, however, that very few of the 250 or so letters reviewed to date are receptive to the proposals. This is, of course, an inevitable consequence of the need to compromise between opposing interests.

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Depositors would be offered better rates of return, but these rates are still well below current market yields. The depository institutions would find their costs to be appreciably higher, but their savings inflows would likely be somewhat better than without the new instrument alternatives. Mortgage credit should be a little more plentiful as a result of the larger deposit inflows, but those interested in obtaining such credit would still be disappointed by the relatively small impact. And, finally, deposit rate ceiling regulations, which are already complicated, would become even more complex, adding to public confusion. Such complexity, I am afraid, is the heritage of Congressional and regulatory efforts to compromise among competing objectives. The Board urges that this Congressional mandate be given prompt review and reconsideration with a view to facilitating simplification and/or decontrol of the ceiling rate structure before it collapses of its own weight.

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SUPPLEMENT TO GOVERNOR PARTEE'S STATEMENT
RESPONDING TO QUESTIONS POSED BY CHAIRMAN ST. GERMAIN
IN HIS LETTER OF MAY 1, 1979

The issues raised in Chairman St. Germain's letter of May 1 are important ones which the regulatory agencies and the Congress have grappled with for some time. Unfortunately, the lack of data in many instances prevents precise and detailed answers to these questions. Nevertheless, I hope the following comments will be of some help in the further deliberations of the Subcommittee.

Let me emphasize at the outset that the Board does not endorse the concept that increases in deposit rate ceilings necessarily lead to higher mortgage interest rates. Such a view implies that thrift institutions possess sufficient power in mortgage markets to pass on increases in their deposit costs to their borrowers. Although the thrift industry as a whole is the principal supplier of residential mortgage credit, individual savings and loan associations and mutual savings banks generally face intense competitive pressures in local markets from other lenders, including mortgage companies which may resell to nondepository institutions such as insurance companies, pension funds and the Government-sponsored agency sources. Thus, on the whole, it seems more reasonable to assume that mortgage rates will be influenced primarily by the relative supply and demand for funds. Under this assumption, an increase in deposit rates, by augmenting the flow of funds to thrift institutions, should tend over time to reduce interest rates on home mortgages. Of course, other factors such as movements in yields on alternative long-term securities also will have an important bearing on mortgage rates and might at times obscure the effects of changes in deposit rate ceilings.

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As you know, the earnings position of the thrift industry has always been the major constraint limiting deposit rate ceiling changes. Consequently, most of the specific questions raised in your letter bear primarily on thrift institutions and are of much less relevance to the commercial banking industry. Moreover, much of the detailed institutional data which you have requested simply is not available for banks. Therefore, most of my comments will be limited to the broader conceptual issues. In so doing, I understand that such institutional data as are available for savings and loan associations and mutual savings banks will be provided by the FHLBB and the FDIC in their responses. The questions are addressed in order, as follows:

1. According to FHLBB data, the spread between average mortgage portfolio returns and the average cost of funds for FSLIC-insured S&Ls was about 175 basis points in the second half of 1978, the latest period for which such information is presently available. No similar data are available for commercial banks, and data for 1978 are not yet available for mutual savings banks.

In terms of historical experience, the spread of 1-3/4 percentage points recorded for S&Ls in 1978-H2 was quite large and was associated with record profits, whether measured in dollars or as a percentage of average total assets. Of course, regional data show variations which are due primarily to geographic differences in deposit account structure, in the average age of mortgage portfolios, and in State usury laws. As a rule, the thrift institutions located in the Northeast, which encompasses the bulk of the mutual savings bank industry and a relatively small proportion of savings and loans, generally have experienced the lowest profit

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margins as a result of older mortgage portfolios, keener competition for deposits, and more stringent usury ceilings.

The spread between average mortgage returns and average cost of funds serves as a useful index of profit levels but may not fully reflect the pressures and/or opportunities faced by institutions as a result of market conditions at a given point in time. As thrifts seek to attract new funds, they must be concerned with the <u>current</u> cost of funds and the <u>current</u> interest rate on new mortgage loans. For example, rates being earned on new mortgages are now only slightly above the maximum rates payable on money market certificates, the principal source of new funds to thrift institutions. Moreover, this spread does not take into account the significant additional net interest expense associated with transfers of existing deposits into money market certificates (MMCs). Thus, although the profitability of thrift institutions reached record levels in 1978, the conclusion is almost inescapable that some downturn is to be expected in 1979. How significant such a decline will be remains to be seen, but this prospect is certainly a factor to be reckoned with in regulatory decisions concerning deposit rate ceilings.

It should be noted that the profits of thrift institutions over the longer run may be enhanced by the MMCs. When interest rates decline, thrift institutions can expect to replace deposits currently held in MMCs with cheaper sources of funds, while most of the high-yielding mortgages currently being made with MMC proceeds are likely to remain on the books of thrift institutions for years to come.

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2. The spread between average returns on mortgages and average cost of funds quoted above does not include fees and points paid to the lender in addition to actual interest.

3. In principle, there is no single number which can be quoted as the minimum spread required for an institution to make a proper return. Such a minimum depends on the circumstances of each individual institution as well as the duration of the period over which it may experience profit pressures. For example, a savings and loan association or a mutual savings bank may be able to withstand temporary losses in its earnings if its capital position is sound and its liquidity is ample. Of course, over the longer run any institution must realize an adequate return if it is to remain in business.

In general, at least two factors govern the minimum long-run spread which an institution must maintain to avoid serious problems. First, the difference between interest earned on assets and interest paid on deposits and other liabilities must be large enough to cover necessary operating expenses. Such expenses typically are about 1 to 1-1/4 per cent of total assets but vary substantially among individual institutions. Second, the net income realized after adjustment for operating expenses, capital gains or losses on securities transactions, and income taxes must be large enough to maintain adequate general reserves (the capital base of a mutual institution). Over the long run, a growing institution must earn sufficient income to allow its capital and reserves to keep pace with its overall expansion. Stock-owned institutions, though they may be able to supplement capital with new issues from time to time, must be in a position to offer stockholders an attractive return in comparison to alternative comparable opportunities for equity investment.

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It is impossible to translate these factors, which vary widely from institution to institution, into a single set of criteria applicable to industry-wide or regional statistics. Nevertheless, historical experience offers some guidance. For example, the S&L industry-wide spread between average mortgage yields and the average cost of funds typically has varied between 120 basis points and 190 basis points.

4. Some detailed data on overhead costs of thrift institutions are collected semiannually by the FHLBB for S&Ls and annually by the FDIC for MSBs. The Federal Reserve also collects similar data annually from a small sample of member banks. These data are difficult to interpret, however, since they necessarily must involve arbitrary judgments by management in attributing operating expenses to various functions.

If institutions are to carry out their functions as mortgage lenders, significant operating expenses necessarily will be increased. But only free competition in deposit and mortgage markets can assure that such costs will be minimized. To the extent that deposit rate regulation and other restrictions, such as portfolio limitations, restrict competition among depository institutions and other intermediaries, the inefficient or uneconomic use of resources is encouraged and overhead costs may be unnecessarily high.

5. No determination has been made by the Federal Reserve System of costs imposed on an institution through related real estate activities of the nature described in this question.

6. The added interest cost to a commercial bank resulting from the transfer of a given amount of funds from one type of account to another will generally be the same as for a thrift institution, given the uniformity of the rate differentials between the two types of intermediaries. When

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translated into an impact on net income as a percent of total assets, however, the effect will be less simply because time and savings accounts are a smaller proportion of total assets at commercial banks. More importantly, the commercial banks enjoy greater flexibility in offsetting or accommodating such cost increases. On the liability side, for example, the transfer of a large volume of funds from interest-sensitive passbook accounts to money market certificates may reduce a bank's exposure to the need to issue short-term managed liabilities, which are presently quite costly.[1/] On the asset side, portfolio yields are much more responsive to market conditions as a result of more rapid portfolio turnover and the widespread use of floating rates.

7. The rising rate account would not require highly sophisticated computer equipment or any technology that is not already available. Many institutions may find, however, that existing computer programs would need substantial revision, that new programs might be required, or that computer services might be needed where such services had not been used before. Adjustments of this sort would, of course, take time and involve some additional administrative costs which would vary from institution to institution.

8. As a matter of definition, the agencies have taken the term "smaller saver" to mean any depositor who does not have sufficient liquid assets to place $10,000 in a single financial instrument. These savers have the most difficulty in obtaining market yields on their funds, and it is primarily this group for whom the proposed new instruments are intended.

1/ In recent years some thrift institutions, particularly S&Ls on the West Coast, have begun to rely more on large-denomination time deposits and other managed liabilities.

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To the extent that the proposals widen the options now available to small savers, and increase their yield and/or liquidity, they will certainly benefit this segment of the population. Of course, the instruments would be available to everyone on the same terms and thus could benefit "larger" savers as well. Admittedly, the proposed instruments do not offer yields that are as attractive at present as can be obtained on market securities.

There has been some controversy as to what demographic group constitutes the "small saver" -- a controversy which, I believe, confuses the issue. The attached table presents data showing the distribution of liquid assets and of accounts at commercial banks and thrift institutions by income and age of family head; account activity data broken down in a similar fashion are not available. The data in the table indicate that family units headed by older persons generally have larger amounts of liquid assets, contrary to the popular impression that elderly people fall disproportionately in the small saver category. On the other hand, the data confirm the supposition that lower-income families typically have smaller liquid asset balances. Regardless of which demographic group falls into the small saver category, the proposed new accounts would provide better savings opportunities to everyone, and particularly to those with small amounts to invest.

9. Cost/benefit projections for depositors by income class have not been made for the proposals advanced by the agencies last month. The assumptions required to make such projections are simply too numerous and too arbitrary to make the final results useful. For example, even for aggregate projections of this nature it is necessary to estimate

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the quantity of funds likely to be transferred from several types of existing accounts, how much money may be shifted to or from nondeposit market investments, how that additional money will be invested, who will be the principal beneficiaries of changes in investment patterns, how much additional administrative costs would be associated with introducing and maintaining the new accounts, and who will bear the burden of these additional costs. The uncertainties inherent in making such assumptions multiply when making projections disaggregated by family income.

Similar problems apply to projections of institutional costs, particularly on a disaggregated basis. We can identify the principal components affecting the costs of banks and thrift institutions although arbitrary assumptions must still be made to generate estimates of effects on earnings. In general, we do not expect the impact of all the proposals taken together to be large -- perhaps a reduction on the order of 5 basis points in the ratio of net income to average assets (annualized) in 1979 and a somewhat larger reduction in 1980.

10. Projections for an environment without Regulation Q become even more complicated. It is not at all clear that institutions would pay prevailing market rates on all deposit liabilities. For example, institutions might offer lower rates on smaller accounts as an offset to the higher costs per dollar of maintaining those accounts. Moreover, in an unregulated environment some institutions might be able to discriminate between deposit instruments designed to attract new funds and those designed to retain existing deposits, paying near-market rates on the former and lower rates on the latter. In addition, the determination

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of market rates themselves would probably be different from now, rendering the data that are presently available useless in making the projection.

The letter inquires also about the role of the Gray Panthers and other organized consumer groups in the planning of the small saver proposals. The class action petition brought by the Gray Panthers before the regulatory agencies last fall has served to focus attention on the pressing problems faced by small savers. On January 18, members of the staffs of the Board, the FHLBB, and the FDIC met with Mr. Robert Gnaizda, counsel for the Gray Panthers, regarding this petition. At that time, Mr. Gnaizda clarified the interests of his client organization and other groups similarly situated in obtaining rates of return reflective of market conditions. These views were taken into account in the formulation of the proposals published for comment on April 3.

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Proportion of Families Holding Selected Levels of Financial Assets in 1977
(in per cent)

	Time deposits (dollars)			Saving deposits (dollars)			Demand deposits (dollars)			Total liquid assets 1/ (dollars)			
	None	1-9,999	10,000 or more	None	1-9,999	10,000 or more	None	1-9,999	10,000 or more	None	1-1.999	2,000-9,999	10,000 or more
Age of family head (years)													
under 25	97.8	1.3	.9	28.0	70.1	1.9	27.8	71.7	.5	10.5	74.4	11.4	3.7
25-34	94.9	3.6	1.5	26.8	67.4	5.8	18.9	80.2	.9	10.2	58.0	23.3	8.5
35-44	92.8	4.7	2.5	20.4	65.5	14.1	13.9	83.7	2.4	8.4	39.3	31.3	21.0
45-54	85.6	8.5	5.9	20.6	58.9	20.5	17.4	80.2	2.4	7.7	34.5	29.4	28.4
55-64	85.1	8.4	6.5	29.3	43.7	27.0	23.2	75.6	1.2	13.0	30.4	22.1	34.5
65-74	83.1	8.1	8.8	36.4	37.3	26.3	24.5	74.7	.8	13.1	32.3	23.0	31.6
75 and over	85.4	6.7	7.9	38.1	41.6	20.3	36.8	62.4	.8	20.2	24.5	24.3	31.0
Family income (dollars)													
less than 3,000	93.0	5.7	1.3	57.2	36.3	6.5	44.7	54.6	.7	30.2	49.6	10.8	9.4
3,000-4,999	95.7	2.1	2.2	52.7	41.9	5.4	49.7	50.3	.0	33.5	47.4	13.3	5.8
5,000-7,499	91.9	5.4	2.7	38.3	55.6	6.1	33.8	65.7	.5	15.7	56.8	15.2	12.3
7,500-9,999	93.2	4.1	2.7	33.3	57.0	9.7	23.8	75.7	.5	9.9	59.5	18.4	12.2
10,000-14,999	90.0	5.1	4.9	21.4	64.5	14.1	15.2	83.9	.9	5.6	53.3	22.6	18.5
15,000-19,999	89.2	5.5	5.3	11.7	74.8	13.5	11.3	87.8	.9	3.4	46.4	32.1	16.1
20,000-24,999	87.4	8.4	4.2	10.4	77.2	12.4	4.4	94.0	1.6	.0	36.7	38.7	24.6
25,000-and over	77.8	11.3	10.9	5.9	50.7	43.4	2.0	93.1	4.9	.6	15.8	31.0	52.6
All	86.4	9.1	4.5	27.0	57.5	15.5	21.0	77.7	1.3	10.9	43.5	24.3	21.2

Source: 1977 Consumer Credit Survey, Board of Governors.

Note: Deposits include holdings at all financial institutions including savings and loan associations, credit unions, mutual savings banks and commercial banks.

1/ Total liquid assets include time deposits, savings deposits, demand deposits and U.S. Government savings bonds.

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