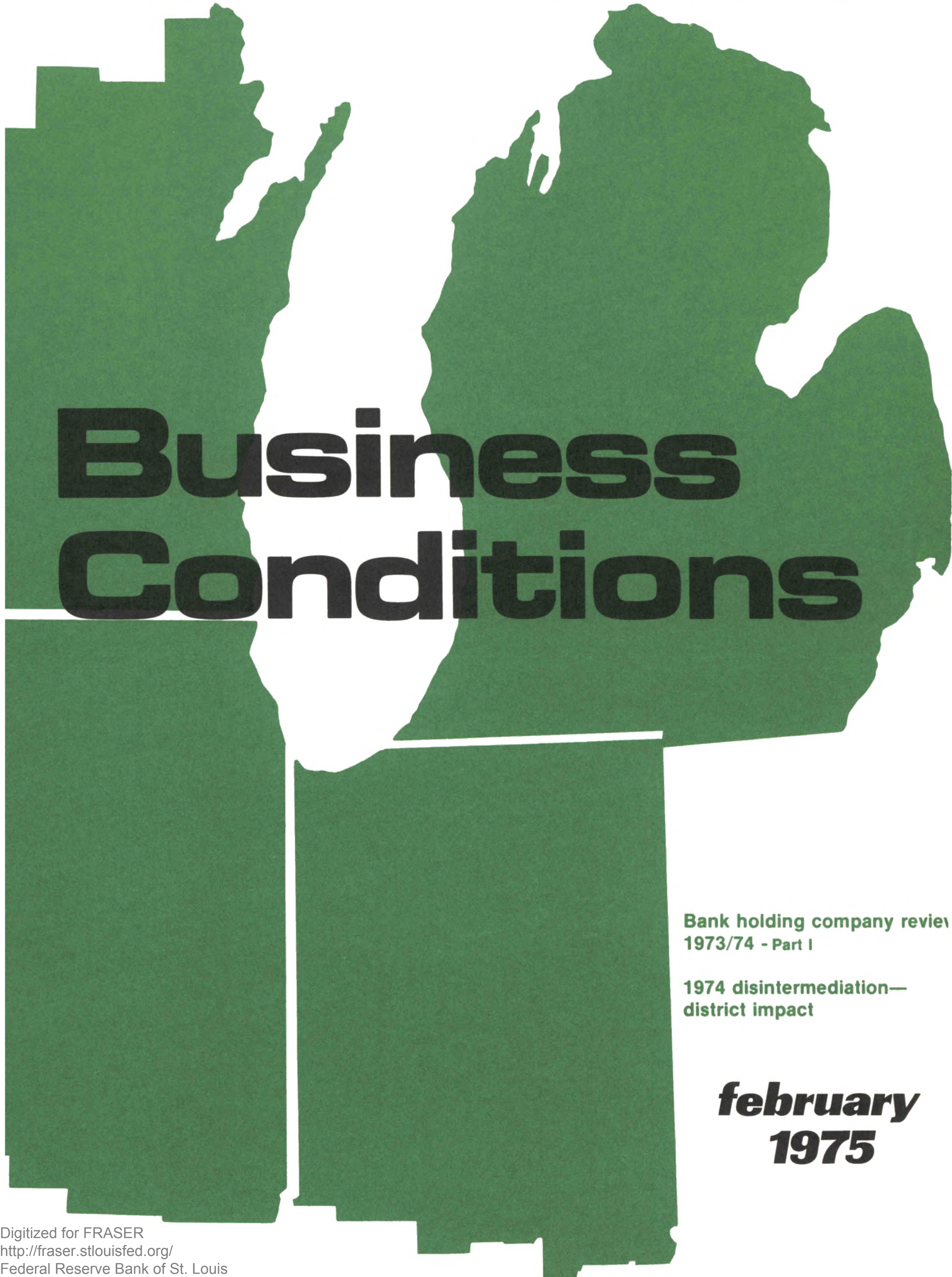
an economic review by the Federal Reserve Bank of Chicago



Business Conditions

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Regulatory changes designed to reduce the magnitude of disintermediation undoubtedly facilitated a reversal of the process in late 1973 and early 1974.

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Bank holding company review 1973/74 - Part I

Forword: The historical developments leading to the 1970 amendments to the Bank Holding Company Act of 1956—and the consequences that flowed from the Federal Reserve System's implementation of the amendments as of year-end 1972—are discussed in detail in "Bank holding companies: an overview," **Business Conditions**, *August 1973. This article traces major developments in bank holding company activity in 1973 and 1974. Part II is scheduled to appear in the April issue of Business Conditions.*

The last few years have witnessed not only an increase in the number of bank holding companies and their domination of American banking, but also a substantial increase in the number of financially related fields that bank holding companies have entered. As the bank holding company movement has matured, however, some fundamental changes in the direction and speed of holding company expansion have become apparent. A reduction in bank holding company activity occurred in 1974 and was due largely to the implementation of a "go slow" policy by the Board of Governors—a policy reflected in the increased number of denials of holding company applications issued by the Board last year—and to a drastic decline in the price of bank stock, which presumably added to the difficulty of acquiring other banks and bank-related companies.

Permissible nonbank activities

One of the foremost responsibilities of the Board of Governors of the Federal Reserve System in regulating bank holding companies is determining which nonbank activities are "closely related to banking" as specified in Section 4(c)(8) of the 1970 amendments to the Bank Holding Company Act. As 1973 opened, the Board had approved 16 general classes of nonbank activities as being permissible for bank holding companies, had denied seven specific activities, and was still weighing the merits of five activities. In late 1973 and early 1974, three of the "pending" activities were added to the permissible list.

Courier service. In November 1973 the Board permitted holding companies to perform courier services under an extensive set of limitations and conditions specifically designed to enhance competition. Bank holding companies are now allowed to transport materials of limited intrinsic value for which the time element is critical (such as cancelled checks) provided that the services are performed on an explicit fee basis, are profit oriented, are paid for directly by the customer, and are made available to the holding company's competitors at the same rates the holding company charges its other customers. Without restrictions, some bank holding companies might have been able to offer courier services free or below cost in an effort to promote other profitable services. This practice could have driven existing courier firms out of business and would have constituted unfair competition—unfair in the sense that existing firms would have lost customers for reasons other than their economic efficiency or the pricing and quality of their product.

In the same order, the Board stated that the evidence submitted in support of allowing holding companies to provide armored car service was inconclusive. However, the Board left open the possibility that new or additional evidence might be persuasive enough to warrant adding armored car services as a permissible activity at a later date.

Management consulting. By statute, bank holding companies have been permitted to provide management consulting services to their affiliated banks since 1956. Section 4(a)(2) of the original Bank Holding Company Act permitted a bank holding company to furnish or perform services for any bank of which the holding company owned or controlled at least 25 percent of the voting shares. Effective February 26, 1974, the Board expanded this activity by amending Regulation Y to permit bank holding companies to provide management consulting services for nonaffiliated banks. In two orders on June 5, 1972, the Board ruled that the performance of general management consulting was not a proper incident to banking and added that activity to the proscribed list.

Several restrictions were placed upon the way in which management consulting services might be provided to nonaffiliated banks so as to minimize, if not eliminate, the potential for unfair competitive practices. Holding companies might provide management consulting advice to banks on a noncontinuing basis provided that: neither the holding company nor its subsidiaries had an equity interest in the client bank; no interlocking officer, director, or employee relationship existed with the client bank; the management advice is rendered on an explicit fee basis; and the names of all banks affiliated with the holding company and all clients that may compete with the potential client bank be disclosed. In the absence of these restrictions, it might have been possible for a bank holding company to exercise control over banks without any ownership interest and without prior Board approval, as required by the act.

Leasing of real property. In April 1974, when the Board added leasing real property to its permissible list, it also amended the existing restrictions on the leasing of personal property in order to make all leasing restrictions more comparable. The main purpose of the restrictions is to make the holding company's ownership of the leased property incidental to the credit transaction, thus maintaining the holding company's role as a financial intermediary. Restrictions common to both types of leasing include the stipulations that: the lease be the functional equivalent of an extension of credit; the property be acquired for this or an earlier lease; the property be leased on a nonoperating basis; the lease be of the full payout type; the maximum term be 40 years; the property be re-leased within two years of the expiration of the lease; and the lessor not retain any interest in the property for a total of more than 50 years.

Pending activities

Late in 1974 the Board determined that two other activities—mortgage guarantee insurance and operating savings and loan associations—should remain on the "pending" list although they were closely related to banking. Both of these activities had been under consideration for a rather long period of time, and in each instance the Board did not specifically proscribe the activity. In fact, the Board declared both activities to be closely related to banking within the meaning of Section 4(c)(8), but said that the public interest would not be served by permitting bank holding companies to perform these activities "*at this time*" (emphasis added).

The Board's reluctance to approve activities that it had determined were closely related to banking and that might produce net public benefits if performed by bank holding companies represented a definite departure from previous Board attitudes. It is interesting to compare the concluding statement in the Board's order declaring that the underwriting of mortgage guarantee insurance would not be an appropriate activity at that time with an earlier statement by the Board regarding bank holding company expansion and diversification. In its September 9, 1974 order focusing on mortgage guarantee insurance, the Board stated:

> . . . the Board believes that these are times when it would be desirable for bank holding companies generally to slow their present rate of expansion and to direct their energies principally toward strong and efficient operations within their existing modes, rather than toward expansion into new activities. This is particularly true with regard to expansion into a new area such as private mortgage insurance involving uncertainties which are sufficient in the Board's view to outweigh at the present time the public benefits that might be expected to result from this proposal.

While not representing a 180-degree turn in position, this statement does represent a very different philosophy from that expressed in the Board's Statement of Principles of February 20, 1969:

> . . . consistent with continued growth and development of a dynamic and increasingly complex economy, banks should be granted greater freedom to innovate new services and procedures, either directly, . . . or through affiliates in a holding company system. . . . Bank holding companies should be allowed to enter certain non-banking areas of activity . . . which would facilitate broader services for the public. . . .

The 1970 amendments to the Bank Holding Company Act brought about a fundamental change in the nature of banking [and in regulators' views of banking] since they created the "need for bank management to move away from thinking altogether like bankers, and to think, instead, like corporate managers looking out over a related set of businesses which includes one or more banks . . ."[1] Recently, however, views expressed by the Board suggest that bankers should devote more time to the business of banking and, at least in the near future, give reduced priority to expansion into new areas. This does not imply that the Board has closed the permissible list to new additions; indeed, in September 1974, the operation of travel agencies was added to the list of activities under consideration. But until the Board signals that conditions have improved sufficiently to warrant a resumption of bank holding company expansion, the banking industry will have little incentive to explore new fields of activity.

Future permissible activities

A prediction of how much time will elapse before the Board shifts its stance on new holding company activities is complicated by the fact that some disagreement exists among Board members as to whether expansion by *all* bank holding companies should be constrained because of the growth-oriented nature and financial philosophy of *some.* The dispute centers upon whether the permissible list should be closed to new activities until an emerging industry trend toward deteriorating capital ratios is clearly reversed. Alternatively, in ruling on new activities, the Board could discriminate against just those holding companies that have significantly leveraged their equity

[1] Jeffrey M. Bucher, "Bankers and the Bank Holding Company," speech before the 79th Annual Convention of the Florida Bankers Association, Bal Harbor, Florida, June 23, 1973.

capital position through heavy reliance on debt, particularly short-term debt.

In a landmark denial, the Board, conceding that operation of a savings and loan association was closely related to banking, concluded that bank holding companies should avoid adding to their debt burden by acquiring leveraged companies requiring periodic infusions of capital. Two Governors, while concurring in that specific denial, said that the Board was espousing too broad a principle in imposing such a requirement on all holding companies. More specifically, Governor Philip E. Coldwell stated:

> . . . conservatively-managed bank holding companies without significant debt should not . . . be denied opportunities for expansion of which they have not previously availed themselves. The Board apparently chooses to apply its so-called "go slow" policy across the board without discriminating between leveraged and non-leveraged holding companies in order to avoid confusion in the industry as to the scope of the policy. In my view, it is our responsibility to examine each holding company's application on a case by case basis and to acknowledge differences among non-leveraged and leveraged holding companies.[2]

If the Board were to adopt Governor Coldwell's more lenient view as an inducement to highly leveraged holding companies to augment their equity capital, the number of permissible nonbank activities should continue to grow. Nevertheless, the growth rate would be much slower than in the past because all of the obviously permissible activities have been approved.

Activities APPROVED by the Board

1. Dealer in bankers' acceptances
2. Mortgage company
3. Finance company
4. Credit card company
5. Factoring company
6. Operating an industrial bank
7. Servicing loans
8. Trust company
9. Adviser to real estate investment trusts and other investment companies
10. General economic information and advice
11. Portfolio investment advice
12. Full pay-out leasing of personal property
13. Full pay-out leasing of real property
14. Community welfare investments
15. Bookkeeping and data processing services
16. Insurance agent or broker in connection with credit extensions
17. Underwriting credit life and credit accident and health insurance
18. Courier service
19. Management consulting to nonaffiliated banks
20. Sale of travelers checks
21. Bullion broker

Activities DENIED by the Board

1. Equity funding (combined sale of mutual funds and insurance)
2. Underwriting general life insurance
3. Real estate brokerage
4. Land development
5. Real estate syndication
6. General management consulting
7. Property management

Activities UNDER CONSIDERATION by the Board

1. Armored car services
2. Mortgage guarantee insurance
3. Savings and loan associations
4. Travel agencies
5. Underwriting and dealing in U.S. Government and certain municipal securities

[2] "Concurring Statement of Governor Coldwell," Board Order of November 4, 1974 denying the application of American Fletcher Corporation, Indianapolis, Indiana, to acquire the Southwest Savings and Loan Association, Phoenix, Arizona.

Slower holding company expansion

After more than doubling in 1973, the pace of bank holding company expansion across the nation experienced a mild setback in 1974. Much the same experience held for the Seventh District. The diminished volume of holding company activity can be attributed largely to the Board's increased denial rate and depressed stock prices.

The total number of bank holding company and merger applications acted upon by the Federal Reserve System in 1974 fell slightly—from 717 in 1973, to 671 in 1974, a 6.4 percent decline.[3] In the latter period the proportion of bank holding company and merger applications denied by the Board—the "denial rate"—increased significantly, up from 4.3 percent in 1973, to 7.1 percent in 1974.[4] The denial rate of bank holding company formations rose dramatically, from less than 1 percent in 1973 to more than 10 percent in 1974; for acquisitions of an additional bank the denial rate was virtually unchanged, declining from 4.5 percent in 1973 to 4.4 percent in 1974. For nonbank acquisitions the Board's denial rate increased slightly, from 6.9 percent in 1973 to 8.6 percent in 1974.

Careful analysis of the orders issued by the Board in 1973 and 1974 reveals noticeable changes in the Board's attitude concerning two issues: capital adequacy and potential competition. Largely as a result of the Board's increasingly strict views on these two matters, the denial rate has increased, many applications have been withdrawn prior to Board action, and an unknown number of applications that might otherwise have been filed have never been written.

The issue of "capital adequacy," raised by the continuing decline in the capital ratios of banks and bank holding companies, has always been of major concern to the Board. This concern has led to the Board's recent implementation of a "go slow" policy—a policy that has been effective in slowing all forms of holding company expansion by sharply reducing the probability of approval of any acquisition that would add significantly to a holding company's debt burden.

Not only has the Board's attitude shifted with regard to banking factors—in particular, the issue of capital adequacy—but the Board appears to have revised its treatment of competitive factors as well. In 1973 and 1974, the Board demonstrated substantial concern with potential and probable future competition. The Board recently denied several applications where no existing competition existed between the applicant and the bank or nonbank company to be acquired but where, it believed, potential and probable future competition would be adversely affected.

Wholly aside from these changes in the Board's attitudes, holding company activity declined in 1974 for another reason—the decline in the price of bank stock. The magnitude of the decline in the value of holding company shares, especially those of the nation's largest bank holding companies, is evidenced by the 40 percent decline in the Salomon Brothers 22-Bank Index in 1974. During the same period, the Standard and Poor's Index of 425 industrials declined 30 percent.

For the purpose of comparison, an unweighted index of bank stock prices was compiled for 33 banks having deposits on June 30, 1974 of less than $100 million. In 1974 the price of these banks' shares

[3] The number of applications processed by the System includes applications acted on by the Board or by the Reserve banks under delegated authority under Sections 3(a)(1), 3(a)(3), 3(a)(5), 4(c)(8), and 4(d) of the Bank Holding Company Act and under the Bank Merger Act. Excluded from the totals shown are Reserve bank actions on 4(c)(8) de novo notifications and System actions on 4(c)(12) notifications.

[4] The 4.3 percent denial rate in 1973 was unusually low by historical standards. In 1966 and 1967, the Board's denial rate exceeded 10 percent; from 1968 to 1970, the denial rate rose from 5.1 to 6 percent, rising again in 1971 to 7.9 percent, and in 1972 to 9 percent.

declined 15.4 percent, which suggests that on average, the shift in the relative price of stocks of large and small banks made the latter feel worse off at the originally agreed-upon exchange ratio. This evidence supports frequently made statements that applications were withdrawn or not filed when the relative change in stock prices made it impossible to renegotiate exchange ratios which would satisfy both the buyer and seller. Indeed, in a few instances, transactions were not consummated even though the applications had been approved by the Board of Governors.

In 1974, 46 applications to acquire banks and bank-related companies and 34 de novo notifications to enter nonbank activities were withdrawn.[5] Not all withdrawals were the consequence of changes in the price of holding company stock. Some applications were withdrawn when it became obvious that the Board would deny them because similar applications had been denied. The withdrawal of applications that have a very high probability of being denied tends to hold down the Board's denial rate. This rate would be expected to decline over time as holding companies learn by experience what factors the Board considers adverse and thus avoid the time and expense of filing applications deemed to have a high likelihood of denial. It is only recently that the importance of changes in Board policy—which caused some applications to be withdrawn and discouraged others from being filed—has been realized. Recognition of the importance of this effect should serve as a warning against relying solely upon the denial rate as an index of the restrictiveness of Board policy.

Nonbank acquisitions

There was a modest shift in 1974 in the importance of certain nonbank activities entered by the acquisition of going concerns. Whereas finance companies overwhelmingly dominated nonbank acquisitions in the nation in 1973, such acquisitions maintained their lead position by only a slight margin last year.

Commercial and consumer finance are areas obviously ripe for bank holding company participation. Banks typically concentrate extensions of business and consumer credit at the short and intermediate range of the maturity spectrum, just as finance companies do. The primary difference between banks and finance companies is with respect to the creditworthiness of the customers they serve, with finance companies specializing in higher risk loans. Historically, it has been considered inappropriate for banks to utilize depositors' funds to make high risk loans of the type that would be made by finance companies.

A finance company subsidiary of a bank holding company usually relies upon the resources of its parent company or upon its own nonbank resources to supply its working capital; thus, it can extend riskier loans than its bank affiliate without arousing regulatory concern. Through its finance company subsidiary, the holding company is able to increase its share of the consumer or business credit market by developing relationships with clients that its bank subsidiary formerly had turned away. Thus, the finance company industry has proven to be a natural extension of the activities performed by holding companies.

Acquisitions of mortgage banking firms accounted for the second largest proportion of nonbank acquisitions in 1973. In 1974 mortgage banking fell to third place, while insurance agencies took over second place among acquisitions requiring Board approval. The increase in the number of insurance agency acquisitions reflects two unrelated forces. First, many holding company formations and bank acquisitions in 1974 involved small banks in rural communities. In many instances these banks had an insurance agency affiliate—often the only local source of insurance. As these banks were acquired by holding companies, the insurance agency was acquired also. The second factor was that a large number of insurance agency cases had been held in abeyance (since early 1972) pending the outcome of hearings requested by the National Association of Insurance Agents and others. Applications that the Board (or in these instances, the appropriate Reserve bank) otherwise would have acted upon in 1972 and 1973, had no objections been raised by third parties, were not approved by the Board until 1974.[6]

District developments

Within the five states of the Seventh Federal Reserve District—Illinois, Indiana, Iowa, Michigan, and Wisconsin—Michigan alone accounted for slightly more than one-third of all bank holding company formations and bank acquisitions in 1974. (Michigan law forbade corporations from owning banks until April 1971.)

Probably due to an increased number of denials, the number of applications from holding companies in the district ceased to accelerate in 1974. The denial rate on applications filed by holding companies in the district increased even more

Number and deposits of banks in holding companies in the Seventh District

	1971			1972			1973			1974*		
	Number of banks	Total deposits	Share of state deposits	Number of banks	Total deposits	Share of state deposits	Number of banks	Total deposits	Share of state deposits	Number of banks	Total deposits	Share of state deposits
		(billion dollars)	*(percent)*		*(billion dollars)*	*(percent)*		*(billion dollars)*	*(percent)*		*(billion dollars)*	*(percent)*
Illinois	135	19.9	50.1	143	25.8	55.9	146	30.9	58.7	149	32.2	59.4
Indiana	22	3.5	29.3	23	4.4	32.3	27	5.2	34.0	28	5.3	33.7
Iowa	147	2.8	37.2	157	3.3	38.9	168	3.8	39.1	171	4.0	40.7
Michigan	19	0.8	3.7	35	5.8	22.7	71	18.3	67.6	81	19.6	70.4
Wisconsin	127	5.3	49.6	136	6.1	50.0	144	6.6	50.4	150	6.8	50.4

*As of June 30, 1974.

[5] Data from the Board's H.2 release, "Applications and Reports Received or Acted on by the Board."

[6] Many of the insurance agency applications acted on by the Board in 1974 involved de novo entry. The Board decides such cases, rather than the Reserve bank acting under delegated authority, whenever substantive objections are raised by a member of the public.

dramatically than for the nation. In 1973, 42 holding company formations and 42 holding company acquisitions of additional banks were approved. None was denied. In 1974, however, seven of 42 applications for holding company formations and one of 37 holding company acquisitions of additional banks by district holding companies were denied.

In the district, as in the nation, finance companies were the most popular nonbank activity for holding companies in 1974, with consumer finance holding a slight edge over commercial finance. The second most commonly entered activity was leasing of both personal and real property. Acting as an insurance agent ranked third.

An analysis of the number of Seventh District holding companies that have begun to perform nonbank activities since passage of the 1970 amendments shows that last year's pattern was not unusual. The most frequently entered nonbank activity over the last four years (1971-74) was personal property leasing.

For all intents and purposes, a full payout lease is the functional equivalent of a credit extension to a business for acquiring capital equipment, one of the primary lending activities of commercial banks. In the last few years, moreover, both the lessee and lessor have accrued advantages from leasing not present in an ordinary loan. The leased equipment ties up none of the lessee's working capital and does not appear as debt on his balance sheet. The lessor (i.e., the bank or bank holding company), being the owner of the equipment, benefits from being able to lessen its tax burden since it is allowed to apply the depreciation of the equipment against its tax liabilities. These side benefits have been sufficient to induce a significant shift to leasing from traditional forms of credit extension.

If proposed changes in accounting principles requiring leases to be capitalized on the balance sheet were adopted, it would reduce leasing's attractiveness to the lessee, thus tending to mitigate the growth of leasing in the future.

It is noteworthy that although real property leasing has been permissible for less than one year, seven holding companies in the district are engaged in this activity; presumably, real property leasing would have ranked higher had it been permissible for a longer period.

While the number of banks affiliated with holding companies in the district states continued to expand in 1974, the rate of expansion trailed that of previous years. The rate of growth of the number of holding company banks increased from 5.4 percent in 1971, to 9.8 percent in 1972, to 12.6 percent in 1973. Last year, however, the acceleration in the rate of expansion came to a halt as the number of bank subsidiaries of holding companies in the five states increased at an annual rate of just under 10 percent. More than 40 percent of the expansion in the number of banks affiliated with holding companies in the five states during the first half of 1974 took place in Michigan. The importance of holding company banks in Michigan's banking structure cannot be overstated. At year-end 1971, the 5.7 percent of Michigan banks that were subsidiaries of holding companies controlled less than 4 percent of state deposits; by mid-1974, almost one-fourth of all Michigan banks—accounting for over 70 percent of state deposits—were subsidiaries of bank holding companies.

At the opposite extreme were Indiana and Wisconsin. In both states the proportion of commercial bank deposits controlled by subsidiaries of holding companies declined in the first half of 1974, while the number of banks affiliated with holding companies increased slightly. This indicates that Indiana and Wisconsin banks not affiliated with holding companies had a faster deposit growth rate than holding company banks.

Harvey Rosenblum

1974 disintermediation— district impact

The distortions in savings flows that result when high market interest rates attract funds away from financial intermediaries has become a familiar phenomenon. In late 1966 and again throughout 1969, time and savings deposits left commercial banks and thrift institutions only to return at a record-breaking pace when interest rates subsequently dropped.

Early in 1973 efforts to restrain excessive credit expansion in the face of accelerating business credit demands again drove market interest rates to levels that threatened disintermediation. To allow more effective competition for funds, the regulatory authorities modified the rules relating to time and savings deposits. Ceiling rates were suspended on large denomination time deposits ($100,000 or more) and were raised on smaller deposits and longer maturities. Although these changes did not prevent disintermediation in the summer of 1973 and for several months during 1974, they undoubtedly reduced its magnitude and facilitated a quicker reversal of the process. Reports by district commercial banks and savings and loan associations (S&Ls) indicate that in the year ending October 31, 1974:

- Both banks and S&Ls realized an overall net inflow of time and savings deposits although less than normal.
- Commercial banks enjoyed a better and more sustained rate of growth than S&Ls.
- Large banks (total deposits $100 million or more) had more rapid growth in total time and savings deposits than smaller banks.
- Expansion was mainly in big denomination deposits at large banks and in consumer-type accounts at smaller banks.
- As market interest rates rose, depositors shifted small denomination time deposits out of shorter-maturity, lower-rate accounts into longer-term, higher-yield accounts.

Market yields and deposit rates

Market yields have been very attractive relative to rates paid by banks and S&Ls on consumer-type deposits (passbook savings and time deposits in denominations less than $100,000) over much of the past two years. In early 1973 the Federal Reserve's Regulation Q and equivalent rules for insured nonmember banks allowed a maximum of 4½ percent on passbook savings, and rates ranging from 5 to 5¾ percent on time deposits in denominations less than $100,000. S&L ceilings were generally ½ percent higher. By mid-1973 the market yield on 3-month Treasury bills exceeded 7 percent and was still rising. To give the financial intermediaries greater leeway to bid for funds, the authorities raised rate ceilings on most time and savings deposits. (See box.) At the same time the difference between the maximum rates S&Ls could pay over what banks could pay was reduced to ¼ percent for most maturity categories. (Higher ceilings on six-year and government unit deposits were not authorized until November 1974.)

These adjustments in regulations still left deposits at a disadvantage relative to competing outlets for savings. Treasury

Maximum interest rates payable on time and savings deposits, January 31, 1975

Type of deposit	Banks	S&Ls (1)
Savings deposits	5	5 ¼
Other time deposits:		
Less than $100,000:		
30 - 89 days	5	(2)
90 days to 1 year	5 ½	5 ¾
1 year to 2 ½ years	6	6 ½ (3)
2 ½ years or more	6 ½	6 ¾ (3)
4 to 6 years	7 ¼ (3)	7 ½ (3)
6 years or more (4)	7 ½ (3)	7 ¾ (3)
Govt. units (5)	7 ¾	7 ¾ (3,6)
$100,000 or more	No maximum	No maximum

(1) Some geographic variations; (2) Not permitted; (3) Minimum $1,000; (4) Effective December 23, 1974; (5) Authorized November 27, 1974; (6) 30 days or more.

bill rates peaked at near 9 percent in 1973, receded to only about 7 percent early last year and then rebounded to a late August record near 10 percent. The summer of 1974 also saw the emergence of "floating rate" notes sold by bank holding companies, the development of money market mutual funds, and high grade corporate bonds with coupons above 9½ percent.

Large certificates of deposit (CDs over $100,000) are competitive with other money market instruments, such as unsecured notes issued by large corporations (commercial paper). Ceilings on CDs maturing in less than 90 days were suspended in June 1970 to enable banks to help finance businesses unable to sell commercial paper in the wake of the Penn Central bankruptcy. By the spring of 1973, the banks could not compete with other money market instruments in maturity areas longer than 89 days and the remaining rate limits on the large CDs were suspended. (An increase in reserve requirements to discourage excessive credit expansion financed by CDs accompanied the suspension order. These requirements were not removed until the fall of 1974.)

S&Ls also issue large denomination CDs, but their access to such funds has been severely restricted by legal limitations on the total amount that can be outstanding and by the fact that S&L CDs have only recently become marketable.

The interest-sensitivity of deposit customers, the credit needs of borrowers, the degree of institutional dependence on consumer-type savings, and the aggressiveness of competition for higher-cost money were the important factors affecting time and savings deposit growth in this environment. The evidence on bank experience cited below is based on responses of district member banks to the Federal Reserve's regular surveys of time and savings deposits on October 31, 1973 and October 31, 1974.

How smaller banks fared

Time and savings deposits represent about two-thirds of total deposit liabilities at member banks in the district. At smaller banks (total deposits less than $100 million) consumer-type deposits comprise 85 percent of total time and savings deposits. The ability of these banks to attract and hold such deposits within legal rate limitations is, therefore, a major factor in bank growth. As of last October 31, the large majority of these banks were offering the best terms permitted under the regulations on consumer-type deposits, as indicated below:

	Percent of banks issuing various accts.	Percent of issuing banks paying ceiling
Passbook	99	83
Other time:		
Original maturity		
Less than 1 year	96	90
1 - 2 ½ years	98	92
2 ½ - 4 years	87	97
4 years or more	83	72

Despite the record interest rates available on credit market instruments, total time and savings deposits at these banks rose 11 percent in the year ending October 31, 1974, compared to 7 percent in the prior 12 months. More than two-thirds of the gain was in consumer-type accounts. There were wide differences among banks, with roughly 8 percent reporting net declines in those accounts.

Passbook savings kept pace with the higher paying consumer-type time deposits—each rose 9 percent. For many savers the liquidity and convenience of passbook savings outweigh the higher yields available on longer-term time accounts. Outstanding consumer-type savings are about evenly divided between passbook savings and other time deposits—certificates and open accounts.

In 1974 consumer-type time deposits with original maturities under two and one-half years declined 14 percent while those with maturities from two and one-half up to four years rose 72 percent. The biggest gains were in the four-year certificates. These accounted for 10 percent of all consumer-type savings at the smaller banks by the end of October 1974—up from 4 percent a year earlier.

Although big CDs rose 20 percent at the smaller banks in the 12 months ending October 31, 1974, they contributed only 8 percent of the total increase in time and savings deposits during that time. Moreover, large deposits were less available when conditions were tightest. When big CDs were expanding strongly at larger banks, growth was insignificant at the smaller banks, most of which were unable to earn enough to cover the cost of CD money.

"All other" time deposits, primarily owned by state and local governments, registered a 26 percent increase at the smaller banks in the year ending October 1974. The survey did not show what proportion of these accounts were large enough to be exempt from rate ceilings. In Indiana and Illinois such deposits were an important source of growth, contributing 40 percent and 25 percent, respectively, of the increase in total time and savings deposits.

Large banks rely on CD market

At member banks with total deposits of $100 million or more, time and savings deposits increased 15 percent in the year ending October 31, 1974. More than two-thirds of this gain was attributable to large denomination CDs exempt from rate ceilings. Most of the increase occurred in the six months, March through August, when business loans were expanding strongly.

At the time of the October survey, outstanding large denomination time deposits at district member banks totaled $13 billion. More than four-fifths of these deposits are liabilities of the very large banks in Chicago and Detroit.

The slowdown in savings was most severe at large banks

	Deposit size *(million dollars)*			
Change in consumer-type deposits*	**Under 25**	**25-50**	**50-100**	**100 & over**
(percent)	*(percent of member banks)*			
Decline	5	10	13	30
Increase:				
0 - 5	8	18	25	29
5 - 10	20	25	37	26
10 - 15	27	27	17	11
15 - 20	14	13	6	3
20 and over	26	7	2	1

*Twelve months ended October 31, 1974.

About half of total time and savings deposits at large banks last October were consumer-type, but this proportion ranged from 34 percent in Illinois to 71 percent in Iowa and Michigan. Branch banks, which are prohibited in Illinois, attract more consumer deposits reflecting more office locations.

The incentive for larger banks to pay the 5 percent maximum rate on passbook savings appears to be related to the importance of consumer-type savings in total time and savings deposits as well as by competitive conditions, other sources of time deposits, and the interest returns available on loans. By last October 31, almost all the large Illinois and Iowa banks were paying the maximum passbook rate compared with only half of the larger banks in Indiana and Michigan. Many banks with a high proportion of deposits in passbook savings form are reluctant to raise the cost of these accounts across the board, especially when even the ceiling rate provides little deterrent to the loss of interest-sensitive money, given the higher yields available elsewhere.

Essentially all of the larger member banks in the district were offering a full maturity spectrum of time certificates and open account deposits in denominations of less than $100,000. Most were paying the ceiling rates on maturities up to four years. About four-fifths were paying the maximum allowable on four-year certificates.

S&L deposit gains were nearly all in high-yield accounts

	Percent change in deposits, year ended October 31, 1974		
Area	Regular passbook	Higher-rate accounts	Total
Chicago	- 3	+ 9	+ 3
Other Illinois	- 3	+15	+ 8
Indianapolis	- 2	+ 6	+ 4
Other Indiana	- 2	+13	+ 6
Des Moines	+ 3	+23	+16
Other Iowa	*	+20	+12
Detroit	+ 1	+25	+13
Other Michigan	- 5	+12	+ 3
Milwaukee	- 1	+12	+ 6
Other Wisconsin	*	+19	+10

*Less than .5 percent.
SOURCE: FSLIC

Total consumer-type deposits rose only 2 percent at the large banks in the year ending October 31, and provided 7 percent of the overall time deposit growth. In Iowa and Indiana, however, they contributed 46 and 32 percent, respectively. The poorer experience in the major financial centers in part reflects the greater availability of alternative investments in those centers.

As at the smaller banks, increases in "all other" time deposits at Indiana and Illinois banks made a significant contribution to time and savings deposits there.

Savings and loans hit harder

Deposits at savings and loan associations are comparable to consumer-type time and savings deposits at banks. Despite the rate edge S&Ls hold over commercial banks, S&Ls in most district areas suffered substantial net outflows for several consecutive months of 1974 after good gains in the first quarter. For the year ending last October, insured savings and loan associations in the five Seventh Federal Reserve District states reported a net savings gain of 6 percent compared to increases of 10 percent and 15 percent in the two previous 12-month periods.

All of the S&L growth was in accounts paying more than the regular passbook rate. Savings in the higher rate accounts rose 14 percent. But outstandings in the regular passbook accounts declined 2 percent, in contrast with the 5 percent commercial bank gain. These comparisons suggest that S&L savers are somewhat more interest-sensitive than bank customers.

Eleanor Erdevig

Interest-bearing deposits of individuals, partnerships, and corporations in denominations of less than $100,000 at Seventh District member banks

	Total weighted average rate[2] October 31		October 31, 1974			
			Savings		Certificates and open accounts	
SMSA[1]	1973	1974	Amounts outstanding	Change from year ago	Amounts outstanding	Change from year ago
	(percent)		*(millions)*	*(percent)*	*(millions)*	*(percent)*
Illinois						
Bloomington	5.39	5.57	36	+14.1	35	+15.8
Champaign-Urbana	5.55	5.67	51	+14.4	65	+21.1
Chicago	5.36	5.43	5,120	+ 1.8	3,333	+ 2.0
Rock Island-Moline	5.29	5.66	133	+ 9.9	204	+ 5.6
Decatur	5.44	5.58	57	+ 6.2	86	+ 3.9
Peoria	5.29	5.44	146	+ 2.1	114	+10.9
Rockford	5.48	5.57	168	+ 4.2	152	+ 3.4
Springfield	5.53	5.64	126	+ 7.5	157	+ 8.0
Other	5.47	5.61	551	+13.0	933	+10.1
State total	5.38	5.47	6,388	+ 3.2	5,079	+ 4.3
Indiana						
Fort Wayne	5.45	5.55	214	+ 8.0	213	+ 8.3
Gary-Hammond	4.87	5.25	270	+31.1	234	-12.4
Indianapolis	5.41	5.58	473	+ 3.3	754	+ 9.2
South Bend	5.42	5.58	142	+11.6	151	+11.6
Terre Haute	5.36	5.54	87	+23.9	69	+16.0
Other	5.36	5.64	500	+ 9.8	940	+13.6
State total	5.33	5.56	1,686	+11.3	2,361	+ 8.4
Iowa						
Cedar Rapids	5.13	5.69	54	+21.7	66	+ 7.2
Des Moines	5.52	5.66	157	+11.4	154	- .6
Dubuque	5.50	5.79	51	+12.2	66	+ 6.1
Sioux City	5.58	5.72	68	+13.9	85	+18.3
Waterloo	5.56	5.67	41	+16.9	53	+ 1.9
Other	5.54	5.71	486	+23.5	1,027	+11.6
State total	5.52	5.71	857	+19.1	1,451	+ 9.7
Michigan						
Ann Arbor	4.82	5.33	170	+ .6	105	+ 3.6
Battle Creek	4.88	5.12	44	+ 8.8	30	+ 7.2
Detroit	5.32	5.45	3,638	+ 1.9	2,955	*
Flint	4.94	5.11	433	- 1.9	184	+34.7
Grand Rapids	5.05	5.62	359	- 1.6	458	+10.6
Jackson	5.05	5.16	108	+ 5.9	65	+17.6
Kalamazoo	5.38	5.37	173	+ .4	142	+ 7.7
Lansing	4.93	5.46	484	- .5	384	- 2.5
Saginaw	5.10	5.30	106	+ 1.7	61	+ 9.6
Other	5.24	5.48	785	+ 6.9	742	+10.8
State total	5.22	5.43	6,300	+ 1.8	5,126	+ 3.7
Wisconsin						
Appleton-Oshkosh	5.55	5.66	99	+ 5.9	120	+ 3.8
Kenosha	5.25	5.42	68	+ 6.8	56	+ 9.9
Madison	5.39	5.46	35	+ 4.3	62	+ .5
Milwaukee	5.47	5.49	650	+ 4.7	442	+ 1.3
Racine	5.40	5.54	79	+ 8.0	71	- 1.6
Other	5.53	5.67	480	+11.6	734	+ 4.5
State total	5.48	5.58	1,411	+ 7.3	1,485	+ 3.2
Seventh District	**5.33**	**5.50**	**16,642**	**+ 4.5**	**15,502**	**+ 5.1**

*Less than .05 percent.

[1] "Other cities" include SMSAs in which there are less than three banks. Davenport-Rock Island-Moline SMSA data were disaggregated in order to include Davenport banks in the Iowa data.

[2] Calculated by weighting each bank's reported offering rate by the dollar amount of outstanding balances in its corresponding deposit category. If a bank did not offer a particular type of contract on October 31, any outstanding balance in that category was excluded in calculating the weighted rate.