Federal Reserve Notes

FEDERAL RESERVE BANK OF SAN FRANCISCO • APRIL 1979

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FED PROPOSES SHIFT IN RESERVE RULES

The Federal Reserve Board of Governors this month proposed adding a three-percent reserve requirement on certain types of borrowings through re-purchase agreements and Federal funds. Banks have used such borrowings increasingly in recent months to help finance the expansion of their loans and investments.

Specifically, the new reserve would apply to repurchase agreements on U.S. Government and Federal agency securities made by member banks or Edge (foreign lending) corporations with any lenders except those whose deposits are subject to the Fed's reserve requirements — and, with the same exceptions, to Federal funds borrowed from any eligible lender. Member-bank borrowings from the U.S. government, principally in the form of Treasury tax-and-loan account note balances, also would become subject to the new reserve requirement, being treated as a new category of time deposit.

A repurchase agreement (RP) involves the simultaneous sale and agreement to repurchase a financial asset at a specified price. Federal funds historically represented excess reserves lent by member banks to each other on an overnight basis, but they now include certain commercial-bank borrowings from a specified group of financial institutions and Federal agencies. Under the Board's proposal, all RPs and Federal-funds borrowings would be subject to reserve requirements except borrowings from a member bank, a U.S. branch or agency of a foreign bank, or an Edge corporation.

According to Fed statistics, about 20 percent of the past six months' growth in commercial-bank credit was financed from repurchase agreements and Federal-funds transactions. Since the beginning of the current business expansion in March 1975, borrowings of this kind have almost tripled in amount, reaching $65 billion at the end of March 1979.

NEW DEVELOPMENTS ON HOUSEHOLD DEPOSITS

Household depositors and financial institutions will be affected significantly by a regulatory ruling and a major court decision announced this month. First, the Federal Reserve and other financial-regulatory agencies released a set of proposals designed to help individuals obtain a higher rate of return on their savings. On the other hand, a Federal appeals court in Washington ruled — in a decision effective January 1, 1980 — that Federal laws don't permit certain new financial practices, such as the automatic transfer of funds between bank savings and checking accounts.

The move toward higher deposit rates was initiated last October, when several senior citizens' groups presented a petition for higher rates to the Federal Reserve Bank of San Francisco. The petition was forwarded to the Board of Governors for action, and after review by that body and other regulatory agencies, the agencies released the proposals for public comment.

The proposals would create 1) a five-year time deposit whose maximum interest rate would be based on, but be below, the rate on U. S. Treasury securities of similar maturity; 2) a bonus savings account that would pay an extra one-half percent on the minimum balance held in the account over a designated twelve-month period; and 3) a rising-rate certificate featuring an interest rate that increases during the term of the certificate.

In addition, the proposals would reduce (from $1,000 to $500) minimum amount requirements applicable to existing categories of long-term deposits (four years or more), and would eliminate all minimum-deposit requirements on savings-and-loan certificates of less than four-years' maturity. The minimum would remain at $10,000 for money-market certificates, whose high rates (tied to the Treasury bill rate) have made them very popular since their inception in mid-1978.

These proposed actions would not change the ceiling rates currently in effect for existing categories of time deposits. Accordingly, the present ceiling rate on IRA and Keogh retirement accounts (with maturities of three years or more) and on government time deposits would remain at 8 percent. However, member banks would be permitted to offer the ceiling rates applicable to the two new time-deposit instruments to governmental units and to IRA and Keogh depositors so long as the maturity,

(Continued on page 4)

SUMMARY OF KEY FED DEVELOPMENTS

MONEY ORDER SALES

The Board of Governors announced permission for bank holding companies to sell money orders, travelers checks and U.S. savings bonds to the public at their nonbank offices. The ruling, which came in the form of an amendment to Federal Reserve Regulation Y, fixed a maximum face value of $1,000 on all such money-order sales... In a related action, the Board approved an application by Citicorp (New York) to utilize a Utah subsidiary to sell money orders, travelers checks and U.S. savings bonds, and to provide consumer-oriented financial-management courses. The subsidiary, Citicorp Person-to-Person Financial Centers, maintains eight offices in Utah.

CRA QUESTIONS AND ANSWERS

The four Federal regulatory agencies responsible for enforcing the Community Reinvestment Act (CRA) have issued two staff papers to answer inquiries which have been frequently asked about the act and its implementing regulations. The first set of questions and answers provides staff guidance on the subjects of community delineation, contents of CRA statements, CRA public notices, and maintenance of files of public comments and recent CRA statements. The second set provides staff guidance on assessment of institutions' records of performance, agency encouragement of institutions under CRA, available sanctions, and the impact of CRA on holding companies and their affiliates. For further information, call the Consumer Affairs Unit of the Federal Reserve Bank of San Francisco, at (415) 544-2224.

CLASSIFICATION OF DELINQUENT DEBT

The Board of Governors issued a proposed plan to standardize industry classification of delinquent consumer-instalment loans, including bank card, check credit and overdraft credit. The new plan is a revision of an earlier plan which incurred industry criticism when implemented briefly last year... Under the new plan, most outstanding consumer instalment loans that are delinquent for more than 120 days (or five monthly payments) would be classified as losses "unless a recent record of regular contractual payments is evident." Loans would be classified as "substandard" in this situation if there is a record of such payments, or if loans are past due for 60 to 120 days (or three to four monthly payments). Under the current practice, most banks charge off delinquent loans which are more than 90 days past due.

LOANS TO BANK OFFICIALS

The Board of Governors issued a final regulation implementing the new Section 22(h) of the Federal Reserve Act, as part of Title I of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA). Section 22(h) establishes four requirements for loans by member banks to bank officials or their related interests: 1) an aggregate lending limit of 10 percent of the bank's capital and surplus on loans (subject to certain exceptions) to any of its executive officers or principal shareholders and their related interests; 2) prohibition of payment by the bank of an overdraft by an executive officer or director; 3) a requirement that every extension of credit by the bank to a bank official or to a related interest be made on substantially the same terms as those prevailing at the time for comparable transactions with other persons not associated with the bank, and not involve more than the normal risk of repayment; and 4) a requirement that every extension of credit by the bank to a bank official or any related interest that would exceed $25,000 in the aggregate be approved in advance by a majority of the bank's entire board of directors, with the interested party abstaining.

EFT CARD LIABILITY

The Board of Governors approved regulations to limit a consumer's liability for unauthorized use of electronic fund-transfer cards (EFT cards) and to set consumer-protection conditions for their unsolicited distribution. The new regulations were developed to implement several provisions of the new Electronic Fund Transfer Act. Before the effective date of the legislation (February 8), there were no limits on distribution of cards, and liability for unauthorized use was determined only by contract if at all. However, as of February 8, 1979, financial institutions must follow certain procedures when distributing cards. For example, the distribution of unsolicited cards must be accompanied by certain disclosures, such as a consumer's liability for unauthorized transfers, how to report the loss or theft of a card, and the institution's business days. While these disclosures are required only in certain instances, the regulation's liability provisions for unauthorized use are applicable to all cardholders, regardless of whether a card was issued prior to or after February 8, 1979, if the card falls under the definition of "accepted access device" and the financial institution has provided a means of identifying the consumer to whom the card was issued. In addition, the Federal Reserve Board has issued for comment a proposal which would require financial institutions to inform all consumers now holding cards of their potential liability and of the need for prompt reporting.

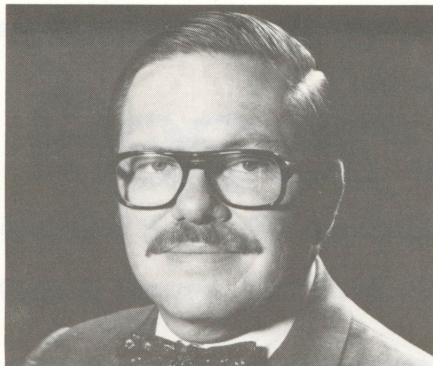
PARTEE DISCUSSES DEPOSIT RATE PROPOSALS

Federal Reserve Governor J. Charles Partee, in Congressional testimony last month, placed the Fed's new deposit-rate proposals in the context of several factors that have existed since 1966, when Congress instructed the Federal financial-regulatory agencies to establish a coordinated set of deposit-rate ceilings. In his view, the regulatory agencies have been forced throughout this period to balance a number of conflicting goals — equity for the small saver, adequacy of mortgage credit flows, competitive balance among depositary institutions, and the financial strength and viability of many of those institutions.

Partee noted that thrift institutions are faced with constraints on the kinds of assets they hold, and thus remain unable to pay market-oriented rates of return on all deposit liabilities during periods of high interest rates. He added, "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.

Partee argued that commercial-bank earnings generally have not been a limiting factor in regulators' decisions to set maximum rates payable on deposits, because of the broader asset mix available to banks than to their thrift-institution competitors. Thus, in setting the initial schedule of deposit-rate ceilings, the regulatory agencies tried to determine the maximum rates that thrift institutions could afford to pay, given their portfolio returns. This set the thrift-institution ceilings. The maximum rates payable by commercial banks then were established at levels up to one percentage point below the thrift-deposit ceilings.

The regulatory agencies in this way intended to give savings-and-loan associations and mutual savings banks a premium or differential to help offset their competitive disad-



J. C. Partee

vantage in relation to commercial banks. That disadvantage resulted, in part, from the thrifts' inability to offer a full range of deposit and lending services to their customers, who were predominantly in the consumer sector. The argument for the differential, of course, has weakened as the thrifts began to assume bank-type lending and deposit powers.

Partee noted that regulatory ceilings have changed over the years, either through increased ceiling rates on existing account categories, or through the introduction of new deposit instruments — primarily the latter. The introduction of successively longer-term certificates dramatically changed the maturity structure of thrift-institution deposit liabilities. When rate ceilings went into effect in 1966, 85 to 90 percent of thrift deposits were in passbook form, but by mid-1978, that proportion had declined to only one-third to one-half of total deposits.

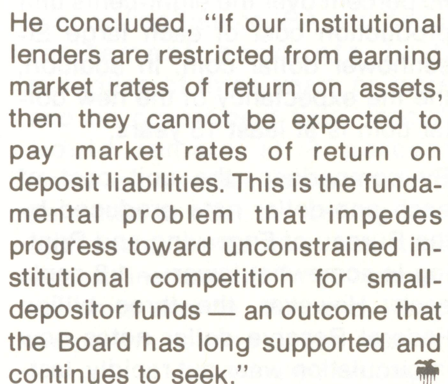
This maturity lengthening has been welcome, he said, since the thrifts hold predominantly long-term assets. Also, substantial early-withdrawal penalties have helped ensure the stability of these longer-term deposits in subsequent periods of rising rates, blunting potential disintermediation.

But he continued, "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." Thrift-institution earnings are being squeezed today by their effort to compete for funds in a period of high interest rates. Even though the average return on thrifts' mortgage portfolios 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.

Partee said that the Federal Reserve could take action on its own to create an attractive instrument for member banks to offer to the small saver, but "we are aware that such unilateral action would risk shifts of funds from thrift institutions, thereby threatening the flow of mortgage credit." He added that 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."

Partee said that Congress should authorize nationwide variable-rate mortgages, with provisions to assure the protection of consumer interests, so that thrift and other institutions could build up asset portfolios providing earnings more flexibly attuned to market developments. He also said that Congress should consider exempting Federally insured depositary institutions from state usury ceilings on residential mortgage rates, especially considering that usury ceilings today are below free-market mortgage yields in 14 states.

He concluded, "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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MINT DIRECTOR SHOWS DOLLAR COIN

Stella B. Hackel, Director of the Mint, visited San Francisco this month to demonstrate the advantages of the Anthony dollar coin before a convention of the National Automatic Merchandising Association. She said that production of the new dollar had reached the 260-million level, and added that roughly 500 million would be available when the coin is released to the public on July 2. For this particular audience, she noted that the new coin is "the most slug- and counterfeit-proof coin in the world."

The Mint Director pointed out that production of the new coin means cost savings for both the Treasury Department and the Federal Reserve. The cost of each of the smaller, new dollar coins is about three cents — a saving of more than 60 percent over the eight-cents unit production cost of each large Eisenhower dollar coin. In addition, the life expectancy of the new dollar coin is at least 15 years.

By comparison, the unit cost of each one-dollar note produced by the Bureau of Engraving and Printing is somewhat lower — 1.8 cents each. However, the three billion Federal Reserve dollar notes now in circulation wear out rapidly, lasting only about 18 months each. At minimum, the new coin has a tenfold service-life advantage over the paper note. Therefore, each coin saves over 80 percent of the production costs for those notes displaced.

Ms. Hackel said that the new dollar coin is larger than a quarter and much smaller than the half-dollar coin. Its surface is a 75-percent-copper and 25-percent-nickel alloy bonded to a 100-percent-copper core. This copper-nickel 'clad' is the characteristic of all U.S. coins now being produced with a value of 10 cents or more.

The Susan B. Anthony face ('obverse') surface of the new coin shows a profile of the woman whose pioneering efforts to gain women the right to vote helped bring about the ratification of the 19th Amendment to the Constitution in 1920. The opposite ('reverse') surface pictures the symbolic eagle of Apollo 11 moon landing. This design originally appeared on the larger Eisenhower dollar coin to commemorate the first U.S. landing on the moon's surface. The new dollar is being minted at the San Francisco, Denver and Philadelphia Mints, and each coin carries the appropriate mintmark designation of S, D or P.

HOUSEHOLD DEPOSITS

(Continued from pg. 1)

minimum amount and other requirements of the new instruments were met.

In the U.S. Court of Appeals decision, the panel said that recent experiments in automatic transfer (ATS) accounts and various thrift-institution innovations are not permitted by existing Federal statutes. Because of various regulatory decisions, banks now offer automatic fund transfers between savings and checking accounts, savings-and-loan associations operate remote service units in shopping centers and other locations, and credit unions permit their customers to write check-like share drafts on their savings accounts.

As a result, the panel said, "three separate and distinct types of financial institutions" created by Congress to serve separate needs now are offering "virtually identical services to the public, all without the benefit of Congressional consideration and statutory enactment." But the court recognized that an immediate shut-down of these services would "necessarily have a deleterious impact on the financial community as a whole," so it delayed its order until next January in the expectation that Congress will adopt new legislation to solve the problem.