Research Department
Federal Reserve
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San Francisco

July 9, 1976

Again, Reg Q

Carol Greenwald, Massachusetts Commissioner of Banks, has recently spearheaded efforts by regional bank supervisors to dilute the impact of deposit interest-rate ceilings at New England depository institutions. According to her plan, regulatory authorities would gradually raise Regulation Q ceilings upon deposit interest rates, by one-half percentage point every six months, until the ceiling became effectively a dead letter.

The Greenwald proposal stems in part from a view that Reg Q is in itself undesirable, and in part from a situation peculiar to New England. Through the issuance of NOW accounts, which are essentially interest-bearing demand deposits, Massachusetts and New Hampshire thrift institutions have moved toward parity in banking services with commercial banks while maintaining a deposit interest advantage. Lifting Reg Q ceilings therefore would place the banks on a more even basis vis-a-vis the thrifts.

Opposition to Reg Q

Actually, the removal of Regulation Q—the Federal Reserve regulation governing rate ceilings—is not a completely new idea. Two recent governmental studies of U.S. financial markets—the Hunt Commission study of 1971 and the FINE study of 1975—have recommended the removal of Reg Q ceilings. Moreover, most economists have opposed these ceilings since their very inception. The basic criticisms revolve around:

- Disintermediation: Reg Q creates a tendency for thirft-institution deposits to flow into other forms not subject to rate ceilings, such as Treasury bills, during periods of rising market interest rates.

- Inequity: Reg Q restrictions primarily affect savers with limited alternatives (primarily low-income individuals) giving them a lower rate of return on their deposits than more affluent individuals can obtain from other forms of saving.

- Obsolescence: Interest-rate controls eventually fail, because such restrictions give financiers an incentive to innovate with new money-market instruments, which inevitably lessen the impact of Reg Q as time goes on.

Despite these objections, Reg Q still persists. A brief examination of its history helps explain why the regulation has remained so surprisingly strong.

Role of ceilings

Commercial banks have operated with ceilings on deposit interest rates since the Banking Act of 1933. These ceilings were designed initially to protect the soundness of the banking system during the difficult depression era, by reducing banks' incentive to make loans at higher rates but also greater risks.

Today, however, the primary role of ceilings is to provide a healthy flow of funds to the housing market, through the mechanism of a lower

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ceiling on bank deposits than on similar savings deposits in S&L's and mutual savings banks. This rate differential provides savers with the inducement to place their funds in the mortgage-oriented thrifts rather than in the banking system. Since S&L's and mutuals are primarily mortgage lenders, the protection of their deposit liabilities from competition with banks should in principle increase the availability of money for the purpose of financing the housing industry.

However, Reg Q has turned out to be a somewhat faulty means of insuring the availability of mortgage money. Its failure is linked to the maturity structure of the portfolios of savings institutions. The mortgage *assets* of savings institutions are long-term and still, for the most part, fixed-rate contracts. The income from a mortgage portfolio is therefore not sensitive to movements in the level of interest rates. Thrift *liabilities*, on the other hand, are time-and-savings deposits which are generally subject to withdrawal at any time. In a situation without ceilings, thrift deposit rates would have to move up and down in step with unregulated market interest rates if institutions wanted to prevent withdrawals. Consequently, the thrifts' income is largely unaffected by the ups and downs of interest rates, but their money costs are greatly affected by such gyrations.

Impact of rising rates

Under these circumstances, the viability of thrift institutions does not create concern when interest rates are falling. In periods of declining rates, the stable income of S&L's enables them to bid for deposits at an attractive price. However, rising interest rates create difficulties. In that situation, the earnings flowing to the thrifts from their portfolios of old mortgage loans remain unchanged—but to secure the deposits to support these loans, they must pay higher rates to stay competitive in the market for private savings. To prevent the potentially damaging impact of a substantial rise in thrift-institution costs, Congress instituted the present system of interest-rate ceilings and rate differentials in the Interest Rate Adjustment Act of 1966.

Reg Q prevents the cost of deposits from rising too rapidly when other interest rates rise. Although this

ensures that deposit funds will not be overly expensive, it does not ensure that deposits will actually be available in volume sufficient to support a growing housing industry. For while Reg Q protects thrift institutions from the competition of banks, it does not protect them from competition from other sources which are unregulated, such as Treasury bills and money-market mutual funds.

As a result, rising interest rates lead to disintermediation, the process whereby funds flow out of savings institutions and into money-market instruments. Disintermediation has created serious liquidity problems for the thrifts during periods of rising interest rates, such as 1966, 1969, and 1973-74. The inevitable consequence is a reduction in the effectiveness of savings institutions as providers of funds for housing.

The Federal Government has tried to alleviate this problem in the past decade by providing for loans and other forms of assistance to thrift institutions. Between 1965 and 1975, the share of total residential mortgage debt held by the Federal National Mortgage Association and the Government National Mortgage Association increased from 3 percent of the total to 13 percent.

Remove Reg Q?

While Regulation Q has turned out to be a less-than-complete solution to the problem of providing sufficient funds for housing, simply removing the ceiling may not be a sufficient cure for the problem. Thus, numerous suggestions have been made for increasing the viability of the thrifts in the absence of Reg Q. The most common recommendation would permit the thrifts to diversify their asset portfolios to hold instruments other than mortgages.

While this proposal would give thrift institutions the ability to increase income along with costs in periods of rising interest rates, it would not ensure that the benefits would also flow to the housing industry, since the thrifts under this new situation would have latitude to reduce their holdings of mortgages. Given this uncertainty, many observers now advocate step-by-step solutions, such as the regional experiment proposed by Commissioner Greenwald, rather than full national deregulation of deposit rates.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 6/23/76	Change from 6/16/76	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	88,728	+ 193	+ 2,991	+ 3.49
Loans (gross, adjusted)—total	66,987	+ 102	+ 2,290	+ 3.54
Security loans	1,504	– 67	+ 464	+ 44.62
Commercial and industrial	22,392	+ 143	– 661	– 2.87
Real estate	20,061	+ 62	+ 378	+ 1.92
Consumer instalment	11,164	+ 37	+ 1,218	+ 12.25
U.S. Treasury securities	9,724	+ 283	+ 1,226	+ 14.43
Other securities	12,017	– 192	– 525	– 4.19
Deposits (less cash items)—total*	88,168	– 859	+ 2,515	+ 2.94
Demand deposits (adjusted)	23,935	– 651	+ 709	+ 3.05
U.S. Government deposits	447	– 581	+ 1	+ 0.22
Time deposits—total*	62,420	+ 635	+ 1,835	+ 3.03
States and political subdivisions	6,235	– 44	– 703	– 10.13
Savings deposits	25,841	– 25	+ 5,445	+ 26.70
Other time deposits‡	27,968	+ 629	– 1,521	– 5.16
Large negotiable CD's	12,712	+ 594	– 3,306	– 20.64

Weekly Averages of Daily Figures	Week ended 6/23/76	Week ended 6/16/76	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	8	76	55
Borrowings	20	0	0
Net free(+)/Net borrowed (–)	– 12	+ 76	+ 55
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales (–)	+ 370	+ 707	+ 1,476
Transactions of U.S. security dealers			
Net loans (+)/Net borrowings (–)	+ 176	+ 401	+ 490

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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