Research Department
Federal Reserve
Bank of
San Francisco

July 7, 1978

FRBSF Weekly Letter

# Certificates

In line with a recent ruling of the Federal Reserve and other regulatory agencies, banks and thrift institutions last month began offering two new types of higher-yielding time deposits — a short-term (six-month) and a long-term (eight-year) certificate. The short-term certificate is especially interesting because its interest rate is tied to a non-regulated market rate — the going rate on six-month Treasury bills. Commercial banks may issue them (in minimum denominations of $10,000) at a rate equal to the six-month T-bill discount rate at time of issue, while the thrifts may pay one-quarter percentage point more. Both may compound on a daily basis, although the rate remains fixed over the six-month term.

The new short-term certificate provides a new twist to Regulation Q, which governs ceiling rates on savings deposits in denominations less than $100,000. With Reg Q, each type of savings certificate has a characteristic interest-rate ceiling which varies according to the size of deposit and the maturity of the certificate — but which in every other case remains constant over time, uninfluenced by shifting market rates.

The existence of interest-rate ceilings permits the phenomenon known as disintermediation — the breakdown of depository institutions' intermediating role between individual savers and final borrowers. When market rates, such as the Treasury-bill rate, rise above Reg Q rates, those depositors with the necessary $10,000 minimum will tend to withdraw their money to buy Treasury bills or similar instruments. As a result, depository institutions will lose deposits, which forces them either to bid against one another for expensive certificates of deposit or to curtail their mortgage and other lending at the worst possible time for their customers. In what follows, we consider how the new certificates may help these institutions cope with such problems.

**Intermediaries**

Regulation Q creates problems for intermediaries — the banks and thrifts — and for borrowers and depositors who use their services. Depository institutions traditionally have supported Reg Q on the ground that it protects them from the adverse effects of competition for the savings dollar. They claim that without such rate ceilings, interest rates on savings deposits would be bid up and net earnings would be reduced. For the banks, low net earnings would in turn reduce the value of their capital — and this in their view would be bad, because bank capital is a form of insurance, a cushion against the risk of failure.

However, during past periods of disintermediation, Reg Q ceilings sometimes seemed to reduce rather than increase net earnings. This is because there is no ceiling on the interest rates paid by borrowers — such as the U.S. Treasury — who compete with banks and thrifts for household deposits. As a result, whenever market rates rise above Reg Q rate ceilings, these

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borrowers bid away deposits from the depository institutions, leaving them with two unattractive options: find more expensive sources of funds or dramatically curtail lending activity. In their search for funds, banks have frequently purchased large ($100,000 and over) certificates of deposit, which have not been subject to Reg Q ceilings since 1973. The high cost of these funds thus has affected net earnings.

The thrifts, who aren't able to participate as actively as banks in the credit markets, during periods of disintermediation have relied instead on assistance from the Federal Home Loan Bank System. With its high credit standing, the System is able to borrow in credit markets in order to lend to thrifts some of the money they lose through disintermediation.

For banks and thrifts, therefore, the new certificates help solve the disintermediation problem. The certificates do not force these intermediaries to compete with one another, since the yield remains regulated—and they help the intermediaries to compete with unregulated borrowers in the money market, since they carry a market yield. Furthermore, the minimum denomination of $10,000—the same minimum required for Treasury-bill purchases—makes it possible for depository institutions to limit their higher interest payments to those customers who might desert them in periods of disintermediation.

The new certificates should be more beneficial to the thrifts than the banks, in view of the higher rate which the thrifts can pay on them. They believe this is an equitable solution, however, because they suffer more than the banks from disintermediation, as a consequence of their greater reliance on volatile savings funds.

**Small savers**

Reg Q rate ceilings prevent the rates paid by banks and thrifts from achieving levels that would occur in a competitive environment. In this situation, then, small savers receive a lower rate of return than they would earn in a competitive environment.

Defenders of rate ceilings, such as thrift-industry spokesmen, contend that the money they save by paying less than the market price for deposit liabilities is partly "passed along" in the form of cheaper mortgages to prospective homeowners. However, the people who benefit from lower-priced mortgages are not necessarily the same people as the ones who are underpaid on their savings. Indeed, according to some studies, the average real-estate borrower has a higher income than the average person who holds his savings predominantly in depository form. Furthermore, it could be argued that Reg Q on occasion leads to higher mortgage rates rather than lower, because mortgage rates would have to be increased to ration the scarce mortgage money resulting from disintermediation.

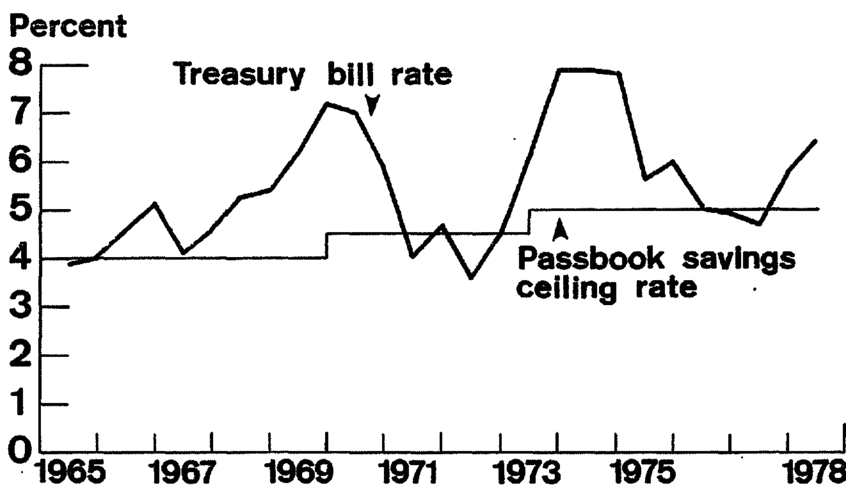
Would the availability of the new money-market certificates compensate for this type of inequity? Perhaps not, because the $10,000 minimum-purchase requirement would limit sales to the same people who have already had the option of obtaining market rates by buying Treasury bills. Large savers would benefit from being offered a choice between the new certificate rate and the T-bill rate. Small savers would not have this option, and thus would benefit only to the extent that better financial health is achieved by the institutions which hold their deposits.

**Large savers**

In view of the way the new certificates were designed, we might expect that sophisticated investors would keep their funds in banks and thrift institutions, while unsophisticated investors would retain their funds in deposits subject to traditional ceiling rates. In practice, however, individual saving behavior may not be quite so clear-cut.

Because of the widespread publicity given to the new certificates, anyone with the necessary $10,000 – no matter how unsophisticated – is likely to shift his savings into this form in order to obtain the higher return. More sophisticated savers may be influenced by the fact that the income from these certificates, unlike the income from Treasury bills, is subject to state and local income taxes. Those individuals might still be tempted to shift their funds out of depository institutions and into T-bills whenever market interest rates rise above thrift-institution rates. Substantial disintermediation may not result, however, because the new certificates still permit a dramatic reduction in the spread between T-bill market yields and after-tax deposit rates.

**Kurt Dew**




Source: U.S. Treasury Department, Federal Reserve Board of Governors.



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## BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

| Selected Assets and Liabilities Large Commercial Banks | Amount Outstanding 6/21/78 | Change from 6/14/78 | Change from year ago Dollars | Change from year ago Percent |
|---|---|---|---|---|
| Loans (gross, adjusted) and investments* | 112,780 | − 946 | + 14,274 | + 14.49 |
| Loans (gross, adjusted)—total | 90,255 | − 1,179 | + 15,160 | + 20.19 |
| Security loans | 1,859 | − 1,251 | − 45 | − 2.36 |
| Commercial and industrial | 27,815 | + 207 | + 3,998 | + 16.79 |
| Real estate | 30,575 | + 239 | + 6,469 | + 26.84 |
| Consumer instalment | 16,137 | + 101 | + 3,425 | + 26.94 |
| U.S. Treasury securities | 8,577 | + 398 | − 1,339 | − 13.50 |
| Other securities | 13,948 | − 165 | + 453 | + 3.36 |
| Deposits (less cash items)—total* | 110,096 | − 998 | + 14,190 | + 14.80 |
| Demand deposits (adjusted) | 29,885 | − 655 | + 2,902 | + 10.75 |
| U.S. Government deposits | 735 | + 323 | + 457 | + 164.39 |
| Time deposits—total* | 77,429 | − 734 | + 10,415 | + 15.54 |
| States and political subdivisions | 6,705 | − 18 | + 1,158 | + 20.88 |
| Savings deposits | 31,469 | − 14 | − 164 | − 0.52 |
| Other time deposits‡ | 36,200 | − 553 | + 8,541 | + 30.88 |
| Large negotiable CD's | 17,600 | − 723 | + 6,761 | + 62.38 |

| Weekly Averages of Daily Figures | Week ended 6/21/78 | Week ended 6/14/78 | Comparable year-ago period |
|---|---|---|---|
| **Member Bank Reserve Position** | | | |
| Excess Reserves(+)/Deficiency (−) | + 50 | − 22 | + 22 |
| Borrowings | 132 | 30 | 4 |
| Net free(+)/Net borrowed (−) | − 82 | − 52 | + 18 |
| **Federal Funds—Seven Large Banks** | | | |
| Interbank Federal fund transactions | | | |
| Net purchases (+)/Net sales(−) | + 311 | + 159 | + 83 |
| Transactions with U.S. security dealers | | | |
| Net loans (+)/Net borrowings (−) | + 170 | + 226 | + 295 |

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

**Editorial comments may be addressed to the editor (William Burke) or to the author....**
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