Research Department
Federal Reserve
Bank of
San Francisco
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What Price Saving?

April turned out to be a fickle month for household savers. At mid-month, 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. But shortly thereafter, a Federal appeals court in Washington ruled against the legality of certain practices which, in effect, permit individual savers to earn interest on their transaction accounts.

These conflicting developments reflect the difficulties created for consumers by two pieces of legislation — one in 1933 which limited the payment of interest on commercial-bank deposits, and another in 1966 which extended the concept of interest-rate ceilings to thrift institutions as well as banks. By limiting "destructive" competition for funds, Congress acted in the first case to support the stability of the banking industry, and in the second case to support the stability of the thrift industry (and by extension, the housing industry). Over time, however, these motherhood issues have conflicted with the equally valid issue of equity for the small saver.

Of course, commercial banks have long paid *implicit* interest in the form of subsidized (or free) check and deposit transactions, convenient locations and other consumer services. But with the sharp rise in market rates over the past decade and a half, consumers have tried to obtain *explicit* interest on their checking accounts, as well as market rates on their time and savings accounts. Those who had enough money and/or sophistication could invest in Treasury bills, money-market funds or other vehicles. Others were limited in what they could obtain, and this situation led groups such as the Gray Panthers (the senior citizens' lobby), to push Congress and the regulatory agencies to remove interest-rate ceilings for small savers.

Conflicting decisions

Responding to these pressures, the regulatory agencies last month issued a set of proposals that would provide for a higher rate of return on household savings. The proposals would create 1) a five-year certificate of deposit with a maximum interest rate based on (but below) the rate on U.S. Treasury securities of similar maturity; 2) a bonus savings account that would pay an extra ½ percent on the minimum balance held in the account over a twelve-month period; and 3) an eight-year certificate featuring an interest-rate ceiling that would increase over that period.

In addition, the proposals would eliminate all minimum-deposit requirements on savings-and-loan certificates of less than four years' maturity, and would reduce the minimum amount to $500 for all other certificates except the 26-week money-market certificates (MMC's). The minimum would

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remain at $10,000 for the MMC's, whose high rates (tied to the Treasury-bill rate) have attracted more than $130 billion in funds since their inception in mid-1978. Also, ceiling rates now in effect on outstanding deposits would remain unchanged.

In the U.S. Court of Appeals decision, the panel said that recent experiments in automatic transfer (ATS) accounts and various thrift-institution innovations were contrary to Federal statutes. Because of favorable regulatory rulings, 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" — not to mention individual savers. Thus it delayed the effect of its order until January 1, 1980, thereby inviting Congress (or the Supreme Court) to step in and solve the problem.

Why rate ceilings?

Federal Reserve Governor J. Charles Partee, in recent Congressional testimony, argued that the problem of rate ceilings reflected the efforts by legislators and regulators to balance several of conflicting goals — equity for the small saver, adequacy of mortgage credit flows, and the financial strength and viability of depositary institutions. He noted that thrift institutions specifically 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 high interest-rate periods.

The regulatory agencies, from 1966 on, thus intended to give savings-and-loan associations and mutual savings banks a premium or differential to help offset their competitive disadvantage in relation to commercial banks, and to help assure an adequate supply of mortgage credit. 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, however, lost much of its force as the thrifts began to assume bank-type lending and deposit powers, especially when thrifts in Northeastern states began to issue check-like NOW accounts.

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 substantially; in fact, only 30 percent of all small-denomination savings were in maturities of less than four years. This maturity lengthening can help to stabilize the thrifts' balance sheets, in view of the fact that they hold predominantly long-term assets. Also, substantial early-withdrawal penalties help to ensure the stability of these longer-term deposits in subsequent periods of rising rates, blunting potential disintermediation, or shifts of funds from the thrifts to money-market vehicles.

Nonetheless, the same set of problems prevailing in 1966 still limits the options available to the regulators to increase rates of return paid to small savers. Thrift-institution earnings again are being squeezed 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 2½ percentage points higher than in 1966, inflation-induced increases in market rates have amounted to over 3½ percentage points in short-term markets and about 4 percentage points in intermediate-term markets over the same period. And with small savers' increased awareness of alternative market instruments, the potential threat of disintermediation is even greater today than before.

Towards solutions

Partee argued that when inflationary pressures moderate, and market interests 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." In his view, Congress should authorize nationwide variable-rate mortgages, with appropriate consumer safeguards, so that thrift and other instutions could build up asset portfolios providing earnings more flexibly attuned to market developments. Again, 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.

Going beyond Partee's recommendations, the situation might seem to call for continued movement in the direction of "unbundling" — that is, the explicit pricing of each charge and each service by depositary institutions at market prices. Corporations and governmental units, through sophisticated cash-management practices, have moved in this direction for some time, willingly paying market rates for services in exchange for receiving market rates of return on all balances they hold. Household savers, on grounds of equity, are now demanding the same treatment — that is, the effective repeal of the long-standing restrictions on deposit-interest payments. Otherwise, they seem to say that they too will shift their funds out of depositary institutions and into market instruments.

William Burke

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 4/18/79	Change from 4/11/79	Change from year ago @ Dollar	Percent
Loans (gross, adjusted) and investments*	124,512	752	+ 17,653	+ 16.52
Loans (gross, adjusted) — total#	101,487	457	+ 16,494	+ 19.41
Commercial and industrial	29,945	72	+ 3,704	+ 14.12
Real estate	36,159	147	+ 7,639	+ 26.78
Loans to individuals	21,025	142	NA	NA
Securities loans	1,593	22	NA	NA
U.S. Treasury securities*	8,024	32	+ 283	+ 3.66
Other securities*	15,001	263	+ 896	+ 6.35
Demand deposits — total#	43,865	182	+ 11,043	+ 33.65
Demand deposits — adjusted	32,027	123	+ 2,197	+ 7.37
Savings deposits — total	29,811	− 320	− 462	− 1.53
Time deposits — total#	49,393	− 448	+ 7,836	+ 18.86
Individuals, part. & corp.	40,105	− 465	+ 7,906	+ 24.55
(Large negotiable CD's)	17,064	− 498	+ 2,593	+ 17.92

Weekly Averages of Daily Figures	Week ended 4/18/79	Week ended 4/11/79	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	− 11	49	72
Borrowings	46	11	11
Net free reserves (+)/Net borrowed(−)	− 57	38	61
Federal Funds — Seven Large Banks			
Net interbank transactions [Purchases (+)/Sales (−)]	+ 2,441	+ 2,701	+ 2,268
Net, U.S. Securities dealer transactions [Loans (+)/Borrowings (−)]	+ 819	+ 737	+ 126

*** Excludes trading account securities.**

 # Includes items not shown separately.

@ Historical data are not strictly comparable due to changes in the reporting panel; however, adjustments have been applied to 1978 data to remove as much as possible the effects of the changes in coverage. In addition, for some items, historical data are not available due to definitional changes.

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