Research Department
Federal Reserve
Bank of
San Francisco

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On the Offensive

The banking and thrift industries have taken the offensive with the introduction of the Money Market Deposit Account (MMDA) and its companion account, the Super-NOW. These new accounts enable banks and thrifts to compete more effectively with money market mutual funds (MMFs). Indeed, the Garn-St. Germain Act, passed in October 1982, had required the Depository Institutions Deregulation Committee (DIDC) to authorize an instrument that was directly competitive with MMFs. Congress intended to promote competition between the depository institutions and the MMFs by providing for a ceiling-free deposit account with liquidity and limited transactions capabilities.

The public has found the MMDA to be an extremely attractive instrument since it offers the important combination of market rates, liquidity, low minimum balances and deposit insurance. Moreover, depository institutions are taking an aggressive marketing stance by offering high interest rates on the MMDA to make it their chief instrument in head-to-head competition with the MMFs.

Banks and thrifts could afford to offer higher rates to make the MMDA more attractive than the Super-NOW because the former is a limited transactions account and personal MMDAs are not subject to reserve requirements. In contrast, Super-NOW balances are treated as transactions balances subject to a 12-percent reserve requirement. In addition, the cost of servicing the limited transactions of MMDAs is less than the cost of providing unlimited checking services for the Super-NOW.

Armed with these new accounts, depository institutions have responded aggressively by developing new products and services in an effort to recapture some of the $232 billion held by taxable MMFs in mid-December, and to capture a larger portion of new funds flowing into the market. Some MMFs will continue to offer features currently not available from depository institutions, such as accounts tied to securities transactions and brokerage services, specific investments (i.e., eurodollars) which offer a higher return with more risk, or tax-exempt funds. These segments of the market will continue to remain fairly insulated from direct competition with depository institutions. The bulk of MMF balances, however, will be subject to competitive pressure from the MMDAs.

Promotional blitz

To introduce MMDAs and, to a lesser extent, Super-NOWs, depository institutions conducted a tremendous promotional blitz. Full-page advertisements and TV spots highlighted those features of the MMDAs not shared by the MMFs, including FDIC/FSLIC deposit insurance of up to $100,000 per depositor, the convenience of holding the account at a "full service" institution, and access to funds via automated teller machines. As if these features were not enough to attract depositors, a wide variety of attractive bonuses ranging from cash to travel offers were thrown in as sweeteners.

In addition, banks and thrifts took full advantage of the ceiling-free interest rate feature of MMDAs and Super-NOWs by offering premium rates well above the market yield paid by MMFs to attract the public's attention and to overcome depositor inertia. While many institutions offered "introductory" rates in the 10- to 12-percent range for MMDAs, a few paid annual rates of 20 percent or more. Institutions competed against each other with these premium rates in an attempt to capture a larger share of the market. As expected, the introductory premiums have declined recently, and MMDA rates have moved into closer alignment with short-term market rates, settling slightly above MMF yields.

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Balance sheets restructured

As of early April, the MMDA had drawn more than $333 billion, perhaps $70 billion of which came from outside the banking system (perhaps $40 billion from MMFs and the rest from instruments such as Treasury bills). In fact, the MMDA has had the most rapid growth of any of the consumer deposit instruments ever authorized. Its growth has been even more dramatic than that experienced by the MMFs during 1980 and 1981. In contrast, the lower rates paid on Super-NOWs and the decision by many banks to "soft-pedal" the account have resulted in its much slower growth. At the end of March, Super-NOWs had grown to about $28 billion, and attracted only a small percentage of new deposits.

Although the taxable MMFs have lost over $50 billion since these accounts were introduced, depository institutions have been drawing money primarily from their existing deposit bases—consumers and businesses with small-denomination time deposits and passbook savings accounts. Furthermore, commercial banks reported sizable reductions in large time deposits outstanding as some large certificates of deposit (CDs over $100,000) were converted into MMDAs and as the inflow of funds into the MMDAs allowed institutions to reduce their need to issue large CDs.

...But at what cost?

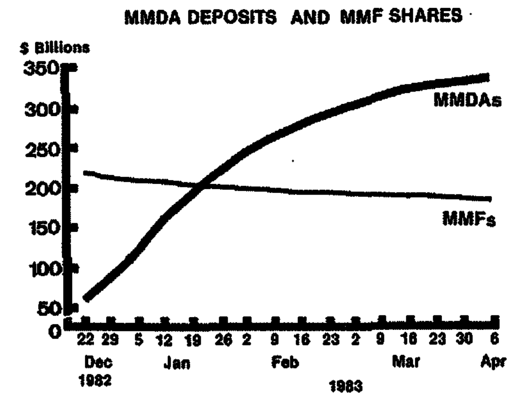
The popularity of the MMDA has not been without cost. Earnings at depository institutions will be affected adversely by the conversion of lower cost liabilities into MMDAs and Super-NOWs. (While the majority of the internal funds converted into MMDAs was already paying market rates, most of the money flowing into Super-NOWs has come from low-yielding checking and NOW accounts.) In addition, earnings will suffer temporarily because of the introductory marketing costs and premiums paid to attract funds into the new accounts.

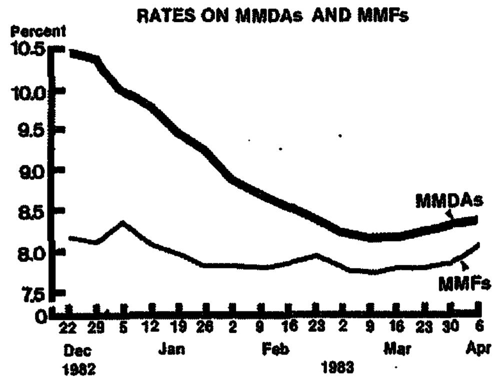
To minimize the negative impact of MMDAs and Super-NOWs on earnings, depository institutions are developing more sophisticated fee schedules. Some institutions have raised service charges and fees to offset the costs of providing checking services with these accounts. Others pay different interest rates depending on the size of balances, or scale service charges according to the balance held in the account in order to segment deposits by fee and rate sensitivity.

Banks and thrifts also face several potentially costly risks associated with their increasing reliance on these short-term variable-rate liabilities. First, the popularity of the new accounts has reduced the effective maturity and thus increased the sensitivity of the cost of bank liabilities to interest rate movements. This development could weigh heavily on the sensitivity of an institution's profits to changes in short-term interest rates, unless other asset adjustments are made. Second, the liquid nature of these deposits increases the possibility of "rate wars" breaking out among competing institutions. Thus, those institutions relying on the MMDA and Super-NOW as potential core deposits are linking a wide variety of banking services to the accounts to prevent their loss to institutions offering higher yields.

The future?

What are the prospects for the MMFs and the depository institutions offering the MMDAs and Super-NOWs? First, it is unlikely that the MMF industry will disappear. Existing regulations allow them to collect funds nationwide, to provide unique services (especially in brokerage-related products), to tailor their risk-return mix and tax status to specific investors' preferences, and to allow unlimited numbers of checks without the imposition of reserve requirements. By differentiating their product, perhaps some MMFs can limit competition with depository institutions. Those MMFs that try to compete will likely offer improved payments services and/or private insurance as important selling points. Moreover, MMFs will have incentives to reduce operating costs and fees to boost the net yields offered.





For depository institutions, the prospects are bright. MMDAs have opened an important market in which deposit insurance and differential reserve requirements on various categories of deposits will give them important advantages over the money market funds.

Deposit insurance on the new accounts is the key feature for small institutions with limited access to the national money markets. In the pre-MMDA world, these institutions had difficulty obtaining funds at the "best" bank rates because of their small size and restricted local markets. When they were able to tap the national markets for uninsured purchased funds (large CDs, primarily), they typically paid a significant risk premium to do so.

The MMDA has generated net inflows at most institutions sufficient to reduce their need for purchased funds. In addition, since the fees these banks and thrifts pay for deposit insurance are typically lower than the risk premia they would have had to pay to obtain funds in the national markets, the MMDA has significantly lowered the marginal cost of funds for smaller institutions. For many, the cost of obtaining funds through the MMDA is so much lower than that of obtaining funds on the open market that they should be able to offer higher yields than the MMFs and still find that their marginal cost for MMDAs is below their marginal cost for open market borrowings.

Institutions (typically larger banks) that already had access to the national markets for purchased funds at the "best" bank rate have found that reserve requirement differentials, rather than deposit insurance, provide them with a major competitive advantage over the MMFs. MMDA deposits in personal accounts do not carry a reserve requirement, while large CDs purchased from depository institutions by MMFs and other non-personal investors have a three-percent reserve requirement. At present, the higher reserve requirement on CDs lowers the rate depository institutions would otherwise be willing to pay by 20 to 30 basis points. The MMFs receive a lower return on these assets, and, because they currently hold nearly 18 percent of their assets in CDs, the reduced return forces them to pay a lower yield to their shareholders. (Of course, not all MMFs will be affected to the same extent because their portfolios vary widely.)

Over time, a number of other factors will also come into play in determining the ability of banks' and thrifts' to offer competitive rates on MMDAs. General movements in short-term interest rates, which determine MMF yields with a lag, and their ability to manage their portfolios, as well as their ability to offer attractive services at a cost that is competitive with MMFs' costs, could very well determine the extent to which depository institutions are able to lure funds away from MMFs.

In the long-run, these qualifications could offset the advantages arising from deposit insurance and differential reserves. Nevertheless, depository institutions are currently making the most of their ability to determine their own rates on MMDAs and of the other advantages they have to outbid the MMFs in the battle for liquid, market-return core deposits.

Conclusion

Depository institutions will continue to press the advantages they have gained with the new instruments. To date, both large and small banks have been able to outbid the MMFs, and thus, to attract billions. The MMDA has indeed proven to be "directly competitive" with a money fund account. Depository institutions should continue to dominate the market and turn a profit now that they can offer these accounts and price them according to their demand for funds, investment opportunities, interest margins, and desired market share.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 4/13/83	Change from 4/6/83	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	163,867	193	5,096	3.2
Loans (gross, adjusted) — total#	142,726	97	5,235	3.8
Commercial and industrial	44,763	– 407	1,950	4.6
Real estate	57,057	– 41	30	0.1
Loans to individuals	23,518	62	248	1.1
Securities loans	3,195	1,202	1,172	57.9
U.S. Treasury securities*	8,220	41	1,878	29.6
Other securities*	12,920	56	– 2,017	– 13.5
Demand deposits — total#	41,914	–1,093	926	2.3
Demand deposits — adjusted	29,218	– 334	800	2.8
Savings deposits — total†	66,429	– 155	34,641	109.0
Time deposits — total#	67,157	366	– 23,508	– 25.9
Individuals, part. & corp.	59,964	356	– 21,256	– 26.2
(Large negotiable CD's)	20,633	174	– 12,554	– 37.8

Weekly Averages of Daily Figures	Week ended 4/13/83	Week ended 4/6/83	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	89	111	81
Borrowings	0	14	31
Net free reserves (+)/Net borrowed(–)	89	97	50

* Excludes trading account securities.
# Includes items not shown separately.
† Includes Money Market Deposit Accounts, Super-NOW accounts, and NOW accounts.

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