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# FRBSF WEEKLY LETTER

December 28, 1984

## New Limits For The New Year

The New Year will bring yet one more chapter in the ongoing saga of deposit interest rate deregulation. On January 1, 1985, the regulatory minimum balances on money market deposit accounts, Super-NOW accounts and 7- to 31-day ceiling-free time accounts will decline to \$1,000 from \$2,500. Only one year later, in 1986, all size limitations on these accounts will be removed.

The lowering of the regulatory minimums for these accounts harbors the potential for inducing shifts among financial assets that could distort the monetary aggregates, particularly M1 and M2. Depositors might choose, for example, to move funds from regular savings deposit accounts, not included in M1, to Super-NOWs, included in M1, which require lower balances. Such transfers would temporarily boost M1 growth and thereby make it more difficult to interpret the behavior of that aggregate. (There also is the question, not addressed directly in this *Letter*, of whether the greater flexibility afforded depository institutions to pay explicit interest on liquid accounts could affect the behavior of the monetary aggregates on a more lasting basis.)

Central to whether the potential for the upcoming regulatory changes to affect the monetary aggregates is of any practical importance is the vigor with which depository institutions promote the smaller accounts. Also of crucial importance is the degree to which existing regulatory size limitations have been binding constraints. This *Weekly Letter* looks at how commercial banks and thrifts are approaching the upcoming regulatory changes and whether the \$2,500 limit has significantly deterred the shifting of funds to deregulated accounts. This *Letter* ends with a discussion of some factors that might be contributing to the continued survival of fixed-ceiling accounts.

### Background

In late 1982 and early 1983, commercial banks and thrift institutions embraced the introduction of two new deregulated accounts — Money Market Deposit Accounts (MMDAs) and Super-NOWs — with great zeal. They competed aggressively for funds by offering extremely attractive interest rates, particularly on the MMDA. The period of

intense competition for the deregulated accounts, however, was relatively short-lived. For example, the average rate on MMDAs at commercial banks was above rates on short-term Treasury securities only through April 1983. From April 1983 to October of this year, the average return on MMDAs remained below short-term Treasury rates. Moreover, following the initial surge, interest rates on the liquid deregulated accounts have tended to lag behind movements in open market rates. As Chart 1 suggests, depository institutions tended to allow the gap between the rates on short-term nondeposit instruments and the rates on MMDAs, and especially Super-NOWs, to widen considerably as interest rates rose in 1984. In the latter part of 1984, interest rates on MMDAs and Super-NOWs also lagged behind the sharp decline in open market rates.

The observation that rates on MMDAs generally are below open market rates should not be surprising given the high cost of attracting and maintaining retail-type deposits. The increase in the gap between deposit and market rates when open market rates rise probably reflects some reluctance on the part of investors to incur the costs and inconvenience of transferring funds. When open market rates decline, depository institutions are slow to adjust their deposit rates downward probably out of the concern that they would jeopardize relationships with depositors that are costly to re-establish.

### Proceeding with caution

Whatever factors are determining the pricing of MMDAs and Super-NOWs, it is unlikely that the change in minimum size will do much to alter the competitive environment for commercial banks and thrifts. Depository institutions in general are not going to take bold marketing steps, such as enticing depositors to open small deregulated accounts by offering relatively high promotional rates. On the contrary, most depository institutions are approaching the lowering of the minimum average balances very cautiously.

The caution on the part of banks and thrifts is reflected in the results of a survey conducted by Trans Data Corporation (a private survey firm).

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That survey found that in the third quarter of this year, about half of the sampled institutions had not made final plans on whether to lower the size limits on either MMDAs or Super-NOWs. The same survey found that only one-third of the sampled institutions had definite plans to lower the limits. Moreover, for institutions that plan to lower the limits, fees and the tiering of interest rates, or perhaps some combination of the two, will hold down yields on the smaller accounts.

Responses to more recent inquiries of western depository institutions by the staff of the Federal Reserve Bank of San Francisco reinforce the findings of Trans Data Corporation. Some commercial banks and thrift institutions have decided to lower the minimum average sizes on both MMDAs and Super-NOWs, while others will reduce the size limit for only one of the accounts. Many depository institutions, however, are claiming a "wait-and-see" attitude.

## Sizing it up

In the absence of aggressive promotions by banks and thrifts, the extent of the shifts and the sources of the transfers to MMDAs and Super-NOWs will probably be determined by the degree to which the current limits represent meaningful barriers to savers. This does not mean that the level of promotion is independent of whether the limits are binding. In fact, the lack of vigor on the part of depository institutions in pursuing the imminent regulatory changes can be interpreted as an indication that the \$2,500 minimum balances for MMDAs and Super-NOWs have not had much impact on depositors' choices of accounts.

More direct evidence also seems to support the view that size limits have not been significant barriers. Balances in Super-NOWs, for example, generally are much higher than the current \$2,500 minimums. Data available from the Trans Data Corporation show that the median size of Super-NOWs is an estimated \$13,000.

After the introduction of Super-NOWs, the average size of regular NOW account balances fell about \$700, indicating that large regular NOWs had been an important source of the transfer of funds among the components of M1. However, with the average balance in regular NOWs at commercial banks still averaging close to \$5000—twice the current minimum for Super-NOWs—it seems clear that depositors' allocations of trans-

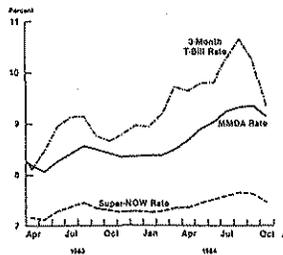
actions deposits between Super-NOWs and regular NOWs was influenced by factors other than minimum deposit requirements.

If the lower minimum average balances were to boost the amount of M1 balances the public wanted to hold, the increase would most likely come from the shifting of savings balances to Super-NOWs. Such shifts, of course, would be mitigated by the simultaneous lowering of the regulatory size limit of MMDAs. Indeed, since interest rates on smaller size personal MMDAs could be expected to be higher than those on comparable Super-NOWs (because the former are not subject to reserve requirements), it would seem at least as likely that M1 balances would be attracted to MMDAs, and thereby depress M1. In fact, the experience with the introduction of these deregulated accounts some two years ago showed that flows to Super-NOWs from outside M1 were about offset by shifts out of M1 to MMDAs.

Even without competition from MMDAs, smaller size Super-NOWs might not have much impact on savers' decisions. The \$2,500 size limit may be as meaningless a deterrent to the shifting of savings balances as it was to the shifting of transactions balances. Just prior to the introduction of the Super-NOW and MMDA, the savings component in the monetary aggregates stood at about \$360 billion. Close to \$310 billion of that total represented fixed-ceiling savings deposits. It is estimated, based on sample data, that approximately 80 percent of these fixed-ceiling deposits were in accounts with balances in excess of \$2,500. Since 1982, fixed-ceiling savings deposits have fallen by over \$60 billion. While a sizeable drop, the persistence of a considerable volume of savings balances in relatively large, fixed-ceiling accounts suggests that the regulatory size limit has not been the primary barrier preventing the remaining savings balances from shifting to Super-NOWs, or even MMDAs for that matter.

The potential of the lower size limits on the deregulated accounts for affecting M2 seems nonexistent. When MMDAs were introduced, M2 was distorted by flows from large time deposit accounts (\$100,000 or more), institution-only money market mutual funds, and other market instruments. However, these non-M2 outlets should not be affected by the lowering of the minimum size for MMDAs. Consequently, the

Chart 1  
Monthly Interest Rates



lower minimum on the MMDA should not attract a measurable amount of funds from outside M2.

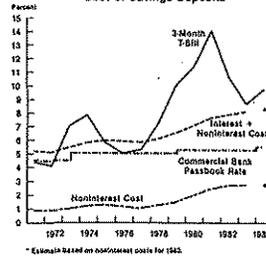
**More that meets the eye**

If account size has not been a significant barrier to the popularity of deposit accounts with market-related rates of return, how do we explain the continued survival of \$250 billion in savings, \$80 billion in personal demand deposits, and \$100 billion in other personal checking accounts excluding Super-NOWs, all of which pay zero or comparatively low fixed rates of interest? Some might argue that lack of information or inertia accounts for the failure of more depositors to shift funds to MMDAs and Super-NOWs. However, the decision of some depositors to remain in fixed-ceiling accounts may be based on other, more tangible, reasons.

One likely reason for the continued attractiveness of personal demand deposits and regular NOWs is the imposition of fees on Super-NOWs. These fees are usually waived only for larger accounts, whereas fees on regular NOWs often are waived for even modest-sized accounts.

By remaining in fixed-ceiling accounts, depositors also may accomplish more than merely avoid fees. Take savings deposit accounts, for example. Over the years, as market interest rates have risen, balances in savings deposits, of course, have declined. The balances that have remained, however, are different in nature from those that have been shifted to other accounts. In particular, the surviving savings deposits are more active on average. Annual deposit turnover rates for savings deposits have increased from 1½ to over 5 between 1977 and 1984. Since more active accounts are more expensive to maintain, institutions have moved to impose fees on smaller savings deposits. While such fees could affect a large number of accounts, they have no impact on the vast majority of deposits because they generally are waived for all but the smallest accounts. Consequently,

Chart 2  
T-Bill Rate and Cost of Savings Deposits



holders of the bulk of savings deposits have not had to cover these higher costs. For these savers, the overall return—that is, the combination of explicit and implicit interest—has risen by far more than that suggested by the fixed-rate ceilings.

Chart 2 shows estimates of the implicit interest (noninterest expenses less fees as a percent of savings deposits) for savings deposits based on Functional Cost Analysis data. While an imperfect proxy for the implicit return on deposits, the data provide some perspective on the growing importance of implicit interest in the overall returns of savings deposits at commercial banks. As the chart suggests, the combined explicit (passbook rate) and implicit (noninterest expenses) return on savings may be what makes such holdings sufficiently attractive for some depositors. The attractiveness of implicit interest for personal deposits is understandable, even in a deregulated environment, because it is tax free.

**Conclusion**

On January 1, the regulatory minimum average balances on MMDAs, Super-NOWs, and 7- to 31-day accounts will be set at \$1,000. The lower denomination accounts will be available to depositors, but the extent of their appeal remains uncertain. Most depository institutions do not plan to promote the smaller accounts very aggressively. Moreover, it does not appear that the higher size limits have been responsible for the bulk of the funds remaining in fixed-ceiling deposit accounts.

The evidence on the effect of size limits on where depositors decide to place their funds indicates that the lower size limits will not seriously distort M1 or M2 in 1985 as a whole. To the extent that the monetary aggregates might be affected, past experience indicates that the impact would be concentrated in the first few months of next year.

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**BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT**

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount	Change	Change from 12/28/83	
	Outstanding 12/12/84	from 11/05/84	Dollar	Percent <sup>7</sup>
Loans, Leases and Investments <sup>1 2</sup>	188,103	632	12,078	7.1
Loans and Leases <sup>1 6</sup>	169,529	695	14,174	9.4
Commercial and Industrial	53,111	300	7,148	16.1
Real estate	61,643	79	2,744	4.8
Loans to Individuals	31,416	204	4,765	18.5
Leases	5,079	4	16	0.3
U.S. Treasury and Agency Securities <sup>2</sup>	11,524	— 81	— 983	— 8.1
Other Securities <sup>2</sup>	7,050	17	— 1,113	— 14.1
Total Deposits	192,358	—2,170	1,361	0.7
Demand Deposits	44,943	—2,024	— 4,294	— 9.0
Demand Deposits Adjusted <sup>3</sup>	29,434	—1,276	— 1,897	— 6.2
Other Transaction Balances <sup>4</sup>	12,668	— 397	— 107	— 0.8
Total Non-Transaction Balances <sup>6</sup>	134,748	253	5,763	4.6
Money Market Deposit Accounts—Total	40,683	177	1,086	2.8
Time Deposits in Amounts of \$100,000 or more	40,668	244	2,503	6.8
Other Liabilities for Borrowed Money <sup>5</sup>	21,661	— 639	— 1,346	— 6.0
<b>Two Week Averages of Daily Figures</b>	Period ended 12/03/84	Period ended 11/19/84		
<b>Reserve Position, All Reporting Banks</b>				
Excess Reserves (+)/Deficiency (—)	65	18		
Borrowings	51	21		
Net free reserves (+)/Net borrowed(—)	13	— 2		

<sup>1</sup> Includes loss reserves, unearned income, excludes interbank loans

<sup>2</sup> Excludes trading account securities

<sup>3</sup> Excludes U.S. government and depository institution deposits and cash items

<sup>4</sup> ATS, NOW, Super NOW and savings accounts with telephone transfers

<sup>5</sup> Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources

<sup>6</sup> Includes items not shown separately

<sup>7</sup> Annualized percent change