IS REGULATION Q STILL NEEDED?

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It is a real pleasure to take part in your Seventh Annual Bank Directors Conference, and I am especially pleased to have the opportunity to be with so many of you who constitute the managements and directorships of the commercial banking industry in the State of Kentucky. As you know, Kentucky is one of seven states which make up the Eighth Federal Reserve District, and our Federal Reserve Bank has one of its major branches here in Louisville. So it is sort of "old home week" to be here in the company of so many of our good friends and associates.

With that warm lead-in, I must admit that the subject of my remarks this afternoon might test the friendships to which I have alluded. For I am going to talk about Regulation Q which has outlived its usefulness and no longer serves a constructive purpose, either for the commercial banking community or for the consuming public in general.

I know that many of you in this audience are understandably apprehensive that the phasing out of Reg. Q would have an adverse effect on the growth and prosperity of your banks, and I am fully aware that the Kentucky Bankers Association has gone on record against the elimination of Reg. Q.

On the other hand, there is significant sentiment currently within the national Administration and within Congress to do away with interest-limiting regulations, and I think a full discussion of the pros and cons of this issue is timely.

First, exactly what is Reg. Q? Reg. Q, which has its roots in the Banking Acts of 1933 and 1935, contains two major provisions: It prohibits paying interest on demand deposits, and it sets ceilings on interest rates that may be paid on savings and time deposits. It also allows thrift institutions a quarter percent advantage over commercial banks in the interest they may pay on savings and time deposits.

Regulation Q was established in response to the Depression of the 30's, when close to one-half of the commercial banks in the United States failed. It grew out of a belief that those bank failures resulted from cutthroat competition between financial institutions in the pricing of interest paid on savings. Amendments to Reg. Q, passed in 1966 and 1975, provide for a minimum differential between interest rate ceilings of commercial banks and thrift institutions as a means of assuring an adequate supply of credit to support the residential home building industry.

Although economic conditions have changed significantly since the time when Reg. Q was first mandated, many of the arguments in support of the concept of controlling interest rate ceilings still persist. Supporters of a continuation of mandated ceilings feel that Reg. Q is necessary to prevent competition that might threaten the solvency of banks and thrift institutions. They feel that a quarter percent differential between interest rates banks may pay and those permitted thrift institutions is necessary to assure continued availability of mortgage funds. They argue that ceilings on deposit interest rates reduce the cost of acquiring loanable funds and thus ultimately protect home buyers from having to pay higher rates of interest on mortgage loans.

Still another argument in defense of Reg. Q is that its elimination would siphon savings deposits from local communities and concentrate them in larger urban centers.

And finally, there is a very real and understandable concern that the elimination of Reg. Q would force banks to pay more for savings deposits which, in turn, would threaten their profit potential.

As a former commercial banker, I sympathize with anyone who is concerned about "the bottom line," and I promise that, in dealing with this subject, I will keep in mind that most of you are in business to make a profit. So I will approach these issues on a pragmatic rather than pure theoretical basis.

Let's consider each of the arguments commonly used in support of Reg. Q. First of all, is Reg. Q really necessary to protect banks from failing? In my opinion, it is not. I would submit that the bidding up of time and savings rates through competition for loanable funds in the early 1930s was not the factor responsible for bank failures during the Great Depression. During those trying times, when the gross national product showed a 50% decline, personal income dropped by 40% and unemployment rose to 25%, the failure of nearly half of the Nation's commercial banks was not the result of high rates of interest being paid on savings accounts. The underlying cause of bank failures during the Great Depression was essentially the inability of borrowers to repay loans because of the economic collapse. Interest ceilings on savings would have had a very negligible effect in stemming the tide of bank failures in those days, and there is little justification today for continuing ceilings for the purpose of avoiding a repetition of the bank failures of the early 1930s.

A second argument used in support of Reg. Q is that the quarter percent differential between interest rates permitted banks and thrift institutions is necessary as a means of assuring an adequate supply of mortgage funds to support the housing industry. This argument is also difficult to defend. In times of inflation when Reg. Q ceiling rates are substantially below market rates, the quarter percent differential does not protect the deposit base of thrift institutions. Over the past decade, withdrawals of passbook savings from thrift institutions have been as widespread as withdrawals from commercial banks. In recent months, notwithstanding the existence of Reg. Q, outflows from thrifts have reached record levels of 11.9% compared with a decline of only 7% at banks, and fixed ceiling time deposits at thrifts have slowed just as they have at banks. So this argument does not hold water.

A third argument frequently cited in support of Reg. Q is that interest ceilings somehow hold down what borrowers ultimately have to pay for loans. This, too, is not substantiable. There is no evidence that any direct relationship exists between what financial institutions pay to attract deposits and what they charge for loans. Let's examine the facts.

In recent years, the ceiling on passbook savings has been consistently about 5%, while interest charged on prime loans has fluctuated all the way from a low of 7% to a high of 13%. Clearly, rates charged on loans fluctuated with credit market conditions irrespective of the fact that the costs of acquiring a significant portion of loanable funds remained stable under Reg. Q.

Financial institutions are simply intermediaries between savers and borrowers in our society. The saver does not concern himself with the interest which the savings institution ultimately charges borrowers. Borrowers, in turn, do not care what costs are incurred by financial institutions in acquiring loanable funds. They borrow as long as the expected value to them of the use of their borrowed funds is greater than the interest they must pay to obtain their loan. Except in the case of usury law limitations, it is the marketplace that determines the pricing of loan transactions rather than any direct relationship between the cost of deposits and interest charged borrowers. Therefore, any artificial ceiling on savers' interest such as under Reg. Q does not have the effect of reducing the cost of loans to consumers. In fact, the opposite is more probably the case. Artifically-low interest rates would probably reduce the availability of time and passbook savings to financial institutions and thus increase the cost of borrowing. This effect is exactly the opposite of what the advocates of Reg. Q contend.

A fourth argument in behalf of maintaining legal limits on interest rates is that such ceilings tend to keep savings deposits from leaving local communities. This argument assumes that, if the ceilings were removed, money center banks with aggressive marketing capabilities would attract savings from smaller communities by offering higher interest rates. In my opinion, this kind of thinking reflects a misplaced belief that small-town savers are unusually naive and blind to savings alternatives available to them which offer higher-than-ceiling rates of return. If that were indeed true, the argument might have some validity. In today's world, however, where wide publicity is given to investment opportunities in government securities, certificates of deposit, money market certificates, money market mutual funds and other readily-available investments, it is unrealistic to believe that savers will continue to hold their deposits indefinitely in pass-book savings at their local banks and pass up higher yields available elsewhere. Coming from the "Show-me" state, I simply can't believe that!

Finally, and probably of greatest concern to you . . . especially those of you who are associated with smaller banks . . is the fear that the phaseout of Reg. Q would increase your interest costs and thereby place pressure on your profit margins. I do not deny that some temporary constraint on your bottom line might occur. It is important, however, to recognize that, regardless of whether Reg. Q is eliminated, the pressures of disintermediation are inevitable. If legal interest on time and savings accounts remains below market rates of interest, savers will accelerate the withdrawal of their savings from banks and thrift institutions, and the resulting outflow of deposits is certain to be as costly as an increase in the interest costs necessary to retain those deposits. As long as inflation persists, banks and savings institutions will be faced with the choice of experiencing disintermediation resulting from legally-mandated, noncompetitive interest ceilings or the necessity to pay higher rates of interest in order to retain their time and savings deposits. I personally believe that, if I were still a commercial banker, I would prefer to compete for savings in the marketplace rather than to sit back and watch my deposit base erode as a result of the constraints of noncompetitive, legally-mandated interest ceilings.

The practical effect of spreads between ceiling and market rates of interest is reflected in the history of the past few years. In 1976 and 1977 when the spread between market rates and Reg. Q ceilings was practically nonexistent, banking institutions were able to expand their savings deposits by a whopping 21% annual rate. Compare this with 1974 when the spread was a relatively modest 2.5%. Under those conditions, savings deposits of banks increased at only a sluggish 8.9% annual rate. Then look what happened during the first half of this year when the spread broadened to 4.5%. During this period, as I have previously pointed out, passbook savings at banks actually declined by 7%. This demonstrates that when regulated ceiling rates are significantly lower than market rates of interest, savers transfer from passbook savings to higher-yielding instruments with inevitably costly consequences to savings institutions.

To those of you who would like to avoid any additional costs that might impact your profits, there are few alternatives left. There is the option, if Regulation Q is eliminated, of facing higher costs in obtaining loanable funds or the alternative of facing a shrinkage of low-cost deposits if it is not. The result is the same: either you will be faced with paying higher interest rates on savings, or you will have to offer other forms of savings instruments that are certain to evolve, or you will face a loss of loanable funds.

So, for the reasons I have stated, I believe that the time has come to gradually. . . and I underscore gradually . . . eliminate Reg. Q and return to the free and competitive market system which has traditionally served our economy so well. I would stress that this transition should be carried out in an orderly fashion and that study should be given to eliminating other legal impediments to free competition among financial institutions. It would be foolhardy to ignore the changes that are occurring in the world of finance, and I am convinced that aggressive, well-managed banking institutions have nothing to fear from free and open competition with other financial institutions.

I mentioned earlier that interest rate regulations were not a problem prior to the advent of inflation. In a non-inflationary economy, interest rates tend to be relatively low, and there is little incentive for savers to seek investments at rates in excess of legally-prescribed ceilings. Disintermediation becomes a problem only when the spread between legal ceilings and market yields is wide, and this occurs only in periods of inflation.

So if you are really concerned with the unhappy alternatives of paying higher rates of interest or facing disintermediation, I suggest that you focus your attention on the real cause of your worries, namely, runaway inflation.

We at the Federal Reserve Bank of St. Louis spend a great deal of our time and resources doing research into the causes and cures of inflation, and we are convinced that, in spite of past policy mistakes, inflation can be wound down. Perhaps the most encouraging development is the degree of concern on the part of the American people of the seriousness of the problem. Public opinion polls indicate that Americans have at least come to the realization that inflation is the most serious domestic problem we face.

Yet, it is not enough merely to identify a problem. More important is the need to face up to the challenge and do something about it.

As you know, there is no shortage of suggested remedies for inflation. Wage and price controls, shoring up the value of the dollar on international exchanges, pumping more oil, these and other theories for dealing with inflation are enjoying a heyday. Unfortunately, most are designed to deal with the symptoms, rather than the causes of the problem.

There is a practical way to reduce inflation! Inflation, the result of too much money relative to the amount of goods produced, can be curtailed in an orderly fashion by gradually reducing the rate of growth of the money supply. If we had not tolerated excessive money growth in 1976, 1977 and 1978, we would not be experiencing the inflation that presently plagues us. And it is not too late to do something about the problem now. If we have the good sense to set long-range goals for the gradual reduction of the growth of the money supply and if we stick with those goals in the face of inevitable pressures to spend more for this and that and for the pet projects of each of us, we can reduce the inflationary pressures that presently threaten the economic, political and social security of us all.

In closing, I would suggest that the problems we have discussed this afternoon are not insoluble . . . that the ingenuity and adaptability of the commercial banking industry in America are fully capable of meeting any competitive challenges that may arise. In my judgment, the most practical way to proceed is to act now to reduce inflation, while at the same time eliminating unnecessary regulatory barriers that inevitably increase the cost of doing business and frustrate the efficiency of our free enterprise system.