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Minutes for February 9, 1960

To: Members of the Board

From: Office of the Secretary

Attached is a copy of the minutes of the Board of Governors of the Federal Reserve System on the above date.

It is not proposed to include a statement with respect to any of the entries in this set of minutes in the record of policy actions required to be maintained pursuant to section 10 of the Federal Reserve Act.

Should you have any question with regard to the minutes, it will be appreciated if you will advise the Secretary's Office. Otherwise, please initial below. If you were present at the meeting, your initials will indicate approval of the minutes. If you were not present, your initials will indicate only that you have seen the minutes.

Chm. Martin M

Gov. Szymczak

Gov. Mills

Gov. Robertson R

Gov. Balderston CCB

Gov. Shepardson

Gov. King

Minutes of the Board of Governors of the Federal Reserve System on Tuesday, February 9, 1960. The Board met in the Board Room at 2:00 p.m.

PRESENT: Mr. Martin, Chairman
Mr. Balderston, Vice Chairman
Mr. Szymczak
Mr. Mills
Mr. Robertson
Mr. Shepardson
Mr. King

Mr. Sherman, Secretary
Mr. Kenyon, Assistant Secretary
Mr. Thomas, Adviser to the Board
Mr. Young, Adviser to the Board
Mr. Molony, Assistant to the Board
Mr. Hackley, General Counsel
Mr. Noyes, Director, Division of Research and Statistics
Mr. Solomon, Director, Division of Examinations

Messrs. Hayes, Bryan, Allen, and Johns, Presidents of the Federal Reserve Banks of New York, Atlanta, Chicago, and St. Louis, respectively
Messrs. Crosse and Roosa, Vice Presidents of the Federal Reserve Bank of New York

Maximum rates of interest under Regulation Q. In accordance with discussion at the meeting of the Board on January 27, 1960, Chairman Martin subsequently informed President Hayes that the Board would be glad to meet with him and Vice Presidents Crosse and Roosa to hear their views regarding the maximum rates of interest payable on time and savings deposits under Regulation Q, Payment of Interest on Deposits. This meeting was held for that purpose.

The meeting began with presentation by Mr. Hayes of a paper prepared by the Federal Reserve Bank of New York under date of February 9, 1960, a copy of which has been placed in the Board's files. This paper dealt with various aspects of the maximum interest rate problem, including the record of previous consideration of the subject, elements involved in the maintenance of sound banking, fundamental differences between time and savings deposits, the relationship of the current maximum rate on time and savings deposits to interest rates available from other sources for the use of funds, and the special problem of foreign-owned time deposits. The memorandum concluded with the following recommendation:

> We would favor establishing a ceiling rate on savings deposits that would be somewhat more restrictive than the rate on time deposits.
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> The ceiling on savings deposits should change only after clear indication of fundamental changes in the levels of long-term interest rates. When the Board raised the ceiling to 3 per cent in 1956, average yields on long-term Government bonds were under 3-1/2 per cent. Conventional home mortgages were freely available at 5 per cent. Yields on both long and intermediate Governments have now been above 4 per cent for nearly a year, and conventional home mortgages in this District are virtually unobtainable under 6 per cent. An increase in the ceiling rate for savings deposits to 3-1/2 per cent, therefore, appears justified, even though many banks probably will not pay it.
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> With respect to time deposits, we would favor the establishment of a ceiling which would give the banks room to move both up and down within it. We do not believe that the ceiling should establish the rate except for periods when the market situation may justify the ceiling rate. We, therefore, do not believe that the ceiling should be changed to follow or conform closely to the market. To do so would not only violate the principle of allowing the greatest amount of market freedom but would pose very difficult administrative problems as well. Under present circumstances, we would like to see the ceiling for time deposits maturing 90 days or more after date of deposit set no lower than 4-1/2 per cent, and perhaps as high as 5 per cent.

Mr. Crosse then presented a memorandum describing the method used by the Federal Reserve Bank of New York in estimating the liquidity requirements of an individual bank, in connection with which he distributed certain charts. Copies of the memorandum and the charts have been placed in the Board's files.

At the conclusion of Mr. Crosse's presentation, Mr. Hayes commented that this tied in with the view of the New York Reserve Bank that there are methods other than Regulation Q to facilitate assuring that banks maintain the necessary kinds of assets to provide adequate liquidity.

Chairman Martin inquired of Mr. Hayes whether he would favor in theory elimination of the regulation of maximum rates of interest payable on deposits, to which Mr. Hayes replied in the affirmative, adding that his view probably differed from that held by some members of the supervisory staff of the New York Bank. To him the basic idea of regulating interest rates payable on time deposits was repugnant and at variance with the whole theory of letting interest rates find their own ceiling. At this juncture he had not given enough study to the question of interest on demand deposits to be sure of his position in that respect.

Mr. Crosse said that the regulation of rates was designed originally to protect banks from competitive excesses and it might be argued that, with some 14,000 banks throughout the country, there was still a need to protect some of them against such excesses. As to savings deposit rates, he felt personally that some protection was still needed, but in theory he would like to see the rate on time deposits as free as possible.

In reply to an inquiry by Governor Balderston as to whether the small savings depositor should be denied the rates granted to the foreign owner of time money, Mr. Crosse asserted that two different kinds of money were involved. While both types of deposit are obligations of commercial banks, the person who has placed his funds on time deposit should expect a higher rate at some times and a lower rate at other times. The savings depositor tends to receive the same rate year after year except for cyclical changes.

Mr. Roosa commented that any market may impose differences between classes of persons who participate in it.

Asked by Governor Balderston whether, from the standpoint of the economy and particularly the Treasury, it would seem to make any particular difference whether foreign funds were placed on time deposit or in Treasury bills, Mr. Roosa replied that foreigners should not be denied an opportunity to choose, but that a special question worthy of serious consideration was explained in the paper presented by Mr. Hayes. The New York City banks needed to develop facilities in order to be equipped to care for the special needs of an international financial community, at a time when they had not only new responsibilities as bankers for the world but also new risks. The private market should be equipped with all legitimate competitive facilities for attracting and holding funds. From the point of view of the vulnerability of the money market to international influences, Mr. Roosa felt it would be better, on balance, to have facilities that would persuade foreigners to hold a relatively high proportion of their funds in instruments that involve negotiated relationships, so as to tend to keep unloading and capital flight subject to some restriction.

After further comments by Mr. Roosa in explanation of this line of reasoning, Governor Robertson inquired whether it could be estimated what portion of the $700 million of time deposits lost by New York City banks in 1959 had gone into the Government securities market. In reply, Mr. Roosa cited reasons that made it difficult to trace the disposition of this time money. However, he thought it possible that as much as two-thirds of the time money that had been lost had gone into Treasury bills or bankers' acceptances.

Governor Robertson then asked for a review of the reasons favoring a higher rate on time than savings deposits, in view of the greater volatility of time deposits.

Mr. Hayes replied that savings deposits, because of their low volatility, are placed in long-term investments which by their nature are slow-changing in yield. On the other hand, the more volatile time deposits have generally been invested in short-term assets whose yields move up and down readily. Also, time deposits are held predominantly by a relatively small group of banks. The time deposits constitute a relatively small proportion of the total deposits of those banks, and have little bearing on the quality of the bank's portfolio as a whole. Thus, there would appear to be no substantial risk to the banking system if leeway were given for the payment of higher rates on time deposits.

Governor Robertson inquired of Mr. Crosse whether the line of reasoning on liquidity that he had expressed was based on an assumption that banks segregate dollars coming in to them through different windows.

Mr. Crosse replied that banks cannot segregate dollars, or at least as a practical matter do not segregate them. However, it is possible to look at the deposit liabilities of a given bank at a given time and find a greater or lesser need for liquidity, based on factors such as past experience and developments in the particular community. In this manner, a potential deposit drain can often be predicted and appropriate steps taken.

Throughout the Second District, Mr. Crosse said, a clearly distinguishable trend line was found below which deposits had not fallen in two years. If the community was stable and prosperous, no reason was seen why they should fall below that trend line, but in depressed areas, where the trend of deposits was downward, the trend line was drawn downward. Mr. Crosse said it was the practice of the New York Bank to appraise liquidity needs on the basis of total time and demand deposits. In cases where it was possible to predict how and when certain deposits would be spent, the New York Bank would insist that the bank have liquid assets sufficient to meet the foreseeable paying out of deposits.

Governor Robertson asked how this tied into the theory of paying a higher rate on time than savings deposits, and Mr. Hayes commented that a bank normally keeps its assets adjusted to the volatility of its deposits. A bank with a relatively high proportion of volatile deposits must make provision for that factor by carrying liquid assets against the volatile deposits. In a period like the past few years, such assets are high-yielding and return a higher rate than the bank's longer-term investments.

Mr. Roosa discussed the relative stability of the average yield on a bank portfolio built up over a period of years and the reasons why the average yield was not susceptible of being changed rapidly. Over a period of time, he said, a bank might not, on average, pay more on time deposits than on savings deposits. At times, however, if the banks wanted to keep the more rate-conscious funds at all, they were faced with the necessity of paying higher rates. This led, of course, to the question whether it was desirable that the funds of rate-conscious investors be kept in commercial banks or whether there were enough other qualified facilities in which such funds might more appropriately be placed.

Governor Szymczak said the assumption would be that the New York City banks needed that kind of deposits if they were going to do the business they wanted to do. However, there was another angle to be considered. It might be said that the person who deposited a certain amount in a bank and left it there for a long time should be encouraged, in order that the bank might go into a longer-term area from the standpoint of its investments.

In commenting on this point, Mr. Hayes suggested that if a person was sufficiently interested in yield, he would be likely to turn from the savings deposit to the time deposit instrument.

Governor Balderston then inquired of Mr. Hayes how he would feel about going to a high ceiling, say 4 or 5 per cent, on savings and time deposits, and letting the banks pay what they thought they could afford to pay.

Mr. Hayes replied that in making his recommendation he had had in mind leaving plenty of leeway, thinking that many banks would not pay the maximum rate. This contemplated that the ceiling would not be a fluctuating one.

Mr. Crosse referred to the fact that a substantial number of banks in the Second District were not yet paying the 3 per cent maximum rate.

He assumed that in most cases a bank would not go to a rate higher than 3 per cent unless it could afford to pay the higher rate. If the majority of banks could afford to pay the higher rate and competition got rough, he assumed that certain banks would sell out, as many already had done in the Second District. This, he said, had been one of the primary reasons for the number of mergers in New York State.

There followed discussion of fund flows that might develop in the event of interest rate changes here and abroad, after which Governor Shepardson referred to the original purpose of the legislation providing for the regulation of rates payable on time and savings deposits. He inquired whether it was felt that adequate control could be exerted through the medium of bank supervision and examination to afford the protection against excesses that was contemplated by the legislation.

Mr. Crosse replied in the affirmative. When Governor Shepardson raised the question whether the time lag inherent in the examining process caused supervisory actions to be largely "after the fact," Mr. Crosse said that he thought the supervisory agencies would be derelict in their duties if such a condition prevailed. With respect to a comment by Governor Szymczak that the Federal Reserve examines only State member banks, Mr. Crosse noted that the Reserve Banks review reports of examination of national banks and are in a position to exercise some moral suasion if necessary. As to insured nonmember banks, he felt that the staff of the Federal Deposit Insurance Corporation was doing a job comparable to that being done with respect to member banks.

In response to an inquiry by Governor Robertson, Mr. Crosse verified that more than 40 per cent of the banks in New York State, outside New York City, had been eliminated since 1945. As to prospects for the rate of mergers in the future if the maximum rate on savings deposits should be increased to 3-1/2 or 4 per cent, Mr. Crosse said there was an irreducible minimum of well-run small banks that would not sell out. He noted that it took roughly 2-1/2 years from the time the maximum rate was increased to 3 per cent for an estimated two-thirds of the banks to go to that rate. There had now been requests from at least half a dozen District country banks for permission to move to a higher rate. These were primarily aggressive banks, in communities where the demand for credit was strong, that were finding their savings deposits being drained off to the metropolitan areas. For other country banks, rate adjustment would probably be a relatively slow process.

The meeting then adjourned.

Secretary