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DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE PRESS RELEASE

COMPTROLLER OF THE CURRENCY | FEDERAL DEPOSIT INSURANCE CORPORATION | FEDERAL HOME LOAN BANK BOARD
FEDERAL RESERVE BOARD | NATIONAL CREDIT UNION ADMINISTRATION | TREASURY DEPARTMENT

For immediate release March 31, 1981

The Depository Institutions Deregulation Committee, established by Congress to bring about an orderly phase-out of interest rate ceilings on deposits, proposed taking two steps in that direction at its meeting March 26.

The Committee requested comment by May 1 on the two following proposals:

1. To remove the present 12 and 11 3/4 percent cap on the maximum interest rate ceiling that applies to Small Saver Certificates offered by thrift institutions and banks respectively. The Small Saver Certificate is a certificate of deposit with a maturity of 2 1/2 years or more. The rate ceiling on this category would continue to be tied to the 2 1/2 year yield on U.S. Treasury securities.

2. To establish the following schedule for deregulating deposit rate ceilings generally, by eliminating rate ceilings on deposits of certain maturities:

July 1, 1981 -- Deposits with maturities of five years or more;
July 1, 1982 -- Deposits with maturities of four to five years;
July 1, 1983 -- Deposits with maturities of two to four years;
July 1, 1984 -- Deposits with maturities of one to two years;
July 1, 1985 -- Deposits with maturities of six months to one year;
April 1, 1986 -- Elimination of all remaining ceilings (as required by law).

The Committee said it would also consider comment concerning deregulation by means of indexing ceiling rates to market rates according to this schedule.

Subjects on which the Committee would particularly like to receive comment are listed on Pages Three and Six of the attached notice of those proposals.

In another action the Committee amended it rules to make new ceiling rates established for the six-month Money Market Certificate and the Small Saver Certificate

(OVER)

effective the day following their announcement. At present, there is normally a two-day delay (from announcement on Monday to the effective date on Thursday).

This will work as follows:

The rates announced Monday, March 30, for both the Money Market Certificate and the Small Saver Certificate remained subject to the existing rule and become effective on Thursday, April 2.

The rate announced on Monday, April 6, for the MMC, will become effective Tuesday, April 7, under the new rule.

The rate announced (on the bi-weekly schedule of announcements of SSC rates) for the SSC on Monday, April 13, will be effective on Tuesday, April 14, under the new rule.

All rates subsequently announced for the MMC or the SSC will be effective the day after announcement.

The Committee took this action to link the rates on these deposits more closely to market rates. It said it would reconsider the matter if severe operational problems emerged. The Committee acted after consideration of comment received on proposals, announced last December, for changes in the Committee's rules regarding the effective date of newly announced ceiling rates for the MMC and the SSC. The comment received is summarized in the attached notice of the Committee's action.

The Committee considered but took no action on proposals before it relating to penalty-free early withdrawal of funds from time deposits in the event of the bankruptcy of the depositor, the Committee's rule regarding the phase-out of finders fees and the ceiling rates on regular savings accounts and interest bearing transaction accounts.

The Committee elected Secretary of the Treasury Donald T. Regan to succeed Federal Reserve Board Chairman Paul A. Volcker as Chairman of DIDC. The members of the Committee are the heads of the agencies listed at the top of Page One.

The Committee will announce the date of its next meeting at a later time.

Attachment

DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE

[12 CFR Part 1204]

(Docket No. D-0019)

NOTICE OF PROPOSED RULEMAKING

Deregulation of Deposit Rate Ceilings

AGENCY: Depository Institutions Deregulation Committee.

ACTION: Proposed rulemaking.

SUMMARY: The Depository Institutions Deregulation Committee ("Committee") is requesting public comment on two proposed actions: (1) removal of the maximum interest rate ceilings ("caps") on 2-1/2 year or more small saver certificates (SSCs) while continuing to index the interest rate limitation on SSCs to the 2-1/2 year yield on U. S. Treasury securities, and (2) establishment of a schedule for which rate ceilings on deposits would be gradually deregulated starting with longer maturities by eliminating such ceilings or, alternatively, by indexing interest rate ceilings to a market rate. The proposals are intended as steps in accomplishing the Committee's objective of an orderly phase-out and ultimate elimination of deposit interest rate ceilings.

DATES: Comments must be received by May 1, 1981.

ADDRESS: Interested parties are invited to submit written data, views, or arguments regarding the proposed rules to Normand R. V. Bernard, Executive Secretary, Federal Reserve Building, 20th Street and Constitution Avenue, N. W., Washington, D. C. 20551. All material submitted should include the Docket Number D-0019. Such material will be made available for inspection and copying upon request except as provided in Section 1202.5 of the Committee's Rules Regarding Availability of Information (12 CFR § 1202.5).

FOR FURTHER INFORMATION CONTACT: Paul S. Pilecki, Senior Attorney, Board of Governors of the Federal Reserve System (202/452-3281), F. Douglas Birdzell, Counsel, Federal Deposit Insurance Corporation (202/389-4261), Allan Schott, Attorney-Advisor, Department of the Treasury (202/566-6798), Rebecca Laird, Senior Associate General Counsel, Federal Home Loan Bank Board (202/377-6446), David Ansell, Attorney, Office of the Comptroller of the Currency (202/447-1880), or Robert H. Dugger, Director, Office of Policy Analysis, National Credit Union Administration Board (202/357-1090).

SUPPLEMENTARY INFORMATION: The Depository Institutions Deregulation Act of 1980 (Title II of P. L. 96-221; 12 U.S.C. §§ 3501 et seq.) ("Act") was enacted to provide for the orderly phase-out and the ultimate elimination of the limitations on the maximum rates of interest and dividends that may be paid on deposit accounts by depository institutions. In adopting the Act, the Congress determined that rate ceilings have: (1) discouraged savings; (2) created inequities for depositors; (3) impeded competition among depository institutions; and (4) not provided an even flow of funds for home mortgage lending. The Congress also found that all depositors, particularly those with modest savings, are entitled to receive a market rate-of-return as soon as it is economically feasible for institutions to pay such rates.

Under the Act, authority to administer deposit rate ceilings and to structure the phase-out of such ceilings has been given to the Committee. The Act also provides that the Committee can phase out rate ceilings by <u>any</u> or all of the following methods:

(1) gradually increase ceilings applicable to <u>all</u> account categories (however when increasing rates on <u>all</u> existing accounts, the DIDC may not exceed market rates);

(2) complete elimination of limitations applicable to <u>particular</u> account categories (both new and existing):

(3) creation of new account categories not subject to limits or with limits set at current market rates;

(4) by any combination of the above methods; and

(5) by any other method.

In accordance with its responsibilities, the Committee is requesting public comment on two proposals that are intended to meet the objective of the Act. The first proposal is designed to further deregulation in the short run by removing the maximum interest rate ceilings ("caps") on 2-1/2 year or more small saver certificates (SSCs). An interest rate limitation would continue to apply to SSCs; the ceiling normally would be determined by the 2-1/2 year yield on U. S. Treasury securities. The second proposal is a longer-term plan of deregulation under which deposit interest rate ceilings would be gradually deregulated starting with longer maturities by eliminating the ceilings or, alternatively, by indexing interest rate ceilings to a market rate. The Committee also is interested in receiving comments on other plans of deregulation of interest rate limitations. Comment is reqested by May 1, 1981.

Removal of the Cap on SSCs

The ceiling rate of interest payable on the SSC is tied to the average 2-1/2 year yield for United States Treasury securities as determined bi-weekly by the United States Treasury. Thrift institutions may pay interest on SSCs at the 2-1/2 year yield announced prior to the date of deposit and commercial banks may pay interest at a rate 25 basis points lower.

On February 27, 1980, prior to the establishment of the Committee, the Federal regulatory agencies announced the establishment of a temporary maximum on the SSC ceiling of 12 per cent for insured savings and loan associations and mutual savings banks and 11.75 per cent for Federally insured commercial banks. This action was viewed as necessary because the agencies believed that the sudden increase in ceilings, which otherwise would have occurred in March 1980, would have been disruptive to many financial institutions, particularly those holding a high proportion of long-term fixed-rate loans. The caps have been binding continuously since November 1980. Absent the cap, the interest limitation on SSCs for the period March 19 through April 1 would be 13.55 per cent for thrift institutions and 13.30 per cent for commercial banks.

There also is a minimum interest rate ceiling on SSCs of 9.50 per cent for thrift institutions and 9.25 per cent for commercial banks, although depository institutions may pay interest at rates lower than the ceiling. The minimum interest rate ceiling, which was established effective June 2, 1980, would not be affected by the proposal.

The Committee believes that removing the cap on the SSC interest rate ceiling would provide a higher return to savers as well as give depository institutions flexibility in choosing their own liability structures. The more market sensitive overall yield that could be offered could improve the competitive position of depository institutions *vis-a-vis* nondeposit alternatives. Moreover, to the extent that institutions would be able to attract longer-term deposits, the flow of funds into the mortgage markets could be improved.

Accordingly, the Committee requests views from the public on a proposal to remove the maximum interest rate ceiling on SSCs of 12 per cent for thrift institutions and 11.75 per cent for commercial banks so that the interest rate limitation could be higher when the average yield on 2-1/2 year Treasury securities exceeds 12 per cent. In particular, the Committee is interested in comments on the effect that this action is likely to have on the flow of funds to depository institutions, on the earnings position of institutions, and on the rates-of-return available to depositors.

Deregulation of Deposit Rate Ceilings by Maturity

Pursuant to its responsibility to phase out deposit rate ceilings, the Committee is considering a proposal to deregulate such ceilings by maturity of deposit. Under this proposal, the Committee would announce a schedule for authorizing new deposit categories with no ceilings starting with longer maturity deposits. As an alternative, a schedule of new deposit categories with ceilings indexed to market rates could be established. If indexed ceilings were adopted they could be established with or without a differential between commercial banks and thrift institutions. In implementing any deregulation plan, the Committee is required to take into account whether economic conditions warrant such action. In this regard, any action under a plan could be accelerated or delayed depending upon the ability of financial institutions to pay market rates as suggested by the schedule. The Committee proposes to implement this action according to the following schedule:

Date	Maturity of deposits for which rate ceilings would be eliminted
July 1, 1981	5 years or more
July 1, 1982	4 to 5 years
July 1, 1983	2 to 4 years
July 1, 1984	1 to 2 years
July 1, 1985	6 months to 1 year
April 1, 1986	no ceilings (as required by statute)

The table below presents the existing time deposit interest rate ceilings to facilitate comparisons of the proposed program to the current ceiling rate structure.

If a phased indexing of ceilings were used, the ceilings at thrifts and commercial banks could be tied to the yields on U. S. Treasury securities of comparable maturities. Under this approach, ceilings on longer-maturity deposits could be below the current SSC ceiling (even with the caps) if the U. S. Treasury yield curve were downward sloping. To avoid setting ceilings that would be lower than those possible under current regulations, public comment also is requested on tying the ceilings on longer-term deposits to the rates on comparable maturity Treasury securities or the SSC ceilings, which ever was greater. In any event, were the cap to be maintained on the SSC it would not have to apply to the "deregulated" instruments.

The Committee believes that the development of its intentions regarding the deregulation of interest rate ceilings is desirable in order to facilitate planning by depository institutions. The approach

CURRENT MAXIMUM INTEREST RATES PAYABLE ON TIME DEPOSITS
(per cent)

Type and maturity of deposit	Commercial banks	S&Ls and MSBs
Fixed Ceiling Time Deposits		
14-89 days	5-1/4	1/
90 days-1 year	5-3/4	6
1-2 1/2 years	6	6-1/2
2 1/2-4 years 2/	6-1/2	6-3/4
4-6 years 2/	7-1/4	7-1/2
6-8 years 2/	7-1/2	7-/4
8 years or more 2/	7-3/4	8
Issued to government units (all maturities)	8	8
IRA/Keogh (3 years or more)	8	8
Variable-Ceiling Time Deposits		
26-week MMCs	3/	3/
2-1/2 year or more SSC	4/	4/

1/ No separate account category.

2/ Such ceilings presently are superseded by the minimum interest rate ceilings on the SSC of 9.50 per cent for thrift institutions and 9.25 per cent for commercial banks (see fn. 4).

3/ Effective for all 26-week MMCs issued beginning June 5, 1981, the interest rate ceilings will be determined by the discount rate (auction average) of the most recently issued six-month Treasury bills as follows:

Bill rate	Commercial bank ceiling	Thrift ceiling
8.75 and above	bill rate + 1/4 per cent	bill rate + 1/4 per cent
8.50 to 8.75	bill rate + 1/4 per cent	9.00
7.50 to 8.50	bill rate + 1/4 per cent	bill rate + 1/2 per cent
7.25 to 7.50	7.75	bill rate + 1/2 per cent
Below 7.25	7.75	7.75

4/ Effective for all SSCs with maturities of 2-1/2 years or more issued beginning June 2, 1980, the ceiling rates of interest will be determined by the 2-1/2-year Treasury yield as follows:

Treasury yield	Commercial bank ceiling	Thrift ceiling
12.00 and above	11.75	12.00
9.50 to 12.00	Treasury yield less 1/4 per cent	Treasury yield
Below 9.50	9.25	9.50

set forth above addresses the issue of providing a market rate-of-return to savers and also allows depository institutions, particularly thrift institutions, time to adjust to an environment of deregulated deposit rate ceilings. Although the asset powers of thrifts have been expanded, it will be a number of years before their asset portfolios are affected materially. In the initial stages of the phase-out savers would be encouraged to place funds in longer-term accounts, which could help correct the imbalance of asset and liability maturities at thrift institutions. In addition, to the extent that longer-term deposits are acquired, institutions may be more willing to channel the funds into the housing market.

The Committee is interested in receiving comments on all aspects of this proposal, including other approaches to deregulation. However, it is particularly interested in receiving comment on the following issues:

1. The desirability of eliminating ceilings versus establishing indexed ceiling rates.

2. The appropriateness of the phase-out schedule in view of the structure of assets and liabilities at depository institutions.

3. The impact of the proposal on the flow of funds to depository institutions.

4. The implications of the proposal for providing depositors an attractive rate of return on their deposits.

5. The impact of the proposal on the earnings of depository institutions.

6. The interrelationship of this proposal with the concept of removal of the cap on the SSC.

7. Other problems or benefits that would be derived from the establishment of a schedule for phasing out interest rate ceilings.

8. Other suggestions related to implementing a plan of deregulation.

In view of the potential benefits that could be derived from these proposed actions on the part of both depository institutions and their customers, the Committee has determined that it is appropriate to provide a thirty-day comment period on this matter. Accordingly, comments on these proposals should be submitted by May 1, 1981.

By order of the Committee, March 31, 1981.

(Signed) Normand R. V. Bernard

Normand R. V. Bernard
Executive Secretary of the Committee

[SEAL]

TITLE 12--BANKS AND BANKING

CHAPTER XII--DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE

[Docket No. D-0016]

PART 1204--INTEREST ON DEPOSITS

Effective Date of Ceiling Rates on MMCs and SSCs

AGENCY: Depository Institutions Deregulation Committee.

ACTION: Final rules.

SUMMARY: The Depository Institutions Deregulation Committee ("Committee") has amended its rules to reduce the period between the announcement and the effective date of the ceiling rates of interest payable on the 26-week money market certificate (MMC) and on the 2-1/2 year or more small saver certificate (SSC). Under the revised rules, the ceiling rates of interest payable on MMCs and SSCs will become effective on the day after they are announced. Ceiling rates for such deposits normally are announced on Monday and, thus, normally will be effective on Tuesday rather than on Thursday as under the present rules. This action was taken by the Committee in order to more closely link the ceiling rates of interest payable on MMCs and SSCs with current market rates.

EFFECTIVE DATE: April 7, 1981.

FOR FURTHER INFORMATION CONTACT: F. Douglas Birdzell, Counsel, Federal Deposit Insurance Corporation (202/389-4261), Paul S. Pilecki, Senior Attorney, Board of Governors of the Federal Reserve System (202/452-3281), Allan Schott, Attorney-Advisor, Treasury Department (202/566-6798), Rebecca Laird, Senior Associate General Counsel, Federal Home Loan Bank Board (202/377-6446), or David Ansell, Attorney, Office of the Comptroller of the Currency (202/447-1880).

SUPPLEMENTARY INFORMATION: The ceiling rate of interest payable on MMCs is tied to the discount rate (auction average) on the most recently issued 26-week United States Treasury bills. Such bills normally are auctioned on Monday and, under current rules, the ceiling rate of interest based on the discount rate (auction average) is effective on the following Thursday, the day on which the Treasury bills normally are issued. This ceiling rate is effective until the next issuance of 26-week United States Treasury bills. The ceiling rate of interest payable on SSCs is tied to the average 2-1/2 year yield for United States Treasury securities as determined bi-weekly by the United States Treasury.

Such average yield normally is announced by Treasury on Monday (based on the average 2-1/2 year yield for the five business days ending on the day of announcement) and, under current rules, the ceiling rates based on their average 2-1/2 year yield are effective for a two-week period beginning on the following Thursday.

On December 19, 1980, the Committee issued for public comment proposed rules under which the ceiling rates announced on Monday would be effective for new MMCs or SSCs issued beginning on the following Tuesday or Wednesday rather than on the following Thursday (45 Fed. Reg. 85059 (1980)). Over 400 comments from the public, including depository institutions, individuals, trade associations, and federal instrumentalities, were received by the Committee on the proposal. Comments of a majority of depository institutions and trade associations favored changing the Thursday date to either Tuesday or Wednesday, while other commentators favored retention of the Thursday effective date. Those favoring a change in the effective date cited the potential for decreasing earnings pressures on and smoothing deposit flows of financial institutions as the primary benefits of such a change. Comments in favor of retention of the Thursday date generally viewed the proposal as having potential operational problems and as disadvantageous to depositors.

After consideration of all of the comments on the proposal, the Committee has determined to change the effective date of the ceiling rate of interest on MMCs and SSCs from Thursday to the day after the new ceiling rates are announced. In this regard, the new ceiling rates on MMCs and SSCs normally are announced on Monday and, therefore, such rates will be effective on Tuesday. When a holiday occurs on Monday, the new ceiling rates are announced on Friday. In those instances, the new ceiling rates will become effective on Saturday. In all cases, the ceiling rates will remain in effect from the day after the announcement of the ceiling rate until the end of the day that a new ceiling rate is announced for the particular category of deposit. As in the past, the ceiling rate applicable to outstanding deposits will not change during the life of the deposit. This action is effective for the new ceiling rate for MMCs to be announced on April 6, 1981, and for the ceiling rate to be announced for SSCs on April 13, 1981.

The Committee believes that this action will benefit depository institutions by more closely linking the ceiling rates payable on MMCs and SSCs with current market rates, thereby smoothing deposit flows among depository institutions. In view of the comments received on the proposal, the Committee believes that the change should not present operational difficulties for institutions. However, the Committee noted that if the change presents unanticipated operational difficulties for depository institutions, it might reconsider the amendment at a future date. In order to provide depositors with a return on their funds invested in MMCs and SSCs that is more closely aligned to current market rates as soon as possible, the Committee finds that good cause exists for making this action effective in less than 30 days.

Pursuant to its authority under Title II of Public Law 96-221, 94 Stat. 142 (12 U.S.C. § 3501 *et seq.*), to prescribe rules governing the payment of interest and dividends on deposits of federally insured commercial banks, savings and loan associations, and mutual savings banks, effective April 7, 1981, the Committee amends Part 1204--Interest on Deposits (12 CFR Part 1204) as follows:

1. Section 104 is revised to read as follows:

§ 1204.104 -- 26-Week Money Market Time Deposits of Less than $100,000.

Commercial banks, mutual savings banks, and savings and loan associations may pay interest on any nonnegotiable time deposit of $10,000 or more, with a maturity of 26 weeks at a rate not to exceed the rates set forth below. Rounding any rate to the next higher rate is not permitted and interest may not be compounded during the term of this deposit.

Rate established and announced (auction average on a discount basis) for U.S. Treasury bills with maturities of 26 weeks at the auction held immediately prior to the date of deposit ("Bill Rate")	Maximum per cent
Commercial Banks	
7.50 per cent or below	7.75
Above 7.50 per cent	Bill Rate plus one-quarter of one per cent
Mutual Savings Banks and Savings and Loan Associations	
7.25 per cent or below	7.75
Above 7.25 per cent, but below 8.50 per cent	Bill Rate plus one-half of one per cent
8.50 per cent, but below 8.75 per cent	9
8.75 per cent or above	Bill Rate plus one-quarter of one per cent

2. Section 106 is revised to read as follows:

§ 1204.106 -- Time Deposits of Less Than $100,000 With Maturities of 2-1/2 Years or More.

(a) A commercial bank may pay interest on any nonnegotiable time deposit with a maturity of 2-1/2 years or more at a rate not to exceed the higher of one-quarter of one per cent below the average 2-1/2 year yield for United States Treasury securities as determined and announced by the United States Department of the Treasury immediately prior to the date of deposit, or 9.25 per cent. Such announcement is made by the United States Department of the Treasury every two weeks. The average 2-1/2 year yield will be rounded by the United States Department of the Treasury to the nearest 5 basis points. The rate paid on any such deposit cannot exceed the ceiling rate in effect on the date of deposit. In no event shall the rate of interest paid exceed 11.75 per cent, except as provided in 12 CFR 217.7(g) and in 12 CFR 329.6(b)(6).

(b) A mutual savings bank or savings and loan association may pay interest on any nonnegotiable time deposit with a maturity of 2-1/2 years or more at a rate not to exceed the higher of the average 2-1/2 year yield for United States Treasury securities as determined and announced by the United States Department of the Treasury immediately prior to the date of deposit, or 9.50 per cent. Such announcement is made by the United States Department of the Treasury every two weeks. The average 2-1/2 year yield will be rounded by the United States Department of the Treasury to the nearest 5 basis points. The rate paid on any such deposit cannot exceed the ceiling rate in effect on the date of deposit. In no event shall the rate of interest paid exceed 12.00 per cent.

By order of the Committee, March 31, 1981.

(Signed) Normand R. V. Bernard

Normand R. V. Bernard
Executive Secretary of the Board

[SEAL]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date March 26, 1981

To Chairman Volcker

From Messrs. Furlong and Regalia

Subject: Reinstating the Differential on the MMC

If the differential on the MMC were reinstated at all levels of the 6-month Treasury bill rate, deposit flows at thrifts likely would pick up, and there could be some improvement in their earnings. The figures below show the projected deposit flows and earnings impacts on thrifts from restoring the differential on the MMC during the remainder of 1981. These calculations are based on an assumption that thrifts can earn a 2 percent margin on new deposits.

If there were no rollover privilege for banks, line 5 could be about doubled.

Thrift Deposit Flow and Earnings Impact of Reinstating the Differential on the MMC

	S&Ls	MSBs	CBs	Total
(1) 1981 QI MMC balances ($ Bils.)1/	196.3	52.0	195.7	444.0
(2) 1981 Q4 MMC balances (no change in differential)	251.0	66.0	247.0	564.0
(3) 1981 Q4 MMC balance (differential, but rollover privileges for banks)	250.0	72.0	232.0	564.0
(4) Additional MMCs in 1981 ($ billions) (1)-(2)	9.0	6.0	-15.0	0
(5) Marginal impact on before tax return on assets (basis points)	6	17	n.a.	n.a.

n.a. - Not available.
1/ Estimated.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date March 26, 1981

To Chairman Volcker

Subject: Removing the SSC cap

From Mr. Furlong

If the caps were removed from the 2-1/2 SSCs, there could be some shifting from existing SSCs. Without the caps, the current SSC ceiling at thrifts and commercial banks would be 13.55 percent and 13.30 percent, respectively. At these rates it would be profitable for depositors to incur early withdrawal penalties and to reinvest the SSCs deposited in June, July and August of last year when the thrift ceiling was 9.5 percent and the bank ceiling was 9.25 percent. The volume of such deposits is estimated to be $13.7 billion at S&Ls, $3.7 billion at MSBs and $9.6 billion at commercial banks. The estimates for the cost impact on thrifts of 100 percent shifting of SSCs is shown below.

	S&Ls	MSBs
	($ millions)	
Deposit Shifted	13,700	3,500
1981		
Early withdrawal penalties earned	650.8	175.8
Additional interest expense 1/	411.0	105.0
Net gain	239.8	70.8
	(Basis points)	
Marginal impact on before tax return on assets	3.5	4.5
1982		
Additional interest expense	618.5	157
Marginal impact on before tax return on assets (basis points)	-8.4	-8.8

1/ Assumes a 360/360 day year.

These figures overstate the cost impact of lifting the caps since they assume 100 percent shifting and have not been adjusted for the margin that could be earned on new deposits attracted by the higher rates. If thrifts could earn a 2 percent margin on new deposits, S&Ls would have to attract about $30.9 billion of new deposits between March 1981 and December 1982, in order to offset the additional cost incurred in 1982. This would represent a monthly new deposit flow of $1.5 billion. Mutual savings banks would have to attract about $7.9 billion, or a monthly new deposit flow of $374 million between now and the end of 1982. Staff is of the view that such monthly flows are quite modest indeed, and easily obtainable.

DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE PRESS RELEASE

COMPTROLLER OF THE CURRENCY FEDERAL DEPOSIT INSURANCE CORPORATION FEDERAL HOME LOAN BANK BOARD
FEDERAL RESERVE BOARD NATIONAL CREDIT UNION ADMINISTRATION TREASURY DEPARTMENT

For immediate release March 26, 1981

Secretary of the Treasury Donald T. Regan was today elected Chairman of the Depository Institutions Deregulation Committee at a regular meeting of the Committee in Washington, D. C.

The Committee was created a year ago by Congress to phase out interest rate ceilings on deposits in commercial banks, mutual savings banks, savings and loans associations and credit unions. Secretary Regan took over the Committee chairmanship from Federal Reserve Board Chairman Paul A. Volcker.

Secretary Regan said after the meeting: "I welcome the opportunity to lead the Committee. Deregulation will enable depository institutions to compete more effectively for funds to lend to individuals and businesses which, in turn, will use them to build new plants, equipment and housing. Most of the funds to finance new homes are provided today by depository institutions."

He went on to say: "The Committee can make a significant contribution to financial market stability by better indicating what the future pace and nature of deregulation will be, thereby reducing individual and institutional uncertainties."

Mr. Regan commented that the Committee's responsibility to phase out Federal deposit interest rate ceilings should benefit small savers and other depositors who will have the opportunity to earn a market rate of interest on their deposits in institutions insured and regulated by the Federal government.

Other members of the Committee are the Chairmen of the Federal Home Loan Bank Board, the Federal Deposit Insurance Corporation, the National Credit Union Administration and the Comptroller of the Currency.

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For release on delivery
9:30 A.M., E.S.T.

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on the Budget

House of Representatives

March 27, 1981

I am pleased to be here today to discuss our shared concerns about the interrelationships of budgetary and monetary policy. I have the distinct impression that there is a broad consensus about the appropriate goals for economic policy, including the priority need for a marked reduction in inflation as a prerequisite for sustained growth in employment, productivity, and real income. The difficult task we have before us is to translate that general consensus into effective action. The Administration has provided a firm lead in its program for economic recovery. I hope that our dialogue today will further contribute to this process by enhancing mutual understanding of our needs and policies.

In principle, it is broadly accepted that the objective of monetary policy must be to restrain growth in money and credit as part of the process of turning back inflationary forces. Indeed, the effort to control inflation has, until now, often seemed to rely almost exclusively on monetary policy. The consequence has been higher interest rates and greater strains on our financial fabric, and on industries particularly dependent on credit markets, than would otherwise be necessary.

There is also understanding that no escape from those financial pressures can be found in expansive monetary policies. In the end, such an approach would only aggravate the very inflationary forces that underly so much of the difficulties in the economy and in financial markets. What is necessary is that other policies -- including most specifically the fiscal decisions that are the province of this Committee -- be in harmony with the need to deal forcefully with inflation. In particular, I cannot stress too strongly the need to change the strong upward trend in Federal spending that has characterized recent years.

As you are painfully aware, inflation is not yet receding. We did avoid a further ratcheting up in the general rate of inflation last year, despite another quantum jump in oil prices and strong wage pressures. But that "holding action" has been accompanied by little growth, on balance, in economic activity since 1979, and unemployment is high in important sectors of the economy.

Moreover, inflationary expectations are now deeply embedded in public attitudes, as reflected in the practices and policies of individuals and economic institutions. After years of false starts in the effort against inflation, there is widespread skepticism about the prospects for success. Overcoming this legacy of doubt is a critical challenge that must be met in shaping -- and in carrying out -- all our policies.

Changing both expectations and actual price performance will be difficult. But it is essential if our economic future is to be secure.

Monetary policy inevitably has a crucial role in this effort. It must be -- and must be seen to be -- consistently directed towards curbing excessive growth in money and credit. Such restraint is inherent in the Federal Reserve's commitment to reduce the growth of money and credit over time until inflationary pressures subside.

Our specific objectives for monetary and credit growth in 1981 were presented to the House and Senate Banking Committees last month. Without going into detail here, these targets point toward further reductions in the growth of money and credit as compared with the rates of increase in other recent years. In the context of strong inflationary pressures, the targets are intended to be restrictive, as they necessarily must be if there is to be a winding down of the inflationary process.

The need for that basic discipline is common to virtually all schools of economic thought and is, as you know, recognized in the Administration's program for economic recovery. The only issue for debate is how vigorously to proceed.

I might also note that our efforts to keep money growth within acceptable bounds will at times be associated with substantial variations in short-term interest rates in response to shifting credit demands, changes in economic activity, or other factors. Increases or declines in short-term rates -- such as have occurred recently -- are sometimes cited as an indication that Federal Reserve "policy" is changing. But those interpretations are misleading. Those interest rate fluctuations typically reflect shifts in credit demands and expectations about inflation and economic activity, which can be volatile, and should not call into question our intent to maintain firm control on monetary growth over time. At times, with inflation strong and the economy expanding, restraint of money and credit expansion may well be associated with high interest rates. But those high interest rates are fundamentally a reflection of the strength of inflation and excessive credit demands; they are not in themselves a policy objective. Indeed, over time restraint on money creation should lead to lower, not higher interest rates, as inflation subsides.

It is clear that the process of reducing inflation through monetary restraint can be painful. It implies less money and credit than is needed to support both the current rate of inflation and sustained growth of real activity. Obviously, the faster that inflation subsides, the greater will be the scope for real gains in economic activity. Monetary policy is, of course, designed to encourage and speed this disinflationary process. But if strong cost pressures from wage settlements, energy prices, or other factors persist or accelerate, strains in financial markets will be greater than otherwise, and real activity is likely to remain constrained. All of that points up the importance of other aspects of economic policy and, in particular, the stance of fiscal policy, the principal concern of this Committee.

The Congress and the Administration are now in the process of making a fundamental reappraisal of the conduct of economic policy. The focus of this effort is the Administration's far-reaching proposals for tax cuts, spending reductions, and regulatory reforms. The design and success of the program that emerges is critical to the effort to reduce inflation and increase productivity. I personally am encouraged by the initial Congressional reactions to the new direction proposed by the Administration. There appears to be broad recognition of the nature and urgency of our problems and a willingness to bring to bear a new discipline on spending.

This Committee and others will be debating, as you must, the Administration's proposals. In my view, it would be inappropriate for me or the Federal Reserve to inject ourselves into consideration of the precise form of the budget and tax cuts. Rather, I will confine myself to some general comments about the overall thrust of the budget, and how it interrelates with the problems and purposes of monetary policy.

In that connection, I want to emphasize that my judgments about appropriate budgetary decisions are not heavily dependent upon a particular forecast about economic activity over the next year or two. Of course, the actual budget results for any fiscal year are in fact sensitive to what is happening with respect to prices, unemployment, real income, and interest rates. But our ability to forecast these variables with precision is demonstrably limited. The range of uncertainty is probably increased at a time of major new policy initiatives and possible "external" shocks because past relationships may be a less reliable guide to the future.

I know you unavoidably will need, in the end, to make precise numerical assumptions in presenting the budget. But rather than suggesting precisely which assumptions are most plausible for fiscal 1982, I believe it more important to emphasize certain basic and longer-run considerations that seem to me valid whether or not growth or inflation turns out moderately better or worse next year than a particular forecast might suggest. I emphasize the point because the problems with which we are dealing are fundamental; they have arisen over a long period of years; and the solutions must be geared to the fundamentals rather than to cyclical concerns, that to a considerable degree are unpredictable in any event. Put another way, I believe we have a clear idea of where the major economic and financial risks lie, and now the task is to minimize them.

Among the fundamental considerations is the desirability, from the standpoint of economic performance over time, of tax reduction. I have little doubt that the growing level of taxes -- relative to GNP approaching the highest level in our history, even during war -- is a factor both in slowing growth, adding to inflationary cost pressures, and distorting savings and investment decisions.

There is no dispute among economists that the particular structure of taxes can have important effects on incentives to work, to save, to invest, and to bear risk. Consequently, to the extent taxes can prudently be reduced, it is important that the reductions be designed in a manner to maximize the beneficial effects on incentives. That is why, as I understand it, the Administration has urged that tax proposals involving other considerations be deferred.

What limits our ability to reduce taxes is, of course, the potential budgetary deficits -- deficits that are already likely to be large in the period immediately ahead. Given restrained growth in money and credit, the sale of Treasury securities to finance a deficit curtails the availability of funds to private borrowers, potentially reducing needed productive investment. As the deficits are larger, the threat of extraordinary pressures and strains on interest rates and financial markets increases, and the more difficult it is to control the money supply and inflation. The risks are increased to the extent deficits are incurred when the economy is expanding.

That is why I emphasized at the start the critical importance of cutting back as sharply as possible the inexorable rise in Federal spending. In my judgment, that must be the keystone in the arch of any new approach to economic policy -- a policy that can offer a real prospect of success in dealing with inflation and in laying the groundwork for lower interest rates and more vigorous growth.

In approaching that job, we should bear in mind the seemingly chronic tendency for actual Federal spending to exceed official estimates for future fiscal years. Recent experience in that regard has been particularly disturbing. We have usually been overly optimistic in our assumptions about economic circumstances, overestimating growth in the economy or underestimating inflation. To be sure, there will always be errors in estimates, and in some circumstances -- an unexpected recession, for example -- a temporary automatic response of expenditures to deteriorating economic conditions may be appropriate. But not all the unanticipated expenditure increases reflect new economic circumstances; the tendency has been to add or enlarge programs and to underestimate their expenditure requirements. If history is any guide, spending tends to exceed intentions as we move from initial budgetary planning to actual results, and I would suggest you appraise the risks in that light.

I would also be cautious, in assessing budgetary prospects, of the view that increased business and personal savings should be looked to as a means of financing a deficit. Savings are exceptionally low today. I share the hope and expectation that new economic policies and declining inflation will restore a more adequate level of savings. But those savings, as and when they materialize, are urgently needed to finance productive investment and housing -- they should not be dissipated in financing prolonged huge budgetary deficits.

For all those reasons, considerations of general economic policy suggest <u>all</u> the risks lie on the side of cutting expenditures too little. I am acutely aware of the difficulties and constraints that you face -- the need to increase defense spending, to protect the truly needy, to pay interest on the national debt, and to maintain strength and continuity in other essential programs. In the broadest sense, those security, social, and other requirements ultimately limit what can be done to reduce spending. But looked at from the standpoint of the need to reduce inflation and encourage economic growth, you cannot, in my judgment, cut too much. Every added dollar of spending cuts will provide more assurance that needed tax reduction can be accomplished within a prudent budgetary framework. Every step toward a reduced budgetary deficit can only help head off tension in financial markets and make room for private investment.

You know how difficult it has been in practice to achieve a reasonable balance between Federal outlays and receipts. The record is clear; there has been only one surplus in the Federal budget in the past 20 years. We will not reach that objective in fiscal 1982. But we must not continue to rationalize decisions that can only have the effect of sustaining huge deficits indefinitely.

In setting the 1982 budget, we can meet two crucial criteria that seem to me implicit in the Administration's thinking. First, we can cut back the upward trend in spending and significantly reduce the ratio of spending to the GNP. Second, we can put the budget on a path that realistically will produce balance and move into surplus as the economy returns to levels of unemployment and capacity utilization characteristic of most recent years.

You are well aware there are no easy choices before you. But the wrong choice, it seems to me, would be to let this opportunity pass to change the direction of Federal spending. Then, the risk of prolonging inflation and unsatisfactory economic performance and of great strains in financial markets would be aggravated. Surely, there is room for cutting if there is the will, and the Administration's proposals for specific cuts over a broad array of programs point the way.

The Federal Reserve has an indispensable role to play in dealing with inflation. To be effective, we must demonstrate that our own commitment is strong, visible, and sustained. That is our intention. But the effectiveness of our effort depends on complementary fiscal, regulatory, and other government policies. I feel sure that we are in fundamental agreement about those concepts. What remains is to confront unflinchingly the hard decisons that this effort will require.

* * * * * *

DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE

COMPTROLLER OF THE CURRENCY | FEDERAL DEPOSIT INSURANCE CORPORATION | FEDERAL HOME LOAN BANK BOARD
FEDERAL RESERVE BOARD | NATIONAL CREDIT UNION ADMINISTRATION | U.S. TREASURY DEPARTMENT

March 26, 1981

The Honorable Alan Cranston
United States Senate
Washington, D. C. 20510

Dear Alan:

Thank you for your letter of March 25 concerning the impact of high interest rates on the earnings of thrift institutions and urging the Depository Institutions Deregulation Committee to take steps to improve the competitive position of those institutions. This matter is very much on my mind, and I want to assure you that my colleagues and I will give your specific suggestions very careful consideration at this afternoon's meeting of the Committee.

Sincerely,

Paul A. Volcker

Paul A. Volcker
Chairman

United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

WASHINGTON, D.C. 20510

March 25, 1981

Honorable Paul Volcker
Chairman
Federal Reserve Board
Constitution Avenue
Between 20th and 21st Streets
Washington, D.C. 20551

Dear Paul,

The 1980 earnings figures for the thrift industry underscores my growing concern about the current state of the industry. Given the expectation of a continued high interest rate environment, it is certain that the 1981 earnings picture for the thrift industry will be less than satisfactory. I believe that it is important for the Depository Institutions Deregulation Committee (DIDC) to turn their immediate attention to this problem.

Through the enactment of the Depository Institutions Deregulation and Monetary Control Act of 1980, the Congress has set in place the framework for all financial institutions to move to a system of open and equal competition among themselves and with non-regulated financial intermediaries such as money market funds. If you will remember the Senate debate on the Monetary Control Act, I proposed a floor amendment to address the problem of the low yielding mortgages held by the thrifts, as it was and is still my belief that until this problem is addressed, deregulation will be a long, painful process and so it has come to be. However, the Congress did not see my point of view and a White House study of the issues was substituted in place of my proposal.

At the next meeting of the DIDC on March 26, I am requesting that DIDC take the necessary steps to improve the competitive position of savings and loan associations and the mutual savings banks. Some specific thoughts, not exclusive, however, that come to mind are the restoration of the interest rate differential on the 6 month money market certificate,elimination of the cap on certificates maturing in 2½ years or more and elimination of minimum ceiling applicable to both 6 months and 2½ year CD's. I believe that a return of the differential, in addition to the other suggestions, would greatly assist the thrifts in attracting and retaining the enormous amount of funds that will be maturing in the form of 6 months money market instruments in April and May of this year. When the rate differential was removed last year permitting banks to roll over MMCS between May 29 and November 30, at the thrift rate, the rationale was to assist small banks with their earning problems, surely the situation now is reversed and urgent action is needed on behalf of the thrift industry.

In recommending this action, I am by no means suggesting a reversal of the deregulation mandate given DIDC by the 1980 legislation. I am simply seeking a short term remedy to what we all hope will be a temporary departure from a pattern of steady growth and continued viability for our nation's savings institutions.

Your immediate consideration of the full scope of this problem in your meeting on Thursday would be most appreciated.

Sincerely,

Alan Cranston

AGENDA

DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE

March 26, 1980

3:00 p.m.

LOCATION: Board Room
Board of Governors of the Federal Reserve System
20th and Constitution Avenue, N.W.
Washington, D. C. 20551

OPEN MEETING

1. Effective date for new ceiling rates on money market certificates (MMCs) and small saver certificates (SSCs).

2. Consideration of penalty-free early withdrawals of time deposit funds in the event of bankruptcy of the depositor.

3. Reconsideration of rule permitting a phaseout of finders fees for qualifying institutions.

4. Ceiling rates on regular savings accounts and on interest-bearing transaction accounts.

5. Discussion of strategies for deregulation and consideration of petitions for ceiling rate adjustments.

6. Election of Chairman and Vice Chairman.

7. Any agenda items carried forward from a previously announced meeting.

interrelationship
$2\frac{1}{2}$ to long-term
strategy

Manageable

eliminate
minimum
ceiling

1. Events rather than formal policy

2.

Ira Kaminow

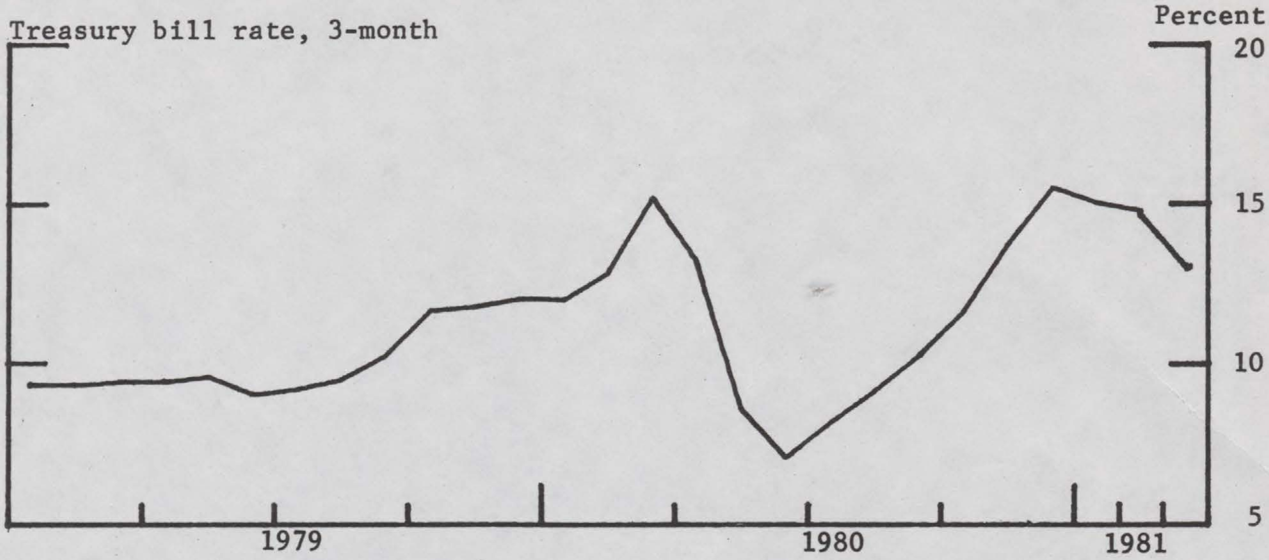
Seven a piece in
Federal Reserve
Bulletin

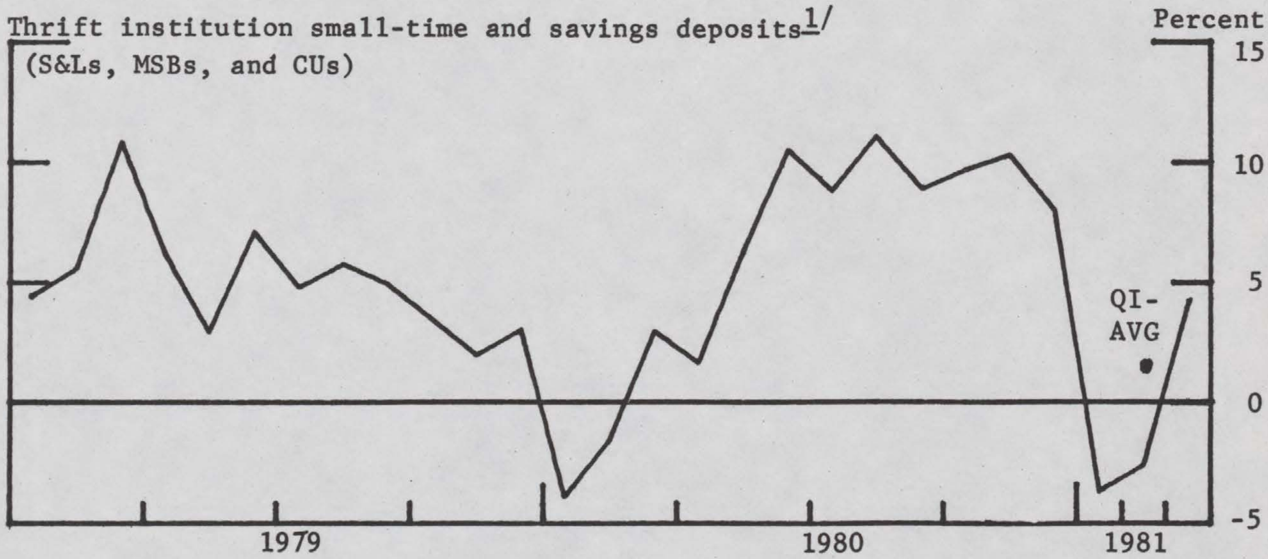
CHARTS AND TABLES FOR
DIDC DEPOSIT FLOW BRIEFING

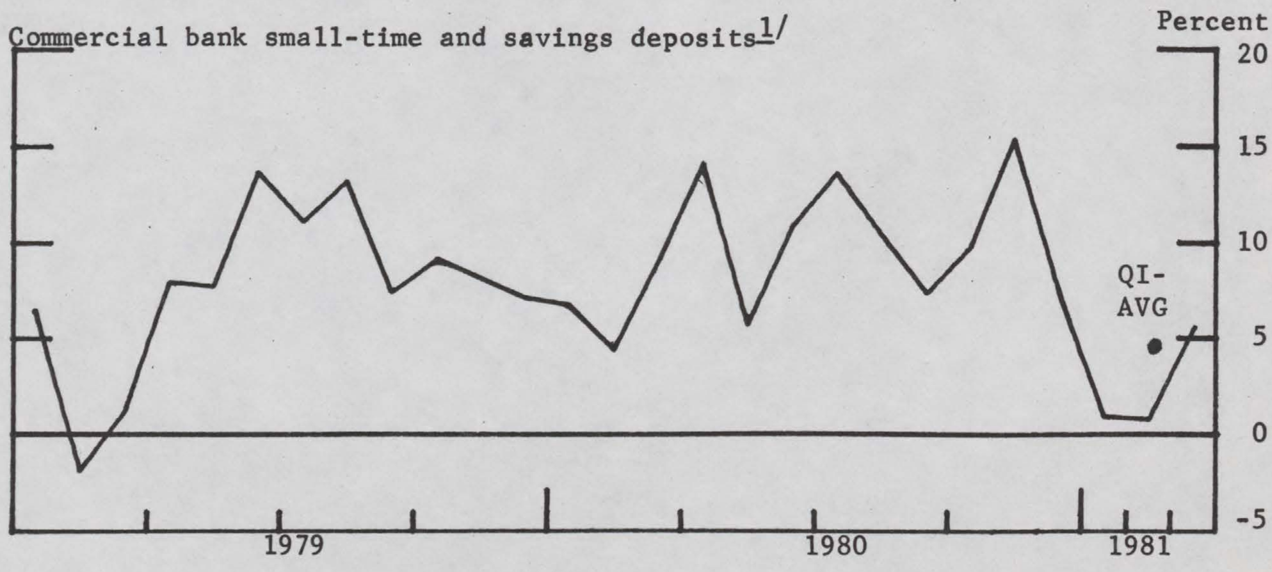
March 26, 1981

Charts and tables prepared by Federal Reserve Board staff (Mr. Regalia).

CHART 1
SHORT-TERM INTEREST RATES AND TOTAL SMALL-TIME AND SAVINGS DEPOSIT GROWTH RATES AT THRIFT INSTITUTIONS AND COMMERCIAL BANKS
(Seasonally adjusted annual rates, monthly average data)

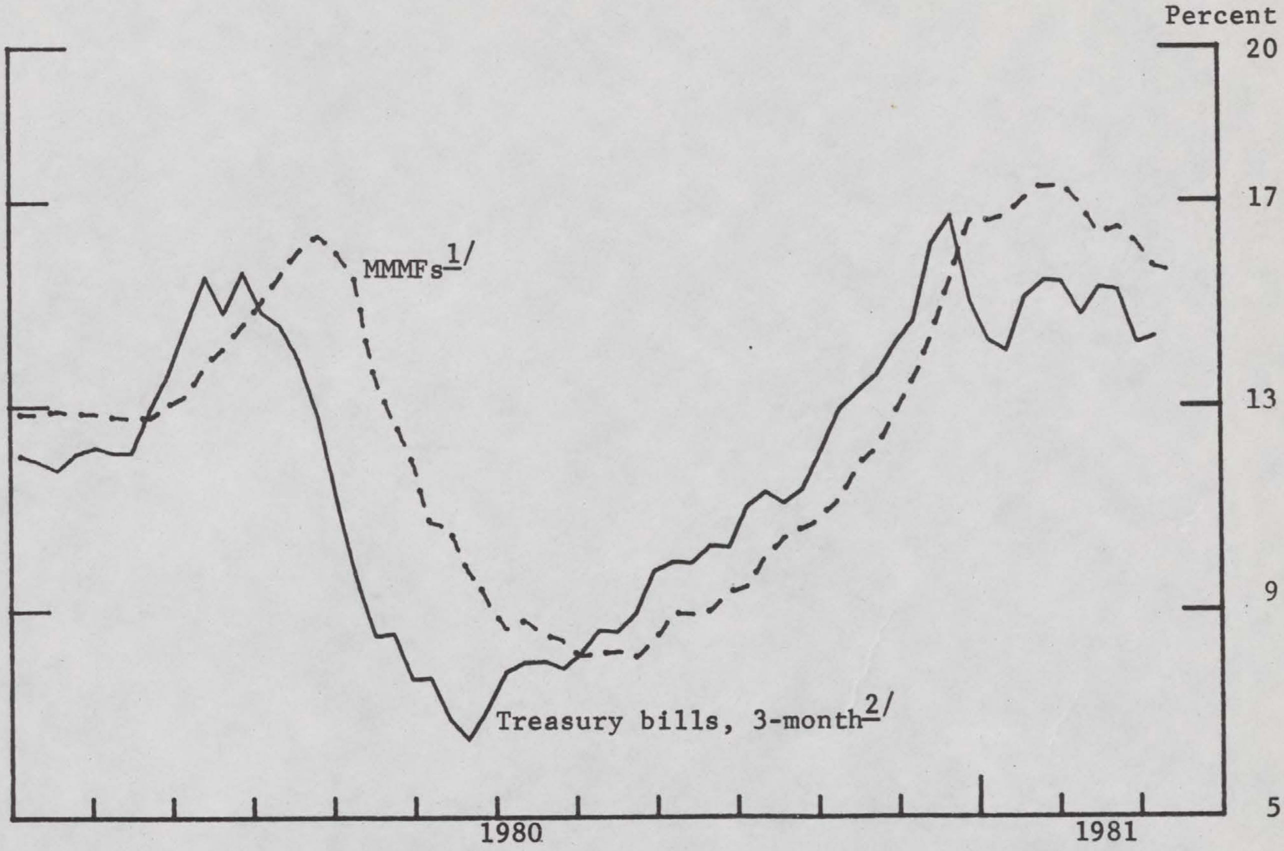


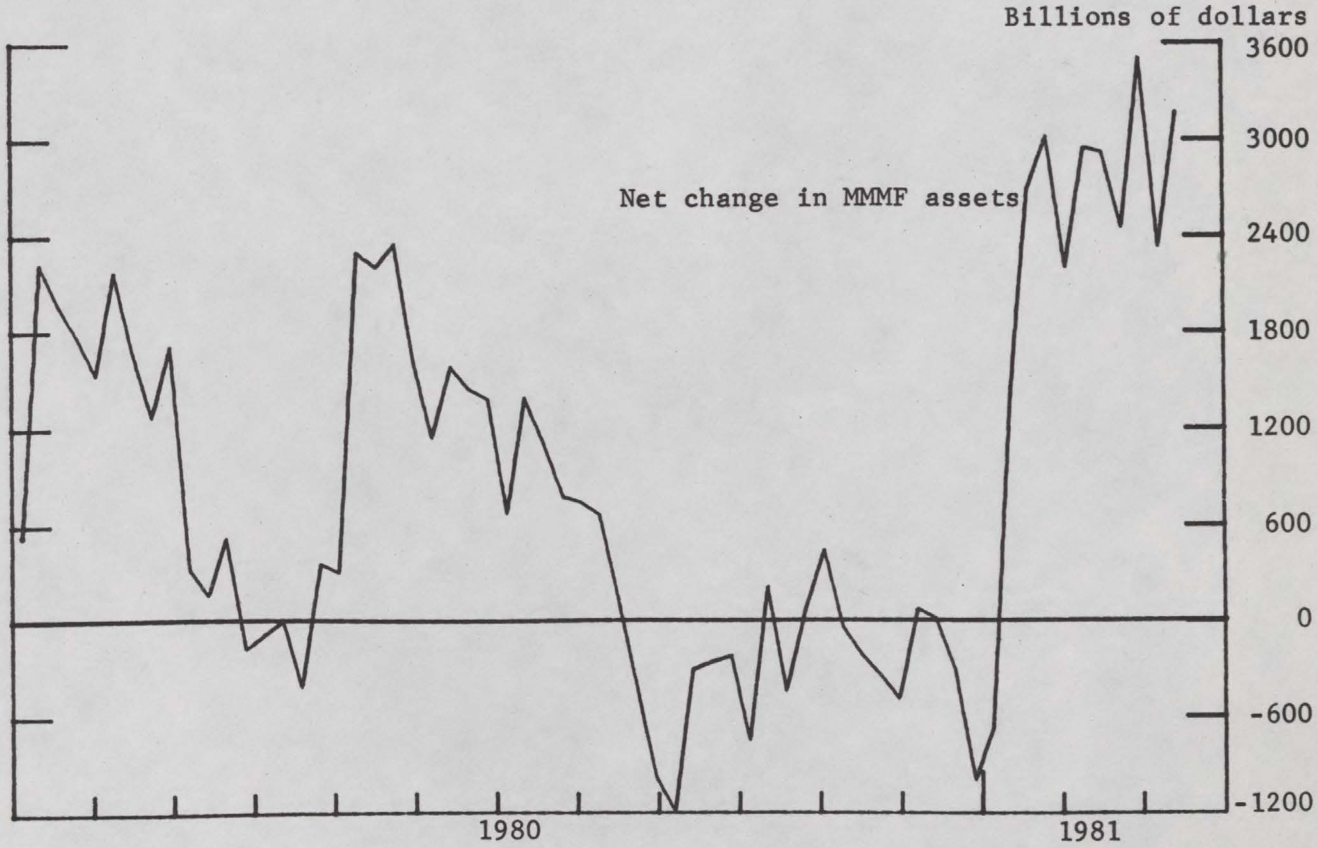




1/ Growth rates for March are estimates.

CHART 2
MONEY MARKET MUTUAL FUNDS
(Weekly, not seasonally adjusted)





1/ Net investment yield to shareholders.
2/ Discount basis.

CHART 3
TOTAL SMALL-TIME AND SAVINGS DEPOSIT GROWTH RATES
AT THRIFT INSTITUTIONS1/
(Month average, seasonally adjusted annual rate)

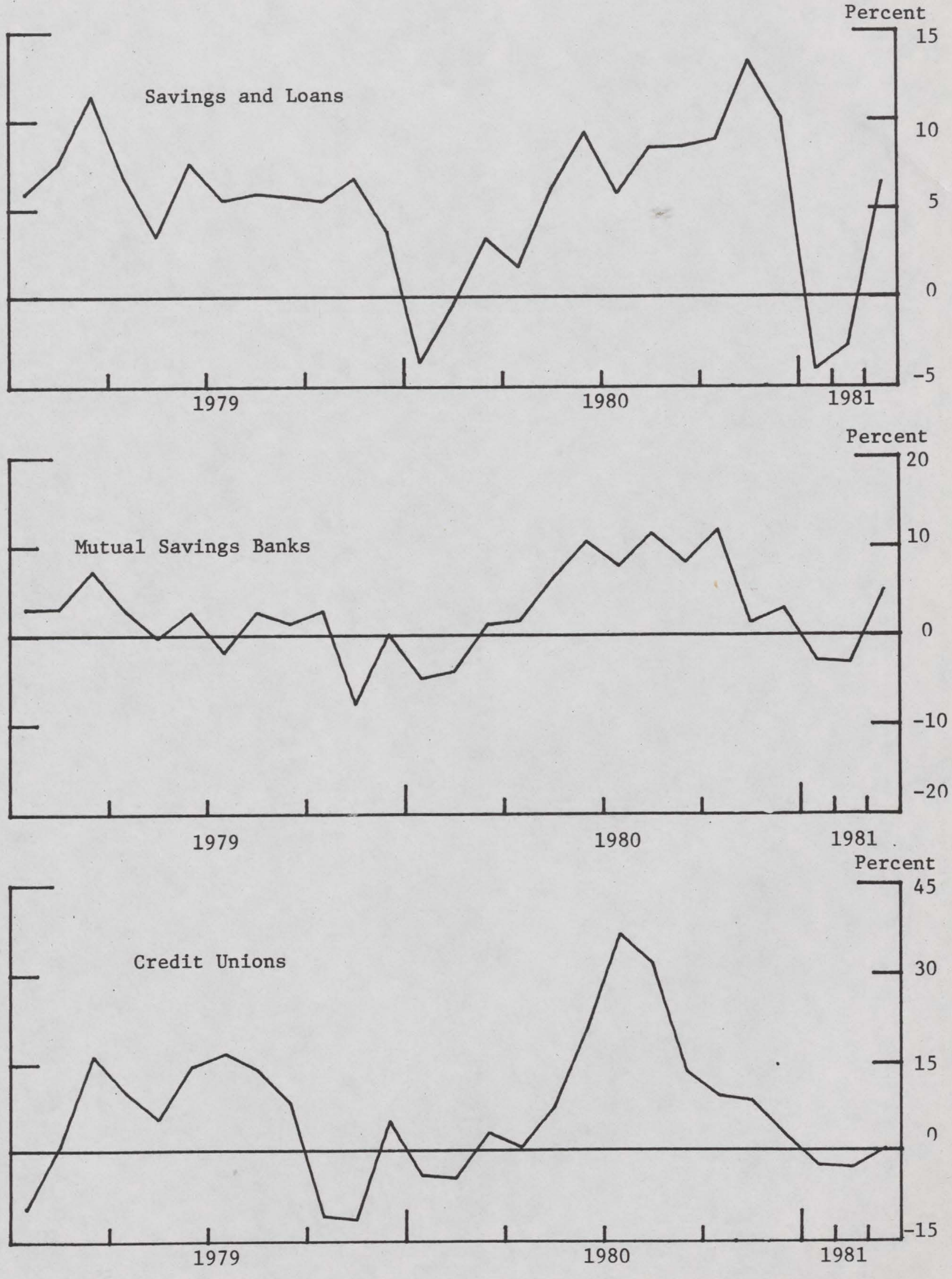
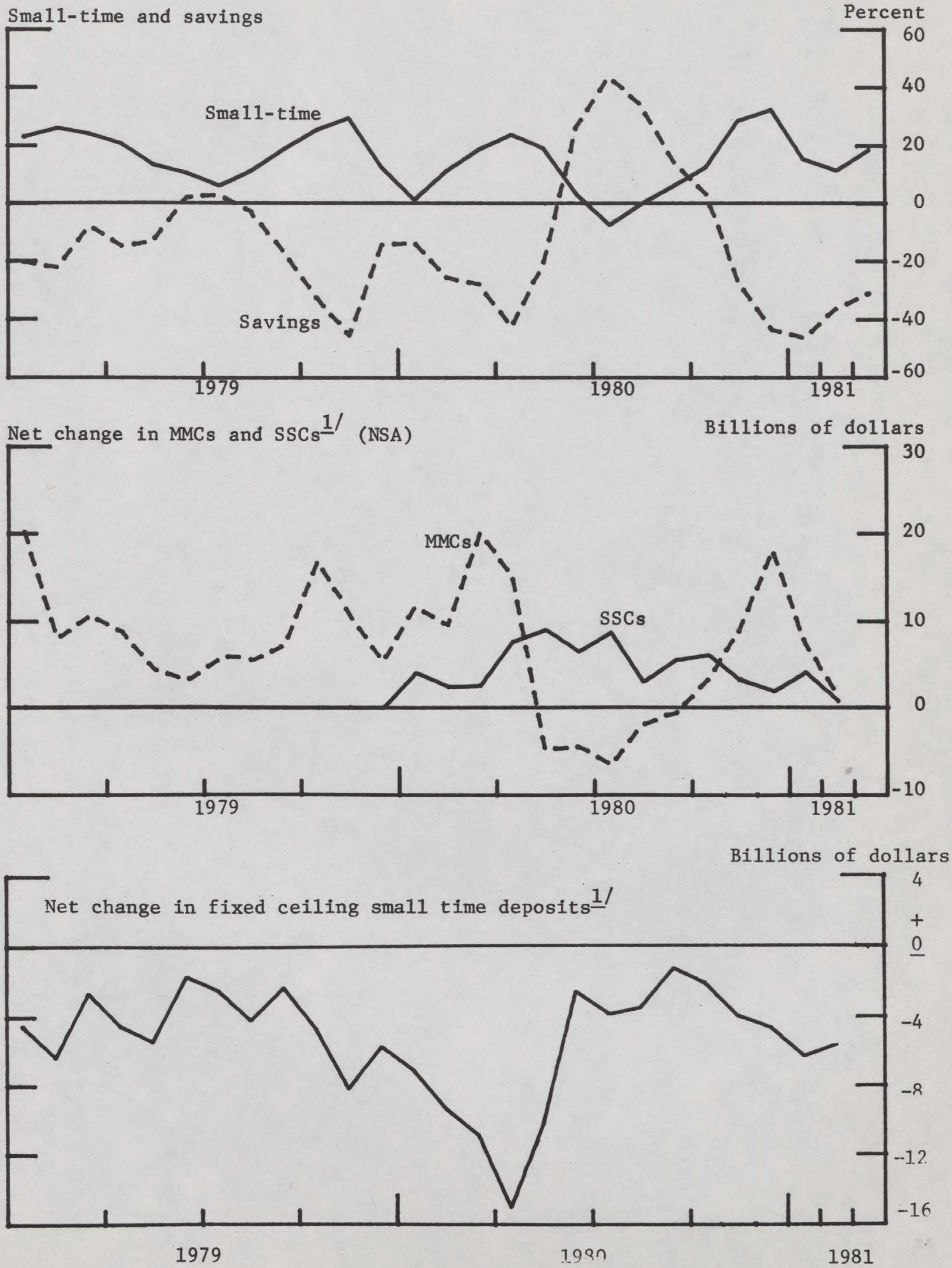
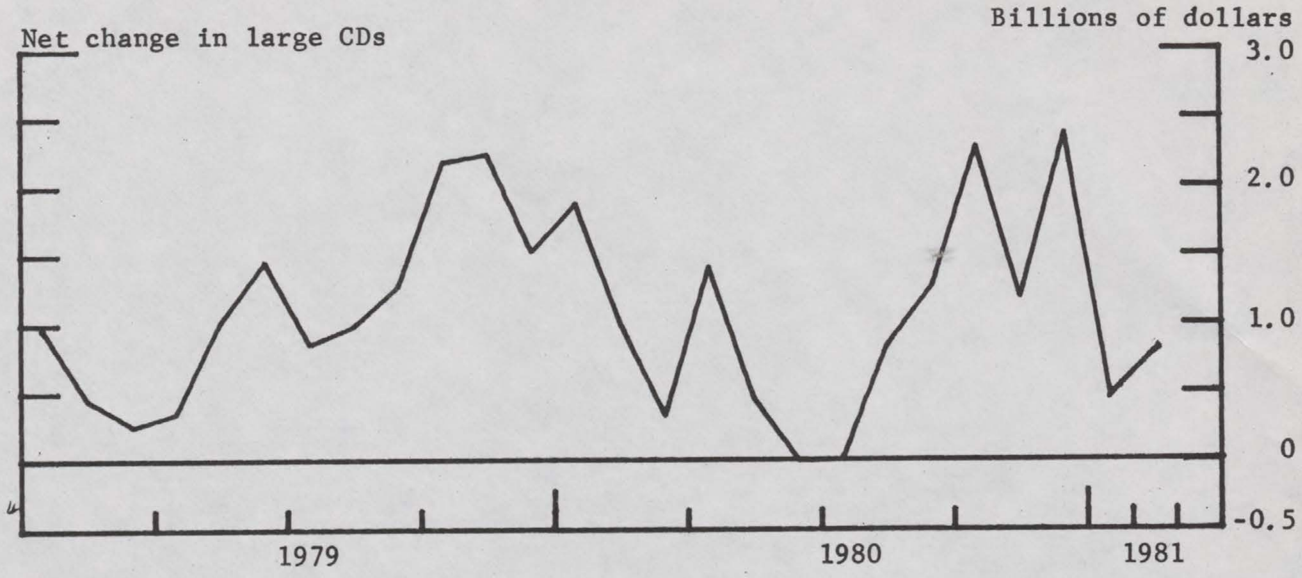


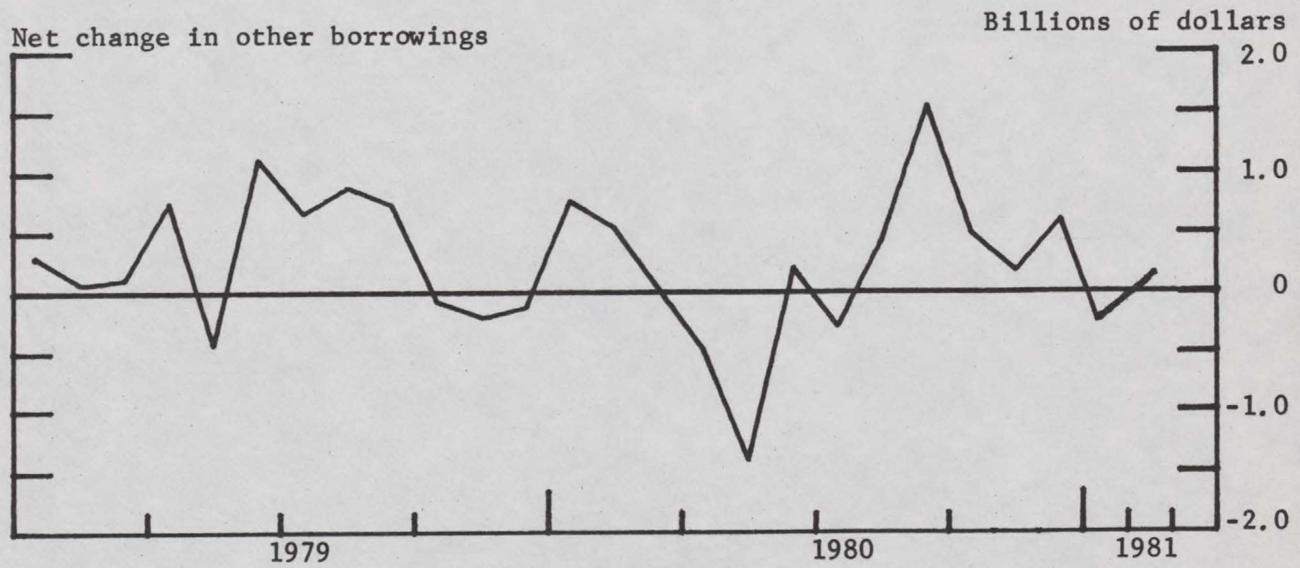
CHART 4
COMPOSITION OF DEPOSIT FLOWS AT THRIFT INSTITUTIONS



1/ Combined savings and loan and mutual savings bank deposits.

CHART 5
MANAGED LIABILITIES OF SAVINGS AND LOAN ASSOCIATIONS
(End-of-month, seasonally adjusted)





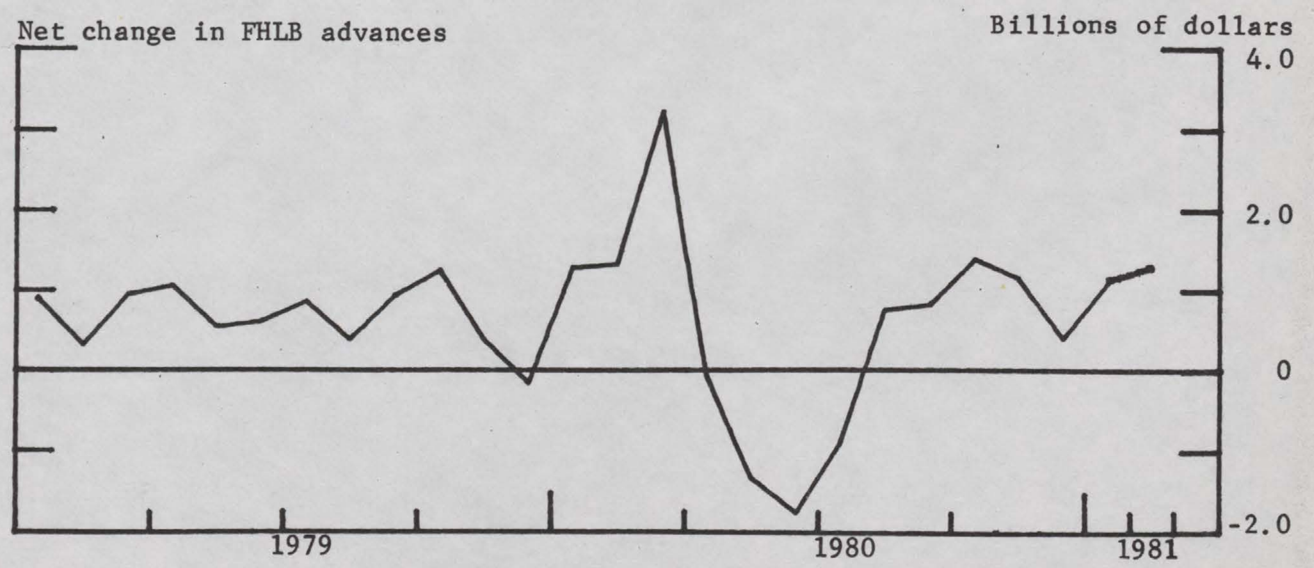
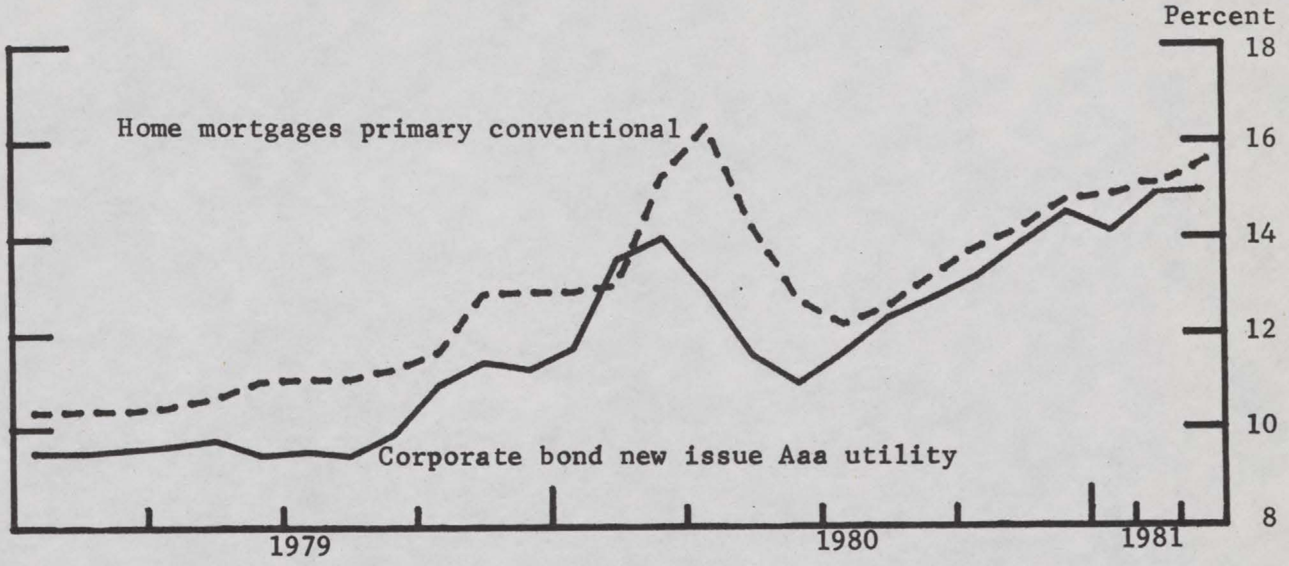
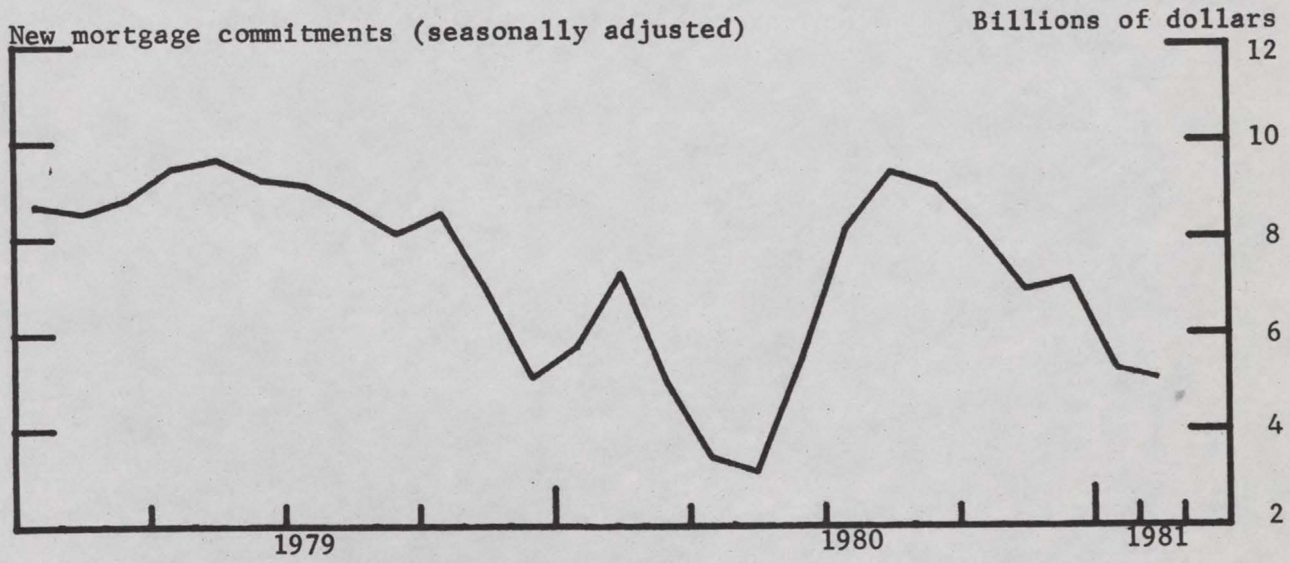
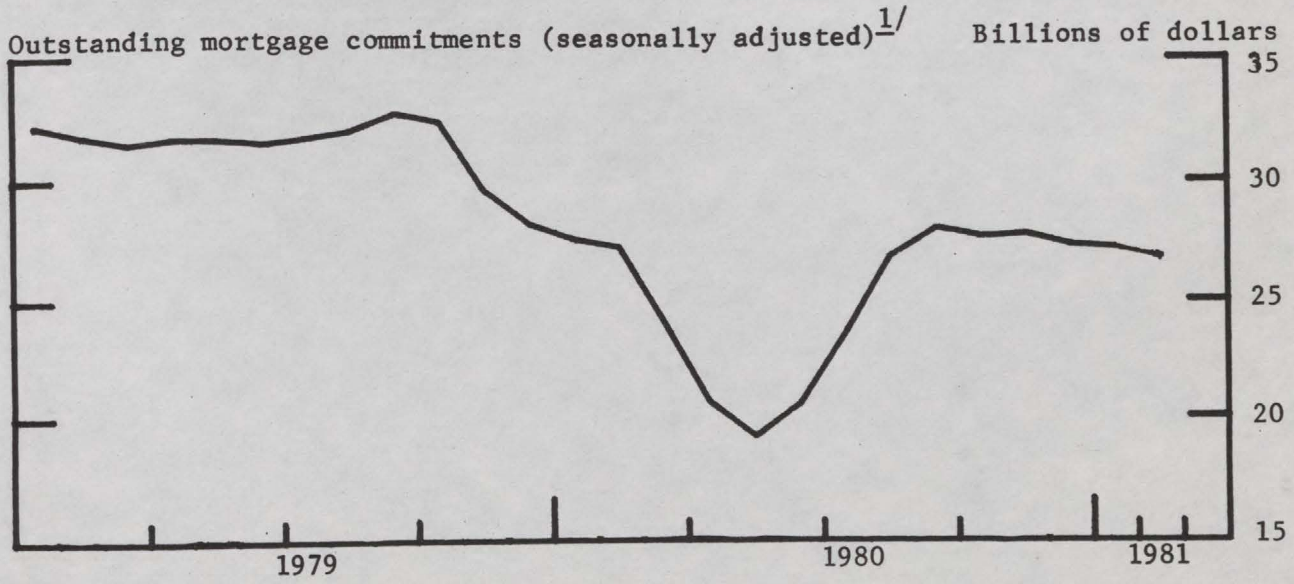


CHART 6
MORTGAGE INTEREST RATES AND MORTGAGE LOAN COMMITMENTS
AT SAVINGS AND LOAN ASSOCIATIONS
(Monthly)

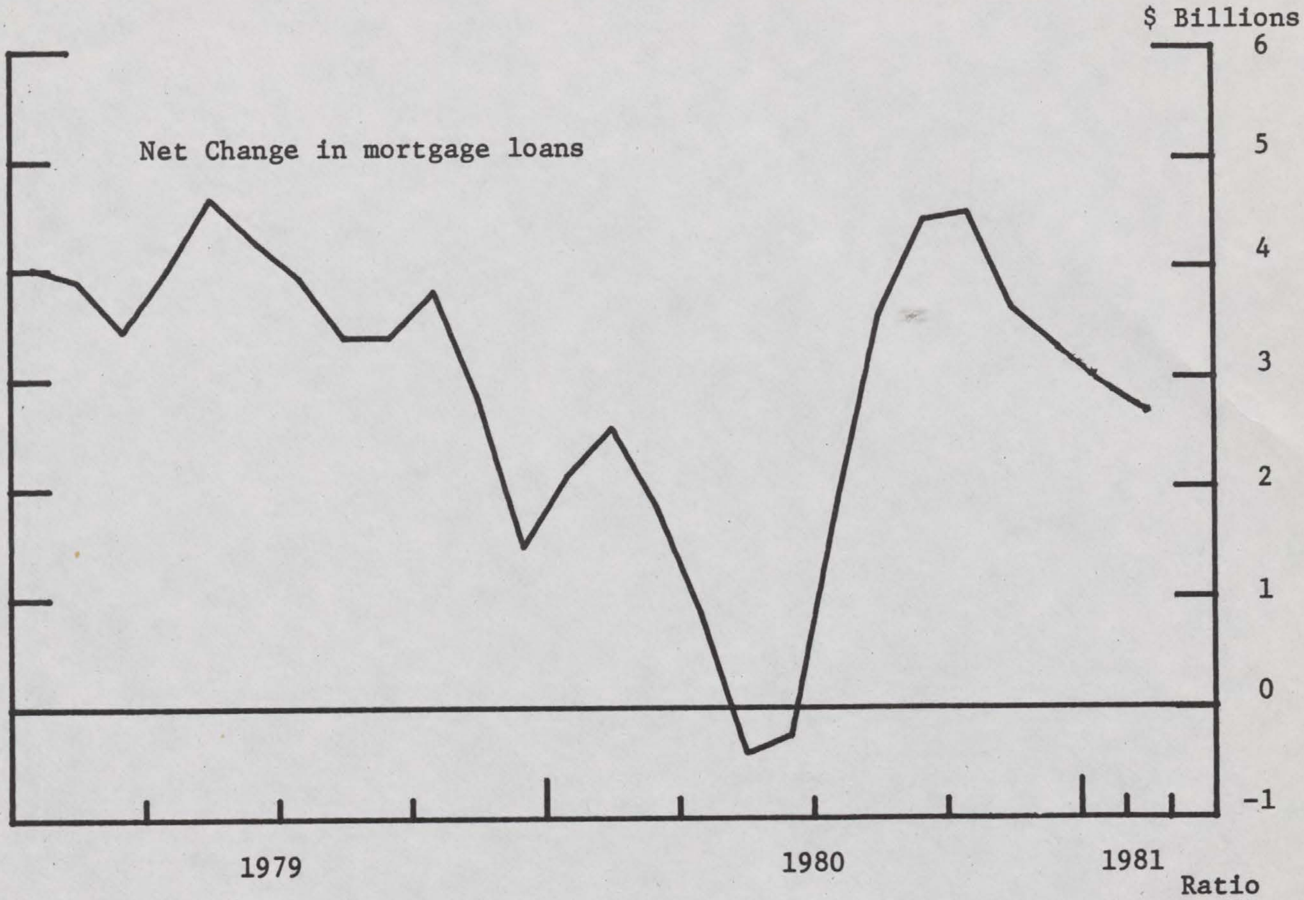


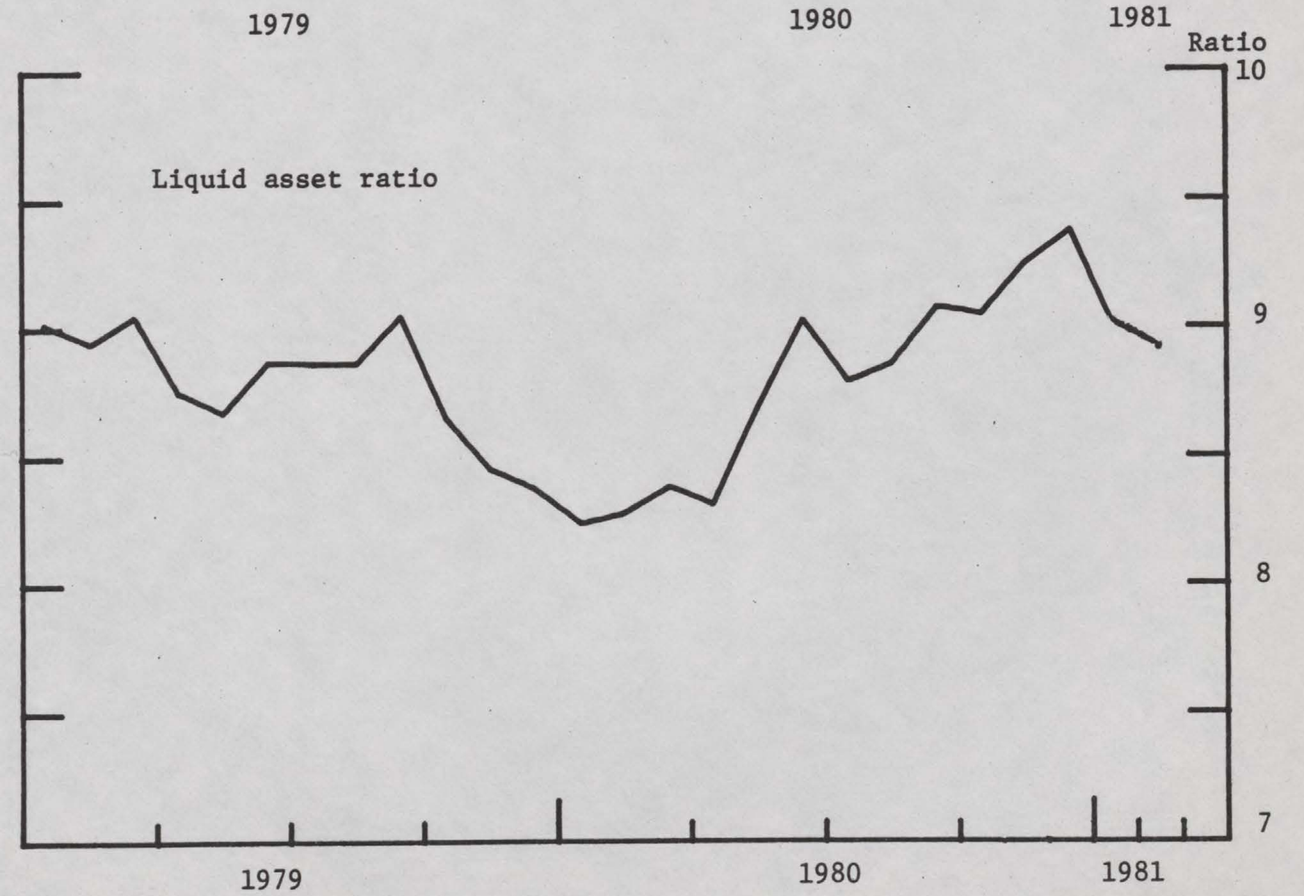




1/ Includes loans in process.

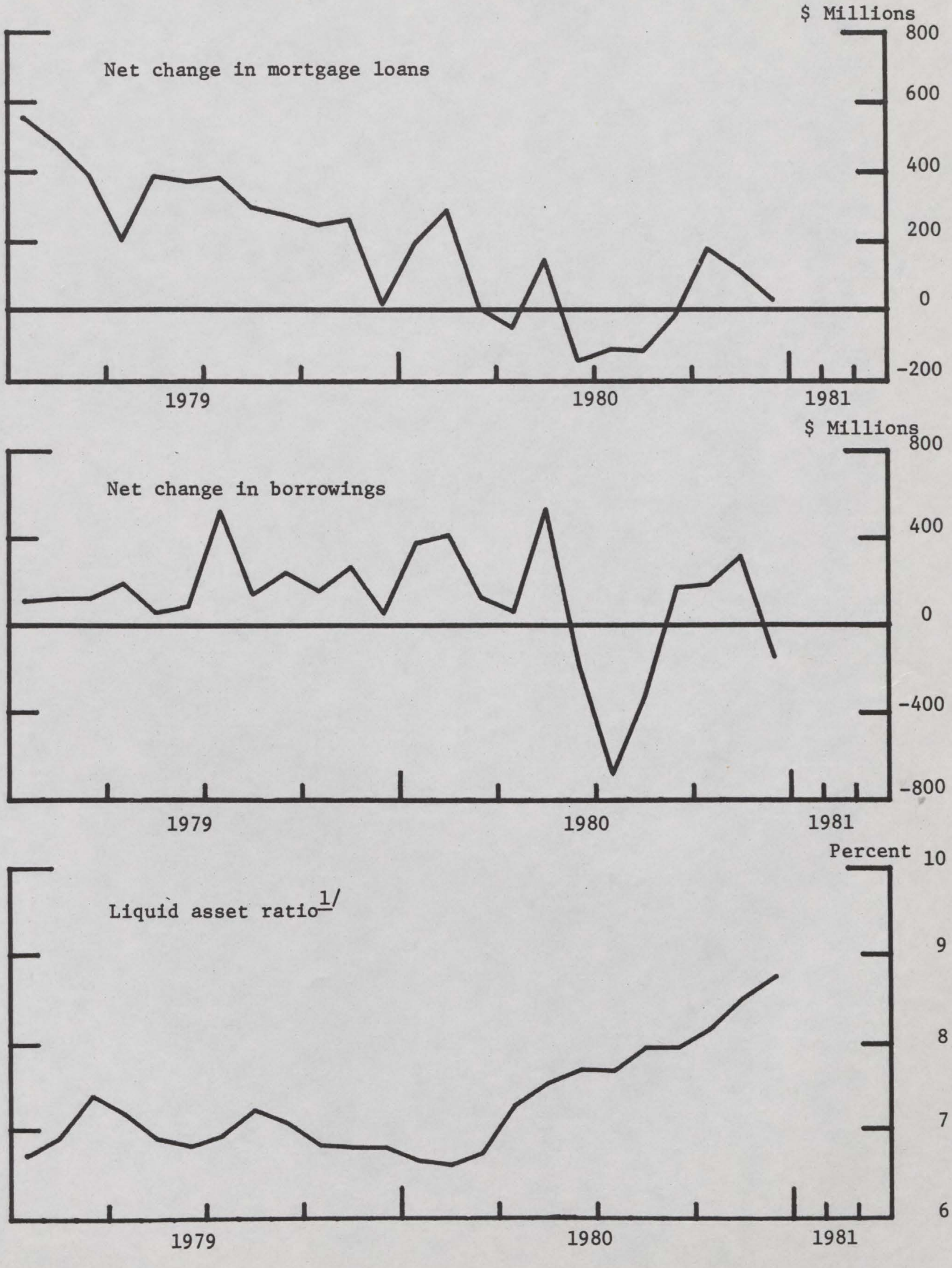
CHART 7
MORTGAGE LENDING AND LIQUID ASSET RATIO
FOR SAVINGS AND LOAN ASSOCIATIONS
(End-of-month, seasonally adjusted)





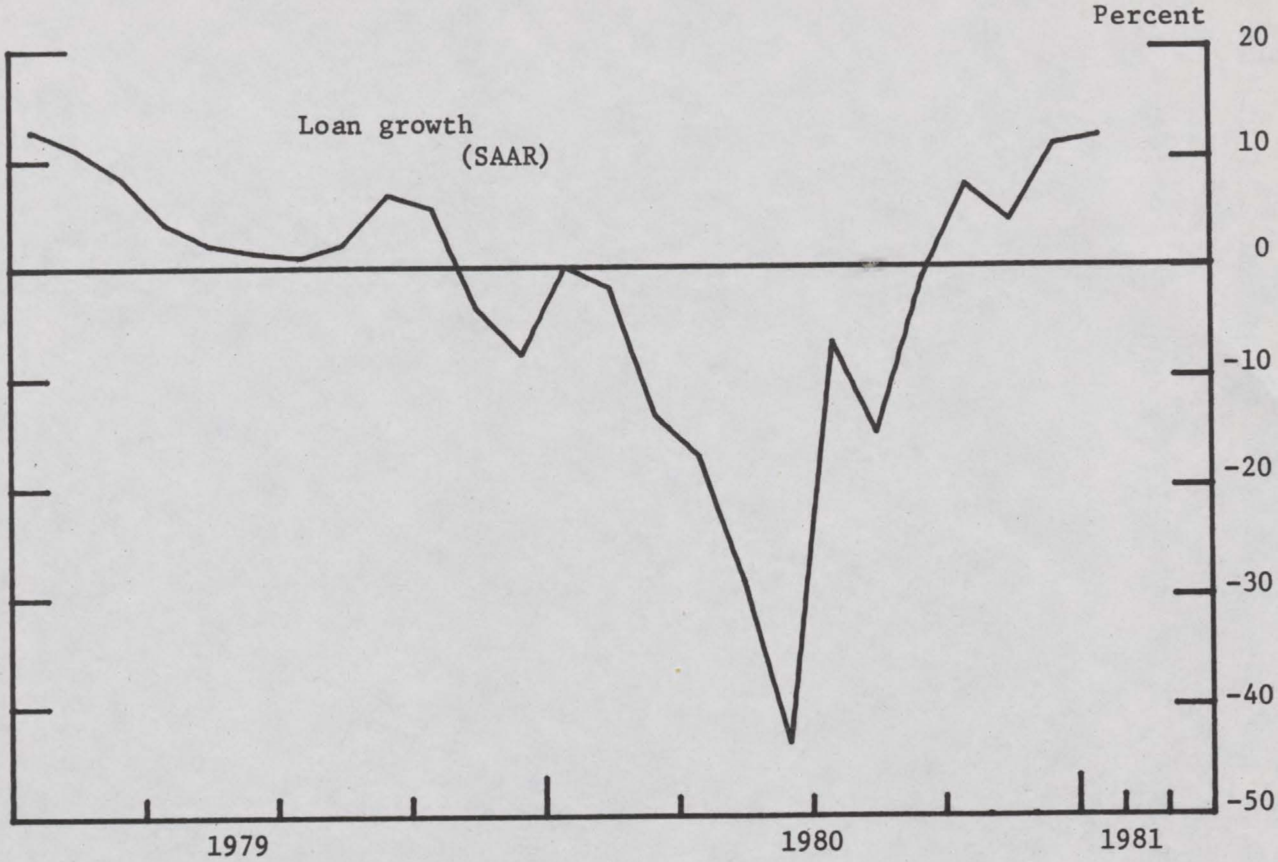
1/ Cash and other liquid assets as a percent of savings plus borrowings payable in 1 year or less at end of month. This ratio is for insured S&Ls only.

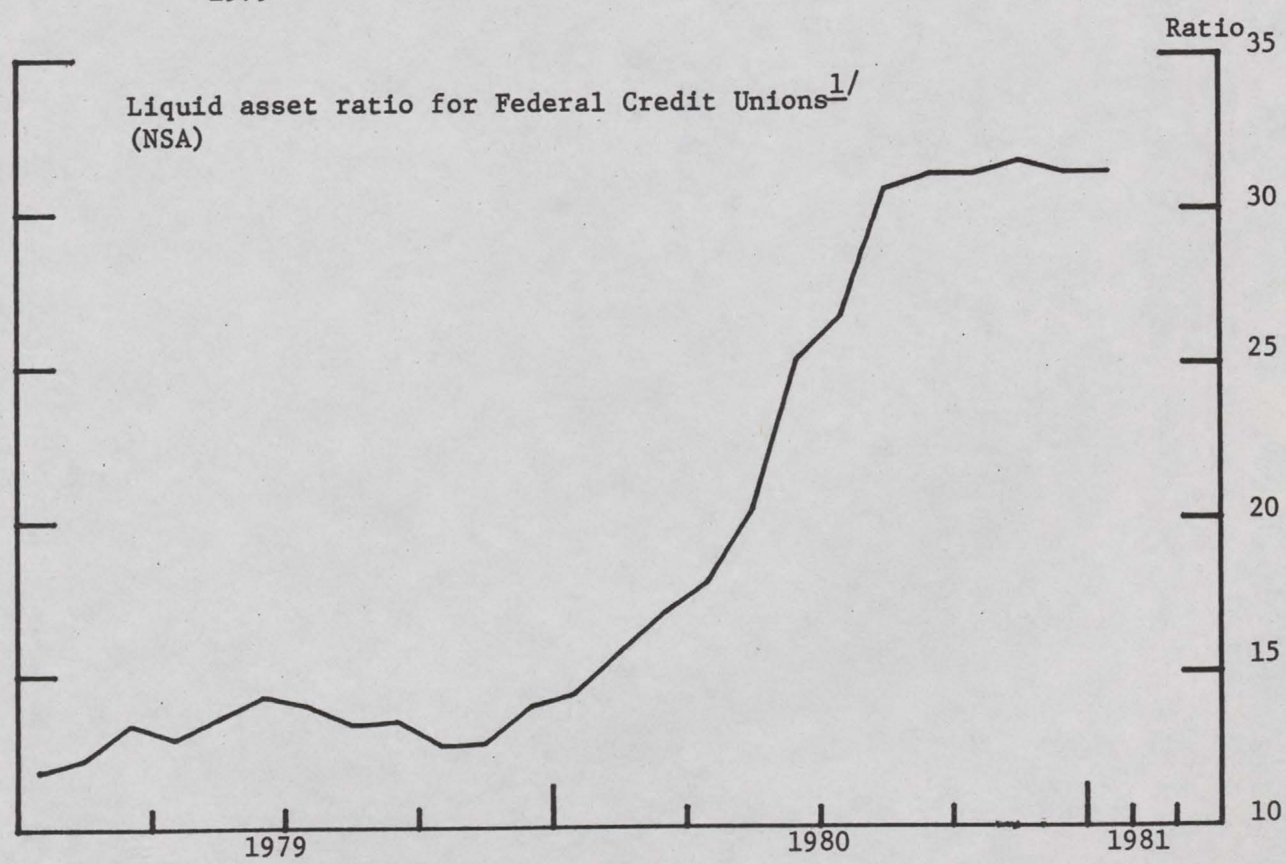
CHART 8
BORROWINGS AND INVESTMENTS OF MUTUAL SAVINGS BANKS
(End-of-month, seasonally adjusted)



1/ This ratio is defined as cash and short-term assets as a percent of deposits plus borrowings.

CHART 9
CREDIT UNION LOANS AND LIQUID ASSET RATIO
(End-of-month)





1/ Total cash and investments minus total notes payable as a percent of total savings.

TABLE 1
RATIO OF NET INCOME TO AVERAGE ASSETS

	FSLIC-Insured S&Ls	MSBs
1972	.77	.60
1973	.75	.54
1974	.54	.35
1975	.47	.38
1976	.63	.45
1977	.77	.55
1978	.82	.58
1979-H1 1/	.69	.46
H2	.64	
1980-H1	.17	-.04
H2 p/	.10	-.16

1/ Figures analyzed by doubling
p/ Preliminary.

Source: FHLBB, NAMSB

TABLE 2
ROLLOVER OF MMCs
($ billions)

		S&L	MSBs	Subtotal	CB	Total
1980	M	35.6	7.4	43.0	30.0	73.0
	A	43.0	12.0	55.0	47.5	102.5
	M	22.3	7.6	29.9	33.5	63.4
	J	28.6	9.6	38.2	20.3	58.5

March 25, 1981

To: Chairman Volcker

Thru: Don Winn *DW*

From: Bill Maloni *Bill*

Subject: Testimony of Alice Rivlin before the House Budget Committee and presentation of the Congressional Budget Office's analysis of the Reagan FY '82 Budget Revisions

--There were very few questions during the hearing relating to monetary policy, although the subject did come up. Largely, Dr. Rivlin defended the CBO's budget projections--which differed sharply from the Administration's--against Republican loyalists who implied, and then later charged, that Rivlin was biased and sanctioned leaks of the CBO numbers to embarrass the new Administration.

Rivlin refuted the charges, pointing out that similar complaints were voiced by the Carter Administration when CBO critically analyzed the latter's energy program. She also responded to the charges that CBO's budget projections invariably had been wrong in recent years by noting that most economic predictions had been wrong and that CBO's errors all had been on underestimating inflation rather than the reverse. So that if indeed CBO again was in error, it was probably low in estimating the inflationary impact of the Reagan proposals and related unemployment and deficit figures.

Specifically, she supported the direction of the President's budget but questioned the positive economic benefits predicted by the Administration, benefits which would ameliorate inflation if they were correct but would probably deepen the budget deficit and prolong inflation if they were too optimistic. Rivlin defended the CBO's analysis on the basis of historical data and patterns.

No member of the Committee asked more than one question on monetary policy. Most asked none. The questions asked were mostly general and did not hint at ingrained anti-Federal Reserve Board attitudes.

No member made explicit comments on monetary policy. No member displayed an understanding of the role monetary policy plays. In fact, several times monetary policy was discussed as if it were an Administration prerogative.

Although neither monetary policy nor the Fed was prominently mentioned at today's hearing, there were some comments made by the Committee members and Dr. Rivlin with regard to these subjects.

Dr. Rivlin

--"A relatively tight monetary policy has helped restrain the growth of inflation" but also inhibits economic development.

--"Current monetary policy can only foster growth if inflation subsides."

--"Monetary policy must stay constant if the Administration's optimistic predictions are to be realized." (She also said that other budget cuts, luck and other factors had to exist simultaneously.)

--"Interest rates have been swinging up and down as the Fed tries to keep control of monetary aggregates." (She also suggested that she expects fewer gyrations in the coming months as the Fed refined its handling of monetary policy.)

--In response to a passing comment by Chairman Jones that the Fed did not seem to do well at meeting its monetary targets, Dr. Rivlin agreed. She further stated that a large deficit could put the Fed "in a very difficult position" if it adheres to its targets.

in a non-sequitur

--Rep. Del Latta (R-Ohio)/mentioned the "Fed's bad antics" before calling on the Congress to cut the indexed (social) programs.

--Rep. Jack Kemp (R-N.Y.) said that the Reagan Administration wants to reduce inflation "with a sounder monetary policy" and he challenged Dr. Rivlin's comments about needing luck on your side to do so. Kemp felt that statements by Treasury Secretary Regan about "reducing the level of monetized debt" were of more hope to the nation than wishing for luck.

--Dr. Rivlin said, "Drastic slowing of the monetary growth would help fight inflation but dramatically slow economic growth."

--Rep. Tom Downey (D-N.Y.), admitting that he did not quite understand the velocity of money, nevertheless asked if the Administration's desired 7-1/2 per cent increase in the velocity of money won't force inflation up. Rivlin agreed. She further stated that the only way that GNP can increase--with a slow growth in money supply--is if you have rapid velocity.

cc: Mr. Syron

USL
UNITED STATES LEAGUE of SAVINGS ASSOCIATIONS WASHINGTON OFFICE
1709 NEW YORK AVENUE, N.W. / WASHINGTON, D.C. 20006 / TEL. (202) 637-8900

March 20, 1981

Mr. Normand R. V. Bernard
Executive Secretary
Depository Institutions
Deregulation Committee
Federal Reserve Building
20th & Constitution Avenue N. W.
Washington, D. C. 20551

Dear Mr. Bernard:

Pursuant to the provisions of 5 U.S.C. 553(e) and Section 1201.6(c) of the Depository Institutions Deregulation Committee's (DIDC) regulation (12 C.F.R. 1201.6(c)), the U. S. League of Savings Associations* hereby submits its petition which seeks reinstatement of the housing differential of, at least, one-quarter percent on the six month money market savings certificate and all other types of savings accounts for the duration of an emergency period. The savings associations represented by the U. S. League are subject to the rules and regulations promulgated by the DIDC with respect to interest rate ceilings under the authority of Section 203 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (P.L. 96-221, Sec. 203; 12 U.S.C. 3502).

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* The U. S. League of Savings Associations has a membership of 4,400 savings and loan associations representing over 99% of the assets of the $625 billion savings and loan business. League membership includes all types of associations -- Federal and state-chartered, stock and mutual. The principal officers are: Rollin Barnard, President, Denver, Colo.; Roy Green, Vice President, Jacksonville, Fla.; Stuart Davis, Legislative Chairman, Beverly Hills, Cal.; William O'Connell, Executive Vice President, Chicago, Ill.; Arthur Edgeworth, Director-Washington Operations; Glen Troop, Legislative Director, Washington; and Phil Gasteyer, Assoc. Director-Washington Operations. League headquarters are at 111 E. Wacker Dr., Chicago, Illinois. 60601. The Washington Office is located at 1709 New York Ave., N. W., Washington, D. C. 20006, Telephone (202) 637-8900.

Recent declines in interest rates have added to prospects for savings losses at our nation's thrift institutions in the period immediately ahead. In March and April, $78 billion of MMCs are maturing at savings and loan associations and mutual savings banks. The failure of institutions to retain and rollover these funds would constitute a major problem for our system of regulated depository institutions. A great part of this problem results from the existence in the marketplace of uncontrolled and unregulated money market mutual funds. The financial regulators, the Administration, and Members of Congress must find a workable solution to this problem. Because legislation has been introduced only recently, it seems likely that an ultimate program with respect to the money market mutual funds is some months distant.

On the other hand, it is possible, without any delay, to address the second factor threatening savings flows at thrift institutions. We refer, of course, to the absence of a housing differential on the most important source of savings now available to savings and loan associations. Money market certificates constitute 42 percent of all savings and loan association retail savings (excluding jumbo certificates).

Yet, because there is no housing differential on that type of account at today's rate levels, there is no reason to expect that savings and loan associations will enlarge their share of the MMC market and experience overall savings gains. Indeed there is every reason to suspect that present MMC balances are vulnerable at maturity to competing investment opportunities -- such as the money market funds with their "backward look" yield advertising and lagged returns.

A healthy flow of retail savings is especially important to savings and loan associations and other thrift institutions. During the savings "dry spells" of recent months, these institutions have been compelled to use Federal Home Loan Bank advances, high-cost jumbo certificates of deposit, and expensive outside sources of borrowing to replace a normal flow of retail savings to meet their withdrawal and loan commitment obligations. This more expensive wholesale borrowing has also been necessary for commercial banks, of course. But the commercial banks are structurally equipped to meet these costs because of the short-term, market-sensitive nature of their earnings portfolios. The same cannot be said for longer-term lenders. As earnings reports for 1980 clearly show, the commercial banking industry is thus better able to replace potential savings losses to money market funds.

Beyond the impact of money market funds and the absence of a housing differential, there is another factor that could affect savings flows at savings and loan associations: the increased attention of the news media to the condition of thrift institutions. That factor, of course, is outside of the DIDC's control. But a possible decline in public confidence in thrift institutions would seem a compelling reason to give immediate thought to taking actions that are within the DIDC's authority, such as reinstating the differential on all accounts. Restoration of the housing differential on all accounts -- even on an interim basis -- would go a long way toward protecting against liquidity strains which might develop from public concern about the soundness of thrift institutions.

On behalf of the 4,400 savings associations represented by the U. S. League, I would appreciate your giving thorough consideration to the issues raised in this letter at the Committee's meeting next week.

Sincerely,

William B. O'Connell

William B. O'Connell
Executive Vice President

ALE:tm

President
THOMAS F. BOLGER, President
McHenry State Bank
McHenry, Illinois 60050

First Vice President
W. C. BENNETT, Chief Executive Officer
Arthur State Bank
Union, South Carolina 29379

Second Vice President
ROBERT L. McCORMICK JR., President/CEO
Stillwater National Bank and Trust Company
Stillwater, Oklahoma 74074

Treasurer
ROBERT H. FEARON JR., President
Oneida Valley National Bank
Oneida, New York 13421

Independent
BANKERS ASSOCIATION OF AMERICA

OFFICE OF THE PRESIDENT

3510 WEST ELM STREET, McHENRY, ILLINOIS 60050

March 20, 1981

Mr. Normand R.V. Bernard
Executive Secretary
Depository Institutions Deregulation
Committee
Federal Reserve Building
20th & Constitution Avenue, N.W.
Washington, D.C. 20551

Dear Mr. Bernard:

The National Savings and Loan League (NSLL) and the American Bankers Association (ABA) have each submitted to the Depository Institutions Deregulation Committee a proposed plan for the deregulation of interest rates, and we understand that these proposals will be included on the agenda for the Committee's March 26 meeting. The two proposals approach the deregulation process from opposite directions: the NSLL plan would phase in market rates beginning with the eight-year certificate; the ABA's plan asks for a short-term market-rate instrument to compete directly with money market mutual funds. The Independent Bankers Association of America, which represents over 7400 community banks, cannot endorse either of the plans because each focuses on only one narrow aspect of the overall rate problem rather than seeking a broader solution which will serve the best interests of all depository institutions.

We certainly do not wish to downplay the seriousness of the issues underlying the two proposals. Interest rate pressures on depository institutions have indeed reached a crisis level, and are two-fold: at a time when regulated depository institutions are already facing earnings difficulties as a result of record-high interest rates, money market mutual funds are concurrently raiding billions of deposit dollars each week. These twin pressures are interrelated, and neither can be isolated and remedied with some "magic bullet" without aggravating the other. For example, increasing the rates on long-term instruments may be the least painful course for depository institutions, but a long-term instrument is not an effective tool to counteract the competition from money market mutual funds. The plan proposed by the NSLL in fact offers everything a consumer is not looking for in 1981: long-term maturity, uncompetitive rates, and no liquidity. The NSLL plan is like giving depository institutions an Edsel while the MMMF's speed off in Ferraris. On the other hand, the high-interest short-term instrument proposed by the ABA could be an insurmountable financial blow to the thrifts, whose current earnings problem is well-publicized.

Much of the depository institutions' current earnings difficulty is the result of general economic conditions which, of course, cannot be resolved by any type of new deposit instrument. In contrast to this problem which evolved rather slowly, the money market mutual funds have suddenly appeared as a new competitor offering parallel services yet unbridled by the multitude of restrictions imposed upon the regulated institutions. MMMFs are not subject to reserve requirements, deposit insurance, interest rate regulation, community reinvestment requirements, routine supervisory examination, and the host of other regulatory requirements that depository institutions face. Add the fact that they can offer checking and higher interest rates, and it is no wonder that MMMFs are draining funds from regulated institutions at a phenomenal rate.

It seems eminently appropriate for the agencies represented as members of the Deregulation Committee to combine priorities with the depository institution industry in order to address the unfettered competition of money market mutual funds as perhaps the most serious obstacle to the orderly deregulation of interest rates. In establishing the Deregulation Committee, the Congress wisely determined that the phase-out of interest ceilings should only be as rapid "as economic conditions warrant" so that the fiscal integrity of financial institutions with long-term low-yielding loan assets would not be undermined. The movement of deposit funds into MMMF's which are outside the scope of the Committee is subverting this Congressional intent to the detriment of the depository institutions.

Until depository institutions are permitted by law and regulation to better compete, equity demands that money market mutual funds play by some of the same rules of the game. We urge the Deregulation Committee to support legislation which would (1) impose a reserve requirement on MMMFs accessible by check; (2) set a ceiling on the MMMFs' yield at the prevailing rate available to regulated depositories; (3) require advertising disclosures of the lack of federal deposit insurance, that the advertised yield is based on an average, and that the rate is not guaranteed; and, (4) impose Community Reinvestment responsibilities. As a measure until legislation can be enacted, the IBAA has asked the Justice Department for a ruling that under the authority of the Glass-Steagall Act, money market mutual funds are "deposits" and as such, a fund accessible by check would be in criminal violation of the Act (letter enclosed).

Although some groups may feel that the Committee's approach to deregulation has been "ad hoc", we believe that the Congress intended for interest ceilings to be phased out with flexibility according to economic conditions. We also believe that the Committee has the responsibility to monitor and influence outside factors which undermine its ability to oversee an orderly phase-out of rates. We hope that the Committee will not yield to deregulation proposals which do not equally serve the interests of all depository institutions, but will instead focus on the underlying competitive problem of money market mutual funds which is shared by all financial institutions.

Sincerely,

Thomas F. Bolger

Thomas F. Bolger
President

TFB/nls

Enclosure

THOMAS F. BOLGER, President
McHenry State Bank
McHenry, Illinois 60050

W. C. BENNETT, Chief Executive Officer
Arthur State Bank
Union, South Carolina 29379

ROBERT L. McCORMICK JR., President/CEO
Stillwater National Bank and Trust Company
Stillwater, Oklahoma 74074

ROBERT H. FEARON JR., President
Oneida Valley National Bank
Oneida, New York 13421

Independent
BANKERS ASSOCIATION OF AMERICA

OFFICE OF THE PRESIDENT

3510 WEST ELM STREET, McHENRY, ILLINOIS 60050

February 26, 1981

Honorable William French Smith
Attorney General
Department of Justice
Room 5111 - Justice Building
Constitution Ave. bet. 9th & 10th Sts.,N.W.
Washington, D. C. 20530

Dear Mr. Attorney General:

On January 9, 1980, Philip B. Heymann, Assistant Attorney General, Criminal Division, wrote an advisory letter to Martin Lybecker, Associate Director, Division of Marketing Management of the Securities and Exchange Commission, on the issue of whether money market mutual funds were in violation of 12 U.S.C. 378(a) when they offered, as a feature of a fund, the ability to access fund participants' assets by check. The then Assistant Attorney General concluded that no violation was involved. We would like to request a review of that opinion on the grounds that it looked too much to the form and not the substance of the law. In turn, the opinion is upsetting the complex scheme of Congressional regulation of depository institutions that has been in place since the early 1930s and altering financial flows to the clear detriment of these institutions.

Basically, that Congressionally mandated regulatory structure is based on a general policy of separating the functions of depository institutions from other forms of commerce, while at the same time preventing brokerage firms, underwriters and mutual funds from engaging in depository banking. One of the key statutes employed to execute this policy is Section 21 of the Glass-Steagall Act, 48 Stat. 189, 12 U.S.C. 378(a). It is a criminal statute, and its enforcement is specifically lodged in the Department of Justice. The law is divided into two clauses. The first, 12 U.S.C. 378(a)(1) fundamentally provides that any person or firm engaged in the business of issuing, underwriting, selling or distributing securities may not also engage in the business of receiving deposits subject to check. The second, (a)(2), provides that no person or firm shall engage in the business of receiving deposits subject to check unless they are chartered to engage in such business by Federal or state law.

The Department's opinion of January 9, 1980, maintained that money market mutual funds in which the participants could access their assets by check were not in violation of 12 U.S.C. 378(a)(1) because the funds were not "deposits". It made no finding as to a violation of (a)(2), but the conclusion follows from the then Assistant Attorney General's opinion that since the funds do not constitute "deposits", there could be no violation of (a)(2).

It is our view that this opinion errs in that it overlooks the fact that money market mutual funds subject to check are considered deposits in the minds of the public. Further, Congress has imposed a scheme of interest rate regulation on deposit instruments (including the newly authorized NOW accounts) offered by commercial banks, mutual savings banks, and savings and loan associations which is constructed in such a manner that they cannot compete with the functionally equivalent instruments offered by money market mutual funds. This is increasingly upsetting the equilibrium of the operations of commercial banks, mutual savings banks, and savings and loan associations. If the flow of funds out of these depository institutions into money market mutual funds continues apace, the very safety and soundness of some of these depository institutions will be threatened with potentially grave implications, not only for these institutions and our nation's financial structure but also for the financing of important sectors of our economy.

It is our belief that Congress did not intend this to occur and that 12 U.S.C. 378(a) would, if interpreted according to its substance by the Department of Justice, prevent this increasingly serious competitive imbalance. Such an interpretation by the Department of Justice would stop money market mutual funds from acting as depository institutions offering checking accounts and halt the present breaching of Congressional policy that purposefully separates depository institutions from other forms of commerce, including investment banking.

Should the Department undertake a review of its previous opinion, the Independent Bankers Association would appreciate the opportunity to participate in a manner deemed appropriate by the Department. If there are any questions on this matter, the Washington staff of the Association would be glad to be of assistance.

Sincerely,

Thomas F. Bolger

Thomas F. Bolger
President

TFB:ks

ROBERT McCLORY
13TH DISTRICT, ILLINOIS

ROOM 2469
RAYBURN HOUSE OFFICE BUILDING
(202) 225-5221

RANKING REPUBLICAN
JUDICIARY COMMITTEE

PERMANENT SELECT COMMITTEE
ON INTELLIGENCE

U.S. INTERPARLIAMENTARY
UNION DELEGATION

Congress of the United States
House of Representatives
Washington, D.C. 20515

DISTRICT OFFICES:
KANE COUNTY
VILLAGE HALL
1200 MEADOWDALE DRIVE
CARPENTERSVILLE, ILLINOIS 60110
(312) 428-4998

LAKE COUNTY
COUNTY BUILDING
18 N. COUNTY STREET
WAUKEGAN, ILLINOIS 60085
(312) 336-4554

MCHENRY COUNTY
56 N. WILLIAMS STREET
CRYSTAL LAKE, ILLINOIS 60014
(815) 459-3399

March 3, 1981

The Honorable William French Smith
Attorney General
Department of Justice
Room 5111 - Justice Building
Washington, D. C. 20530

Dear Mr. Attorney General:

In line with other communications which you have received, I would request your careful review of an advisory letter from former Assistant Attorney General Philip Heymann to the Securities and Exchange Commission (SEC) relative to money market mutual funds. In his letter, Mr. Heymann apparently advised that access to these funds by check would not violate the federal law (12 U.S.C. 378(a)).

The concern which has been expressed to me by various bankers and representatives of bankers' associations confirm that the practices approved by Mr. Heymann's letter would seem to impinge upon the traditional and closely supervised prerogatives of commercial bankers.

While I have endeavored to warn the commercial banking industry for many years about the inroads being made by savings and loan associations, credit unions and other financial institutions, this latest practice of brokerage houses could pose the most serious threat to our commercial bankers of any which they have experienced.

I would urge your thoughtful review of the opinion of former Assistant Attorney General Heymann.

As a further basis for this request, I am enclosing a photocopy of a letter from my constituent, Thomas F. Bolger of McHenry, Illinois, who is the current president of the Independent Bankers Association of America.

Mr. Bolger's letter is most convincing that Mr. Heymann's advisory opinion should be vacated or its application deferred.

Sincerely yours,

Robert McClory
Member of Congress

RMcC:lr

Enclosure

USL
UNITED STATES LEAGUE of SAVINGS ASSOCIATIONS WASHINGTON OFFICE
® 1709 NEW YORK AVE. N.W. WASHINGTON D.C. 20006/TEL (202) 637-8900

Mr. Ettin - for info

March 17, 1981

#850

Mr. Paul Volcker
Chairman
Federal Reserve Board
Constitution Avenue & 20th Streets N.W.
Washington, D.C. 20551

Dear Chairman Volcker:

On behalf of the United States League of Savings Associations,* I wish to comment on the various proposals which would (1) create new short-term savings certificates (American Bankers Association's proposal), (2) raise the ceilings on longer-term certificates (National Savings and Loan League's proposal) and (3) raise the 30-month CD ceiling.

The severe earnings sequeeze currently being experienced by the nation's savings associations is now well acknowledged. The Reagan Administration, the Secretary of the Treasury, the Chairman of the Federal Reserve Board and the two national

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*The U. S. League of Savings Associations has a membership of 4,400 savings and loan associations representing over 99% of the assets of the $625 billion savings and loan business. League membership includes all types of associations--Federal and state-chartered, stock and mutual. The principal officers are: Rollin Barnard, President, Denver, CO: Roy Green, Vice President, Jacksonville, FL; Stuart davis, Legislative Chairman, Beverly Hills, CA; William O'Connell, Executive Vice President, Chicago, IL; Arthur Edgeworth, Director-Washington Operations; Glen Troop, Legislative Director, Washington; and Phil Gasteyer, Associate Director-Washington Operations. League Headquarters are at 111 East Wacker Drive, Chicago, IL 60601. The Washington Office is located at 1709 New York Avenue N.W., Washington, D.C. 20006, Telephone: (202) 637-8900.

rating services have all commented on the impact that too-rapid deregulation and record high interest rates have had on the thrift industry. The simple fact is that the rapid pace of the deregulation process now threatens the viability of a number of savings associations.

Because of the current conditions in the thrift industry, we feel that further actions by the Depository Institutions Deregulation Committee to raise the cost of money to thrifts would be completely irresponsible. Rather, the Committee should seek to slow the liability-oriented deregulation process.

Any move towards authorization of new types of savings accounts should have as its goal lowering, not raising the cost of savings to depository institutions. The Committee must realize that such authorizations are in effect regulatory speculations on the future course of interest rates.

It would make little sense to extend maturities of savings and loan obligations at what we all hope is the peak in interest rates. Further, the added costs of additional low denomination short-term accounts would be extremely burdensome at this point in the interest rate cycle. The earnings impact of any or all of the above proposals would be quite severe.

Sincerely,

William B. O'Connell

William B. O'Connell
Executive Vice President

Deregulation of Deposit Rate
Ceilings by Maturity

As alternatives to the proposals submitted by the National Savings and Loan League and Citibank for deregulating by deposit maturity, the Committee may wish to review the three schedules presented below. These options imply a somewhat faster pace of deregulation than under the National League's proposal, but slower than under Citibank's.

	Maturity of deposits for which rate ceilings would be indexed or eliminated		
Date	Option 1	Option 2	Option 3
July 1, 1981	8 years or more	6 years or more	4 years or more
July 1, 1982	6 to 8 years	4 to 6 years	3 to 4 years
July 1, 1983	4 to 6 years	2 to 4 years	2 to 3 years
July 1, 1984	2 to 4 years	1 to 2 years	1 to 2 years
July 1, 1985	1 to 2 years	6 mos. to 1 year	6 mos. to 1 year
April 1, 1986	no ceilings	no ceilings	no ceilings

If a phased indexing of ceilings were used, the ceilings at thrifts and commercial banks could be tied to the appropriate Treasury security yield. It should be noted that under this approach ceilings on longer-maturity deposits could be below the current 2-1/2 year SSC ceiling (even with the caps) if the yield curve were downward sloping. To avoid setting ceilings that would be lower than those possible under current regulations, a rule could be adopted that tied the ceilings on longer-term deposits to the rates on comparable maturity Treasury securities or the 2-1/2 SSC ceilings, which ever was greater. In any event, any cap maintained on the SSC would not apply to the "deregulated" instruments.

Chart 1

DEPOSIT RATE CEILINGS FOR MMCs AND
SSCs AT THRIFTS
(Weekly)

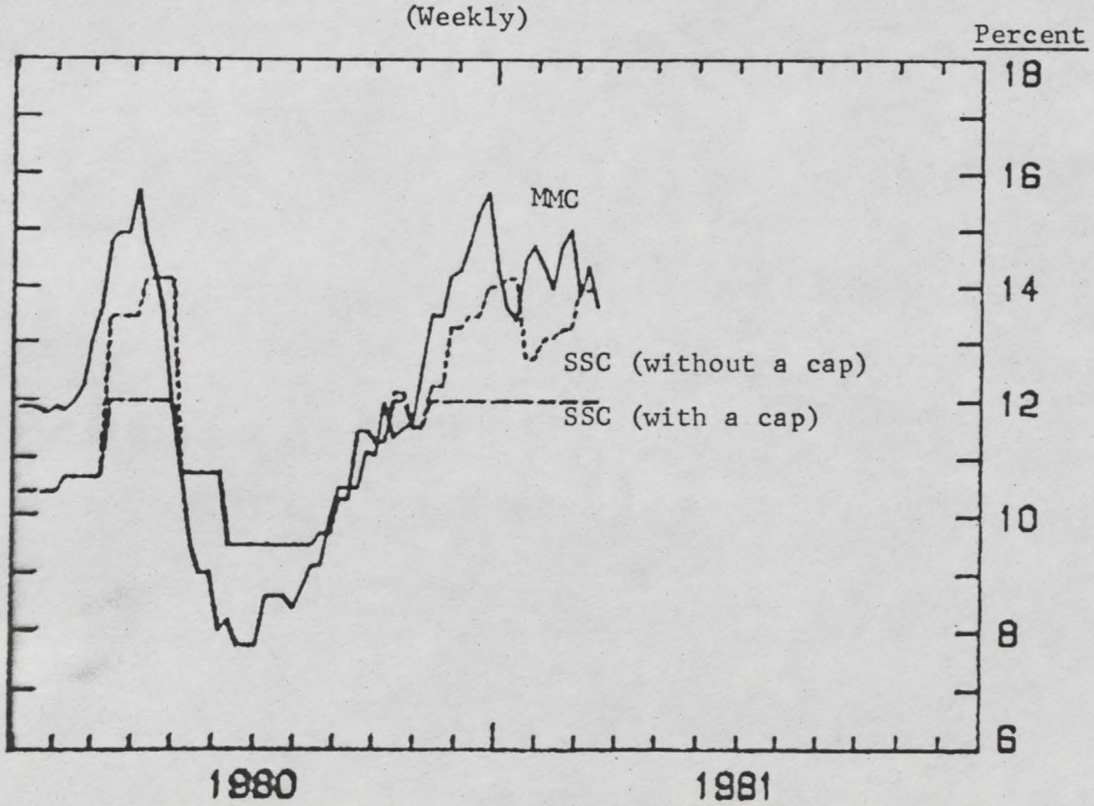


Chart 1A

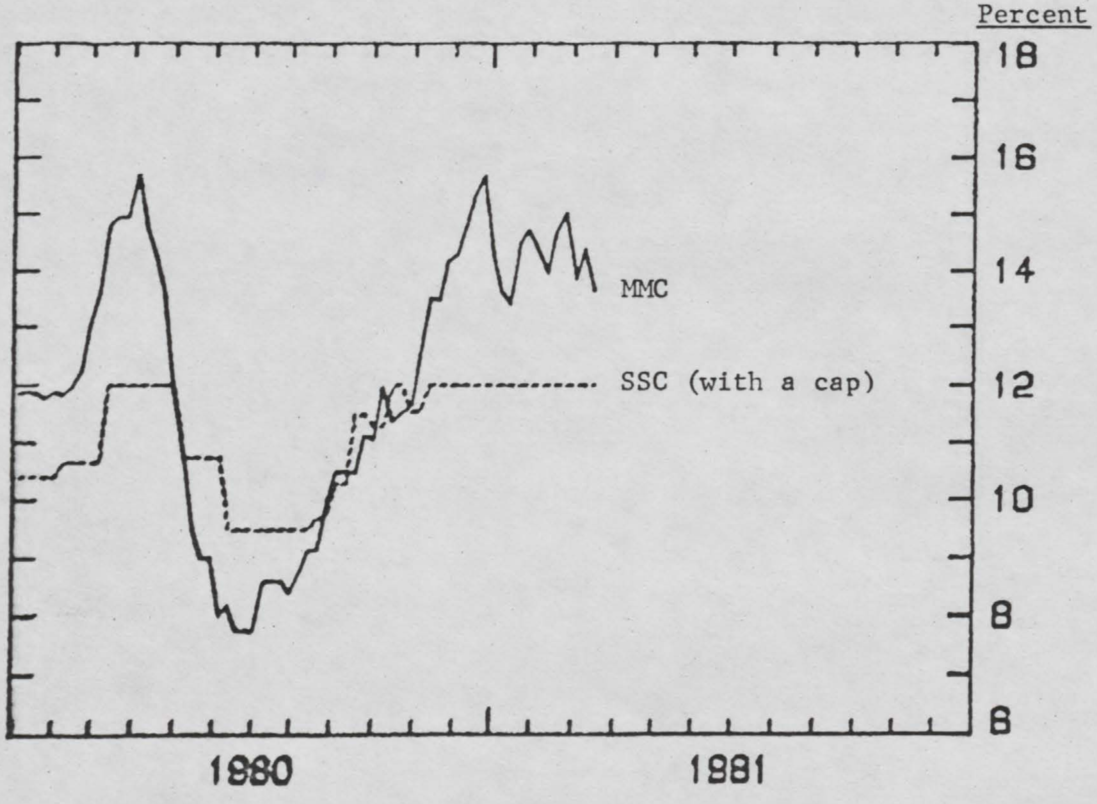


Chart 1B

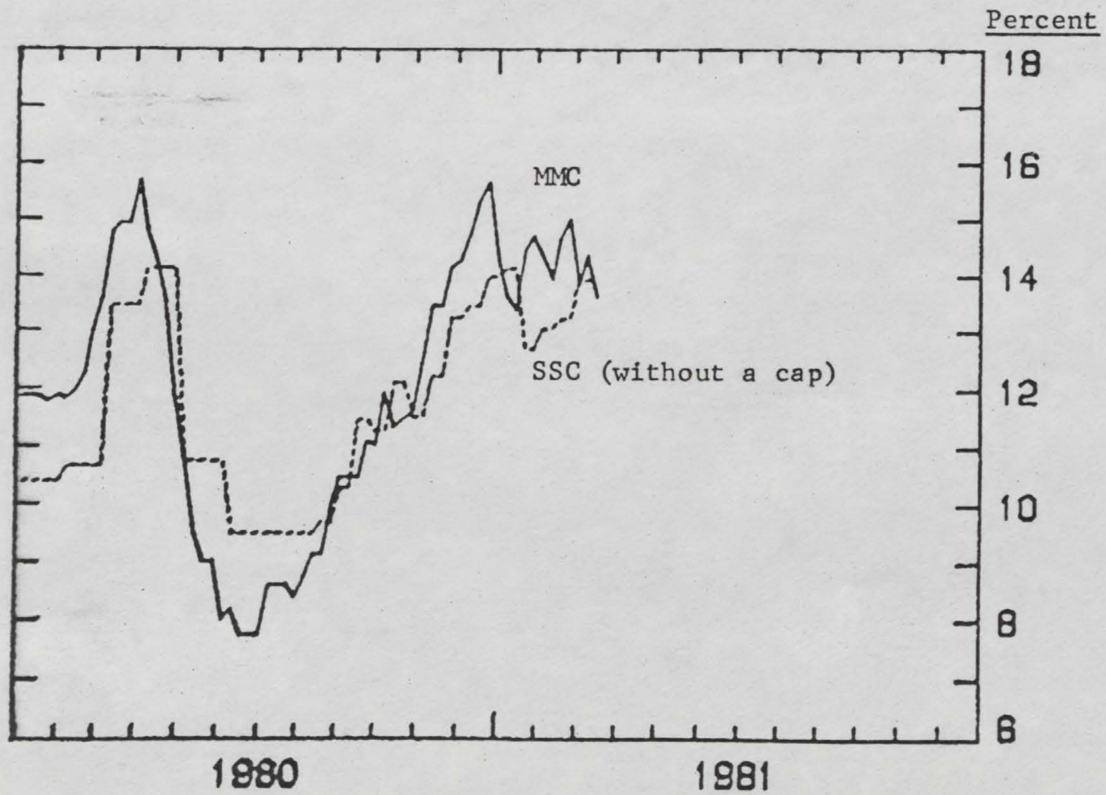
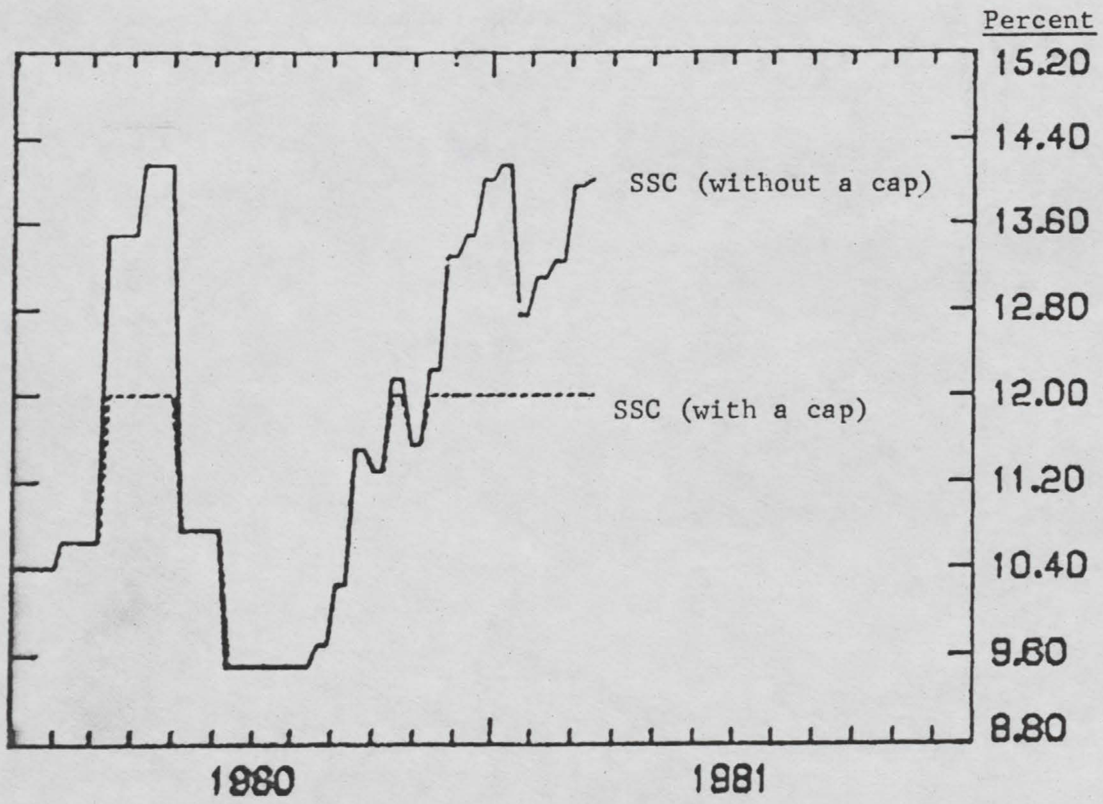


Chart 1C



Percent
15.20
14.40
13.60
12.80
12.00
11.20
10.40
9.60
8.80
SSC (without a cap)
SSC (with a cap)
1980
1981

Chart 2

MMC CEILING LESS SSC CEILING
(Weekly)

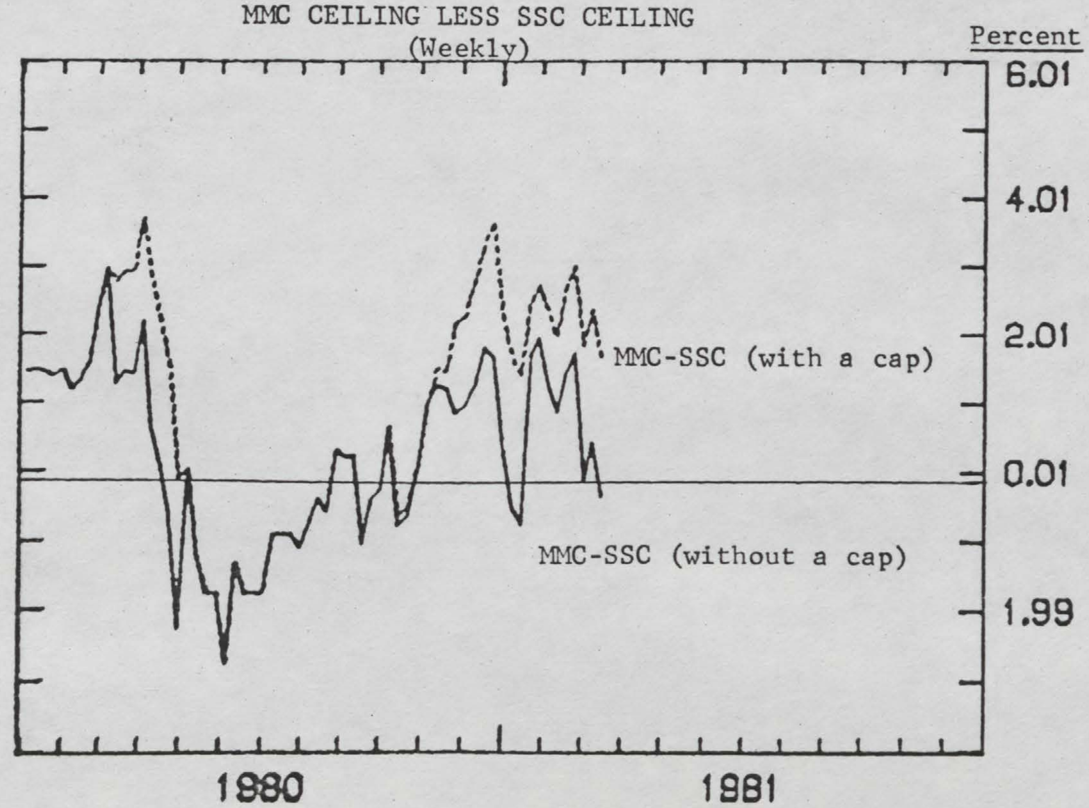


Chart 3
SSC CEILING LESS 5-YEAR TREASURY SECURITY YIELD
(Weekly)

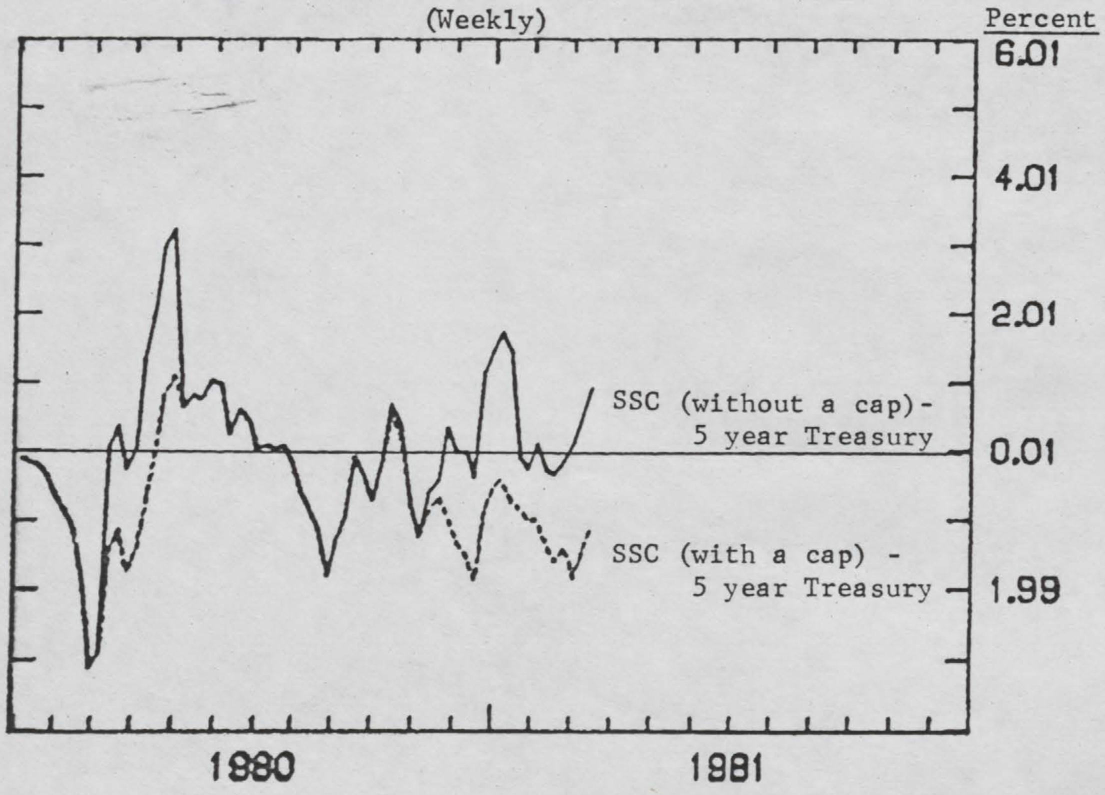
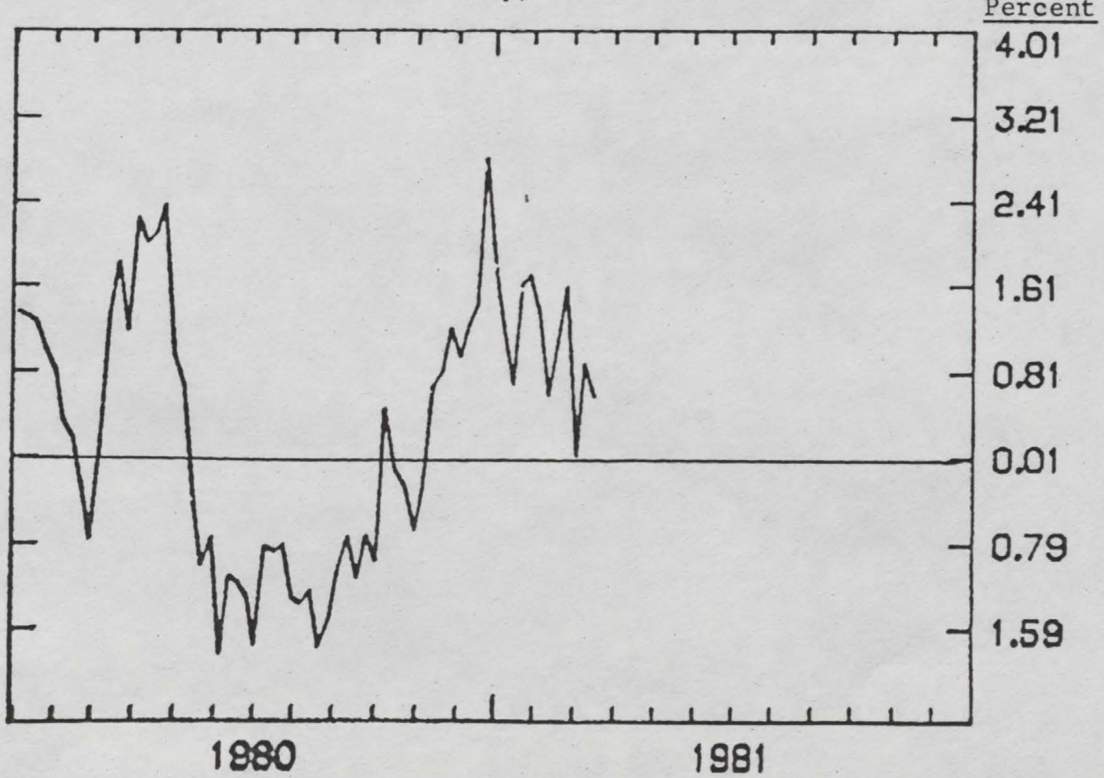


Chart 4

MMC CEILING LESS 5-YEAR TREASURY SECURITY YIELD
(Weekly)



NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS
200 PARK AVENUE
NEW YORK, N.Y. 10166
TELEPHONE 212-973-5432

Since NAMSB 1920

Cable Address:
Savings, New York

March 17, 1981

Mr. Normand R. V. Bernard
Executive Secretary
Depository Institutions Deregulation Committee
Federal Reserve Building
20th Street and Constitution Avenue, N.W.
Washington, D. C. 20551

Dear Mr. Bernard:

The National Association of Mutual Savings Banks has given intensive consideration to possible new deposit instruments and other changes in deposit interest rate regulations. This effort has been conducted through NAMSB's Special Committee on Short-Run Issues and its Subcommittee on Deposit Instruments. The conclusions reached by the Special Committee and its Subcommittee were approved today by NAMSB's Board of Directors and are summarized in this letter.

In the years ahead, savings banks will need a broadened array of deposit instruments throughout the maturity spectrum to meet a variety of objectives -- to promote a better balance between assets and liabilities, to reward long-term savers and to compete with largely unregulated money market funds. Introduction of such an array of deposit instruments at the present time would be impractical in view of the deteriorating earnings position of thrift institutions and the volatile condition of financial markets. Consideration should continue to be given to new deposit instruments for introduction when more favorable conditions prevail.

In the meantime, certain important changes can and should be adopted now:

1. <u>Encourage longer-term deposits and help stabilize the deposit structure by eliminating the cap on CDs maturing in 2-1/2 years or more. In addition, eliminate minimum ceilings applicable to both 6-month and 2-1/2 year CDs</u>. Currently, ceiling rates on market-linked CDs maturing in 2-1/2 years or more are subject to a 12 per cent cap and a 9.5 per cent minimum

ceiling for thrift institutions (11.75 and 9.25 per cent for commercial banks). At the same time, ceiling rates on 6-month money market certificates are subject to a 7.75 per cent minimum ceiling for all institutions. These provisions subvert the very purpose of market-linked accounts. In practice, they reduce the ability of savings banks to compete in high interest rate periods, while artificially placing a floor under deposit interest costs in low interest rate periods. Caps and minimum ceilings on market-linked accounts should, therefore, be eliminated.

If these changes were adopted, rate ceilings on certificates with maturities of 2-1/2 years or more would be free to move with market interest rates. Thrift institutions would be able to pay a rate equal to the rate on Treasury securities maturing in 2-1/2 years, while commercial banks would have a ceiling 25 basis points lower. Thus, the thrift institution differential would continue to apply to 2-1/2 year and longer-term market-linked certificates.

Removal of the 12 per cent cap would improve the attractiveness of intermediate- and longer-term certificates, thereby encouraging longer deposit maturities and a better mix between assets and liabilities. This change would also be consistent with the Committee's responsibility to provide for the orderly deregulation of deposit interest rate ceilings. Thus, the proposed change would provide depository institutions with increased latitude to experiment with rates and terms on intermediate- and long-term certificates.

In our judgment, removal of the 12 per cent cap would be the preferable means of freeing up the intermediate- and long-term area. It has been proposed that ceiling rates on certificates be raised to market levels according to a pre-arranged schedule, starting in 1981 with maturities of 8 years or more and proceeding to shorter maturities in subsequent years. While we support the general objective of this proposal, we believe that elimination of the 12 per cent cap would be a better way of providing increased flexibility for individual institutions and achieving the objectives of the Depository Institutions Deregulation Act.

2. Restore the thrift institution differential on 6-month money market certificates. Regulatory actions in March 1979 and May 1980 all but eliminated the thrift institution differential on 6-month CDs. The most recent action was apparently designed to assist small commercial banks to roll over maturing MMCs. As we pointed out at the time, no evidence existed of a serious problem among commercial banks, while the implications for thrift institutions were clearly unfavorable.

Our expectations regarding the impact of erosion of the differential have been fully realized. Disintermediation at thrift institutions has been aggravated by shifts of funds to commercial banks. Thus, the commercial bank share of total 6-month CD growth rose from 29 per cent in 1978 to 43 per cent in 1979 and again to 52 per cent in 1980. Based on this evidence, it may be expected that restoration of the differential would reverse or retard the decline in the thrift institution share of the 6-month CD market.

The full differential should be restored on 6-month CDs and maintained on all other accounts as long as Regulation Q authority remains on the books. To implement this change, the commercial bank ceiling should be set at the 6-month Treasury bill rate, while the thrift institution ceiling should be 25 basis points higher.

Restoring the differential is critical now, in view of the large volume of 6-month CDs which will mature at thrift institutions in the near future. At savings banks, for example, an estimated $23 billion, or 44 per cent of total industry holdings of 6-month CDs, will reach maturity in March and April alone. Restoring the differential would encourage rollover of maturing certificates and help avert serious liquidity strains.

3. Permit depository institutions to disclose fully the effects of compounding interest in advertising longer-term certificates. Current regulations restrict interest rate advertising to annual percentage yields on longer-term certificates. This restriction should be amended to permit more complete disclosure of the effects of compounding.

With respect to passbook savings account rate ceilings, the Depository Institutions Deregulation Act requires the DIDC to vote on whether to increase ceiling rates by at least one-quarter of one percentage point no later than September 1981 and at specified dates threafter. An increase in passbook rate ceilings would merely raise interest costs without attracting new money. Nor would it be helpful in retaining present deposits. No change is justified at the present time, therefore, especially in view of the depressed earnings position of thrift institutions. In this regard, the savings bank industry as a whole is operating in the red and all signs point to deepening bottom-line losses in 1981.

With respect to the short-term area, proposals have been advanced for a new deposit account to compete with money market funds. A preferable course, in our judgment, would be the broader use of nondeposit liability instruments -- such as consumer repurchase agreements, participation certificates and mortgage-backed securities. Increased use of nondeposit liability instruments would provide savings banks with greater flexibility since individual institutions could vary rates, maturities and other terms in line with local market conditions and the needs of the institution. Deposit accounts, by contrast, are typically offered uniformly by all institutions in a given market area, regardless of the circumstances of the individual institutions. For this reason, we believe strongly that the use of nondeposit liability instruments should not be inhibited by the bank regulatory agencies.

We respectfully request that these recommendations be placed on the agenda for discussion at the next meeting of the Depository Institutions Deregulation Committee.

Sincerely yours,

A B Hooke

Albert B. Hooke
Chairman

Saul B. Klaman

Saul B. Klaman
President

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

Meeting of Thrift Institutions Advisory Council

with the

Board of Governors of the Federal Reserve System

Thursday, March 12, 1981

10:30 a.m.

AGENDA

1. Current and immediately prospective developments in thrift institutions industry in terms of deposit flows, including experience with NOW accounts, home mortgage activity, earnings, and the general financial condition of various segments of the industry (e.g. S&L's, mutual savings banks, credit unions, large/small institutions, geographic differences).

2. Federal Reserve Board's action plan for thrift industry survival.

3. Current recommendations of the Council for survival of the thrift industry.

NOTE: List of Thrift Institutions Advisory Council members is attached.

1. Administration split
2. get it quick

1. Ceiling cap
2. Insurance fund adequacy
3. Money Mkt funds
4. Mergers
5. FR leadership

1. Panacea
2. What does Fed want
Specialized

Cosmetics
1. Permit monetary policy - inflation + commercial banks
2. Differential - survival differential
3. avoid handouts

M.M. funds - U.S. Gov't

THRIFT INSTITUTIONS ADVISORY COUNCIL MEMBERS

Mr. Harry Albright
President
Dime Savings Bank of New York
New York, New York

Assets $4,643,108,574
Deposits 4,109,535,378

Mr. Edwin Brooks
President
Security Federal Savings and Loan Association
Richmond, Virginia

Assets over $115 million

Mr. Dwyer
General Manager
Pentagon Federal Credit Union
Box 310
Arlington, Virginia

Deposits $522 million

Mr. Robert Garver
President
Charlestown Savings Bank
Boston, Massachusetts

Assets $821,292,546
Deposits 735,701,226

Ms. Mary Gigsby
President
Houston First American Savings Association
Houston, Texas

Assets over $911 million

Mr. Raleigh Greene
Chairman of the Board and President
Florida Federal Savings and Loan Association
St. Petersburg, Florida

Assets over 1 1/2 billion

Mr. Walter Kropp
Chairman of the Board
Ohio Federal Savings and Loan Association
Columbus, Ohio

Assets over $245 million

Mr. James Montgomery
President
Great Western Savings and Loan Association
Beverly Hills, California

Assets over 9 billion

Mr. Herbert Sandler
Chairman of the Board
World Savings and Loan Association
Oakland, California

Assets over 5 billion

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date February 4, 1981

To Board of Governors

From Normand Bernard N.B.

Subject: Agenda for next meeting with Thrift Institutions Advisory Council

The next meeting of the Board with the new Thrift Institutions Advisory Council is scheduled for March 12. To give Council members an opportunity to discuss agenda issues with their industry colleagues, we would like to circulate a tentative agenda by mid-February. Any suggestions you may have for the agenda would be appreciated by close of business Wednesday, February 11.

For your information there are attached some materials prepared by the Council relating to the first meeting on January 9 and also a copy of the agenda for that meeting.

Attachments

Sent to Mr. Kichline for draft reply

THE BANK OF NEW YORK

NEW YORK'S FIRST BANK - FOUNDED 1784 BY ALEXANDER HAMILTON

48 WALL STREET, NEW YORK, N.Y. 10015

ROBERT ORTNER
SENIOR VICE PRESIDENT
AND ECONOMIST

March 5, 1981

#766

Chairman Paul Volcker
Board of Governors of the
Federal Reserve System
Constitution Avenue
Washington, D.C. 20551

Dear Paul:

I am enclosing a copy of a brief paper I wrote on some macro aspects of the Reagan program. My comment is generally supportive, especially regarding depreciation reform and spending cuts which you have been also strongly advocating. I thought you would be especially interested in the part on monetary policy because I find, as I am sure you are aware, that the monetary policy you are proposing will not accommodate the projections incorporated in the President's program. We certainly believe, however, that you are on the right track, and we continue to support strongly your own policies.

I am also enclosing a summary of our own projections through 1982. You will note that we do have a minus sign for the next quarter, but I would describe that quarter as essentially flat and not "down 3%." The more interesting part is 1982 where we show not much over 1% real gain contrasted with the President's projection of 4.2%. Our relative pessimism has much to do with the expected growth in monetary aggregates that you are promising, probable velocity limits and continuing high interest rates.

Please send our regards to Barbara. With best wishes,

Sincerely,

Bob

enc.

THE BANK OF NEW YORK
NEW YORK'S FIRST BANK - FOUNDED 1784 BY ALEXANDER HAMILTON

48 WALL STREET, NEW YORK, N.Y. 10015

ROBERT ORTNER
SENIOR VICE PRESIDENT
AND ECONOMIST

February 26, 1981

"AMERICA'S NEW BEGINNING: A PROGRAM FOR ECONOMIC RECOVERY"

Summary

It's Jones-Conable and Kemp-Roth, spending cuts, deregulation, and monetary restraint. This program is offered as a new departure in economic policy which will get the economy moving ahead and bring down both unemployment and inflation.

Tax cuts are offered in two ways: the program essentially adopts the Jones-Conable bill which proposed liberalized depreciation, using the "10-5-3" guideline lives, and the Kemp-Roth bill which provides tax cuts for individuals of 10% a year for three years. To keep the Federal budget deficit from exploding and to help fight inflation, substantial spending cuts are proposed, amounting to $41 billion in fiscal 1982, and rising to $104 billion in 1984 when, it is hoped, the budget will be brought into balance. Federal regulations will be dismantled where they are found to be unnecessary or inefficient, to reduce inflationary costs and stifling burdens on business, and monetary growth will be limited to underwrite the fight against inflation.

Our analysis finds that not all of these goals will be achieved. Budget deficits probably will remain larger than projected, and the economic growth assumed is not likely to be achieved as expansion of money and credit is reduced over this period. Nevertheless, this program deserves national support. It will begin to move the economy in the right directions, and important parts of it may still be adjusted later as necessary.

Tax Cuts - Which are Supply-Side?

The overriding problem in the economy today is productivity. Its deterioration has undermined real growth and real income and has added materially to inflation. Chart 1 shows the long term slide in the growth of productivity, to the point where it has actually declined for three years in a row, its worst performance of the post-war period. This slide has been accompanied by a similar decline in real compensation per man-hour. Poor performance in productivity is the reason real income per capita is doing so poorly. It is also the reason that labor's attempts to increase real incomes through larger wage increases are doomed to failure. A faster rise in wages without a corresponding increase in productivity results in an increase in labor costs which is passed along by employers. The result is simply faster inflation and, as shown in Chart 2, it leaves workers no better off than they were before.

How do we get out of this vicious spiral? One of the President's comments provides the key. We must give our workers the tools with which to compete in world markets, and to produce the rising standards of living everyone wants. Capital spending is not the only factor involved in the complex causes affecting productivity, but the relationship between capital stock per worker and output per man-hour shown in Chart 3 is obvious. Growth in capital stock per worker began slowing in the 1960's and virtually stopped after 1970, with disastrous results on productivity.

In our view the most important component of the package is depreciation reform which will enable business firms to write off assets faster, save taxes, and thereby help to raise capital outlays. The new guideline schedules are: ten years for most buildings (some fifteen and eighteen years), five years for machinery and equipment, and three years for vehicles and for equipment used for research and development. In addition, the investment tax credit was increased to 6% from 3 1/3% for the three-year category and will be 10% where applicable for the other categories. To underscore their importance, the President proposed making these changes retroactive to January 1st. The Administration projects the tax reduction from this source to amount to only $2.5 billion in fiscal 1981, but to rise rapidly to $10 billion next year, and eventually to nearly $60 billion in 1986. These estimates are contained in Table 1, along with the even larger projected cuts in personal taxes. These personal tax cuts, the Kemp-Roth bill, will reduce personal tax rates 10% a year for three years, at which time the range of rates will be reduced to 10% to 50%, from the present 14% to 70%.

While depreciation reform seems to be universally accepted as "supply-side," there is considerable controversy surrounding the Kemp--Roth bill as a supply-side measure. According to the "super supply-siders," Kemp-Roth is not advocated because it puts more disposable income and spending power in the pockets of consumers, but because it will induce them to work harder, save more, invest more, produce more and, as a result, reduce inflation. In economic affairs, causes and effects are always multiple and complicated, but we suspect that most of the tax cut will show up on the demand side. It was, undoubtedly, this characterization of Kemp-Roth as strictly supply side that led Vice-President George Bush to refer to it, during last year's primaries, as "voodoo economics." A more generous characterization might be that it is Say's Law in reverse. The economist, J.B. Say, suggested almost two hundred years ago that supply creates its own demand. Perhaps with slight exaggeration, it seems that Kemp-Roth supply-siders are arguing that demand creates its own supply - and then some.

The President himself has some concern over this bill, at least in terms of its current impact on the Federal budget. As a result, he proposed that it be made effective July 1st instead of January 1st as promised in his presidential campaign. The budgetary consideration is important. The first 10% installment will amount to a cut of $26 billion at annual rate, but delaying it until July 1st will reduce receipts in fiscal 1981 by only $6.4 billion, because it will be in effect for only one quarter of the fiscal year which ends September 30th.

There are several arguments in favor of adopting the Kemp-Roth bill, as proposed by Mr. Reagan, which Mr. Bush can now support with integrity: It is part of a package which includes depreciation reform and large-scale spending cuts; it offsets tax increases that have been caused by "bracket creep," and some personal tax relief is therefore overdue; even if it is largely spent, as it probably will be, there is slack in the economy at present, and a pickup in final demand will also help to encourage capital spending by raising operating rates; political reality requires its inclusion to achieve passage of the rest of the package; and, finally, enacting only the first 10% installment now, would permit the second and third to be postponed if the scheduled spending cuts cannot be achieved, and/or it appears final demand is overstimulated.

Spending Cuts and Budget Prospects - Some Doubts

While Mr. Reagan did not predicate the tax reductions on prior spending cuts, it is clear that the spending cuts are critical to the achievement of the balanced budget he is projecting in 1984. The President specifically exempted two areas from the "hit list:" national defense and the so-called safety net programs of income maintenance. (Although these will be reviewed for waste and inefficiency). And, of course, interest on the national debt is a true "uncontrollable." These three categories are shown in Table 2, along with proposed outlay ceilings. All remaining spending areas are included in "other," and the table shows the extent to which "other" must be reduced to achieve the projected total spending limit. Allowing for inflation, "other" will have to be cut by nearly one-half in real terms during the next three years to achieve the spending targets. In the President's words, "If misery loves company, then everybody better love everybody else, because we didn't overlook anyone."

The spending cuts are not intended only to reduce budget deficits. Combined with tax reductions they will serve to transfer the economy back to the private sector. And this process will be reinforced by regulatory reforms. Removing unnecessary regulations will reduce the inflationary costs of compliance and stop the government from stifling private initiative.

The entire program has been heralded as a completely new departure in economic policy. What is new? Certainly not big personal tax cuts or even depreciation reform. What is genuinely new is the sincere effort to eliminate waste in government, reduce spending, balance the budget, and return the economy to the private sector.

Are these budgetary targets achievable? Probably not. The budgetary totals are closely dependent on the Administration's economic assumptions shown in Table 3. If inflation remains higher than projected, spending and the deficit will also be correspondingly higher, although there may be some offset, as receipts would also be greater.

The projected drop in inflation should not be rejected out of hand because it appears substantial over the next five years. Inflation dropped from 11% in 1974 to 5.7% in only two years. It could improve again, even if not that dramatically, given a little luck in food and energy prices and a better-managed economy.

Real growth is even more important to the budget, and this looks less promising. If the economy operates below the projected trends, both receipts and outlays would be affected adversely. Receipts would be held down by slower growth in incomes, while spending would be raised because of higher unemployment costs and other necessary income maintenance. It is our opinion that the targets for economic expansion will not be realized.

The Economy and Monetary Policy - Still in Conflict

It is almost ironic that the President also encouraged the Federal Reserve Board to continue a policy of monetary restraint, thereby presenting a kind of united front. If the Board does this, monetary policy will not accommodate the projected growth shown in Table 3, nor, therefore, the dramatic improvement in the budget deficit.

Chart 4 traces the path of the velocity of M2 since 1958. It is a simple ratio of GNP to the M2 monetary aggregate. Using the Administration's projections for increases of nominal GNP of 12.8% in 1982, 12.4% for 1983, etc., and either steady or slowly declining increases in M2, produces a dramatic rise in velocity, to an extent never seen before. This pattern of velocity implies high interest rates which will abort the rapid business expansion. The combination of policies proposed, therefore, may give us guns and some butter, but not guns and very many houses and cars. The obvious way out of this dilemma would be to find inflation slowing even faster than projected. Barring that, we may have to be more patient in achieving the goals of the program.

Overall Assessment - Go for It!

It should not be surprising that a program encompassing such large changes in taxing and spending would run into criticism. In Congress, there seems to be general agreement that spending cuts are desirable, but the coming negotiations over whose sacred programs will be gored may be another matter. Tax cuts are also generally applauded but there are already demands that "working people" get a larger share of the reductions. The cuts are, in fact, pretty much across the board, and this criticism misses the essential point of the program. If the program works to promote productivity and real growth, the "non-rich" will be its greatest beneficiaries through increased jobs, and rising real income and standards of living. It will now be interesting to follow the program's progress through Congress. Hopefully, it will be legislated largely as proposed, with the exception that a firm commitment not be made now as to the size and timing of the second and third installments of the personal tax cuts.

In any case, the President's basic economic philosophy is correct. The source of this country's wealth is not regulation, entitlements, and income redistribution. It is output. If this program achieves part of its goals, Mr. Reagan will bequeath to the country a better economy than he inherited.

CHART I

Productivity and Real Compensation per Manhour

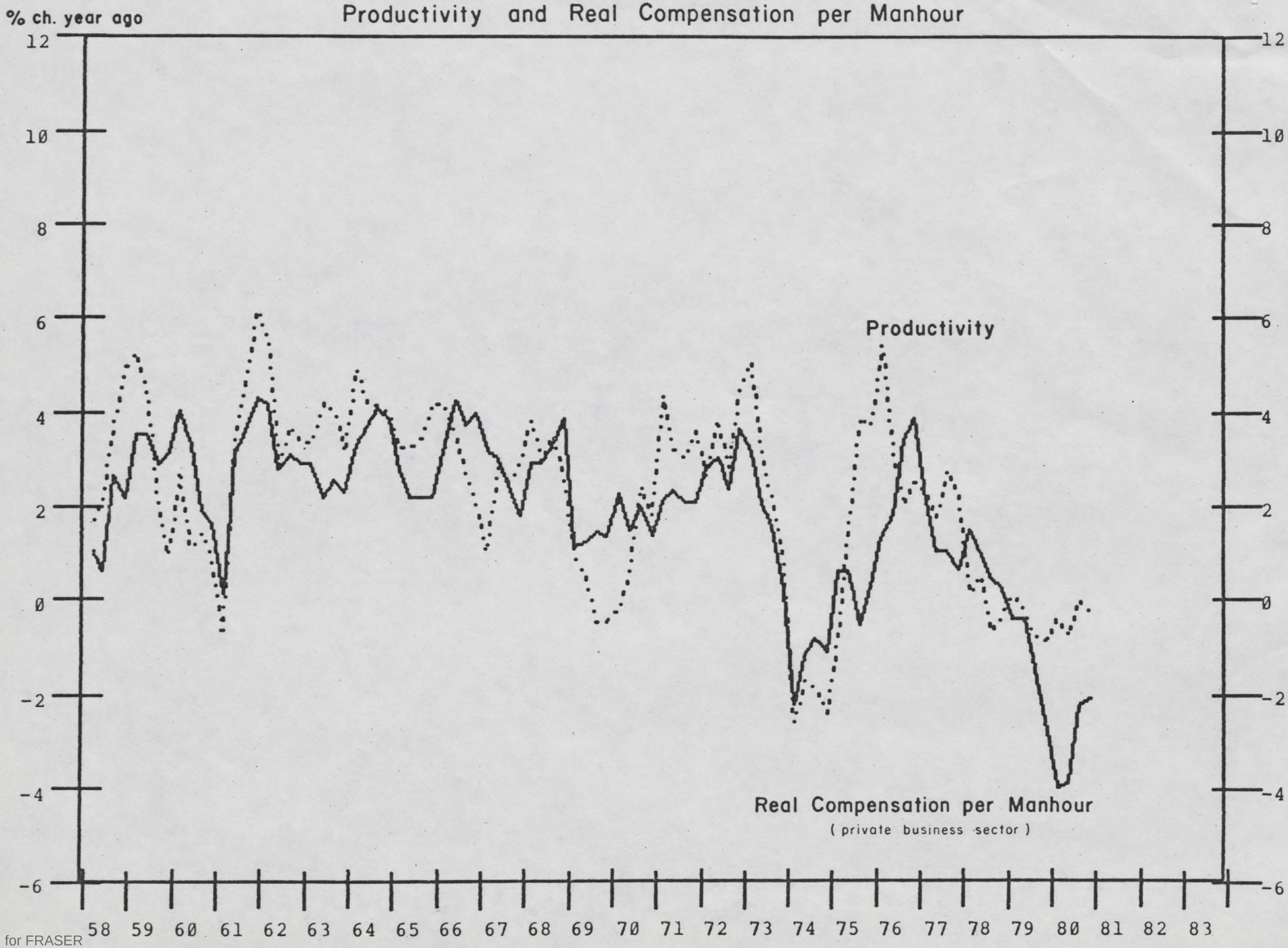


CHART 2

Unit Labor Costs and Inflation

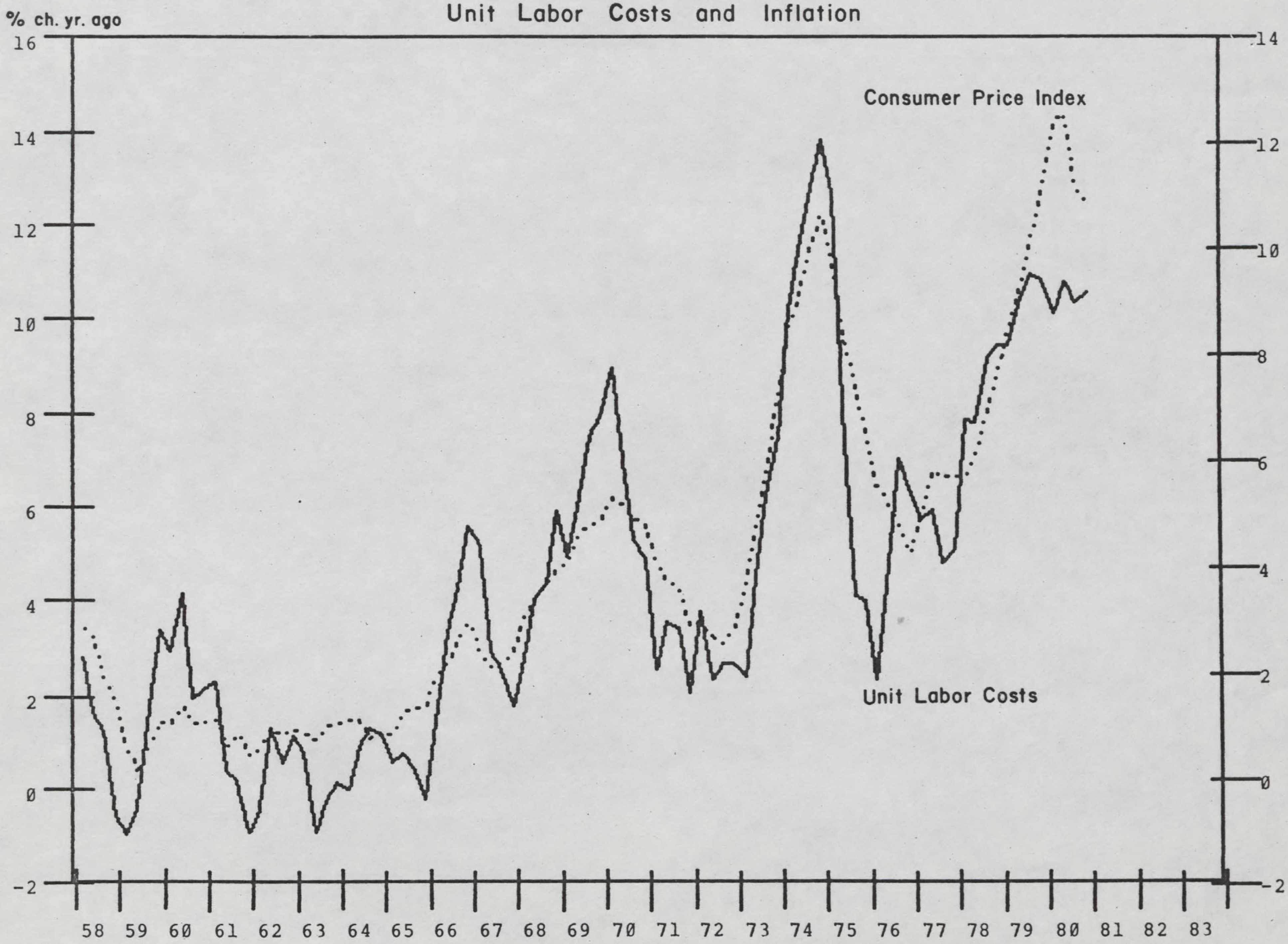


CHART 3

Capital Stock and Productivity

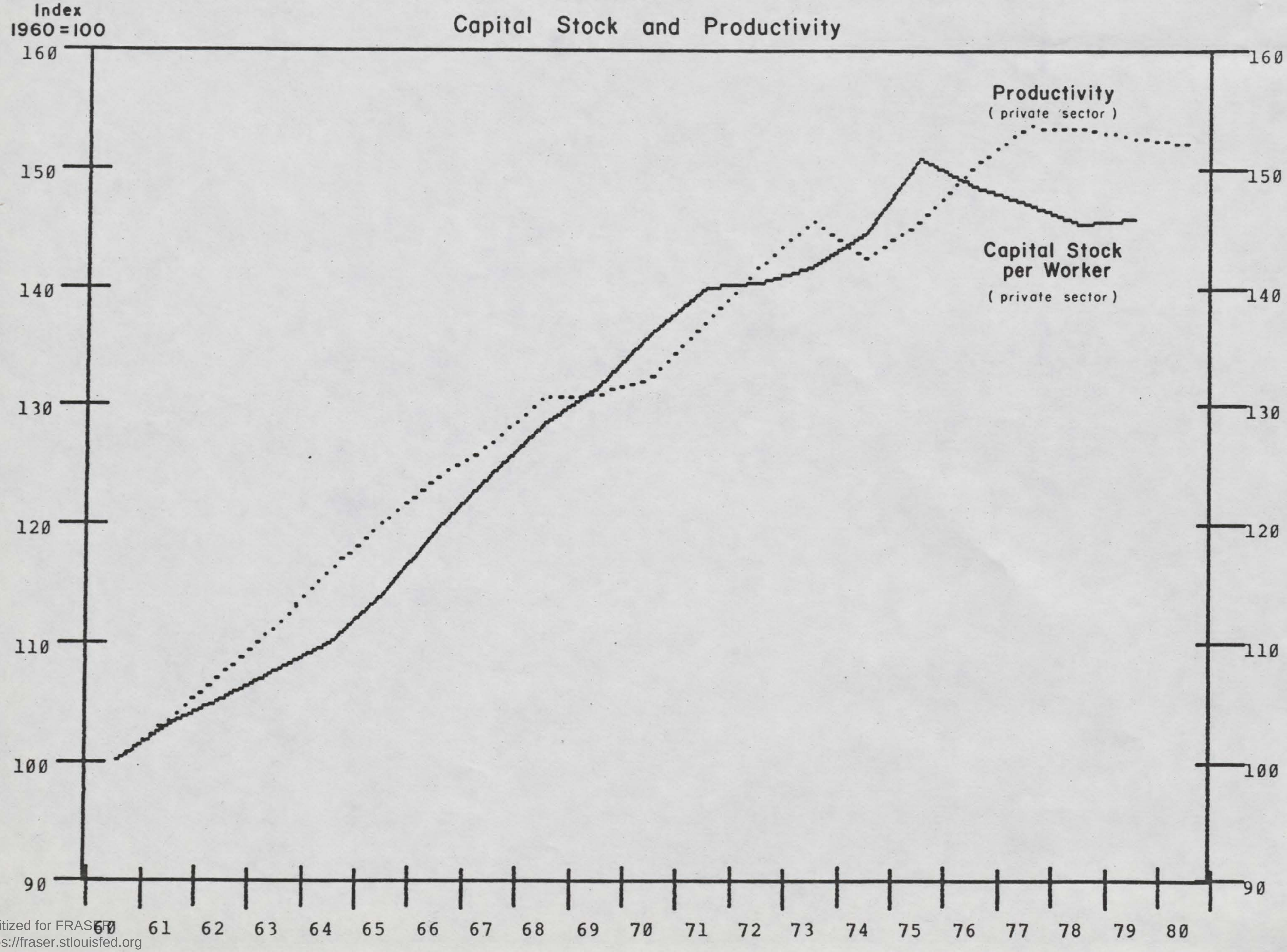


Table 1

Planned Tax Cuts - Fiscal Years ($Billions)

	1981	1982	1983	1984
Current Tax Receipts	609	702	808	917
Individual Income Tax Reductions	-6.4	-44	-81	-118
Depreciation Reform	-2.5	-10	-19	-30
Proposed User Charges	--	2	2	3
Receipts with New Tax Policy	600	650	710	772

Table 2

Budget Projections - Fiscal Years ($Billions)

	1980	1981	1982	1983	1984
Defense	136	158	184E	215E	250
Interest (net)	53	64	66E	67E	67
Social & Welfare Programs (Safety Net)	193	239	262E	286E	313
Other	198	193	184E	165E	142
Total Outlays	580	655	696	733	772
Receipts	520	600	651	710	772
Def. (-) or Surplus	-60	-55	-45	-23	0

E - estimated for 1982 and 1983

Table 3

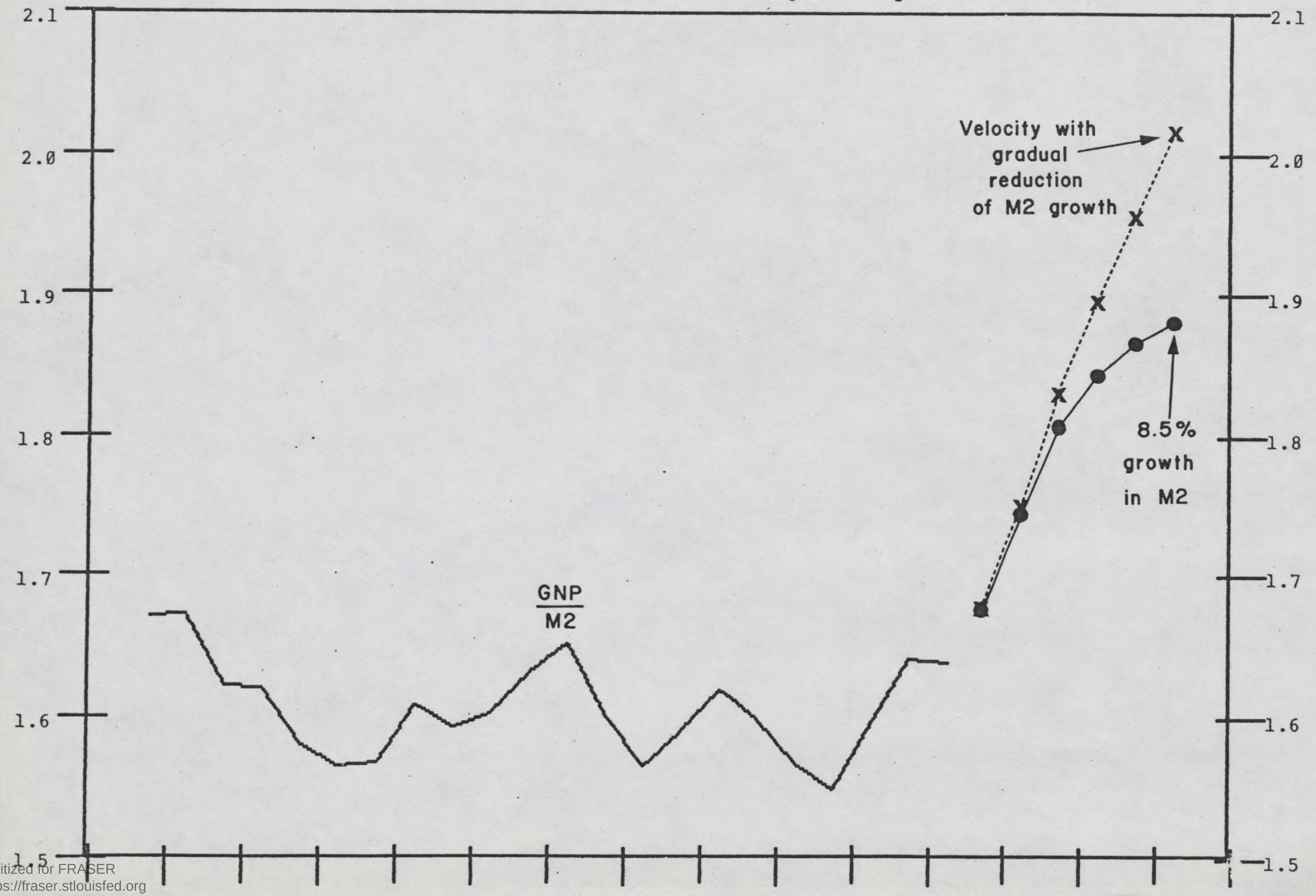
Economic Environment - % Change

	Actual		Projections					
	1979	1980	1981	1982	1983	1984	1985	1986
Consumer Price Index	11.3	13.5	11.1	8.3	6.2	5.5	4.7	4.2
Real GNP	3.2	-.1	1.1	4.2	5.0	4.5	N.A.	N.A.
Unemployment	5.8	7.2	7.8	7.2	6.6	6.4	6.0	5.6
Pre-Tax Corp. Profits	14.4	-4.7	-1.2	15.4	16.3	12.7	11.3	11.4
Personal Income	12.9	11.2	11.0	11.5	11.5	9.9	9.3	9.2
Nominal GNP	12.0	8.9	11.1	12.8	12.4	10.8	9.8	9.3

Note: N.A. - not available

CHART 4

Money Velocity and the Reagan Program



THE BANK OF NEW YORK--PUBLIC SECTOR PROJECTIONS, 3/2/81

FEDERAL GOVERNMENT RECEIPTS AND EXPENDITURES
($BILL., SEAS. ADJ. ANNUAL RATES)

	QUARTERS											
	1980:1	1980:2	1980:3	1980:4P	1981:1	1981:2	1981:3	1981:4	1982:1	1982:2	1982:3	1982:4
RECEIPTS:												
PERSONAL TAX & NONTAX RECEIPTS.............	246.9	252.0	259.4	273.0	285.7	295.0	277.9	288.4	298.4	308.8	297.0	307.7
CORPORATE PROFITS TAX ACCRUALS.............	80.5	60.9	66.7	67.6E	66.0	64.3	63.8	63.9	62.4	62.2	62.3	59.6
INDIRECT BUSINESS TAX & NONTAX ACCRUALS....	31.9	38.7	42.9	48.9	55.5	59.4	64.3	68.7	72.6	75.5	77.4	78.6
CONTRIBUTIONS FOR SOCIAL INSURANCE.........	169.2	169.3	171.8	178.6	198.2	201.7	206.0	210.8	220.5	225.2	230.4	235.5
EXPENDITURES:												
PURCHASES OF GOODS & SERVICES..............	190.0	198.7	194.9	212.1	214.5	219.0	224.0	234.5	238.5	243.0	247.5	257.5
TRANSFER PAYMENTS TO PERSONS...............	224.4	232.2	260.4	262.6	271.3	274.7	293.8	296.6	299.8	302.7	321.0	324.2
TRANSFER PAYMENTS TO FOREIGNERS............	4.5	3.8	4.9	4.9	4.7	4.7	4.7	4.9	5.2	5.3	5.4	5.4
GRANTS-IN-AID TO STATE & LOCAL GOVERNMENTS.	85.5	87.2	87.7	91.4	88.6	88.1	90.8	84.1	84.8	85.6	85.5	78.6
NET INTEREST PAID..........................	50.3	54.4	53.5	55.3	59.5	65.8	68.1	70.6	74.3	77.1	81.0	83.9
SUBSID. LESS CURRENT SURPL. OF GOV. ENTERP.	10.1	11.0	13.7	13.1	12.1	12.2	11.4	11.6	12.7	11.8	12.4	11.0
LESS: WAGE ACCRUALS LESS DISBURSEMENTS.....	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
RECEIPTS...................................	528.4	520.9	540.8	568.1E	605.5	620.4	612.0	631.7	654.0	671.7	667.1	681.4
ANNUAL RATE OF CHANGE....................	11.7	-5.6	16.2	21.8	29.0	10.2	-5.3	13.5	14.9	11.3	-2.7	8.9
EXPENDITURES...............................	564.7	587.3	615.0	639.4	650.6	664.5	692.9	702.3	715.3	725.5	752.7	760.5
ANNUAL RATE OF CHANGE....................	20.8	17.0	20.2	16.8	7.2	8.8	18.2	5.5	7.6	5.8	15.9	4.2
SURPLUS OR DEFICIT (-), NIA ACCOUNTS.......	-36.3	-66.5	-74.2	-71.3E	-45.1	-44.1	-80.9	-70.5	-61.3	-53.8	-85.6	-79.1

NOTES: P- PRELIMINARY. E- ESTIMATE.
ANNUAL RATES OF CHANGE ARE PERIOD-TO-PERIOD % CHANGES AT COMPOUND ANNUAL RATES.

Table 1

THE BANK OF NEW YORK--ECONOMIC PROJECTIONS, 3/2/81

LINE		QUARTERS 1980:1	1980:2	1980:3	1980:4P	1981:1	1981:2	1981:3	1981:4	1982:1	1982:2	1982:3	1982:4	YEARS 79	80	81	82
	NATIONAL PRODUCT AND INCOME SUMMARY ($BIL., SEAS. ADJ. ANNUAL RATES)																
1	GROSS NATIONAL PRODUCT........	2571.7	2564.8	2637.3	2732.3	2816.0	2882.5	2964.5	3043.0	3118.0	3197.0	3280.0	3356.0	2413.9	2626.5	2926.5	3237.8
2	ANNUAL RATE OF CHANGE........	12.6	-1.1	11.8	15.2	12.8	9.8	11.9	11.0	10.2	10.5	10.8	9.6	12.0	8.8	11.4	10.6
3	REAL GNP (1972 DOLLARS).......	1501.9	1463.3	1471.9	1486.5	1496.0	1493.9	1500.2	1501.9	1506.1	1512.4	1520.3	1522.4	1483.0	1480.9	1498.0	1515.3
4	ANNUAL RATE OF CHANGE........	3.1	-9.9	2.4	4.0	2.6	-0.6	1.7	0.5	1.1	1.7	2.1	0.6	3.2	-0.1	1.2	1.2
5	GNP DEFLATOR (1972=1.0).......	1.7123	1.7528	1.7918	1.8380	1.8823	1.9295	1.9761	2.0261	2.0702	2.1138	2.1574	2.2044	1.6276	1.7737	1.9535	2.1364
6	ANNUAL RATE OF CHANGE........	9.3	9.8	9.2	10.7	10.0	10.4	10.0	10.5	9.0	8.7	8.5	9.0	8.5	9.0	10.1	9.4
7	FINAL SALES (1972$)...........	1502.8	1462.0	1476.9	1492.3	1498.8	1492.3	1498.3	1497.7	1505.3	1510.8	1521.1	1524.9	1472.9	1483.5	1496.8	1515.5
8	ANNUAL RATE OF CHANGE........	3.1	-10.4	4.1	4.2	1.8	-1.7	1.6	-0.2	2.0	1.5	2.8	1.0	3.5	0.7	0.9	1.3
9	BUS. FIXED INVESTMENT (1972$).	165.0	156.1	155.5	156.1	156.8	156.3	155.5	155.2	155.5	156.0	156.6	156.3	163.3	158.2	156.0	156.1
10	ANNUAL RATE OF CHANGE........	2.2	-19.9	-1.5	1.6	1.9	-1.5	-1.8	-0.8	0.7	1.3	1.5	-0.6	6.5	-3.1	-1.4	0.1
11	POST-TAX CORPORATE PROFITS....	182.9	146.5	159.1	161.5E	161.5	159.0	158.0	157.5	155.5	154.0	154.5	149.5	167.8	162.5	159.0	153.4
12	4-QTR. PERCENT CHANGE........	11.1	-11.0	-8.4	-4.0	-11.7	8.5	-0.7	-2.5	-3.7	-3.1	-2.2	-5.1	19.5	-3.1	-2.2	-3.5
13	PERSONAL INCOME (1972$).......	1207.9	1194.9	1207.4	1220.1	1220.7	1217.7	1227.8	1231.3	1232.5	1235.5	1248.4	1255.9	1197.5	1207.6	1224.4	1243.1
14	ANNUAL RATE OF CHANGE........	-0.4	-4.2	4.3	4.3	0.2	-1.0	3.3	1.1	0.4	1.0	4.2	2.4	3.7	0.8	1.4	1.5
15	DISP. PERS. INCOME (1972$)....	1021.0	1008.2	1018.5	1025.8	1024.0	1020.1	1041.4	1042.7	1042.0	1042.9	1064.6	1069.2	1011.5	1018.4	1032.1	1054.7
16	ANNUAL RATE OF CHANGE........	1.3	-4.9	4.1	2.9	-0.7	-1.5	8.6	0.5	-0.3	0.4	8.6	1.7	3.1	0.7	1.3	2.2
17	PERSONAL SAVING RATE (%)......	4.9	6.2	6.1	5.2	4.7	4.5	5.7	5.5	5.0	4.7	6.1	6.2	5.3	5.6	5.1	5.5
	MONETARY VARIABLES																
18	M1B-ANN. RATE OF CHANGE, S.A..	5.9	-2.5	15.4	11.3									7.8	6.4		
19		CURRENT GROWTH TARGET RANGE FOR 80-4 TO 81-4: 6% TO 8.5%															
20	M2-ANN. RATE OF CHANGE, S.A...	7.5	5.7	17.0	9.4									8.9	9.1		
21		CURRENT GROWTH TARGET RANGE FOR 80-4 TO 81-4: 6% TO 9%															
22	C&I LOANS-L. BKS. ($BIL.,S.A.)	161.2	160.2	162.8	170.9									147.1	163.8		
23	ANNUAL RATE OF CHANGE........	17.1	-2.4	6.7	21.5									16.4	11.4		
24	FED FUNDS RATE-%..............	15.05	12.69	9.84	15.85	16.50	15.00	16.00	16.00	15.00	14.00	16.00	16.00	11.19	13.36	15.88	15.25
25	AAA CORP. BOND RATE-%.........	12.14	11.20	11.58	12.83	13.10	13.00	13.25	13.25	12.75	12.25	13.00	13.00	9.63	11.94	13.15	12.75
	OTHER ECONOMIC INDICATORS (SEASONALLY ADJUSTED)																
26	CONS. PRICE INDEX (1967=1.0)..	2.371	2.448	2.491	2.569	2.645	2.726	2.788	2.849	2.911	2.974	3.035	3.098	2.176	2.470	2.752	3.004
27	ANNUAL RATE OF CHANGE........	16.9	13.7	7.2	13.2	12.4	12.8	9.4	9.0	9.0	8.9	8.5	8.6	11.3	13.5	11.4	9.2
28	4-QTR. PERCENT CHANGE........	14.2	14.4	12.8	12.7	11.6	11.4	11.9	10.9	10.1	9.1	8.9	8.7	11.3	13.5	11.4	9.2
29	PROD. PRICE INDEX-FG(1967=1.0)	2.371	2.431	2.512	2.561	2.626	2.707	2.779	2.844	2.909	2.972	3.033	3.095	2.177	2.469	2.739	3.002
30	ANNUAL RATE OF CHANGE........	16.7	10.5	14.1	8.0	10.5	12.9	11.1	9.7	9.5	8.9	8.5	8.4	11.1	13.4	10.9	9.6
31	IND. PRODUCTION (1967=1.0)....	1.525	1.446	1.421	1.491	1.524	1.527	1.519	1.528	1.530	1.544	1.559	1.558	1.525	1.471	1.525	1.548
32	ANNUAL RATE OF CHANGE........	-0.1	-19.1	-6.7	21.1	9.2	0.8	-2.1	2.4	0.5	3.7	3.9	-0.3	4.4	-3.6	3.7	1.5
33	CAR SALES* (MIL. UNITS).......	10.8	7.6	8.8	9.1	9.3	8.8	9.0	9.0	9.3	9.5	9.3	8.8	10.6	9.1	9.0	9.2
34	HOUSING STARTS* (MIL. UNITS)..	1.234	1.055	1.390	1.534	1.500	1.300	1.250	1.200	1.350	1.400	1.450	1.400	1.722	1.303	1.313	1.400
35	UNEMPLOYMENT RATE -%..........	6.2	7.3	7.5	7.5	7.4	7.5	7.7	8.0	8.2	8.3	8.3	8.4	5.8	7.1	7.6	8.3

NOTES: P-PRELIMINARY. E-ESTIMATE. S.A.-SEASONALLY ADJUSTED. *-AT ANNUAL RATES.
ANNUAL RATES OF CHANGE ARE PERIOD TO PERIOD % CHANGES AT COMPOUND ANNUAL RATES.

MEMORANDUM

The purpose of this memorandum is to (1) review the present plight of the thrift industry in New York State, which has resulted in unprecedented operating losses of nearly $500 million (2) describe the basis on which the State and New York City, despite these staggering operating losses, impose their grossly unfair franchise taxes on thrift institutions, and (3) propose a legislative change in the franchise tax formula which is essential to ameliorate the drain on the net worth of thrift institutions caused by the inequitable existing tax formula.

The Crisis: Its Origin and Effect

The effect of inflation and high interest rates upon long-term assets consisting of fixed-rate mortgages and bonds has resulted in a financial crisis for the thrift industry -- particularly in New York State. Since World War II, national and state policy has caused the thrift industry to concentrate its investment in mortgage lending. In New York State this situation was exacerbated by statute and regulation that precluded thrifts from adjusting interest rates to the market. Limited by low-yielding, fixed-rate assets, mutual savings banks and savings and loan associations are in an earnings and capital crisis with no historical precedent other than the early 1930's.

The essential facts confronting New York State thrift institutions are as follows:

(1) <u>Thrifts have sustained and will continue to sustain unprecedented operating losses in 1980 and 1981.</u>

(a) New York State savings banks and savings and loan associations experienced operating losses approximating $500 million in 1980.

(b) These institutions are anticipated to lose almost twice this sum -- one billion dollars -- this year.

(2) <u>These operating losses result from inflation and national policies which are beyond the control of thrift institutions.</u>

(a) In 1981, 50% of all the deposits in savings banks will be tied to interest rates on Treasury Bills. These rates, fixed by the Federal Reserve in its effort to control the money supply, are beyond the ability of thrifts to control.

(b) In June 1979, one-half of the deposits in savings banks were composed of passbook accounts paying 5-1/2% or fixed-rate certificates in an average range of 2-1/2 years' duration. Since then, passbook accounts have declined by $6 billion, while time certificates indexed to the Treasury Bill rate have increased by $3 billion, with current rates in excess of 15%.

(c) In 1979, 40% of deposits were in passbook accounts. In 1980, 30% were in passbook accounts. In 1981, it is anticipated there will be a further erosion. The consequence is that the cost of money for savings banks continues to rise precipitously.

(d) In the case of six-months certificates, the average cost of these certificates over the last two and one-half years (since they were first authorized) has been 10.53% (exclusive of compounding). The average earnings of thrift institutions during this same period has been 8.02%, leaving a negative spread of 2.51% during this period.

(e) Massive deposit outflows have continued. The deposit loss of thrifts, despite the high interest rates that they have been required to pay by the pegging of rates to the Treasury Bill rates, amounted to $5.5 billion in 1979. In 1980, there were $3.6 billion in deposit outflows.

(f) Banks losing deposits must either (1) use all their cash flows resulting from amortization of mortgages or maturing bond portfolios to pay depositors who are withdrawing funds from their institutions or (2) borrow from commercial banks or the Federal Home Loan Bank (if they are members).

(g) Mortgages and bonds were the principal investments (up until the December 1980 legislation) in which thrifts were authorized to invest. Up until 1980, it was possible for thrifts to hold investments until maturity, thereby avoiding any losses resulting from their sale in depreciated markets. It is significantly questionable that thrifts can continue to do so now because of continued heavy deposit outflows and operating losses.

(h) The losses sustained by thrifts must be charged to undivided profits and surplus. This means that the only assets that are unburdened by claims of depositors have been reduced, exacerbating the earnings problems of savings banks. Specifically, when these losses are taken, the erosion not only threatens the vitality of the institution's "rainy day" fund, but results in a cannibalizing of valuable earning assets of the bank, hastening the pressure on earnings.

(i) More thrifts will be forced to borrow to meet these pressures. But for every $100 million borrowed, the cost is either $25 million in interest expense (including opportunity cost in connection with compensating balances kept with commercial banks) or $30 million in losses if investments are sold.

(3) <u>As a consequence, thrifts are invading net worth in order to pay interest and dividends to depositors.</u>

(a) Net worth ratios were reduced in 1980 by 60 basis points for all New York mutuals combined and by one full percentage point for mutuals in metropolitan New York City. Thus, net worth ratios that hovered at 6-1/2% at the start of 1980, have been reduced to below 6% by year end. Many institutions fell way below this level.

(b) For many large mutual institutions in Manhattan and Brooklyn, the reduction in net worth ratios will result in levels below the statutory minimum — 5% of the amount due depositors. In order for these institutions to pay dividends to depositors, the Superintendent of Banks, in her discretion, must authorize their Trustees to pay dividends by transferring the required sums of money from net worth.

<u>The Effect of Present Franchise Tax Laws</u>

Despite these staggering operating losses, thrift institutions will have to pay alternative minimum franchise taxes of $118 million for 1980 and an equal amount for 1981 ($71 million to the State and $47 million to New York City) — unless the present law is changed to tax thrifts on a more equitable basis. In effect, the present franchise tax laws will further undermine the condition of thrift institutions since these franchise taxes will be paid out of retained (past) earnings at a time when those amounts are needed to mitigate operating losses.

Fundamental Fairness Requires that Thrifts be Taxed on a Comparable Basis to Commercial Banks

Article 32 of the New York Tax Law imposes a franchise tax on all banking corporations, including commercial banks, savings banks and savings and loan associations. The basic tax -- 12% of net income -- is the same for each type of banking corporation (Tax Law, §1455(a)).

Article 32, however, also imposes an alternative minimum tax for banking institutions which have no or low income. For commercial banks, this alternative minimum tax is based on a percentage of their capital stock. For thrift institutions, however, the alternative minimum tax is based on the interest and dividends credited to their depositors. This arbitrary distinction results in a grossly excessive and unfair tax on thrift institutions.

For example, a typically large commercial bank with no net income (or losses) is required to pay an alternative minimum tax of about $1 million, based on its capital stock. At the same time, a typically large thrift institution with no net income (or losses) is required to pay an alternative minimum tax in excess of $5 million, based on interest and dividends paid its depositors -- even though its asset size is less than 20% of the large commercial bank.

Not only is this result grossly excessive and inequitable, but there is no rational basis for the distinction. Commercial banks have all of the powers and perform all of the services of thrift institutions. Yet, until this year, thrift institutions were unable to perform many of the services performed by commercial banks.

Moreover, a tax on capital stock is sharply different from a tax on interest and dividends paid to depositors. Capital stock represents an amount invested in a commercial bank. Interest and dividends, on the other hand, do not represent invested capital. They represent payments made for borrowed funds.

Thrift institutions should be taxed on a basis comparable to commercial banks. Although thrift institutions do not have capital stock, the nearest equivalent is 34% of the surplus fund or account required (by the State Banking Department) to be maintained by each thrift institution in order for it to have adequate capital for safe and sound operations. Accordingly, the Tax Law should be amended to provide for an alternative minimum tax based on 34% of the surplus fund or account maintained by thrift institutions.

thwarted Unless the

Deregulation of Deposit Rate Ceiling by Maturity

Three possible schedules for "deregulating" deposit rate ceilings by maturity are presented below. The schedule in Option 1 is similar to the one proposed by the National Savings and Loan League and the schedule in Option 3 is comparable to the Citibank proposal.

The Depository Institutions Deregulation Act of 1980 authorizes the DIDC to create new deposit categories without ceilings or with ceilings indexed to market rates; new accounts with indexed ceilings may be established with or without a differential between commercial banks and thrift institutions. Accordingly, the maturity categories contained in each of the three options are permissible if the DIDC acts to establish instruments with these maturity and rate characteristics as new account categories.

If a phased indexing of ceilings were used, the ceilings at thrifts and commercial banks could be tied to the appropriate Treasury security yield. It should be noted that under this approach ceilings on longer-maturity deposits could be below the current 2-1/2 year SSC ceiling (even with the caps) if the yield curve were downward sloping. To avoid setting ceilings that would be lower than those possible under current regulations, a rule could be adopted that tied the ceilings on longer-term deposits to the rates on comparable maturity Treasury securities or the 2-1/2 SSC ceilings, which ever was greater. In any event, any cap maintained on the SSC would not apply to the "deregulated" instruments.

Date	Maturity of deposits for which rate ceilings would be indexed or eliminated: Option 1	Option 2	Option 3
July 1, 1981	8 years or more	5 years or more	3 years or more
July 1, 1982	6 to 8 years	4 to 5 years	2 to 3 years
July 1, 1983	4 to 6 years	2 to 4 years	1 to 2 years
July 1, 1984	2 to 4 years	1 to 2 years	6 months to 1 year
July 1, 1985	1 to 2 years	6 months to 1 year	--
April 1, 1986	no ceilings	no ceilings	no ceilings

Chairman Volcker
B-2046

DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE

COMPTROLLER OF THE CURRENCY
FEDERAL RESERVE BOARD
FEDERAL DEPOSIT INSURANCE CORPORATION
NATIONAL CREDIT UNION ADMINISTRATION
FEDERAL HOME LOAN BANK BOARD
U.S. TREASURY DEPARTMENT

May 8, 1981

The Honorable Thomas P. O'Neill, Jr.
Speaker of the House of Representatives
Washington, D.C. 20515

Dear Mr. Speaker:

Pursuant to the requirements of Section 206 of the Depository Institutions Deregulation and Monetary Control Act of 1980, I am pleased to submit my annual report on the activities of the Depository Institutions Deregulation Committee during its first year of operation and on the viability of depository institutions.

Sincerely,

Paul A. Volcker

Paul A. Volcker
Chairman

Note--Identical letters were sent to:

Vice President Bush
Chairman Garn
Chairman St Germain
Senator Williams
Congressman Stanton

May 8, 1981

REPORT OF ACTIVITIES OF THE DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE
AND
REPORT ON THE VIABILITY OF DEPOSITORY INSTITUTIONS
BY
PAUL A. VOLCKER, CHAIRMAN
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

I. ACTIONS OF THE DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE 1/

A. Meeting of December 12, 1980

Early withdrawal penalty. At its meeting on December 12, the DIDC considered four amendments to the rule adopted at the May 28 meeting which had modified the penalty for early withdrawal of time deposits. The modification had increased the effect of the minimum penalty in the early months of a deposit's life and could have the result that a depositor who makes an early withdrawal of a deposit might receive less than had been deposited.

First, the Committee voted not to permit penalty-free withdrawals from an institution in the event of termination of federal deposit insurance. The Committee members were concerned that eliminating the early withdrawal penalty could accelerate deposit outflows and thus exacerbate problems of institutions whose federal insurance had been terminated. Since statutory provisions relating to deposit insurance terminations allow for a two year carry-over period during which deposit insurance remains in effect, depositors continue to be protected for the carry-over period.

1/ A report on meetings prior to December 12 was included in a preliminary report to the appropriate Congressional Committees. A copy of that report, dated September 30, 1980, is attached.

The Committee approved a second proposed amendment, which was to limit the required penalty for early withdrawal from an IRA or Keogh plan during the first seven days after it is opened to the amount of interest already earned, with no invasion of principal. The amendment was adopted in order to eliminate a conflict with IRS regulations which require that unless a disclosure statement has been given seven days prior to the opening of an IRA account, the IRA depositor must have the right to revoke the account without forfeiture of any principal for seven days after it is opened. The amendment was made effective December 15, 1980.

The third proposal was to allow penalty-free early withdrawal in the event of bankruptcy of the depositor. Although the Committee was concerned about expanding exceptions to the early withdrawal penalty rule, the Committee agreed to solicit public comment on the bankruptcy issue. The notice of proposed rulemaking was issued on December 18, 1980, with the comment period ending February 16, 1981.

The Committee took no action on the fourth proposed modification, which would have permitted exceptions to the early withdrawal penalty rule in emergency or hardship cases. The view of the Committee was that adoption of such exceptions could result in severe enforcement problems and that defining workable emergency and hardship circumstances would be difficult. The Committee left open the possibility that this issue might be reconsidered at a later date.

<u>Phaseout of finders fees</u>. The Committee voted to accept specific terms for a phaseout of finders fees. At its September 9, 1980, meeting the Committee had adopted a rule defining finders fees as a payment of interest

for purposes of determining compliance with interest rate ceiling regulations. However, the Committee had been concerned that application of the new rule on December 31, 1980, could seriously affect any institution that had relied heavily on finders fees to attract deposits. Therefore, the Committee had requested public comment on a phaseout proposal that would provide such institutions a limited time to develop replacement sources of funds. However, the Committee also had to consider possible detrimental effects of a phaseout on institutions not qualifying for a phaseout operating in the same market as an eligible institution.

The Committee decided to permit a phaseout under the following specific terms. To be eligible, an institution must be certified by its primary federal supervisor to have demonstrated that on average finders fees have been paid on 25 percent or more of its outstanding domestic small-denomination (under $100,000) time and savings deposits over a two and a half year period ending June 30, 1980. Other institutions were required to eliminate finders fees on December 31, 1980. The length of the phaseout for institutions meeting the test is 18 months, divided into three 6-month periods beginning January 1, 1981. The base for the phaseout is the amount of domestic small-denomination time and savings deposits outstanding on June 30, 1980, on which finders fees had been paid. The base amount may not be exceeded during the phaseout period. The maximum amount of small-denomination time and savings deposits that may be raised through the continued use of finders fees is limited to 85 percent of the amount of domestic small denomination time and savings deposits on which finders fees had been paid maturing in the first 6-month period, 60 percent of the amount of such deposits maturing in the second 6-month period, and 40 percent of the amount of such deposits maturing in the third 6-month period. Any maturing domestic small-denomination time deposits on which a finders fee had been paid and that is renewed, whether or not a finders fee is paid upon renewal, must be included in the amount of deposits obtained through the use of finders fees for the purpose of determining compliance with the percentage limitations. All finders fees must be paid in cash, with the exception that an institution may use as finders fees any merchandise it owned on December 1, 1980. Mass media advertising of finders fees during the phaseout period is prohibited. Any advertisement, announcement, or solicitation concerning the continued availability of finders fees during the phaseout period is limited to direct contact by the institution with its depositors or former sponsors of depositors or to displays or distributions of promotional material in an institution's offices.

Request to phase out prepayment of interest. The Committee considered a request from the Bank of Boulder (Colorado) to provide a phaseout period for institutions that would be adversely affected by the DIDC's rule prohibiting the prepayment of interest in either cash or merchandise, effective December 31, 1980. The Committee had agreed to consider the request because of the similarity of the issue to the phaseout of finders fees. However, the Committee decided not to take any action at the meeting but to collect further information on this issue from the Bank of Boulder or other affected depository institutions, and to consider the matter at a later date.

Effective date for new ceiling rates on MMCs and SSCs. The Committee decided to request public comment on a proposal to advance the effective date on new ceiling rates for MMCs (26-week money market certificates) and SSCs (2-1/2 year or more small saver certificates). The ceiling rates, which are based on yields on Treasury securities of equivalent maturities, were announced on Mondays (or the previous Friday if Monday is a holiday) and went into effect on the following Thursday. This lag allowed depositors the opportunity to accelerate deposits prior to the effective date of a lowered ceiling or to withhold deposits prior to the effective date of a higher ceiling. Reducing the lag between the announcement date and effective date would lessen short-term fluctuations in deposit flows but could create operational problems for depository institutions, including the difficulty of changing advertisements on short notice. The Committee requested comments on these issues by February 16, 1981.

Adjustments in terms of IRA/Keogh accounts. At the December 12 meeting, the Committee requested public comment on five options to make IRA/Keogh deposit accounts more attractive by reducing administrative obstacles to periodic additions to such accounts and by increasing yields available to individuals who are saving for their retirement.

The first option is to reduce the minimum maturity of special IRA/Keogh accounts from three years to one year. The change would put the minimum maturity on a consistent basis with tax law which has been changed to permit tax-free rollovers of IRA funds from one trustee to another to occur once a year rather than once every three years.

The next two options are alternative plans for establishing a new one-year notice account that would permit regular additions to the account with interest paid on these additions at the original contract rate. The purpose of these options is to simplify the handling of periodic routine additions to IRA and Keogh accounts.

The fourth option would increase, revise, or eliminate the interest rate ceiling for IRA/Keogh accounts. The fifth option would create a new type of IRA/Keogh account with no ceiling rate and a minimum 14-day maturity.

The Committee believed that the proposed changes would enable depository institutions to tailor IRA/Keogh plans to market circumstances and saver needs. Individuals would thereby be encouraged to save for their retirement, and the competitive position of depository institutions would be improved with respect to nondepository institutions.

Petitions from American Bankers Association and others. The Committee considered petitions from the American Bankers Association and other organizations to modify previous Committee actions relating to interest rate ceilings. Three proposals were discussed, but the Committee decided to take no action on any of them at that time.

One issue was whether a higher ceiling rate of interest should be established on savings accounts than on interest-bearing transaction accounts at commercial banks. The Committee was concerned that the lack of a differing ceiling rate between these accounts at commercial banks complicates the interpretation of money supply data. They agreed that if a differential were imposed, it should be done by raising the ceiling rate on savings accounts rather than by lowering the ceiling rate on transaction accounts. However, it was felt that raising the rates on savings was not appropriate at that time, given its impact on the earnings of depository institutions, but that the issue would remain under continuing review by the Committee. On a related matter, the Committee also agreed to take no action on a petition to apply the ceiling rate on NOW accounts to all savings accounts accessible by electronic means.

The third issue concerned the request to make permanent the temporary authority, adopted for a six-month period at the May 28 meeting, that allowed commercial banks to roll over MMCs at the ceiling rate applicable to thrift institutions. The Committee felt that since no differential between bank and thrift institution ceiling rates on MMCs had applied for several months and since the rollover provision had been adopted to deal with a specific problem, there was no need to make the temporary provision permanent.

B. February 26, 1981, Action

Temporary amendment on premium rule. On February 26, 1981, the DIDC announced a temporary amendment to its rule on the use of premiums, which had become effective on December 31, 1980. The rule had allowed depository institutions to continue to offer premiums of gifts to depositors opening a new account and had increased the dollar value of permissible premiums to $10 for deposits of less than $5,000 and $20 for deposits of $5,000 or more. The rule also provided that no more than two premiums could be given to any account within a 12-month period.

After the rule became effective, the Committee became concerned that a number of institutions were engaging in promotional activities that could undermine the intent of the rule by establishing and advertising programs in which a depositor's funds would be placed in multiple accounts, thus allowing the depositor to receive multiple premiums. The temporary rule, announced and effective February 26, prohibits depository institutions from soliciting or otherwise promoting deposits from customers on the basis that the funds will be divided into more than one account by the institution for the purpose of providing more than two premiums within a 12-month period.

The Committee asked for public comment on the temporary amendment and alternative measures by April 1, 1981.

C. Meeting of March 26, 1981

Implementation date on variable ceiling certificates. At the March 26 meeting the DIDC voted to change the implementation date for new ceiling rates on 26-week MMCs and 2-1/2 year or more SSCs to the business day following their announcement, effective April 7, 1981. The ceiling rates, which for the MMCs are tied to 26-week Treasury bill rates (auction average on a discount basis) and for the SSCs are tied to the 2-1/2 year yield on Treasury securities, are generally announced on Monday and, under the rule existing at the time of the meeting, became effective the following Thursday.

At its December 12, 1980, meeting the DIDC had requested public comment on the proposal to shorten the lag between the announcement and implementation of the variable ceiling rates. A major argument in support of an earlier implementation date was that the two-day lag provided customers with a risk-free interest rate hedge that added to the interest costs of depository institutions. If the new rate was lower than the old rate, depositors had two days to lock in the higher rate; if the new rate was higher than the old rate depositors could postpone their deposits until Thursday when the higher rate became available. The major argument against an earlier implementation date was the potential for operational problems involved in obtaining the correct new rate, disseminating the rate to the institutions' branches and advertising the rate to customers.

The Committee agreed to eliminate the lag and to make the implementation date of the new ceiling rate the day following the Treasury bill auction.

However, the Committee indicated that it might reconsider the issue if severe operational problems emerged.

Possible bankruptcy exception to the early withdrawal penalty rule. At the December 12 meeting the DIDC had asked for public comment on a proposal to permit depository institutions to allow withdrawal of time deposits before maturity without penalty in the event of bankruptcy of a depositor. After consideration of the comments received, the Committee voted not to make an exception to the early withdrawal penalty rule in the case of depositor bankruptcy.

Reconsideration of finders fee phaseout. The DIDC considered a petition to reconsider its action taken at the December 12 meeting granting qualifying institutions the right to phase out the use of finders fees in the solicitation of small denomination time and savings deposits. The petitioners asserted that the action provided an unfair advantage to a single institution and was arrived at improperly. The Committee determined that there was no competitive problem at the time since no institutions were offering finders fees under the phaseout rule. In addition, the Committee's General Counsel gave the opinion that there had been no improper communication and that the Committee's action was supported by the public record. Therefore, the DIDC reaffirmed its December 12 action.

Deposit rate ceilings on interest-bearing transaction accounts and savings accounts. Concern was again expressed that the ceiling rates on interest bearing transaction accounts and savings accounts at commercial banks are at the same level. As a result, depositors tend to merge accounts, and deposits accumulated for different uses are thus not distinguishable for monetary policy purposes. However, the DIDC did not want to create a differential by lowering ceilings on transaction accounts since that would be inconsistent with the thrust of deregulation. On the other hand, raising the savings rate ceiling for commercial banks would legally require a similar increase in the ceiling for thrift institutions and increase their costs at a time when their earnings already were under pressure without significantly increasing their deposit flows. For these reasons, the Committee decided to take no action but to continue to review the situation and take action to establish different ceiling rates as soon as possible.

Strategies for deregulation. Under the DIDMCA, the Committee is authorized to administer deposit rate ceilings and to structure the phaseout of the ceilings. The Act provides that the Committee can phase out the rate ceilings by any or all of the following methods: (1) gradually increase ceilings applicable to all account categories, without exceeding market rates; (2) eliminate ceilings applicable to particular account categories; (3) create new types of accounts with no ceiling or with ceilings set at current market rates; (4) any other method; (5) a combination of any of these methods. A number of depository institutions had requested the Committee to adopt a longer-term plan for deregulation of deposit rate ceilings to facilitate their planning, and several industry groups had submitted recommendations for directions such plans could take. At the March 26 meeting, the Committee discussed longer-term strategies for deregulation and agreed that they would like to establish a fixed schedule for a phaseout of ceilings to the extent feasible. They requested public comment by May 1, 1981, on two proposals.

The first was a proposal to remove the present cap on the interest rate that can be paid on small saver certificates. At present, the rate ceiling on these 2-1/2 year or longer time deposits is tied to the 2-1/2 year yield on U.S. Treasury securities subject to a cap rate of 12 percent at thrift institutions and 11-3/4 percent at banks. This category of deposit would continue to be subject to a rate ceiling based on the 2-1/2 year Treasury yield.

The second proposal on which the Committee requested public comment was to establish a schedule for eventually deregulating all deposit rate ceilings by eliminating rate ceilings according to maturity categories. Deposits with maturities of five years or more would have no ceiling rates as of July 1, 1981; ceilings for deposits with four or five year maturities would be eliminated July 1, 1982; two to four year maturities--July 1, 1983; one to two year maturities--July 1, 1984; maturities of six months to one year--July 1, 1985; all remaining ceilings--April 1, 1986, as required by law. The Committee also would consider comment concerning deregulation by means of indexing ceiling rates to market rates according to the above schedule or any other alternatives.

The Committee also discussed the question of restoring the differential in the ceiling rates on money market certificates but decided that reimposition of the differential would be contrary to the Committee's deregulatory mandate.

Election of Chairman. The Committee elected Secretary of the Treasury Donald T. Regan to succeed Federal Reserve Board Chairman Paul A. Volcker as Chairman of the DIDC, effective on the date of the next meeting. The election of the Vice Chairman was deferred until that meeting.

II. REPORT ON THE VIABILITY OF DEPOSITORY INSTITUTIONS

A. Background

The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) requires that each member of the DIDC report annually to the Congress on the economic viability of depository institutions. Six months after enactment of the bill, the Congress also requested an interim report, and my report was sent to Congress on September 30, 1980. In the months since the interim report was submitted, interest rates have risen, reaching historically high levels during the period, and deposit flows have weakened, in part in response to the relatively high yields on money market mutual funds (MMMFs) since the end of 1980. Despite the slowing of deposit flows, the institutions' liquidity remains ample. However, the sharp increase in interest rates has put growing pressure on their earnings. Depository institutions have become increasingly dependent on deposits whose rates fluctuate with market interest rates while, especially for thrift institutions, their asset portfolios are heavily weighted toward fixed rate long-term mortgages acquired when interest rates were much lower.

The current problems of depository institutions will be alleviated as reduced inflation results in lower interest rates, and as thrift institutions take advantage of the new asset powers permitted by the DIDMCA and new, more flexible mortgage instruments. Over the longer-term, removal of deposit rate ceilings also will strengthen the ability of the financial institutions to adapt to changing financial environments. In the interim, however, until the institutions' assets and liabilities come into better balance, the DIDC must continue to evaluate carefully the effects of its actions on the viability of depository institutions.

B. Differential

The Depository Institutions Deregulation and Monetary Control Act requires that in the report each member of the DIDC assess whether removal of any differential between rates payable on deposits by banks and those payable by thrift institutions will adversely affect the housing finance market or the viability of the thrift industry.

The DIDC took no action to affect differentials in rate ceilings at its last two meetings. At present, thrifts are permitted to pay a higher rate than banks on certain types of accounts. These include passbook savings accounts, fixed ceiling time accounts, small saver certificates, and--when the Treasury bill rate is within the range of 7.25 percent and 8.75 percent--money market certificates. There is no differential on the ceiling rates on negotiable orders of withdrawal (NOWs), government accounts, individual retirement accounts (IRAs), Keogh accounts, and MMCs at most Treasury bill rates.

The differentials on ceiling rates for thrifts, which were first instituted by regulation in 1966, were designed to help thrifts compete effectively with banks. The higher rate permitted on thrift accounts was intended to compensate for the thrifts' lack of the "one-stop" convenience enjoyed by commercial banks.

The differentials probably have benefitted thrift institutions, although for savings accounts, banks' share of the total has increased since the mid-1960s, despite the differential. Thrift institutions gained a larger share of time deposits, however, when they were permitted to pay a higher rate on all of these deposits. The possible effect of the removal of the differential on thrift time deposit flows is illustrated by the experience following the March 15, 1979, elimination of the thrift differential on MMCs over certain bill ranges, an action taken before the DIDC was established. After that action, the relative flow of MMC funds to thrifts fell, resulting in a decline in the thrift share of outstanding MMC balances to about 55 percent recently. In contrast, thrifts' share of the flow of SSCs, the other major category accounting for growth of small time deposits, has been relatively stable at close to 70 percent of the total; thrifts have been permitted to pay a higher rate than commercial banks on these accounts since they were introduced in January 1980. While the elimination of the differential on MMCs has reduced flows to thrifts, it has probably assisted most the small to medium-sized banks with limited access to money markets and, through these banks, it has assisted the consumers, small businesses, and agricultural borrowers that depend on their credit extensions.

Moreover, it is not clear that the lack of a differential on MMCs has significantly impaired the viability of the thrifts or the flow of funds to housing. Given the short maturity of these deposit inflows it is unlikely that these funds would have been channeled into mortgages. Indeed, the differential on the SSCs, which have maturities of 2-1/2 years or longer, was maintained by the DIDC in part because it was felt that flows into these accounts were more likely to be used for mortgage lending. The additional flows to thrifts, had the differential on MMCs been retained, would have been obtained at relatively high money market rates, essentially substituting for money market borrowing or advances from the Home Loan Bank System, and therefore would have had only a small impact on earnings.

It is not the absence of deposit flows, but rather the holdings of long-term, low-yielding assets that have been responsible for the current problems of some thrift institutions as deposit costs rose. Current difficulties in the mortgage credit market seem to result more from the inability or unwillingness of borrowers to pay high rates rather than to the unavailability of credit.

The impact of further elimination of differentials would depend on the means chosen. If the removal were effected by placing the same binding ceiling on all institutions, thrift flows might be reduced as occurred in the MMC experience. However, if the differential were removed through the elimination of all ceilings, as is eventually required under DIDMCA, the effect is less clear. During periods when thrifts operated without ceilings, such as prior to 1966 and during the wild card certificate experiment of 1973, they generally paid higher rates than commercial banks on similar types of deposits. If ceilings were removed thrifts could again choose to offer rates higher than those at banks. However, given the current financial conditions and the composition of thrift asset portfolios, that step would exacerbate the current earnings pressure on the thrift institutions, which would seem to preclude a rapid elimination of all ceilings. As thrift institutions are able to take advantage of their new asset powers and flexible mortgage instruments, this consideration will become less important.

During the transition to the ceilingless environment required by the DIDMCA, the Committee must consider the impact of removal of the differential on deposit flows and earnings pressures at thrifts and on the availability of funds for housing. For these reasons the Committee has moved cautiously in raising ceilings and eliminating differentials. These concerns, however, must be weighed against claims for equitable treatment by commercial banks and their borrowers, including small business and agriculture.

C. Disintermediation

The DIDMCA directs each member of the DIDC to report on "findings concerning disintermediation of savings deposits from insured banks and insured thrift institutions to uninsured money market innovators paying market rates to savers." The principal such innovator has been money market mutual funds which have been in existence since 1972 and have grown to include over 100 funds with $118 billion in assets in over 6 million shareholder accounts. Most of the expansion has occurred in the last two years; the level of the funds' assets has more than doubled since January 1980 (see table 1).

The main reason for the growth of the funds is that they offer a liquid asset with a relatively high yield and a low initial investment requirement. They have seemed especially attractive when short-term rates are high and exceed longer-term rates, as has frequently been the case in recent years. MMMFs have been appealing to institutional investors--such as bank trust funds--for whom they offer a diversified portfolio at low management costs as an alternative to direct investment in money market instruments. It has been estimated that 40 percent of MMMF shares are from institutional investors, but MMMFs have also attracted household investments, thus obtaining funds that would otherwise be placed in the money market directly or at depository institutions. Because of government regulations and constraints imposed by asset portfolios, banks and thrift institutions are handicapped in offering the public an instrument that is as attractive as MMMF shares. Money market certificates pay a relatively high rate but require a minimum deposit of $10,000 and a minimum maturity of six months with substantial penalties for early withdrawal. Small saver certificates offer a low minimum deposit, but a longer maturity and, currently, a lower yield than MMCs or MMMFs. Passbook savings

TABLE 1
MONEY MARKET MUTUAL FUNDS
(Billions of dollars, not seasonally adjusted)

End of Month	Level
1980-January	53.0
February	60.3
March	60.5
April	60.7
May	70.0
June	76.2
July	80.6
August	79.3
September	77.4
October	77.5
November	76.5
December	74.4
1981-January	85.0
February	96.7
March	111.5
April 1/	118.5

1/ As of April 29.

accounts and interest bearing transaction accounts have the liquidity and low minimum deposit characteristics but a low rate of return.

Although it is impossible to determine with certainty where the flows to these funds might otherwise have been directed, the rapid growth of MMMFs has been a cause for concern for the depository institutions and their regulators. MMMF shares lack the insurance characteristics and guaranteed rate of return of a bank or thrift institution deposit, but in many other respects they are similar to savings accounts and to some extent, even interest-bearing transaction accounts, given the ability of shareholders to redeem their investments by a check written to a third party (usually with a relatively high mininum size requirement). Thus, the lack of reserve requirements, interest rate ceilings, and any other bank-related regulations on MMMFs has raised the question of competitive inequity with respect to banks and thrift institutions. Moreover, to the extent that MMMFs are used as transaction accounts, some regulation may be necessary to gain closer control of the money supply.

Several possible solutions to these problems have been offered by industry sources and others; these include placing interest rate ceilings on MMMFs or placing restrictions on how they may invest their assets. A disadvantage of many of these proposals is that they would extend the scope of regulation of financial markets at a time when efforts generally are being directed to free markets from unnecessary governmental interference. Another problem would be that the small savers who do not have the ability to move their funds to other money market instruments would receive a lower return on their savings, perhaps discouraging some much-needed saving in the economy.

An additional proposal is to place reserve requirements on MMMFs. Under DIDMCA, financial institutions eventually will be required to hold reserves on transaction accounts at the rate of 3 percent on the first $25 million and 12 percent on the remainder. Congress could place similar requirements on MMMFs, or at least on that portion of MMMF shares whose redemption characteristics make them functionally equivalent to transaction accounts at banks and thrifts. Under this proposal, the return on MMMFs offering such services would be lower, and a source of the competitive inequity might be removed. MMMFs would then probably segregate accounts intended for transaction purposes from those intended for longer term savings, which could improve the ability of the Federal Reserve to control and interpret movements in the monetary aggregates.

However, it is not clear that a reserve requirement on MMMF transaction accounts would result in a substantial inflow to depository institutions. Many of the shareholders, especially of institutional accounts, who have the ability would move their funds to other money market instruments when MMMF yields declined because of reserve requirements. Most evidence indicates that household shareholders on average do not use their accounts as transaction balances; it seems likely, therefore, that if MMMFs were able to minimize the impact of reserve requirements by restricting access to their accounts or by setting up special transaction account funds, a reserve requirement option might have only a little impact on their ability to attract household funds.

D. Recommendations

Under the DIDMCA, each member of the DIDC is asked to make recommendations on measures to encourage savings, provide equitable treatment of small savers, ensure a steady and adequate flow of funds to thrift institutions and the housing market, and maintain the economic viability of depository institutions.

In recent years, the personal savings rate in this country has declined to very low levels by historical standards. A large part of the decline is attributable to the rapid rate of inflation which has encouraged a "buy now" psychology. By pushing taxpayers into higher brackets, inflation also has reduced the real, after-tax rates of return to savers and the after-tax cost of borrowing.

The most important step that can be taken to encourage savings is to reduce inflation. In that regard, Federal Reserve monetary policy is focussed on a staged reduction in the rate of growth of the money supply to levels consistent with a return to price stability. This goal will be realized more quickly and with less strain on financial markets if monetary policy is complemented by fiscal policies of the Congress and the Administration aimed at reducing Federal expenditures and the Federal deficit.

Another step that could be taken to encourage savings and investment is to make changes in our tax system. As currently structured, this system is biased against both saving and investment, especially when inflation is strong and interest rates high. A significant reduction in Federal spending will set the stage for the possibility of tax reductions which could alleviate these problems. Tax-related disincentives would be reduced to some extent by a cut in tax rates across the board. Other options have been mentioned that would structure tax reductions with an eye to stimulating savings. However, most proposals--such as those that exclude a portion of interest income from taxation--would mainly reduce taxes for those who would save in any case, with little impact on the incentive to increase savings; at the same time, they would increase the Federal borrowing requirement as a result of the reduction in tax receipts. Therefore, unless taxes on consumption are raised to compensate for the loss in receipts, tax relief targeted to stimulate savings must be designed to encourage a large amount of new savings while having little impact on the taxation of existing savings. It appears to be extremely difficult to structure a proposal that meets these criteria for cost-effectiveness.

Deregulation of interest rates at depository institutions on both the borrowing and lending sides would also tend to encourage savings. Artificial constraints on lending rates stimulate demand for borrowing in an inflationary environment, while limits on rates paid on deposits discourage saving--especially for smaller savers with limited access to money market instruments. Of course, one of the major purposes of the Congress in the passage of the Depository Institutions Deregulation Act was to enable small savers to receive a market rate of return on their savings, as soon as it becomes economically feasible for depository institutions to pay such a rate. Under the existing law, the DIDC has sufficient authority to effect an orderly phaseout of deposit rate ceilings. Progress towards this goal, as rapidly as possible, must be a keystone of any program to stimulate saving.

The DIDC currently has proposals out for public comment on steps that could raise rates available to all savers. First, the Committee has requested comment on a proposal to remove the cap on the SSC and let its rate ceiling be tied at all levels to the yield on similar maturity U.S. Treasury securities. The second proposal would eliminate rate ceilings more generally, proceeding by maturity of deposit, with ceilings on longer maturity deposits being removed first. Comments on both of these proposals were requested by May 1 and will be considered at the Committee's next meeting.

With a phaseout of deposit rate ceilings, it will be necessary for depository institutions, especially thrift institutions, to adjust their portfolios in order to be able to pay market rates of interest on deposits. As thrift institutions take advantage of the expanded asset powers permitted to them under the DIDMCA and increase their usage of innovative alternatives to conventional fixed-rate mortgages, they will be in a better position to offer market rates on deposits without severely reducing their earnings. The ultimate result will be more equitable treatment of small savers and a steadier flow of lending by thrifts in the mortgage market, although the total flow of funds to mortgages over time may not be appreciably larger.

Although the thrift institutions have received a wide range of new powers to help them withstand the interest rate cycle, currently the major problem for the thrift industry and the housing market is a continuing high rate of inflation and the concomitant high level of interest rates. The best way to solve the current problems of the thrift and housing industries is to continue to make the reduction of inflation the highest priority of both fiscal and monetary policies. The sooner policies are put into effect to reduce significantly the Federal budget which would complement a continuing monetary policy of slowing the growth of the money supply, the sooner inflation will be reduced and the sooner the outlook for the thrift institutions will improve. In the interim, interested regulatory agencies are studying measures that may be desirable during the transition period to assure the continued soundness of these institutions.

September 30, 1980

REPORT OF ACTIVITIES OF THE DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE AND REPORT ON THE VIABILITY OF DEPOSITORY INSTITUTIONS

BY

PAUL A. VOLCKER, CHAIRMAN

I. ACTIONS OF THE DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE

A. Meeting of May 6

At its organizational meeting on May 6, the Depository Institution Deregulation Committee (DIDC) adopted Rules of Organization and Procedure, Rules Regarding Availability of Information, and Rules Regarding Public Observation of Meetings. The DIDC also adopted two rules concerning the payment of interest on deposits. The first rule authorized depository institutions to permit a depositor to withdraw at any time without penalty all interest earned on a time deposit that has been renewed automatically on the same terms (same maturity and same rate of interest) as the original deposit. This action conformed the rules of the Federal Deposit Insurance Corporation (FDIC) and Federal Reserve with those of the Federal Home Loan Bank Board (FHLBB). The second rule authorized depository institutions to continue to pay interest on time deposits for up to seven days after maturity. Both of these actions were designed to allow depositors at all institutions increased flexibility in making investment decisions.

B. Meeting of May 28

At its meeting on May 28, the DIDC raised the ceiling rates of interest payable on the 26-week money market certificate ("MMC") and on the 2-1/2 year or longer small saver certificate ("SSC"), effective for MMCs issued beginning on June 5 and for SSCs issued beginning on June 2. The primary objectives of these actions were to enable depository institutions to compete more effectively for funds against such investment outlets as money market mutual funds and Treasury securities, and to provide consumers with a higher rate of return on their savings. By allowing depository institutions the flexibility to offer somewhat higher returns, these changes were expected to facilitate larger deposit flows, thus enhancing credit flows to the markets served by depository institutions. (The ceiling rates on MMCs and SSCs and the yields on Treasury securities and money market mutual funds over the last six months are shown in Table 1).

MMC: Under the rules adopted, the ceiling rate of interest payable on the MMC by all institutions is at least 1/4 percent higher than the rate established for 6-month Treasury bills (auction average on a discount basis). When the Treasury bill rate is 8-3/4 percent or higher, both commercial banks and thrift institutions may pay interest at a ceiling rate of 1/4 percent above the bill rate. A differential of up to 1/4 percent between the ceiling rates payable by commercial banks and thrifts is retained when the Treasury bill rate is more than 7-1/4 percent but less than 8-3/4 percent. The rule also established a minimum ceiling rate of 7-3/4 percent which all institutions may pay when the Treasury bill rate is 7-1/4 percent or below. The minimum ceiling was adopted in recognition of the fact that Treasury security yields are not only generally below other market rates but usually lead declines in other rates available to savers. A minimum ceiling thus puts institutions in a better position to attract funds from market instruments at lower rates of interest, should the institution choose to do so. In addition, at rate levels that make the minimum ceilings effective, institutions would be in a relatively favorable earnings position to be able to bid for funds. Moreover, the experience gained in an environment of somewhat wider latitude

Table 1

Rates of Return on MMCs and Alternative Investments

(percent)

1980 Week Ending		6-month Treasury Bill Rate: Auction Rate	6-month Treasury Bill Rate: 6-month Investment Yield	Commercial Bank MMC Rates: New Rule: Nominal	Commercial Bank MMC Rates: New Rule: Effective 2/	Commercial Bank MMC Rates: Old Rule: Nominal	Commercial Bank MMC Rates: Old Rule: Effective 2/	Thrift MMC Rates: New Rule: Nominal	Thrift MMC Rates: New Rule: Effective 2/	Thrift MMC Rates: Old Rule: Nominal	Thrift MMC Rates: Old Rule: Effective 2/	MMMF 1/ Average 7-day net yield: First Generation	MMMF 1/ Average 7-day net yield: Clones
April	2	15.70	18.04	--	--	15.70	16.55	--	--	15.70	16.55	15.04	--
	9	14.80	16.88	--	--	14.80	15.57	--	--	14.80	15.57	15.56	15.80
	16	14.23	16.15	--	--	14.23	14.95	--	--	14.23	14.95	16.03	17.00
	23	13.55	15.29	--	--	13.55	14.21	--	--	13.55	14.21	16.32	15.46
	30	11.89	13.24	--	--	11.89	12.42	--	--	11.89	12.42	16.03	13.90
May	7	10.79	11.91	--	--	10.79	11.24	--	--	10.79	11.24	15.52	11.89
	14	9.50	10.37	--	--	9.50	9.86	--	--	9.50	9.86	13.61	9.93
	21	8.78	9.54	--	--	8.78	9.10	--	--	9.00	9.33	12.72	10.06
	28	8.92	9.70	--	--	8.92	9.25	--	--	9.00	9.33	11.99	8.76
June	4	7.75	8.35	--	--	7.75	8.02	--	--	8.00	8.28	10.73	8.16
	11	8.17	8.82	8.42	8.71	8.17	8.45	8.67	8.98	8.42	8.71	10.63	8.16
	18	6.94	7.42	7.75	8.01	6.94	7.16	7.75	8.01	7.19	7.42	9.79	7.76
	25	6.66	7.11	7.75	8.01	6.66	6.87	7.75	8.01	6.91	7.13	9.19	7.53
July	2	7.11	7.62	7.75	8.01	7.11	7.34	7.75	8.01	7.36	7.56	8.66	7.50
	9	8.10	8.74	8.35	8.64	8.10	8.38	8.60	8.91	8.35	8.64	8.82	7.83
	16	8.11	8.76	8.36	8.66	8.11	8.40	8.61	8.93	8.36	8.66	8.57	7.71
	23	8.11	8.76	8.36	8.66	8.11	8.39	8.61	8.92	8.36	8.66	8.43	7.50
	30	7.91	8.52	8.16	8.44	7.91	8.18	8.41	8.71	8.16	8.44	8.13	7.76
Aug.	6	8.28	8.95	8.53	8.83	8.28	8.57	8.78	9.10	8.53	8.83	8.20	8.34
	13	8.87	9.64	9.12	9.46	8.87	9.20	9.12	9.46	9.12	9.46	8.22	8.17
	20	8.89	9.66	9.14	9.48	8.89	9.22	9.14	9.48	9.14	9.48	8.12	8.24
	27	9.77	10.69	10.02	10.41	9.77	10.15	10.02	10.41	9.77	10.15	8.43	-- 6/
Sept.	3	10.25	11.26	10.50	10.93	10.25	10.66	10.50	10.93	10.25	10.66	8.96	--
	10	10.25	11.26	10.50	10.93	10.25	10.66	10.50	10.93	10.25	10.66	8.93	--
	17	10.23	11.24	10.48	10.91	10.23	10.64	10.48	10.91	10.23	10.64	9.01	--
	24	10.88	12.01	11.13	11.60	10.88	11.34	11.13	11.60	10.88	11.34	n.a.	--

* Footnotes on next page.

Table 1 (Cont'd)

Rates of Return on 2-1/2 year-or-Longer Small Saver Certificates

(percent)

1980	Constant Maturity 2-1/2 Year Treasury Bond	Commercial Banks				Thrifts			
		New Rules 3/ 5/		Old Rules 4/ 5/		New Rules 3/ 5/		Old Rules 4/ 5/	
		Nominal	Effective	Nominal	Effective	Nominal	Effective	Nominal	Effective
Monthly									
January	10.90			10.15	10.84			10.40	11.12
February	11.15			10.40	11.12			10.65	11.40
March	14.00			11.75	12.65			12.00	12.94
April	14.65			11.75	12.65			12.00	12.94
May	11.25			10.50	11.23			10.75	11.51
2 Weeks Ending									
June 11	9.05	9.25	9.83	8.30	8.78	9.50	10.11	8.55	9.06
25	9.00	9.25	9.83	8.30	8.78	9.50	10.11	8.55	9.06
July 9	8.60	9.25	9.83	7.85	8.28	9.50	10.11	8.10	8.56
23	9.05	9.25	9.83	7.85	8.28	9.50	10.11	8.10	8.56
Aug. 6	9.05	9.25	9.83	8.30	8.78	9.50	10.11	8.55	9.06
20	9.70	9.45	10.05	8.95	9.50	9.70	10.33	9.20	9.77
Sept. 3	10.25	10.00	10.67	9.50	10.11	10.25	10.95	9.75	10.39
17	11.50	11.25	12.08	10.75	11.51	11.50	12.36	11.00	11.80
Oct. 1	11.30	11.05	11.85	10.55	11.29	11.30	12.14	10.80	11.57

1/ Includes any capital gains or losses.

2/ The effective rate assumes reinvestment of principal and interest at the same rate for another six months.

3/ Minimum ceiling rates of 9-1/2 percent at thrifts and 9-1/4 percent at banks are established.
Maximum rates set in March will continue.
Between the minimum and maximum rates payable, thrifts may pay the 2-1/2 year Treasury securities rate and banks may pay this rate less 1/4 of a percentage point.
The rate will change bi-weekly beginning Monday, June 2, based on average daily yields for the five business days ending every other Monday, and will be effective the following Thursday.
The temporary cap of 12 percent at thrifts and 11-3/4 percent at banks which was set in February 1980 remains in effect.

4/ Rate ceiling changed on first calendar day of each month, based on average 2-1/2 year yield on Treasury securities.
This yield was announced three business days prior to the first day of the month, and was based on the average daily yields for the preceding five business days.
Nominal ceilings at banks and thrifts were 3/4 and 1/2 of a percentage point, respectively, below the 2-1/2 year Treasury securities yield.

5/ The effective rate assumes continuous compounding on a 365/360 day basis.

6/ The removal of the special deposit requirement ended the distinction between clone and other MMMFs.

in rate setting may serve the depository institutions well as we move toward wider deregulation.

Under the previous rules, the maximum rate of interest payable by commercial banks on MMCs was the Treasury bill discount rate. The maximum rate of interest payable by thrift institutions on MMCs was 1/4 percent above the Treasury bill discount rate when that rate was less than 8-3/4 percent, 9 percent when the Treasury bill discount rate was between 8-3/4 percent and 9 percent, and the Treasury bill discount rate when that rate was above 9 percent. Thus, under the former rules, when the Treasury bill discount rate was 9 percent or above, there was no differential between the ceiling rates payable on MMCs by banks and thrifts.

In establishing the new MMC rate ceilings, the DIDC also faced the prospect that the decline in Treasury rates then occurring would reintroduce a differential on MMCs in favor of thrifts. In this regard, commercial banks that are relatively large lenders in the mortgage, small business, and agricultural credit markets--and which, especially in the agricultural credit market, tend to be quite small--had a large volume of MMCs scheduled to mature in the late spring and early summer. Such institutions could have faced substantial deposit attrition and subsequent pressure on their ability to extend credit if the differential reemerged for a sustained period. In view of these concerns, while permitting the differential to reappear if market rates declined somewhat from the May levels, the DIDC also gave commercial banks the one time option of renewing maturing MMCs with the same depositor at a rate equal to the thrift ceiling rate for a period of six months (May 29 through November 30, 1980).

SSC. For the same reasons as the MMC ceiling adjustment--to increase flows to depository institutions--new SSC ceiling rates for all institutions were established that are 1/2 percent higher than the previous ceilings. As in the case of MMCs, and for the same reason, the rule also established minimum ceiling rates payable on SSCs. These minimum ceiling rates are 9-1/4 percent for commercial banks and 9-1/2 percent for thrift institutions, regardless of the average 2-1/2 year yield for Treasury securities. The 1/4 percent differential between the ceiling rates payable on the SSC by banks and thrift institutions was left intact because these longer-term deposits were considered particularly appropriate to the maturity structure of thrift institutions' asset portfolios and provide a more solid base and incentive for mortgage lending.

Under the new rule, the ceiling rate for thrift institutions is the higher of 9-1/2 percent or the average 2-1/2 year yield for Treasury securities. The ceiling rate for commercial banks is the higher of 9-1/4 percent or the average 2-1/2 year yield for Treasury securities less 1/4 percent. The maximum ceilings of 12 percent (for thrift institutions) and 11-3/4 percent (for commercial banks) imposed on the SSCs by the federal financial supervisory agencies effective February 27, 1980, were retained. In addition, the new rule provides that the ceiling rate payable on SSCs will be determined biweekly. Under the previous rules, the ceiling rates were determined monthly. For thrift institutions the ceiling rate of interest on SSCs formerly was 12 percent or 1/2 percent below the 2-1/2 year Treasury rate, whichever was lower; for commercial banks the ceiling rate formerly was 11-3/4 percent or 3/4 percent below the 2-1/2 year Treasury rate, whichever was lower.

Growth of savings and small-denomination time deposits has accelerated substantially at banks and thrifts since the May adjustments in the ceiling rates on MMCs and SSCs, as shown in Table 2. However, much of the deposit growth in recent months is attributable to a tremendous influx of savings deposits, the ceiling rate on which had not been adjusted. Most observers feel that the deposit growth reflects a temporary "parking" of deposits by the public which will later be used to acquire more permanent financial assets after the interest rate outlook becomes clearer. Although banks and thrifts have experienced net outflows of MMC balances since the spring, such outflows have moderated most recently and have been more than offset at both banks and thrift institutions by larger inflows of the 30-month SSCs; the advantage of the 25 basis point differential for thrifts on SSCs has had the effect of larger relative inflows for thrifts. Presumably, the growth of small denomination time deposits at both sets of institutions would have been lower, or even negative, without the DIDC actions of late May--especially after taking account of the increases in market yields since June.

The acceleration of total small-denomination time and savings deposits flows, in combination with stronger loan demand at lower interest rates, has contributed to a pickup in mortgage activity. At S&Ls, mortgage commitments rose slightly in June after eight straight months of decline, and outstanding commitments moved up a sizable $3.0 billion in July and a further $3.1 billion in August. Mortgage holdings of S&Ls, which actually declined in May and June, began to turn up in July, posting a $1.6 billion gain, and a further $3.6 billion gain in August (see Table 3). Real estate

Table 2

Composition of Deposit Flows
(Seasonally adjusted, percentage annual rate of growth) 1/

	All Depository Institutions			Commercial Banks			Thrifts		
	Savings Deposits	Small Denomination Time Deposits	Total Savings & Small Time	Savings Deposits	Small Denomination Time Deposits	Total Savings & Small Time	Savings Deposits	Small Denomination Time Deposits	Total Savings & Small Time
1980--Jan.	-14.1	9.5	0.3	-12.4	21.9	6.6	-15.2	2.3	-3.8
Feb.	-25.1	17.4	1.1	-22.5	25.9	4.7	-27.7	12.5	-1.4
March	-33.6	29.0	5.5	-35.6	42.5	9.0	-31.7	20.8	3.1
April	-44.7	36.1	6.9	-43.3	54.4	14.1	-45.5	24.9	1.8
May	-14.6	16.5	5.6	7.0	14.0	5.7	-21.3	19.0	6.3
June	27.8	2.7	11.3	32.4	-2.8	10.9	23.7	5.2	10.8
July (prelim)	38.2	-3.6	10.8	39.2	-3.2	13.6	37.2	-3.9	8.9
Aug. (prelim)	28.0	1.0	10.6	25.9	0.1	10.4	29.1	1.8	10.5

Memo: Flows in billion of dollars, not seasonally adjusted

	6-month MMCs		30-month SSCs		Sum of MMCs and SSCs	
	Commercial Banks	Thrifts	Commercial Banks	Thrifts	Commercial Banks	Thrifts
1980--April	19.3	17.0	2.8	7.2	22.1	24.2
May	-2.7	-5.6	4.6	9.1	1.9	3.5
June	-3.4	-5.2	4.2	6.3	.8	1.1
July	-4.3	-7.7	4.5	8.4	.2	.7
August	-.9	-.8	1.5	3.1	.5	2.3

1/ Commercial bank data are daily average, and thrift data are average of month ends.

Table 3

Net Change in Mortgage Loans at Thrift Institutions
(Billions of dollars, seasonally adjusted)

	Mutual Savings Banks	S&Ls	Total
1980-January	.2	2.1	2.3
February	.3	2.2	2.5
March	--	1.6	1.6
April	--	.6	.6
May	.1	-.5	-.4
June	-.2	-.3	-.5
July	-.1	1.6	1.5
August	n.a.	3.6	n.a.

lending by small commercial banks has behaved similarly, with a contraction in such loans in the second quarter and renewal of expansion in July and August (Table 4).

Early withdrawal penalty: At its May 28 meeting, the DIDC also modified the rule requiring the imposition of a penalty for early withdrawal of time deposits. The new rule increased the minimum penalty in the early months of a deposit's life, while leaving the minimum penalty in subsequent months virtually unchanged. The new rule adopted by the DIDC requires imposition of a minimum penalty of an amount equal to three months simple interest on the funds withdrawn where the original maturity of the time deposit is three months to one year and six months simple interest on the funds withdrawn where the original maturity of the time deposit is more than one year. Where a time deposit with an original maturity of less than three months is paid before maturity, the penalty is the forfeiture of an amount equal to the amount of interest that could have been earned on the funds withdrawn at the simple interest rate if the funds had remained on deposit until maturity. Under the previous rules, the minimum required penalty did not exceed the interest accrued or already paid on the time deposit. Under the rule adopted by the DIDC, the penalty may require a reduction in the principal sum of the deposit where funds are withdrawn in the early months of a a deposit's life.

The penalty rule was modified in view of the DIDC's apprehension that lenders may not be willing to commit additional deposit inflows to mortgage and other credit markets because of their concern that those deposits would be rapidly withdrawn before maturity if market rates subsequently rose.

Table 4

Bank Loans By Class of Banks
(Billions of dollars, seasonally adjusted)

	Small Banks				Large Banks
	Real estate loans	Business loans	Other loans	Total loans	Total loans
1980 January	1.6	.3	3.3	5.2	4.5
February	1.2	1.6	2.9	5.7	6.3
March	.4	.9	.4	1.7	.8
April	-.6	-1.8	--	-2.4	-2.1
May	-.3	-.5	-3.6	-4.4	-6.5
June	-.6	-.9	-1.8	-3.3	-2.2
July	1.0	-.7	.5	.8	-.9
August	.3	.6	-.9	0	7.3

In the environment of rising interest rates in late 1979 and early 1980, the volume of withdrawals prior to maturity for the purpose of acquiring higher yielding deposits--often at the same institution--rose sharply because, under the former penalty rule, the amount of the penalty in the early months of a deposit's life was not sufficient to offset the gain from reinvestment. Technically, this reflected the provision that the minimum required penalty was imposed only on accrued interest and did not require a reduction in the amount of the original deposit; in the early months of a deposit's life, there was insufficient accrued interest to act as a deterrent to early withdrawal when interest rates are rising appreciably. Under these circumstances, depositories moved to protect earnings by investing the proceeds of MMCs and SSCs in money market instruments, rather than making loans.

While the DIDC was aware that the depositor who breaks a deposit contract by withdrawing the deposit prior to maturity may be concerned upon finding the principal reduced by early withdrawal penalties, a similar situation would also occur if an investor were to liquidate a market security prior to maturity in a rising rate environment. In the DIDC's opinion, the revised early withdrawal penalty rule was especially appropriate in view of the growth in deposits with yields linked to market instruments. The benefit that individuals receive via the higher rates available on such deposits has to be balanced with the need to maintain flows to various credit markets. This can be facilitated by having depositors share some of the interest rate risk that traditionally has been borne by depository institutions, a risk that appeared to be limiting the willingness of the institutions to commit funds to their traditional credit markets. Nevertheless, at the September 9 meeting, the Committee directed its staff once again to review the early withdrawal penalty rule, including in particular the possiblity of defining "emergency" provisions that, in specified circumstances, might permit early withdrawal with no or minor penalty.

C. Meeting of June 25

At its meeting on June 25, the DIDC adopted a rule providing that a penalty need not be applied to a withdrawal from an IRA or Keogh account time deposit prior to maturity if the owner is disabled or age 59-1/2 or over. This rule conformed the rule of the Federal Home Loan Bank Board to the rules previously adopted by the Federal Reserve and FDIC. The rules of the FHLBB formerly permitted exemption from the early withdrawal penalty only when withdrawal was made to effect a taxable distribution of the account.

D. Meeting of September 9

At its meeting on September 9, the DIDC adopted rules concerning the use of premiums, finders' fees, and the prepayment of interest. Public comment was solicited on these rules on May 6, 1980, and the comment period expired on July 16, 1980.

Premiums. The issue of premiums offered as gifts to depositors has been controversial, with both sides bringing cogent arguments in defense of their positions before the DIDC. The issue arose because some depository institutions were allocating their costs of the gifts given as premiums in such a way as to avoid the intent of the rule, viz., to permit only a de minimis gift to a depositor. The Committee had proposed to ban premiums outright in view of the considerable difficulty the agencies were encountering administering their premium rules, but at its June meeting the Committee announced that any implementation of a ban would be delayed until the end of the year, in order that thrift institutions and premium suppliers could make plans for the fall season. After reviewing the more than 5,000 public comments received, the DIDC decided to permit depository institutions to continue to offer premiums of gifts to depositors at the time of opening a new account or adding to or renewing an existing account. However, in order to make the premium rule effective and enforceable, the Committee increased the dollar limits of permissible premiums from $5 for deposits of less than $5,000, and $10 for deposits of $5,000 or more to $10 and $20, respectively, and specified that the new cost limits include <u>all</u> costs associated with the premium offered (shipping, handling, packaging, etc.). In addition, depository institutions are required to prepare a statement that certifies compliance with the new premium rule. This statement will be reviewed in the course of the examination process.

<u>Finders' fees</u>. The Committee had also proposed to treat finders' fees paid to third parties who bring depositors to a depository institution as a payment of interest to the depositor for purposes of determining compliance with deposit ceiling rate limitations. This proposal was made in view of evidence suggesting that such fees were being passed on to the depositor and, hence, being used to avoid deposit rate ceilings. The Committee at its September meeting adopted a rule requiring that such fees be paid in cash and be regarded as the payment of interest to the depositor for purposes of determining compliance with deposit ceiling rate limitations. Certain incentive programs for the employees of a depository institution were exempted from this rule, and the Committee also is soliciting public comment on a

proposal to permit a two-year phase-out of finders' fees by those institutions that have relied heavily on such fees.

The Committee also adopted a rule prohibiting the prepayment of interest in either cash or merchandise.

The premium, finders' fees, and prepayment of interest rules, which apply only to deposits subject to ceiling interest rate limitations, were adopted to facilitate the administration of such ceilings fairly and effectively during the phase-out period. The rules are effective December 31, 1980.

Rate ceilings on interest-bearing transaction accounts. The legislative history of P.L. 96-221 indicates that the DIDC should work toward rate ceiling parity on transaction accounts at all institutions. Consequently, public comment was requested on June 25 on four options for uniform ceilings on interest-bearing transaction accounts at commercial banks, mutual savings banks, and savings and loan associations. The DIDC proposed to define transaction accounts to include NOW accounts, savings accounts subject to automatic transfer (ATS), telephone transfers (TTS), and preauthorized nonnegotiable transfers (PNTS), and savings accounts that permit payments to third parties by means of an automated teller machine (ATM), remote service unit (RSU) or other electronic device. In addition, the DIDC proposed to establish a uniform ceiling on transaction accounts that would be below the ceiling rate of interest on "regular" savings accounts. A spread would help the Federal Reserve distinguish between transaction and liquid asset accounts for the purpose of monitoring the growth of transaction balances. However, to achieve both rate ceiling uniformity on transaction accounts and a spread between such accounts and all regular savings accounts would require either a roll-back in the ceiling rate on some transaction accounts or an increase in the passbook ceiling rate that could further erode thrift earnings.

After considering over 750 comments on its proposals, the DIDC decided to take action at this time only with reference to the ceiling rate of interest payable on NOW accounts; on December 31, 1980 all institutions are authorized to pay 5-1/4 percent on NOW accounts as compared to the 5 percent ceiling presently authorized in New England, New York, and New Jersey. The ceiling rates of interest payable on all other accounts were left unchanged. In taking this action, the DIDC recognized the importance for monetary policy of a spread between the ceiling rates of interest payable on transaction and nontransaction accounts, but did not wish to roll back any transaction account ceiling and did not believe that the earnings of thrifts should be further strained by an increase in the passbook ceiling rate at this time. However, the DIDC announced its intention to raise the passbook savings ceiling rate as soon as feasible, hopefully in 1981; in any event, by law a 25 basis point increase in the passbook ceiling rate must be considered by the DIDC no later than September 30, 1981.

Time deposits with maturities of 14-29 days. The third action taken by the DIDC at its September 9 meeting was to establish a deposit ceiling rate for banks that are members of the Federal Reserve System on time deposits of under $100,000 with original maturities (or notice periods) of 14 - 29 days. The rate established for such deposits is 5-1/4 percent. The DIDC's action was prompted by the recent action of the Federal Reserve shortening the minimum maturity of time deposits from 30 to 14 days. The DIDC also announced that in the event the FDIC and the FHLBB take similar action in the future to shorten the minimum required maturity of time deposits for institutions under their jurisdiction to 14 days, the ceiling rate of interest payable on such time deposits will be 5-1/4 percent for insured nonmember commercial banks and 5-1/2 percent for insured mutual savings banks and savings and loan associations.

II. FINDINGS ON DISINTERMEDIATION

The Deregulation Act directs each member of the DIDC to evaluate the degree to which uninsured money market innovators paying market rates have contributed to disintermediation at depository institutions. The sophistication of small investors has grown impressively in recent years. Many investors have discovered that the yield and liquidity characteristics of money market instruments, and money market mutual funds that buy them, to be superior to deposits for many purposes--an advantage that reflects to a substantial extent the ceilings applicable to deposit rates at banks and thrifts. This increasing familiarity with attractive alternatives to deposits has meant that changes in relative yields have led to episodes of large diversions of deposits to market instruments, probably with the most impact on the availability of credit at smaller institutions that have limited ability to supplement their deposits with managed liabilities.

This distortion of credit flows was particularly serious when overall financial conditions were unusually taut early this year. Substantial funds were flowing into the central money markets where yields were highest, severely reducing the availability of credit in local markets across the country. A significant share of this diversion reflected the rapid growth of money market mutual funds. In this environment, under the authority of the Credit Control Act, a 15 percent special deposit requirement was placed on any increase in the total assets of money market mutual funds, effective March 14, to restrain the growth of credit through these funds and hence encourage a more normal distribution of credit growth in local financial markets. The deposit requirement was lowered two months later to 7-1/2 percent and was eliminated in July after the pressures in financial markets eased sufficiently and credit became available to a wide variety of borrowers at lower interest rates.

There has been a relaxation of the immediate difficulties facing small banks and thrifts in competing with market instruments and money funds since the period of extremely high interest rates in the spring. The raising of the ceiling rates on MMCs and SSCs in May contributed to a better competitive position for depositories, as has the recent increase in market rates which, for some short period, will raise deposit offering rates above yields available on money fund shares since the latter still have in portfolio assets acquired at lower yields. But there are obvious limitations on the extent to which raising ceiling rates can be a short-term solution to the problem of disintermediation, given the existing assets and earnings of the institutions. Even when the deregulatory process is completed over the next five and one-half years, depository institutions will still operate under much more restrictive regulations than money funds or direct issuers of debt, including reserve requirements on transaction and nonpersonal time accounts.

There are also economic limitations on placing constraints on market alternatives that compete with depositories for funds. The recent experience with the imposition of special deposit requirements on the money funds helps to illustrate an important limitation of programs of selective restraints on money market instruments: many investors are in a position to turn to higher-yielding alternatives when new regulations lower the net returns of specific financial assets. When the offering rates on the money funds declined after the special deposit requirements were applied, noncompetitive tenders in the weekly Treasury bill auctions surged to record levels (table 5), as investors who were able to do so bypassed the funds and purchased debt market instruments directly. To be sure, the imposition of special deposit requirements on the money funds did assist in redirecting credit flows to local markets,

Table 5

Selected Investment Alternatives for Small Investors
(Billions of dollars, not seasonally adjusted)

	Money Market Mutual Funds		Noncompetitive Tenders in Weekly Treasury Bill Auctions	Net MMC Flows at Depository Institutions	
	Level 1/	Change	(Monthly Average)	Level 1/	Change
1980-					
January	53.0	7.8	1.25	291.1	25.3
February	60.3	7.3	1.12	307.3	16.2
March	60.5	.2	1.68	342.6	35.3
April	60.7	.2	1.85	378.9	36.3
May	70.0	9.3	1.11	370.6	-8.3
June	76.2	6.2	.88	362.0	-8.6
July	80.6	4.5	1.19	350.1	-11.9
August	79.3	-1.3	1.21	348.0	-2.1

1/ End of month

but if the special deposit requirements had remained in place for a protracted period, even the immediate gains by local financial institutions might not have been sustained.

Also, it must be recognized that almost one-quarter of the assets held by the money funds are controlled by funds that have large minimum investment standards, and the individuals and institutions that can meet such standards can be assumed to be sophisticated investors who operate freely in money and capital markets and do not think of deposits subject to rate ceilings as an alternative. Indeed, the average account size at all the money funds was over $20,000 in July. Moreover, even the smaller shareholders in the money funds clearly have gained an understanding of investment alternatives that will lead them to seek out high-yielding financial assets.

There are partially offsetting advantages to deposits at thrifts and banks, such as federal deposit insurance and the ability of depository institutions to offer customers a wide variety of services in one location. Nevertheless savers have become extremely sensitive to even small changes in the relative yields of different financial assets, including deposits, and a diversion of flows from depository institutions to money funds and market instruments could very well recur if a rekindling of inflationary pressures drives up market interest rates. In that event, perhaps a solution can be found that is equitable to small investors and still allows thrifts to raise funds during periods of high and rising interest rates without wholesale damage to earnings. One approach might be to force, in effect, a choice by the money funds between reserve requirements or not offering check-writing services on their shares. I am not inclined to advocate the legislation of such regulatory authority at this juncture, however.

III. DIFFERENTIAL BETWEEN RATES PAID ON DEPOSITS BY BANKS AND THRIFTS AND THE VIABILITY OF THE HOUSING INDUSTRY

The differentials in ceiling rates have been an important element of the environment in which thrift institutions operate. The Deregulation Act requires each member of the DIDC to assess whether removal of any differential between rates paid by banks and thrifts will adversely affect the housing finance market or the viability of the housing industry.

With one limited exception, interest rate differentials have been left unchanged by the DIDC. As reviewed above, the May actions narrowed the differentials on the 6-month MMCs in some respects, but did not substantially change the rules concerning the differential in the market range of interest rates prevailing at either the time of the actions or most recently. The new minimum ceiling rates authorized in May have eliminated the differential for only three weeks, and the temporary provision giving commercial banks the six month privilege of rolling over maturing MMCs at thrift ceiling rates has eliminated the differential for maturing deposits for only seven weeks since authorized at the end of May. Since early August, bill rates have been at levels that have removed the MMC ceiling rate differential under the new rules, but the levels of bill rates would have done so under the previous rules as well.

Since 1966 as inflation has accelerated, thrift institutions have recurrently found their returns on assets lagging behind the increases in their costs of funds. In an attempt to improve their competitive position without paying interest rates that might otherwise be demanded by the market, the differentials on ceiling rates vis-a-vis commercial banks were introduced by regulation in 1966. Thrifts have come to rely on this competitive edge in the years since, and a justifiably cautious attitude must be taken toward dismantling the structure of differentials on time and savings deposits as long as inflation continues to push market rates of interest above the average return on thrift institutions' long-term assets.

The ultimate removal of ceiling rates--as required by the Depository Institutions Deregulation Act--of course would mean the end of the differential. The legislative history states that, through the period during which the ceilings are phased out over the next five and one-half years, the Committee may increase ceiling rates on those accounts subject to the statutory differential required by Public Law 94-200, provided that the differential is maintained. Beyond that, judgements about the level of the ceiling rates and any modifications of differentials on new deposit classes that may be authorized will depend upon a balancing of the special problems of the thrift and housing industries against the claims of consumers and others for equity. Small businesses and agriculture, in particular, that rely heavily on bank credit have a strong and recognized claim for equitable treatment. The DIDC's power to affect the distribution of credit is limited, however, by the economic reality, described in Section II, that the public is increasingly aware of its market alternatives to deposits. Saver sophistication implies that depository institutions cannot be protected by unrealistically low ceiling rate limitations for long periods of time. The actions of the DIDC fully reflect concern that sudden removal of the differential may adversely affect housing, and also reflect efforts to place all institutions in a somewhat better competitive position. Progress in restoring a more competitive setting for depository institutions, while gradual, would appear essential over time to avoid atrophy in the thrift industry.

The phasing-in of new asset and liability powers for thrift institutions under the Depository Institutions Deregulation and Monetary Control Act next year should, over time, provide opportunities for improved and cyclically more stable earnings for thrifts. Improved earnings would help lay the groundwork for more flexible policies toward interest rate ceilings and ultimately their phase-out. With the introduction of NOW accounts, thrift institutions across the country will be in a position to compete for household interest-bearing transactions balances with banks on similar terms, a major change in the competitive landscape. The innovations in mortgage contracts made over the last year will also enhance the long-run ability of thrift institutions to compete with commercial banks and the market over the interest rate cycle.

IV. RECOMMENDATIONS

A. The economic viability of thrift institutions was recently appraised by the Interagency Task Force created by the Deregulation Act of 1980. The findings and recommendations of the Task Force--in which the Federal Reserve participated--were submitted to the President and the Congress on June 30 of this year.[1/]

At the time of the Task Force report, declining interest rates were contributing to improvement in the health of the thrift industry. However, the recent increase in short- and intermediate-term interest rates has raised offering rates on MMCs and SSCs well above the levels prevailing at the time

1. The recommendations were: 1) nonmember S&Ls and mutual savings banks should give serious consideration to joining the FHLB System, and credit unions should join the Central Liquidity Facility; 2) more flexible and cost-responsive mortgage instruments should be developed, and the federal regulatory agencies should encourage more widespread use of these instruments, subject to adequate consumer safeguards; 3) state legislatures should review and alter statutes that may inhibit the ability of thrift institutions to sell mortgages in the secondary market; 4) state legislatures should also review their taxation of thrift institutions so as to avoid inequitable taxes that could compound serious earnings problems; 5) Congress should give serious consideration to an override of state ceilings on rates charged on a variety of consumer loans in order to increase the incentives for thrift institutions to take advantage of the expanded asset powers provided by the Deregulation Act.

of the Task Force's report, placing some renewed pressure on the earnings margins of thrifts. If interest rates rise further and money market mutual funds reemerge as a critical element in diverting funds from thrifts and small banks, these institution once again may be under severe pressure.

In looking at ways to address specific competitive imbalances, we should not lose sight of the fact that inflation is the fundamental problem which has led thrift institutions to their current state. As inflation has increased, market interest rates have risen more or less commensurately since the mid-1960s with plainly adverse consequences for thrift institutions with large portfolios of fixed rate mortgages. The increases in short-term yields forced thrift institutions to fund their mortgage portfolios at lower and lower profit margins, and the relief provided by higher mortgage yields has not yet been sufficient to offset the higher costs of deposits, as the slow turnover of long-term mortgages kept the total returns on thrift portfolios below market rates of interest. Moreover, the higher mortgage yields have had the perverse effect of slowing down the repayments of older, low rate mortgages. Thus, as long as inflation continues, tinkering with regulations on financial intermediaries will not solve the root problem, and distortions will continue to appear. As high rates of inflation and shifts in inflationary expectations are reflected in high and volatile interest rates, thrift institutions that borrow short and lend long and small banks that do not have access to money markets for funds will be vulnerable to recurrent earnings and liquidity pressures. This central problem exemplifies the importance of dealing with inflation.

B. <u>Encouraging savings</u> will also be helped by reducing the rate of inflation. In recent years, inflation has whittled away the returns of savers, and our tax system has cut deeply into the remaining returns on investment. Many careful investors have seen the purchasing power of their financial capital fall, squeezed by both inflation and taxes. The acceleration of inflation in recent years has rewarded the nimble, rather than the productive, and has encouraged the accumulation of debt to purchase existing physical assets, rather than the growth of savings to build our capital stock. The causes of the decline in the savings rate are complex, however, and even with a reduction in the rate of inflation, changing savings habits will not easily be accomplished. However, there are things that Congress can do to encourage savings. At a minimum, the Federal government should reexamine policies that discourage savings or divert it away from productive investment.

In evaluating the factors affecting savings, it is important to underline the impact of the real after-tax rates of return earned by savers. I have not, in principle, been in favor of indexing the tax system to inflation, lest we are drawn into further patchwork solutions to inflation and away from attacking the problem head-on. But I am nevertheless sensitive to the fact that in inflationary periods the progressivity of the tax system can pull real after-tax rates of return on financial assets to zero and even into the negative range. The DIDC, by keeping ceiling rates at depository institutions reasonably competitive, can assist in raising nominal and after-tax returns to savers, but the forces of unanticipated inflation and the tax structure transcend the confines of the DIDC's authority. Indeed, real rates of return even in unregulated financial markets have been extremely low and sometimes negative in recent years.

It is of fundamental importance that the federal government not divert investable funds away from housing, plant, and equipment by heavy reliance on deficit financing. Not only would smaller deficits reduce the inflationary pressures now rampant in the economy, but they would release a larger proportion of society's savings for private investment, a point made in the 1980 Economic Report of the President with which I strongly concur.

C. Equitable treatment of small savers is a key goal of the Deregulation Act of 1980, and the DIDC has begun to move toward improving the returns available to small depositors. In authorizing the deregulation of deposit rate ceilings, the Congress set a timetable of six years, and substantial progress could not be expected in just the first six months of that period. Nevertheless, the DIDC did raise the ceiling rates on MMCs and SSCs in May; the ceiling on NOW accounts will be increased at the end of this year. And the remarkable rise in the outstanding amount of MMCs and SSCs has already increased the returns to savers who had previously held their funds in fixed-rate accounts. The total volume of MMCs and SSCs has passed $400 billion, with about 60 percent of these deposits held by thrift institutions and 40 percent by banks.

There are, however, significant limitations on the ability of depositories, especially thrift institutions, to pay market rates of return over the interest rate cycle. Constrained by large portfolios of fixed rate mortgages made in periods of much lower interest rates, thrifts cannot quickly raise their offering rates on deposits without possibly grave consequences to their earnings. With the passage of time and implementation of the many innovations in thrift assets and liabilities, I look forward to eventual removal of the current array of ceiling rates that will permit fairer treatment of small savers.

D. <u>A steady and adequate flow of financing to thrift institutions and housing</u> has become more likely with the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980. Together with recent regulatory actions, the list of innovations at thrift institutions that will help thrifts through the interest cycle is impressive: NOW accounts, variable rate mortgages, renegotiable rate mortgages, and, of course, MMCs and SSCs, to cite just a few. The ultimate consequences to thrift institutions and the housing industry of these changes will take time to become clear. In my judgment, thrift institutions need time to adapt to the changes already made, and I would not urge additional legislative actions now.

The immediate prospects for thrift institutions and the housing industry in the months ahead will depend upon more than legislative and regulatory innovations, however. The persistence of intense inflationary pressures as the economy moves out of recession raises the possibility of further upward movements of market rates of interest. A federal tax cut that adds to inflationary demands would heighten the risk of interest rate increases that would renew tendencies toward disintermediation and stall the incipient recovery in homebuilding. Indeed, the recurring theme in my recommendations must be my concern with the dislocations that inflation has wrought in the patterns of savings and investment in the United States and, in particular, in the thrift industry. But I believe that we can lower inflation by the patient application of carefully designed monetary and fiscal policies. When we succeed in this task, we will have gone a long way toward solving the pressing and important problems of housing and the thrift industry.

DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE PRESS RELEASE

COMPTROLLER OF THE CURRENCY FEDERAL DEPOSIT INSURANCE CORPORATION FEDERAL HOME LOAN BANK BOARD
FEDERAL RESERVE BOARD NATIONAL CREDIT UNION ADMINISTRATION TREASURY DEPARTMENT

For immediate release February 26, 1981

The Depository Institutions Deregulation Committee today announced a temporary amendment to its rule on the use of premiums which will prohibit a depository institution from soliciting the opening of multiple accounts from a depositor in order to provide more than one premium at a time.

The Committee adopted new rules in September on premiums, finders fees and prepayment of interest which became effective December 31, 1980. Since then, an increasing number of depository institutions have advertised premium programs in which a lump sum brought in by a depositor may be broken up by the institution and placed in multiple accounts, thus enabling the institution to give a premium for each account.

These programs have the effect of undermining the Committee's intent by making it possible for the institution to provide more premiums than would otherwise be permitted if the funds remain in one account.

The temporary rule, which becomes effective immediately, prohibits depository institutions from soliciting or otherwise promoting multiple accounts for the purpose of paying multiple premiums. The Committee asked for public comment by April 1, 1981 on this rule and on alternative methods that also might be adopted on a permanent basis.

The Committee's Federal Register notice will be available shortly.

Savings Association League of New York State
700 White Plains Road
Scarsdale, New York 10583
(914) 472-3500

Paul A. Schosberg
President

Your Savings Associations

Original to Bernard

February 24, 1981

Mr. Paul A. Volcker, Chairman
Board of Governors of the
Federal Reserve System and
Chairman, Depository Institutions
Deregulation Committee
Federal Reserve Building
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Dear ~~Mr. Volcker~~ Paul:

Our request of February 2, 1981, for an outright prohibition on all premium offerings by all financial institutions has developed a totally new sense of urgency and I urge the Depository Institutions Deregulation Committee to assign the highest priority to an immediate consideration of such a ban.

During the three weeks since I first wrote to you requesting consideration of a prohibition on premium offerings, banks and thrift institutions throughout the New York City metropolitan area have increasingly begun to use misleading and deceptive advertisements to promote their premium and cash offerings for savings deposits. As I predicted, a growing number of financial institutions now utilize advertisements which reflect the pre-1981 advertisements for finders' fees for new deposits. At the same time, they use multiple account openings and split deposits to open accounts and immediately add to the accounts to facilitate the giving of cash and gifts of substantially greater value than the $10 and $20 limitations intended in 12 CFR 1204.109.

Now, Chase Manhattan Bank, NA of New York has heightened the cash offering competition with the introduction of its "Chase Against Inflation" campaign. It has blanketed the metropolitan area print media (see ads enclosed) with questionable advertisements offering "the biggest cash bonus of any New York bank" for new savings deposits. Chase now offers "up to $400

The Savings Association League of New York State has a membership of 105 state and federally-chartered savings and loan associations with assets in excess of $23 billion. The principal officers are Charles C. Weyant, chairman; Paul A. Schosberg, president; Vincent R. Tortorello, vice president-administrative services and treasurer; Edward B. Kramer, vice president-public affairs; and Gerald M. Seixas, secretary. League headquarters are at 700 White Plains Road, Scarsdale, New York 10583 Telephone (914) 472-3500.

Whose members belong to the
Federal
Home Loan
Bank System

more than you will find anywhere else" by paying cash bonuses of up to $800 on 30-month deposits of $100,000 and similarly higher bonuses on smaller deposits.

Clearly, other financial institutions will move quickly to establish cash offerings that are competitive with the Chase program and we face the inevitable return to the pre-1981 situation in which the regulations governing premium offerings were routinely circumvented. To curtail these growing abuses, the Savings Association League of New York State once again urges the Depository Institutions Deregulation Committee to enact a permanent prohibition on all premium offerings by all financial institutions. The savings and loan industry of New York State first called for such a prohibition on March 26, 1980, and we predicted at that time that the situation would worsen until a total ban is enacted.

Very truly yours,

Paul

Paul A. Schosberg

PAS:flm
Enc:

IF YOUR PASSBOOK CAN'T KEEP UP WITH INFLATION, BRING IT TO CHASE.

THE CHASE AGAINST INFLATION PLAN.

$10,000 PLUS SAVINGS CERTIFICATE 6 MONTHS	$1,000 PLUS SAVINGS CERTIFICATE 30 MONTHS
15.801% EFFECTIVE ANNUAL YIELD ON*	12.28% EFFECTIVE ANNUAL YIELD ON**
15.010% YEARLY INTEREST RATE	11.75% YEARLY INTEREST RATE

PLUS THE BIGGEST CASH BONUS OF ANY NEW YORK BANK.

WHEN YOU DEPOSIT	CASH BONUS	PLUS 6-MONTH INTEREST	WHEN YOU DEPOSIT	CASH BONUS	PLUS 30-MONTH INTEREST
$100,000	$500	$7,588	$100,000	$800	$33,578
$80,001	$200	$6,070	$80,001	$640	$26,863
$60,001	$150	$4,553	$60,001	$480	$20,147
$40,001	$100	$3,035	$40,001	$320	$13,431
$20,001	$50	$1,517	$20,001	$160	$6,716
$15,001	$35	$1,138	$15,001	$120	$5,037
$10,001	$25	$758	$10,001	$80	$3,358
—	—	—	$5,001	$40	$1,679
—	—	—	$1,501	$10	$504

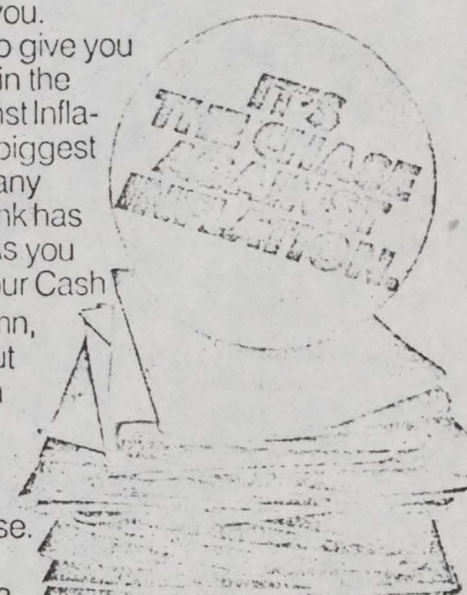
*Yield assumes reinvestment of principal and interest at maturity for an additional 26-week term at the same rate. However a different rate may be in effect at that time.
**This yield assumes that principal and interest remain on deposit for a full year. Interest compounded [illegible]

With inflation raging in the double digits, your passbook doesn't have a chance. And that has you enraged.

It's tough enough saving money today, but when you're only earning 5½% interest, or 6½% or even 8%, you're losing more than you're gaining.

We know. And we're going to show you how to get ahead in the Chase Against Inflation.

Whether your balance is $1,000 or $100,000, Chase has inflation-fighting savings certificates that will give you higher interest. Just compare the rates in this ad with the rate on your passbook and you can see that your money will be worth more with us. If you want to know exactly how much more, come in and we'll explain it to you.



We'll also give you a head start in the Chase Against Inflation with the biggest cash bonus any New York bank has ever given. As you can see on our Cash Bonus Column, you'll walk out with as much as $800. So bring your passbook to Chase. Where your savings get a chance to amount to something. For information, call (212) 223-5017/5018. Out of state, call (800) 223-1338.

Federal regulations prohibit the compounding of interest on a 6-Month Certificate of Deposit. Substantial interest penalty required for early withdrawal of Time Deposits. In the event of an early withdrawal an amount equal to the cash bonus will be deducted from the account(s). To comply with Federal regulations it may be necessary to open more than one account with your deposit.
Chase reserves the right to change the terms of this offer at anytime.

CHASE

Daily News, Monday, February 23, 1981

WE FOUND A WAY TO GIVE YOU A BIGGER CASH BONUS THAN ANY OTHER NEW YORK BANK.

IT'S THE CHASE AGAINST INFLATION.

We want you to get a head start in the Chase Against Inflation. And we're making it possible with the biggest cash bonus of any New York bank. Up to $400 more than you'll find anywhere else.

All you have to do is bring your passbook to Chase. We'll transfer your money into a high interest savings certificate. And, as you can see on our Cash Bonus Chart, you'll walk out with as much as $800. You've got a lot to gain in interest, too. Chase has inflation-fighting savings certificates that give you higher interest than your passbook. This week for instance, our 6-month Savings Certificate at 15.01% gives you an annual yield of 15.80%.* And our 30-month Savings Certificate at 11.75% yields an annual rate of 12.28%.**

So whether your balance is $1,000 or $100,000, your money will be worth more with us. And if you're wondering how much more, come in and we'll explain it to you. With all we have to offer, your money has a better fighting chance with us in the Chase Against Inflation.

For information, call (212) 223-[illegible] Out of state, call [illegible]

THE CHASE AGAINST INFLATION CASH BONUS.

WHEN YOU DEPOSIT	6-MONTH C.D. CASH BONUS	30-MONTH C.D. CASH BONUS
$100,000	$500	$800
$80,001	$200	$640
$60,001	$150	$480
$40,001	$100	$320
$20,001	$50	$160
$15,001	$35	$120
$10,001	$25	$80
$5,001	—	$40
$1,501	—	$10

National Savings and Loan League

1101 Fifteenth Street NW
Washington, D.C. 20005
202 331-0270 Cable: NATLISA

Richard S. Lawton
President

January 22, 1981

Mr. Normand R. V. Bernard
Executive Secretary
Depository Institutions Deregulation
Committee
Federal Reserve Board
20th and Constitution Avenue, N.W.
Washington, D.C. 20551

Dear Mr. Bernard:

The National Savings and Loan League is very concerned with both the speed and direction of deposit ceiling deregulation. This concern is heightened by the difficult earnings position in which the savings and loan industry finds itself. Therefore, we would like to petition the Depository Institutions Deregulation Committee (DIDC) to change its deregulation process. The details of our petition are contained in the attachment to this letter.

Without repeating entirely what is in the attachment, we are petitioning the DIDC to adopt a deposit deregulation plan which concentrates on raising to market the rate ceilings on longer term certificates first and providing for a 25 basis point differential for thrift institutions. We believe there are a number of reasons why this is a preferable strategy, and they are given in the paper.

We are also providing a copy of this letter and attachment to each member of the DIDC. We would request that this petition be considered at the next meeting of the Committee.

Sincerely yours,

Richard S. Lawton

Richard S. Lawton

The National Savings and Loan League, in behalf of its member associations, hereby petitions the Depository Institutions Deregulation Committee (DIDC) to adopt a deposit deregulation strategy which would raise to market the rates paid on new classes of accounts beginning with the longest term certificates. We propose that this strategy, which is explained below in more detail, be adopted as a substitute for the early raising and phasing out of interest rate ceilings on passbook accounts. While deregulation of deposit interest rate ceilings will be difficult for all depository institutions to adapt to, this is especially true for savings and loan associations, long characterized by asset/liability maturity imbalance and huge exposure to interest rate risk.

Up to now, the major acts of deregulation by the DIDC, its predecessor (the ICC) and the Congress have been accomplished on the liability side of the balance sheet, with most of the deregulation occurring in relatively short and medium-term maturities. The National League is concerned about the imbalance or uneveness between asset and liability deregulation and is further concerned that deposit deregulation has not encouraged savings and loans to reduce the imbalance between the maturities of their assets and liabilities. Discussion at the December 12 meeting of the DIDC centered on raising the rate ceiling on passbook accounts. A recent petition from the American Bankers Association to the DIDC recommends authorization of a new short-term account to compete with mutual money market funds (MMMFs).

While the National League is very much aware of the competition that MMMFs have given to all depository institutions, we are also aware that in an environment increasingly characterized by volatile interest rates, concentrating one's liabilities in short term instruments (possibly because of consumer preferences but also lack of alternatives) while being forced to make longer term loans is a prescription for an increasingly severe earnings crunch, which is exactly where the S&L industry finds itself at this time. While the S&L industry made some progress in reducing this imbalance in the early 1970's with longer term certificates, much of this progress has been lost since creation of the MMC. MMC growth has been so phenomenal that $30 billion in MMCs will roll over in January alone, with another $36 billion in March. This has wreaked havoc on the imbalance problem. Consequently, the National League would like to petition the DIDC to take up the following proposal at its next meeting.

The National League proposes that the DIDC cease its present deregulation strategy, which amounts to an _ad hoc_ approach. This _ad hoc_ approach has caused a great deal of uncertainty to depository institutions of all types, making it extremely difficult for managers to plan short and long term operating strategies. Because of the uncertainty which this present approach has caused, the Congress has expressed its displeasure with the way the DIDC has chosen to deregulate.

The National League also believes that a deregulation strategy which concentrates on phasing out rate ceilings on passbook accounts is flawed because it does not take into account the asset/liability maturity imbalance of S&Ls. Most deregulation of deposits has occured mainly in short and, to some extent, medium term maturities. No conscientious attempt has been made to encourage institutions to offer, and savers to accept, longer term instruments. Even though the 30 month certificate can actually have a maturity of up to 10 years, with normal yield curves, there is no premium for going long.

The National League proposes that the DIDC minimize this uncertainty and encourage institutions to lengthen maturities of liabilities by announcing a scheduled phaseup to market rates, beginning with longer term certificates. This deregulation plan is proposed as a substitute for phasing out passbook ceiling rates. The National League would propose the following schedule:

July 1, 1981 -- raise to market the rates paid on all certificates issued or renewed after that date with an original maturity of 8 years or more

July 1, 1982 -- raise to market the rates paid on all certificates issued or renewed after that date with an original maturity of 6½ years or more

July 1, 1983 -- raise to market the rates paid on all certificates issued or renewed after that date with an original maturity of 5 years or more

July 1, 1984 -- raise to market the rates paid on all certificates issued or renewed after that date with an original maturity of 3½ years or more

July 1, 1985 -- raise to market the rates paid on all certificates issued or renewed after that date with an original maturity of 2 years or more

March 31, 1986 -- Congressionally-directed end of rate decontrol process

By market, we mean the appropriate Treasury rate, plus a differential of 25 basis points for thrift institutions. On July 1, 1981, thrifts and banks, under this proposal, would be able to pay the Treasury rate on 8-year securities for 8-year certificates or the Treasury 10-year rate on 10-year certificates, for example. For instance, as of January 22, 1981, Treasury bonds maturing in May of 1989 (approximately 8 years) were yielding 12.64 percent. Under our proposal, thrifts would be able to pay 12.89 percent and banks, 12.64 percent. These rates would float with the market like the small saver certificate rate. On July 1, 1982, all institutions would be able to not only pay market-indexed rates on the above certificates, but on any certificate 6½ years or greater in maturity. Again, the market index would be the appropriate Treasury rate. We would propose that thrifts enjoy a 25 basis point differential because of their statutory commitment to mortgage finance. A 25 basis point differential makes the most sense on longer term certificates because it is these certificates which are best used for housing investment.

Prior to each of the above dates, we would further recommend that the DIDC make an affirmative finding that the freeing up of the new shorter maturities would not be deleterious to the financial soundness of any class of depository institutions. We believe this is critical.

The arguments in favor of this particular proposal are as follows:

- o this strategy will provide certainty to all depository institutions on the course of deposit rate deregulation
- o this strategy will help savings and loan associations balance the maturities of their assets and liabilities since savers can be expected to shift funds toward longer term certificates as ceilings are raised to market and normally sloped yield curves reappear
- o this proposal gradualizes the deregulation process and, therefore, allows savings and loans to become familiar with their new powers before significant deposit deregulation is mandated
- o real deregulation would eventually occur as opposed to small increases in the passbook ceiling rate which, we believe, contains very few benefits to the saving public (an increase of 50 basis points on a $2,000 passbook account only yields an extra $10 per year in interest) yet, at the same time is costly to depository institutions

The National League is extremely concerned that deposit deregulation has been occuring at a much faster pace than asset deregulation. For instance, in June of 1978, the MMC was created, and accounts at this time for over one-third of all deposits in S&Ls. Similarly, the small saver certificate, created in January of 1980, accounts for approximately 10 percent of all deposits. Thus, almost 50 percent of deposits are in these two market-sensitive instruments, yet the S&L industry has not yet been given the authority to offer realistic adjustable rate mortgages. The FHLBB's VRM regulations are useless. Its

RRM regulations, while an improvement, still fall far short of what is necessary. Changes to both of these regulations have been proposed by the FHLBB, but they still do not provide sufficient flexibility.

What the National League requests of the DIDC is to use its influence to encourage the various regulatory agencies, as well as the Congress, to provide realistic asset powers to S&Ls, especially adjustable rate mortgage authority. The National League supports the principle of paying market rates of interest to savers, but S&Ls can only do that if they can earn market rates on their assets. Further, S&Ls do not expect, generally, to make abnormal profits with the new consumer lending, trust and NOW account powers provided in H.R. 4986. While all of these powers are necessary to compete in a deregulated world, they will not be the source of significant profits since a competitive market, generally, already exists for these services. We do expect these powers will help stabilize profit levels somewhat, however.

Finally, the League would like to reiterate that the deregulation process has taken a strange course. Asset deregulation should precede or occur simultaneously with liability deregulation, not follow it. The current approach, exacerbated by the recent volatility in interest rates, has caused unprecedented earnings pressures on S&Ls. 1980 will be the worst earnings year for S&Ls, with average aggregate earnings close to 15 basis points return on assets. If interest rates remain at present levels, 1981 will be worse. Even if they fall gradually, as we expect, 1981 will only be a repeat of 1980. The significance of this is that 1980 was the worst earnings year in the history of the savings and loan industry. The previous low was 43 basis points in the first half of 1975, during the previous housing recession, three times the current level of profits. Therefore, we would request that the DIDC act quickly and constructively to encourage the passage of realistic asset powers for S&Ls as part of the deposit deregulation process.