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USL
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WILLIAM B. O'CONNELL
President

BOARD OF GOVERNORS
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September 28, 1983

Mr. Mark G. Bender
Executive Secretary
Depository Institutions Deregulation Committee
Room 3025
Department of the Treasury
15th Street and Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Mr. Bender:

The United States League of Savings Institutions* wishes to comment briefly on the two items which the Depository Institutions Deregulation Committee has scheduled as agenda items for the Committee's September 30, 1983 meeting: (1) the elimination of the thrift institution differential on passbook accounts and on time deposits of 7 to 31 days in amounts under $2,500; and (2) the reduction of required deposit minimums on Super NOW Accounts, Money Market Deposit Accounts and ceiling-free time deposits of 7 to 31 days.

* The U. S. League of Savings Institutions, formerly the U. S. League of Savings Associations, has a membership of 3,500 companies representing over 99% of the assets of the $730 billion savings and loan business. League membership includes all types of associations -- Federal and state-chartered, stock and mutual. Recently, many prominent savings banks have joined the League as members. The principal officers are: Leonard Shane, Chairman, Huntington Beach, California; Paul Prior, Vice Chairman, New Castle, Indiana; William O'Connell, President, Chicago, Illinois; Stuart Davis, Legislative Chairman, Beverly Hills, California; and Roy Green, Executive Vice President, Phil Gasteyer, Legislative Counsel, Jim Freeman, Senior Legislative Representative, Washington, D. C. League headquarters are at 111 East Wacker Dr., Chicago, Illinois 60601. The Washington Office is located at 1709 New York Avenue N. W., Washington, D. C. 20006. Telephone: (202) 637-8900.

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We are well aware, of course, that Section 426 of Public Law 97-320, the Garn-St Germain Depository Institutions Act of 1982, mandates that all interest rate differentials be eliminated by January 1, 1984. Our member institutions continue both their operational and investment planning with that date for ending the thrift differential in view, and will be prepared for this near-final rate deregulation step at that time. To take that step any sooner would cause a serious disruption in the rebuilding and recovery process in which our institutions have been engaged since enactment of Garn-St Germain and the moderation of market interest rates. We would ask that any action elininating the differential be effective no earlier than on January 1, 1984.

We also oppose the reduction or elimination of the current $2,500 minimum deposit requirement effective for Super NOW Accounts, Money Market Deposit Accounts and ceiling-free time deposits of 7 to 31 days. Any downward changes in these minimum requirements would have the effect of disrupting the recovery of savings institutions at a time when the industry, on average, stands a chance of experiencing its first year of positive earnings since 1980.

We estimate that if the minimum balance requirement were eliminated at this time, the shifts that would occur of low balance convenience deposits into higher rate accounts would cost the savings and loan business more than one-fourth of the expected total earnings of the business in 1983. This bottom line cost would amount to $420 million for the first 12 months after this change.

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Further, our ability to continue as a reliable source of long-term housing finance would be eroded even beyond that which we experienced with the introduction of the Money Market Deposit Account itself. Savings institution managers are having difficulty managing what they describe as a maturity warp -- the uncertainty and the imbalance which derives from relying on essentially short-term deposits to make long-term mortgage loans. At least the $2,500 minimum deposit requirement by limiting the conversion of low balance convenience deposits provides institutions with a small degree of manageability. We believe also that the DIDC should take into consideration the adverse potential impact of reducing or eliminating minimum deposit requirements on borrower interest rates. Mortgage interest rates, although down from the record highs of 1981-82, still remain at levels which effectively close the lending window on thousands of would-be homeowners. Today we see rates trending somewhat lower, and this is being welcomed within the long-depressed home construction industry. The slightest upward tick in rates sends shudders through that industry, and we fear that the contemplated minimum deposit requirement reduction or removal could have that impact.

We would ask, then, that the DIDC not impede the recovery of our own savings institutions and that of the home construction industry by lowering or eliminating minimum deposit requirements at this time.

Finally, it has been our observation that the rapid pace of deposit interest rate deregulation, changes in early withdrawal penalties, and the creation of new accounts have served to promote confusion in the marketplace

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among consumers. Effective on October 1, 1983 -- the very day after the DIDC's next scheduled meeting -- major changes will become effective. These changes have already required managers of savings institutions to conduct another round of informational programs to better educate depositors on the alternatives available to them. We believe confusion among depositors could be held to a minimum if the DIDC would provide sufficient breathing time between its actions.

In summary, the U.S. League of Savings Institutions opposes the elimination of the thrift institution differential before January 1, 1984, and opposes the elimination or reduction of minimum deposit requirements at this time.

Thank you for this opportunity to comment on the DIDC's agenda items. Should you have any questions, please feel free to contact me.

Sincerely,

William B. O'Connell
President

WBO/js

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DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE
Washington, D.C. 20220

COMPTROLLER OF THE CURRENCY
FEDERAL RESERVE BOARD

FEDERAL DEPOSIT INSURANCE CORPORATION
NATIONAL CREDIT UNION ADMINISTRATION

FEDERAL HOME LOAN BANK BOARD
DEPARTMENT OF THE TREASURY

September 13, 1983

Memorandum For: DIDC Staff

From: Mark Bender
Executive Secretary

Subject: September 30, 1983 DIDC Meeting

The next DIDC Meeting will be held on September 30, 1983 at 10:00 a.m. in the Auditorium of the Department of Commerce, which is located at 14th and Constitution Avenue, N.W.

There are a few matters about this meeting which I would like to bring to your attention.

First, a list of names of those staff members planning to attend this meeting is needed from each agency. Those listed will have access to the Secretary's entrance at the Department of Commerce just prior to the beginning of the meeting. All others will enter through the 14th Street side of the Commerce Building and follow signs to the auditorium. IMPORTANT: All agencies should submit their list of names to Ms. Sharon Kindrock, Room 1060, Main Treasury Building, by no later than Friday, September 23, 1983. If any name changes need to be made on these lists, please call Ms. Kindrock with the change as soon as possible (566-5152). Upon entering the Secretary's entrance at Commerce, just follow the signs to "DIDC Members and Staff" entrance to the stage.

Second, at this meeting the seating arrangements at the table and behind the table are limited (see diagram of stage setup attached). We can accommodate each Committee Member and one of their staff members at the table. The other staff members, who normally sit at the table will have to sit behind the table. All additional DIDC staff members will sit in designated areas which will be posted (see diagram again).

There will be a seat at the table for Briefing Speakers, which will be used in the same manner as has been done at past meetings at Treasury. All Briefing Speakers should be seated behind the table, if he or she is not already seated at the table.

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The only people who will be allowed on stage are those wearing white badges with black lettering that say "DIDC Staff", special technicians and other designated people.

There will be a Press Conference immediately following the 10:00 a.m. DIDC Meeting in the conference room directly behind the stage.

Attachment

MB/spk

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Stairs ---

Back of Stage -- Members and Staff will enter through Conference Room and exit

DIDC Staff Seating (Approx. 16 seats max.)

FHLBB Stf. | Mr. Wallison | Chmn. Regan | Mr. Healey | Mr. Eastburn

Briefing Speaker | FRB Stf. | VChmn. Volcker | FDIC Stf. | Mr. Isaac

Mr. Gray | NCUA Stf. | Mr. Callahan | OCC Stf. | Mr. Conover

Stairs

Front of Stage

Floor (Open space, no seating)

Stairs

Theater-style Seating
Capacity: 500 persons

Stairs

Press Seating

DIDC Staff (Excess)

Public Seating

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

August 11, 1983

TO: Board of Governors

FROM: Normand Bernard NB

For Information Only

Attached are materials relating to the DIDC recommendation to remove the statutory prohibition against the payment of interest on demand deposits. These materials include (1) Secretary Regan's letter to Congress containing the DIDC recommendation, (2) a draft of the recommended legislation, and (3) a related staff memorandum.

Attachment

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NATIONAL CREDIT UNION ADMINISTRATION

FEDERAL HOME LOAN BANK BOARD
DEPARTMENT OF THE TREASURY

August 4, 1983

Dear Mr. Chairman:

The Depository Institutions Deregulation Committee recently considered the question of whether and to what extent interest-bearing transaction accounts should be made available by depository institutions to members of the public not eligible to hold NOW accounts. In connection with this discussion, the Committee considered whether (1) it should authorize a fully transactional money market deposit account ("MMDA"), and (2) there should continue to be a statutory prohibition against paying interest on demand deposits by Federally-insured depository institutions. While the Committee is of the view that it can authorize a fully transactional MMDA, others question the Committee's authority in light of the statutory prohibition against paying interest on demand deposits. In order to eliminate the potential for protracted litigation, the Committee determined to present the issue of paying interest on demand deposits to Congress.

The Committee concluded that this statutory prohibition is no longer justified and recommends that depository institutions be permitted to pay interest on demand deposits. An extensive analysis of the issue of payment of interest on demand deposits was undertaken by the Committee's staff. A copy of this study is enclosed for your information. The study concludes that the arguments for prohibiting the payment of interest on demand deposits in the 1930s appear to have little validity today. In this regard, certain developments have weakened significantly the economic effect of the prohibition, such as (1) implicit interest payments on demand deposits through the provision of customer services either free or at fees below cost, (2) market development of close demand deposit substitutes that earn interest (e.g., money market mutual funds and sweep accounts), and (3) legislative and regulatory changes to permit explicit interest-bearing transaction accounts that are legally distinct from demand deposits.

Since many transactions balances earn close to a market return either implicitly or explicitly, we believe that the cost implications for depository institutions of the removal of the prohibition against the payment of interest on demand deposits would be of manageable size and largely temporary. Although some depositors with active accounts might be disadvantaged, depositors on average would tend to benefit from permitting the payment of interest on demand deposits. On balance, it seems that interest bearing demand deposits would result in a more efficient allocation of the economy's resources.

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The removal of the prohibition of payment of interest on demand deposits without authority to limit rates paid prior to March 31, 1986, would diminish the effectiveness of the present ceiling on NOW accounts of less than $2,500 as well as on passbook savings accounts since depositors could keep their savings balances in ceiling free demand deposits. Therefore, if the prohibition against payment of interest on demand deposits is removed, the Congress may wish to give the DIDC authority to apply ceilings to demand deposits of less than $2,500 until March 31, 1986, at the same ceiling rates permitted for NOW accounts and ATS accounts in order to assure competitive equity for these accounts.

The Committee is also of the view that the current statutory requirement that it hold quarterly meetings should be removed. The actions of the Committee to date, including the creation of the Money Market Deposit Account, have gone a long way toward achieving the Committee's objective of providing for "the orderly phaseout and ultimate elimination of" all interest rate ceilings. In fact, by October 1, 1983, there will be no ceilings on all new or renewed time deposits with maturities of more than 31 days.

The Committee believes that the remaining actions to complete the deregulation process may be accomplished without mandatory quarterly meetings; rather, the Committee can schedule meetings as required by events. This would provide the Committee additional flexibility in completing its work. Therefore, the Committee requests Congress to repeal the requirement that it hold public meetings at least quarterly.

A draft bill that would accomplish these objectives is enclosed.

Sincerely,

Donald T. Regan

Donald T. Regan
Chairman

The Honorable
Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Enclosures

Identical letter sent to Chairman St Germain, House Committee on Banking, Finance and Urban Affairs

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A BILL

To permit the payment of interest on demand deposits held by depository institutions.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Short Title

SEC. 101. This Act may be cited as the "Demand Deposit Deregulation Act".

Payment of Interest on Demand Deposits

SEC. 102(a). The first and second sentences of section 19(i) of the Federal Reserve Act (12 U.S.C. 371a) are hereby repealed.

(b). The third sentence of section 19(i) of the Federal Reserve Act is amended by striking out "Notwithstanding any other provision of this section, a" and inserting in lieu thereof "A".

SEC. 103. The first sentence of section 18(g)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1828(g)(1)) is hereby repealed.

SEC. 104. The second sentence of section 5(b)(1)(B) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464(b)(1)(B)) is hereby repealed.

SEC. 105. Section 19(b) of the Federal Reserve Act (12 U.S.C. 461(b)) is amended by striking the last sentence in subparagraph (8)(A) and inserting in lieu thereof the following: "This subparagraph does not apply to (1) any category of deposits or accounts which are first authorized pursuant to Federal law in any State after April 1, 1980; nor (2) an amount equal to the amount by which current total demand deposits exceeds the amount of demand deposits held by the

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institution on a daily average basis during the 14-day period preceding the date of enactment of this Act, held by each depository institution located outside of Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Rhode Island, and Vermont, except as permitted by order or regulation of the Board.".

SEC. 106. Section 204 of Public Law 96-221 (12 U.S.C. 3503) is amended by adding at the end thereof a new subsection (c) to read as follows:

"(c) The Deregulation Committee shall not later than six months from the effective date of this Act establish rules permitting the payment of interest on demand deposits at the same rates that are permitted for accounts subject to withdrawal by negotiable or transferable instrument for the purpose of making transfers to third parties authorized under section 2(a) of Public Law 93-100 (12 U.S.C. 1832(a)). Interest may not be paid by a depository institution on any demand deposit until such rules are issued by the Deregulation Committee.".

SEC. 107(a). Section 207(b)(2) of Public Law 96-221 (12 U.S.C. 3506(b)(2)) is amended to read as follows: "The first sentence of section 18(g) of the Federal Deposit Insurance Act (12 U.S.C. 1828(g)) is amended by striking out "payment and" and by striking out ", including limitations on the rates of interest and dividends that may be paid";".

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(b). Section 207(b)(3) of Public Law 96-221 (12 U.S.C. 3506(b)(3)) is amended to read as follows: "The second, fourth and seventh sentences of section 18(g) of the Federal Deposit Insurance Act (12 U.S.C. 1828(g)) are hereby repealed;".

SEC. 108. The second sentence of section 203(b) of the Depository Institutions Deregulation Act of 1980 (12 U.S.C. 3502(b)) is hereby repealed.

SEC. 109. This Act shall take effect 180 days from the date of enactment, except that section 108 shall take effect on the date of enactment of this Act.

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Section-by-Section Analysis

SEC. 101. The title of the Act is the Demand Deposit Deregulation Act.

SEC. 102. This section repeals the prohibition in the Federal Reserve Act against payment of interest on demand deposits by member banks.

SEC. 103. This section repeals the provision in the Federal Deposit Insurance Act prohibiting the payment of interest on demand deposits held by insured nonmember banks and insured branches of foreign banks.

SEC. 104. This section repeals the provision in the Home Owners Loan Act prohibiting a federal savings and loan association or federal savings bank from paying interest on demand deposits.

SEC. 105. This section amends the transitional provisions for the phase-in of reserve requirements. When reserve requirements were instituted for all depository institutions, a transitional period of eight years was adopted to allow nonmember institutions to build up gradually to the required reserve level. (Member banks were given a shorter transitional period to adjust their reserves downward to the new level.) This transitional provision was adopted for two reasons: (1) to avoid an undue burden on nonmember institutions putting up reserves for the first time; and (2) to prevent disruption in the conduct of monetary policy through a sudden decrease in the amount of reserve balances held. NOW

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accounts were first authorized for all depository institutions (except those in New England, New York, and New Jersey where they had been authorized previously) effective after the implementation of the new reserve requirements. These accounts were exempted from the phase-in of reserve requirements because it would not be burdensome to depository institutions to hold full reserves against them since they were newly authorized accounts. However, when interest on demand deposits is permissible, nonmember depository institutions may attempt to avoid the full reserve requirement on NOW accounts by converting the accounts to demand deposits which are subject to the phase-in. Section 105 reduces the potential for avoidance of reserve requirements by requiring a nonmember depository institution to continue to hold full reserves against the amount by which an institution's total demand deposits exceeds the base of total demand deposits during a period immediately prior to the enactment of this bill. Nonmember depository institutions in New England, New York and New Jersey however would continue to receive the full phase-in of reserve requirements on NOW accounts and demand deposits. The Federal Reserve is given authority to make exceptions to this requirement.

SEC. 106. This section authorizes the DIDC to establish rules concerning the payment of interest on demand deposits. Such rules shall authorize interest to be paid on

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demand deposits under the same rate limitations as for NOW accounts. Therefore the Committee would be required to establish the same rate ceiling on demand deposits of under $2,500 as is established for NOW accounts of under $2,500. These regulations shall be implemented not later than six months from the effective date of the Act (one year from day of enactment).

SEC. 107. This section makes technical conforming changes to the Depository Institutions Deregulation Act of 1980.

SEC. 108. This provision removes the requirement that the DIDC meet in public at least quarterly.

SEC. 109. This section delays the effective date of the Act to allow depository institutions an opportunity to prepare for the operational changes made by the Act. The effective date for removing the requirement that the DIDC meet quarterly is effective immediately.

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

June 14, 1983

TO: Depository Institutions Deregulation Committee

SUBJECT: The Payment of Interest on Demand Deposits

FROM: DIDC Staff[1]

I. Introduction

At its meeting of March 1, the Committee asked the staff to prepare an analysis of the issues raised by the payment of interest on demand deposits. The Committee, of course, does not have the authority to take direct action with regard to the statutory prohibition of the payment of interest on demand deposits. However, its views on the current prohibition could be communicated to the Congress, in which authority rests. The Committee's decision with regard to authorizing MMDAs with unlimited transactions capabilities for businesses could be delayed pending congressional consideration of, or be made independent of, the broader issues of interest on demand deposits.

This memorandum analyzes the implications of paying interest on demand deposits.[2] It is intended to serve as a companion to the accompanying staff memorandum "Money Market Deposit Accounts with Unlimited Transfers for

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1. This memorandum was prepared mainly by staff of the Board of Governors of the Federal Reserve System (D. Lindsey, R. Avery, E. Boutilier, F. Furlong, P. Lloyd-Davies, B. Opper and P. Pilecki.)

2. These issues were previously examined in "The Impact of the Payment of Interest on Demand Deposits," a study of the staff of the Board of Governors of the Federal Reserve System (S.H. Axilrod, J.D. Paulus, E.C. Ettin, D.E. Lindsey and T.D. Simpson), January 1977.

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Those Not Eligible to Maintain NOW Accounts," dated June 14, 1983. The analysis of the impact on depository earnings of a fully transactional MMDA for businesses contained in the earlier version of that memorandum, dated February 26, 1983, has been revised so as to facilitate comparison with the present memorandum's analysis of the earnings impact of removing restrictions on demand deposit interest. The summary section of the present memorandum, pp. 2 through 5, contains a direct comparison of the conclusions in the two memoranda regarding earnings impacts of interest on demand deposits versus a transactional MMDA for businesses.

Other sections of the present memorandum discuss the historical background of the prohibition of interest on demand deposits, existing returns to the public on transactions balances, the impact on depositors of explicit interest on demand deposits, monetary policy considerations, and legislative implications related to removing the prohibition of interest on demand deposits.

II. Summary

(1) The justifications underlying the prohibitions of interest on demand deposits enacted in 1933 and 1935 were that the payment of interest on banker's balances gave rise to a substantial movement of funds from rural areas to money center banks and that interest rate competition weakened the soundness of banks. Some researchers have suggested that these arguments had little validity at the time and it seems clear they have less validity today.

(2) The economic effects of the prohibition have been eroded by (a) the payment of implicit interest on demand deposits through provision of services priced below cost; (b) the emergence through the workings of market forces of instruments closely substitutable for demand deposits, such as federal funds and repurchase agreements, traded in nationwide markets, and money market

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mutual funds; and (c) the authorization through legislative and regulatory action of deposits with transactions characteristics bearing explicit interest that are legally distinct from demand deposits, such as NOW accounts and MMDAs.

(3) Although the implicit interest rate now paid to many demand depositors may approximate the level of the explicit rate they would earn if the prohibition were eliminated, the rate paid to certain depositors, including some households and medium and small businesses, seems to be lower than they might receive with explicit interest on demand deposits. To be sure, tax considerations would serve to diminish the benefits to households since explicit interest is taxable while services charges are not tax deductible. Some households with small, active accounts could experience a fall in their overall after-tax return on transactions accounts in a regime of explicit interest and higher fees. On the other hand, household and business depositors on average would tend to gain by receiving explicit interest rather than subsidized services of equivalent cost to institutions, since customers tend to overuse subsidized services and hence value them below their marginal cost of production. In general, the inducement for "unbundling" of charges for services combined with explicit interest presumably would contribute to a more efficient allocation of the economy's resources. Moreover, depositors themselves would have less incentive to expend resources to minimize their holdings of transactions balances if additional dollars put in these accounts earned explicit interest.

(4) The impact of interest on demand deposits on the earnings of depository institutions is expected to be minor in the long run. Indeed, eliminating interest rate restrictions on household transactions deposits would have little bearing on institutions' long-run profits, since the ceilings

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on regular NOW and ATS accounts already are scheduled to be removed by March 31, 1986. In the case of business demand deposits, competitive pressures over time likely would move most implicit rates near competitive levels, even in the absence of explicit interest on business demand deposits.

(5) In the short run, though, the payment of explicit interest on demand deposits could temporarily lower earnings of commercial banks. In the first year or so, pre-tax profits may be reduced in an estimated range of $1 to $2 billion or 5 to 10 percent, assuming the continuation of current levels of market interest rates. This earnings reduction would be composed of a 1 to 2-1/2 percent decline related to interest-bearing household transactions deposits plus a 4 to 7-1/2 percent fall related to interest-bearing business demand deposits. The latter range for business demand deposits is identical to the estimated first-year earnings impact of authorizing a fully transactional MMDA for businesses, since the two accounts are functionally equivalent. Although the industry-wide impact of interest on demand deposits would appear manageable, certain individual institutions might be especially vulnerable to earnings pressures during the transition period; however, these same institutions also would face earnings pressures in the long run in any event.

(6) For the smallest commercial banks (assets of less than $100 million) and the largest commercial banks (assets of $1 billion or more) the estimated first-year earnings impacts of paying interest on demand deposits are virtually the same--ranging from 4-1/2 to 9 percent of 1982 pre-tax profits. Although large commercial banks tend to rely much more heavily on business demand deposits, smaller banks generally deal more with medium- and small-size businesses whose shifting of funds to interest-bearing demand deposits will have the greatest potential for increasing costs. Medium-size commercial banks

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($100 million to $1 billion) are likely to experience the largest first-year earnings reduction--estimated at 6-1/2 to 13 percent of their 1982 pre-tax income. These institutions tend to have not only a relatively high overall reliance on business demand deposits (which, as noted, will in general involve a larger cost impact than other ownership categories) but also a relatively high share of their demand deposits held by medium- and small-size companies (which will be the type of deposit likely to contribute most to enlarged deposit cost).

(7) For thrift institutions, removing the restrictions on the payment of interest on transactions deposits is not likely to have a noticeable impact on their cost of funds. These institutions have a smaller proportion of their deposits in NOW account balances than commercial banks and have very few demand deposits. Eliminating both ceilings on all NOW accounts and the prohibition of interest on demand deposits could lead to some transitional increase in their costs. However, since at present the combined implicit and explicit yield on NOWs is evidently close to a competitive rate, totally deregulating NOWs would have only a minor impact on thrift earnings even in the first year.

(8) The process of removing the statutory prohibition against the payment of interest on demand deposits would not be unduly complicated. However, removal of the prohibition of payment of interest on demand deposits raises the issue of whether a specific statutory provision is needed regarding the phase-in of reserve requirements under the Monetary Control Act of 1980.

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III. Historical Background

Section 19(i) of the Federal Reserve Act, which provides in part that "No member bank shall, directly or indirectly, by any device whatsoever, pay any interest on any deposit which is payable on demand," was added by the Banking Act of 1933. This prohibition against interest payments on demand deposits was extended to insured nonmember banks and mutual savings banks by the Banking Act of 1935.[1] Federally chartered savings and loan associations were not authorized to accept demand deposits until passage of the Garn-St Germain Depository Institutions Act of 1982, which permits such associations (as well as federal savings banks) to accept demand accounts of individuals and organizations that have a business, corporate, commercial, or agricultural loan relationship with the association as authorized by its charter or by law. At the same time this authority was granted to federally chartered savings and loans and federal savings banks, the Congress extended to them the prohibition against interest on demand deposits.

Banks began to pay interest on selected accounts during the early part of the nineteenth century. By the mid-1800s, large banks in New York City had attracted a considerable volume of bankers' balances--that is, deposits of other commercial banks--and were paying interest on those

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1. The authority of mutual savings banks to offer demand deposits is governed by state law. Most states which charter mutual savings banks have authorized them to offer demand deposits. Nevertheless, while the state regulates the authority to offer demand deposits, it is federal law which prohibits mutual savings banks from paying interest on those accounts.

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deposits. In the century before the passage of the Banking Act of 1933, the payment of interest on deposits was frequently criticized by bankers, regulators, and legislative bodies. Before the Federal Reserve System was established, such criticism was usually directed toward interest payments on bankers' balances and the role these balances were thought to have played in the periodic banking crises that occurred between 1857 and 1907.[1]

The concern over interest payments on bankers' balances also continued during the 1913 to 1933 period. With the threat of banking panics seemingly eliminated by the establishment of the Federal Reserve System, attention turned to the uses to which bankers' balances were put by money center banks.[2] It was argued that interest payments attracted funds from rural areas to money centers for the purpose of financing speculative investments in the securities market. Further, it was commonly alleged

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1. Bankers' balances served as a highly liquid repository of funds for many smaller rural banks which tended to experience strong seasonal fluctuations in deposits and loans related to spring planting and fall harvesting. These banks would rely upon their deposits at large banks to meet local customers' demand for funds. During periods of normal economic activity, large banks had little difficulty in adjusting to seasonal contractions in bankers' balances. However, when conditions tightened, the money center banks found it difficult to liquidate loans or other assets on short notice. According to critics of interest payments on bankers' balances, the resulting inability of large banks to meet their obligations to small banks during such periods caused severe stress on financial markets and was mainly responsible for banking panics. These critics contended that if interest had not been paid on bankers' balances, smaller banks would have invested their funds locally and the crises would have been averted.

2. See 77 Cong. Rec. 3729 (1933) (Remarks of Senator Glass).

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that such speculatively invested funds were being diverted from productive uses in rural areas.[1]

The legislative history of the Banking Act of 1933 is relatively sparse; it was enacted in a crisis atmosphere without formal hearings. Concern at that time did not center on the issue of interest on demand deposits, but rather on other issues, such as establishing federal deposit insurance. However, from the limited discussion of the 1933 Act and from legislative history of the 1935 Act extending the prohibition to insured nonmember banks, some reasons appear to emerge for the provision prohibiting interest payments on demand deposits. First, the popular view was advanced in 1933 that the payment of interest on bankers' balances encouraged substantial movement of funds from rural areas to money center banks able to pay higher interest rates, thus limiting credit availability to rural areas.[2] After the experience with the prohibition in 1933, Congress further realized that the prohibition of interest on demand deposits could reduce bank costs significantly,[3] thereby better enabling banks to meet deposit insurance assessments, and encouraging them to participate in the federal deposit insurance program. Senator Carter Glass observed that, "If banks are relieved of the competitive necessity of bidding for demand deposits on interest, they will not only have money to meet this

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1. See 77 Cong. Rec., Pt. 4, pp. 3729, 4165, 4166 (1933) (Remarks of Senator Glass).

2. See Senator Glass' comments cited in note 2 on page 7.

3. Address by J.F.T. O'Connor, Comptroller of the Currency to the American Bankers' Association at Chicago, Illinois, on September 7, 1933, printed in Hearings on H. R. 5357 before the House Committee on Banking and Currency, 74th Cong., 1st Sess. 173 (1935).

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assessment . . . but they will have almost an equal amount left over."[1] Some congressmen also believed that the payment of interest on demand deposits led to excessive competition between banks for customers who had large deposits causing these large depositors to shift their funds on demand more frequently than might be expected and thus weakening the stability of the banks.[2]

An objective look at these reasons after the passage of time reveals some flaws in the reasoning. The argument that payment of interest on bankers' balances drained substantial loanable funds from rural areas did not consider that local loans generally earned considerably more than bankers' balances over most of the period prior to the prohibition. Thus, the interest that could be earned on such balances was not the sole incentive for holding them. Among the possible reasons overlooked by those arguing for the prohibition were: (1) bankers' balances were a convenient form in which smaller banks could hold liquid funds against seasonal swings in deposits and loan demand; (2) country banks generally maintained balances with correspondent banks to facilitate check clearing and other transactions; and (3) bankers' balances served as a highly attractive short-term asset for the purpose of diversifying the portfolios of rural banks and stabilizing the expected return on their assets.

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1. 77 Cong. Rec. 4168 (1933).

2. Hearings on S. 1715 and H. R. 7617 before the Subcommittee of the Senate Committee on Banking and Currency, 74th Cong., 1st Sess. 492 (1935) (statement of Benjamin M. Anderson, Jr., Economist, Chase National Bank of New York.)

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The bankers' balance argument appears even less applicable to issues connected with interest on demand deposits under current circumstances than it was in 1933. Rural areas are no longer dependent largely upon rural bank deposits for loanable funds, and rural banks have several channels available for placing interest-bearing highly liquid funds in nonlocal institutions. One example is the federal funds market, in which a depository institution may make overnight loans of its excess funds to another institution that needs such funds.

The other principal argument for the prohibition of interest on demand deposits concerned bank safety and stability. At least two studies have examined the question of whether interest rate competition for bank deposits heightened the instability of the banking system in the early thirties.[1] Neither found evidence that rate competition for demand deposits led to bank failures.

In summary, more recent analysis indicates that, in retrospect, prohibiting the payment of interest on demand deposits in 1933 lacked strong justification. Moreover, the arguments for the prohibition at the time it was enacted seem to have little validity today.

There have been several studies done on behalf of the U. S. Government since passage of the 1933 Act regarding payment of interest on

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1. George J. Bentson, "Interest Payments on Demand Deposits and Bank Investment Behavior," Journal of Political Economy, October, 1964, and Albert H. Cox, Jr., Regulation of Interest on Bank Deposits (Michigan Business Studies, Vol. XVII, #4, 1966.)

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demand deposits.[1] Every report issued as a result of these studies prior to the 1977 study by Federal Reserve staff has recommended retaining the prohibition against the payment of interest on demand deposits, although the FINE Report in 1975 recommended eventually phasing it out over time. As recently as October 1982, the prohibition was ratified when savings and loan associations were authorized to accept demand deposits by the Garn-St Germain Act in connection with an expansion of asset powers provided by Title III of that Act to enable thrifts to diversify their investments. Section 312 states that "a(n) association may not pay interest on a demand account." There is no discussion of this prohibition in the legislative history. It would appear that the Congress may not have intended the provision as a reaffirmation that interest on demand deposits should be prohibited as a policy matter.

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1. Money and Credit and Their Influence on Jobs, Prices and Growth, the Report of the Commission on Money and Credit, (1961); U. S. Committee on Financial Institutions, Report to the President of the United States (Heller Committee) (1963); Report of the President's Commission on Financial Structure and Regulation (Hunt Commission) (1971); the "discussion principles" of Financial Institutions and the Nation's Economy (FINE), a report issued by the House Committee on Banking and Currency (1975); "The Impact of the Payment of Interest on Demand Deposits," 1977, op. cit.

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IV. Existing Returns on Transactions Balances

Despite the legal prohibition against payment of interest on demand deposits, several developments have weakened significantly the economic effect of the prohibition. These developments may be classified as: (1) the implicit payment of interest on demand balances through the provision of services to customers at prices below costs; (2) the spontaneous emergence of arrangements that provide close substitutes for demand deposits, such as sweep accounts and money market mutual funds, and (3) the legislative and regulatory changes that permited explicit interest-bearing transactions accounts legally distinct from demand deposits but, in some cases, functionally equivalent.

Implicit Interest on Demand Deposits

The most common services provided to demand deposit holders below cost relate to transactions activity such as processing and collecting checks or electronic items deposited to accounts, debiting accounts for checks drawn on them, providing cash withdrawals and preparing periodic statements of account activity. The subsidy to account holders involved in providing these services at a price below cost constitutes one form of implicit interest on account balances. Indications of the magnitude of this subsidy from the standpoint of bank costs can be gleaned from data collected in the Federal Reserve System's Functional Cost Analysis (FCA) program, which is designed to measure the costs and revenues associated with various commercial bank functions.[1]

The average implicit subsidy given personal demand depositors through the provision of subsidized transactions services at reporting banks in 1981

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1. In 1981, 614 banks participated in the program. They do not however, constitute a random sample; only 58 of the respondents had deposits over $200 million, and some of the survey questions were answered only by a subset of banks.

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(the latest available data) is shown in Table 1. On average, bank expenses to service personal checking accounts exceeded income from customer charges by about $45 per year at small banks (less than $50 million in deposits) and by about $73 at medium-size banks ($50 to $200 million in deposits).[1] By dividing this implicit interest by the average account balance, the transactions subsidy is estimated to be about 4-1/2 percent at small banks and 7 percent at medium banks.[2]

Table 2 shows the implicit transactions subsidy paid to business depositors in 1981, based on a comparable estimation procedure. The average rate is about 2 percent, which is significantly lower than the estimated rate for personal depositors; although annual expenses per account are between 2 and 3 times expenses per personal account, the average business account balance reported in the FCA data is 5 to 10 times the size of the average personal account.

However, these estimated implicit rates only capture the return to demand depositors who make no use of subsidized bank services other than those directly associated with account maintenance shown in line 2. While this may be true of many individual depositors, it is not the case for most business account holders, who also receive implicit payments in other forms. First, balances may be used to compensate for credit services such as loan commitments or takedowns. Recent evidence suggests that balance requirements on loan

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1. Not enough large banks ($200 million or over in deposits) provided data broken down by personal and business accounts to permit reliable estimates.

2. This, of course, represents the cost of the subsidy to the bank rather than the value of the subsidy to the depositor. As discussed further in Section VI below, the latter value will be somewhat lower, since the depositor will be induced by the artificially low price to use some services that benefit him by less than the cost to the bank.

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Table 1

Implicit Interest Cost of Non-Interest Bearing Personal Checking Accounts, per Account, by Size of Bank, 1981

	Banks with Deposits of	
	up to $50 million	$50-$200 million
(1) Average balance	$1,019	$1,055
(2) Expenses	$88	$105
(3) Income from charges	$43	$32
(4) Net cost (implicit interest payment) [2 - 3]	$45	$73
(5) Implicit interest rate [4 ÷ 1]	4.44%	6.93%

1. Account maintenance cost, plus all expenses associated with deposits and check clearing.

Source: Functional Cost Analysis - 1981 Average Banks

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Table 2

Implicit Interest Cost of Commercial Checking Accounts,
per Account, by Size of Bank, 1981

		Banks with Deposits of	
		up to $50 million	$50-$200 million
(1)	Average balance	$5,288	$9,868
(2)	Expenses[1]	$145	$242
(3)	Income from charges	$29	$39
(4)	Net cost (implicit interest payment) [2 - 3]	$117	$203
(5)	Implicit interest rate [4 ÷ 1]	2.21%	2.06%

1. Account maintenance cost, plus all expenses associated with deposits and check clearing.

Source: Functional Cost Analysis - 1981 Average Banks

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commitments, for example, have been set around 5 percent of the unused line.[1] If the customer chooses not to pay by holding balances, a typical annual fee is 3/8 percent of the unused line. Thus, the implicit rate of return on such a balance held to pay for a loan commitment is 100 x (3/8 ÷ 5) = 7.5 percent, in addition to the return from other subsidized services. In recent years, however, the trend has been away from balances and toward fees for credit services.

Second, additional compensating balances may be held to pay for other operating services such as wire transfers, processing credit card drafts, payroll preparation, securities safekeeping, transfer agent activities, lock boxes, cash concentration accounts, and zero balance accounts.[2] In general, large corporations are far more likely to use these services than small businesses or individuals. As a result, demand deposit balances of large corporations are more likely to be fully utilized in formally compensating the bank for a variety of subsidized operational services as well as for loan services than are the accounts of small businesses or individuals.

The remaining types of subsidized services involve less formal arrangements. Banks may provide convenience through a branch network; they also may give advice regarding general financial planning, tax counseling, mergers, and local or national economic conditions. While compensating balances may not

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1. See Appendix A to the November 30, 1982 DIDC staff memorandum, "Transactional Money Market Deposit Account." The data discussed there refer to conditions last summer before the sharp decline in interest rates, and the balance requirement has probably since risen.

2. See the accompanying June 14, 1983 DIDC staff memorandum, "Money Market Deposit Accounts with Unlimited Transfers for Those Not Eligible to Maintain NOW Accounts" for a description of how balance requirements are determined. The implicit return on such compensating balances, at least for large corporate customers, generally is set to provide a market-determined rate of return to business depositors, less the cost of reserve requirements to the bank.

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be formally required for these services and their costs not captured by FCA data, providing the services nevertheless is costly and in effect represents payment of implicit interest.

Rough estimates of average overall implicit rates now earned by households and businesses on transactions deposits are presented in Section V.

The Emergence of Close Substitutes for Demand Deposits

In recent decades, numerous market innovations, in some cases stimulated by high market interest rates that accompanied historically high rates of inflation, have afforded payment of explicit interest on balances that provide many of the same functions as demand deposits. The following list provides several examples, but is not a complete description of such innovations.

(i) The federal funds market provides a convenient outlet for eligible lenders (depository institutions, U.S. government agencies, securities dealers and certain others) to place very short-term (mostly overnight) funds at a market rate to borrowing banks, principally large money center banks. As this market developed over time, it effectively replaced the market for interest-bearing bankers' balances that existed before 1933.

(ii) Repurchase agreements also offer a large sized, very liquid asset to lenders ineligible for the federal funds market, especially corporations and state and local governments.

(iii) Money market mutual funds are investment companies registered with the S.E.C. under the Investment Company Act of 1940. They invest exclusively in money market instruments and provide checking privileges subject to restrictions (usually with a minimum check size). Many have been established by brokerage houses and are used primarily by individuals. Others cater principally to institutional investors such as pension funds.

(iv) Sweep accounts allow a bank at the end of each day to transfer out of a demand deposit account balances above a pre-arranged dollar limit either into money market instruments or into a money market mutual

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fund share. Funds also may be transferred automatically back to the account to cover payments when the balance falls below a pre-set level. Thus, the account serves as transactions vehicle, while a market return is earned on surplus funds.

Legislated Interest-Bearing Transactions Accounts

While the demand deposit substitutes listed above have emerged from market forces, other accounts providing both explicit interest and transactions services have been introduced through legislation or regulation. Below is a summary of the most important developments; Table 3 provides data on their growth since 1980.

(i) In 1974, the Congress permitted Massachusetts commercial banks and thrifts to offer NOW accounts. These accounts had been offered by mutual savings banks two years earlier. The authority to issue NOW accounts was extended to other New England states in 1976, to New York in 1978, to New Jersey in 1979 and to the entire nation at the end of 1980. Legally, the accounts are treated as savings accounts, and explicit interest paid is subject to a rate ceiling. Depositors eligible to hold these accounts at present include individuals, governmental units and nonprofit corporations. Check-like drafts may be written on the account balance, which gives the account all the economic advantages of a demand deposit, with the additional advantage of explicit interest. A similar account, the share draft account, was authorized at credit unions in 1974.

(ii) The Garn-St Germain Depository Institutions Act of 1982 directed the DIDC to authorize commercial banks and thrifts to issue the money market deposit account (MMDA), intended to be equivalent to and competitive with money market funds. This account has a minimum average monthly balance of $2,500, is subject to no interest rate ceiling, and permits six preauthorized or automatic transfers a month, of which only three may be by check. It is available to all depositors.[1]

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1. See Frederick T. Furlong, "New Deposit Instruments," Federal Reserve Bulletin, May 1983.

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Table 3

Balances in Accounts with Transactions Capabilities at Depository Institutions[1]
(monthly average, not seasonally adjusted)

	December 1980		April 1983	
	$ Billions	% of Total	$ Billions	% of Total
Gross demand deposits[2]	369	93	330	42
Regular NOW, ATS and share draft accounts	27	7	91	11
Money market deposit accounts	n.a.	n.a.	341	43
Super NOW accounts	n.a.	n.a.	29	4
Total	396	100	791	100

n.a.—not applicable.

1. Commercial banks, savings and loan associations, mutual savings banks and credit unions.

2. Excludes demand deposits due to commercial banks, certified checks and officer's checks.

Source: Federal Reserve System Report of Deposits, used for reserve requirement purposes.

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(iii) The DIDC also authorized depository institutions to issue Super NOWs, beginning in January 1983. These are fully transactional NOW accounts with average monthly balances over $2,500 and with no interest rate ceilings. Depositors eligible to hold regular NOW accounts also may hold Super NOWs. Thus, eligible depositors prepared to invest $2,500 or more already have access to a transactions account with unconstrained explicit interest.

(iv) The Monetary Control Act of 1980 requires all restrictions on interest rates paid on all time and savings accounts to be eliminated by March 31, 1986. This includes regular NOW accounts; consequently, by 1986, individuals and others eligible to hold NOW accounts will have a fully transactional account without a regulated minimium balance or interest ceiling. Thereafter, neither the continued prohibition of interest on demand deposits nor any other regulation will represent a legal impediment to banks wishing to pay explicit interest on individuals' transactions balances. Indeed, in 1982, all interest rate restrictions on share draft accounts at credit unions were eliminated, so share draft depositors already have a transactions account with neither a statutory or regulatory minimum balance nor any interest rate restrictions.

V. Estimates of Impact of Demand Deposit Interest on Depository Earnings

As of April 1983, gross demand deposits amounted to about $330 billion, while regular NOW, ATS and share draft account balances totaled over $90 billion, and Super NOWs nearly $30 billion. Virtually all demand deposits and three-fourths of interest-bearing checkable deposits were held at commercial banks. The relative importance of transactions deposits in general, and demand deposits in particular, as a source of funds for commercial banks and thrift institutions is depicted in Table 4. For commercial banks, transactions deposits averaged 21.4 percent of domestic assets as of December 1982,

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Table 4

Reliance on Transactions Deposits and Demand Deposits
By Type of Institution

	Transactions deposits[1] as percent of domestic assets	Demand deposits[1] as percent of domestic assets
Commercial banks[2]	21.4	17.0
Savings and loan associations[3]	1.4	0.1
Mutual savings[4] banks	2.5	1.0

1. The commercial bank figures for demand deposits exclude demand deposits due to commercial banks, certified checks, and officers checks. The figures for demand deposits for savings and loans and mutual savings banks consist of demand deposits subject to transfer by draft.

2. Based on Call Report data for December 1982.

3. Based on Call Report data for June 1982.

4. Based on Call Report data for Federally insured mutual savings banks for December 1982.

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compared to an average of 1.4 percent for savings and loans at mid-year and 2.5 percent for mutual savings banks at year end.

To help assess whether demand deposits have represented a relatively cheap source of funding, a statistical study of their influence on profitability across commercial banks was conducted for each of the years 1978 through 1982. Bank profitability, measured as an institution's ratio of before tax-profits to assets, was related to several variables including its ratio of demand deposits to assets. The results indicate that for the years 1978 through 1981, an institution's reliance on demand deposits had a statistically significant positive impact on profitability. Moreover, the impact appears to have been greater in the years when market interest rates were higher. In contrast, with the sharp drop in interest rates that occurred in the last half of 1982, the estimates for that year do not reveal a statistically significant relation between profitability and reliance on demand deposits. This suggests that last year demand deposits in general were not a significantly more attractive means of funding than other sources. Put another way, given interest rate levels prevailing in 1982 on average, institutions likely would not have been willing to pay much more in explicit interest for demand deposits than they already were paying on average implicitly.

The impact that eliminating the prohibition of interest on demand deposits can be expected to have on earnings of depository institutions is addressed in the remainder of this section. The analysis assumes that the ceiling rate on regular NOW (and ATS) accounts also would be eliminated at the same time, since restraining the competitive position of institutions whose transactions balances are concentrated primarily in NOW accounts, such as thrift institutions, would not seem warranted. The discussion focuses

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principally on commercial banks where transitory earnings pressures would be more likely to develop given their relatively heavy reliance on transactions deposits for funding. (Effects on thrift earnings are discussed beginning on p. 45.) In order to obtain quantitative estimates of earnings impacts for the first year or so after interest on demand deposits is authorized, this section will first examine in detail the three main factors that will determine how converting to such a regime initially would alter earnings.

The first factor is how much higher than otherwise the combined explicit and implicit rates paid on affected deposits would be, as measured by costs incurred by commercial banks. The residual implicit rate represents the cost of services still provided less the revenue obtained through (presumably increased) service charges--per dollar of affected deposits. While an increase in the sum of these average explicit and implicit rates would be more pronounced at levels of market interest rates comparable to those prevailing in recent years, the above evidence suggests that given the sharp drop in market rates in the second half of 1982, implicit rates now paid on a significant portion of demand deposits may not be much different from the overall rates institutions would pay at current market rates if explicit interest were allowed. Nevertheless, the average overall yield on certain demand deposits could rise, particularly for deposits of medium- and small-size businesses. This effect could be heightened during an initial transition period if institutions--especially thrifts--viewed the authorization of explicit interest on all demand deposits as an opportunity to increase market shares by offering still higher introductory interest returns, as was the case with MMDAs. In addition, explicit rates could tend to foster more competition since depositors could more easily compare offering rates among institutions.

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Second, earnings could be put under further, albeit largely transitory, pressure to the degree that depository institutions have to absorb some of the fixed costs associated with resources currently used to provide the services comprising implicit interest. Although institutions could recoup some of these costs by charging more for services, the quantity of such services demanded would tend to fall. Thus, institutions could not recoup that portion of existing fixed costs associated with unneeded facilities that cannot be quickly dismantled or other resources that cannot be readily converted to alternative uses. This absorbed cost associated with discontinued services can be expressed as a percent of the volume of affected deposits. This figure--unrecouped fixed costs of idle resources per dollar of affected deposits--can be added to the increased average rate paid on affected deposits to derive the total cost impact per dollar of affected deposits.

The third factor is the amount of affected deposits--that is, the volume of funds that would move into accounts offering a deregulated explicit rate. Presumably, institutions would continue to offer conventional demand deposits, if not regular NOWs, along side the new transactions accounts bearing a deregulated explicit rate. By passing the initiative to switch accounts on to depositors, institutions would avoid the full adverse cost impact of converting all demand deposits at once to explicit interest-bearing form. This third factor then boils down to the size of the shifts into the new accounts authorized by the legislative change, and whether the source of funds is existing demand deposits, other deposits or market instruments.

The probable magnitude of these three factors will be examined sequentially for household demand deposits, regular NOW and ATS accounts, and business demand deposits. It should, of course, be emphasized that these estimates--which will be presented as ranges--are not as precise as might be presumed from the

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detailed estimates presented below. They should be interpreted as rough estimates of likely impacts on the assumption of a continuation of today's levels of market interest rates.

Transitional Net Cost Impact for Household Demand Deposits

Increase in Average Rate Paid on Affected Deposits. Evidence from available Functional Cost Analysis data lends support to the presumption that the implicit return on the bulk of household demand deposits is not significantly below the explicit rate institutions would be willing to pay. The previous section noted that in 1981 the implicit return on household demand deposits at a sample of commercial banks with assets of $50 to $200 million was about 7 percent. Although data beyond 1981 are not yet available, implicit rates paid likely have followed historical patterns in showing little short-run responsiveness to movements in market interest rates, in part owing to the large fixed cost component in implicit remuneration. Thus, this FCA data may well be suggestive of average implicit rates prevailing today. By comparison, the average explicit yield on Super NOWs at commercial banks was only 7.2 percent as of the end of April of this year.[1] Taking into account the depositories' return to intermediation and the likelihood that any shortfall of service charges below operating expenses largely reflected incomplete transitional adjustments, a 7 percent overall rate may well approximate the competitive rate of return on transactions balances at today's level of market interest rates. To be sure, the FCA data indicate that the implicit return on household demand deposits at a sample of the smallest banks was below 7 percent in 1981. But it is unlikely

1. In the last week of April, the coupon-equivalent yield on three-month Treasury bills was 8.4 percent. If Treasury bills had represented the investment outlet for funds acquired by Super NOWs, then the marginal reserve requirement cost to an institution bearing the full 12 percent required reserve ratio on transaction accounts would have amounted to about 1 percentage point.

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that any significant volume of household demand deposits is paid implicitly much less than 1 to 2 percentage points below what would be earned in long-run equilibrium if explicit interest were allowed and market rates were around current levels--even considering the possibility that explicit rates would tend to foster more competition since depositors could more readily compare offering rates among institutions.

In an attempt to capture or protect market shares, commercial banks as well as other depositories initially might raise overall average yields on these balances above long-run equilibrium levels relative to market interest rates. It seems unlikely, however, that commercial banks or thrift institutions would have much additional incentive to compete for household deposits. Explicit market interest rates already are paid on ceiling-free Super NOWs and MMDAs. The pricing of Super NOWs since their introduction suggests that institutions have not been inclined to bid aggressively for those accounts. Thus, lifting the prohibition of interest on household demand deposits seems unlikely to touch off a "bidding war" among institutions.

These considerations underpin the high and low estimates of 1 and 2 percentage points for the net increase in overall rates paid on average on those household balances transferring to interest-bearing demand deposits. These estimates, shown in line 1 of Table 5, cover the transition period of a year or so following the effective date of the regulatory change.

Fixed costs absorbed. Commercial banks could face further downward earnings pressures by having to absorb some of the fixed costs associated with the provision of services that now constitute implicit interest payments. The adverse impact on earnings would be tempered as institutions receive revenue from separately pricing services that the public is willing to continue to purchase and as institutions abandon those services that can not be provided on a

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Table 5

Estimated Transitional Effect on Commercial Banks' Before-Tax Earnings of Removing Interest Rate Prohibition on Household Demand Deposits

	Low Estimate	High Estimate
(1) Increase in rate[1] (% + 100)	.01	.02
plus		
(2) Fixed cost absorbed (% + 100)	.006	.015
times		
(3) Household demand deposits affected ($ billions)	$5	$5
equals		
(4) Increase in net costs ($ billions)	$.08	$.18

1. The sum of the average explicit rate and the decline in the average implicit rate.

Source: Federal Reserve staff estimates.

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cost-effective basis. Since the process of scaling back their operating facilities could take some time, a portion of existing fixed costs would initially be absorbed by commercial banks in an environment of explicit interest. In the first year this absorbed fixed cost is assumed to equal one-tenth to three-tenths of the implicit interest currently earned on those household demand deposits converting to interest-bearing accounts. With implicit returns on shifted deposits between 6 and 5 percent--as assumed in the low and high cost estimates, respectively, in line 1--then the absorbed cost to commercial banks would be between .6 and 1.5 percent of the shifted deposits--as shown in line 2 of Table 5.

The volume of affected deposits. The volume of transfers to demand deposits earning explicit interest is likely to be relatively small. Households maintaining demand deposits currently could earn an explicit return if they wished by opening a regular NOW or Super NOW account. Considerable shifting to NOWs already has occurred. In 1981--the first year of nationwide NOW accounts--the estimated volume of demand deposits shifted to NOWs represented about 40 percent of the amount of household demand deposits outstanding at the beginning of the year.[1] After the early months of that year and subsequently, though, shifts to NOWs from demand deposits abated substantially until the advent of Super NOWs early this year when substantial shifting resumed for several months before tapering off again. While inertia may explain why some households have not switched, other depositors likely have determined that the combination of noninterest-bearing accounts and "free" services is more advantageous. After all, explicit interest would be subject to income taxes while the fees for services could not be deducted from income. For certain demand depositors--particularly depositors with active accounts but with small average balances--the after-tax

1. The actual level of household demand deposits fell by much less than two-fifths, since shifts to NOWs were offset by flows of new funds to these demand deposits.

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return could well be higher with a noninterest-bearing demand deposit account having no or low service charges rather than with an interest-bearing NOW account subject to higher service charges.

Even so, publicity surrounding the authorization of interest on demand deposits and advertising of newly offered household accounts would induce some further shifting out of noninterest earning household demand deposits. The most likely accounts to shift would be larger, inactive accounts with low implicit returns.[1] Since these shifts would increase the fraction of remaining regular demand deposits represented by smaller, active accounts--which are less profitable--depositories may take the opportunity to impose higher service charges on these old accounts as well. This reaction would induce still further deposit shifts. If all interest rate restrictions were lifted, a reasonable assumption may be that at most something on the order of 5 percent of the estimated $90 billion level of household demand deposits outstanding would shift to interest-bearing demand deposits (over and above the amount that would have shifted in any event to Super NOW accounts). This $5 billion is shown on line 3 of Table 5; inflows from other sources to interest-bearing household demand deposits are assumed to be negligible given that the shifting to Super NOWs from non-M1 sources has evidently about run its course already.

Increased net cost. Estimates of the increased net cost to commercial banks during the first year or so of explicit interest on household demand deposits is derived in line 4 of Table 5 by multiplying the sum of estimates of the higher rate and the fixed cost absorbed per dollar of affected deposits by this estimate of affected deposits. The resulting figure ranges from $80 to $180 million for the first year.

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1. Recent survey data indicate that about one-fourth of the current $90 billion in household demand deposits are in accounts over $2,500.

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Transitional Net Cost Impact for NOW and ATS Accounts

Increase in average rate paid on affected deposits. Functional Cost Analysis data indicate that regular NOW holders receive both an explicit and implicit rate on their balances. The implicit portion of the yield appears close to 2 percentage points. Combined with the 5-1/4 percent explicit rate generally paid at present, the overall return seems to represent a fully competitive rate of remuneration, considering the cost of reserve requirements. Thus, line 1 of Table 6 assumes no increase in the sum of explicit and implicit rates paid on regular NOW and ATS balances would occur on average if the rate ceiling were removed; that is, the decline in the implicit rate is offset by the increase in the explicit rate.

Fixed costs absorbed. To the extent commercial banks raise explicit rates, they will attempt to recoup the cost of current services through added fees. However, NOW and ATS account depositors might not be willing to purchase the same level of services once new charges are levied even if a fully competitive explicit interest rate were paid on account balances, although the relative cutback might be somewhat less than for household holders of demand deposits. It seems reasonable to assume, as in line 2 of Table 6, that commercial banks during the first year would absorb average fixed costs between one-tenth and two-tenths of the 2 percent implicit interest cost, which amounts to an annual expense to these commercial banks of .2 to .4 percent of regular NOW and ATS balances affected.

The volume of affected deposits. Lifting the ceiling on regular NOW and ATS accounts could affect a large volume of deposits at commercial banks. Line 3 of Table 6 gives the estimate that some $70 billion of such accounts may be affected in the first year, representing virtually all the funds held in such accounts at commercial banks.

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Table 6

Estimated Transitional Effect on Commercial Banks' Before-Tax Earnings of Removing Interest Rate Restrictions on Regular NOW and ATS Accounts

		Low Estimate	High Estimate
(1)	Increase in rate[1] (% + 100)	*	*
	plus		
(2)	Fixed cost absorbed (% + 100)	.002	.004
	times		
(3)	Regular NOW and ATS accounts affected ($ billions)	$70	$70
	equals		
(4)	Increase in net costs ($ billions)	$.14	$.28

1. The sum of the increase in the average explicit rate and the decrease in the average implicit rate.

*--negligible

Source: Federal Reserve staff estimates.

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Increased net cost. The absorption of fixed costs on regular NOW and ATS accounts is estimated to depress earnings of commercial banks by between $140 and $280 million in the first year. It should be emphasized again that the elimination of interest rate restrictions on regular NOW and ATS accounts is due to occur by March 31, 1986 in any case, giving rise to earnings pressures at that time. In anticipation, institutions could try to reduce that future impact by making operational adjustments in the interim.

Transitional Net Cost Impact for Business Demand Deposits at Commercial Banks

Increase in average rate paid on affected deposits. Some medium- and small-size firms apparently are not now being compensated fully for their demand deposit holdings. These businesses are less likely than large firms to make extensive use of credit and operational services that usually make up the implicit interest payments involved in compensating balance agreements. Despite their relatively low utilization of these services, these businesses probably receive at current market rates implicit returns that are only 1 to 2 percentage points below what would otherwise be paid for those funds after complete adjustment to explicit interest on demand deposits.[1]

To be sure, allowing explicit interest on business demand deposits would provide commercial banks with a new instrument. These institutions could be inclined to offer attractive rates for a short period of time to capture market

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1. Judging from information provided recently by Federal Reserve Bank staff, perhaps a quarter of the demand deposits of small firms, on average, are held beyond amounts required as compensation for credit and operational services. Assuming a 7 percent implicit return on the other three-quarters of the balances implies a weighted average return of 5-1/4 percent. Further assuming a 7 percent overall return on all demand balances for these firms after explicit interest is introduced implies an increase in the average overall return for small firms of 1-3/4 percent, which is consistent with the text's assumption of a 1 to 2 percent increase for those small- and medium-size firms that are not now receiving a competitive rate and that switch to an interest-bearing demand deposit.

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share. However, even in the case of business demand deposits, using high offering rates for this purpose might not be a particularly productive strategy. Large business depositors apparently already earn close to a competitive rate on demand deposits (after adjusting for reserve requirements). Medium- and small-size business depositors would find it costly to switch from one depository institution currently providing transaction and other services to another institution. Thus, to attract these customers, a competing commercial bank might have to offer a substantial premium for more than just a short period of time.[1]

All things considered, a reasonable assumption seems to be that the average explicit rate on demand deposits opened by those small- and medium-size firms that currently are not paid full compensation would be only 1 to 2 percentage points higher than these firms receive now. Large firms are assumed to experience no change in returns. Also assuming that those medium- and small-size businesses that could experience an increase in returns account for one-half of business funds shifted gives an average increase in yields on all converted business demand deposits of 1/2 to 1 percent (line 1 of Table 7).[2]

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1. Upward pressure on rates could occur if thrift institutions also received expanded powers to offer business demand deposits. But at present most thrifts probably are not in a position to provide the array of services usually demanded or required by corporate customers. Hence, thrift competition would be unlikely to raise costs to commercial banks appreciably.

2. This assumption is based in part on Federal Trade Commission data on the cash and demand deposit holdings of businesses in 1982. Those data indicate that, among manufacturing firms, companies with assets of less than $100 million accounted for 60 percent of the cash and demand deposit holdings. The results from a survey of financial companies (not including depository institutions) and nonfinancial companies conducted by a private research firm suggest that the fraction of business demand deposits held by medium- and small-size firms could be somewhat greater than 60 percent. Some medium- and small-size firms, however, already are fully compensated for demand balances and would not experience an increase in the rate paid by a commercial bank for the funds. Thus, if all firms were equally likely to shift to an interest-bearing demand account, the balances with a potential for gaining a higher return would be less than 60 percent--perhaps around 50 percent.

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Table 7

Estimated Transitional Effect on Commercial Banks' Before-Tax Earnings of Removing Interest Rate Prohibition on Business Demand Deposits

		Low Estimate	High Estimate
(1)	Increase in rate[1] (% + 100)	.005	.01
	plus		
(2)	Fixed cost absorbed (% + 100)	.003	.006
	times		
(3)	Business demand deposits affected ($ billions)	$90	$90
	equals		
(4)	Increase in net costs ($ billions)	$.72	$1.44

1. The sum of the average explicit rate and the decrease in the average implicit rate.

Source: Federal Reserve staff estimates.

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Fixed costs absorbed. Some large business depositors may wish to cut back on cash management services once they can obtain an explicit rate on their demand deposits, even though this rate would reflect the continued cost of reserve requirements. Some smaller business customers, too, might curtail their use of bank services once pricing schedules were instituted. However, banks likely will be able to scale down more quickly facilities related to the provision of business services than those related to household services. If the cost absorbed by commercial banks were one-twentieth to one-tenth of the current average implicit yield (assumed to be between 6-1/2 and 6 percent in the low and high cost estimates, respectively, in line 1) on business funds that would shift, earnings would be reduced by a further .3 to .6 percent of business demand deposits earning explicit interest. This estimate is shown in line 2 of Table 7.

The volume of affected deposits. There is little basis for judging what volume of business demand deposits initially would be shifted to interest-bearing checking accounts. In the long run, businesses conceivably might shift most of their transactions balances to interest-bearing demand accounts, since they would not be impeded by tax considerations from paying explicit fees for services rather than receiving them as implicit returns to balances held. However, some time probably would elapse before existing compensating balance arrangements unwind. If, during the first year, one-half of the demand deposits of businesses were to shift, about $90 billion would be involved (line 3 of Table 7). The unwinding of compensating balance arrangements could induce firms to place some funds transferred out of existing business demand deposits in instruments other than interest-bearing demand deposits. This outflow from transactions balances is assumed to be just offset, but no more than offset, by funds transferred out of other sources into interest-bearing

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business demand deposits. The differential reflecting the cost of transaction reserve requirements between rates on demand deposits versus alternative deposit and non-deposit investment outlets may well discourage substantial inflows of investment-type funds to interest-bearing business demand deposits.

Increased net cost. These component estimates imply that authorizing interest on business demand deposits alone would raise annual bank costs in the first year by between $720 million and nearly $1.5 billion (line 4 of Table 7). This range of earnings impacts is identical to the estimate in the accompanying memorandum for the first-year cost impacts for commercial banks of allowing businesses a fully transactional MMDA.[1] And, as would be expected since depository institutions cannot now offer an interest-bearing transactions account to businesses, removing the prohibition of interest for business demand deposits is estimated to have a significantly larger cost impact than for household accounts--as may be seen by comparing the first 3 lines of Table 8.

Overall Earnings Impact for All Transactions Accounts at Commercial Banks

The estimates for the combined first-year earnings impact for affected household and business transactions deposits range from about $1 to $2 billion at annual rates (Table 8).[2] This range represents between 5 and 10 percent of

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1. See the accompanying June 14, 1983 DIDC staff memorandum, "Money Market Deposit Accounts with Unlimited Transfers for Those Not Eligible to Maintain NOW Accounts".

2. The earnings impact of authorizing interest payments on demand deposits due to commercial banks is estimated to be negligible, since existing implicit returns associated with clearing and other services are doubtless near a competitive rate of return, and since the transaction reserve requirement will dissuade lenders of federal funds from switching to interbank demand deposits. Similarly, little cost impact is likely to be associated with interest on the relatively small amount of balances held in state and local demand deposits, since the extent of conversion of these funds to interest earning demand deposits will probably be minor in light of the current eligibility of municipalities for NOWs and Super NOWs.

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Table 8

Estimated Transitional Effect on Commercial Banks' Before-Tax Earnings of Removing Interest Rate Restrictions on All Transactions Deposits ($ billions)

	Low Estimate	High Estimate
Increase in net costs for:		
(1) Household demand deposits affected	.08	.18
plus		
(2) Regular NOW and ATS accounts affected	.14	.28
plus		
(3) Business demand deposits affected	.72	1.44
equals		
(4) Total increase in net costs	.94	1.90
Memo:		
(5) Total increase in net costs as percent of 1982 before-tax earnings	4.9%	9.9%

Source: Federal Reserve staff estimates in Tables 5 - 7.

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1982 before-tax income for commercial banks.[1] These estimates, of course, are subject to considerable uncertainty. If depository institutions were to increase substantially interest rates on transactions deposits in an attempt to secure larger market shares, the transitional costs could be higher than those shown in Table 8. On the other hand, to the extent that the combination of explicit interest and higher yields attract new funds to depository institutions that could be invested at a positive spread, earnings pressures would be eased somewhat.[2]

It is worth reemphasizing that the ceilings on regular NOW and ATS accounts are scheduled to be removed by March 31, 1986 in any event. Depository institutions hence will bear earnings pressures of $140 to $280 million out of the $1 to $2 billion overall impact at that time unless they take advantage of the longer interval to position themselves for this change in advance. Thus, the portion of the total earnings impact attributed to regular NOW and ATS accounts really represents potential costs that depositories ultimately will confront regardless of whether or not interest on demand deposits is authorized.

Also worth pointing out is that estimates of the overall earnings impact of interest on demand deposits assumes the continuation of present levels of market interest rates. Earnings impacts would be enlarged by higher market rates but reduced by further rate declines.

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1. Pre-tax profits for all insured commercial banks in 1982 were $19.2 billion.

2. As noted, only a small volume of funds can be expected to transfer from market instruments or large CDs and Eurodollar deposits to interest-bearing business demand deposits in light of the transaction reserve requirements that would make demand deposit yields relatively less attractive. As also noted, transfers of savings-type balances into newly authorized household demand deposits may be limited since most interest-sensitive households may have already opened a Super NOW.

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Differential Impacts by Bank Size

The preceding estimates of impacts on costs and earnings apply to the banking system as a whole. However, effects on particular institutions or groups of institutions may vary widely depending upon the type of market and customer served, with some institutions less able to withstand transition costs than others. In particular, those institutions with relatively large amounts of deposits that are likely to switch to interest-bearing accounts (such as small- and medium-size business accounts) would tend to experience relatively greater reductions in earnings.

Reliance on transactions deposits varies considerably among commercial banks. However, the existing differences apparently are not strongly related to asset size. As shown in the top panel of Table 9, the relative reliance on transaction deposits among the different size groups has been reasonably similar, except for the largest banks. The higher ratios for medium and smaller institutions in 1982 appear primarily to reflect their holdings of NOW and ATS accounts. The proportions of demand deposits to domestic assets, shown in the bottom panel of Table 9, reveal less of a systematic difference between large and small institutions.

While reliance on total demand deposits is similar among size categories of commercial banks, considerable differences exist in the ownership of those deposits at large and small banks. As Table 10 shows, smaller commercial banks tend to rely relatively more on household demand deposits, while larger commercial banks have more business demand deposits. To the extent the lifting of interest rate restrictions on transactions deposits would have a greater impact on the cost of business deposits, earnings pressures might be expected to be less at smaller banks than at larger banks. On the other hand, the business

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Table 9

Commercial Bank Reliance
on Transactions Deposits[1]
(percent)

Commercial banks by asset class (dollars)	December 1980	December 1981	December 1982
Ratio of transactions deposits to domestic assets			
Under $25 million	26.3	25.8	24.8
$25 million to $100 million	26.4	25.9	24.6
$100 million to $1 billion	22.3	25.8	24.1
$1 billion and over	23.1	22.4	19.2
Ratio of demand deposits to domestic assets			
Under $25 million	25.5	20.1	17.7
$25 million to $100 million	25.0	20.1	17.7
$100 million to $1 billion	20.4	21.0	18.4
$1 billion and over	21.7	19.7	16.1

1. Excludes demand deposits due to commercial banks, certified checks and officer's checks.

Source: Call Reports

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Table 10

Distribution of Business and Household Demand Deposits
by Size of Commercial Bank
December 1982
(percent)

Commercial banks by asset class (dollars)	Ratio to domestic assets	
	Business demand deposits	Household demand deposits
Less than $25 million	5.4	9.0
$25 million to $100 million	8.6	7.0
$100 million to $1 billion	10.6	5.2
$1 billion or more	10.6	3.5

Source: Federal Reserve staff estimates based on the Survey of Ownership of Demand Deposit Accounts of Individuals, Partnerships, and Corporations and the Call Report, both for December 1982.

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demand deposits held at small commercial banks are more likely to be those of medium- and small-size firms. Shifts from noninterest-bearing demand deposits of these smaller businesses to interest-bearing demand deposits have the greatest potential for raising the cost of funds for commercial banks. Taking explicit account of these offsetting considerations, estimates in Table 11 show little difference between the smallest and largest commercial banks in cost increases relative to 1982 pre-tax profits arising from eliminating interest rate restrictions on transactions balances. The estimates in the table suggest that the commercial banks most affected by allowing interest on demand deposits would be medium-size banks (assets of $100 million to $1 billion). While these medium size banks have the same relative reliance on business demand deposits as larger banks, they also have a larger fraction of these deposits held by small- and medium-size firms that potentially is subject to greater cost increases.

Disaggregating the estimated cost increases by size of bank does reveal the potential for a differential impact from allowing interest on demand deposits. However, the estimates in Table 11 still mask the degree to which individual institutions would experience difficulties during a transition period. The most vulnerable institutions would appear to be those that have <u>both</u> a high proportion of deposits in rate-constrained transactions accounts <u>and</u> low earnings. Table 12 shows the number of commercial banks by size class that had in 1982 <u>both</u> a high ratio of demand deposits to assets--either the highest quartile or decile of demand deposits to total assets--<u>and</u> low earnings--either those institutions in the lowest quartile or decile of before-tax income to domestic assets. Depending on which criterion is applied, the number of vulnerable institutions ranges from 171 to 817 out of about 14,000 commercial banks. The vast majority of the institutions that could face the most difficulty are smaller banks

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Table 11

Estimated Transitional Impact on
Commercial Banks' Before-Tax Earnings of Removing Interest
Rate Restrictions on Transactions Deposits

Commercial banks by asset class (dollars)	Low Estimate	High Estimate
	— Net cost increase in $ millions —	
Less than $25 million	46	95
$25 million to 100 million	167	338
$100 million to $1 billion	266	536
$1 billion or more	461	928
Total	940	1,897
	— Net cost increase as a percent of 1982 profits before taxes —	
Less than $25 million	4.4	9.1
$25 million to 100 million	4.4	8.8
$100 million to $1 billion	6.4	12.9
$1 billion or more	4.6	9.2
Total	4.9	9.9

Source: Federal Reserve staff estimates.

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Table 12
Number of Vulnerable Banks
Low Earnings and High Transactions Balances
Insured Commercial Banks
1982

	Size: Total Domestic Assets (Millions of Dollars)									
	0-5	5-10	10-25	25-50	50-100	100-250	250-1,000	1,000-5,000	Over 5,000	Total
Those banks within lowest quartile of ratio of earnings to domestic assets and										
-- Highest quartile of ratio of demand deposits to domestic assets	32	104	243	156	94	89	59	32	8	817
Those banks within lowest decile of ratio of earnings to domestic assets and										
-- Highest decile of ratio of demand deposits to domestic assets	8	26	68	37	16	10	4	2	0	171
MEMO: Total number of banks	326	1,410	4,230	3,719	2,394	1,307	512	185	41	14,124
MEMO: Ratios										
Ratio of earnings to domestic assets										
-- Lowest quartile	.0067	.0068	.0074	.0081	.0080	.0068	.0060	.0056	.0041	0074
-- Lowest decile	-.0036	-.0011	.0016	.0038	.0043	.0028	.0028	.0030	.0029	.0027
-- Median	.0132	.0114	.0116	.0117	.0111	.0098	.0086	.0078	.0056	.0111
Ratio of demand deposits to domestic assets										
-- Highest quartile	.3070	.2262	.2183	.2177	.2248	.2331	.2523	.2645	.2288	.2261
-- Highest decile	.5092	.2934	.2774	.2754	.2768	.2839	.2959	.2984	.2523	.2833
-- Median	.2166	.1756	.1681	.1669	.1736	.1858	.2119	.2264	.1877	.1743

Source: Call Reports, June and December, 1982.

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(assets of less than $100 million). As shown in the memorandum items, demand deposits at subcategories of these smaller banks ranged from about one-fifth to more than one-half of domestic assets at the end of 1982, while earnings ranged from .8 percent of assets to losses of more than .36 percent of assets.

Impact On Thrift Institutions

Removal of restrictions on the payment of interest on transactions deposits per se is not likely to have a noticeable impact on the cost of funds at thrift institutions. Savings and loans and mutual savings banks currently have relatively few NOW accounts and very few demand deposits. Table 13 shows that this limited reliance of savings and loans on transactions deposits is uniform across size categories. In contrast, some difference is apparent in the ratios of transactions deposits to assets for mutual savings banks. As of December 1982, for the smallest mutual savings banks transactions deposits were equivalent to 5.6 percent of assets, compared with 2.2 percent at the larger institutions (top panel of Table 14). The differences reflect primarily the relatively large holdings of NOW accounts as opposed to noninterest-bearing demand deposits at smaller savings banks. As the bottom panel of Table 14 shows, the ratios of demand deposits to assets as of December 1982 were not much different across size groups.

The demand deposits held at thrifts for the most part are household deposits, which already could earn explicit interest if shifted to a regular NOW or Super NOW account. However, if thrift institutions were to raise rates on transactions accounts in an attempt to gain market share or in response to competion, earnings would tend to be adversely affected, although if any new fund inflows could be invested at a positive spread, this depressing effect would tend to be offset. In this regard, though, as argued earlier, depository

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Table 13

Savings and Loan Association Reliance
on Transactions Deposits[1]
(percent)

Savings and loans by asset class (dollars)	December 1980	December 1981	June 1982
Ratio of transactions deposits to domestic assets			
Under $25 million	.2	1.1	1.4
$25 million to $100 million	.2	1.1	1.4
$100 million to $1 billion	.2	1.3	1.6
$1 billion and over	.2	1.2	1.3
Ratio of demand deposits to domestic assets			
Under $25 million	*	*	.1
$25 million to $100 million	*	*	.1
$100 million to $1 billion	*	*	.1
$1 billion and over	*	*	*

*--Less than .05 percent.

1. Demand deposits consist of demand deposits subject to transfer by draft.

Source: Call Reports

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Table 14

Mutual Saving Bank Reliance
on Transactions Deposits[1]
(percent)

Mutual savings banks by asset class (dollars)	December 1980	December 1981	December 1982
Ratio of transactions deposits to domestic assets			
Under $25 million	2.3	3.9	5.6
$25 million to $100 million	4.2	3.6	4.3
$100 million to $1 billion	1.9	2.5	2.8
$1 billion and over	1.4	1.7	2.2
Ratio of demand deposits to domestic assets			
Under $25 million	0.5	1.2	2.0
$25 million to $100 million	1.0	1.0	1.2
$100 million to $1 billion	0.9	1.1	1.1
$1 billion and over	0.8	0.7	1.0

1. Federally insured mutual savings banks. Demand deposits consist of demand deposits subject to transfer by draft.

Source: Call Reports

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institutions would seem to have little added incentive to compete aggressively for household deposits.[1]

Elimination of the ceiling on all NOWs by itself could lead to some transitional increase in costs for thrift institutions. As apparently is the case for commercial banks, thrift institutions likely compensate regular NOW depositors through a combination of explicit and implicit interest payments. If fully explicit yields were paid on all NOWs, thrifts may have to absorb some of the fixed cost incurred in supplying services used to pay implicit returns. Given the limited importance of NOWs as a source of funding at savings and loans and mutual savings banks, such costs may be no more than $50 to $100 million. However, with the still generally weak earnings at thrifts, the marginal impact on some institutions could be more significant. This could be particularly true of the very small mutual savings banks that apparently rely relatively heavily on transactions deposits.

Longer-run Earnings Impacts

Eliminating interest rate restrictions on household transactions deposits would have little bearing on the long-run profits of depository institutions, since the ceiling on NOW and ATS accounts already is scheduled to be removed by March 31, 1986, and the associated costs will have to be faced in time in any event. Moreover, given time, households that would initially shift into interest-bearing demand deposits also would probably move into an unconstrained NOW account anyway. In addition, fixed costs incurred by discontinuing services associated with both household and business depositors would disappear

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1. If authorization to pay interest on demand deposits were coupled with expanded powers for savings and loans to offer transactions accounts to businesses, they may be willing to bid more aggressively for business funds than for household demand deposits, since internal shifting would be minimal. However, success in this effort, as noted earlier, may be limited.

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in the long run as the scaling back of facilities and the retraining of personnel is completed.

In the case of business demand deposits, the impact on profits in the long run largely depends on whether explicit interest arrangements would permanently foster more competition and less price discrimination than those involving implicit interest, since any initial period of "loss leader pricing" would surely be short-lived judging by the experience with MMDAs. The evidence for large corporations suggests that even with implicit interest these depositors currently are paid close to a competitive rate. In addition, it appears that medium- and small-size businesses are becoming more active cash managers. It seems likely that, even without explicit interest on business demand deposits, competitive pressures over time would move implicit rates on most business demand deposits closer to competitive rates. Thus, in the long run, profits of depository institutions may not be much different with or without explicit interest on demand deposits. Of course, to the extent that implicit yields on certain business demand deposits would take some time to move to their long-run equilibrium relative to market rates, depository institutions may be able to earn some economic rent in the interim.

While long-run profits may not be much different, explicit interest on demand deposits could eliminate the "dead-weight" losses associated with circumventing the current restrictions. For example, paying interest on transactions balances through sweep arrangements involving RPs is more costly than directly crediting an interest-bearing transactions account. In addition, by charging separately for services, depository institutions would not supply services that depositors valued less than the marginal cost of producing the services. Along the same lines, depository institutions would be less inclined to

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use extensive branching networks that in part have been used to offer an implicit return through the convenience of branch locations.

VI. Impact on Depositors of Explicit Interest on Demand Deposits

Impact on Household Depositors

Households currently can hold Super NOW accounts which are not subject to deposit rate constraints. The only present limitation on these accounts is the $2,500 minimum balance requirement, which in effect will be removed by March 31, 1986, when the ceiling rate on all NOW accounts is scheduled to be eliminated. Since the Super NOW is operationally equivalent to a market-rate demand deposit, the major impact on consumers of deregulating demand deposits essentially would be to accelerate by three years the deadline for removing the minimum balance requirement. Should the Congress remove all restrictions on the payment of interest on demand deposits, it would seem appropriate, as noted earlier, for the DIDC simultaneously to remove all restrictions on the payment of interest on NOW and ATS accounts. On the other hand, the Congress could allow interest on demand deposits but authorize the DIDC to set the same ceiling rate on these deposits as for regular NOWs and/or the same minimum balance as for Super NOWs until March 31, 1986. With this option the Committee could either lift ceilings on all transactions deposit accounts or perhaps subject demand deposits to the same rate or minimum balance limitations that apply to NOWs. In the case in which all restrictions on transactions accounts were eliminated, this change--by moving up in time the opportunity to earn a market rate--would directly affect only those households eligible for NOW accounts but with account balances below the Super NOW minimum, although other households may also be induced to switch to a transactions account with an unconstrained rate.

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Quantifying the overall net gains accruing to such depositors after restrictions on interest on transactions deposits are lifted is difficult. Estimates in the last section suggest that in the first year, at least, certain households would receive explicit plus residual implicit payments on demand deposits that are $50 to $100 million (.01 or .02 times $5 billion) in excess of the cost of providing their present implicit returns.

These estimates, however, represent only a component of the pre-tax gains to households from explicit interest, since depositors on average not only will benefit from the increase in average rates paid, but also will obtain further welfare gains as well. No depositor now receiving subsidized services necessarily places a value on those services as high as their cost of production.[1] Therefore, depositors can be made still better off by receiving explicit interest--of course, valued dollar-for-dollar by depositors--instead of "undervalued" services having equivalent costs of production. The added annual gains arising from this effect would be at least equal to the fixed costs absorbed by commercial banks in the first year on both demand deposits and NOWs affected--or an estimated range of $170 to $355 million.[2] In combination, then, the annual before-tax

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1. The provision of services at a price below cost encourages depositors to overuse them, so that the value obtained will be less than the cost to the institution on the margin. This is likely to be the case particularly for transactions services in individual accounts, where the depositor has no incentive to economize on the writing of checks. Similarly, services such as expensive premises, branching networks and fast teller services may be valued by depositors at less than their production cost.

2. As an illustration drawn from the high cost estimates in Table 5, the total explicit interest to be paid on the $5 billion of shifted household demand deposits (assuming no residual implicit interest) would be $350 million (.07 x $5 billion). Offsetting this gain would be the added fees that households will have to pay for services plus the value of services foregone. If households purchased at full cost the same services they were previously paid as implicit interest, it would then cost them an additional $250 million (.05 x $5 billion). Some of these purchases would be discontinued, however, since their value to depositors will be less than their (continued on p. 52)

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value of these two effects benefitting households is at least as large as the overall pre-tax cost to commercial banks of explicit interest on household deposits in the first year--in an estimated range of $220 to $455 million. The influence of taxes, however, works to diminish the gains to household depositors, since explicit interest is taxable and service charges are not tax deductible.

Not all depositors are likely to be equally affected. Some households with small balances in demand deposits but with sizable account activity now are earning a greater than competitive return, in effect being subsidized by depositors with large balances but inactive accounts. If a regime of explicit interest payments induced higher service charges even on noninterest-bearing

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(continued from p. 51)
newly established price. Households might be willing to pay only, say, $100 million more than now in charges for those services that they would continue to demand when fully priced. Of the other $150 million cost of services that would be discontinued, banks in the first year will only be able to reduce the variable costs associated with producing them, amounting to, say, $75 million. Another $75 million (.015 x $5 billion) of fixed costs associated with discontinued services would be absorbed by banks in the first year. Of course, in the first year banks would have been willing to continue to offer the discontinued services previously costing $150 million ($75 million in variable costs plus $75 million in fixed costs) if households had been willing to cover the $75 million in variable costs of producing them. Assuming that, in the first year or so, banks price these services to cover only variable costs, the fact that households are assumed unwilling to continue to use these services when prices reflect variable costs reveals that they would value these discontinued services by less than $75 million. The net pre-tax gain to households in the first year, then, is the explicit interest received, $350 million, minus the added service charges paid, $100 million, minus the value to households of the discontinued services, which is at most $75 million. This means the total net gain to households in the first year is at least $175 million or $75 million in excess of the increase in rates paid on demand deposits--with the $75 million representing the high estimate of fixed costs absorbed in discontinuing services related to household demand deposits. Even the $175 million overall gain represents an underestimate of first-year pre-tax welfare gains to households in the high cost case. Households will experience a further gain by in effect giving up services with variable costs to banks of $75 million that households value by less than $75 million in exchange for $75 million in explicit interest that is valued in full.

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demand deposits, a possibility mentioned earlier, certain households would be adversely affected, particularly after taxes, unless they are able to curtail their account activity.

Impact on Business Depositors

Because a transactions account at depository institutions without a regulated interest ceiling is not now available to business, the potential impact of allowing interest on demand deposits could be larger for businesses than individuals. On the other hand, businesses, particularly large ones, also are much more likely currently to be using credit and operational bank services, and receiving those services in lieu of explicit deposit interest. In addition, large businesses are more likely to have both the size and financial sophistication to take advantage of cash management techniques to minimize their transactions balances. Thus, large businesses apparently already are receiving a highly competitive return on their demand deposits.

Available evidence, previously discussed, suggests that some small- and medium-sized firms could gain more than large firms from explicit interest on demand deposits. Estimates in Section V suggest that small- and medium-sized firms initially may obtain annual interest payments in an unregulated rate environment some $450 to $900 million in excess of the present cost to banks of providing them implicit returns. In contrast to households, the pecuniary payments and service charges would not in general involve any diminished gains owing to tax considerations. As with households, the advent of explicit pricing will generate further welfare gains for all business depositors as explicit interest replaces subsidized services that businesses undervalue—such as cash management services for large businesses (especially in a regime of explicit interest) and teller time, financial advice and branch services for smaller

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businesses. These additional annual gains would at least equal the fixed costs absorbed in the first year by institutions discontinuing business services--an estimated $270 to $540 million per year. Again, the overall annual gain to business depositors before taxes is at least as large as the first-year pre-tax cost to depository institutions for business accounts--$720 to $1,440 million.

VII. Monetary Policy Considerations

Monetary policy issues raised by permitting interest on demand deposits are essentially the same as those associated with a fully transactional MMDA for businesses, which are examined in the accompanying DIDC staff memorandum dated June 14, 1983. In summary, introducing explicit interest on demand deposits may temporarily induce additional uncertainty regarding the interpretation of movements in the monetary aggregates, particularly the M1 measure of transaction balances. However, uncertainties recently have been considerable in any case, in view of the authorization of nationwide NOWs, of the Super NOW and of the MMDA, and any added uncertainties associated with explicit interest on demand deposits can be expected to diminish over time. In addition, future problems of measuring and interpreting movements in transactions balances would be mitigated by the resultant lessened incentive to develop new transactions-type instruments outside the depository system. It should be noted, though, that explicit interest on demand deposits likely will induce a somewhat faster response in rates paid on M1-type deposits to a change in market interest rates. This effect may reduce further the sensitivity of M1 demand to movements in market rates, leading to additional complications for the conduct of monetary policy.

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would result in lower reserve requirements for such institutions without substantively changing the type of account that is offered. To avoid disruptions in the conduct of monetary policy, the Monetary Control Act could be amended so that the phase-in would not apply to interest-bearing demand deposits held by depositors eligible for NOW accounts in the 42 states in which NOW accounts are subject to the full 12 percent reserve requirement on transaction accounts. An alternative method for reducing the incentive for depository institutions in these states to shift NOW account customers to interest bearing demand deposits--but without the difficulty of identifying the eligibility of deposit holders for NOW accounts--would be to apply the full transaction account reserve requirement to demand deposits in excess of the volume of demand deposits held by an institution at the time of enactment.[1]

Under the Garn-St Germain Depository Institutions Act of 1982, federally insured savings and loan associations are permitted to offer demand accounts to persons or organizations that have a business, corporate, commercial, or agricultural loan relationship with the association (12 U.S.C. § 1464(b)(1)(A); 96 Stat. 1496). In addition, an association may

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1. Suppose a depository institution in one of the 42 states that do not phase in the reserve requirements on NOW accounts had at the time of enactment $200 of demand deposits on which the reserve requirement was being phased in and $100 of NOW accounts subject to the full transaction account reserve requirement. After enactment all demand deposit growth over and above the $200 would be subject to full reserve requirements, including shifts from NOW accounts into interest-bearing demand deposits.

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accept demand accounts from a commercial, corporate, business, or agricultural entity for the sole purpose of effectuating payments thereto by a nonbusiness customer (12 U.S.C. § 1464(b)(1)(B)). The issue of interest-bearing demand deposits seems independent of the provision of the Garn-St Germain Act, which was intended to provide S&Ls with only limited commercial checking account authority. Thus, this memorandum does not address the issue as to whether these limitations should remain in place. It should be noted that maintaining these limitations would require that NOW account eligibility not be changed.

Removing the prohibition against payment of interest on demand deposits suggests that the current interest rate ceilings on NOW and ATS accounts should also be removed at the same time or that the DIDC be given authority to apply interest ceilings to demand deposits until March 31, 1986.

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date November 10, 1982

To Chairman Volcker

From Messrs. Ettin and Schwartz

Subject: Background for meeting with Secretary Regan on DIDC-Garn Account

For your background preparatory to your meeting with Secretary Regan, attached are:

1) An "issue" list containing areas of agreement and outstanding major and minor issues.

2) Checklist of decisions to be made at Monday's DIDC meeting.

3) A very abbreviated summary of comments, focusing on views expressed by trade groups.

4) A note on the preliminary staff views of the effect of the new account on internal deposit shifting and earnings in 1983.

The memorandum to be the basis for the DIDC meeting at 8 a.m. on Monday, November 15, is not yet available, but will be in your car when you return from Texas.

Attachments

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ISSUE LIST

I. There is general agreement that the account must

-- have no minimum maturity (although there could be a reservation of notice)

-- have no interest rate ceiling

-- have a minimum denomination no greater than $5,000

-- allow three preauthorized or automatic transfers and three other third party payments (e.g., drafts) per month

-- be made available to all customers

-- be federally insured

-- be effective no later than December 14

II. Major undecided issues

1. Should there be a minimum initial and maintenance denomination lower than $5,000 (e.g., $2,500 or no regulatory minimum)

   -- FHLB and NCUA reportedly support no regulatory minimum

   -- issue is simplicity and deregulation vs. risks of additional capital erosion from costly internal deposit shifts

2. Number of transfers: If no drafts were written in a particular month, should six preauthorized or automatic transfers be permitted that month, or if the drafts were not written, should the number of preauthorized or automatic transfers be limited to three per month? In either case no more than three drafts per month would be permitted. Either interpretation would satisfy Congressional intent.

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3. Regulations to limit evasions

-- no loophole accounts

-- same charge on overdrafts on this or linked accounts as on overdrafts on other unrelated accounts

-- no automatic or preauthorized payments from this account to cover amount owed on multiple transaction credit facilities (e.g., credit cards).

4. Regulation to avoid elimination of remaining deposit ceilings:

Cannot guarantee rate for longer than, say, seven days.

III. Selected minor undecided issues

1. If there is a regulatory maintenance balance

(a) Over how long a period should it be calculated, e.g., a month

(b) What occurs when balance falls below it, e.g., cut rate to NOW account rate.

2. Reservation of notice: e.g., seven days.

3. Should there be a minimum size for drafts or other transactions?

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3,000 5,000 8,000

-DRAFT-

CHECKLIST OF DECISIONS TO BE MADE BY THE DIDC TO IMPLEMENT SECTION 327 OF THE DEPOSITORY INSTITUTIONS ACT OF 1982

I. FEATURES STRONGLY RECOMMENDED BY STAFF ON THE BASIS OF STATUTE AND/OR LEGISLATIVE HISTORY

- o No minimum maturity on the account
- o No limitation on the rate of interest payable on account balances which meet any minimum maintenance balance the committee may adopt
- o No restriction on account eligibility
- o Account effective not later than December 14, 1982

II. OTHER CHARACTERISTICS

Minimum Denomination

1. The minimum initial denomination should be:

   - o $5,000;
   - o $2,500;
   - o $1,000;
   - o Other; or
   - o Left to the discretion of the institution

2. The minimum subsequent or maintenance balance should be:

   - o Same as initial;
   - o Other; or
   - o Left to the discretion of the institution.

3. To determine compliance with the minimum maintenance balance requirement, if any, the institution may use the average balance over:

   - o One day;
   - o One month (as defined in item 15); or
   - o Other

4. If the balance in the account falls below the required minimum maintenance balance, if any:

   - o A ceiling rate equal to the institution's NOW account rate should be imposed for the entire month (as defined in item 15)

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- o A ceiling rate equal to the institution's NOW account rate should be imposed for the remainder of the month (as defined in item 15);

- o Other

Transactions

5. Authorization and interpretation of transactions which the Act provides will not subject the account to transaction account reserves:

   - o Three preauthorized or automatic transfers only and three third party checks only are permitted per month; or

   - o Six transfer per month are permitted, no more than three of which can be effectuated by draft.

6. Additional transactions:

   - o Limit transactions to these authorized in item 5, but consider allowing expanded transaction features at the next Committee meeting;

   - o Allow depository institutions to offer the account with no limit on transactions (including drafts). (This would subject the account to transaction account reserve requirements under the Federal Reserve Board's current Regulation D).

7. Drafts drawn on the account must have a minimum denomination of:

   - o $500;

   - o Other; or

   - o Left to the discretion of the institution.

8. Preauthorized or automatic transfers must have a minimum denomination of:

   - o $500;

   - o Other; or

   - o Left to the discretion of the institution.

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Maturity

9. Reservation Notice Requirement:

   - o Institutions must reserve the right to require at least seven days' notice prior to withdrawal (any reservation notice that is invoked would apply to all depositors); or
   - o Other

10. An institution is required to reserve the right to change the effective rate of return on the account at its discretion (including the interest rate or method of calculation of the interest rate) at least as often as every:

   - o One day;
   - o Seven days;
   - o Month (the "month" defined in item 15); or
   - o No restrictions on guarantee of rate.

11. Institutions may not offer the account with a contracted maturity greater than

   - o No contracted maturity will be allowed;
   - o 1 day;
   - o 7 days;
   - o One month (the "month" as defined in item 15); or
   - o Let the institution determine the maturity of the account.

Miscellaneous

12. Loans:

   - o Prohibit loans to meet minimum denomination and maintenance balance; or
   - o Do not prohibit loans in connection with this deposit account

13. Overdrafts:

   - o The rate of interest and other charges imposed on an overdraft credit arrangement offered in connection with this account must be not less than those imposed on overdrafts for customers that do not possess this account; or
   - o No prohibition on overdraft arrangements.

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14. Credit card tie-ins:

    o Prohibit automatic or preauthorized debits from the new account to pay the balances owed on credit cards or similar multiple transaction credits; or

    o Do not prohibit such tie-ins.

15. Definition of "month":

    o Calendar month or statement cycle of at least four weeks; or

    o Calendar month only.

16. Date used to monitor compliance with draft limitations should be:

    o Date on draft;

    o Date of payment;

    o Either of the above.

17. Procedures to ensure compliance with withdrawal limit:

    o DIDC regulations should require that institutions must either prevent withdrawals in excess of three automatic or preauthorized and three checks per month, or adopt procedures to monitor accounts on an ex post basis and contact customers that have a greater number of such withdrawals.

    o Other

18. Restrictions on the size and frequency of withdrawals by mail, telephone (via check to the depositor), messenger, or in person:

    o No restrictions on such withdrawals; or

    o Other restrictions

19. Additional deposits:

    o No regulatory restrictions on additional deposits and permit sweeps from other accounts; or

    o Other

20. Effective Date:

    o December 14, 1982 (60 days from date of enactment); or

    o Other

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November 10, 1982

TO: Chairman Volcker

FROM: Normand Bernard NB.

SUBJECT: Tabulations of Trade Association and Other Comments on new Money Market Deposit Account

The DIDC Federal Register notice (copy attached) suggested that the Garn-St Germain Depository Institutions Act and its legislative history have mandated the following six features as the minimum necessary to implement the Act.1/

1. no minimum maturity
2. no interest rate ceiling
3. initial minimum denomination no greater than $5,000
4. not subject to transaction reserve requirements if limited to three preauthorized or automatic transfers and three other third-party payments (including drafts) per month
5. available to all depositors
6. insured by the FDIC or FSLIC

The comments of the major trade associations (and of the Thrift Institutions Advisory Council) are summarized in the tables that follow. There are two sets of these tables, based on two separate classifications, i.e., by topic and by trade association. Also attached is a table summarizing the more than 1,200 comments received from the public.

1/ Several of the trade associations commented explicitly that they agree with the above listing of the minimum requirements of the Act. However, the Investment Company Institute (in a 50-page letter of comment) argues that the maximum rate payable on the account must be "a market-referenced-rate", the absence of which could lead to predatory pricing by large institutions. The ICI and the American Council of Life Insurance also argue that the new account is not automatically required to be insured. (These issues are discussed in the forthcoming staff memo to the DIDC.)

Attachments
1. Tabulations
2. DIDC request for public comment.
3. Copies of trade association letters.

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Trade Association Comments on New Money Market Account

Features	American Bankers Association	Reserve City Bankers	Independent Bankers Association
General comments	Allow maximum flexibility to institutions.	Allow maximum flexibility to institutions.	Leave most of details to institutions.
Minimum initial denomination	No higher than $5,000, with phase-out schedule.	No higher than $2,500.	$5,000
Maintenance balance	Same as minimum initial balance.	Leave up to institution (if any is set, should be below initial).	Same as minimum initial balance.
Maximum rate when account is below maintenance	NOW account rate.	NOW account rate if any limit is set.	NOW account rate.
Minimum denomination for drafts	No restrictions.	No restrictions.	No restrictions.
Require institutions to reserve right of notice of withdrawal	Require 7-day reservation clause.		Require 7-day reservation clause.
Loans to meet initial minimum	No restrictions.	No restrictions.	Prohibit.
Additional deposits and sweeps from other accounts	No restrictions.	No restrictions.	No restrictions.
Time limit of interest rate guarantee	No restrictions.	No restrictions.	No restrictions.
Maximum maturity	No restrictions	No restrictions	No restrictions.
Enforcement of limitation on monthly withdrawals	Ex post review.	Ex post review.	
Definition of "month"	Calendar month or statement cycle.	Statement month (calendar or other).	
Restrictions on overdraft credit associated with account	No restrictions.	No restrictions.	Prohibit overdrafts.
Limitations on withdrawals	No limits on in-person, over-the-counter, messenger, mail, or ATM withdrawals.	Unlimited withdrawals by mail, telephone, messenger, or in person.	Let individual institution set own rules on in-person withdrawals.
Implementation of account	As soon as possible and no later than December 14.	No later than December 14.	
Other comments	Recommend optional account with unlimited third-party transfers (subject to transaction reserves).	Recommend optional account with unlimited third-party transfers (subject to transaction reserves).	

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Trade Association Comments on New Money Market Account

Features	Consumer Bankers Association	Conference of State Bank Supervisors	Thrift Institutions Advisory Council
General comments	Allow maximum flexibility to institutions.	Allow maximum flexibility to institutions.	Allow maximum flexibility to institutions.
Minimum initial denomination	Prefer none; otherwise urge phase down schedule or removal date.	Prefer none; otherwise no higher than $2,500.	Divided views. $2,500 (S&Ls) and $5,000 (MSBs).
Maintenance balance	No restrictions (if any maintenance to be set, suggest $2,500).		Same as initial minimum.
Maximum rate when account is below maintenance	No restrictions.		5 percent.
Minimum denomination for drafts	No restrictions.		No restrictions.
Require institutions to reserve right of notice of withdrawal	Allow but do not require.		Do not require.
Loans to meet initial minimum	No restrictions.		Prohibit.
Additional deposits and sweeps from other accounts	No restrictions (also allow sweeps to other accounts).		No restrictions (also allow sweeps to other accounts).
Time limit of interest rate guarantee	No restrictions.	No restrictions but monitor for possible abuses.	Prefer daily rate; 7-day maximum acceptable.
Maximum maturity	No restrictions.		7 days.
Enforcement of limitation on monthly withdrawals	Ex post review.		
Definition of "month"	Calendar or statement cycle of at least 4 weeks.		Calendar or statement month.
Restrictions on overdraft credit associated with account	No restrictions.		
Limitations on withdrawals	Unlimited withdrawals by mail, telephone, messenger, or in person.		Unlimited withdrawals by mail, messenger, or in person or by telephone and ATMs if permitted by Regulation D.
Implementation of account	Allow 30 days.		December 14.
Other comments			Recommend optional account with unlimited third-party transfers (subject to transaction reserves). Also, urge no premiums.

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Trade Association Comments on New Money Market Account

Features	U.S. League	National Savings and Loan League	NAMSB
General comments	Avoid restrictions that might limit appeal; critical that new account not be used to circumvent other ceilings.		Minimize danger of major shifts from passbook accounts.
Minimum initial denomination	No higher than $5,000 or lower than $2,500.	$5,000	$5,000
Maintenance balance	Same as minimum initial balance.	$5,000	$5,000
Maximum rate when account is below maintenance	5% for days below minimum.	Thrift passbook rate.	NOW account rate.
Minimum denomination for drafts	No restrictions.	No restrictions.	
Require institutions to reserve right of notice of withdrawal	Do not require.	Do not require.	Do not require.
Loans to meet initial minmimum	Prohibit.	No restrictions.	Prohibit.
Additional deposits and sweeps from other accounts	No restrictions.	No restrictions.	No restrictions.
Time limit of interest rate guarantee	7 days maximum.	No restrictions.	7 days maximum.
Maximum maturity			
Enforcement of limitation on monthly withdrawals	Self-policing to be monitored by regulatory agencies.	Give broadest latitude to institutions.	Give maximum flexibility to institutions.
Definition of "month"		Calendar months.	
Restrictions on overdraft credit associated with account	Discourage such overdrafts by not allowing preferential rate.	No restrictions.	
Limitations on withdrawals	Allow broadest latitude possible. Should not require any penalties.	No restrictions on payments to depositor, including via ATM's.	Include in-person withdrawals in limit of 3 preauthorized or automatic transfers.
Implementation of account	December 14 or 30 days after regs published.	December 14.	Numerous MSBs feel 30 days insufficient lead time.
Other comments	No restrictions on account maintenance, transaction, or other fees; no restrictions on compounding; no premiums allowed.	Recommend optional account with unlimited third-party transfers (subject to transaction reserves).	Eliminate 4-week moving average on 6-month MMC's.

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Trade Association Comments on New Money Market Account

	Minimum Initial Denomination	Maintenance Balance	Maximum Rate When Account Below Maintenance	Minimum Denomination for Drafts
American Bankers Association	No higher than $5,000.	Same.	NOW account rate.	No restrictions.
Reserve City Bankers	No higher than $2,500.	Leave up to institution.	NOW account rate.	No restrictions.
Independent Bankers Association	$5,000.	Same.	NOW account rate.	No restrictions.
Consumer Bankers Association	Prefer none, otherwise urge phasedown schedule.	No restrictions.	No restrictions.	No restrictions.
Conference of State Bank Supervisors	Prefer none, but no higher than $2,500.			
U.S. League	No higher than $5,000. No lower than $2,500.	Same.	5 percent.	No restrictions.
National Savings and Loan League	$5,000	Same.	Thrift passbook rate.	No restrictions.
NAMSB	$5,000	Same.	NOW account rate.	
Thrift Institutions Advisory Council	$2,500	Same.	5 percent	No restrictions.

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	Require Institutions to Reserve Right of Notice of Withdrawal	Loans to Meet Initial Minimum	Additional deposits and Sweeps from Other Accounts	Time limits on Interest Rate Guarantee
American Bankers Association	Require 7-day reservation clause.	No restrictions.	No restrictions.	No restrictions.
Reserve City Bankers		No restrictions.	No restrictions.	No restrictions.
Independent Bankers Association	Require 7-day reservation clause.	Prohibit.	No restrictions.	No restrictions.
Consumer Bankers Association	Do not require.	No restrictions.	No restrictions.*	No restrictions.
Conference of State Bank Supervisors				No restrictions, but monitor for abuses.
U.S. League	Do not require.	Prohibit.	No restrictions.	7 days maximum.
National Savings and Loan League	Do not require.	No restrictions.	No restrictions.	No restrictions.
NAMSB	Do not require	Prohibit.	No restrictions.	7 days maximum.
Thrift Institutions Advisory Council	Do not require	Prohibit	No restrictions.*	Prefer daily rate; 7-day maximum acceptable.

* Also allow sweeps to other accounts.

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	Enforcement of Limitation on Monthly Withdrawals	Restrictions on Overdraft Credit Associated with Account	Limitations on Withdrawals	Other Comments (See also Note below)**
American Bankers Association	Ex post review.	No restrictions.	No limits on in-person, mail, messenger, or ATMS.	Recommend optional account with unlimited third-party transfers (subject to transaction account reserve requirements).
Reserve City Bankers	Ex post review.	No restrictions.	No limits on in-person, mail, telephone, or messenger.	Same as above.
Independent Bankers Association		Prohibit overdrafts.	Institutions should set own rules on in-person.	
Consumer Bankers Association	Ex post review.	No restrictions.	No limits on in-person, mail, telephone, or messenger.	
Conference of State Bank Supervisors				
U.S. League	Self-policing.	Discourage by not allowing preferential rate.	Allow broadest latitude possible.	
National Savings and Loan League	Broadest latitude to institutions.	No restrictions.	No limits on payments to depositors, including ATMs.	Same as above.
NAMSB	Broadest latitude to institutions.		Include in-person in 3 per month limit.	
Thrift Institutions Advisory Council			No limits on in-person, mail, or messenger or by telephone/ ATMs/RSUs as per Reg D.	Same as above.

**Note: U.S. League and TIAC recommend no premiums; U.S. League recommends no restrictions on fees for transactions, etc.

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Summary of Public Comments
(other than trade associations)

General comments

Total of 1,227 comments received through November 3, with over 90 percent from depository institutions. New account overwhelmingly viewed as welcome opportunity to compete on level playing field, but concern expressed that DIDC might limit its attractiveness through excessive regulation.

Minimum initial denomination

No general consensus. Nearly 65 percent recommended a minimum of $3,000 or less, including 24 percent who favored no restrictions. At the other extreme, 40 percent of commercial banks and 44 percent of NSBs (but only 22 percent of S&Ls) urged a minimum of $5,000 (or more), commonly citing concern about the cost impact of internal shifts of funds into the new account.

Maintenance balance

Typically citing operational simplicity, over 60 percent of respondents recommend the same minimum and maintenance balances; about 25 percent favored letting institutions set their maintenance balances and the remainder favored a maintenance balance lower than the initial balance.

Maximum rate when account is below maintenance

About 65 percent of respondents felt a reduced rate should be required on balances below maintenance level, with the NOW rate, the institution's passbook rate, or a zero rate all mentioned as appropriate. Those advocating institutional discretion on this penalty rate noted that MMFs do not pay a lower rate on small balances.

Minimum denomination for drafts

About 56 percent of commercial banks, 54 percent of S&Ls, and 42 percent of MSBs preferred to leave the choice to the institution, with many noting that operationally a minimum draft size would be difficult to police. Those recommending a mandated minimum most frequently suggested $500.

Require institutions to reserve right to notice of withdrawal

Many of the 60 percent who opposed a requirement that they reserve the right to require 7-day's notice of withdrawal evidently misunderstood the request for comment as asking whether they favored a mandatory 7-day notice prior to any withdrawals. The 40 percent who approved seemed to understand that they would only be reserving the right to require 7 days' notice which could provide a buffer against extraordinary developments but which probably would never be invoked.

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Loans to meet initial minimum

Close to 3/4 of thrifts recommended that such loans not be permitted, while a slight majority of commercial banks favored allowing them. Prohibition was viewed as necessary to enforce meaningful minimum initial and maintenance balances. Comments in favor cited the absence of similar restrictions on MMFs.

Additional deposits and sweeps from other accounts

More than 86 percent of all respondents favored no restrictions on additional deposits and over 70 percent favored permitting sweeps, with commercial banks registering the lowest majority (65 percent).

Time limit of interest rate guarantee

Nearly 2/3 of commercial bank respondents and over 1/2 of S&Ls favored no limitation, while a majority of MSBs preferred some limit. Those in favor of a limit noted that its absence would effectively deregulate accounts that are presently subject to a rate ceiling. The most frequent specification for a limit was 7 days or less (43 percent) or over 7 days and less than 30 days (38 percent).

Maximum maturity

Over 90 percent of respondents favored none.

Enforcement of limitation on monthly withdrawals

Most respondents favored either ex post monitoring by the institution (62 percent) or allowing the institution to decide how to enforce compliance (25 percent). Only 13 percent favored strict enforcement via dishonoring checks. Considerable concern was expressed regarding operational difficulties in monitoring compliance. Nearly 70 percent indicated a preference for using date of payment rather than draft date as the basis for control.

Definition of "month"

Over 70 percent of respondents indicated a preference for using the statement cycle or institutional discretion, with the balance favoring use of the calendar month.

Restrictions on overdraft credit associated with an account

Citing maximum flexibility and competitive equity with MMMFs, 62 percent of respondents opposed any restrictions on overdraft credit arrangements.

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Limitations on withdrawals

Nearly 3/4 of respondents favored unlimited withdrawals by mail, telephone, messenger, or in-person. Many letters also expressed disagreement with the staff position which proposed regarding telephone transfers as pre-authorized transfers if made to third parties or to another deposit account of the same depositor.

Implementation date

About 1/2 of respondents indicated that 30 days was adequate lead time to implement the new account, with some conditioning their affirmative reply on the simplicity of the account. Those answering in the negative cited such operational problems as restrictions on the number of drafts and minimum balances, with smaller institutions especially concerned about such problems.

Other comments

Many respondents suggested that the DIDC consider an account that provides unlimited checking and is reservable as a transaction account.

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DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE
Washington, D.C. 20220

PRESS RELEASE

October 18, 1982

Money Market Deposit Account

In the attached Federal Register notice the Depository Institutions Deregulation Committee (DIDC) announces a 15 day public comment period on the new money market deposit account.

The Garn-St Germain Depository Institutions Act of 1982 directs the DIDC to authorize a new Federally insured account to be offered by commercial banks, savings and loan associations and mutual savings banks that is directly competitive with money market mutual funds.

The Garn-St Germain Act requires that this account: (1) have no limitation on the maximum rate of interest payable; (2) be in effect no later than 60 days from enactment of the Garn-St Germain Act; (3) not be subject to transaction account reserve requirements (as defined by the Board of Governors of the Federal Reserve System, as of August 1, 1982) even though no minimum maturity is required, and even though up to three preauthorized or automatic transfers plus three third-party transfers are permitted per month; and (4) be "directly equivalent to and competitive with money market mutual funds registered with the Securities and Exchange Commission under the Investment Company Act of 1940."

The Committee is requesting comments on features not specifically set forth in the Garn-St Germain Act; e.g., minimum initial denomination, maintenance balance, denomination of withdrawals, whether institutions should be required to reserve the right to require seven days' notice of withdrawal, and whether loans should be permitted to meet the minimum denomination requirement.

Attachment

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DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE

12 CFR Part 1204

[Docket No. D-0026]

Money Market Deposit Account

AGENCY: Depository Institutions Deregulation Committee.

ACTION: Proposed rulemaking.

SUMMARY: The Depository Institutions Deregulation Committee ("Committee") is required by the Garn-St Germain Depository Institutions Act of 1982 ("Garn-St Germain Act") to authorize a new insured deposit account, available to all depositors, to compete with money market mutual funds. The Garn-St Germain Act requires that this account: (1) have no limitation on the maximum rate of interest payable; (2) be in effect no later than 60 days from enactment of the Garn-St Germain Act; (3) not be subject to transaction account reserve requirements (as defined by the Board of Governors of the Federal Reserve System, as of August 1, 1982) even though no minimum maturity is required, and even though up to three preauthorized or automatic transfers plus three third-party transfers are permitted per month; and (4) be "directly equivalent to and competitive with money market mutual funds registered with the Securities and Exchange Commission under the Investment Company Act of 1940." No minimum denomination was set forth in the Garn-St Germain Act, although the Conference Report suggested it be no more than $5000. The Committee is requesting comments on features not specifically set forth in

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the Garn-St Germain Act; e.g., minimum initial denomination, maintenance balance, denomination of withdrawals, whether institutions should be required to reserve the right to require seven days' notice of withdrawal, and whether loans should be permitted to meet the minimum denomination requirement.

DATE: Comments must be received by (15 days from the date of publication).

ADDRESS: Interested parties are invited to submit written data, views, or arguments concerning the proposed rules to Gordon Eastburn, Acting Executive Secretary, Depository Institutions Deregulation Committee, Room 1058, Department of the Treasury, 15th Street and Pennsylvania Avenue, N.W., Washington, D.C. 20220. All material submitted should include the Docket Number D-0026 and will be available for inspection and copying upon request, except as provided in § 1202.5 of the Committee's Rules Regarding Availability of Information (12 CFR § 1202.5).

FOR FURTHER INFORMATION CONTACT: Alan Priest, Attorney, Office of the Comptroller of the Currency (202/447-1880); Joseph DiNuzzo, Attorney, Federal Deposit Insurance Corporation (202/389-4147); Rebecca Laird, Senior Associate General Counsel, Federal Home Loan Bank Board (202/377-6446); Paul S. Pilecki, Senior Attorney, Board of Governors of the Federal Reserve System (202/452-3281); or Elaine Boutilier, Attorney-Adviser, Treasury Department (202/566-8737).

LIST OF SUBJECTS IN 12 CFR Part 1204: Banks, banking.

SUPPLEMENTARY INFORMATION: The Depository Institutions Deregulation Act of 1980 (Title II of P.L. 96-221; 12 U.S.C. §§ 3501 et seq.) ("DIDA") was enacted to provide for the orderly phaseout

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and ultimate elimination of the limitations on the maximum rates of interest and dividends that may be paid on deposit accounts by depository institutions as rapidly as economic conditions warrant. Under DIDA, the Committee is authorized to phase out interest rate ceilings by any one of a number of methods including the creation of new account categories not subject to interest rate limitations or with interest rate ceilings set at market rates of interest.

Section 327 of the Garn-St Germain Act specifically requires the Committee to authorize a new insured deposit account, which "shall be directly equivalent to and competitive with money market funds." The Garn-St Germain Act prohibits any limitation on the maximum rate of interest payable on the new account. The Garn-St Germain Act also states that the account shall not be subject to reserve requirements on transaction accounts even though no minimum maturity is required and even though up to three preauthorized or automatic transfers and three transfers to third parties are permitted.

The Committee has solicited public comment on short-term deposits previously. After the June 25, 1981 meeting, the Committee requested comments on the desirability of authorizing a new deposit instrument with characteristics similar to money market mutual funds, although the Committee did not put forth a specific proposal at that time. 46 Fed. Reg. 36712 (July 15, 1981). After the September 22, 1981 meeting, the Committee requested comments on three specific proposals for short-term time deposits. 46 Fed. Reg. 50804 (October 15, 1981).

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One of the short-term accounts proposed in the October 15, 1981 notice was a $5000-minimum denomination NOW account, which is similar in concept to the account set forth in the Garn-St Germain Act. Consequently, the Committee has received comments on an instrument that possesses essentially all of the features of the congressionally-mandated account. Certain features are mandated by the Garn-St Germain Act and cannot be changed. However, some features were left by Congress to the Committee's discretion. Accordingly, comment is requested only on features not specified in the Act. Public comment is being requested in view of the interest expressed by competitors of depository institutions for an opportunity to comment on the features the Committee may designate.

The new account proposed by the Committee would have the following features as required by the Garn-St Germain Act and its legislative history: (1) no minimum maturity; (2) no interest rate ceiling; (3) an initial minimum denomination no greater than $5000; (4) allow up to three preauthorized or automatic transfers and three other third-party payments (including drafts) per month without being subject to transaction account reserve requirements; (5) available to all depositors; and (6) insured by the FDIC or FSLIC. The Committee is considering whether or not to impose a minimum initial denomination and/or maintenance balance of less than $5000 and requests comments on this feature. In connection with the minimum balance, the Committee may impose an interest rate limitation (such as the NOW-account rate) on accounts which fall below the minimum maintenance balance, and prohibit loans to meet the

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minimum initial denomination. The account will permit limited withdrawals to be made, and certain requirements are being considered by the Committee in regard to these withdrawals, e.g. (1) a minimum denomination on drafts; (2) unlimited withdrawals by the depositor by mail, telephone, messenger or in person, except that telephone transfers to third parties or another deposit account of the depositor would be regarded as preauthorized transfers; (3) require an institution to monitor on an ex post basis to determine compliance with the withdrawal limitations; and (4) require an institution to reserve the right to require seven days' notice prior to withdrawal. Although the maximum rate of interest paid on the account may not be limited, the Committee is concerned that institutions will circumvent the requirements on other time deposits by guaranteeing a rate of interest for a substantial time period, therefore the Committee is considering a limitation on the time period for which an institution may guarantee an interest rate. The Committee also may restrict overdraft credit arrangements offered in connection with this new account.

The Committee requests comments on the new account as proposed above, and particularly requests comments on the following issues:

(a) What should be the minimum initial denomination? (The Conference Report suggests that it be no more than $5000, and interest has been expressed in a $2500 minimum denomination.)

(b) Should the maintenance balance differ from the initial denomination? If so, what should it be?

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What would be the possible consequences of having no maintenance balance? Would it be operationally easier to have the maintenance balance the same as the minimum initial denomination?

(c) Should an institution be required to pay a lower rate of interest, such as the NOW-account rate, for accounts which fall below the maintenance balance?

(d) Should a minimum denomination be set for drafts? If so, should it be $100, $500, or some other amount?

(e) Should depository institutions be required to reserve the right to require seven days' (or some other time span) notice prior to withdrawal?

(f) Should loans be permitted to meet the minimum initial denomination?

(g) Should any restrictions be placed on additional deposits? Should sweeps <u>from</u> other accounts be permitted?

(h) Should the time period for which an institution can guarantee an interest rate be limited? If so, what should it be? Or should the account have a maximum maturity?

(i) How should the limitation on the number of withdrawals per month be enforced? For example, should the institution be required to monitor accounts on an <u>ex post</u> basis to determine compliance? How should "month" be defined for purposes of this limitation? Should the date of payment by the institution or the

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date written on the draft control for purposes of compliance with the three drafts per month limitation?

(j) Should any restrictions be placed on overdraft credit arrangements offered in connection with this account?

(k) Should unlimited withdrawals by mail, telephone, messenger, or in person be permitted to the depositor? (The staff believes that telephone transfers should be regarded as preauthorized transfers if the transfer is to a third person or to another deposit account of the same depositor.)

(l) Is thirty days (or some shorter or longer period) adequate lead time for depository institutions to implement operational changes for this account?

The issues set forth above are not intended to limit the area of comment. The Committee requests comments on those questions and on any other aspect of the account which the public wishes to address, particularly with respect to characteristics that would make this account "directly equivalent to and competitive with" money market funds.

The Committee has considered the potential effect on small entities of the proposal to establish a new deposit instrument, as required by the Regulatory Flexibility Act (5 U.S.C. § 603 et seq.). In this regard, the Committee's action, in and of itself, would not impose any new reporting or recordkeeping requirements. Consistent with the Committee's statutory mandate to eliminate deposit interest rate ceilings, this proposal would enable all

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depository institutions to compete more effectively in the marketplace for short-term funds. Depositors generally should benefit from the Committee's proposal, since the new instrument would provide them with another investment alternative that pays a market rate of return. If low-yielding deposits shift into the new account, depository institutions might experience increased costs as a result of this action. However, their competitive position vis-a-vis nondepository competitors would be enhanced by their ability to offer a competitive short-term instrument at market rates. The new funds attracted by the new instrument (or the retention of deposits that might otherwise have left the institution) could be invested at a positive spread and would therefore at least partially offset the higher costs associated with the shifting of low-yielding accounts.

The Committee is asking for comments for a 15-day period. This short comment period is made necessary by the fact that the Garn-St Germain Act requires the new account to be available within 60 days of enactment. Because the Committee desires to give the depository institutions adequate time to prepare and market the account, time for comment must be limited to allow time for compilation and consideration of the comments, a Committee vote on the features and publication of the final rule. Therefore, comments on this account should be submitted promptly.

By Order of the Committee, October 15, 1982.

G. Eastburn

Gordon Eastburn
Acting Executive Secretary

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date November 10, 1982

To Mr. Edward C. Ettin

From Michael Moran and Edward F. McKelvey

Subject: The New Money Market Deposit Account: A Preliminary Analysis of Potential Shifting and Earnings Effects

Summary

At your request, the staff has prepared several tables to help gauge the potential effects of the new account to be authorized by the DIDC at its meeting next Monday, November 15. Attention is focused on shifts of deposits from passbook savings accounts, since these represent the most costly transfers of funds, and on the amounts of new funds from outside the depository institutions that would be needed to offset the negative impact of passbook shifts on the earnings of these institutions. Shifts of funds from other accounts would have relatively small effects on earnings and thus are not considered in the analysis that follows.

In brief, the results indicate that even at current reduced level of interest rates all depository institutions could lose about $2 to $2-1/4 billion in annualized earnings (before taxes) if as much as 50 percent of the balances above $5,000 were to shift into the new account; this loss would be about evenly divided between thrift institutions and commercial banks (see table 4, page 9, second line of middle panel). The staff analysis also suggests that, under the same interest rate and shifting assumptions, additional pre-tax cost to depository institutions of setting the minimum denomination at $2,500 would be on the order of $3/4 billion (table 5, page 10).

These estimates are, of course, highly sensitive to both the assumed level of interest rates and the proportion assumed to shift out of passbook accounts, as illustrated in tables 4 and 5. They also depend to a lesser extent on the interest margin that institutions can earn on new funds, assumed

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in the analysis to be 150 basis points. The remainder of this memorandum reviews the basis for these very rough estimates.

Discussion

As shown in table 1, surveys conducted earlier this year indicate that substantial proportions of savings balances at banks and thrifts alike are in accounts with balances over $5,000--the highest minimum denomination being contemplated by the DIDC for the new account. These proportions range from a low of 60 percent at commercial banks to as much as 72 percent at mutual savings banks. In addition, about $50 billion, or roughly one-sixth of all passbook balances, are held in accounts between $2,500 and $5,000; as a fraction of total assets this figure is about 2 percent.

Table 2 presents "break-even" flows of funds that institutions would have to attract, under a variety of assumptions regarding interest rates on the new account, in order to offset the cost increase associated with each dollar shifting into the new account from passbook deposits; entries in the table should thus be read as amounts of new inflows, in dollars, per dollar shifted. Underlying these calculations is an assumption that new funds can be invested profitably at a spread of 150 basis points.[1] As the table indicates, if institutions were to pay 8 percent on the new account--a rather low figure--commercial banks would need $1.83 in new inflows per dollar shifting from passbooks in order to neutralize the loss in earnings; thrifts would need slightly less--$1.67--because of the 25 basis point differential

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1. While institutions can undoubtedly "earn" more than this by using the new funds to pay down high-cost advances or to acquire relatively high-yielding mortgages, they also will probably invest a significant amount of funds in liquid assets at virtually no gain. On balance we believe that 150 basis points is a reasonable average.

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currently permitted on passbook accounts. The table also illustrates how quickly the break-even ratio rises with increases in the assumed rate on the new account; for example, at 10 percent the corresponding figures are $3.17 and $3.00.

In table 3, the results of these calculations are converted into aggregate inflows that the institutions would have to attract in order to break even under the assumption that 50 percent of the "eligible" passbook deposits were to shift; for this purpose "eligible" passbooks have been defined as those over $5,000 or, in the lower panel, $2,500.[1] It is clear that, under the assumptions underlying table 3, substantial new inflows would be required if the institutions were to break even on the new account. For example, if they paid 9 percent on a $5,000 account, depository institutions would have to get $226 billion in new funds to offset the cost effects of losing half their larger passbook balances to the new account; with a $2,500 minimum on the new account this figure would be about 27 percent larger.

The figures in table 3 can be adjusted relatively easily for changes in the assumed percentage of shifts out of eligible passbooks. If 25 percent is thought to be an appropriate figure, for example, each entry should simply be divided by 2; in the illustration above the required new money would be $113 billion. For a 75 percent shifting assumption each figure should be multiplied by 1.5, producing a result of $339 billion in the case illustrated.

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1. It should be noted that this definition of "eligible" passbooks understates the actual amount that is at risk, quite possibly by a significant margin, in as much as individuals can combine resources from several different assets to meet whatever minimum requirement is imposed. This type of activity, though probably significant, is impossible to quantify and hence has been excluded from the analysis. In our view, the least unsatisfactory way to account for the possibility of such pooling is to assume that a relatively large proportion, like 50 percent, of "eligible" accounts shifts.

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All of the figures shown in table 3 are much larger than the new inflows that the staff anticipates the new account will generate in the first year of its existence. While projections of this sort are admittedly quite crude and subject to substantial error, the staff's current thinking is that total small time and savings growth will be boosted by about $50 billion (net of internal transfers to the new account) in the first 6 months after the account is introduced; by the end of 1983 this figure might rise a bit further to about $60 billion.[1]

Taking $60 billion as a best guess of the first year's new money flow, it would appear that earnings for all depository institutions (before taxes) would be about $2 to $2-1/4 billion lower than they otherwise would have been, using the 50 percent shifting, 9 percent interest rate scenario and assuming that the new account has a minimum denomination of $5,000 (see middle panel of table 4, second line). Of this amount, commercial banks would stand to lose about $1 billion or a bit more, while S&Ls and MSBs would each sustain industry-wide losses in the $1/2 billion range. In proportion to total assets, MSBs would experience the largest setback, reflecting a greater presence of passbooks with high balances in their deposit account structure.

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1. In arriving at this estimate, the staff has assumed that money market funds will be the primary source of transfers from outside the institutions. Indeed, many money fund investors--for example, institutional investors, cash management account holders, and the larger shareholders of general purpose and broker/dealer funds (with accounts over $100,000)--will not find the new account attractive, while inertia and preference for the money funds will limit the degree of shifting by other money fund clients. Flows from outside sources other than money funds--Treasury securities, corporate bonds, equities, and the like--probably would be quite small. Of course, many of the transfers that do take place in the first six months will represent portfolio reallocations; hence somewhat less will flow in during the next six months.

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A rough adjustment for the effects of setting the minimum denomination at $2,500 would be to increase the aggregate estimated loss by about $3/4 billion, about two-thirds of which would be sustained by commercial banks (see table 5, middle panel, second line). When compared to the increase in "eligible" deposits, this additional loss seems large. The reason for this is that a reduction in the minimum denomination from $5,000 to $2,500 is not likely to draw much additional new money to the depository institutions; average balances at money funds are already well above $10,000, even for household accounts, and not much is below $5,000. The main effect of the lower minimum is therefore to encourage more internal shifting and consequently to increase interest costs.

Finally, tables 6 and 7 give some evidence about the number and size of those institutions most vulnerable to the cost effects of passbook transfers. In table 6 insured savings and loans associations are arrayed by their capital adequacy as measured by the net worth ratio (rows) and by the proportion of total deposits held in the form of savings accounts (columns); table 7 presents similar data for mutual savings banks. Institutions that are in the most precarious position are those in the upper right-hand portion of each table; these are the institutions whose capital has already been depleted and which have a relatively large potential loss to sustain from passbook shifts. As the tables indicate, S&Ls are in somewhat better shape, relatively speaking, than MSBs. Few institutions will face immediate problems, but many will probably be affected seriously, especially MSBs. As shown in the last row of table 7, 225 MSBs, with nearly half the industry's assets, have more than 30 percent of their deposits in passbook accounts.

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Table 1

SIZE DISTRIBUTION OF PASSBOOK SAVINGS DEPOSITS
AT COMMERCIAL BANKS AND THRIFT INSTITUTIONS

Size category	Commercial banks[1/]	Savings and loans[2/]	Mutual savings banks[3/]	Total
	Percent of Total Passbook Savings			
less than 2,500	21.3	19.0	14.7	--
2,500 to 5,000	18.8	16.2	13.3	--
greater than 5,000	59.8	64.8	72.0	--
	Passbook Savings in Billions of Dollars[4/]			
less than 2,500	$33.7	$17.1	$6.9	57.7
2,500 to 5,000	29.8	14.6	6.2	50.6
greater than 5,000	94.6	58.5	33.7	186.8
Total	158.1	90.2	46.8	295.1
	Percent of Total Assets			
less than 2,500	1.9	2.5	4.0	2.2
2,500 to 5,000	1.7	2.1	3.6	2.0
greater than 5,000	5.5	8.6	19.5	7.2
Total	9.2	13.2	27.1	11.4

1. Based on a survey conducted by the American Bankers Association in February 1982.
2. Based on a survey conducted by the U.S. League of Savings Associations in Jaunary 1982.
3. Based on a survey conducted by the National Association of Mutual Savings Banks in February 1982.
4. The dollar volume of savings deposits in each size category was derived by applying the percentages from the top portion of the table to the passbook savings balances in September 1982.

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Table 2

BREAK-EVEN RATIO:
NEW DEPOSITS TO SHIFTED PASSBOOK SAVINGS DEPOSITS
REQUIRED FOR DEPOSITORY INSTITUTIONS TO BREAK EVEN[1]/
ON THE NEW MONEY MARKET DEPOSIT ACCOUNT

Interest rate on the New Account	Commercial bank break-even ratio	Thrift Institution break-even ratio
8.0%	1.83	1.67
9.0	2.50	2.33
10.0	3.17	3.00
12.0	4.50	4.33

1. The break-even ratios assume that new funds attracted can be reinvested at a 150 basis point spread. The rate currently paid on commercial bank passbook savings is 5.25 percent and the thrift rate is 5.5 percent.

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Table 3

DOLLAR VOLUME OF NEW FUNDS REQUIRED
TO BREAK EVEN IF 50 PERCENT OF ELIGIBLE
PASSBOOK SAVINGS DEPOSITS SHIFT[1/]

Interest rate on the New Account	Commercial Banks	Savings and Loans	Mutual Savings Banks	Total
	----------$5,000 minimum denomination----------			
8.0	86.6	48.8	28.1	163.5
9.0	118.3	68.2	39.3	225.8
10.0	149.9	87.8	50.6	288.3
12.0	212.9	126.6	73.0	412.5
	----------$2,500 minimum denomination----------			
8.0	113.8	61.0	33.3	208.1
9.0	155.5	85.2	46.5	287.2
10.0	197.2	109.7	59.9	366.8
12.0	279.9	158.3	86.4	524.6

1. The data presented in the table assumes that 50 percent of the eligible passbook savings deposits (i.e. those with balances higher than the minimum denomination on the new account) will shift. The data can be adjusted easily to show the effects of alternative assumptions. For example, if only 25 percent of eligible passbook deposits shift, the above data should be divided by 2; if 75 percent of the eligible passbook deposits are assumed to shift, the above data should be multiplied by 1.5.

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Table 4

ESTIMATED REDUCTION IN 1983 PRE-TAX EARNINGS UNDER ALTERNATIVE SHIFTING AND INTEREST RATE ASSUMPTIONS[1]/

Shifting and Interest Rate Assumption	Commercial Banks	Savings and Loans	Mutual Savings Banks	Total
	---------- Billions of Dollars ----------			
25 percent shifting				
8 percent	0.1	0.1	0.1	0.3
9 percent	0.3	0.2	0.2	0.7
10 percent	0.5	0.3	0.2	1.1
12 percent	0.9	0.6	0.4	1.9
50 percent shifting				
8 percent	0.7	0.4	0.3	1.3
9 percent	1.1	0.6	0.4	2.1
10 percent	1.5	0.9	0.6	2.9
12 percent	2.3	1.4	0.9	4.5
75 percent shifting				
8 percent	1.2	0.7	0.5	2.4
9 percent	1.8	1.1	0.7	3.6
10 percent	2.4	1.5	0.9	4.7
12 percent	3.6	2.2	1.3	7.1

1. All calculations are based on an account with a $5,000 minimum denomination; interest rates refer to those paid on the new account, which are assumed to be reflective of market conditions.

NOTE: Detail may not add to totals because of rounding.

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Table 5

ESTIMATED INCREASE IN 1983 PRE-TAX LOSSES
ASSUMING A $2,500 MINIMUM DENOMINATION

Shifting and Interest Rate Assumption	Commercial Banks	Savings and Loans	Mutual Savings Banks	Total
	---------- Billions of Dollars ----------			
25 percent shifting				
8 percent	0.2	0.1	*	0.3
9 percent	0.2	0.1	*	0.3
10 percent	0.3	0.1	0.1	0.5
12 percent	0.4	0.2	0.1	0.7
50 percent shifting				
8 percent	0.3	0.2	0.1	0.6
9 percent	0.5	0.2	0.1	0.8
10 percent	0.6	0.3	0.1	1.0
12 percent	0.9	0.4	0.2	1.5
75 percent shifting				
8 percent	0.5	0.2	0.1	0.8
9 percent	0.7	0.3	0.1	1.1
10 percent	0.9	0.4	0.2	1.5
12 percent	1.3	0.6	0.3	2.2

* - less than $50 million.

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Table 6

NUMBER OF FSLIC-INSURED S&Ls AND TOTAL ASSETS
BY NET WORTH RATIO AND SAVINGS DEPOSITS
TO TOTAL DEPOSIT RATIO[1/]
(June 1982)

Net Worth Ratio	Ratio of Savings Deposits to Total Deposits				
	less than 10%	10 to 20	20 to 30	greater than 30%	Total
less than 0.0	22	34	14	6	76
	0.9	7.8	2.1	1.7	12.5
0.0 to 1.0	54	43	25	12	134
	3.9	9.7	11.2	1.2	26.0
1.0 to 2.0	95	138	46	13	292
	9.9	42.8	17.4	1.5	71.6
2.0 to 3.0	129	270	95	27	521
	18.7	95.6	27.1	3.5	144.9
3.0 to 4.0	117	346	114	23	600
	12.6	123.3	27.7	3.8	167.4
4.0 to 5.0	107	303	102	39	551
	11.5	83.3	15.7	4.2	114.7
greater than 5.0	198	609	342	188	1,337
	9.0	82.4	34.5	12.5	138.5
Total	722	1,743	738	308	3,511
	66.4	445.0	135.8	28.3	675.5

1. The first entry in each cell is the number of FSLIC-insured S&Ls and the second entry is the total assets for that group of institutions.

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Table 7

NUMBER OF FDIC-INSURED MUTUAL SAVINGS BANKS
AND TOTAL ASSETS DISTRIBUTED BY NET WORTH RATIO
AND SAVINGS DEPOSITS TO TOTAL DEPOSIT RATIO[1/]
(June 1982)

Net Worth Ratio	Ratio of Savings Deposits to Total Deposits					
	less than 10%	10 to 20	20 to 30	30 to 40	greater than 40%	Total
1.0 to 2.0[2/]	--	--	3	5	--	8
			5.7	6.0		11.7
2.0 to 3.0	--	1	9	3	1	14
		0.2	8.5	3.7	*	12.5
3.0 to 4.0	--	--	11	14	1	26
			11.9	4.5	0.2	16.7
4.0 to 5.0	--	2	23	23	4	52
		0.4	37.9	12.9	1.6	52.7
5.0 to 6.0	--	--	17	35	7	59
			7.4	11.8	1.0	20.2
greater than 6.0	1	1	32	99	33	166
	0.3	0.5	12.8	22.6	7.1	43.3
Total	1	4	95	179	46	325
	0.3	1.0	84.2	61.4	10.0	157.0

*--less than 50 million.
1. The first entry in each cell is the number of FDIC-insured MSBs and the second entry is the total assets for that group of institutions.
2. There are no FDIC-insured MSBs with a net worth ratio below 1.0 percent.

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DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE
Washington, D.C. 20220

COMPTROLLER OF THE CURRENCY
FEDERAL RESERVE BOARD

FEDERAL DEPOSIT INSURANCE CORPORATION
NATIONAL CREDIT UNION ADMINISTRATION

FEDERAL HOME LOAN BANK BOARD
DEPARTMENT OF THE TREASURY

APPENDIX B

MEMORANDUM TO: Depository Institutions Deregulation Committee

FROM: Peter J. Wallison
General Counsel

SUBJECT: Legal Authority of the DIDC to Authorize a Deposit Account with Unlimited Transaction Capability

At its meeting on November 15, 1982, the Committee authorized depository institutions to offer accounts which, among other things, have no interest rate ceilings, limited transaction features, and are available to all categories of customers. In taking this action, the Committee indicated that at its next meeting it would consider authorizing a new account without limitations as to the number of transactions permitted to the depositor.

This memorandum addresses the Committee's authority to establish such an account for all categories of depositors. It is my conclusion that Congress provided the Committee with the authority to establish such an account.

DISCUSSION

Section 327 of the Garn-St Germain Depository Institutions Act of 1982 ("Garn-St Germain Act") requires the Committee to authorize a new deposit account that would be "directly equivalent to and competitive with" money market mutual funds, leaving it to the Committee to design an account that meets this

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standard. The language of Section 327 of the Act and its legislative history make clear that Congress considered certain characteristics to be essential for a truly competitive account -- no interest rate ceiling, a minimum initial denomination that does not exceed $5000, at least limited transaction features, and availability to all customers -- but Congress did not restrict the DIDC's authority to add other characteristics that would make the account "directly equivalent to and competitive with" money market mutual funds.

Thus, as was the case when the Committee voted to adopt a limited transaction account at its last meeting, the features of any account created by the DIDC under the mandate of Section 327 are ultimately defined by the DIDC's judgment as to what characteristics are necessary or appropriate to assure that depository institutions may compete effectively with money market mutual funds for the saver's dollar.

The new account authorized by the Committee at its last meeting included the following principal features: no interest rate ceilings, a minimum initial deposit requirement of not less than $2500, up to six transfers from the account (no more than three of which can be by check), and availability to all customers.

The issue to be considered by the Committee at this meeting is whether to authorize an additional account, with the same or similar features, which would have no limitation on the number of transactions that might be effected in the account. In my view, the Committee is authorized to create such an account if, in its

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judgment, an unlimited transaction feature would make such an account "directly equivalent to and competitive with" money market mutual funds.

The legislative history of Section 327 shows that Congress considered transaction features to be important for any truly competitive account, but was concerned that the reserve requirements ordinarily associated with transaction accounts would place depository institutions at a cost disadvantage in relation to money market funds. Thus, in suggesting to the DIDC what characteristics of money market funds make them strong competitors of depository institutions, the Senate Banking Committee noted:

> The bank regulatory agencies must take into account in the design of the new instrument the fact that the most competitive features of the money market mutual funds are their low minimum balances, their high liquidity in terms of withdrawals and their third party drafts, and the absence of reserve requirements on such funds (which gives them a cost advantage).

S. Rep. No. 97-536, 97th con. 2d Sess. 19 (1982).

To deal with the problem of reserve requirements, Congress simply provided an exemption from such requirements for accounts which do not permit more than six transfers, only three of which may be by check. But in so doing, Congress did not restrict the authority of the DIDC to create an account which, although subject to reserve requirements, would be competitive with money market mutual funds because it permitted more than six transactions.

In this connection, the DIDC might determine in its discretion that 12 transfers would attract a substantial

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number of customers who currently maintain accounts in money market funds, or that unlimited accessibility to the account by check -- a feature available to many money market fund shareholders -- is appropriate to attract customers who value this liquidity feature more highly than the rate of interest paid on the account.

If it draws these conclusions, or others which reflect its judgment as to the relevant characteristics necessary to make an acount "directly equivalent to and competitive with" money market mutual funds, the Committee is authorized to create an account with unlimited transaction capabilities.

There is no requirement in the Garn-St Germain Act or elsewhere that the new account with unlimited transaction capabilities be made available to less than all categories of customers. Although Section 706 of the Act did not extend eligibility for NOW accounts to business customers of depository institutions, this is not a significant indicator of Congressional intent with regard to the new account. First, the legislative history of Section 327 makes quite clear that availability of the new account to all customers was, in Congress' view, essential for a truly competitive account. As stated by the Senate Banking Committee:

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> It is the direction of this Committee that DIDC create a new deposit account for use by regulated depository institutions (banks, mutual savings banks, savings and loan associations) which: (1) shall be available to all types of depository institutions customers...

id.* To read section 706 as a limitation on this statement would be to allow an inference to overcome an unambiguous declaration of intention by the Committee of Congress that was principally responsible for drafting Section 327.

Second, and perhaps more important, at the time the Act was passed, Congress could not know whether the DIDC would determine that an unlimited transaction account available to all customers was appropriate in order to provide depository

---

* Universal availability was a consistent theme in describing the characteristics of the new account, as demonstrated by the following colloquy on the floor of the House:

> [Mr. Stanton] Now, if I may, Mr. Chairman, follow-up with one additional question concerning those eligible to open this new account to be created by the DIDC. We are aware that anyone--private individuals, partnerships, corporations, business organizations, public units, and so on -- are eligible to open a money market fund account. There are no limitations or restraints imposed as to who can own a MMMF account. In light of this, Mr. Chairman, I would again presume that it is the intent of the conferees that the DIDC, in authorizing this new account which is to be directly equivalent to and competitive with money market mutual funds should recognize that there are not to be any restrictions, limitations, or prohibitions imposed as to who is eligible to hold this new account.
>
> Mr. St Germain: Once again, the gentlemen is precisely right. It is the conferees clear intent that the DIDC is not to impose any limitations as to who is eligible to open this new account. 128 Cong. Rec. H. 8436 (Daily Ed. Oct. 1, 1981).

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institutions with an account "directly equivalent to and competitive with" money market mutual funds. If the DIDC were to determine that this characteristic is not appropriate for a competitive account, then a NOW account would continue to be an attractive alternative for those who are eligible to use it and place a high value on its unlimited transaction features. On the other hand, if the DIDC were to decide that unlimited transaction features would significantly increase the competitiveness of a new account created under the mandate of Section 327, it is authorized by Congress to add that feature to the new account. Under these circumstances, the NOW account would lose its viability, but there is nothing in the Act or its legislative history to suggest that the supersession of the NOW account by a new competitive account created under Section 327 of the Act was not fully consistent with Congressional intent.

Accordingly, in my opinion the DIDC is free to authorize an account under Section 327 of the Garn-St Germain Act which is available to all customers and permits unlimited transactions by depositors.

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Discount

Confusion about who is "primary dealer" - reporting or dealing

Critical of Fed reaction to warning

Solomon inaccurate in saying Fed did not know about Drysdale - Peter says many told Fed.

7 of Feds role - certainly have responsibility for banking system

Less active in surveillance than 5 years ago

How much was Drysdale doing before they separated? Peter thinks a lot - and regulation on broker-dealer didn't help.

Learn to say leave it to what to take initiative

PSA + GSDA

Thinks broad enough

Less Fed role or more "active" in reminding what of importance of "prudent credit"

Enforce through banking system, where we have regulatory authority.

Thinks Comark was not on broker line, reporting to Fed, etc.

Wouldn't have done business with them.

Toffee & Peter

active in PSA

Chairman + V.C.

GS part

Titz in GSA.

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Goldman tacks

1. Borrowing of securities & cash
2. Anonimity -
3. When issued - trading — extended in last year
4. Role of financing middleman - know who is on other side
5. Standing of firm
6. Margin

Guidelines -
Information

Primary Dealer Association

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Probably have to have a ceiling (and differential) Arrow Act.

New Short-Term Account

1. May be offered on either Time Open or Certificate basis.

7-31 day fixed or notice with one-day grace period.

2. Term - 7 day fixed maturity with one day grace period for withdrawals. Automatic renewal permitted. Interest rate set weekly. Depository institutions are also permitted to offer the account on a 7 day notice basis.

min. $20,000 average balance

3. Minimum Denomination - $20,000 initial and maintenance. (minimum daily balance)

no restriction

4. Eligibility - same as for savings account (including $150,000 maximum account size for corporations for Reg D and Q purposes).

have to be held

5. Additional Deposits - amounts deposited between maturity dates are initialized at next maturity date (maximum 13 day hold in fixed maturity mode).

6. Withdrawal and Early Withdrawal Penalty -

Same

- withdrawal at maturity of amounts above the minimum denomination without affecting the rate paid on the remaining funds.

Same

- withdrawal at maturity of amounts that bring the remaining balance below the minimum sets the rate on the remaining funds to the savings account rate.

loss of interest earned on amount withdrawn

- minimum early withdrawal penalty of loss of one week's interest ~~earned~~ on higher of $20,000 or amount withdrawn (and passbook rate on remaining funds if remaining balance falls below minimum). including ~~of~~ invasion of principal.

or no early withdrawal

$40-50 12-13% rate.

optional

- non-negotiable.

Same

7. Permitted Means of Withdrawal - include in person, by mail, by telephone instruction, by standing order.

.32 per $1000 per day

Same

8. Impermissible Means of Withdrawal - include by check and by automatic transfer triggered by balance in this or another account. (Additional deposits to the account triggered by balance in this or another account are also prohibited.)

loopholes same. secured loans permitted.

9. Loans to meet the minimum denomination and loans secured by the account are prohibited. There is the additional requirement that the overdraft rate on transaction accounts to which the balances in the proposed account are transferred at maturity may not be lower than the rate on such overdrafts for depositors that do not hold the proposed account.

Same.

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don't mention it.

10. Reserve Requirements - same as for time deposits.

11. Rate Ceiling of 50 basis points below the rate on the 91-day certificate (this implies a thrift differential) or 50 b.p. below 90-day bill rate (this implies no differential). The 50 b.p. is partially offset by the difference between quarterly compounding on the 91-day account and weekly, daily, or continuous compounding on the proposed account. The account would no longer be subject to a rate ceiling as of April 1, 1983.

Same as 91 day certificate. or no ceiling

if there's a differential it applies to IRA/Keogh, governments

May 1, 1983

12. Premiums should be prohibited or limited to two per depositor per year (in contrast to the current two per account per year).

Same

only applies if there is a ceiling.

13. Effective Date of September 1, 1982.

Same

ceiling & differential suspended when 91 day bill rate has been below 9% for 4 consecutive auctions.

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Proposed Short-Term Account

I. Rate:

- No ceiling or a ceiling with a differential in favor of thrifts (see attachment).

II. Denomination:

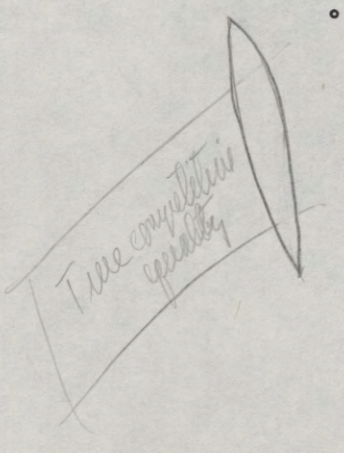
- Minimum daily balance of $20,000.
- If the average balance falls below the required minimum, the rate is reduced to the passbook rate.

III. Maturity:

- Range of 7 to 31 days.
- The form can be either an enforced notice or a specific term.
- The length of the grace period before automatic rollover is one business day.

IV. Provisions Regarding Additional Deposits:

- New deposits permitted at any time but must be held in the account for the full notice or maturity period.
- No sweeps into this new account from another account triggered by the level of the balance in any account.



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V. Notice and Withdrawal Provisions:

- No withdrawal by third-party draft drawn directly on this new account.
- No sweeps from this account to another account automatically triggered by the level of the balance in any account.
- The permissible means of delivering notice are: telephone or other telecommunication, mail or messenger, in person, and standing order.
- The permissible forms of payment are: check or cash to depositor, cash, draft or electronic transfer by institution to third parties, and transfer to any other account held by depositor.

VI. Minimum Early Withdrawal Penalty:

- Loss of interest that has been earned on the amount withdrawn back to the previous notice or maturity date, but no less than the amount that would have been earned for one-half the period.

VII. Miscellaneous Restrictions:

- Prohibit loans to depositors to meet required balance.
- Prohibit the use of this account as collateral for a loan.
- The overdraft rate on transaction accounts to which the balances in the new account are transferred may not be lower than the rate on such overdrafts for depositors that do not hold the proposed account.

VIII. Negotiability:

- Non-negotiable.

IX. Eligibility:

- No restrictions.

savings account

X. Effective Date:

- September 1, 1982.

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ATTACHMENT
(for an account with an indexed ceiling
and a differential)

I.a) Interest Rate Ceiling and Differential:

- 91-day Treasury Bill rate, auction average, bank discount basis for thrift institutions and 25 basis points less for commercial banks.

- Ceiling rate and differential eliminated on May 1, 1983 and suspended whenever the 91-day Treasury bill rate has been 9% or below for four consecutive Treasury bill auctions.

- Differential applies to all types of accounts, including IRA/Keogh and governmental unit deposits.

- Adjustment of the rate permitted at the discretion of the institution, but not less frequently than the maximum maturity or notice authorized for the account.

I.b) Compounding:

- Permitted without restriction.

I.c) Premiums:

- Limited to two per account holder per year.

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DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE
Washington, D.C. 20220

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

AGENDA

DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE

June 29, 1982

3:30 p.m.

Cash Room

Open Meeting

1. Consideration of Alternative Short-Term Deposit Accounts.

2. Consideration of Rules for Establishment of Interest Rates on Accounts Not Subject to Interest Rate Limitations.

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FHLB

MONEY MARKET ACCOUNT

Minimum Balance:	$20,000 as of 9/1/82 Reductions in minimum balance shall be accomplished on a phased-in schedule after enactment of legislation containing the provisions of Title I of S.1720. Subsequent to the enactment of such legislation the minimum balance shall be $15,000 as of 90 days after enactment, 10,000 as of 120 days after enactment, and 5,000 as of 150 days after enactment.
Maturity:	None
Interest Rate:	Daily interest may be paid based on the interest rate of the most recent 91-day Treasury bill auction and may be compounded daily for thrift institutions. The interest rate allowable for commercial banks shall be the 91-day Treasury bill rate less 25 basis points with daily compounding allowed. The differential shall be removed one year subsequent to the enactment of legislation containing the provisions of Title I of S.1720.
Maintenance of Balance:	No interest shall be paid on the account if it drops below the minimum specified level.
Transfers:	A maximum of three drafts or pre-authorized transfers per month. Dollar limitations to be specified by individual associations.
Withdrawal Penalty:	None
Reserve Requirement:	None (3% for nonpersonal)
Additional Deposits:	No limit
Eligibility:	All depositors
Effective Date:	9/1/82
Other:	No loopholes, No premiums

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FDIC

6/29/82

MONEY MARKET ACCOUNT

Minimum Balance:	$20,000 as of 10/1/82 $15,000 as of 1/1/83 $10,000 as of 4/1/83 $ 5,000 as of 7/1/83 $ 0 as of 10/1/83 Reductions in minimum balance after 10/1/82 subject to delay or rescission depending on experience with deposit flows and actions by Congress to deregulate thrift asset powers
Maturity:	None (14-day reservation notice as with present passbook accounts)
Interest Rate:	No ceiling (interest at passbook rate if balance drops below minimum)
Withdrawals:	No limit except no sweeps and only three third-party drafts per month (mandatory $25 charge per item for each draft beyond three). Telephone transfers, etc., permissible
Withdrawal Penalty:	None
Reserve Requirement:	None (3% for nonpersonal)
Additional Deposits:	No limit
Eligibility:	All depositors
Effective Date:	10/1/82
Other:	No loans to meet initial or maintenance balances

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Agenda Item 2 -- Establishment of Interest Rates on Accounts Not Subject to Ceilings

--In response to inquiries from depository institutions, the Committee is requested to determine the manner in which interest rates may be established or adjusted on deposit categories exempt from rate ceilings, i.e. the 3-1/2 year or 18 month IRA deposit.

--Under existing rules of the agencies, the deposit contract must state explicitly the specified rate or procedure for determining the rate to be paid.

--Depository institutions indicate that the current rule reduces their flexibility in adjusting rates on outstanding deposits not subject to rate ceilings. For example, they wish to retain the discretion to pay a bonus from time to time on outstanding balances or adjust the rate to meet competition.

--The memorandum proposes three options for the Committee's consideration:

  --Give institutions complete discretion in setting interest rates payable on such accounts. This option provides the maximum degree of discretion to institutions and would be most consistent with deregulation. This option was favored previously by Pratt, Isaac and Callahan.

  --Require institutions to specify in the deposit contract a minimum rate or the means of determining the rate, beyond which discretionary bonuses would be permitted. This option enables consumers to determine with certainty the minimum amount of interest they will receive and provide the depository institution with discretion to meet competition.

  --Require institutions to specify in the deposit contract a minimum rate or the means of determining the rate, beyond which no discretionary bonuses would be permitted. In addition, any variable rate must be based on a predetermined schedule or on an index over which the institution has no control or discretion. This option is most consistent with assuring that depositors will not be mislead into believing that the depositor will receive a bonus when the institution does not intend to pay one. It also assures that institutions will not be "forced" by depositors to pay higher rates on outstanding balances.

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Please Indicate Your Vote -- For deposit categories not subject to Federal interest rate limitations, depository institutions:

☐ 1. May retain complete discretion in establishing the interest rate and amount payable and are not restricted to using only rate indexes established for independent business purposes or indexes not under their control. 1/

☐ 2. Must establish a minimum interest rate or amount payable but may reserve the right to pay a bonus in a manner determined solely in the depository institution's discretion.

☐ 3. Must specify in the deposit contract a specific interest rate or a verifiable standard for determining interest rates or bonus amounts. In addition, the interest rate on a variable rate time deposit must be based on a predetermined schedule or on an index over which the depository institution does not have control or discretion.

_____
DIDC Member Signature

Attachment: Staff Memorandum

1/ Under state laws governing contracts, material terms such as the rate of interest generally would have to be stated and agreed upon in order to create a contract between the depositor and the depository institution.

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May 1982 Savings Account Balances

(Table 3-B June 28, 1982)

Commercial Banks	$160.5 B	5 1/4 %
Thrifts	190.4 B	
S&Ls	96.8	5 1/2 %
MSBs	47.3	5 1/2 %
CUs	46.2	no ceiling.

Market rate		At spread between market rate and passbook rate of	Earnings impact is CBs	S&Ls	MSBs
9 1/4-1/2	4	percentage points	$6.4 Billion	3.9	1.9
10 1/4-1/2	5		8.0	4.8	2.4
11 1/4-1/2	6		9.6	5.8	2.8
12 1/4-1/2	7		11.2	6.8	3.3
13 1/4-1/2	8		12.8	7.7	3.8

This weeks MMCD rate 13.669

91-day account rate 13.269 for thrifts

13.019 for CBs.

32 cents a day

1000

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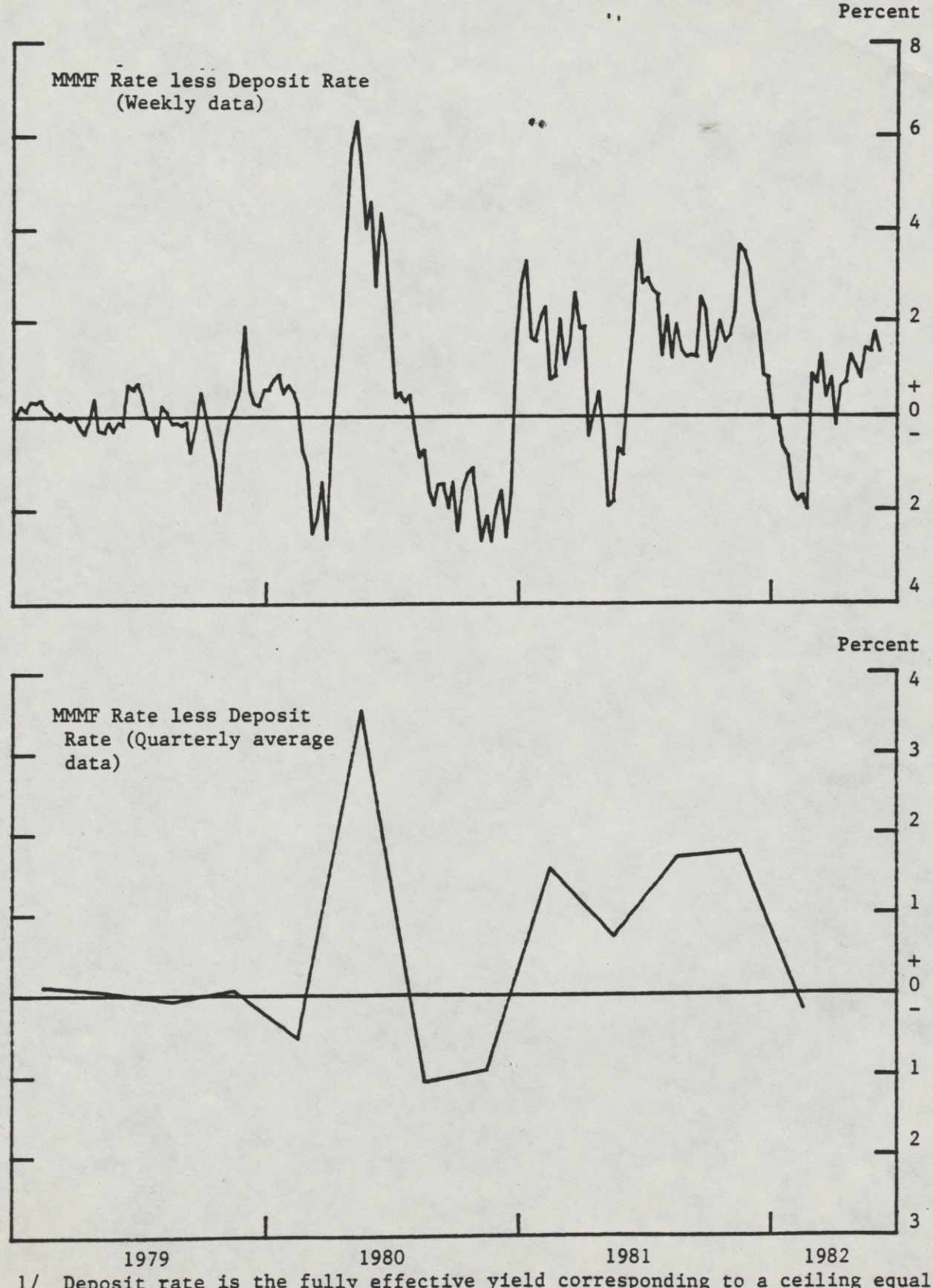
Chart 1

SPREADS BETWEEN YIELDS ON MMMFs
AND A HYPOTHETICAL SHORT-TERM DEPOSIT 1/



1/ Deposit rate is the fully effective yield corresponding to a ceiling equal to the 91-day Treasury bill rate, auction average discount basis.

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PROPOSED INVESTMENT ACCOUNT

Minimum Initial Deposit	$25,000 @ 20,000
Minimum Balance Maintained	$15,000
Maturity	7-31 day notice and/or maturity 1-day grace period
Interest Rate	No Ceiling (or) Ceiling: 91 day T-bill for thrifts Differential: -25 basis points for banks
Withdrawals	No limit on dollar size No withdrawals by draft
Withdrawal Penalty	Loss of interest earned
Reserve Requirement	None (3% for nonpersonal)
Additional Deposits	No limit ——— unlimited at 15,000
Eligibility	All depositors
Other	No loopholes Non-negotiable

Bill payer ?

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DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE
Washington, D.C. 20220

PRESS RELEASE

October 18, 1982

Money Market Deposit Account

In the attached Federal Register notice the Depository Institutions Deregulation Committee (DIDC) announces a 15 day public comment period on the new money market deposit account.

The Garn-St Germain Depository Institutions Act of 1982 directs the DIDC to authorize a new Federally insured account to be offered by commercial banks, savings and loan associations and mutual savings banks that is directly competitive with money market mutual funds.

The Garn-St Germain Act requires that this account: (1) have no limitation on the maximum rate of interest payable; (2) be in effect no later than 60 days from enactment of the Garn-St Germain Act; (3) not be subject to transaction account reserve requirements (as defined by the Board of Governors of the Federal Reserve System, as of August 1, 1982) even though no minimum maturity is required, and even though up to three preauthorized or automatic transfers plus three third-party transfers are permitted per month; and (4) be "directly equivalent to and competitive with money market mutual funds registered with the Securities and Exchange Commission under the Investment Company Act of 1940."

The Committee is requesting comments on features not specifically set forth in the Garn-St Germain Act; e.g., minimum initial denomination, maintenance balance, denomination of withdrawals, whether institutions should be required to reserve the right to require seven days' notice of withdrawal, and whether loans should be permitted to meet the minimum denomination requirement.

Attachment

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DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE

12 CFR Part 1204

[Docket No. D-0026]

Money Market Deposit Account

AGENCY: Depository Institutions Deregulation Committee.

ACTION: Proposed rulemaking.

SUMMARY: The Depository Institutions Deregulation Committee ("Committee") is required by the Garn-St Germain Depository Institutions Act of 1982 ("Garn-St Germain Act") to authorize a new insured deposit account, available to all depositors, to compete with money market mutual funds. The Garn-St Germain Act requires that this account: (1) have no limitation on the maximum rate of interest payable; (2) be in effect no later than 60 days from enactment of the Garn-St Germain Act; (3) not be subject to transaction account reserve requirements (as defined by the Board of Governors of the Federal Reserve System, as of August 1, 1982) even though no minimum maturity is required, and even though up to three preauthorized or automatic transfers plus three third-party transfers are permitted per month; and (4) be "directly equivalent to and competitive with money market mutual funds registered with the Securities and Exchange Commission under the Investment Company Act of 1940." No minimum denomination was set forth in the Garn-St Germain Act, although the Conference Report suggested it be no more than $5000. The Committee is requesting comments on features not specifically set forth in

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the Garn-St Germain Act; e.g., minimum initial denomination, maintenance balance, denomination of withdrawals, whether institutions should be required to reserve the right to require seven days' notice of withdrawal, and whether loans should be permitted to meet the minimum denomination requirement.

DATE: Comments must be received by (15 days from the date of publication).

ADDRESS: Interested parties are invited to submit written data, views, or arguments concerning the proposed rules to Gordon Eastburn, Acting Executive Secretary, Depository Institutions Deregulation Committee, Room 1058, Department of the Treasury, 15th Street and Pennsylvania Avenue, N.W., Washington, D.C. 20220. All material submitted should include the Docket Number D-0026 and will be available for inspection and copying upon request, except as provided in § 1202.5 of the Committee's Rules Regarding Availability of Information (12 CFR § 1202.5).

FOR FURTHER INFORMATION CONTACT: Alan Priest, Attorney, Office of the Comptroller of the Currency (202/447-1880); Joseph DiNuzzo, Attorney, Federal Deposit Insurance Corporation (202/389-4147); Rebecca Laird, Senior Associate General Counsel, Federal Home Loan Bank Board (202/377-6446); Paul S. Pilecki, Senior Attorney, Board of Governors of the Federal Reserve System (202/452-3281); or Elaine Boutilier, Attorney-Adviser, Treasury Department (202/566-8737).

LIST OF SUBJECTS IN 12 CFR Part 1204: Banks, banking.

SUPPLEMENTARY INFORMATION: The Depository Institutions Deregulation Act of 1980 (Title II of P.L. 96-221; 12 U.S.C. §§ 3501 et seq.) ("DIDA") was enacted to provide for the orderly phaseout

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and ultimate elimination of the limitations on the maximum rates of interest and dividends that may be paid on deposit accounts by depository institutions as rapidly as economic conditions warrant. Under DIDA, the Committee is authorized to phase out interest rate ceilings by any one of a number of methods including the creation of new account categories not subject to interest rate limitations or with interest rate ceilings set at market rates of interest.

Section 327 of the Garn-St Germain Act specifically requires the Committee to authorize a new insured deposit account, which "shall be directly equivalent to and competitive with money market funds." The Garn-St Germain Act prohibits any limitation on the maximum rate of interest payable on the new account. The Garn-St Germain Act also states that the account shall not be subject to reserve requirements on transaction accounts even though no minimum maturity is required and even though up to three preauthorized or automatic transfers and three transfers to third parties are permitted.

The Committee has solicited public comment on short-term deposits previously. After the June 25, 1981 meeting, the Committee requested comments on the desirability of authorizing a new deposit instrument with characteristics similar to money market mutual funds, although the Committee did not put forth a specific proposal at that time. 46 Fed. Reg. 36712 (July 15, 1981). After the September 22, 1981 meeting, the Committee requested comments on three specific proposals for short-term time deposits. 46 Fed. Reg. 50804 (October 15, 1981).

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One of the short-term accounts proposed in the October 15, 1981 notice was a $5000-minimum denomination NOW account, which is similar in concept to the account set forth in the Garn-St Germain Act. Consequently, the Committee has received comments on an instrument that possesses essentially all of the features of the congressionally-mandated account. Certain features are mandated by the Garn-St Germain Act and cannot be changed. However, some features were left by Congress to the Committee's discretion. Accordingly, comment is requested only on features not specified in the Act. Public comment is being requested in view of the interest expressed by competitors of depository institutions for an opportunity to comment on the features the Committee may designate.

The new account proposed by the Committee would have the following features as required by the Garn-St Germain Act and its legislative history: (1) no minimum maturity; (2) no interest rate ceiling; (3) an initial minimum denomination no greater than $5000; (4) allow up to three preauthorized or automatic transfers and three other third-party payments (including drafts) per month without being subject to transaction account reserve requirements; (5) available to all depositors; and (6) insured by the FDIC or FSLIC. The Committee is considering whether or not to impose a minimum initial denomination and/or maintenance balance of less than $5000 and requests comments on this feature. In connection with the minimum balance, the Committee may impose an interest rate limitation (such as the NOW-account rate) on accounts which fall below the minimum maintenance balance, and prohibit loans to meet the

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minimum initial denomination. The account will permit limited withdrawals to be made, and certain requirements are being considered by the Committee in regard to these withdrawals, e.g. (1) a minimum denomination on drafts; (2) unlimited withdrawals by the depositor by mail, telephone, messenger or in person, except that telephone transfers to third parties or another deposit account of the depositor would be regarded as preauthorized transfers; (3) require an institution to monitor on an ex post basis to determine compliance with the withdrawal limitations; and (4) require an institution to reserve the right to require seven days' notice prior to withdrawal. Although the maximum rate of interest paid on the account may not be limited, the Committee is concerned that institutions will circumvent the requirements on other time deposits by guaranteeing a rate of interest for a substantial time period, therefore the Committee is considering a limitation on the time period for which an institution may guarantee an interest rate. The Committee also may restrict overdraft credit arrangements offered in connection with this new account.

The Committee requests comments on the new account as proposed above, and particularly requests comments on the following issues:

(a) What should be the minimum initial denomination? (The Conference Report suggests that it be no more than $5000, and interest has been expressed in a $2500 minimum denomination.)

(b) Should the maintenance balance differ from the initial denomination? If so, what should it be?

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What would be the possible consequences of having no maintenance balance? Would it be operationally easier to have the maintenance balance the same as the minimum initial denomination?

(c) Should an institution be required to pay a lower rate of interest, such as the NOW-account rate, for accounts which fall below the maintenance balance?

(d) Should a minimum denomination be set for drafts? If so, should it be $100, $500, or some other amount?

(e) Should depository institutions be required to reserve the right to require seven days' (or some other time span) notice prior to withdrawal?

(f) Should loans be permitted to meet the minimum initial denomination?

(g) Should any restrictions be placed on additional deposits? Should sweeps <u>from</u> other accounts be permitted?

(h) Should the time period for which an institution can guarantee an interest rate be limited? If so, what should it be? Or should the account have a maximum maturity?

(i) How should the limitation on the number of withdrawals per month be enforced? For example, should the institution be required to monitor accounts on an <u>ex post</u> basis to determine compliance? How should "month" be defined for purposes of this limitation? Should the date of payment by the institution or the

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date written on the draft control for purposes of compliance with the three drafts per month limitation?

(j) Should any restrictions be placed on overdraft credit arrangements offered in connection with this account?

(k) Should unlimited withdrawals by mail, telephone, messenger, or in person be permitted to the depositor? (The staff believes that telephone transfers should be regarded as preauthorized transfers if the transfer is to a third person or to another deposit account of the same depositor.)

(l) Is thirty days (or some shorter or longer period) adequate lead time for depository institutions to implement operational changes for this account?

The issues set forth above are not intended to limit the area of comment. The Committee requests comments on those questions and on any other aspect of the account which the public wishes to address, particularly with respect to characteristics that would make this account "directly equivalent to and competitive with" money market funds.

The Committee has considered the potential effect on small entities of the proposal to establish a new deposit instrument, as required by the Regulatory Flexibility Act (5 U.S.C. § 603 et seq.). In this regard, the Committee's action, in and of itself, would not impose any new reporting or recordkeeping requirements. Consistent with the Committee's statutory mandate to eliminate deposit interest rate ceilings, this proposal would enable all

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depository institutions to compete more effectively in the marketplace for short-term funds. Depositors generally should benefit from the Committee's proposal, since the new instrument would provide them with another investment alternative that pays a market rate of return. If low-yielding deposits shift into the new account, depository institutions might experience increased costs as a result of this action. However, their competitive position vis-a-vis nondepository competitors would be enhanced by their ability to offer a competitive short-term instrument at market rates. The new funds attracted by the new instrument (or the retention of deposits that might otherwise have left the institution) could be invested at a positive spread and would therefore at least partially offset the higher costs associated with the shifting of low-yielding accounts.

The Committee is asking for comments for a 15-day period. This short comment period is made necessary by the fact that the Garn-St Germain Act requires the new account to be available within 60 days of enactment. Because the Committee desires to give the depository institutions adequate time to prepare and market the account, time for comment must be limited to allow time for compilation and consideration of the comments, a Committee vote on the features and publication of the final rule. Therefore, comments on this account should be submitted promptly.

By Order of the Committee, October 15, 1982.

G. Eastburn

Gordon Eastburn
Acting Executive Secretary

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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

DATE: June 18, 1982

TO: Depository Institutions Deregulation Committee

SUBJECT: Design of Short-Term Deposit Instrument

FROM: DIDC Staff*

At its March 22 meeting, the Committee adopted a long-run strategy for deregulating deposit rate ceilings. At the same time, the Committee expressed its continuing concern about the ability of depository institutions to compete with money market mutual funds (MMMFs) and, particularly, about the weakness of deposit flows to thrift institutions. In view of this concern, the Committee adopted the 91-day, $7,500 minimum time deposit with a 25 basis point differential for thrifts. The Committee also directed the staff to continue efforts to design a shorter-term instrument to enhance the ability of depository institutions to compete with MMMFs. This memorandum reviews the basic issues involved in designing such an instrument, including monetary policy considerations, and then discusses in more detail the possible features that the Committee may wish to consider.[1]

I. The Fundamental Issues

Since June 1981, when the Committee first solicited public comment on this matter, total assets of MMMFs have grown from $127 billion to $203

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* This memorandum was prepared primarily by the staff of the Federal Reserve Board (Messrs. Ettin, Schwartz, McKelvey, and Ms. Glassman).

1/ These issues have been discussed in greater detail in previous staff memoranda; see particularly, "Short-Term Instrument Proposals," March 15, 1982.

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billion (roughly three-fifths of which is held by household investors). During the same period, total small-denomination time and savings deposits increased from $1,171 billion to $1,242 billion; savings deposits, however, declined from $365 billion to $347 billion. In order to maintain their customer base, many banks and thrifts are attempting to pay depositors a market rate of interest on short-term funds through a variety of sweep arrangements, but unless they are able to offer a short-term instrument directly depository institutions will continue to lose savings deposits to MMMFs, and sweep arrangements will continue to proliferate.

The Committee's efforts to design a competitive short-term instrument may be hampered by the consideration of two issues. One of these is that a new short-term account will draw funds from savings accounts, thereby raising institutions' costs. As indicated previously to the Committee, at current market rates each dollar shifted from a savings account to a short-term market rate account would require the institutions to attract $3 to $4 of external funds in order to break even.[1]

The second issue, of concern to the Federal Reserve staff, is the effect that any new instrument would have on monetary policy. The Federal Reserve regards the maintenance of a distinction between transaction and other accounts as essential to its conduct of monetary policy. If the new account were to blend transactions and savings features, it would further blur the distinctions among accounts, making it more difficult to define and control the money supply; this would be true even if the new account were subject to

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1/ An extensive discussion of break-even analysis and related issues can be found in the previously cited staff memorandum, "Short-Term Instrument Proposals," March 15, 1982, pp. 14-19.

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transaction account reserve requirements. On the other hand, regardless of any restrictions which the Committee may impose on this account, the conduct of monetary policy will continue to be complicated as nondepository institutions provide savers with instruments that combine transactions and savings features. Currently, under the Board's Regulation D, any deposit instrument with a maturity or required notice period of less than 14 days, or any account that can be used ordinarily to pay third parties, is subject to transaction account reserve requirements.[1] The Board's statutory authority would permit it to shorten the 14-day maturity break to accommodate a new time account, so long as that account had limited transaction features; this would make the account eligible for time deposit reserve requirements.[2] The Committee is therefore faced with the difficult task of designing an instrument which can effectively compete with other market rate instruments, such as MMMF shares, but which minimizes savings deposit outflows and, to the extent practicable, takes into account the Federal Reserve's monetary policy considerations.

1/ In particular, the Federal Reserve Board now imposes transaction reserve requirements on (1) any account with a maturity or required notice period of less than 14 days, (2) any account on which a draft can be drawn--all demand deposits, NOWs, share drafts, and similar "other checkable deposits," (3) automatic transfer accounts, and (4) any account on which more than three monthly preauthorized or telephone transfers can be made. The Federal Reserve has also asked Congress for authority to extend reserve requirements to MMMFs that serve as the functional equivalent of transactions accounts.

2/ Under the Monetary Control Act, savings deposits and nontransferable time deposits held by persons are not reservable, while transferable time deposits and time deposits held by other than natural persons are subject to a reserve requirement of zero to 9 percent; the Board's current reserve requirement on such time deposits generally is 3 percent. Even if the Board adopted a zero percent reserve requirement on any new account, member banks would still be subject to a small (and declining) reserve requirement on the aggregate of their time and savings deposits during the phase-down period of reserve requirements under the Monetary Control Act.

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II. Design of the Instrument

The balance of this memorandum discusses the characteristics that a new short-term instrument might have, taking into account the above considerations. The key variables are the minimum denomination, maturity, and interest rate; a number of other features are also presented for the Committee's consideration. In addition, the Committee should be aware that limitations placed on the new instrument to reduce costs and facilitate monetary policy will also result in operational complexities for institutions. Attachment A summarizes the decision variables for the new instrument.

Minimum Initial Deposit. A large minimum balance requirement would minimize the potential for internal shifting from savings accounts, but would make the new instrument less competitive as well.[1] The staff believes that an initial minimum denomination on the order of $10,000 to $25,000 would be likely to prevent a large amount of internal deposit shifts. In determining the minimum initial deposit, the Committee may also wish to keep in mind: (1) the possibility of future adjustments in the minimum deposit requirement as information develops about internal deposit shifts, and (2) the desirability of reducing pressure on institutions to offer sweep accounts to MMMFs and retail repurchase agreements, many of which have been based on smaller denominations.

1/ A substantial proportion of savings deposits are in accounts with high balances. In December 1981, the FDIC indicated that 75 percent of savings account balances at MSBs were in excess of $5,000 and 41 percent were in excess of $15,000. These results were similar to a February 1982 survey conducted by the National Association of Mutual Savings Banks. In August 1980, the FHLBB indicated that 70 percent of the funds in regular savings accounts at S&Ls were in accounts with balances in excess of $5,000 and 45 percent were over $10,000. A small sample survey by the American Bankers Association in March 1982 indicated that at commercial banks about 60 percent of savings deposit balances were in excess of $5,000 and 38 percent were in excess of $10,000. The latter survey also indicated that almost three-fourths of total NOW balances were in excess of $5,000 and almost half were in excess of $10,000.

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Minimum Subsequent or Maintenance Balance. To accommodate occasional withdrawals, the Committee may wish to consider establishing a minimum maintenance balance lower than the initial deposit requirement. MMMFs typically permit shareholders to maintain balances below the initial balance requirement. A similar provision for the new instrument, however, would be tantamount to reducing the initial balance requirement for those depositors in a position to meet it by borrowing or temporarily rearranging assets. Moreover, considerations of simplicity and consistency with minimum balance requirements for other deposit accounts suggest that the maintenance balance on the new instrument be the same as the initial minimum.

In order to determine if withdrawals have reduced the balance in the proposed account below the required minimum, the Committee must specify the period over which the minimum is to be maintained. The Committee could require that the minimum balance be maintained as an average over some interval (e.g., a week) or that it be met at all times. For accounts failing to meet this requirement, however defined, the Committee could stipulate that they be closed or, alternatively, that the rate paid on the remaining balance not exceed the applicable savings deposit ceiling. Institutions would, of course, be free to impose more restrictive provisions.

Maturity. To the extent that savings account holders place a high value on liquidity, requiring the proposed new account to have a fixed maturity or required notice period, even if it were short, might limit internal shifting from savings accounts. The resultant illiquidity compared to MMMFs might be offset by the convenience and insurance of the deposit instrument. Moreover, the Federal Reserve staff indicates that the shorter the maturity the greater are its monetary policy concerns. Therefore, the Committee staff suggests two

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options: (1) a 7-day instrument, or (2) in order to provide flexibility to issuing institutions, authorization of an instrument with any maturity between 7 and 31 days, or perhaps between 7 and 90 days.[1]

Whatever the maturity selected, the institutions could be permitted to offer the account in two versions: (1) a time deposit open account (which has no specific maturity) with an enforced notice requirement before withdrawal equal to the period selected, or (2) a time deposit with specific maturity, the balance of which would be automatically rolled over (after perhaps a 1-day grace period) if the depositor did not instruct otherwise. Discussions with depository institutions suggest a wide range of opinion regarding the operational difficulties of a short-term notice account; some can handle such an account with little difficulty, while others can do so only at great inconvenience. Authorizing both versions would permit greater flexibility to individual institutions.

Rate. There are several arguments in favor of and against imposition of a rate ceiling on any new deposit. The major arguments for a ceilingless account are:

(1) a ceiling might limit the competitiveness of the account;

(2) one objective of the DIDC is to remove all deposit rate ceilings by 1986;

(3) the available evidence suggests that institutions do not price irrationally;

1/ A specific or maximum maturity (as opposed to a minimum maturity) is nescessary if the Committee does not wish to deregulate all ceilings for deposits equal to or above the proposed minimum denomination. In March, the Committee adopted a deregulation schedule based on maturity which would effectively be superseded for deposits above the minimum denomination on the new account unless a specific or maximum maturity were adopted.

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(4) as compared to an account with a market-indexed ceiling, a ceilingless account will not further exacerbate internal shifts from savings accounts, since the savings account ceiling is so far below the market rate;

(5) there is evidence that, in the market for competitive short-term instruments, virtually all issuers pay the ceiling rate and if there were no ceiling some institutions might pay less and some more than what would have been the ceiling rate; and

(6) institutions need the flexibility in the rates they can pay, especially in the early months of the new instrument, to regain depositors lost to MMMFs and other instruments.

The major arguments for imposing an indexed ceiling are:

(1) because of MMMFs, the competition for short-term deposits may be so intense as to make irrelevant the historical experience that irrational pricing has not occurred in other maturity categories;

(2) the operating losses of thrifts may necessitate restraint of rate competition in the short run; and

(3) a ceiling would be necessary if the Committee intends to establish a rate differential between banks and thrifts.

If the Committee chooses to impose an interest rate ceiling, the ceiling should move fairly closely with market rates to make the account competitive. There are several other issues that the Committee would need to address, including the choice of a base rate (e.g., 91-day bill rate), the relationship of the ceiling to the base rate, the frequency with which the ceiling would change, and compounding provisions. These matters are discussed more fully in the appendix.

Rate Differential. In deciding whether to impose a rate ceiling and whether to establish a rate differential for thrifts, the Committee may wish to review its objectives in adopting the 91-day account at the March 22 meeting and its purpose in directing the staff to prepare additional short-term deposit proposals. As noted earlier, the Committee adopted the 91-day account to

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enhance the competitive posture of depository institutions vis-a-vis MMMFs, and it imposed a rate differential to enhance thrift deposit flows which were especially weak compared to commercial banks. Thrift deposit flows have improved subsequent to the May 1 introduction of the 91-day account with a differential, although the extent to which the 91-day account is responsible for that improvement cannot be determined.

It should be noted that, for those depositors in a position to meet the minimum denomination balance requirement, the proposed account may be equally or more attractive to consumers in most respects than is the 91-day account, depending on the other specific features chosen by the Committee. If so, the new account may attract funds that otherwise would have gone to the 91-day account, and the intended effects of the Committee's action in establishing a differential on the 91-day account may be diminished considerably. If a differential is imposed, the Committee should also consider whether it will apply to IRA/Keogh and public unit deposits.

Additional Deposits. Flexibility to accept additional deposits to the proposed new account would make it more competitive with MMMFs, but would raise the problem of how to assure that the additional funds remain on deposit for the prescribed maturity or notice period. With regard to fixed-maturity term deposits, the simplest approaches would be either to permit additional deposits only at the time of renewal or to allow additional deposits at any time. With respect to additional deposits, the Committee could permit such funds to be withdrawn at the next scheduled maturity date or, alternatively, could require the issuing institutions to establish procedures assuring that each additional deposit remains in the account for at least the prescribed

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maturity period.[1] This latter approach might be particularly appropriate for notice accounts, where the timing of notices for specific withdrawals introduces additional complexities.[2] For monetary policy reasons, the Federal Reserve staff recommends that the Committee not permit additional deposits to the proposed new account if such deposits are triggered automatically by the level of balances maintained in this or any other account.

Withdrawals. The staff recommends no regulatory prohibition on the size or number of withdrawals from the proposed new account, provided that the funds to be withdrawn have satisfied the minimum maturity or notice period. For notice accounts, once the institution has received notification, withdrawals could occur only after the specified number of calendar days has passed. Institutions would have to require at least the minimum notice, which could be given by telephone or other telecommunication, mail or messenger, in person (over-the-counter or through an ATM), or by standing order. For term accounts, withdrawals

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1/ Examples of acceptable procedures for fixed maturity accounts include, but are not limited to, the following:

(1) Each deposit would re-initialize the maturity of the original deposit.
(2) Each deposit would be subject to "first-in-first-out" accounting to assure that each additional deposit was maintained for the term of the account.
(3) An institution would be permitted to set up an "accounting cycle" equal to the original term of the offered account. New deposits received after the accounting cycle had begun would be regarded as maturing at the end of the next complete accounting cycle. In effect, each deposit would be on "hold" until the end of the following cycle.

2/ Examples of acceptable procedures for notice accounts include, but are not limited to, the following:

(1) Any additional deposit would cancel any notice to withdraw that had already been received, unless that notification called for a longer remaining interval than the minimum notice period.
(2) "First-in-first-out" accounting to assure that each deposit would be maintained for at least the minimum notice period.
(3) Establishment of an accounting cycle equal to the notice interval. For funds received after the beginning of an accounting cycle, notice of withdrawal could be given only at or after the beginning of the next accounting cycle. In effect, the opportunity to give notice on any particular deposit would be deferred until the beginning of the next accounting cycle.

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could be made by any of the same methods. Any funds not withdrawn by the end of the grace period would automatically roll over.

In view of its monetary policy concerns, the Federal Reserve staff believes that the Committee should not authorize any new short-term account that can be used in connection with third-party payments. Thus, even though such an approach would limit the attractiveness of a new instrument relative to MMMFs, the Federal Reserve staff suggests that the Committee prohibit both third-party negotiable drafts that can be drawn directly on the account and the automatic triggering of deposits and transfers by changes in balances of this or any other account. The Federal Reserve staff would not object, however, to allowing the depositor to initiate unlimited deposits, transfers, or payments by telephonic notification or standing instructions, so long as such transactions were in compliance with minimum maturity or notice period provisions.

Early Withdrawal Penalty. In view of the short maturity or notice on the proposed account, the Committee could prohibit early withdrawals under any circumstances. This approach would eliminate the need for early withdrawal penalties. If the Committee chose instead to authorize early withdrawals, it might establish either of the following penalties: (1) loss of earned interest (as adopted on the 91-day account) or (2) the standard penalty (loss of interest that would have been earned if held to maturity, which could require invasion of principal).[1] Once again, institutions could adopt a more restrictive penalty or prohibit early withdrawals altogether.

1/ Either of these penalties could be relatively small for a partial withdrawal since the number of days for which interest would be forfeited would be small owing to the short-term nature of the account.

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Miscellaneous Restrictions. The staff recommends that the Committee consider whether to prohibit loans to depositors that are designed to help depositors meet initial or maintenance balances. If such loans were permitted they would undercut the purpose of these requirements. A second issue relates to overdraft privileges, which would still be permissible on NOW or demand deposits to which the new account is transferable. In order to prevent devices designed to circumvent the minimum maturity or notice requirements, however, the Committee may wish to consider requiring that the rate charged on such overdrafts be substantially equal to the rate charged for depositors that do not hold the proposed account.

Eligibility. The staff recommends that depository institutions be permitted to offer the proposed new account to all depositors.

Effective Date. In order to provide sufficient time for institutions to plan marketing strategies and redesign systems, the staff recommends that the effective date of any new instrument be September 1, 1982, about two months after announcement of the Committee's decision. The staff believes that further public comment on this instrument is not necessary because the terms of the proposed deposit were the subject of an extensive public comment period previously conducted by the Committee, and the Committee's decision as to the specific characteristics of the proposed deposit would be within the scope of the Committee's previous proposals and public comments received to date.

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Attachment A

SUMMARY OF DECISION VARIABLES FOR A
PROPOSED SHORT-TERM DEPOSIT ACCOUNT

I. Rate

1. No ceiling.
2. Indexed ceiling with no differential in favor of thrifts (see Attachment B if this option is selected).
3. Indexed ceiling with a differential in favor of thrifts (see Attachments B and C if this option is selected).

II. Denomination

1. Initial minimum balance.
2. Maintenance minimum balance.
3. Period over which maintenance balance is to be calculated.
   a. 1 day.
   b. 1 week.
   c. 1 month.
   d. Period equal to maturity (or notice period) of the account.
   e. Institutions' choice of above.
4. Action to be taken if balance falls below minimum.
   a. Rate reduced (e.g., to applicable passbook ceiling or to zero) until new deposits bring balance up to the minimum maintenance balance.
   b. Account must be closed and remaining balance must be paid to depositor or transferred to another account of the depositor; initial minimum balance would be required to re-open account.

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III. Maturity

1. Specific (e.g., only 7 days) or a permissible range (e.g., 7 to 31 days or 7 to 90 days).
2. Form: enforced notice, specific term, or both.
3. For term accounts, the length of the grace period (e.g., 1 business day) before automatic rollover.

IV. Provisions Regarding Additional Deposits

1. For fixed-maturity accounts.
   a. New deposits permitted only at maturity (or by the end of the grace period).
   b. New deposits permitted without re-initializing the maturity.
   c. Any procedure, including but not limited to the above, that assures that each new deposit remains in the account for at least the prescribed maturity period.
2. For notice accounts: any procedure that assures that additions to the account are maintained for at least the notice period.
3. Sweeps into the proposed account from another account.
   a. Permitted.
   b. Prohibited.

V. Notice and Withdrawal Provisions

1. Possible restrictions.
   a. Amount withdrawn must have remained on deposit for required maturity or notice period (notice period measured from time institution receives notification).
   b. No withdrawal by third-party draft drawn directly on the proposed account.

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c. No sweeps to another account automatically triggered by the level of the balance maintained in the new account or any other account.

2. Permissible means of delivering notice.

a. Telephone or other telecommunication.

b. Mail or messenger.

c. In person (including ATM).

d. Standing order.

3. Permissible forms of payment.

a. Check or cash to depositor.

b. Cash, draft, or electronic transfer by institution to third parties.

c. Transfer to any other account held by the depositor.

VI. Early Withdrawal Penalty

1. Early withdrawal prohibited.

2. Early withdrawal permitted but with penalty of:

a. Loss of earned interest.

b. Loss of interest that could have been earned if funds withdrawn had been held to maturity (or for notice period), requiring invasion of principal.

VII. Possible Miscellaneous Restrictions

1. Prohibit loans to depositors to meet initial or maintenance balances.

2. Require that overdraft rate on NOW or demand deposit accounts to which the balances in the new account are transferable not be substantially lower than the rate on such overdrafts for depositors that do not hold the proposed account.

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3. Prohibit transferability and/or negotiability.

4. Prohibit loans to the account holder that use the account as collateral. (Under existing regulation, minimum loan rate would be 1 percent over the rate being paid on the deposit.)

VIII. Eligibility of Depositors

1. No restrictions.

2. Limited to those eligible for NOW accounts (i.e., individuals and certain nonprofit organizations).

3. Limited to individuals only.

IX. Effective Date

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Attachment B

SUMMARY OF DECISION VARIABLES IF AN INDEXED CEILING
IS IMPOSED ON THE PROPOSED SHORT-TERM INSTRUMENT

I. Base Rate (e.g., the 91-day bill rate auction average, discount basis).

II. Relationship of the Ceiling Rate to the Base Rate

A. Spread from base rate.

B. 4-week averaging option, as on MMC.

III. Frequency of Changes in Ceiling Rate

IV. Adjustment of Rates Payable on Existing Accounts to Ceiling Changes

A. Allow institutions either to adjust to the new ceiling or maintain the rate established at the time the account was opened or rolled over.

B. Require institutions to keep the rates on existing accounts fixed until they roll over.

C. Require institutions to reduce the rates paid on existing accounts if the ceiling falls before the account matures or the notice period has expired.

V. Compounding

A. Permit without restriction.

B. Limit compounding period to maturity of account or length of enforced notice period.

VI. Miscellaneous Issues

A. May institutions offer RPs to future or current holders of the new deposit at a rate in excess of that offered to other customers?

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B. May premiums be offered on the account--if so, existing rule (i.e., two per account per year), at each rollover period, or no more than, say, four times a year?

C. May fees be paid to third party brokers for this account?

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Attachment C

SUMMARY OF ADDITIONAL DECISION VARIABLES IF A DIFFERENTIAL IS IMPOSED ON THE CEILING RATE FOR THE PROPOSED NEW SHORT-TERM INSTRUMENT

I. Size of Differential (e.g., thrifts can pay 25 basis points more than commercial banks).

II. Duration of Differential

A. Permanent.

B. Temporary, e.g., one year.

III. Conditions Under Which Differential is Eliminated (e.g., eliminated when base rate is below 9 percent for four consecutive weeks and reimposed when base rate exceeds 9 percent for 4 consecutive weeks).

IV. Applicability of Differential to Special Types of Deposits

A. IRA/Keogh deposits.

B. Governmental unit deposits.

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APPENDIX

ISSUES RELATING TO DETERMINATION OF A CEILING RATE

If the Committee imposed an indexed ceiling--with or without a differential--it would have to address several additional issues. These include: the choice of a base rate, the relationship of the ceiling to the base rate, compounding provisions, the frequency with which the ceiling rate changes, and whether rates payable on existing account balances may be adjusted when the ceiling changes.

The staff would recommend using the 91-day bill rate (auction average, discount basis) as the base rate, with or without any 4-week averaging adjustment such as occurs on the MMC. The ceiling rate could then be set above, equal to, or somewhat below the base rate.

A major consideration in establishing a ceiling is the relationship between the ceiling and yields on MMMFs and other open market instruments. The insurance and convenience aspects of a deposit instrument are valued by many individuals, suggesting that a ceiling somewhat below these alternative yields would still enable the new account to attract funds. For illustrative purposes, Chart 1 displays the historical rate spread--measured on both a weekly and quarterly average basis--that would have prevailed since 1979 between the average MMMF yield and the rate on a short-term account if the ceiling had been equal to the 91-day bill rate (quoted on a discount basis). Even though management fees are deducted, the average MMMF yield tends to be higher because most of the assets held by these funds are private securities yielding higher rates of return. The chart indicates that even with daily compounding a deposit rate ceiling equal to the bill rate would have allowed MMMFs to pay, on average, over 50 basis points more than the depository institutions.

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From a practical point of view, the staff notes that it would be extremely difficult to prohibit compounding effectively on an instrument with a short maturity. On a fixed-term account, institutions legally must pay out or credit interest at maturity, even if the balance in the account is rolled over automatically. On a notice account, the Committee has somewhat more flexibility. It could, for example, limit the crediting and compounding of interest to periods of one quarter or more. If the Committee authorized both notice and fixed-term accounts, any restriction on compounding for notice accounts would result in yield differentials between the two; it is likely, however, that institutions would invent ways around any such restriction that are difficult to anticipate. Since the primary concern about compounding is its effect on the cost of funds, the staff suggests that the Committee address this issue in its consideration of the relationship between the ceiling and the rate base. In this regard, Table 1 illustrates that at Treasury bill rates of 12 percent, compounding would add between 37 and 77 basis points to the nominal ceiling depending on the frequency of the compounding.

One mechanical issue with respect to a ceiling rate involves the rules that would govern adjustments of rates paid on existing account balances to changes in the interest rate ceiling. The Committee could, for example, allow institutions the discretion either to change to the new ceiling or to maintain the rate established at the time the account was opened or rolled over. Alternatively, the Committee could require that institutions maintain the rate established at the time the account was opened or rolled over. In any event, at maturity or at the end of an interval equal to the notice period, the institution would be required to change the rate on an existing account balance if it exceeded the ceiling rate then in force for new deposits.

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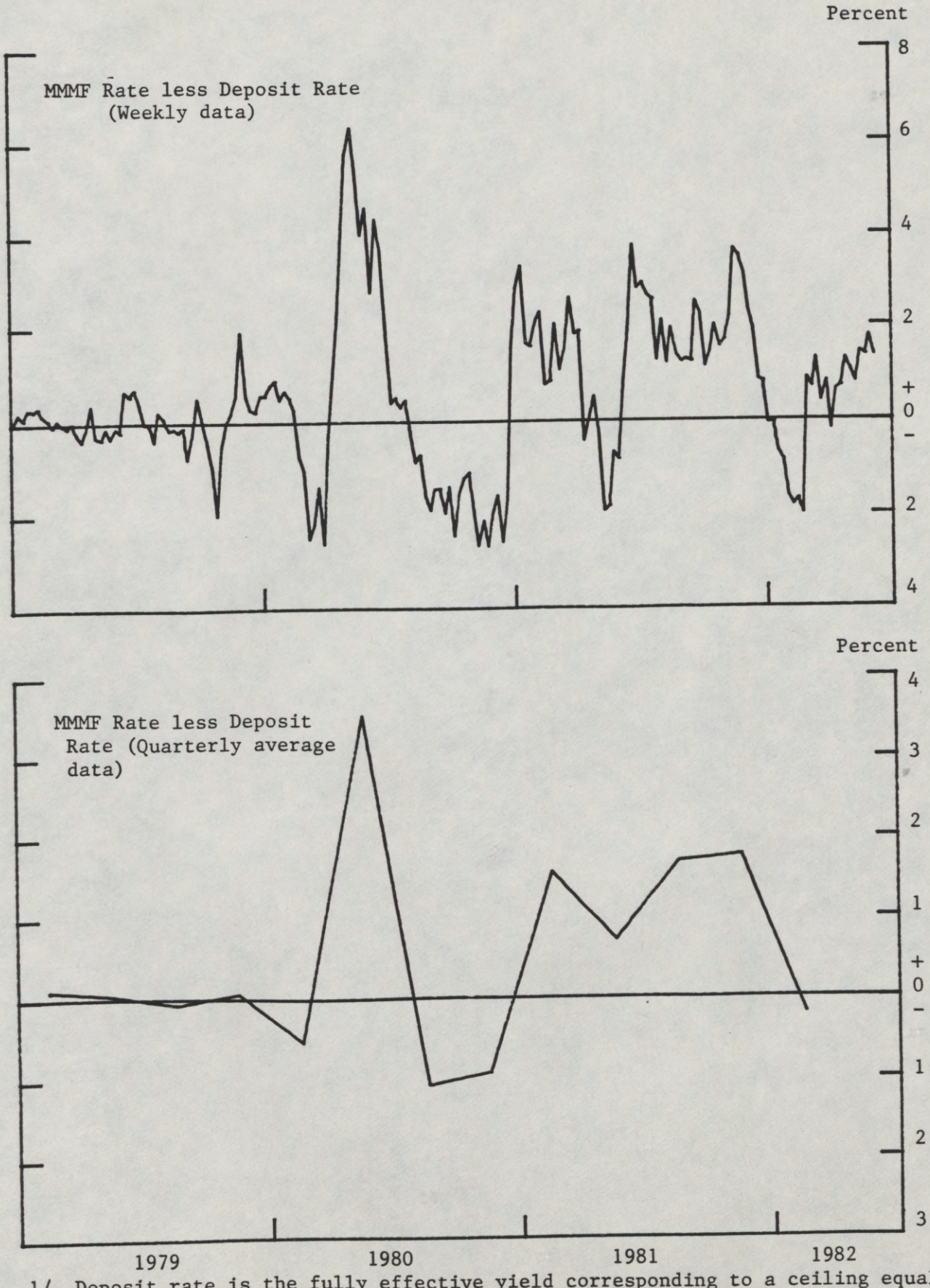
Chart 1

SPREADS BETWEEN YIELDS ON MMMFs
AND A HYPOTHETICAL SHORT-TERM DEPOSIT 1/



1/ Deposit rate is the fully effective yield corresponding to a ceiling equal to the 91-day Treasury bill rate, auction average discount basis.

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Table 1

EFFECTIVE YIELDS CORRESPONDING TO A 12 PERCENT NOMINAL CEILING FOR VARIOUS COMPOUNDING PERIODS--365/360 BASIS

Type of Compounding	Effective Rate	Increased Yield Due to Compounding	Percent of the Continuously Compounded Increase
	---- percent per annum ----		
1) Continuous	12.938	.771	100
2) Daily	12.935	.768	99+
3) Weekly	12.922	.755	98
4) Quarterly (91 day)	12.734	.567	74
5) Semi-annual (182 days)	12.538	.371	48
6) No compounding[1/]	12.167	--	0

1/ The fact that the effective rate is about 17 basis points higher than the nominal rate even with no compounding is due to the artificial year.

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FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF THE CHAIRMAN

June 15, 1982

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OF THE
FEDERAL RESERVE SYSTEM
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The Honorable George Bush
President of the Senate
United States Senate
Washington, D.C. 20510

Sir:

I am hereby transmitting our report on the economic viability of depository institutions as required by Section 206 of the Depository Institutions Deregulation and Monetary Control Act of 1980.

Sincerely,

William M. Isaac
Chairman

Enclosure

CC: All DIDC Members

Honorable Paul Volcker
Chairman, Federal Reserve Board

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1982 REPORT TO CONGRESS ON THE ECONOMIC VIABILITY OF DEPOSITORY INSTITUTIONS (AS REQUIRED BY SECTION 206 OF THE DEPOSITORY INSTITUTIONS DEREGULATION AND MONETARY CONTROL ACT OF 1980)

By
William M. Isaac, Chairman
Federal Deposit Insurance Corporation

Introduction

Section 206 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (P.L. 96-221) mandates that each member of the Depository Institutions Deregulation Committee (DIDC) separately report to Congress annually on issues relating to the economic viability of depository institutions. This report contains our comments and recommendations on various issues which the DIDC faces in its efforts to eliminate deposit interest rate ceilings at depository institutions.

The task facing the DIDC is made difficult by important but frequently conflicting objectives. In our deliberations we must not lose sight of the benefits from deposit rate deregulation. Interest rate ceilings force many depositors to earn a below-market return on their investments and these rate restrictions have placed all depository institutions at a competitive disadvantage in the financial services industry. At the same time, however, we must give due consideration to the earnings position of many thrift institutions.

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Let me turn to the specific issues which we were asked to address in Section 206 of P.L. 96-221. After discussing these issues, I will outline a comprehensive deregulation program which we feel deals with the fundamental problems facing the banking and thrift industries. The Appendix contains a summary of recent DIDC policy actions.

An Assessment of Whether the Removal of Any Differential Between the Rates Payable on Deposits and Accounts by Banks and Those Payable by Thrift Institutions Will Adversely Affect the Housing Finance Market or the Viability of the Thrift Industry

Relative Importance of the Differential

The instruments offered by depository institutions which carry a rate differential in favor of thrift institutions are shown in table 1. Overall, the importance of deposits subject to a differential at thrift institutions has been steadily declining (see table 2). We would expect this decline to continue as those deposits subject to a differential shift into alternative higher-yielding instruments or leave thrift institutions altogether.

Fixed-ceiling time and savings deposits. Fixed-ceiling time deposits have been declining in importance for the past several years and the low rate ceilings on these deposits, relative to market rates, will insure that these deposits will continue to diminish in importance in the future. Passbook deposits declined steadily in importance over most of 1981. Although factors such as sharp declines in market interest rates and end-of-the-quarter interest crediting have resulted in slight increases in passbook balances, this general outflow trend will likely continue.

Small Savers Certificates (SSCs). SSCs have increased substantially in importance at thrift institutions since the 12% interest rate "cap" was removed on August 1, 1981. Allowing institutions to pay a market rate on this

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Table 1. Maximum interest rates payable on time and savings deposits at federally-insured depository institutions.

Account Type	Commercial Banks	S&Ls and MSBs
Savings Deposits	5.25%	5.50%
Negotiable Order of Withdrawal (NOW) Accounts	5.25	5.25
Fixed-Ceiling Time Deposits by Maturity:		
14 to 89 days	5.25	n.a.[a]
90 days to 1 year	5.75	6.00
1 to 2-1/2 years	6.00	6.50
2-1/2 to 4 years	6.50	6.75
4 to 6 years	7.25	7.50
6 to 8 years	7.50	7.75
8 years and over	7.75	8.00
Variable-Ceiling Time Deposits by Maturity:		
91-day time deposit	91-day Treasury bill rate minus 25 basis points	91-day bill rate
6-month Money Market Certificate	6-month Treasury bill rate plus 25 basis points[b]	
12-month All Savers Certificate	70% of 12-month Treasury bill rate	
30-month to 3-1/2 year Small Savers Certificate	2-1/2 year Treasury security rate minus 25 basis points	2-1/2 year Treasury security rate
Ceiling-Free Time Deposits by Maturity:		
18-month or more individual retirement accounts and Keogh (H.R. 10) plans	Not Limited	Not Limited
3-1/2-year time deposits	Not Limited	Not Limited
Time deposits with denominations of $100,000 or more	Not Limited	Not Limited

[a]n.a. signifies account categories generally not available at S&Ls and MSBs.

[b]A rate differential in favor of thrifts is imposed when the 6-month bill rate drops below 9 percent.

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Table 2. Relative Proportion of deposits at FSLIC-insured S&Ls and all MSBs which are subject to a differential.[a]

	Percent of Total Deposit Balances							
	(a) Passbook Savings Deposits		(b) 30-month Small Saver Certificates		(c) Fixed-Ceiling Time Deposits		Total Deposits Subject to a Differential (a + b + c)	
Time Period	S&Ls	MSBs	S&Ls	MSBs	S&Ls	MSBs	S&Ls	MSBs
1981								
January	19.9	34.3	10.6	8.6	22.6	21.8	53.1	64.7
February	19.5	33.7	10.8	8.9	21.6	21.0	51.9	63.6
March	19.9	33.5	11.2	9.1	21.1	20.3	52.2	62.9
April	19.6	33.5	11.7	9.5	20.3	19.9	51.6	62.9
May	19.0	33.0	11.6	9.6	19.3	19.5	49.9	62.1
June	19.1	32.4	11.9	9.6	18.9	19.2	49.9	61.2
July	18.8	32.5	12.1	9.8	17.6	18.5	48.5	60.8
August	18.1	31.6	13.3	10.8	16.4	17.7	47.8	60.1
September	18.1	31.0	15.1	12.0	15.8	16.8	49.0	59.8
October	17.4	30.4	17.0	12.9	14.0	16.1	48.4	59.4
November	17.4	30.2	18.0	13.6	13.6	15.3	49.0	59.1
December	17.8	30.4	18.7	14.1	12.9	14.8	49.4	59.3
1982								
January	17.6	30.4	19.6	14.9	11.9	14.1	49.1	59.4
February	17.3	30.1	20.2	15.3	11.1	13.8	48.6	59.2
March	17.4	30.0	21.0	15.8	10.7	13.3	49.1	59.1

Source: The Federal Home Loan Bank Board, the Federal Reserve Board, and the National Association of Mutual Savings Banks.

[a]As yet, no data are available on the new 91-day instrument.

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instrument has dramatically increased its attractiveness. At present many consumers find it advantageous to "lock in" the relatively high yields which are currently available on this instrument. It is not likely, however, that the SSC will continue to grow as rapidly as it has since August 1981. To some extent, the SSC will be replaced by the new 3-1/2 year, ceiling-free deposit instrument which was introduced on May 1, 1982.

91-day time deposit. This instrument was introduced on May 1, 1982. It has a temporary differential in favor of thrift institutions and an interest rate ceiling, for thrifts, equal to the 91-day Treasury bill rate (auction average on a discount basis). The differential is slated to be permanently removed on May 1, 1983, or temporarily removed in the event the 91-day Treasury bill rate remains less than or equal to 9% for four consecutive bill auctions. The success of this instrument will depend heavily upon the level of the 91-day bill rate relative to the rates paid on both the MMC and money market mutual fund shares, its closest competitors.

Current Plans for the Removal of the Differential

The SSC, which currently has a differential, will be gradually replaced by a new ceiling-free deposit instrument. Effective May 1, 1982 the SSC maturity range was reduced to 2-1/2 years to less than 3-1/2 years (the old range was from 2-1/2 years to less than 4 years). Also on May 1 a ceiling-free time deposit with a minimum maturity of 3-1/2 years became effective. On April 1, 1983, the SSC maturity range will be reduced to 1-1/2 years to less than 2-1/2 years and the minimum maturity on the new ceiling-free instrument will be reduced to 2-1/2 years. Finally, on April 1, 1983, the SSC will be effectively superseded as the minimum maturity on the ceiling-free instrument is reduced to 1-1/2 years and the minimum maturity on the SSC is not correspondingly reduced.

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The rate differential on the new 91-day instrument was imposed as a temporary measure to aid thrift deposit flows. As mentioned previously, the differential on this instrument is slated to be removed on May 1, 1983. While this differential is in effect, however, we expect that it will result in improved flows to thrift institutions. Although it is not possible to estimate its precise impact, FDIC staff analysis indicates that a 25 basis point differential in favor of thrift institutions does have an effect upon where consumers choose to deposit their funds. Unfortunately, it is likely that many of the benefits thrifts get from the differential will come at the expense of commercial banks. Hardest hit will be the smaller banking institutions which provide a significant portion of mortgage and agriculture credit to rural areas.

Currently, there are no plans for the removal of the differential on accounts which were in existence on December 10, 1975.[1] However, one result of the deregulation schedule which was passed by the DIDC at its March 22, 1982, meeting is that all fixed-ceiling time deposits in existence on December 10, 1975, will be gradually replaced by the new ceiling-free time deposit which was introduced on May 1, 1982.

At this time, we do not see any immediate reason why the differential on passbook savings deposits should be removed. Such action would only serve to encourage a shifting of low-cost funds from thrifts to commercial banks. This would exacerbate thrift earnings problems while providing only limited benefits to the banks. Low rate ceilings have greatly diminished passbook

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[1]Section 102 of P.L. 94-200 requires that the differential on all accounts in existence on December 10, 1975, may not be removed without the approval of both houses of Congress.

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accounts as an investment vehicle and, at current rate ceiling levels, passbook balances cannot be viewed as a viable source for mortgage lending.

Over the long run, the thrift differential cannot be considered as desirable for either the thrift industry or the housing market. The existence of a differential necessarily implies the imposition of some interest rate ceiling on deposits at both thrifts and commercial banks; however, experience has shown that the long-run viability of the thrift industry will depend upon its ability to compete with alternative market investments for funds. Even allowing rate ceilings to float with market rates does not permit depository institutions to compete effectively with alternative investments over all phases of the interest rate cycle. Additionally, rate ceilings drastically limit an institution's ability to construct deposit contracts which it feels will best suit its own customers.

Recommendations for Measures Which Would Encourage Savings, Provide for the Equitable Treatment of Small Savers, and Ensure a Steady and Adequate Flow of Funds to Thrift Institutions and the Housing Market

To Encourage Savings

Lately there has been much concern over the low U.S. household saving rate, both in absolute terms and relative to other industrialized countries. Table 3 provides information on the household saving rate from 1970 to the present. Although various cultural and structural differences make saving comparisons between different countries somewhat difficult to interpret, the saving rate in this country has remained relatively low for several years. While reducing inflation and achieving sustained growth in the economy are most important for improving the savings outlook, some tax incentives in the Economic Recovery Tax Act of 1981 should encourage saving.

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Table 3. The National Income and Product Account (NIPA) saving rate, 1970 through the first quarter of 1982 (quarterly data are seasonally adjusted).

Time Period	Saving Rate
1970	8.0
1971	8.1
1972	6.5
1973	8.6
1974	8.5
1975	8.6
1976	6.9
1977	5.7
1978	5.2
1979	5.3
1980-I	4.9
-II	6.2
-III	6.1
-IV	5.1
1981-I	4.6
-II	5.4
-III	5.2
-IV	6.1
1982-I	5.5

Source: U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts of the United States, Table 2.1.

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The expansion in Individual Retirement Account (IRA) and Keogh Account eligibility on January 1, 1982, provides savers with a powerful tax incentive to save for retirement. These funds tend to be a stable, long-term source of funds for depository institutions. In order both to aid these institutions in capturing their "fair share" of these new funds and to encourage saving, the DIDC has allowed all depository institutions to offer a ceiling-free, IRA/Keogh time deposit with a minimum maturity of 1-1/2 years. Between December 1, 1981, when this account was first authorized, and March 31, 1982, this deposit account has attracted an estimated $7.2 billion.

All Savers Certificates--which provide a federally-insured, tax-free investment--have grown in volume to $51 billion (as of April 30, 1982). Some of this money represents new saving which would otherwise not have occurred. In addition, the scheduled reduction in income tax rates should encourage people to save by increasing their disposable income.

Last, but also of great importance, is the continued removal of deposit interest rate ceilings. To date, depository institutions are able to offer ceiling-free time deposits with maturities of 3-1/2 years and over and on certain IRA/Keogh deposits. We feel that the continued removal of deposit rate ceilings should go a long way toward encouraging saving by those who are reluctant to seek investment vehicles outside federally-insured depository institutions.

To Provide for the Equitable Treatment of Small Savers

During 1981 and the first quarter of 1982, the DIDC undertook several substantial actions designed specifically to aid the small saver and, at the same time, to improve fund flows into depository institutions. On August 1, 1981, the Committee removed the 12.00/11.75% "cap" on the Small Savers Certificate.

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This action resulted in a substantial increase in the rate ceiling applicable to this instrument (see table 4). This is significant for the small saver because the SSC has no federally-regulated minimum denomination. As a consequence, many institutions offer the SSC in minimum denominations of as low as $100.

The Committee has also adopted a 3-1/2 year minimum-maturity time deposit which has no interest rate ceiling. The minimum maturity on this instrument will decrease by one year on April 1, 1983, 1984, and 1985. On March 31, 1986, the minimum maturity will drop to that for time deposits in existence at that time. Thus, by 1986, complete time deposit rate deregulation will be accomplished. In order that small savers are not excluded from purchasing this new certificate, the DIDC has not imposed a mandatory minimum denomination requirement and, furthermore, depository institutions must offer this instrument in a $500 denomination.

Alternatives to deposit accounts do exist for many savers (for example, money market mutual funds offer an account which earns a market rate, provides instant liquidity and some funds require minimum denominations of as low as $1,000). However, federal insurance and convenience requirements do limit some savers to accounts at depository institutions. This is evidenced by the fact that a substantial portion of passbook savings deposits are in accounts with relatively high balances. For example, an estimated 24% of passbook savings deposits at MSBs are in accounts with denominations of $25,000 or more. Certainly alternatives for these savers exist. However, for reasons other than rates of return on their savings, they choose to remain at a depository institution. Therefore, the only way to generally provide complete equity to savers would be through further deposit rate deregulation.

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Table 4. Average SSC Rate Ceilings in Effect for Thrift Institutions, January 1981 through May 1982.

Time Period	Average Thrift SSC Rate Ceiling[a]
1981	
January	12.00
February	12.00
March	12.00
April	12.00
May	12.00
June	12.00
July	12.00
August[b]	15.78
September	16.50
October	15.79
November	14.10
December	13.02
1982	
January	14.24
February	14.77
March	14.23
April	14.30
May	13.89

[a]The rate ceilings listed are on a simple annual basis, compounding is permitted. Commercial banks are restricted to paying a maximum of 25 basis points less than the thrift rate.

[b]The 12.00 percent "cap" on SSC rates was removed on August 1, 1981.

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To Ensure a Steady and Adequate Flow of Funds to Thrift Institutions and the Housing Market

Deposit Flows

Deposit flows at both S&Ls and MSBs deteriorated during 1981 relative to the 1980 performance. As shown in table 5, S&Ls experienced a $25.4 billion net deposit outflow during 1981 (excluding interest credited) while registering a net inflow of only $10.7 billion in 1980. Relatively speaking, the MSB experience has been somewhat worse, with net outflows of $13.8 billion in 1981 and $4.9 billion in 1980. Although in absolute terms MSB outflows have been smaller than those at S&Ls, the net outflows as a percentage of total deposits has been greater at mutual savings banks.

To a large extent, this deterioration of deposit flows can be directly linked to the inability of thrifts to compete--due to deposit rate controls--with alternative market investments. The consistently higher market interest rates during 1981 relative to 1980, in conjunction with increased consumer awareness of alternative investment opportunities, has resulted in a large degree of disintermediation (see table 5). For example, money market mutual funds increased by $107 billion during 1981 compared to a $29 billion increase during 1980. It is likely that deposit flow problems will continue as long as deposit interest rate restrictions remain binding and market interest rates remain at their relatively high levels.

The All Savers Certificate (ASC) has, so far, had only a slight impact upon thrift deposit flows. This certificate attracted a substantial amount of new money when it was first introduced in October 1981. During that month, S&Ls attracted $16.5 billion and MSBs $4.0 billion into ASC deposits. Since that time, however, ASC growth has been much slower, with average monthly

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Table 5. Deposit flows at federally-insured savings and loan associations and at all mutual savings banks, January 1980 through April 1982.

Time Period	S&L Deposit Flows ($ Millions) Excluding Interest Credited	S&L Deposit Flows ($ Millions) Including Interest Credited	MSB Deposit Flows ($ Millions) Excluding Interest Credited	MSB Deposit Flows ($ Millions) Including Interest Credited
1980				
January	1,167	2,035	-1,436	-928
February	1,079	1,823	-543	-79
March	-696	4,345	-679	930
April	-817	321	-1,024	-449
May	1,785	3,004	242	861
June	-169	5,210	-176	1,716
July	961	2,355	246	843
August	1,285	2,481	1	610
September	6	5,518	-460	1,377
October	2,550	3,827	-169	403
November	1,461	2,476	-227	312
December	2,055	7,563	-639	1,255
Totals for 1980	10,668	40,956	-4,863	6,851
1981				
January	599	2,060	-979	-365
February	879	2,276	-385	296
March	-2,137	3,694	-757	1,224
April	-4,638	-2,857	-2,025	-1,234
May	-70	1,696	-676	148
June	-5,759	317	-1,387	542
July	-5,538	-3,491	-1,935	-1,133
August	-3,290	-1,343	-1,542	-672
September	-3,799	2,172	-1,679	319
October	1,601	3,688	-65	789
November	-1,530	481	-1,060	-188
December	-1,723	4,717	-1,283	849
Totals for 1981	-25,404	13,411	-13,774	574
1982				
January	-138	1,959	-1,064	-225
February	761	1,909	-233	603
March	-1,284	5,228	-868	1,124
April[a]	-5,209	-2,547	-1,800	-800

Source: Federal Home Loan Bank Board and the National Association of Mutual Savings Banks.

[a]Preliminary.

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increases of only $1.1 billion at S&Ls and $0.33 billion at MSBs. As of April 1982, ASC balances at S&Ls stood at $23.1 billion (4.4% of total deposits) and $6.0 billion at MSBs (4.0% of total deposits).

Flows of Funds to Thrift Institutions and the Housing Market

Improved flows of funds into thrift institutions depend upon their ability to pay a market rate to their depositors. Unfortunately, the heavy reliance upon standard fixed-rate mortgages have left thrifts holding a large percentage of below-market-rate assets. This impedes their ability to pay market rates to depositors and still remain profitable. The long-run solution is to enable the thrifts to offer assets whose yields are more closely linked to current market rates.

The Depository Institutions Deregulation and Monetary Control Act of 1980 ("the Act") has provided greater leeway for thrift institutions to acquire short-term assets. The Act allows federally-chartered S&Ls and MSBs to invest up to 20 percent of their assets in secured and unsecured consumer loans and other corporate securities. In addition, federal MSBs are authorized to make commercial, corporate, and business loans of up to five percent of total assets. While this liberalization of asset powers will allow thrifts a greater amount of diversity in their portfolios, we do not feel the Act has gone far enough.

Providing the DIDC with a mandate to deregulate the liability side of the balance sheet at thrift institutions, yet not allowing for a mechanism whereby the asset portfolios are deregulated will result in a structural imbalance. Depository institutions are entering a new age which will be marked by a significant amount of deregulation and, hence, increased competition. Shortly, thrifts will no longer be offered the protection of deposit rate ceilings.

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By the same token, high interest rates, technological innovations, and increased consumer sophistication have resulted in many financial innovations. Nondepository institutions have accelerated their efforts to compete for deposits, thus, further blurring the distinction between depository institutions and their close competitors. In this emerging competitive environment, it is important that thrift institutions have the greatest amount of flexibility to compete with other financial institutions.

It should be noted that certain tax incentives exist which have encouraged thrifts to emphasize home mortgage lending. Even though these income-tax provisions are currently of no use to the thrifts which are losing money and, therefore, not paying federal income taxes, such limitations will become binding in the future when thrift earnings improve. In this circumstance thrifts will be discouraged from fully implementing any new asset powers.

Although thrift institutions are major contributors to housing finance, the overall performance of the housing market is also influenced by other factors. In pursuing monetary and fiscal policy goals, the federal government has, at times, caused competition for scarce funds in the credit markets to intensify. During these periods, mortgage and housing activity contracts much more sharply than activity in most other sectors of the economy. On the other hand, mortgage purchases by federally-sponsored credit agencies have aided housing activity, particularly during periods of tight money and high interest rates.

To conclude, an adequate flow of funds to the housing market does not depend upon forcing thrifts to be residential mortgage specialists. If providing thrifts with expanded asset powers reduces the thrift presence in the housing market, we believe that much of this slack will be taken up by other

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lenders. In a stable financial environment, a greater demand for housing finance will exist and financial intermediaries will supply the necessary funds at market rates.

Findings Concerning Disintermediation of Savings Deposits from Insured Banks and Insured Thrift Institutions to Uninsured Money Market Innovators Paying Market Rates to Savers

The growth of money market mutual funds (MMFs) has contributed substantially to the disintermediation of savings deposits from insured banks and thrift institutions. It is impossible to precisely determine how much of this dollar inflow has been due to the interest rate restrictions imposed upon depository institutions. However, it is likely that this volume has been significant since depository institutions currently have no viable short-term instrument with which to compete with MMFs.

Table 6 shows the net monthly MMF inflows (sales minus redemptions) for non-institutional-only funds.[2] Net MMF inflows were much stronger in 1981 ($87 billion) than during 1980 ($25 billion). In large part, this was due to the relatively higher interest rates during 1981.

MMFs will likely continue to be a principal competitor facing depository institutions throughout 1982. New and existing MMFs are attempting to cater to a broader spectrum of customers. For example, Sears, in conjunction with its subsidiary Dean Witter Reynolds, is offering a money fund which is

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[2] Institutional-only funds are excluded from the analysis because their high minimum denominations (typically $100,000 or over) preclude investment by the typical individual saver.

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Table 6. Net monthly inflows (sales minus redemptions) into non-institutional-only money market mutual funds, January 1980 through April 1982.

Time Period	Monthly Inflows ($ Billions)	
1980		
January	6.94	
February	5.62	
March	0.61	
April	-0.79	
May	4.88	
June	2.05	
July	2.56	
August	3.72	
September	-0.13	
October	1.15	
November	-0.32	
December	-1.09	1980 Total = 25.20
1981		
January	8.64	
February	8.81	
March	11.36	
April	7.10	
May	1.08	
June	7.16	
July	10.93	
August	8.53	
September	7.71	
October	6.34	
November	8.18	
December	1.57	1981 Total = 87.41
1982		
January	5.88	
February	-0.56	
March	5.16	
April	-0.63	

Source: Donoghue's Money Fund Report of Holliston, MA 01746.

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designed to attract the relatively small saver.[3] Also contributing to MMF growth are the increasingly popular tie-in arrangements between MMFs and depository institutions. These so-called "sweep" accounts provide a link between a MMF and a demand or NOW account whereby excess balances from the transaction account are automatically swept into the MMF on a daily basis. Currently such services are offered by several hundred commercial banks, but plans now exist which may expand this number to several thousand.

Finally, electronic funds transfer innovations will continue to increase the accessibility of MMF accounts. A reduction in the cost and time for transfers in and out of MMFs should enhance the liquidity of money funds and, as a result, increase their popularity. As we have seen in the past, if depository institutions are constrained as to the services which they can offer, these missing services will simply be provided by alternative institutions.

The DIDC is considering a short-term deposit instrument to enable institutions to better compete with money market mutual funds (MMFs) and, at the same time, limit the adverse earnings implications which would arise from internal shifts from low-yielding passbook deposits. Although the majority of passbook accounts have relatively low balances (the average passbook balance at thrift institutions is estimated at $2,500), there exist many very high balance accounts. Tables 7 and 8 list estimates of the size distribution of passbook balances at MSBs and S&Ls; respectively.

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[3]The Sears fund requires an initial investment of only $1,000 and additions can be made in increments of only $50. By MMF standards, these requirements are minimal. In addition, if current plans materialize, Sears MMF account holders will be able to access their accounts via any Sears retail outlet.

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Table 7. Estimated size distribution of passbook savings deposits at mutual savings banks.

Passbook Deposit Size Category	Percent of Total Passbook Balances
Under $5,000	25%
$5,000 - $14,999	34
$15,000 - $24,999	17
$25,000 and Over	24

Source: December 4, 1981 telephone survey conducted by the Federal Deposit Insurance Corporation.

Table 8. Estimated size distribution of passbook savings deposits at savings and loan associations.

Passbook Deposit Size Category	Percent of Total Passbook Balances
Under $2,500	16%
$2,500 - $4,999	15
$5,000 - $7,499	13
$7,500 - $9,999	9
$10,000 and Over	46

Source: August 1980 Federal Home Loan Bank Board Survey.

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It is likely that any short-term deposit will attract some funds from existing passbook accounts, the net effect of which could be an increase in costs to depository institutions. A comparatively high minimum denomination feature would limit this internal shifting. At the same time, a minimum denomination in the $15,000 to $25,000 range would still allow institutions to compete effectively with MMFs. As can be seen in table 9, a substantial proportion of MMF money held by households are in accounts with balances in excess of $25,000.

As a final note, should the Committee adopt this instrument, it intends to periodically re-examine the minimum denomination feature with a eye toward its reduction. With experience, the DIDC will be better able to judge the amount of passbook shifting which comes with various minimum denominations.

Recommendations for Such Legislative and Administrative Actions as the Member Involved Considers Necessary to Maintain the Economic Viability of Depository Institutions

A number of measures can be taken to minimize disruptions to our financial system and to insure that the current problems we are facing do not recur in the future.

First, is enactment of the Regulator's Bill to give the federal insuring agencies greater flexibility in dealing with the immediate problems facing thrift institutions.

Second, is the federal override of state usury ceilings and prohibitions of due-on-sale clauses. Although some preemptions of state usury ceilings are contained in the Depository Institutions Deregulation and Monetary Control Act of 1980, major qualifications to these provisions add an additional element of uncertainty to the portfolio management problems facing depository institutions, especially in an unstable interest rate environment. Prohibitions of

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Table 9. Estimated size distribution of money market mutual fund accounts held by households.

MMF Account Size Category	Percent of Total Household Balances
Under $5,000	5%
$5,000 - $9,999	11
$10,000 - $19,999	19
$20,000 - $29,999	9
$30,000 and Over	56

Source: March 11, 1981 survey conducted by the Investment Company Institute.

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due-on-sale clauses are particularly detrimental to thrift earnings because they slow the rate of turnover of their low-yielding mortgage portfolios. Mutual savings banks currently have over 75 percent of their mortgages in assets yielding less than 10 percent.

Finally, new asset powers for thrifts, such as those contained in S.1720 should be enacted. The financial difficulties facing some thrifts may preclude their immediate utilization of these powers. However, it is important that thrifts have broader portfolio flexibility, know their portfolio options, and plan for the future. This will allow them to make the most efficient use of the new funds which they will obtain as the deregulation process continues, and will also allow them to become viable competitors in the financial marketplace of the future.

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Appendix:

DIDC Policy Actions, January 1981 Through May 1982

Notation Vote--February 16, 1981

The Committee adopted a temporary amendment to its rule on the use of premiums which prohibited an institution from soliciting the opening of multiple accounts in order to provide more than one premium at a time. In addition, the Committee solicited public comment on whether this rule should be made permanent. (This rule was made permanent in March 1982).

Committee Meeting--March 26, 1981

1. Adopted a final rule, effective April 7, 1981, which moves the effective implementation date on ceiling rate changes on the MMC and SSC from Thursday to Tuesday.

2. Request for public comment on phasing out interest rate ceilings by maturity and on a proposal to remove the "caps" on the SSC.

Committee Meeting--June 25, 1981

1. Final rule, effective August 1, 1981, whereby the Committee adopted a schedule to phase out interest ceilings by maturity beginning with deposits with a maturity of four years or more. Along with this action, the Committee reduced the maturity range of the SSC from 2-1/2 years and over to 2-1/2 years to less than 4 years. The U.S. District Court for the District of Columbia subsequently declared invalid the above phase out action on the ground that it eliminated the differential on an account in existence on December 10, 1975. This court action, however, did not affect the SSC maturity reduction.

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2. Final rule, effective August 1, 1981, which removed the "caps" on the SSC.

3. Request for public comment on a proposal to increase savings deposit rate ceilings.

4. Request for public comment on a proposal to allow the MMC rate ceiling to be based upon a moving average of past and present 26-week Treasury bill rates. Additionally, the Committee requested comment on the creation of a new short-term time deposit.

Notation Vote--September 3, 1981

The Committee adopted regulations authorizing depository institutions to issue All Savers Certificates. This action became effective on October 1, 1981.

Committee Meeting--September 22, 1981

1. Adopted a final rule which would allow depository institutions, beginning December 1, 1981, to offer a new ceiling-free IRA/Keogh time deposit with a minimum maturity of 1-1/2 years. In addition, the Committee granted institutions permission for the waiver of early withdrawal penalties for conversions of existing IRA/Keogh accounts into this new account. (This latter action was subsequently rescinded by the Committee.)

2. Adopted a final rule, effective November 1, 1981, which would increase passbook savings deposit rate ceilings by 50 basis points. This action was subsequently postponed by the Committee.

3. Adopted a final rule, effective November 1, 1981, which would permit the MMC rate ceiling to be based upon a 4-week moving average of past and current 6-month Treasury bill auction rates.

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4. Final rule to readopt the MMC and SSC ceiling rate changes which were originally adopted on May 28, 1980. This action was in response to a U.S. District Court ruling that indicated the DIDC had the authority to make the rate ceiling changes, but required that the Committee first solicit public comment on such changes. (Comment was requested by the Committee on August 13, 1981.)

5. Request for public comment on various proposed short-term deposit instruments.

6. Request for public comment on a new deregulation schedule which would phase out deposit rate ceilings by maturity beginning with the introduction of a new 3-1/2 year and over maturity deposit which would have no regulated rate ceiling.

Notation Vote--October 20, 1981

The Committee voted to postpone the 50 basis point increase in passbook savings deposit rate ceilings.

Notation Vote--November 19, 1981

The Committee acted to rescind permission for waiver of early withdrawal penalties for conversion of existing IRA/Keogh accounts into the new 1-1/2-year account.

Committee Meeting--December 16, 1981

During this meeting the Committee voted to defer consideration of the pending agenda items to the March 22, 1982 meeting. These items were:

a) consideration of a plan to deregulate interest rate limitations on time deposits;

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b) consideration of short-term deposit instrument proposals; and

c) consideration of the interest rate ceiling for savings deposits.

Committee Meeting--March 22, 1981

1. The Committee adopted a final rule authorizing depository institutions to offer--effective May 1, 1982--a $7,500 minimum denomination time deposit with a 91-day maturity. This instrument has a rate ceiling equal to the 91-day Treasury bill rate (auction average on a discount basis) for thrift institutions and 25 basis points less for commercial banks. This rate differential will be removed on May 1, 1983 and will be suspended any time the 91-day Treasury bill rate is 9% or below for four consecutive rate auctions. It is reinstate during the one-year period if the rate should rise above 9% and it is not suspended again until it falls to 9% or below for another four auction period.

2. Final rule adopting a schedule to deregulate interest rate ceilings on time deposits by authorizing a new time deposit instrument. This instrument has no federally imposed interest rate ceiling and has an initial minimum maturity of 3-1/2 years that will be reduced by one year on April 1, 1983, 1984, and 1985. On March 31, 1986, the minimum maturity will be reduced to that for all time deposits in existence on that date. This instrument has no federally required minimum denomination, however, institutions that do select to offer this time deposit are required to offer a $500 denomination. This latter restriction is designed to prohibit institutions from setting a minimum denomination so high as to exclude the small saver.

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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

DATE: June 15, 1982

TO: Depository Institutions Deregulation Committee

SUBJECT: Short-term Deposit Proposals

FROM: DIDC Staff*

At its March 22 meeting, the Committee adopted a long-run strategy for deregulating deposit rate ceilings. At the same time, the Committee expressed its continuing concern about the ability of depository institutions to compete with money market mutual funds (MMMFs) and, particularly, about the weakness of deposit flows to thrift institutions. In view of this concern, the Committee adopted the 91-day, $7,500 minimum time deposit with a 25 basis point differential for thrifts. The Committee also directed the staff to continue efforts to design a shorter-term instrument to enhance the ability of depository institutions to compete with MMMFs. This memorandum reviews the basic issues involved in designing such an instrument, including monetary policy considerations, and then discusses in more detail the possible features that the Committee may wish to consider.[1]

I. The Fundamental Issues

Since June 1981, when the Committee first solicited public comment on this matter, total assets of MMMFs have grown from $127 billion to $203

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* This memorandum was prepared primarily by the staff of the Federal Reserve Board (Messrs. Ettin, Schwartz, McKelvey, and Ms. Glassman).

1/ These issues have been discussed in greater detail in previous staff memoranda; see particularly, "Short-term Instrument Proposals," March 15, 1982.

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billion (roughly three-fifths of which is held by household investors). During the same period, savings deposits at depository institutions declined from $367 billion to $350 billion and total small-denomination deposits (including savings accounts) increased from $1,172 billion to $1,244 billion. In order to maintain their customer base, many banks and thrifts are attempting to pay depositors a market rate of interest on short-term funds through a variety of sweep arrangements. Unless they are able to offer a short-term instrument directly, however, depository institutions will continue to lose savings deposits to MMMFs, and sweep arrangements will continue to proliferate.

The design of a new short-term instrument involves the consideration of two fundamental issues that limit the potential competitiveness of the instrument. One concern is that a new short-term account will draw funds from savings accounts, thereby raising institutions' costs. As indicated previously to the Committee, at current market rates each dollar shifted from a savings account to a short-term market rate account would require the institutions to attract $3 to $4 of external funds in order to break even.[1]

The second issue, of concern to the Federal Reserve staff, is the effect that any new instrument would have on monetary policy. The Federal Reserve regards the maintenance of a distinction between transaction and other accounts as essential to its conduct of monetary policy. If the new account were to blend transactions and savings features, it would further blur the distinctions among accounts, making it more difficult to define and control the money supply; this would be true even if the new account were subject to

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1. An extensive discussion of break-even analysis and related issues can be found in the previously cited staff memorandum, "Short-Term Instrument Proposals," March 15, 1982, pp. 14-19.

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transaction account reserve requirements. On the other hand, regardless of any restrictions which the Committee may impose on this account, the conduct of monetary policy will continue to be complicated as nondepository institutions provide savers with instruments that combine transactions and savings features. Currently, under the Board's Regulation D, any deposit instrument with a maturity or required notice period of less than 14 days, or any account that can be used ordinarily to pay third parties, is subject to transaction account reserve requirements.[1] The Board's statutory authority would permit it to shorten the 14-day maturity break to accommodate a new time account, so long as that account had limited transaction features; this would make the account eligible for time deposit reserve requirements.[2] The Committee is therefore faced with the difficult task of designing an instrument which can effectively compete with other market rate instruments, such as MMMF shares, but which minimizes savings deposit outflows and, to the extent practicable, takes into account the Federal Reserve's monetary policy considerations.

1/ In particular, the Federal Reserve Board now imposes transaction reserve requirements on (1) any account with a maturity or required notice period of less than 14 days, (2) any account on which a draft can be drawn--all demand deposits, NOWs, share drafts, and similar "other checkable deposits," (3) automatic transfer accounts, and (4) any account on which more than three monthly preauthorized or telephone transfers can be made. The Federal Reserve has also asked Congress for authority to extend reserve requirements to MMMFs that serve as the functional equivalent of transactions accounts.

2/ Under the Monetary Control Act, savings deposits and nontransferable time deposits held by persons are not reservable, while transferable time deposits and time deposits held by other than natural persons are subject to a reserve requirement of zero to 9 percent; the Board's current reserve requirement on such time deposits generally is 3 percent. Even if the Board adopted a zero percent reserve requirement on any new account, member banks would still be subject to a small (and declining) reserve requirement on the aggregate of their time and savings deposits during the phase-down period of reserve requirements under the Monetary Control Act.

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II. Design of the Instrument

The balance of this memorandum discusses the characteristics that a new short-term instrument might have, taking into account the above considerations. The key variables are the minimum denomination, maturity, and interest rate; a number of other features are also presented for the Committee's consideration. In addition, the Committee should be aware that limitations placed on the new instrument to reduce costs and facilitate monetary policy will also result in operational complexities for institutions. Attachment A summarizes the decision variables for the new instrument.

Minimum Initial Deposit. A large minimum balance requirement would minimize the potential for internal shifting from savings accounts, but would make the new instrument less competitive as well.[1] The staff believes that an initial minimum denomination on the order of $10,000 to $25,000 would be likely to prevent a large amount of internal deposit shifts. In determining the minimum initial deposit, the Committee may also wish to keep in mind: (1) the possibility of future adjustments in the minimum deposit requirement as information develops about internal deposit shifts, and (2) the desirability of reducing pressure on institutions to offer sweep accounts to MMMFs and retail repurchase agreements, many of which have been based on smaller denominations.

1/ A substantial proportion of savings deposits are in accounts with high balances. In December 1981, the FDIC indicated that 75 percent of savings account balances at MSBs were in excess of $5,000 and 41 percent were in excess of $15,000. These results were similar to a February 1982 survey conducted by the National Association of Mutual Savings Banks. In August 1980, the FHLBB indicated that 70 percent of the funds in regular savings accounts at S&Ls were in accounts with balances in excess of $5,000 and 45 percent were over $10,000. A small sample survey by the American Bankers Association in March 1982 indicated that at commercial banks about 60 percent of savings deposit balances were in excess of $5,000 and 38 percent were in excess of $10,000. The latter survey also indicated that almost three-fourths of total NOW balances were in excess of $5,000 and almost half were in excess of $10,000.

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Minimum Subsequent or Maintenance Balance. To accommodate occasional withdrawals, the Committee may wish to consider establishing a minimum maintenance balance lower than the initial deposit requirement. MMMFs typically permit shareholders to maintain balances below the initial balance requirement. A similar provision for the new instrument, however, would be tantamount to reducing the initial balance requirement for those depositors in a position to meet it by borrowing or temporarily rearranging assets. Moreover, considerations of simplicity and consistency with minimum balance requirements for other deposit accounts suggest that the maintenance balance on the new instrument be the same as the initial minimum.

In order to determine if withdrawals have reduced the balance in the proposed account below the required minimum, the Committee must first specify the period over which the minimum is to be maintained. The Committee could require that the minimum balance be maintained as an average over some interval (e.g., a week) or that it be met at all times. For accounts failing to meet this requirement, however defined, the Committee could stipulate that they be closed or, alternatively, that the rate paid on the remaining balance not exceed the applicable savings deposit ceiling. Institutions would, of course, be free to impose more restrictive provisions.

Maturity. To the extent that savings account holders place a high value on liquidity, requiring the proposed new account to have a fixed maturity or required notice period, even if it were short, might limit internal shifting from savings accounts. The resultant illiquidity compared to MMMFs might be offset by the convenience and insurance of the deposit instrument. Moreover, the Federal Reserve staff indicates that the shorter the maturity the greater are its monetary policy concerns. Therefore, the Committee staff suggests two

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options: (1) a 7-day instrument, or (2) in order to provide flexibility to issuing institutions, authorization of an instrument with any maturity between 7 and 31 days, or perhaps between 7 and 90 days.[1]

Whatever the maturity selected, the institutions could be permitted to offer the account in two versions: (1) a time deposit open account (which has no specific maturity) with an enforced notice requirement before withdrawal equal to the period selected, or (2) a time deposit with specific maturity, the balance of which would be automatically rolled over (after perhaps a 1-day grace period) if the depositor did not instruct otherwise. Discussions with depository institutions suggest a wide range of opinion regarding the operational difficulties of a short-term notice account; some can handle such an account with little difficulty, while others can do so only at great inconvenience. Authorizing both versions would permit greater flexibility to individual institutions.

Rate. There are several arguments in favor of and against imposition of a rate ceiling on any new deposit. The major arguments for a ceilingless account are:

(1) a ceiling might limit the competitiveness of the account;

(2) the objective of the DIDC is to deregulate;

(3) the available evidence suggests that institutions do not price irrationally;

1/ A specific or maximum maturity (as opposed to a minimum maturity) is necessary if the Committee does not wish to deregulate all ceilings for deposits equal to or above the proposed minimum denomination. In March, the Committee adopted a deregulation schedule based on maturity which would effectively be superseded for deposits above the minimum denomination on the new account unless a specific or maximum maturity were adopted.

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(4) as compared to an account with a market-indexed ceiling, a ceilingless account will not further exacerbate internal shifts from savings accounts, since the savings account ceiling is so far below the market rate;

(5) there is evidence that, in the market for competitive short-term instruments, virtually all issuers pay the ceiling rate and if there were no ceiling some institutions might pay less and some more than what would have been the ceiling rate; and

(6) institutions need the flexibility in the rates they can pay, especially in the early months of the new instrument, to regain depositors lost to MMMFs and other instruments.

The major arguments for imposing an indexed ceiling are:

(1) because of MMMFs, the competition for short-term deposits may be so intense as to make irrelevant the historical experience that irrational pricing has not occurred in other maturity categories;

(2) the operating losses of thrifts may necessitate restraint of rate competition in the short run; and

(3) a ceiling would be necessary if the Committee intends to establish a rate differential between banks and thrifts.

If the Committee chooses to impose an interest rate ceiling, the ceiling should move fairly closely with market rates to make the account competitive. There are several other issues that the Committee would need to address, including the choice of a base rate (e.g., 91-day bill rate), the relationship of the ceiling to the base rate, the frequency with which the ceiling would change, and compounding provisions. These matters are discussed more fully in the appendix.

Rate Differential. In deciding whether to impose a rate ceiling and whether to establish a rate differential for thrifts, the Committee may wish to review its objectives in adopting the 91-day account at the March 22 meeting and its purpose in directing the staff to prepare additional short-term deposit proposals. As noted earlier, the Committee adopted the 91-day account to

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enhance the competitive posture of depository institutions vis-a-vis MMMFs, and it imposed a rate differential to enhance thrift deposit flows which were especially weak compared to commercial banks. Thrift deposit flows have improved subsequent to the May 1 introduction of the 91-day account with a differential, although the extent to which the 91-day account is responsible for that improvement cannot be determined.

It should be noted that for those depositors in a position to meet the minimum denomination balance requirement the proposed account may be equally or more attractive to consumers in most respects than are the 91-day deposits, depending on the other specific features chosen by the Committee. If so, the new account may attract funds that otherwise would have gone to the 91-day account, and the intended effects of the Committee's action in establishing a differential on the 91-day account may be diminished considerably. If a differential is imposed, the Committee should also consider whether it will apply to IRA/Keogh and public unit deposits.

Additional Deposits. Flexibility to accept additional deposits to the proposed new account would make it more competitive with MMMFs, but would raise the problem of how to assure that the additional funds remain on deposit for the prescribed maturity or notice period. With regard to fixed-maturity term deposits, the simplest approaches would be either to permit additional deposits only at the time of renewal or to allow additional deposits at any time. With respect to additional deposits, the Committee could permit such funds to be withdrawn at the next scheduled maturity date or, alternatively, could require the issuing institutions to establish procedures assuring that each additional deposit remains in the account for at least the prescribed

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maturity period.[1] This latter approach might be particularly appropriate for notice accounts, where the timing of notices for specific withdrawals introduces additional complexities.[2] For monetary policy reasons, the Federal Reserve staff recommends that the Committee not permit additional deposits to the proposed new account if such deposits are triggered automatically by the level of balances maintained in this or any other account.

Withdrawals. The staff recommends no regulatory prohibition on the size or number of withdrawals from the proposed new account, provided that the funds to be withdrawn have satisfied the minimum maturity or notice period. For notice accounts, once the institution has received notification, withdrawals could occur only after the specified number of calendar days has passed. Institutions would have to require at least the minimum notice, which could be given by telephone or other telecommunication, mail or messenger, in person (over-the-counter or through an ATM), or by standing order. For term accounts, withdrawals

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1/ Examples of acceptable procedures for fixed maturity accounts include, but are not limited to, the following:

(1) Each deposit would re-initialize the maturity of the original deposit.
(2) Each deposit would be subject to "first-in-first-out" accounting to assure that each additional deposit was maintained for the term of the account.
(3) An institution would be permitted to set up an "accounting cycle" equal to the original term of the offered account. New deposits received after the accounting cycle had begun would be regarded as maturing at the end of the next complete accounting cycle. In effect, each deposit would be on "hold" until the end of the following cycle.

2/ Examples of acceptable procedures for notice accounts include, but are not limited to, the following:

(1) Any additional deposit would cancel any notice to withdraw that had already been received, unless that notification called for a longer remaining interval than the minimum notice period.
(2) "First-in-first-out" accounting to assure that each deposit would be maintained for at least the minimum notice period.
(3) Establishment of an accounting cycle equal to the notice interval. For funds received after the beginning of an accounting cycle, notice of withdrawal could be given only at or after the beginning of the next accounting cycle. In effect, the opportunity to give notice on any particular deposit would be deferred until the beginning of the next accounting cycle.

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could be made by any of the same methods. Any funds not withdrawn by the end of the grace period would automatically roll over.

In view of its monetary policy concerns, the Federal Reserve staff believes that the Committee should not authorize any new short-term account that can be used in connection with third-party payments. Thus, even though such an approach would limit the attractiveness of a new instrument relative to MMMFs, the Federal Reserve staff suggests that the Committee prohibit both third-party negotiable drafts that can be drawn directly on the account and the automatic triggering of deposits and transfers by changes in balances of this or any other account. The Federal Reserve staff would not object, however, to allowing the depositor to initiate unlimited deposits, transfers, or payments by telephonic notification or standing instructions, so long as such transactions were in compliance with minimum maturity or notice period provisions.

Early Withdrawal Penalty. In view of the short maturity or notice on the proposed account, the Committee could prohibit early withdrawals under any circumstances. This approach would eliminate the need for early withdrawal penalties. If the Committee chose instead to authorize early withdrawals, it might establish either of the following penalties: (1) loss of earned interest (as adopted on the 91-day account) or (2) the standard penalty (loss of interest that would have been earned if held to maturity, which could require invasion of principal).[1] Once again, institutions could adopt a more restrictive penalty or prohibit early withdrawals altogether.

1/ Either of these penalties could be relatively small for a partial withdrawal since the number of days for which interest would be forfeited would be small owing to the short-term nature of the account.

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Miscellaneous Restrictions. The staff recommends that the Committee consider whether to prohibit loans to depositors that are designed to help depositors meet initial or maintenance balances. If such loans were permitted they would undercut the purpose of these requirements. A second issue relates to overdraft privileges, which would still be permissible on NOW or demand deposits to which the new account is transferable. In order to prevent devices designed to circumvent the minimum maturity or notice requirements, however, the Committee may wish to consider requiring that the rate charged on such overdrafts be substantially equal to the rate charged for depositors that do not hold the proposed account.

Eligibility. The staff recommends that depository institutions be permitted to offer the proposed new account to all depositors.

Effective Date. In order to provide sufficient time for institutions to plan marketing strategies and redesign systems, the staff recommends that the effective date of any new instrument be September 1, 1982, about two months after announcement of the Committee's decision. The staff believes that further public comment on this instrument is not necessary because the terms of the proposed deposit were the subject of an extensive public comment period previously conducted by the Committee, and the Committee's decision as to the specific characteristics of the proposed deposit would be within the scope of the Committee's previous proposals and public comments received to date.

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Attachment A

SUMMARY OF DECISION VARIABLES FOR A
PROPOSED SHORT-TERM DEPOSIT

I. Rate

1. No ceiling.
2. Indexed ceiling with no differential in favor of thrifts (see Attachment B if this option is selected).
3. Indexed ceiling with a differential in favor of thrifts (see Attachments B and C if this option is selected).

II. Denomination

1. Initial minimum balance.
2. Maintenance minimum balance.
3. Period over which maintenance balance is to be calculated.
   - 1 day.
   - 1 week.
   - 1 month.
   - Period equal to maturity (or notice period) of the account.
   - Institutions' choice of above.
4. Action to be taken if balance falls below minimum.
   - Rate reduced (e.g., to applicable passbook ceiling or to zero) until:
     - new deposits bring balance up to the minimum maintenance balance.
     - new deposits bring balance up to the initial minimum balance.

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- Account must be closed and remaining balance must be paid to depositor or transferred to another account of the depositor; initial minimum balance would be required to re-open account.
- Must institutions notify the depositor on the first day the balance in the account falls below the minimum.

III. Maturity

1. Specific (e.g., only 7 days) or a permissible range (e.g., 7 to 30 days).
2. Form: enforced notice, specific term, or both.
3. For term accounts, the length of the grace period (e.g., 1 business day) before automatic rollover.

IV. Provisions Regarding Additional Deposits

1. For fixed-maturity accounts.
   - New deposits permitted only at maturity (or by the end of the grace period).
   - New deposits permitted without re-initializing the maturity.
   - Any procedure, including but not limited to the above, that assures each new deposit remains in the account for at least the prescribed maturity period.
2. For notice accounts.
   - Any procedure that assures that additions to the account are maintained for at least the notice period.
3. Sweeps into the proposed account from another account.
   - Permitted.
   - Prohibited.

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V. Notice and Withdrawal Provisions

1. Possible restrictions.

- Amount withdrawn must have remained on deposit for required maturity or notice period (notice period measured from time institution receives notification).
- No withdrawal by third-party draft drawn directly on the proposed account. VS FHLB
- No sweeps to another account automatically triggered by the level of the balance maintained in the new account or any other account. VS

2. Permissible means of delivering notice

- Telephone or other telecommunication.
- Mail or messenger.
- In person (including ATM).
- Standing order.

all

3. Permissible forms.

- Check or cash to depositor.
- Cash, draft, or electronic transfer by institution to third parties.
- Transfer to depositor's checking or NOW account.

all

VI. Early Withdrawal Penalty

1. Early withdrawal prohibited.

2. Early withdrawal permitted but with penalty of:

- Loss of earned interest.
- Loss of interest that could have been earned if funds withdrawn had been held to maturity (or for notice period), requiring invasion of principal.

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VII. Possible Miscellaneous Restrictions

1. Prohibit loans to depositors to meet initial or maintenance balances.
2. Require that overdraft rate on NOW or demand deposit accounts to which the balances in the new account are transferable not be substantially lower that the rate on such overdrafts for depositors that do not hold the proposed account.
3. Prohibit transferability and/or negotiability.
4. Prohibit loans to the accountholder that use the account as collateral. (Under existing regulation, minimum loan rate would be 1 percent over the rate being paid on the deposit.)

VIII. Eligibility of Depositors

1. No restrictions.
2. Limited to those eligible for NOW accounts (i.e., individuals and certain nonprofit organizations).
3. Limited to individuals only.

IX. Effective Date

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Attachment B

SUMMARY OF DECISION VARIABLES IF AN INDEXED CEILING WITHOUT A DIFFERENTIAL IS IMPOSED ON THE PROPOSED SHORT-TERM INSTRUMENT

I. Base Rate (e.g., the 91-day bill rate auction average, discount basis).

II. Relationship of the Ceiling Rate to the Base Rate

- Spread from base rate.
- 4-week averaging option, as on MMC.

III. Frequency of Changes in Ceiling Rate

IV. Adjustment of Rates Payable on Existing Accounts to Ceiling Changes

- Allow institutions either to adjust to the new ceiling or maintain the rate established at the time the account was opened or rolled over.
- Require institutions to keep the rates on existing accounts fixed until they roll over.
- Require institutions to reduce the rates paid on existing accounts if the ceiling falls before the account matures or the notice period has expired.

V. Compounding

- Permit without restriction.
- Limit compounding period to maturity of account or length of enforced notice period.

VI. Miscellaneous Issues

- May institutions offer RPs to future or current holders of the new deposit at a rate in excess of that offered to other customers?

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- May premiums be offered on the account--if so, existing rule (i.e., two per account per year), at each roll over period, or no more than, say, four times a year?
- May fees be paid to third party brokers for this account?

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Attachment C

SUMMARY OF ADDITIONAL DECISION VARIABLES IF A DIFFERENTIAL IS IMPOSED ON THE CEILING RATE FOR THE PROPOSED NEW SHORT-TERM INSTRUMENT

I. Size of Differential (e.g., thrifts can pay 25 basis points more than commercial banks).

II. Duration of Differential

- Permanent.
- Temporary, e.g., one year.

III. Conditions Under Which Differential is Eliminated (e.g., eliminated when base rate is below 9 percent for four consecutive weeks and reimposed when base rate exceeds 9 percent).

IV. Applicability of Differential to Special Types of Deposits

- IRA/Keogh deposits.
- Governmental unit deposits.

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APPENDIX

ISSUES RELATING TO DETERMINATION OF A CEILING RATE

If the Committee imposed an indexed ceiling--with or without a differential--it would have to address several additional issues. These include: the choice of a base rate, the relationship of the ceiling to the base rate, compounding provisions, the frequency with which the ceiling rate changes, and whether rates payable on existing account balances may be adjusted when the ceiling changes.

The staff would recommend using the 91-day bill rate (auction average, discount basis) as the base rate, with or without any 4-week averaging adjustment such as occurs on the MMC. The ceiling rate could then be set above, equal to, or somewhat below the base rate.

A major consideration in establishing a ceiling is the relationship between the ceiling and yields on MMMFs and other open market instruments. The insurance and convenience aspects of a deposit instrument are valued by many individuals, suggesting that a ceiling somewhat below these alternative yields would still enable the new account to attract funds. For illustrative purposes, Chart 1 displays the historical rate spread--measured on both a weekly and quarterly average basis--that would have prevailed since 1979 between the average MMMF yield and the rate on a short-term account if the ceiling had been equal to the 91-day bill rate (quoted on a discount basis). Even though management fees are deducted, the average MMMF yield tends to be higher because most of the assets held by these funds are private securities yielding higher rates of return. The chart indicates that even with daily compounding a deposit rate ceiling equal to the bill rate would have allowed MMMFs to pay, on average, over 50 basis points more than the depository institutions.

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From a practical point of view, the staff notes that it would be extremely difficult to prohibit compounding effectively on an instrument with a short maturity. On a fixed-term account, institutions legally must pay out or credit interest at maturity, even if the balance in the account is rolled over automatically. On a notice account, the Committee has somewhat more flexibility. It could, for example, limit the crediting and compounding of interest to periods of one quarter or more. If the Committee authorized both notice and fixed-term accounts, any restriction on compounding for notice accounts would result in yield differentials between the two; it is likely, however, that institutions would invent ways around any such restriction that are difficult to anticipate. Since the primary concern about compounding is its effect on the cost of funds, the staff suggests that the Committee address this issue in its consideration of the relationship between the ceiling and the rate base. In this regard, Table 1 illustrates that at Treasury bill rates of 12 percent, compounding would add between 37 and 77 basis points to the nominal ceiling depending on the frequency of the compounding.

One mechanical issue with respect to a ceiling rate involves the rules that would govern adjustments of rates paid on existing account balances to changes in the interest rate ceiling. The Committee could, for example, allow institutions the discretion either to change to the new ceiling or to maintain the rate established at the time the account was opened or rolled over. Alternatively, the Committee could require that institutions maintain the rate established at the time the account was opened or rolled over. In any event, at maturity or at the end of an interval equal to the notice period, the institution would be required to change the rate on an existing account balance if it exceeded the ceiling rate then in force for new deposits.

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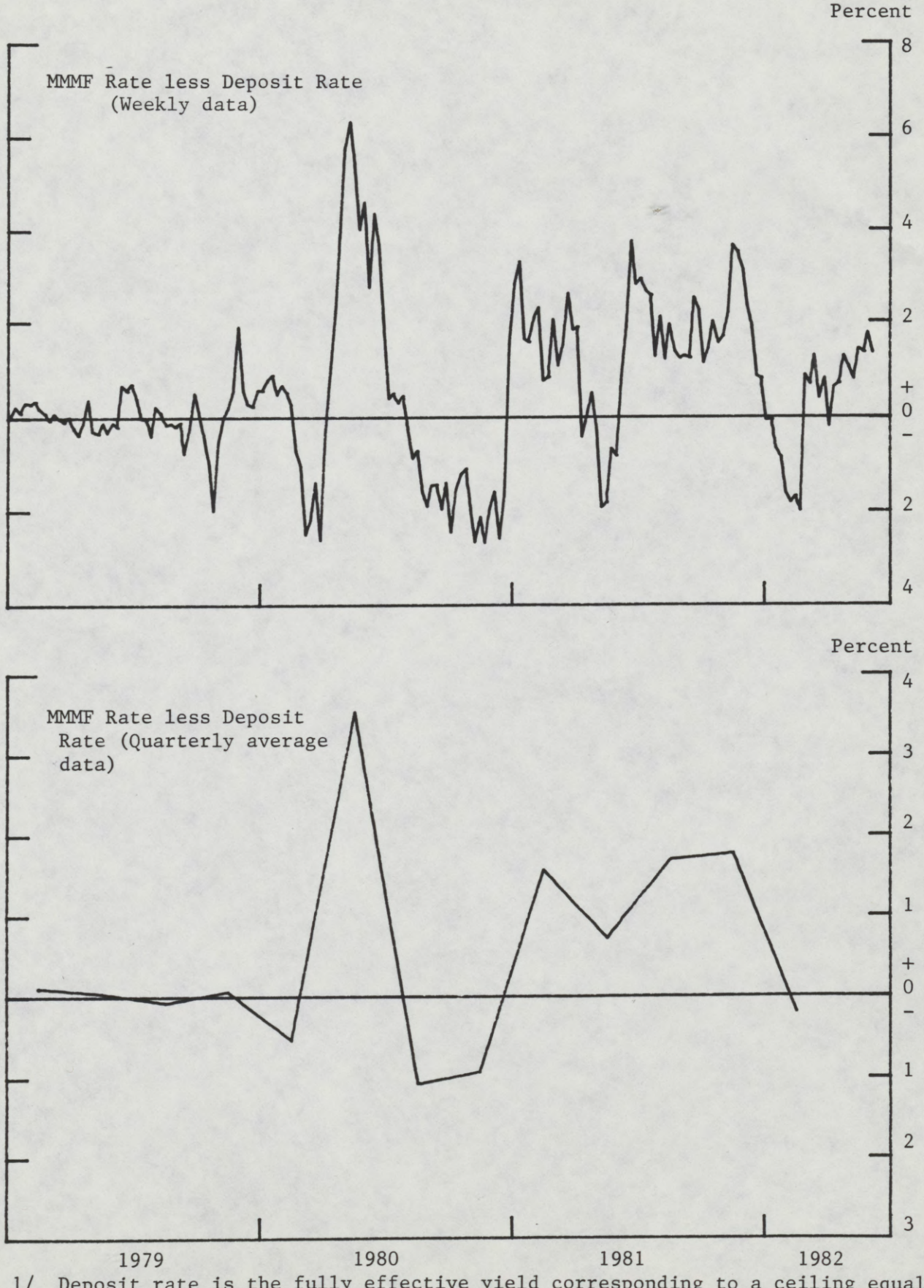
Chart 1

SPREADS BETWEEN YIELDS ON MMMFs
AND A HYPOTHETICAL SHORT-TERM DEPOSIT 1/



1/ Deposit rate is the fully effective yield corresponding to a ceiling equal to the 91-day Treasury bill rate, auction average discount basis.

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Table 1

EFFECTIVE YIELDS CORRESPONDING TO A 12 PERCENT NOMINAL CEILING FOR VARIOUS COMPOUNDING PERIODS--365/360 BASIS

Type of Compounding	Effective Rate	Increased Yield Due to Compounding	Percent of the Continuously Compounded Increase
	---- percent per annum ----		
1) Continuous	12.938	.771	100
2) Daily	12.935	.768	99+
3) Weekly	12.922	.755	98
4) Quarterly (91 day)	12.734	.567	74
5) Semi-annual (182 days)	12.538	.371	48
6) No compounding[1/]	12.167	--	0

1/ The fact that the effective rate is about 17 basis points higher than the nominal rate even with no compounding is due to the artificial year.

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WORLD SAVINGS
AND LOAN ASSOCIATION

June 10, 1982

The Honorable Richard T. Pratt, Chairman
Federal Home Loan Bank Board
1700 "G" Street, N.W.
Washington, D.C. 20552

Dear Dick:

We understand that the Depository Institutions Deregulation Committee ("Committee") will consider action at its meeting on June 29 on a seven-day market rate account with a relatively high minimum denomination. It is our opinion that the account which has been proposed for comment has several serious pitfalls. The purpose of this letter is to strongly urge the Committee to consider instead the adoption of a new form of short-term deposit which we believe will be successful because it possesses all of the attributes necessary to be competitive with Money Market Mutual Funds (MMMF) and other short-term investments while avoiding certain dangers and shortcomings of the seven-day account being considered.

Background

It should be clear now to almost everybody that the thrift industry is in dire straits. Operating losses are substantial and net worth erosion has become critical. In addition to the earnings and net worth problems, there has been a continuing loss of savings to competitive instruments offered by unregulated, non-depository institutions. The steady movement of consumer deposits out of thrift institutions has serious overtones and perhaps even greater, and more immediate, consequences than those presented by the industry's shrinking capital. Although a magnificent job has been done in maintaining public confidence to date, there is growing evidence that a breach of that public confidence is taking place.

A New Account Similar to a Money Market Mutual Fund is Needed

It is absolutely essential that the Committee now authorize an account which is certain to be successful. Accordingly, we believe that this new form of deposit must possess the attributes of a product in which the public has already demonstrated an intense interest, namely, the Money Market Mutual Fund. In addition, it is imperative that the account be simple and easy to market.

20TH STREET AND BROADWAY, OAKLAND, CALIFORNIA 94612 (415) 645-9414
MEMBER OF GOLDEN WEST FINANCIAL CORPORATION

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Objectives of a New Account

If properly designed, we believe that a new form of short-term deposit should enable commercial banks and thrift institutions to successfully compete with MMMFs for the first time. Moreover, such an account should be able to stop the continuing outflow of consumer savings from depository institutions in general, and from thrift companies in particular, without an excessive transfer of funds from lower rate passbook accounts. In our opinion, the objectives of such an account should strike an appropriate balance between the need to resolve the growing cash flow needs of thrift institutions on the one hand, and the concerns over the industry's earnings and net worth problems on the other hand.

Suggested Characteristics of a Competitive Deposit

Based on the lessons learned by the remendous success of MMMFs and the experience we have gained from marketing a highly effective consumer repurchase agreement ("repo") program, we believe that a short-term account should possess the following characteristics in order to meet the needs and objectives discussed above:

Interest Rate: The weekly average rate paid by the nation's leading MMMFs taken from Donohue's Money Funds Report or, preferably, as determined by the Federal Reserve Board. The interest rate should be fixed for a seven-day period.

Differential: Thrift institutions must be authorized to pay 1/4% more than the rate proposed above.

Term: Thirty (30) days, renewable automatically for successive like periods. No maturity notification should be required.

Minimum Opening Balance: We recommend a $2,000 minimum opening balance. However, if the Committee chooses a larger minimum, we strongly urge a minimum balance of no more than $5,000.

Minimum Maintenance Balance: $2,000.

Withdrawals: Permitted without notice in amounts of at least $500 up to three times per month. Withdrawals may be made by check. Withdrawals of less than $500 would be subject to a $10 processing fee.

Deposits: Permitted in amounts of $500 or more.

no premiums

The account proposed above offers features which are highly competitive with MMMFs and other short-term instruments in a package that is easy to understand and easy to market. In our view, this deposit will satisfy the public's demand for high

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yield, short maturity and reasonable access and thus will be very successful in halting the erosion of consumer deposits from depository institutions and in attracting new savings. At the same time, we believe that transfers of passbook savings into this new account will not be excessive or inordinately expensive given the cash flow benefits to be realized.

Our experience in working with financial institution lobby groups, interested legislators and industry regulators indicates that it is likely that there will be diverse opinions regarding the appropriateness of the account proposed above. Because several of these divergent views can be anticipated, we would like to take this opportunity to discuss the two major issues expected to be raised.

First, some commercial bankers may argue that the interest rate on the proposed account should be deregulated completely rather than be limited to an index and that there should not be a differential even for an interim period. Those who raise these objections are either ignorant of the current condition of thrift institutions or seek to take advantage of the plight of that industry. We submit that to totally deregulate any new short-term account would give the comparatively healthy commercial banking industry an insuperable advantage over the severely weakened thrift institutions, thereby further abbreviating the business life expectancy of many savings and loans and savings banks.

We believe that the key objectives of public policy for the Committee at this time should be to enable depository institutions in general to become competitive with unregulated intermediaries and to remedy the increasingly severe liquidity problems facing thrift companies. We submit that the proposed account accomplishes these objectives by giving commercial banks the long-sought opportunity to compete with MMMFs on an equal footing. At the same time, thrift institutions will be provided the means to bolster their cash flows and, it is to be hoped, win some positive publicity by virtue of a return to healthy savings gains. Finally, we believe that the highly competitive market rate of the account proposed makes full deregulation unnecessary at this time and thus forestalls until a more appropriate time an action which could have disastrous results for thrifts if taken now.

Second, it is expected that some thrift company executives will argue that funds generated by the new form of market-rate deposit we have proposed will be too costly in view of the large operating losses and declining capital of the industry. In addition, although a very large percentage of the liabilities of thrift institutions are already at or approaching market rates, objections will still be expressed by those who fear that transfers from passbook accounts to the new deposit form will be particularly expensive.

Admittedly, the diminishing net worth positions of thrift institutions are cause for extreme concern. However, less obvious and even more dangerous, in our opinion, are the growing liquidity problems of the thrift industry stemming from its inability to effectively compete for consumer savings. Indeed, it is not

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inconceivable that continuing consumer deposit losses could trigger a cash flow crisis. Thus, we believe that the benefits which will be provided to the industry at a most critical time through enhanced cash flow and liquidity far outweigh the cost of the competitive product.

We would also like to say a few words about concerns over the transfers from passbook accounts. These accountholders can be divided into two categories: those who will not transfer and those who will. The first group, a large core of stable passbook deposits, have not been tempted by market rates (which have been available at financial institutions since June of 1978) and are not likely to move now simply because of the advent of the proposed account. The second group uses the passbook as a parking lot for funds. As long as thrift institutions do not have a competitive product, these depositors are prime candidates for disintermediation into MMMFs or any other attractive, high-yielding instrument. This passbook customer will satisfy his needs. When his current financial instrument does not meet his requirement for yield and liquidity, he goes elsewhere. We believe that it is somewhat naive to expect the saver to continue indefinitely to be content with a 5 1/4 - 5 1/2% return when he is being bombarded with profitable alternatives. The gap in the savings and loan product line (the absence of a high-yielding, liquid account) created a vacuum that spawned a $200 billion MMMF industry. Currently, in a desperate attempt to fill this gap and to retain customers, several depository institutions have actually linked up with MMMFs and created an account which will facilitate the movement of savings funds into MMMFs through a sweep arrangement. To summarize, there is a large portion of passbook savings that is immobile. The balance of these accounts is unstable and highly susceptible to the best offer. Experience has demonstrated that it is patently shortsighted (and, at this junction, dangerous) to expect to retain savings with yields that are well below market in a market rate world. Under the present circumstances, we believe the most judicious course of action must include an attempt to retain "group two" of our passbook funds by offering an account with an attractive rate, rather than face the high likelihood of losing these funds entirely.

Conclusion

In the past four years since the adoption of the popular six-month money market account, regulators have been unable to design a successful short-term account. One major reason for this failure has been the effort to create a deposit which will not lure funds from passbook accounts, either through the use of long minimum terms or high minimum balances. The result of all of this effort has been the creation of a sizeable number of relatively noncompetitive products. It is now exceedingly critical that the Committee focus instead on the products being offered in the financial marketplace, in general, and specifically those offered by MMMFs, and adopt a form of deposit which will enable commercial banks and

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thrift institutions to once again aggressively compete for consumer funds without being at a disadvantage to other unregulated intermediaries. We believe that we have described the characteristics of such an account in this letter and we urge the Committee to favorably consider our recommendation.

Sincerely,

Herbert M. Sandler
Chairman of the Board
and Chief Executive Officer

HMS:jy

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Chairman—
We are appealing to the precedent of Pratt's demand that the short-term instrument not be done by notation vote to try to get this item onto the agenda for 6/29. it may not change the substantive outcome but at least it assures an airing of the issues of what is interest. Neal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM

Date: 6/9/82

To: Chairman Volcker

From: NORMAND BERNARD NB.

Notation vote request. I understand that Neal Soss has already discussed this memo with you. Gil Schwartz is a principal author of the accompanying memo.

Neal: FYI

I understand that most, and possibly all, of the other DIDC members will vote for Option I.

Attachment

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DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE
Washington, D.C. 20220

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

JUN 08 1982

MEMORANDUM TO: Distribution

FROM: Steve Skancke SJS

Attached for presentation to your respective DIDC member is the final notation ballot on the Establishment of Interest Rates on Accounts not Subject to Interest Rate Limitations.

Please return this ballot to me as soon as your member has voted. If you expect a delay, please let me know.

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DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE
Washington, D.C. 20220

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

June 7, 1982

TO. Depository Institutions Deregulation Committee

FROM: Steven L. Skancke SLS
Executive Secretary

SUBJECT Request for Notation Vote on Establishment of Interest Rates on Accounts Not Subject to Interest Rate Limitations

Your notation vote is requested to determine whether the Committee's actions to create new deposit accounts without Federal interest rate limitations (1) should allow depository institutions complete discretion in setting interest rates payable on such accounts, (2) should require in the deposit contract the specification of a minimum rate or the means for determining the rate, beyond which discretionary bonuses would be permitted, or (3) should require in the deposit contract the establishment in advance of a specific rate or a specific means by which to determine the rate, beyond which no bonuses would be permitted.

Current DIDC member agency rules 1/, adopted under authority since transferred to the DIDC, require that time deposits issued by depository institutions specify at the time the deposit agreement is entered into, the rate of interest paid, and if such rate is variable, that it be indexed to an independently verifiable standard. Interpretations of these rules would seem to prohibit depository institutions from paying a bonus subject solely to their own discretion or paying interest at a rate subject solely to their control. In addition, FDIC rules would require imposing an early withdrawal penalty for payment of a discretionary bonus.

The Committee has been asked to review these agency interpretations and determine whether they should continue to apply. (DIDC action will not affect current agency advertising or disclosure regulations nor will it prevent agencies from issuing such further regulations they deem necessary to assure consumer protection.) A DIDC staff memorandum providing additional background is attached.

1/ National Credit Union Administration rules are not involved.

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Please Indicate Your Vote -- For deposit categories not subject to Federal interest rate limitations, depository institutions:

/__/ 1. May retain complete discretion in establishing the interest rate and amount payable and are not restricted to using only rate indexes established for independent business purposes or indexes not under their control. 1/

/__/ 2. Must establish a minimum interest rate or amount payable but may reserve the right to pay a bonus in a manner determined solely in the depository institution's discretion.

/__/ 3. Must specify in the deposit contract a specific interest rate or a verifiable standard for determining interest rates or bonus amounts. In addition, the interest rate on a variable rate time deposit must be based on a predetermined schedule or on an index over which the depository institution does not have control or discretion.

_____
DIDC Member Signature

Attachment: Staff Memorandum

1/ Under state laws governing contracts, material terms such as the rate of interest generally would have to be stated and agreed upon in order to create a contract between the depositor and the depository institution.

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DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE
Washington, D.C. 20220

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

TO: Depository Institutions Deregulation Committee

FROM: DIDC Staff *

SUBJECT: Establishment of Interest Rates on Accounts Not Subject to Interest Rate Limitations

ACTION REQUESTED: The Committee is asked to determine the extent of discretion that depository institutions may have in establishing interest rates for deposit categories that are not subject to Federal interest rate limitations.

BACKGROUND: At its September 22, 1981 and March 22, 1982 meetings, the DIDC authorized new deposit account categories not subject to Federal interest rate limitations. Inquiries from depository institutions have raised questions concerning the permissible methods of establishing interest rates on such accounts. Some of the individual agencies, in interpreting their current regulations, have indicated that deposit contracts must state explicitly either the specified rate to be paid on the deposit or the method for determining the rate. This is to enable the depositor to verify that he or she is receiving the correct amount of interest. Also, some agency rules provide that any discretionary increase in the rate of interest paid on a time deposit constitutes an early withdrawal.

Several institutions (see, for example, the attached petition of the Philadelphia Savings Fund Society) have asked whether it is permissible to establish a rate on deregulated accounts whereby the deposit contract would state the minimum rate paid on the time deposit, but also would provide that the institution retains the right to pay a higher interest rate or bonus solely at its discretion. Any such higher rate or bonus could depend on one or more variables, such as the rate offered by competitors or the earnings

* This memorandum was prepared primarily by the staff of the Federal Reserve Board and the Treasury Department.

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of the institution and, under some of the proposals would be at the sole discretion of the depository institutions.

DISCUSSION: The staff believes that this issue is significant for all existing and future deposits not subject to an interest rate ceiling, including the new IRA/Keogh 1-1/2-year and the 3-1/2-year minimum maturity account categories. The range of options available to the Committee includes (1) allowing depository institutions to retain complete discretion in establishing rates and amounts of interest to be paid on account categories not subject to interest rate limitations; (2) requiring a stated minimum rate or amount of interest but permitting discretionary bonuses to be paid in addition; and (3) reaffirming existing DIDC member agency (not NCUA) rules and interpretations.

Adopting the first option would permit depository institutions to base their interest rate on any index or schedule they deem appropriate for the account. Thus, current FHLBB and Federal Reserve rules requiring that the index be outside the control of the institution, or the FDIC rule limiting the choice of an index to one established for an independent business purpose, no longer would apply. As a result, an institution and a depositor, for example, would be able to agree on a rate of interest that varies with the institution's cost of funds or profitability and where the relationship between the index and the rate of interest paid would be subject to the discretion of the institution. Such a grant of discretion, however, would not override state laws and general principles of contract law, nor would it override advertising and other consumer protection requirements now present in DIDC member agency rules and interpretations.

Option two would require depository institutions to specify a minimum rate of interest, or a method for determining that rate of interest. In addition to this minimum an institution would retain discretion to pay a bonus for whatever purpose it would deem appropriate. A variable rate would continue to be governed

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by FDIC, FHLBB and Federal Reserve restrictions on permissible indexes upon which the rate could be based.

In option three, current FDIC, FHLBB and Federal Reserve rules and interpretations on setting and changing interest rates, and the selection of appropriate indexes, are maintained. This option would prohibit the establishment of a time deposit where an institution retains discretion over any part of the amount or rate to be paid, including the discretion to pay a bonus or to pay an unspecified amount above a minimum. Institutions would have to inform the holder of a time deposit at the time an account is opened of the rate of interest or, if a variable rate account, the specific method that will be used in computing and paying interest on the account.1/

In resolving this issue, the Committee must determine the balance between (1) consumer protection and (2) preserving the benefits that may accrue to both depositors and institutions by allowing greater flexibility in developing deposit contracts. Discretionary rate and bonus arrangements may permit depository institutions to be more competitive and, as a result, increase their deposit flows. Consumers may benefit from higher interest payments than they would otherwise receive. On the other hand, there is potential that some institutions may mislead consumers into believing that they will receive an unspecified rate of interest or a bonus on a time deposit but have little or no intention of paying the bonus. In addition they may decide to provide higher rates or bonuses to some depositors, but not others.

1/ These rules were established to protect consumers from the allure of higher rates of return when the higher rates are not guaranteed or the method of determining these higher rates is not verifiable. Under their provisions, an institution may provide in its time deposit contracts for the payment of a bonus or an increase in the rate of interest if it specifies the verifiable conditions under which the bonus will be paid or the rate increased. For example, an institution could include a provision that a bonus of one percent will be paid on an account if the institution's ratio of net income to average total assets for a year exceeds a pre-established amount, such as 1.50%.

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If the Committee determines that its rules governing ceiling-free accounts mean that institutions may retain discretion over the rate or amounts of interest to be paid on such accounts, this would supersede existing agency rate-setting rules, but not advertising or disclosure rules. This would seem to be consistent with the Committee's September 1981 and March 1982 deregulation of deposit interest rates on certain account categories. As a practical matter, market constraints would likely require that institutions establish at least a minimum rate to attract depositors, and depositors would likely learn of institutions that do not deal in good faith. The regulatory agencies would be free to issue additional advertising and disclosure guidelines with regard to rate and bonus arrangements to protect consumers against misleading practices.

If the Committee believes that current restrictions governing the establishment of interest rates or payments of bonuses are needed to complement advertising and disclosure rules in assuring protection of depositors, then the current agency rate regulations and interpretations can be reaffirmed by the DIDC, and institutions will be required to specify in the deposit contract the method of establishing any interest paid.

As an alternative, the Committee may wish to choose option two which requires that a minimum rate or a verifiable method of determining a rate be established in a deposit contract but that institutions be given discretion to pay bonuses above that rate.

Attachment: Philadelphia Savings
Fund Society Petition

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PSFS

THE PHILADELPHIA SAVING FUND SOCIETY • THE NATION'S FIRST MUTUAL SAVINGS BANK

M. Todd Cooke
Chairman

February 19, 1982

Mr. Steven L. Skancke
Executive Secretary
Depository Institutions
Deregulation Committee
Department of the Treasury
15th Street & Pennsylvania Avenue, NW
Washington, DC 20220

Dear Mr. Skancke:

The Philadelphia Saving Fund Society (PSFS) requests that the Depository Institutions Deregulation Committee (DIDC) issue a ruling whereby DIDC Regulations supercede FDIC Rules and Regulations to permit maximum rate flexibility for the new IRA/Keogh accounts. Specifically, PSFS requests that Section 329.4(e)(1) of the FDIC Rules and Regulations be superceded. This section has the effect of limiting the ability of financial institutions to provide market interest rates for IRA/Keogh accounts and defeats the DIDC's intention to deregulate the interest rate ceiling for these accounts. Thus, it prohibits financial institutions from aggressively competing with non-financial institutions for retirement deposits.

PSFS submits the attached petition for DIDC review and action. Implementation of PSFS' recommendation will ultimately benefit customers in that competition and not regulation will determine the interest rate paid on these deposits.

Thank you for your consideration.

Sincerely,

M. Todd Cooke

1212 MARKET STREET • PHILADELPHIA, PA 19107 (215) 636-6100

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PSFS' PETITION TO AMEND FDIC REGULATIONS FOR IRA/KEOGH ACCOUNTS

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Background

On December 18, 1980, the DIDC requested comments on proposed changes to existing regulations to allow greater flexibility in administration of and competition for IRA/Keogh deposits. Comment was specifically requested on whether or not the proposed IRA/Keogh account should be indexed to a ceiling rate or totally deregulated. At its June 25, 1981 meeting, the DIDC elected to defer action on the IRA/Keogh accounts pending the outcome of legislative revisions being considered by Congress.

The Economic Recovery Tax Act of 1981, signed into law on August 13, 1981 by President Reagan, amended existing IRA/Keogh legislation by providing for higher contributions and expanding the eligibility requirements for IRA's. It did not address the earlier issues which the DIDC was considering.

Later in the year, at its September 22, 1981 meeting, the DIDC reconsidered these proposals and approved a new time deposit category for IRA/Keogh acounts. The new account provided for (1) a minimum maturity of eighteen months, (2) no regulated interest rate ceiling, and (3) additional deposits without extending the maturity will be permitted.

The Issue

PSFS believes that the DIDC staff did not adequately address the issue of a deregulated interest rate ceilings when it wrote the final regulations concerning the new IRA/Keogh account. FDIC guidelines specifically state that if a financial institution establishes a variable rate IRA/Keogh account, the interest rate must be equal to the indicator as noted in the terms and conditions of the account. This does not provide any flexibility to pay higher than the indicator and, in fact, it fixes the indicator as a "regulated" interest rate ceiling.

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The Law

Section 1204.118(a) of the DIDC Regulations provides for the new IRA/Keogh account and reads:

> (a) A commercial bank, mutual savings bank or savings and loan association may pay interest at any rate as agreed to by the depositor on any time deposit with a maturity of one and one-half years or more, that consists of funds deposited to the credit of, or in which the entire beneficial interest is held by, an individual pursuant to an Individual Retirement Account agreement or Keogh (H.R. 10) Plan established pursuant to 26 U.S.C. (I.R.C. 1954) 219, 401, 408 and related provisions.

Section 329.4(e) of the FDIC Rules and Regulations state:

> (e) Application of penalty to changes in interest rates or maturities.-(1) Increases in interest rates on existing time deposits. Where there is an increase in the rate of interest paid on any time deposit, the deposit will be treated as having been withdrawn by the depositor, prior to maturity, on the date on which the deposit begins to earn interest at the higher rate.

An exception is granted to this regulation in Section 329.4(e) (3) of the FDIC Rules and Regulations which reads:

> (3) Exceptions. The provisions of this paragraph (e) do not apply to an increase in the rate of interest paid on a time deposit where such increase is explicitly authorized by the terms of the original deposit contract and may not be granted or withheld at the opposition of the bank.

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PSFS believes that the FDIC's interpretation of this regulation is not consistent with the intentions of the DIDC when they authorized the new IRA/Keogh account.

PSFS' Variable Rate IRA/Keogh Account

PSFS has been advised by the FDIC that its Variable Rate IRA/Keogh account is in violation of FDIC Regulations. The FDIC has cited PSFS' method of determining the interest rate to be inconsistent with FDIC Regulations. PSFS' Terms and Conditions for the Variable Rate IRA/Keogh account include the following statement regarding the interest rate paid.

> "During the initial term, interest will be payable at a variable annual rate which is subject to change on a weekly basis. The Interest Rate will vary in conjuncton with each variation in the auction average discount rate for most recently issued six-month U.S. Treasury Bills as announced by the U.S. Treasury Department following each weekly six-month U.S. Treasury Bill Auction. On the first business day after each Auction, the Interest Rate will be redetermined and reset so as to produce, for the period it is in effect, a Percentage Yield at least equal to 90% of the then-current Auction Rate."

The FDIC contends that the statement "at least equal to 90%" does not conform with the exception granted in Section 329.4(e)(3) of its Rules and Regulations. The rate of interest paid is not readily ascertainable by the customer.

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PSFS believes that its method of determining the interest rate does conform with FDIC Rules and Regulations, in addition to the DIDC Regulations, which authorize the account for the following reasons:

The DIDC authorized no interest rate restrictions for the new account so that banks, mutual savings banks and saving and loan associations could actively compete with non-financial institutions for customers' deposits. Money Market Funds, for example, do not index their rate to any external or internal indicator. They have complete latitude in determining their rates. It was the DIDC's intent, we believe, to provide equal flexibility to financial institutions. Accordingly, PSFS' Terms and Conditions were designed to provide this flexibility and latitude in the weekly establishment of its rate. It guaranteed an interest rate to its customers that would be based on prevailing market conditions. This allows PSFS to compete aggressively with non-financial institutions for customers' deposits, rather than lose them to non-financial institutions because of rate restrictions.

The DIDC also expressed concern that the customer be able to determine the indicator to which the interest rate would be indexed. PSFS clearly states in its terms and conditions what the guaranteed minimum rate would be, as previously quoted, on page 3.

Customers can readily determine what the six-month auction rate is and know the minimum amount of interest that will be earned for the period. When PSFS elects to pay a rate higher than the guaranteed minimum, it is because market conditions require it if PSFS wishes to continue to attract new deposits. The

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payment of a higher rate of interest to the customer certainly cannot be considered as a disservice to the customer. In addition, PSFS makes its rates available through branch signage, special rate "hotlines", advertising in newspapers and an insert mailed with each quarterly statement showing the interest rates for each period.

It is important for the DIDC to provide financial institutions with maximum flexibility in the competition for IRA/Keogh deposits. These deposits represent long-term, stable funds for financial institutions. If other restrictions are placed on these accounts, such as the interest rate restrictions identified in the FDIC guidelines, PSFS believes financial institutions will be at a major competitive disadvantage.

PSFS Recommendation

PSFS has supported the DIDC in its efforts to deregulate and improve the administration of IRA/Keogh account. PSFS recommends that the DIDC issue a ruling whereby DIDC regulations supercede existing FDIC Regulations to provide for a truly deregulated IRA/Keogh account.

If this petition is accepted, financial institutions would be able to compete on a truly equal basis with non-financial institutions for customers' desposits. Competition will benefit potential customers by encouraging the payment of a market return on funds invested.

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BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM

Date: 6/9/82

To: Chairman Volcker

From: NORMAND BERNARD N.B.

Notation vote request. I understand that Neal Soss has already discussed this memo with you. Gil Schwartz is a principal author of the accompanying memo.

I understand that most, and possibly all, of the other DIDC members will vote for Option I.

Attachment

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DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE
Washington, D.C. 20220

COMPTROLLER OF THE CURRENCY
FEDERAL RESERVE BOARD

FEDERAL DEPOSIT INSURANCE CORPORATION
NATIONAL CREDIT UNION ADMINISTRATION

FEDERAL HOME LOAN BANK BOARD
DEPARTMENT OF THE TREASURY

June 7, 1982

TO. Depository Institutions Deregulation Committee

FROM: Steven L. Skancke SLS
Executive Secretary

SUBJECT Request for Notation Vote on Establishment of Interest Rates on Accounts Not Subject to Interest Rate Limitations

Your notation vote is requested to determine whether the Committee's actions to create new deposit accounts without Federal interest rate limitations (1) should allow depository institutions complete discretion in setting interest rates payable on such accounts, (2) should require in the deposit contract the specification of a minimum rate or the means for determining the rate, beyond which discretionary bonuses would be permitted, or (3) should require in the deposit contract the establishment in advance of a specific rate or a specific means by which to determine the rate, beyond which no bonuses would be permitted.

Current DIDC member agency rules 1/, adopted under authority since transferred to the DIDC, require that time deposits issued by depository institutions specify at the time the deposit agreement is entered into, the rate of interest paid, and if such rate is variable, that it be indexed to an independently verifiable standard. Interpretations of these rules would seem to prohibit depository institutions from paying a bonus subject solely to their own discretion or paying interest at a rate subject solely to their control. In addition, FDIC rules would require imposing an early withdrawal penalty for payment of a discretionary bonus.

The Committee has been asked to review these agency interpretations and determine whether they should continue to apply. (DIDC action will not affect current agency advertising or disclosure regulations nor will it prevent agencies from issuing such further regulations they deem necessary to assure consumer protection.) A DIDC staff memorandum providing additional background is attached.

1/ National Credit Union Administration rules are not involved.

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Please Indicate Your Vote -- For deposit categories not subject to Federal interest rate limitations, depository institutions:

/__/ 1. May retain complete discretion in establishing the interest rate and amount payable and are not restricted to using only rate indexes established for independent business purposes or indexes not under their control. 1/

/__/ 2. Must establish a minimum interest rate or amount payable but may reserve the right to pay a bonus in a manner determined solely in the depository institution's discretion.

/__/ 3. Must specify in the deposit contract a specific interest rate or a verifiable standard for determining interest rates or bonus amounts. In addition, the interest rate on a variable rate time deposit must be based on a predetermined schedule or on an index over which the depository institution does not have control or discretion.

_____
DIDC Member Signature

Attachment: Staff Memorandum

1/ Under state laws governing contracts, material terms such as the rate of interest generally would have to be stated and agreed upon in order to create a contract between the depositor and the depository institution.

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DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE
Washington, D.C. 20220

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

TO: Depository Institutions Deregulation Committee

FROM: DIDC Staff *

SUBJECT: Establishment of Interest Rates on Accounts Not Subject to Interest Rate Limitations

ACTION REQUESTED: The Committee is asked to determine the extent of discretion that depository institutions may have in establishing interest rates for deposit categories that are not subject to Federal interest rate limitations.

BACKGROUND: At its September 22, 1981 and March 22, 1982 meetings, the DIDC authorized new deposit account categories not subject to Federal interest rate limitations. Inquiries from depository institutions have raised questions concerning the permissible methods of establishing interest rates on such accounts. Some of the individual agencies, in interpreting their current regulations, have indicated that deposit contracts must state explicitly either the specified rate to be paid on the deposit or the method for determining the rate. This is to enable the depositor to verify that he or she is receiving the correct amount of interest. Also, some agency rules provide that any discretionary increase in the rate of interest paid on a time deposit constitutes an early withdrawal.

Several institutions (see, for example, the attached petition of the Philadelphia Savings Fund Society) have asked whether it is permissible to establish a rate on deregulated accounts whereby the deposit contract would state the minimum rate paid on the time deposit, but also would provide that the institution retains the right to pay a higher interest rate or bonus solely at its discretion. Any such higher rate or bonus could depend on one or more variables, such as the rate offered by competitors or the earnings

* This memorandum was prepared primarily by the staff of the Federal Reserve Board and the Treasury Department.

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of the institution and, under some of the proposals, would be at the sole discretion of the depository institutions.

DISCUSSION: The staff believes that this issue is significant for all existing and future deposits not subject to an interest rate ceiling, including the new IRA/Keogh 1-1/2-year and the 3-1/2-year minimum maturity account categories. The range of options available to the Committee includes (1) allowing depository institutions to retain complete discretion in establishing rates and amounts of interest to be paid on account categories not subject to interest rate limitations; (2) requiring a stated minimum rate or amount of interest but permitting discretionary bonuses to be paid in addition; and (3) reaffirming existing DIDC member agency (not NCUA) rules and interpretations.

Adopting the first option would permit depository institutions to base their interest rate on any index or schedule they deem appropriate for the account. Thus, current FHLBB and Federal Reserve rules requiring that the index be outside the control of the institution, or the FDIC rule limiting the choice of an index to one established for an independent business purpose, no longer would apply. As a result, an institution and a depositor, for example, would be able to agree on a rate of interest that varies with the institution's cost of funds or profitability and where the relationship between the index and the rate of interest paid would be subject to the discretion of the institution. Such a grant of discretion, however, would not override state laws and general principles of contract law, nor would it override advertising and other consumer protection requirements now present in DIDC member agency rules and interpretations.

Option two would require depository institutions to specify a minimum rate of interest, or a method for determining that rate of interest. In addition to this minimum an institution would retain discretion to pay a bonus for whatever purpose it would deem appropriate. A variable rate would continue to be governed

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by FDIC, FHLBB and Federal Reserve restrictions on permissible indexes upon which the rate could be based.

In option three, current FDIC, FHLBB and Federal Reserve rules and interpretations on setting and changing interest rates, and the selection of appropriate indexes, are maintained. This option would prohibit the establishment of a time deposit where an institution retains discretion over any part of the amount or rate to be paid, including the discretion to pay a bonus or to pay an unspecified amount above a minimum. Institutions would have to inform the holder of a time deposit at the time an account is opened of the rate of interest or, if a variable rate account, the specific method that will be used in computing and paying interest on the account.1/

In resolving this issue, the Committee must determine the balance between (1) consumer protection and (2) preserving the benefits that may accrue to both depositors and institutions by allowing greater flexibility in developing deposit contracts. Discretionary rate and bonus arrangements may permit depository institutions to be more competitive and, as a result, increase their deposit flows. Consumers may benefit from higher interest payments than they would otherwise receive. On the other hand, there is potential that some institutions may mislead consumers into believing that they will receive an unspecified rate of interest or a bonus on a time deposit but have little or no intention of paying the bonus. In addition they may decide to provide higher rates or bonuses to some depositors, but not others.

1/ These rules were established to protect consumers from the allure of higher rates of return when the higher rates are not guaranteed or the method of determining these higher rates is not verifiable. Under their provisions, an institution may provide in its time deposit contracts for the payment of a bonus or an increase in the rate of interest if it specifies the verifiable conditions under which the bonus will be paid or the rate increased. For example, an institution could include a provision that a bonus of one percent will be paid on an account if the institution's ratio of net income to average total assets for a year exceeds a pre-established amount, such as 1.50%.

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If the Committee determines that its rules governing ceiling-free accounts mean that institutions may retain discretion over the rate or amounts of interest to be paid on such accounts, this would supersede existing agency rate-setting rules, but not advertising or disclosure rules. This would seem to be consistent with the Committee's September 1981 and March 1982 deregulation of deposit interest rates on certain account categories. As a practical matter, market constraints would likely require that institutions establish at least a minimum rate to attract depositors, and depositors would likely learn of institutions that do not deal in good faith. The regulatory agencies would be free to issue additional advertising and disclosure guidelines with regard to rate and bonus arrangements to protect consumers against misleading practices.

If the Committee believes that current restrictions governing the establishment of interest rates or payments of bonuses are needed to complement advertising and disclosure rules in assuring protection of depositors, then the current agency rate regulations and interpretations can be reaffirmed by the DIDC, and institutions will be required to specify in the deposit contract the method of establishing any interest paid.

As an alternative, the Committee may wish to choose option two which requires that a minimum rate or a verifiable method of determining a rate be established in a deposit contract but that institutions be given discretion to pay bonuses above that rate.

Attachment: Philadelphia Savings
Fund Society Petition

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PSFS

THE PHILADELPHIA SAVING FUND SOCIETY • THE NATION'S FIRST MUTUAL SAVINGS BANK

M. Todd Cooke
Chairman

February 19, 1982

Mr. Steven L. Skancke
Executive Secretary
Depository Institutions
Deregulation Committee
Department of the Treasury
15th Street & Pennsylvania Avenue, NW
Washington, DC 20220

Dear Mr. Skancke:

The Philadelphia Saving Fund Society (PSFS) requests that the Depository Institutions Deregulation Committee (DIDC) issue a ruling whereby DIDC Regulations supercede FDIC Rules and Regulations to permit maximum rate flexibility for the new IRA/Keogh accounts. Specifically, PSFS requests that Section 329.4(e)(1) of the FDIC Rules and Regulations be superceded. This section has the effect of limiting the ability of financial institutions to provide market interest rates for IRA/Keogh accounts and defeats the DIDC's intention to deregulate the interest rate ceiling for these accounts. Thus, it prohibits financial institutions from aggressively competing with non-financial institutions for retirement deposits.

PSFS submits the attached petition for DIDC review and action. Implementation of PSFS' recommendation will ultimately benefit customers in that competition and not regulation will determine the interest rate paid on these deposits.

Thank you for your consideration.

Sincerely,

M. Todd Cooke

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PSFS' PETITION TO AMEND FDIC

REGULATIONS FOR IRA/KEOGH ACCOUNTS

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Background

On December 18, 1980, the DIDC requested comments on proposed changes to existing regulations to allow greater flexibility in administration of and competition for IRA/Keogh deposits. Comment was specifically requested on whether or not the proposed IRA/Keogh account should be indexed to a ceiling rate or totally deregulated. At its June 25, 1981 meeting, the DIDC elected to defer action on the IRA/Keogh accounts pending the outcome of legislative revisions being considered by Congress.

The Economic Recovery Tax Act of 1981, signed into law on August 13, 1981 by President Reagan, amended existing IRA/Keogh legislation by providing for higher contributions and expanding the eligibility requirements for IRA's. It did not address the earlier issues which the DIDC was considering.

Later in the year, at its September 22, 1981 meeting, the DIDC reconsidered these proposals and approved a new time deposit category for IRA/Keogh acounts. The new account provided for (1) a minimum maturity of eighteen months, (2) no regulated interest rate ceiling, and (3) additional deposits without extending the maturity will be permitted.

The Issue

PSFS believes that the DIDC staff did not adequately address the issue of a deregulated interest rate ceilings when it wrote the final regulations concerning the new IRA/Keogh account. FDIC guidelines specifically state that if a financial institution establishes a variable rate IRA/Keogh account, the interest rate must be equal to the indicator as noted in the terms and conditions of the account. This does not provide any flexibility to pay higher than the indicator and, in fact, it fixes the indicator as a "regulated" interest rate ceiling.

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The Law

Section 1204.118(a) of the DIDC Regulations provides for the new IRA/Keogh account and reads:

(a) A commercial bank, mutual savings bank or savings and loan association may pay interest at any rate as agreed to by the depositor on any time deposit with a maturity of one and one-half years or more, that consists of funds deposited to the credit of, or in which the entire beneficial interest is held by, an individual pursuant to an Individual Retirement Account agreement or Keogh (H.R. 10) Plan established pursuant to 26 U.S.C. (I.R.C. 1954) 219, 401, 408 and related provisions.

Section 329.4(e) of the FDIC Rules and Regulations state:

(e) Application of penalty to changes in interest rates or maturities.-(1) Increases in interest rates on existing time deposits. Where there is an increase in the rate of interest paid on any time deposit, the deposit will be treated as having been withdrawn by the depositor, prior to maturity, on the date on which the deposit begins to earn interest at the higher rate.

An exception is granted to this regulation in Section 329.4(e) (3) of the FDIC Rules and Regulations which reads:

(3) Exceptions. The provisions of this paragraph (e) do not apply to an increase in the rate of interest paid on a time deposit where such increase is explicitly authorized by the terms of the original deposit contract and may not be granted or withheld at the opposition of the bank.

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PSFS believes that the FDIC's interpretation of this regulation is not consistent with the intentions of the DIDC when they authorized the new IRA/Keogh account.

PSFS' Variable Rate IRA/Keogh Account

PSFS has been advised by the FDIC that its Variable Rate IRA/Keogh account is in violation of FDIC Regulations. The FDIC has cited PSFS' method of determining the interest rate to be inconsistent with FDIC Regulations. PSFS' Terms and Conditions for the Variable Rate IRA/Keogh account include the following statement regarding the interest rate paid.

> "During the initial term, interest will be payable at a variable annual rate which is subject to change on a weekly basis. The Interest Rate will vary in conjuncton with each variation in the auction average discount rate for most recently issued six-month U.S. Treasury Bills as announced by the U.S. Treasury Department following each weekly six-month U.S. Treasury Bill Auction. On the first business day after each Auction, the Interest Rate will be redetermined and reset so as to produce, for the period it is in effect, a Percentage Yield at least equal to 90% of the then-current Auction Rate."

The FDIC contends that the statement "at least equal to 90%" does not conform with the exception granted in Section 329.4(e)(3) of its Rules and Regulations. The rate of interest paid is not readily ascertainable by the customer.

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PSFS believes that its method of determining the interest rate does conform with FDIC Rules and Regulations, in addition to the DIDC Regulations, which authorize the account for the following reasons:

The DIDC authorized no interest rate restrictions for the new account so that banks, mutual savings banks and saving and loan associations could actively compete with non-financial institutions for customers' deposits. Money Market Funds, for example, do not index their rate to any external or internal indicator. They have complete latitude in determining their rates. It was the DIDC's intent, we believe, to provide equal flexibility to financial institutions. Accordingly, PSFS' Terms and Conditions were designed to provide this flexibility and latitude in the weekly establishment of its rate. It guaranteed an interest rate to its customers that would be based on prevailing market conditions. This allows PSFS to compete aggressively with non-financial institutions for customers' deposits, rather than lose them to non-financial institutions because of rate restrictions.

The DIDC also expressed concern that the customer be able to determine the indicator to which the interest rate would be indexed. PSFS clearly states in its terms and conditions what the guaranteed minimum rate would be, as previously quoted, on page 3.

Customers can readily determine what the six-month auction rate is and know the minimum amount of interest that will be earned for the period. When PSFS elects to pay a rate higher than the guaranteed minimum, it is because market conditions require it if PSFS wishes to continue to attract new deposits. The

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payment of a higher rate of interest to the customer certainly cannot be considered as a disservice to the customer. In addition, PSFS makes its rates available through branch signage, special rate "hotlines", advertising in newspapers and an insert mailed with each quarterly statement showing the interest rates for each period.

It is important for the DIDC to provide financial institutions with maximum flexibility in the competition for IRA/Keogh deposits. These deposits represent long-term, stable funds for financial institutions. If other restrictions are placed on these accounts, such as the interest rate restrictions identified in the FDIC guidelines, PSFS believes financial institutions will be at a major competitive disadvantage.

PSFS Recommendation

PSFS has supported the DIDC in its efforts to deregulate and improve the administration of IRA/Keogh account. PSFS recommends that the DIDC issue a ruling whereby DIDC regulations supercede existing FDIC Regulations to provide for a truly deregulated IRA/Keogh account.

If this petition is accepted, financial institutions would be able to compete on a truly equal basis with non-financial institutions for customers' desposits. Competition will benefit potential customers by encouraging the payment of a market return on funds invested.

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TO: U.S. League Executive Committee

RE: Recommendations of Deregulation Policy Committee to DIDC

The U.S. League Committee on Deregulation Policy met in Washington on June 15 to discuss the U.S. League position in regard to any new short-term account to be authorized by the DIDC at its upcoming meeting on June 29, 1982. The recommendations are as follows:

1. Any U.S. League support for a new account is contingent upon savings associations obtaining significant new asset powers as presently pending before the Senate. No such account should be declared effective by the DIDC unless and until legislation is enacted providing such powers.

2. Bearing in mind the asset powers contingency, the Committee recommends:

   a. Minimum balance of $10,000.
   b. Minimum maintenance belance of $10,000.
   c. If the account balance falls below the minimum balance, the rate on the account falls to 0%.

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d. Provisions for a notice arrangement for withdrawals or a term as in a certificate are unacceptable because of the extreme operational and administrative problems created for associations and customers, computer problems, difficulty of enforcement, etc. In lieu thereof, the Committee recommends a time deposit, open account approach under which funds must be on deposit for a minimum of 7 days before they are eligible for withdrawal. This approach also eliminates the issue of a withdrawal penalty in that funds cannot be withdrawn prematurely.

e. The account should be structured so that it is not reservable, i.e., it would not be transactionable, no automatic transfers, no more than 3 pre-authorized transfers per month, etc.

f. The rate on the account should be indexed to the 91-day T-Bill rate (discount basis). The rate would change the day following each weekly auction.

g. No averaging of rates such as is presently authorized for six-month MMC's.

h. A thrift institution differential would be provided with banks paying 25 basis points less than the T-Bill rate.

i. Deposits and withdrawals could be made in any amount as determined by the institution.

k. Compounding is permitted.

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McKeesport National Bank
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Independent BANKERS ASSOCIATION OF AMERICA

WASHINGTON OFFICE

1625 MASSACHUSETTS AVENUE N.W. - SUITE 202, WASHINGTON, D.C. 20036 202/332-8980

Okun

April 14, 1982

Honorable Donald T. Regan
Chairman
Depository Institutions Deregulation Committee
Department of the Treasury
15th & Pennsylvania Ave., N.W. - Rm. 3330
Washington, D. C. 20220

Dear Mr. Secretary:

The IBAA was very disappointed by the DIDC's failure to approve a short-term competitive deposit product for banks at its March 22 meeting. We strongly urge that the DIDC immediately review this matter looking towards the prompt authorization of such a product. Continued inaction by the DIDC will result in additional billions of dollars being drained out of the communities we serve by money market mutual funds, including the new "sweep" accounts established at banks in conjunction with money market mutual funds.

As you know, we have not in the past endorsed a specific competitive deposit product. In this letter we urge that the Committee consider a specific product having the following characteristics:

1. An account with no limitation on the frequency or amount of deposits.

2. A minimum initial deposit and balance requirement of $10,000. We believe that a $10,000 minimum is needed to protect existing passbook savings accounts although many of our members would favor a lower ceiling.

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3. Third party transfers would not be permitted and internal transfers would be governed by the same rules as savings accounts so that a depositor could not use the account to automatically cover checks or drafts drawn on a related demand account. Such internal transfers would require a specific customer instruction.

4. Since Regulation D effectively limits the number of withdrawals, a minimum dollar amount for withdrawals need not be established. Many institutions will wish to establish minimum accounts for withdrawals or internal transfers in order to differentiate the account from passbook accounts.

5. The account should have the same deposit insurance as other deposits so that consumers seeking a market rate of return can deposit funds in an insured account at a federally supervised financial institution.

6. It is imperative that the account not have an interest rate differential. The IBAA recognizes that an account without interest rate ceilings is a method to accomplish this increasingly important end. However, thousands of IBAA members still would prefer a product that is indexed to competitive market rates rather than a wildcarded product.

Many of our members have also expressed support for the proposal offered by FDIC Chairman Isaac at the March 22 meeting. The Isaac proposal would establish a $25,000 account with a withdrawal notice requirement. We strongly encourage prompt DIDC action to adopt the new account described in this letter and the proposal suggested by Chairman Isaac.

Sincerely,

Robert L. McCormick, Jr.
President

cc: Fed Chairman Paul Volcker
FDIC Chairman William Isaac
FHLBB Chairman Richard Pratt
NCUA Chairman Edgar Callahan
Comptroller C. Todd Conover

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RG

June 2, 1982

Mr. Louis H. Nevins
Senior Vice President
National Association of
Mutual Savings Banks
1709 New York Avenue, N.W.
Washington, D. C. 20006

Dear Lew:

The IBAA had its annual convention in mid-March. One of the major issues before the IBAA at that time was the question of whether we should join the ABA in supporting a ceilingless $5,000 super NOW account or whether we should maintain our traditional position that all new depository institution products be indexed to appropriate market rates. The latter was the position of the IBAA on IRA/Keogh accounts.

Our policy bodies agreed that the IBAA should support a "new short-term transaction product" without an interest rate differential. Our policy bodies did favor the $5,000 to $7,500 minimum. We also moved off the position that the new short-term transaction account should be indexed to appropriate market rates without fully embracing the wildcard concept since thousands of our member banks still favored indexation.

A telegram setting forth our position was sent from the convention to all members of DIDC, and we copied the key members of the House and Senate Banking Committees. A copy of the letter and the attached cable which we sent to Chairman Garn is attached.

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After the March 22 meeting and after we had received the attached letter from Chairman Volcker, the new competitive transaction account product that we sought no longer appeared to be in the cards.

Looking towards forging a compromise which might be acceptable to the members of the DIDC, we began working with Chase and the consumer bankers behind their $10,000 investment account idea. Our support of this general concept was the last letter we wrote to the DIDC.

Such an investment account would be a step in the right direction but clearly would not allow depository institutions to compete effectively with money market mutual funds in our marketplace.

Sincerely,

Kenneth A. Guenther
Executive Director

Enclosures
cc: Mr. Arthur Edgeworth

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June 4, 1982

COMPROMISE SHORT-TERM DEPOSIT INSTRUMENT

"INVESTMENT ACCOUNT"

Depository institutions need a new deposit account to compete with the money market mutual funds. It needs three characteristics:

1. It must be truly competitive.

2. It must not disrupt monetary policy.

3. It must not drain funds from existing low-cost deposits.

In order to be competitive, the deposit must be accessible, and it must pay a rate comparable to that of the money market funds. However, a transaction account would be required to bear reserves of 12%, which would reduce its yield significantly below that of the non-reserved money market funds.

Therefore, the Depository Institutions Deregulation Committee should authorize a new account called an investment account, that would be a special class of savings account (as is the NOW account) with no interest rate ceiling, no reserve requirements, and no third party transfer capability.

The principal characteristics of such an investment account:

1. No Interest Rate Ceiling.

   The financial institution should be permitted to pay a rate appropriate for its local market as determined by the institution (either fixed, fixed periodically, or floating). This will permit the institution to vary the rate as conditions demand, rather than being "locked-in", unless the institution elects to fix the rate.

2. No Third Party Transfers.

   The account is not a transaction account, but an investment account. Therefore, all third party transfers would be prohibited. Withdrawals could be made upon customer instruction in cash, by telephone transfer, ATM, or internal transfer to another account. Withdrawals would be limited to three per month.

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3. Deposits.

After the investment account is opened, there should be no limitation on the frequency or size of deposits.

4. Minimum Initial Deposit and Balance.

A $10,000 initial balance will enable financial institutions to protect their best customers, and to compete for 83% of the balances in money market funds.

5. No Minimum Withdrawal.

Institutions may wish to establish minimum withdrawal amounts, but the limitation of three withdrawals per month discourages withdrawals.

6. Eligibility.

Eligibility should be restricted to those eligible for NOW accounts.

7. Deposit Insurance.

The same deposit insurance rules that apply to other accounts should apply to the investment account.

There is no need for reserves on this account, since it has no transaction capability and ownership of the account is limited to individuals and non-profit organizations. Commercial firms cannot use the account. The limited withdrawal rule hampers use of the account for cash management purposes. Since it has no transaction capability, it will not interfere with monetary policy. In fact, to the extent that the new account discourages further movement of the deposits of financial institutions to the money market funds, it will assist in the control of the money supply.

Since it will pay a market rate and the funds will be available when needed, the account will be competitive with the money market funds. The investment account will encourage deposit stability because the market rate of return will discourage interest rate shopping and depositors will not be faced with periodic reinvestment decisions as is the case with maturing certificates of deposit.

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Since it is a new class of deposit, institutions can price the service charges and fees at will to further discourage the movement of funds. The institutions will be free to impose other terms and conditions as they see fit.

It is important to the well-being of the thrift institutions to discourage the transfer of passbook deposits into this new account. Therefore, the new account should be differentiated from passbook accounts by these features:

1. Its name, an "Investment Account".

2. By prohibiting use of a passbook as an access device.

3. By limiting monthly withdrawals to three.

4. By allowing only withdrawals or internal transfers, on customer instruction.

5. By requiring a $10,000 minimum deposit.

6. By allowing automatic deposits, but not automatic withdrawals.

7. By allowing fixed or floating interest rates set by the market.

8. Whatever fees and service charges the offering institutions choose to impose.

ADVANTAGES:

1. No maturity date, thus avoiding periodic investment decisions by depositors and the risk of losing the deposit at those times.

2. No reserve requirements, since it is a personal savings account.

3. No index, so rates can find their own level, which may be below rates paid in the national money market.

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4. Rates may be either fixed or variable, and may be changed at the discretion of the institution. Deposits are not "locked in" at a high rate for a long time.

5. Funds would have the same day availability, as do passbooks, but not through a third party transfer. While not fully competitive with money market fund liquidity, it is sufficient.

6. The account is operationally simple.

7. It encourages saving and discourages withdrawals.

8. Money market funds have 83% of their balances in accounts of $10,000 or more, and depository institutions could compete for that money.

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DRAFT

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

DATE: April 13, 1982

TO: Depository Institutions Deregulation Committee

SUBJECT: Short-term Deposit Proposals

FROM: DIDC Staff *

At its March 22 meeting, the Committee authorized a new certificate with a 91-day maturity, a $7,500 minimum denomination, a ceiling rate tied to the 91-day bill auction average, and a temporary 25 basis point differential in favor of thrift institutions. At that meeting, however, the Committee instructed the staff to prepare for Committee consideration additional proposals for a shorter-term deposit that would provide depository institutions with a more competitive vehicle vis-a-vis money market mutual funds (MMMFs) and other market instruments.

As discussed more fully in previous staff memoranda, the fundamental problem before the Committee is to design a deposit that will minimize potential high-cost internal shifts from savings accounts while simultaneously maximizing the competitive appeal of the new instrument and minimizing operational difficulties for issuing institutions.[1/] In balancing these parameters, the staff felt that four variables were particularly important:

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* This memorandum was prepared primarily by Edward C. Ettin of the staff of the Federal Reserve Board.

1/ See particularly, "Short-term Instrument Proposals," March 15, 1982.

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1. Minimum Denomination. The larger the minimum balance requirements, the less potential for internal shifting from savings accounts, but the less competitive the new instrument. 1/ A high minimum denomination would also tend to limit shifts from 6-month MMCs; although such shifts would not have a significant impact on immediate costs, they would make the cost structure of depository institutions more sensitive to changes in interest rates. Similarly, a high minimum denomination would differentiate any new instrument from the $7,500, 91-day certificate adopted at the last DIDC meeting.

2. Liquidity. There is a presumption that savings account holders place extreme emphasis on liquidity. Requiring the proposed new account to have a short fixed maturity or permitting withdrawal only after a notice period might therefore serve to limit internal shifting from savings accounts. The resultant reduced liquidity relative to MMMFs might be offset by the convenience and insurance of the deposit instrument.

1/ A substantial proportion of savings deposits are in high balance accounts. In December 1981, the FDIC indicated that 75 percent of MSB savings account balances were in excess of $5,000 and 41 percent in excess of $15,000. These results were similar to a February 1982 survey of the National Association of Mutual Savings Banks. In August 1980, the FHLBB indicated that 70 percent of S&L regular savings were in accounts with balances in excess of $5,000 and 45 percent in excess of $10,000. A small sample survey by the American Bankers Association in March 1982 indicated that at commercial banks about 60 percent of savings deposit balances were in excess of $5,000 and 38 percent in excess of $10,000. The latter survey also indicated that almost three-fourths of total NOW balances were in excess of $5,000 and almost half in excess of $10,000.

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3. Rate. Whiel the convenience and insurance associated with deposits suggests that depository institutions need not offer the same yield as MMMFs in order to attract sizable deposit flows, offering rates cannot deviate significantly from market yields if the instrument is to be competitive. While a competitive instrument could be achieved with an indexed ceiling, a ceiling free account would provide more flexibility to issuing institutions.

4. Operational feasibility and convenience. Limited staff discussion with depository institutions has suggested the importance of providing operational flexibility to permit offering institutions to integrate a new instrument into their internal systems and particular marketing strategies The Committee may, therefore, wish to balance potential characteristics of the proposed new instrument designed to limit internal shifts against such problems for depository institutions.

In designing a short-term instrument, the staff has attempted to take account of the conflicts inherent in the Committee's objectives as reflected in these four key variables. The balance of this memorandum discusses the detailed characteristics of the staff's proposal and presents certain options for the Committee's consideration.

Monetary Policy. Before reviewing each characteristic, it is relevant to summarize the reserve requirement issues associated with the

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creation of a new deposit instrument and the associated monetary policy considerations. The Federal Reserve Board, under the Monetary Control Act, has the exclusive authority for determining the applicability of Federal reserve requirements to current and future deposit instruments. Under the Board's current Regulation D, any deposit instrument with a maturity or required notice period of less than 14 days is subject to transaction account reserve requirements. In addition, any account upon which a check or draft can be drawn and any account that can be used as a normal practice to pay third parties are also regarded as transaction accounts.[1/] The Federal Reserve staff has indicated that its Board could, however, regard any new account with a shorter maturity as a time deposit, particularly if it had limited withdrawal features, and could establish a zero percent reserve requirement on this category of time deposit.[2/] The more the new instrument has characteristics that facilitate third-party payments the greater is the likelihood that the Federal Reserve would regard the account as a transaction account in order to carry out its responsibilities for controlling the monetary aggregates--especially the transaction aggregate M1. However, the Federal Reserve staff advises that any account that permits third party payments as a normal

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1/ The Federal Reserve Board now imposes transaction reserve requirements on (1) any account with a maturity or required notice period of less than 14 days, (2) any account on which a draft can be drawn--all demand deposits, NOWs, share drafts, and similar "other checkable deposits," (3) automatic transfer accounts, and (4) any account on which more than three monthly preauthorized or telephone transfers can be made. The Federal Reserve has also asked Congress for authority to extend reserve requirements to MMMFs.

2/ Under the Monetary Control Act, savings deposits and non-negotiable time deposits held by persons are not reservable, while negotiable time deposits and time deposits held by other than natural persons are subject to a reserve requirement of zero to 9 percent; the Board's current reserve requirement on such time deposits generally is 3 percent. Even if the Board adopted a zero percent reserve requirement on any new account, member banks would still be subject to a small (and declining) reserve requirement on the aggregate of their time and savings deposits during the phase-down period of reserve requirements under the Monetary Control Act.

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practice, even if reservable as a transaction account, would complicate the conduct of monetary policy.

More generally, the Federal Reserve staff believes that, in order for the Federal Reserve to interpret movements in the monetary aggregates, it is important to minimize the degree of blurring between transaction and non-transaction deposits. A new deposit instrument that combines high yield with extremely short maturity, and particularly one that permits or facilitates third party payments, would increase the difficulty of interpreting the degree to which such an instrument is being used for transaction purposes relative to serving as an investment vehicle. In view of the monetary policy concerns, the Federal Reserve staff believes that the Committee should prohibit outright an account that can be used to facilitate third-party payments. Thus, even though it would limit its attractiveness relative to MMMFs, the Federal Reserve staff suggests that the new instrument have a maturity (or notice) of no less than seven days, that third-party negotiable drafts drawn directly on the account be prohibited, and that automatic or preauthorized withdrawal notifications from the new account to a transactions account also be prohibited. Unlimited telephone notifications by the depositor, however, would be permitted.

Minimum Initial Deposit. The staff recommends that the Committee adopt a relatively high initial minimum denomination--between $10,000 and $25,000--in order to reduce internal deposit shifts. In determining the minimum initial deposit, the Committee may also wish to keep in mind (1) the possibility of future reductions in the minimum deposit requirement as information develops about internal deposit shifts, (2) the desirability of reducing pressure on institutions to offer sweep accounts to MMMFs and retail RPs, many of which have been based on smaller denominations, and (3) its judgment about the size of any maintenance minimum after the initial deposit.

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Minimum Subsequent or Maintenance Balance. On the presumption that depositors will wish to add to and draw on the balance in the new instrument after the account is opened, the Committee may wish to consider requiring a minimum maintenance balance different from the initial deposit minimum. Simplicity and consistency with other minimum balance requirements suggest that the maintenance balance be the same as the initial minimum. Flexibility in the use of the account suggests that the maintenance balance might be on the order of $5,000 less than the minimum initial balance, but such an approach may be tantamount to reducing the initial balance requirement if depositors can temporarily adjust their asset holdings to meet the initial balance requirement.

In any event, the Committee will have to determine two other issues with regard to the maintenance balance: (1) the rate to be paid if the balance falls below the regulatory minimum. The staff suggests two options: (a) the passbook rate or (b) closure of the account (and conversion to a passbook or transaction account) if the balance falls below the minimum maintenance balance for a specified period. The staff recommends the first option. (2) The interval over which the minimum maintenance balance is to be calculated. The staff recommends that institutions be permitted the option of determining the maintenance balance as the average for any interval from one day to one month.

Maturity. As previously noted, the shorter the maturity of the new instrument the more competitive it would be with MMMFs, the larger is the potential for internal deposit shifts from passbook accounts, and, at least below seven days, the more the Federal Reserve staff indicates it will be

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a potential problem for monetary policy. The Committee staff suggests two options: (1) a 5-day instrument or (2) a 7-day instrument. 1/

Whatever the maturity selected, the staff recommends that institutions be permitted to offer the account in either or both of two versions: (1) a time deposit open account (which has no specific maturity), with an enforced notice requirement before withdrawal equal to the period selected or (2) a time deposit with specific maturity, the balance of which would be automatically rolled over (after a 1-day grace period) if the depositor did not give the institution other instructions. Staff discussions with a few depository institutions suggest that some can handle a notice account operationally, others can do so at great inconvenience, and still others would find it extremely difficult operationally.

Rate. There is a difference of opinion among the staff on the issue of rate. A majority of staff recommends that there be no regulatory rate ceiling. This group argues: a ceiling might inhibit the competitive nature of the account; the objective of the DIDC is to deregulate; the available evidence suggests that institutions do not price irrationally; a ceilingless feature, as opposed to a market-indexed ceiling, will not exacerbate internal shifts from savings accounts, since the savings account ceiling is so far below the market rate; there is evidence that, in the market for competitive short-term instruments, virtually all issuers pay the ceiling rate and if there were no ceiling, some institutions might pay less and some more than what would have been the ceiling rate; and insti-

1/ A specific or maximum maturity (as opposed to a minimum maturity) is necessary in order to avoid in effect deregulating all ceilings for deposits equal to or above the proposed minimum denomination. The Committee in March adopted a deregulation schedule based on maturity, which would otherwise be superseded for deposits above the minimum size unless a specific or maximum maturity is adopted.

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tutions need the flexibility, especially in the early months of the new instrument, to use rate to regain depositors lost to MMMFs and other instruments.

Others among the staff believe that the new instrument should have an indexed ceiling. Institutions could be permitted to choose either varying the rate on outstanding deposits in line with the weekly index or maintaining a fixed rate based on the index in the initial week of the term account. Staff supporting a ceiling on the new account argue that the Committee has already adopted a deregulation plan based on maturity; the insurance and convenience of deposits imply that institutions can offer less than MMMFs and still attract funds; and the operating losses of thrifts imply the need to restrain rate competition in the short-run. Indeed, the FHLBB staff argues the need for at least a temporary differential on this account to avoid inconsistency with the Committee's March decision with regard to the 91-day deposit and in order to facilitate improvement in thrift deposit inflows relative to those of banks. Most of the DIDC staff do agree that, in contrast to the 91-day account, the attractiveness of the proposed instrument would increase bank deposit inflows even if there were a thrift differential.

If there were an indexed ceiling imposed--with or without a differential--the Committee would have to choose a base rate and a mechanical indexing method. The staff would recommend that the 91-day bill rate (auction average, discount basis, no 4-week averaging option) as the base rate and that the ceiling rate be equal to the base rate. The upper panel of Chart 1 shows the weekly spread by which MMMF yields would have exceeded the rate

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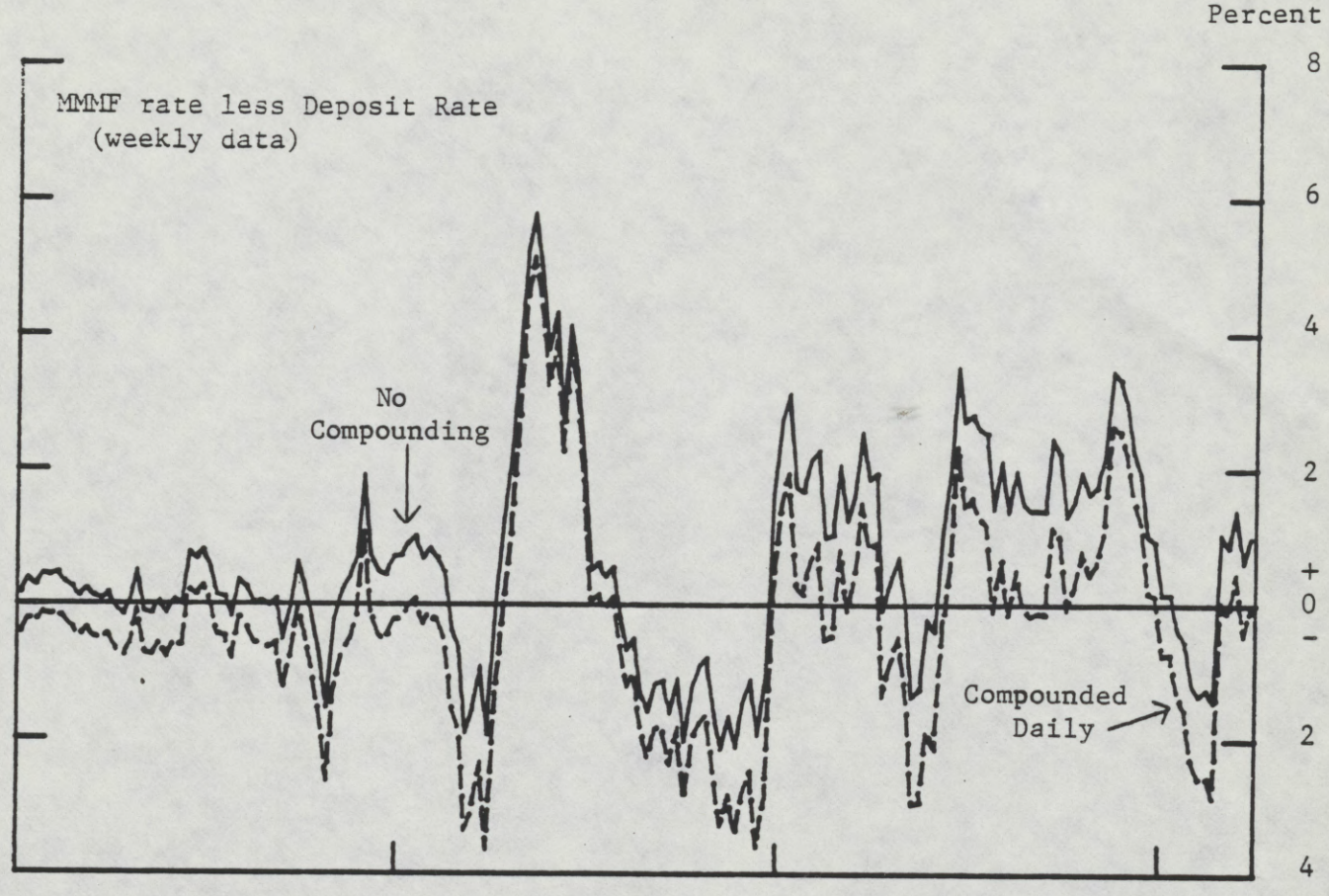
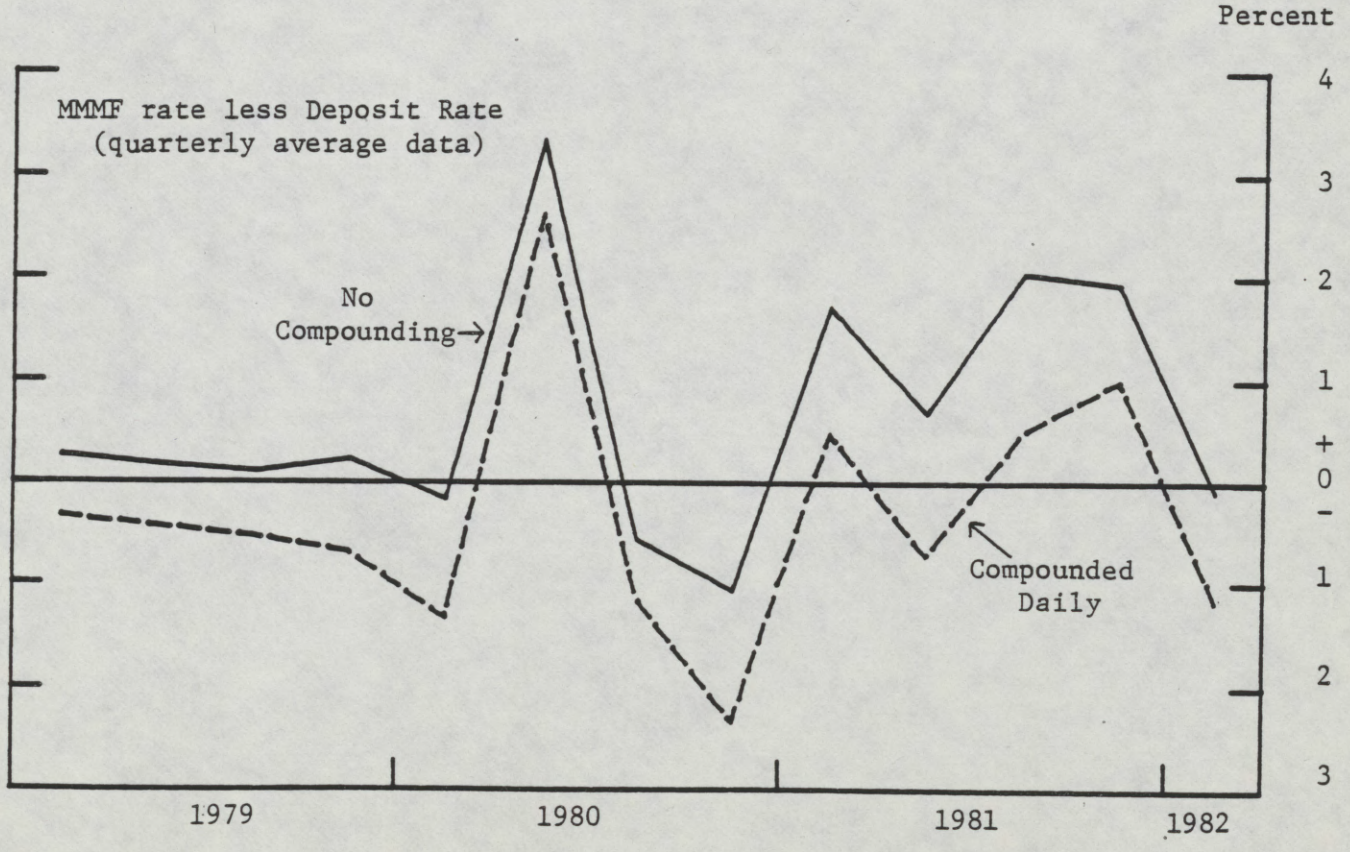
CHART 1

INTEREST RATE SPREADS BETWEEN MMMFs
AND A SHORT-TERM DEPOSIT EQUAL TO THE 91-DAY
TREASURY BILL RATE (Discount Basis)





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on such a deposit since 1979, with and without compounding; the lower panel shows the same spread on a quarterly average basis. With daily compounding (the dashed line), over the entire period the deposit rate would have on average exceeded the MMMF yield by over 30 basis points; in about two-thirds of the weeks since 1979 the deposit rate (daily compounding) would have exceeded MMMF yields.

The staff notes that it would be technically difficult effectively to prohibit compounding on the proposed instrument, even with a ceiling. First, for a fixed-term account (even if automatically rolled over) institutions legally must pay out or credit interest at maturity. Second, if the Committee authorized both fixed-term and notice accounts and prohibited the crediting of interest on the latter any more frequently than, say quarterly, the effective yields on the two similar accounts would be different. Additionally, as shown in the last two columns of Table 1 (which shows effective yields on instruments with a 13 percent nominal yield) the difference in effective yield between quarterly and continuous compounding is relatively small. At current rates, compounding adds 45 to 90 basis points to effective yields.

Should the Committee choose to impose a ceiling and a differential, the staff would recommend that thrifts be permitted to pay the bill rate and commercial banks 25 basis points less. We would further recommend that the same procedure be adopted as on the new 91-day deposit instrument, viz., the differential would disappear after one year, and, during that year, for any interval after the auction average on the 91-day bill rate falls below 9 percent for four consecutive auctions.

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Table 1

Effective Yields on a 13.0 Percent Certificate
for Various Compounding Periods--365/360 Basis

	Type of Compounding	Effective Rate	Increased Yield Due to Compounding	Percent of the Continuously Compound Increase
1)	Continuous	14.088	.907	100
2)	Daily	14.085	.904	99+
3)	Weekly	14.070	.889	98
4)	Quarterly (91 days)	13.847	.666	73
5)	Semi-annual (182 days)	13.616	.435	48
6)	No within 1/ period compounding	13.181	--	0

1/ The fact that the effective rate is about 18 basis points higher than the nominal rate even with no within period compounding is due to the artificial year.

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Finally, as noted earlier, regardless of whether the account is subject to ceilings or not, the staff recommends that a ceiling rate equal to the applicable passbook rate be imposed whenever the balance on the account falls below the minimum maintenance requirement.

Additional Deposits. The staff recommends that the new account be structured so that institutions can accept additional deposits without a quantitative regulatory limit. If the Committee adopts such a proposal--which would add to the flexibility of the account--it will have to provide for rules regarding the effect of additional deposits on the maturity of the account.

For notice accounts, the staff suggests that institutions be free to use any or all of the following methods:

1) "First-in-first-out" accounting controls to assure that each deposit is maintained for at least the minimum notice period;

2) Establishment of an accounting cycle equal to the notice interval. For funds received after the beginning of the accounting cycle notice of withdrawal could be given only at or after the beginning of the next accounting cycle. In effect, each deposit would be on "hold" until the beginning of the next accounting cycle.

3) Any other procedure that assures additions to the account are maintained for at least the notice period.

For term (specific maturity) accounts, the problem of additional deposits becomes somewhat more complicated. With some minor exceptions, existing agency regulations require that additional deposits re-initialize

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the maturity of the entire balance of the account. The staff recommends that the Committee permit institutions to use any or all of the following methods for accepting additional deposits to the proposed term account:

1) Each deposit re-initializes the maturity of the original deposit.

2) Each deposit is subject to "first-in-first-out" accounting to assure that each additional deposit is maintained for the term of the account.

3) An institution is permitted to set up an "accounting cycle" equal to the original term of the offered account. New deposits received after the accounting cycle has begun will be regarded as maturing at the end of the next accounting cycle. In effect, each deposit will be on "hold" until the end of the next accounting cycle.

4. Any other procedure that assures all additions to the account are maintained for at least the term of the account.

Withdrawals. The staff recommends no regulatory prohibition on the size or number of withdrawals from the proposed new account.

For notice accounts, withdrawals could occur only after the specified number of calendar days (discussed under maturity above) after the time the depository institutions receive notification. Notice would not be optional to the institution but must actually be given by the depositor, and would be permitted by telephone or other telecommunication, mail or messenger, or in-person (over-the-counter or through an ATM).

For term accounts, withdrawals could occur only at maturity (or before the end of the grace period). Notification of intent to withdraw

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could occur any time before the end of the grace period by the same procedure as for a notice account. If no notification were received by the end of the grace period, the deposit would automatically roll over.

Federal Reserve staff note that automatic and/or preauthorized notification for withdrawal would facilitate the use of the account for transaction purposes, raising monetary policy concerns; they urge prohibition of such arrangements and indicate that the Federal Reserve Board might impose transaction reserve requirements on accounts with such withdrawal features. The Federal Reserve staff recommends that the Committee require that all notifications require specific action by the depositor and automatic, preauthorized, standing and similar withdrawal or transfer notifications be prohibited.

Withdrawals from any version of the new account could only be by (1) check or cash to the depositor or by the institution's draft to a third party and (2) by transfer to the depositor's checking or NOW account. No withdrawals by third-party draft drawn directly on the account would be permitted.

Early Withdrawal Penalty. A majority of the staff recommend that, since the maturity or notice on the proposed account is so short, no early withdrawals be permitted under any circumstances. This approach would eliminate the need for early withdrawal penalties. If the Committee chose to permit early withdrawals, it might authorize one of the following early withdrawal penalties: (1) loss of earned interest (as adopted on the 91-day account) or (2) the standard penalty (loss of 3-months interest, which could require invasion of capital). Of course, if early withdrawal

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is permitted any institution could adopt a more restrictive early withdrawal penalty or prohibit such withdrawals if it chose to do so.

Eligibility. The staff is unanimous in its recommendation that the proposed new account have no regulatory limitation on eligibility for all depositors.

Miscellaneous Restrictions. The staff recommends a regulatory prohibition on loans to depositors designed to meet initial or maintenance balances. Overdraft privileges would still be permissible on NOW or demand deposits to which the new account is transferable, but staff recommends regulations that require that the rates charged on such overdrafts should not be substantially lower than the rates charged on such overdrafts for depositors that do not hold the proposed account.

To assure that withdrawal before maturity or notice is not facilitated, or the early withdrawal penalty (if any) is avoided, the Federal Reserve staff recommends either that no loans be permitted using the account as collateral or that such loans have a minimum loan rate equal to the rate being earned on the deposit **plus** the institution's lending rate to other customers using Government securities or other similar high quality collateral. In addition, to further minimize the use of this account for transactions purposes, the Federal Reserve staff recommends that the new instrument be issued only in non-negotiable form.

Effective Date. In order to provide a sufficient interval for institutions to plan marketing strategies and design systems, the staff recommends that the effective date of any new instrument be 60 days after announcement of the Committee's decision. The staff believes that further

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public comment on this instrument is not necessary because the terms of the proposed deposit were the subject of an extensive public comment period previously conducted by the Committee and the Committee's decision as to the specific characteristics of the proposed deposit would be within the scope of the comments received to date.

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DRAFT

BALLOT FOR SHORT-TERM DEPOSIT PROPOSALS

I. I am in favor of authorizing a new short-term deposit instrument at this time.

Yes _____

No _____

(If you vote no you may still wish to complete the rest of the ballot in order to affect the design of the instrument in the event that a majority favors authorization.)

II. MINIMUM DENOMINATION

1. The minimum initial denomination should be (check one)

$25,000 _____

Other _____
(Please specify amount)

2. The minimum subsequent or maintenance balance should be (check one)

Same as initial minimum _____

$5,000 less than initial minimum _____

Other _____
(Please specify amount)

3. For purposes of calculating the subsequent or maintenance balance, the institution may use average daily balances over (check one).

One day _____

The same as my answer to III-1 below _____

Any period not to exceed a calender month _____

Other _____
(Please specify amount)

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III. MATURITY

1. The maturity of the new instrument should be (check one)

5-days _____

7-days _____

Other _____
(Please specify)

2. The instrument must be in the form of (check one)

Time deposit open account with notice period equal to my vote in III-1 _____

Specific maturity equal to my vote in III-1 (with a 1-day grace period) _____

Institutions may have their choice of either or both of the above _____

IV. RATE

1. Institutions should be authorized to pay (check one)

Any rate they wish (no ceiling) _____

An indexed ceiling rate with no differential in favor of thrifts 1/ _____

An indexed ceiling rate with a differential in favor of thrifts 1/ _____

2. If the balance in the account falls below the minimum specified in my vote on II-2 (check one)

A ceiling rate no higher than the applicable savings account ceiling should be imposed _____

The account must be closed _____

(See next page)

1/ If an indexed ceiling is adopted (either with or without a differential) the Committee will be asked to determine other issues listed in the Appendix to this ballot.

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The institution may select either or both of the above _____

Other _____
(Please specify)

V. ADDITIONAL DEPOSITS

1. There should be no dollar limit or frequency limit on additional deposits (check one)

Agree _____

Limitations should be imposed as follows _____
(Please specify)

2. For notice accounts, if additional deposits are authorized, the institution (check one)

Must adopt first-in-first-out accounting procedures to assure that each additional deposit is maintained for the minimum notice period _____

An institution is permitted to set up an accounting cycle equal to the notice interval. For funds received after the accounting cycle has begun, notice of withdrawal could be given only at or after the beginning of the next accounting cycle _____

Any procedure that assures that additional deposits are maintained for at least the notice period. _____

The institution is permitted to use any or all of the above _____

Other _____
(Please specify)

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3. For term accounts, if additional deposits are authorized (check one)

Each deposit re-initializes the maturity of the original deposit _____

Each deposit is subject to first-in-first-out accounting to assure that each additional deposit is maintained for the term of the account _____

An institution is permitted to set up an accounting cycle equal to the original term of the offered account. New deposits received after the accounting cycle has begun will be regarded as maturing at the end of the next accounting cycle _____

Any procedure that assures that additional deposits are maintained for the maturity period _____

The institution is permitted to use any or all of the above _____

VI. WITHDRAWALS

1. No drafts may be drawn on the account, notification for withdrawals may not be automatic and/or preauthorized, notice or maturity requirements must be met, and there should be no limitations on dollar size or number of withdrawals (check one).

Agree _____

Disagree _____

If disagree, there should be limitations as follows _____
(Please specify)

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VII. EARLY WITHDRAWAL PENALTY

1. Early withdrawal penalties (check one)

There is no early withdrawal penalty and the deposit should be withdrawable only after notice or at maturity _____

Early withdrawal permitted at the cost of

Earned interest _____

Standard penalty of 3-months interest (with invasion of principal required if necessary) _____

Other _____
(Please specify)

VIII. ELIGIBILITY

1. Deposit may be offered to all depositors without limit (check one)

Agree _____

Disagree _____

IX. MISCELLANEOUS

1. Institutions may not make loans to depositors for the purpose of meeting or maintaining minimum balance requirements (check one)

Agree _____

Disagree _____

2. The rate charged on overdrafts on NOW or demand deposits may not be substantially lower for holders of the proposed account than for other depositors (check one)

Agree _____

Disagree _____

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3. With regard to loans using the account as collateral (check one)

Subject to the standard minimum loan rate of 1 percent over the deposit rate 1/ _____

The minimum loan rate will be the deposit rate plus the loan rate to other customers using high quality collateral _____

No loans may be made using the account as collateral _____

4. The account may only be offered in non-negotiable form (check one)

Agree _____

Disagree _____

5. Effective date will be 60 days after announcement

Agree _____

Disagree _____

I propose an effective date of _____

X. COMMENTS

_____
[Signature]

1/ This option would likely to give rise to transaction account reserve requirements since institutions would likely offer transfers to checking or NOW accounts before the end of the notice or maturity period.

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APPENDIX

If the Committee adopts an indexed ceiling it will be asked on a subsequent ballot to make decisions with regard to:

- the base rate (e.g., the 91-day bill auction average)
- a 4-week averaging option
- the relationship of the ceiling rate to the base rate
- fixed ceiling vs. variable ceiling
- compounding
- tied RPs
- premiums.

In addition, if the Committee decides that there should be a ceiling differential in favor of thrifts, it will be asked on a subsequent ballot to make decisions with regard to:

- the size of the differential
- permanent or temporary
  - if temporary, conditions under which it goes into effect and is eliminated
- applicability of differential to IRA/Keogh deposits and deposits of governmental units.

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NEW DEPOSIT INFLOWS REQUIRED
TO BREAKEVEN ON HIGH
YIELDING OVERNIGHT ACCOUNT

ASSUME

1) New instrument costs 7-1/2 percentage points above savings account ceiling (13 percent rate on new instrument)

2) New money attracted can be invested at 2 percentage point spread

NEW DEPOSIT INFLOWS NEEDED TO BREAKEVEN
AT VARIOUS PROPORTIONS OF SHIFTS
IN SAVING DEPOSITS TO NEW ACCOUNT
(Billions of Dollars)

Proportion of Savings Deposits That Would Otherwise Have Been Retained That Shift to New Account in 1982	S&Ls	MSBs	CBs	Total
10 Percent	31.9	16.1	58.5	106.5
20 Percent	63.8	32.3	117.0	213.0
30 Percent	95.6	48.4	175.5	319.5
40 Percent	127.5	64.5	234.0	426.0
50 Percent	159.4	80.6	292.5	532.5
Memo: Average Savings Balances Otherwise Retained in 1982 (Billions of Dollars)	$85	$43	$156	$284
Percent of Deposit	16%	27%	13%	
Memo: Non-Institutional Money Fund Balances as of Feb. 24, 1982 (Billions of Dollars)				$155.1

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ASSISTING TROUBLED THRIFTS

1. Federal Reserve Board staff projects before tax losses in 1982 of $6 to $7 billion for S&Ls and $1½ to $2 billion for MSBs.

2. Projection implies:

   a) 250 S&Ls, with assets of $50 billion, will have negative net worth in 1982.

   b) Another 350 S&Ls, with assets of $70 billion, will have positive capital ratios of less than 1 percent of assets in 1982.

   c) Twelve large MSBs, with assets of $20 to $25 billion, will have capital ratios below 2 percent in 1982--the point at which assistance is required for MSBs.

   d) If interest rates remain above 12 percent in 1983

      1) 300 to 500 S&Ls (assets of $65 to $115 billion) will have negative capital in 1983.

      2) Seven to 10 large MSBs (assets of $7 to $12 billion) will need assistance in 1983.

3. Largest problem at FSLIC (more institutions with more assets in trouble).

   a) FSLIC resources in 1982:

      1) $1-1/4 to $1-1/2 billion of income from premiums and portfolio.

      2) Fund has $5-1/4 billion of assets at market value ($7 billion at book value).

   b) To husband resources, FSLIC in 1982 plans

      1) Let some institutions with negative net worth continue to operate.

      2) Assist mergers of worst cases with heavy reliance on indemnifying future income on acquired assets and minimal up front payment.

      3) "Paper" capital infusions where necessary.

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c) FSLIC outlays are netted against income in the budget. Under normal circumstances, such outlays are negative. For fiscal 1982, the budget calls for FSLIC positive outlays of $38 million; in 1983 negative $150 million.

d) In calendar 1982, FSLIC could constrain its outlays as implied by budget.

1) Assist in merger only of 150-200 worst cases.

2) Modest up front payments to acquirers in exchange for income indemnifications, desirable locations, and current earnings benefit of purchase accounting. 1/

e) If interest rates remain high in 1983, FSLIC will need assistance

1) Number of institutions needing help will rise and number of merger partners will decline.

2) Larger up front payments needed.

3) Indemnification payments from 1981-82 mergers could exceed $1 billion.

4. FDIC has far fewer problems

a) FDIC resources:

1) $2 billion of income from portfolio and premiums

2) $11 billion fund at market ($12.2 billion at book value).

b) Resources sufficient to handle MSB mergers.

c) However, may find it difficult to obtain merger partner for large MSBs in New York City and hence may have to use capital infusion.

5. If problem is worse than projected, or for contingency planning, could consider two options: supplementing FSLIC resources or capital infusion.

1/ "Purchase accounting" has been used in all recent S&L mergers. Under this approach, the acquired institution's assets are marked to market and the difference between the premium paid, if any, and the net worth of the acquired institution (usually negative) is capitalized as "goodwill" by the acquiring institution. Goodwill is amortized over a longer period than the discount on the acquired mortgage portfolio. The annual net difference is added to income each year. Of course, there is no immediate increase in capital from this approach.

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6. Supplementing FSLIC resources

a) Four sources of funding

1) Congressional appropriations, which will be reflected in the unified budget at the time of the FSLIC outlay and in budget authority at time of the appropriation.

2) Increases in the FSLIC Treasury "tap", which is now $750 million as compared to $3 billion for the FDIC. Increasing the tap would be reflected in increased borrowing authority at the time of the Congressional legislation and in the unified budget only if and when any funds taken down are spent by the FSLIC.

3) Market borrowing by the FHL Banks which would be relent to the FSLIC. The borrowing would not be captured in any budget but any expenditure by the FSLIC would be in the unified budget at the time of the outlay. Increased security issuance by the FHL Banks for this purpose could affect the risk premiums required by the market for FHL Bank securities. Legislation may be required to permit the FSLIC to borrow from the FHL Banks.

4) FSLIC borrowing from the Federal Reserve. The borrowing would not be captured directly in any budget, but the securities markets would have to absorb Treasury securities that the Federal Reserve would otherwise acquire; the expenditure of the FSLIC would be in the unified budget only at the time of the outlay. Legislation may be required to permit the FSLIC to borrow from the Federal Reserve.[1/] There are obvious precential problems with central bank assistance, making it more difficult to deny similar treatment to future socially and/or politically necessitous sectors. Unless drawdowns are extremely large over short periods of time, there are no monetary control problems since open market operations could neutralize the reserve effects of such loans.

b) Problem with approach: merger assistance provides no repayable debt to the FSLIC; FSLIC annual income ($1-1/2 billion) permits limited debt service capacity and any repayment slows future growth of fund relative to deposits.

7. Capital infusion plans repayable out of future income of assisted thrifts.

a) Costs in 1982 in order to maintain 2 percent capital ratios

---

1/ The Federal Reserve loan could be made under Section 13(3) or 13(13) of the Federal Reserve Act. The Board's Regulation A requires five Board members to find that "unusual and exigent" circumstances exist.

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1) S&Ls: $1-3/4 to $3 billion (800 to 1,000 S&Ls).

2) MSBs: $150 million (8 large MSBs).

b) Costs in 1983 to maintain 2 percent ratios if interest rates stay above 12 percent.

1) S&Ls: $4 billion (1,400 to 1,700 S&Ls).

2) MSBs: $500 million (15 large MSBs).

c) Program could exist simulataneously with merging weakest thrifts.

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 8, 1982

To Chairman Volcker

From Edward C. Ettin

Subject: Additional Comments from Depository Institutions on a Short-term Deposit Instrument

Harry Albright, Dime Savings Bank of New York. Harry feels that a high denomination, short maturity (or notice account) will not do particularly well and is not a solution to money fund competition. He argues that some sort of sweep arrangement is required. Dime's ideal account would be a $15,000 initial minimum ($5,000 maintenance) tied to a $2,500 NOW with sweeps in and out of the NOW when the balance falls below or goes above $2,500; the account should be ceilingless. His second best account would limit sweeps to three times a month (the first, tenth, and thirtieth of the month). His third best account would be to make the account a 7-day maturity account, but with automatic sweeps in and out of NOWs at maturity.

I indicated that anything with a sweep into a NOW would essentially be a transaction account and would not only probably be reservable as such but would cause the Fed considerable difficulties in setting money targets, interpreting movements in the aggregates, and controlling M1. While he indicated that he understood my concerns, he suggested that the genie was already out of the bottle with money funds and depository institution-money fund sweep arrangements. Dime is planning next month to introduce an RP sweep into and out of its NOW accounts. It already offers "checking" account draws on MMCs and SSCs by permitting customers to write checks covered by loans secured by MMC and SSC balances at 1 percent over the deposit rate; Dime has $170 million of such accounts with 10 to 20 percent of the balances in such form actively used as credit lines.

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Dime has 21 percent of its deposits in passbook form and is not concerned about internal shifts; Harry feels that his savings accounts will erode anyway and his proposed account will not significantly accelerate the rate of erosion. He agrees that the MSB industry has a higher savings ratio than Dime, that only a handful of MSBs would agree with Dime's proposal, and that the NAMSB would severely criticize DIDC action similar to his suggestion.

Harry kept returning to the view that the Fed must stop depository institution sweeps with money funds and that the genie was out of the bottle.

Mary Grigsby, Houston First American Savings Association. Mary called back to modify her 30-60-90-day term account proposal, suggesting that the DIDC ought to authorize institutions to offer 8 to 89 days time deposits at variable or fixed indexed ceiling rates. Such accounts, preferably with a thrift differential, could be used to replace retail RPs; S&Ls are running short of collateral.

Jack Kalchbrenner, Shawmut Corporation. His operating staff feels notice accounts would be difficult. A short-term account would probably shift more from MMCs and the new 91-day account than from savings deposits at his bank. (He feels he will get a 10 percent savings deposit shift.) Asset and liability management would be made more difficult--especially until experience was gained; it would be especially difficult profitably to lay off the funds without taking a maturity mismatch risk. In order to stop sweep pressures, he feels a $10,000 minimum initial and $5,000 minimum maintenance balance is needed.

cc: Soss

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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

April 8, 1982

TO: Chairman Volcker

FROM: Edward C. Ettin

The attached was sent to DIDC staff. You might be interested in the size of the ballot if there is a notation vote. I have also marked in the memo those specific places where I refer to Federal Reserve monetary policy concerns (see pp. 3, 5, 6, 7, 8, 13, 14 and 15 and on the ballot pp. 6 and 7).

Attachment.

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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

DATE: April 8, 1982

TO: Depository Institutions Deregulation Committee

SUBJECT: Short-term Deposit Proposals

FROM: DIDC Staff *

DRAFT

At its March 22 meeting, the Committee authorized a new certificate with a 91-day maturity, a $7,500 minimum denomination, a ceiling rate tied to the 91-day bill auction average, and a temporary 25 basis point differential in favor of thrift institutions. At that meeting, however, the Committee instructed the staff to prepare for Committee consideration additional proposals for a shorter-term deposit that would provide depository institutions with a more competitive vehicle vis-a-vis money market mutual funds (MMMFs) and other market instruments.

As discussed more fully in previous staff memoranda, 1/ the fundamental problem before the Committee is to design a deposit that will minimize potential high-cost internal shifts from savings accounts while simultaneously maximizing the competitive appeal of the new instrument and minimizing operational difficulties for issuing institutions. In balancing these parameters, the staff felt that four variables were particularly important:

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* This memorandum was prepared primarily by Edward C. Ettin of the staff of the Federal Reserve Board.

1/ See particularly, "Short-term Instrument Proposals," March 15, 1982.

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1. Minimum Denomination. The larger the minimum balance requirements, the less potential for internal shifting from savings accounts, but the less competitive the new instrument. 1/ A high minimum denomination would also tend to limit shifts from 6-month MMCs; although such shifts would not have a significant impact on immediate costs, they would make the cost structure of depository institutions more sensitive to changes in interest rates. Similarly, a high minimum denomination would differentiate any new instrument from the $7,500, 3-month certificate adopted at the last DIDC meeting.

2. Liquidity. There is a presumption that savings account holders place extreme emphasis on liquidity. Requiring the proposed new account to have a short fixed maturity or permitting withdrawal only after a notice period might therefore serve to limit internal shifting from savings accounts. The resultant reduced liquidity relative to MMMFs might be offset by the convenience and insurance of the deposit instrument.

DRAFT

1/ A substantial proportion of savings deposits are in high balance accounts. In December 1981, the FDIC indicated that 75 percent of MSB savings account balances were in excess of $5,000 and 41 percent in excess of $15,000. These results were similar to a February 1982 survey of the National Association of Mutual Savings Banks. In August 1980, the FHLBB indicated that 70 percent of S&L regular savings were in accounts with balances in excess of $5,000 and 45 percent in excess of $10,000. A small sample survey by the American Bankers Association in March 1982 indicated that at commercial banks about 60 percent of savings deposit balances were in excess of $5,000 and 38 percent in excess of $10,000. The latter survey also indicated that almost three-fourths of total NOW balances were in excess of $5,000 and almost half in excess of $10,000.

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3. Rate. The staff assumed that the ability to offer a market rate is necessary. However, there is some difference of opinion among the staff as to whether the account should be ceilingless or--should the Committee adopt a ceiling--how close that ceiling need be to MMMF yields to be competitive.

4. Operational feasibility and convenience. Limited staff discussion with depository institutions has suggested the importance of providing operational flexibility to permit offering institutions to integrate a new instrument into their internal systems and particular marketing strategies. The Committee may, therefore, wish to balance potential characteristics of the proposed new instrument designed to limit internal shifts against such problems for depository institutions.

In designing a short-term instrument, the staff has attempted to take account of the conflicts inherent in the Committee's objectives as reflected in these four key variables. The major characteristics of our proposal are summarized in Table 1. The balance of this memorandum discusses the detailed characteristics of the staff's proposal and presents certain options for the Committee's consideration.

Monetary Policy. Before reviewing each characteristic, it is relevant to summarize the reserve requirement issues associated with the

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TABLE 1

SUMMARY OF THE PROPOSED ACCOUNTS'
MAJOR CHARACTERISTICS 1/

Minimum Initial Deposit: Between $10,000 and $25,000

Minimum Subsequent Deposit: Options

- Same as minimum initial deposit, or
- $5,000 less than minimum initial deposit

Maturity: Options

- 5 days
- 7 days
- 14 days
- Institutions' choice within 5- to 31-day range

Options for any of the above

- Notice account (from time notification received by institution)
- Fixed maturity (1 day grace period, automatic rollover)
- Institutions' choice to offer either or both

Rate: Options

- Ceilingless
- Related to 91-day bill rate (variable ceiling permissible) with option of
  - o No differential
  - o Temporary thrift differential of 25 basis points

If account balance falls below minimum, option of

- Rate falls to savings passbook rate
- Account must be closed

Compounding permitted

Additional Deposits: No quantitative minimum

Withdrawals: No quantitative minimum
Enforced notice or at maturity
Withdrawal may be paid only to depositor or third party or transfer to NOW or demand deposit account
No withdrawals by draft directly on proposed account

Early Withdrawal Penalty: Options

- None since withdrawal permitted only at maturity or after notice
- Loss of earned interest
- Loss of 3-months interest (including invasion of account balance)

Eligibility: All depositors

1/ Important technical and policy issues are discussed in text and omitted from table.

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creation of a new deposit instrument and the associated monetary policy considerations. The Federal Reserve Board, under the Monetary Control Act, has the exclusive authority for determining the applicability of Federal reserve requirements to current and future deposit instruments. Under the Board's current Regulation D, any deposit instrument with a maturity or required notice period of less than 14 days is subject to transaction account reserve requirements. In addition, any account upon which a check or draft can be drawn and any account that can be used as a normal practice to pay third parties are also regarded as transaction accounts.[1/] The Federal Reserve staff has indicated that its Board could, however, regard any new account with a shorter maturity as a time deposit, particularly if it had limited withdrawal features, and could establish a zero percent reserve requirement on this category of time deposit.[2/] The more the new instrument has characteristics that facilitate third-party payments the greater is the Federal Reserve's need to regard the account as a transaction account in order to carry out its responsibilities for controlling the monetary aggregates--especially the transaction aggregate M1. However, the Federal Reserve staff advises that any account that permits third party payments as a normal

DRAFT

1/ The Federal Reserve Board now imposes transaction reserve requirements on (1) any account with a maturity or notice of less than 14 days, (2) any deposit account on which a draft can be drawn--all demand deposits, NOWs, share drafts, and similar "other checkable deposits," (3) automatic transfer accounts, and (4) any account on which more than three monthly preauthorized or telephone transfers can be made. The Federal Reserve has also asked Congress for authority to extend reserve requirements to MMMFs.

2/ Under the Monetary Control Act, savings deposits and non-negotiable time deposits held by persons are not reservable, while negotiable time deposits and time deposits held by other than natural persons are subject to a reserve requirement of zero to 9 percent; the Board's current reserve requirement on such time deposits is 3 percent. Even if the Board adopted a zero percent reserve requirement on any new account, member banks would still be subject to a small (and declining) reserve requirement on the aggregate of their savings, personal and non-negotiable time deposit during the current phase-down of reserve requirements under the Monetary Control Act.

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practice, even if reservable as a transaction account, would complicate the conduct of monetary policy.

More generally, the Federal Reserve staff believes that, in order for the Federal Reserve to interpret movements in the monetary aggregates, it is important to minimize the degree of blurring between transaction and non-transaction deposits. A new deposit instrument that combines high yield with extremely short maturity, and particularly one that permits or facilitates third party payments, would increase the difficulty of interpreting the degree to which such an instrument is being used for transaction purposes relative to serving as an investment vehicle. In view of the monetary policy concerns, the Federal Reserve staff believes that the Committee should prohibit outright an account with characteristics that facilitate the use of the account for third-party payments. Thus, even though it would limit its attractiveness relative to MMMFs, the Federal Reserve staff suggests that the new instrument have a maturity (or notice) of no less than seven days, that third-party negotiable drafts drawn directly on the account be prohibited, and that automatic or preauthorized transfers from the new account to a transactions account also be prohibited. Unlimited telephone notifications by the depositor, however, would be permitted.

Minimum Initial Deposit. The staff recommends that the Committee adopt a relatively high initial minimum denomination--between $10,000 and $25,000--in order to reduce internal deposit shifts. In determining the minimum initial deposit, the Committee may also wish to keep in mind (1) the possibility of future reductions in the minimum deposit requirement as information develops about internal deposit shifts, (2) the desirability of reducing pressure on institutions to offer sweep accounts to MMMFs and retail RPs, many of which have been based on smaller denominations, and (3) its judgment about the size of any maintenance minimum after the initial deposit.

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Minimum Subsequent or Maintenance Balance. On the presumption that depositors will wish to add to and draw on the balance in the new instrument after the account is opened, the Committee may wish to consider requiring a minimum maintenance balance different from the initial deposit minimum. Simplicity and consistency with other minimum balance requirements suggest that the maintenance balance be the same as the initial minimum. Flexibility in the use of the account suggests that the maintenance balance might be on the order of $5,000 less than the minimum initial balance, but such an approach may be tantamount to reducing the initial balance requirement if depositors can temporarily adjust their asset holdings to meet the initial balance requirement.

In any event, the Committee will have to determine two other issues with regard to the maintenance balance: (1) the rate to be paid if the balance falls below the regulatory minimum. The staff suggests two options: (a) the passbook rate or (b) closure of the account (and conversion to a passbook or transaction account) if the balance falls below the minimum maintenance balance for a specified period. The staff recommends the first option. (2) The interval over which the minimum maintenance balance is to be calculated. The staff recommends that institutions be permitted the option of determining the maintenance balance as the average for any interval from one day to one month.

Maturity. As previously noted, the shorter the maturity of the new instrument the more competitive it would be with MMMFs, the larger is the potential for internal deposit shifts from passbook accounts, and, at least below seven days, the more the Federal Reserve staff indicates will be

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the potential problem for monetary policy. The Committee staff suggests four options: (1) a 5-day instrument, (2) a 7-day instrument, (3) a 14-day instrument, or (4) authorization of institutions to offer maturities in the range of 5 to 31 days.

Whatever the maturity selected, the staff recommends that institutions be permitted to offer the account in either or both of two versions: (1) a time deposit open account (which has no specific maturity) with an enforced notice requirement before withdrawal equal to the maturity (or maturity range) selected or (2) a time deposit with specific maturity, the balance of which would be automatically rolled over (after a 1-day grace period) if the depositor did not give the institution other instructions. Staff discussions with a few depository institutions suggest that some can handle a notice account operationally, others can do so at great inconvenience, and still others would find it extremely difficult operationally.

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Rate. There is a difference of opinion among the staff on the issue of rate. A majority of staff recommends that there be no regulatory rate ceiling. This group argues that the objective of the DIDC is to deregulate; the available evidence suggests that institutions do not price irrationally; the lack of a regulated rate ceiling, as opposed to a market indexed ceiling, will not exacerbate internal shifts from savings accounts, since the issue of liquidity is a more important factor than rate in inducing shifts; there is evidence that, in the market for competitive short-term instruments, virtually all issuers pay the ceiling rate and if there were no ceiling, some institutions might pay less and some more than what would have been the ceiling rate; and institutions need the flexibility, especially in the early months of the new instrument, to use rate to regain depositors lost to MMMFs and other market instruments.

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Others among the staff believe that the new instrument should have an indexed ceiling. Institutions could be permitted to choose either varying the rate on outstanding deposits in line with the weekly index or maintaining a fixed rate based on the index in the initial week of the term account. Staff supporting a ceiling on the new account argue that the Committee has already adopted a deregulation plan based on maturity; the insurance and convenience of deposits imply that institutions can offer less than MMMFs and still attract funds; and the operating losses of thrifts imply the need to restrain rate competition in the short-run. Indeed, the FHLBB staff argues the need for a temporary differential on this account to avoid inconsistency with the Committee's March decision with regard to the 91-day deposit and in order to facilitate improvement in thrift deposit inflows relative to those of banks. Most of the DIDC staff do agree that, in contrast to the 91-day account, the attractiveness of the proposed instrument would increase bank deposit flows even if there were a thrift differential.

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If there were an indexed ceiling imposed--with or without a differential--the Committee would have to choose a base rate and a mechanical indexing method. The staff would recommend the 91-day bill rate (auction average, discount basis, no-4-week averaging option) as the base rate and that the ceiling rate be equal to the base rate. The upper panel of Chart 1 shows the weekly spread by which MMMF yields would have exceeded the rate

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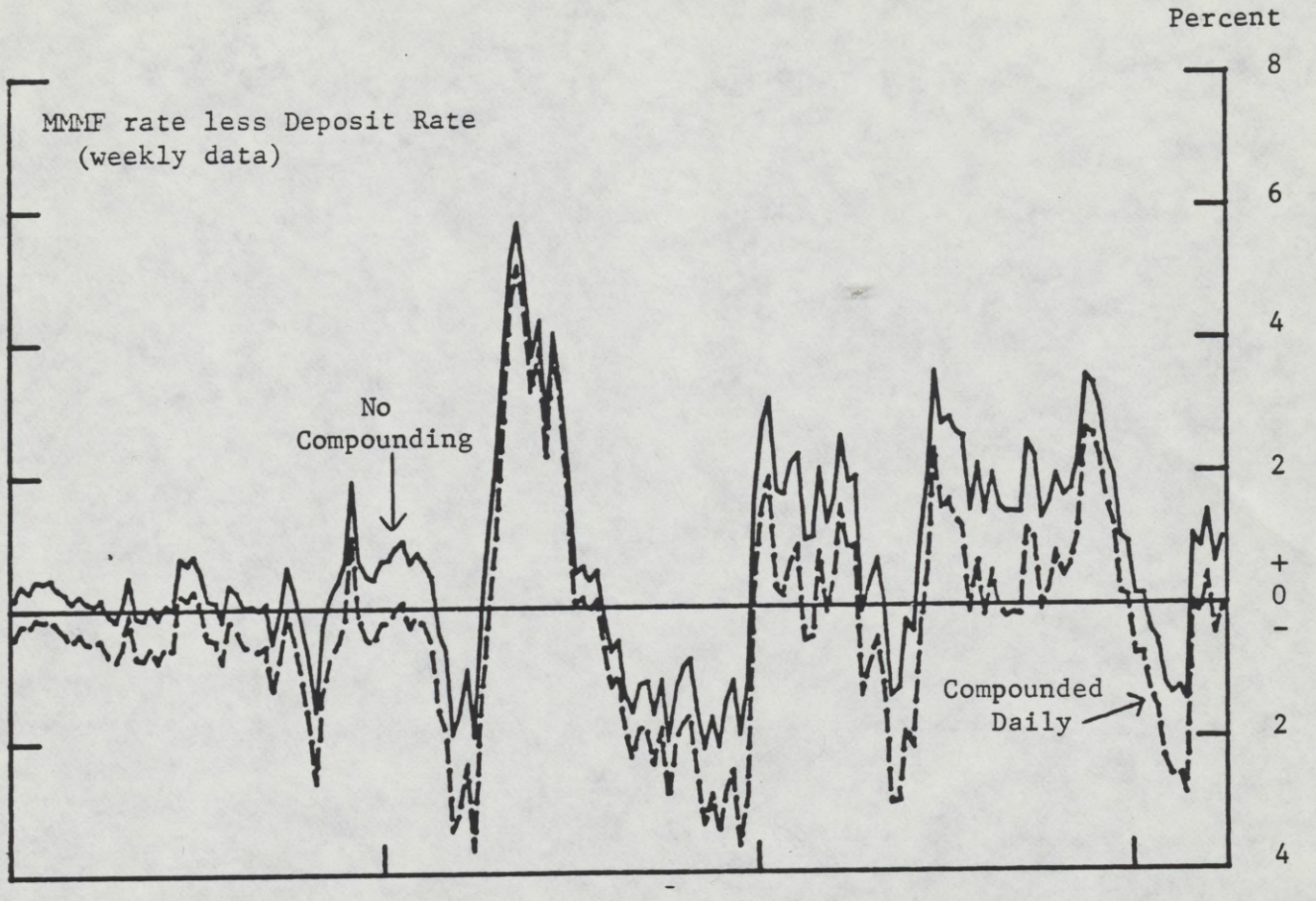
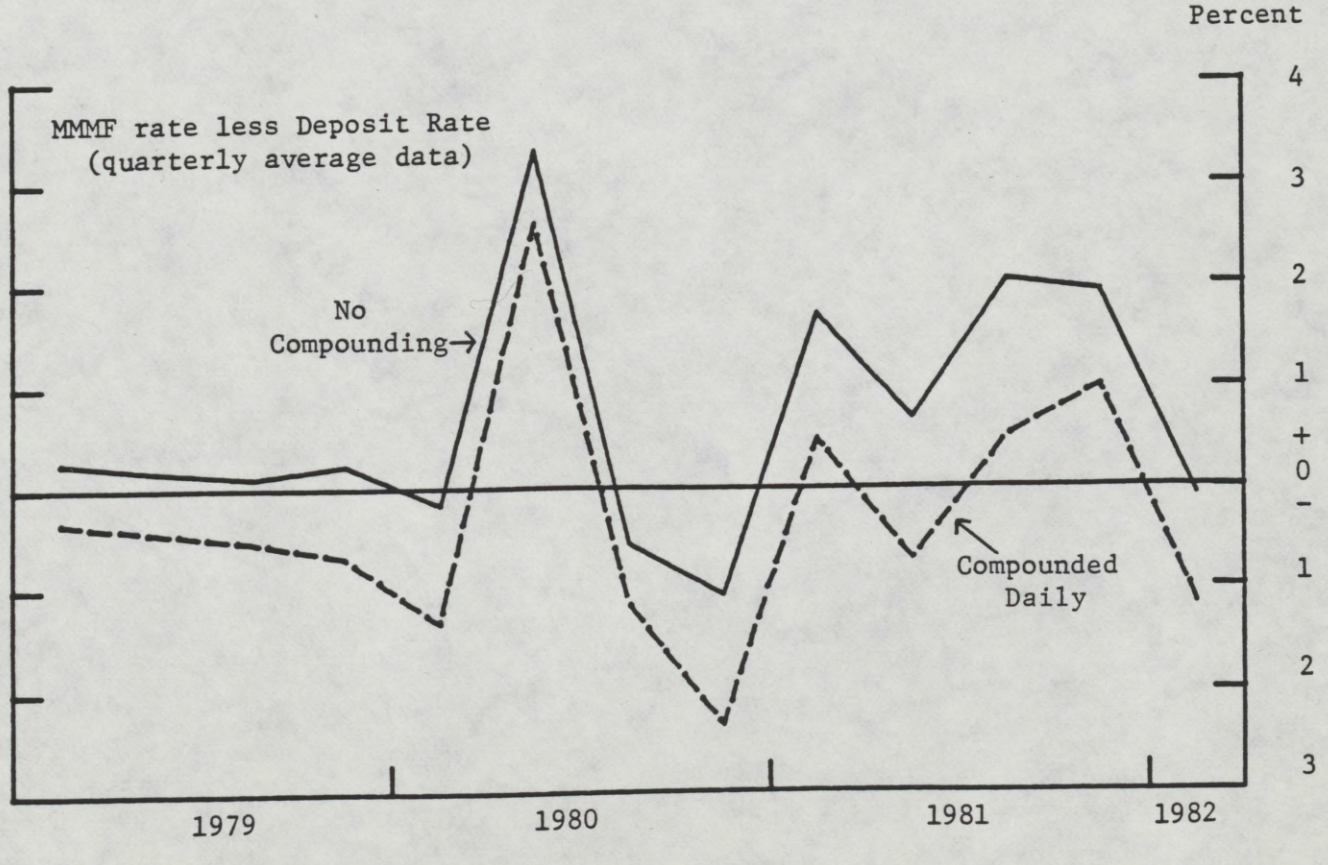
CHART 1

INTEREST RATE SPREADS BETWEEN MMMFs
AND A SHORT-TERM DEPOSIT EQUAL TO THE 91-DAY
TREASURY BILL RATE (Discount Basis)





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on such a deposit since 1979, with and without compounding; the lower panel shows the same spread on a quarterly average basis. With daily compounding (the dashed line), over the entire period the deposit rate would have on average exceeded the MMMF yield by over 30 basis points; in about two-thirds of the weeks since 1979 the deposit rate (daily compounding) would have exceeded MMMF yields.

The staff notes that it would be technically difficult effectively to prohibit compounding on the proposed instrument, even with a ceiling. First, for a fixed-term account (even if automatically rolled over) institutions legally must pay out or credit interest at maturity. Second, if the Committee authorized both fixed-term and notice accounts and prohibited the crediting of interest on the latter any more frequently than, say quarterly, the effective yields on the two similar accounts would be different. Additionally, as shown in the last two columns of Table 2 (which shows effective yields on instruments with a 13 percent nominal yield) the difference in effective yield between quarterly and continuous compounding is relatively small. At current rates, compounding adds 45 to 90 basis points to effective yields.

Should the Committee choose to impose a ceiling and a temporary differential, the staff would recommend that thrifts be permitted to pay the bill rate and commercial banks 25 basis points less. We would further recommend that the same procedure be adopted as on the new 91-day deposit instrument, viz., the differential would disappear after one year, and, during that year, for any interval after the auction average on the 91-day bill rate falls below 9 percent for four consecutive auctions.

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Table 2

Effective Yields on a 13.0 percent Certificate
for Various Compounding Periods--365/360 Basis

	Type of Compounding	Formula	Effective Rate	Increased Yield Due to Compounding	Percent of the Continuously Compound Increase
1)	Continuous	$r = e^{\frac{365\ (.13)}{360}} - 1$	= 14.088	.907	100
2)	Daily	$r = \left(1 + \frac{1\ (.13)}{360}\right)^{365} - 1$	= 14.085	.904	99+
3)	Weekly	$r = \left(1 + \frac{7\ (.13)}{360}\right)^{\frac{365}{7}} - 1$	= 14.070	.889	98
4)	Quarterly (91 days)	$r = \left(1 + \frac{91\ (.13)}{360}\right)^{\frac{365}{91}} - 1$	= 13.847	.666	73
5)	Semi-Annual (182 days)	$r = \left(1 + \frac{182(.13)}{360}\right)^{\frac{365}{182}} - 1$	= 13.616	.435	48
6)	No within period compounding 1/	$r = \left(1 + \frac{365(.13)}{360}\right) - 1$	= 13.181	--	0

1/ The fact that the effective rate is about 18 basis points higher than the nominal rate even with no within period compounding is due to the artificial year.

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Finally, as noted earlier, regardless of whether the account is subject to ceilings or not, the staff recommends that a ceiling rate equal to the applicable passbook rate be imposed whenever the balance on the account falls below the minimum maintenance requirement.

Additional Deposits. The staff recommends that the new account be structured so that institutions can accept additional deposits without quantitative regulatory limit once the account is opened. If the Committee adopts such a proposal--which would add to the flexibility of the account--certain problems regarding the account's maturity are raised.

For notice accounts, there are two options:

1) requiring that institutions adopt "first-in-first-out" accounting controls to assure that each deposit is maintained for at least the minimum notice period, or

2) imposing no regulatory limitation on the holding period for additional deposits. While individual institutions may not allow it, this option would permit institutions to accept additions to the new account for holding periods as short as overnight.

The Federal Reserve staff indicates that its Board is likely to be concerned about the monetary policy implications of the second approach and would urge that the Committee prohibit such additions; the Federal Reserve would be likely to impose transaction account reserve requirements to such deposits which might be held for very short periods.

For term (specific maturity) accounts, the problem of additional deposits becomes somewhat more complicated. Under existing agency regulations, additional deposits re-initialize the maturity of the account to the original maturity at the time of the additional deposit. The staff

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recommends that the Committee permit institutions to use any or all of the following methods for accepting additional deposits to the proposed term account:

1) Each deposit re-initializes the maturity of the original deposit.

2) Each deposit is subject to "first-in-first-out" accounting to assure that each additional deposit is maintained for the term of the account.

3) An institution is permitted to set up an "accounting cycle" equal to the original term of the offered account. New deposits received after the accounting cycle has begun will be regarded as maturing at the end of the next accounting cycle. In effect, each deposit will be held in interest-bearing escrow until it can be added at the beginning of a new regulatory maturity term.

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A fourth option might be:

4) No regulatory limitation to the holding period for additional deposits.

The Federal Reserve staff opposes the fourth option for the same monetary policy reasons as noted above and indicates the likelihood that the Federal Reserve Board might impose transaction account reserve requirements on such deposits which might be held for very short periods.

Withdrawals. The staff recommends no regulatory prohibition on the size or number of withdrawals from the proposed new account.

For notice accounts, withdrawals could occur only after the specified number of calendar days (discussed under maturity above) after

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the time the depository institutions receives notification. Notice would not be optional to the institution but must actually be given by the depositor, and would be permitted by telephone or other telecommunication, mail or messenger, or in person (over-the-counter or through an ATM).

For term accounts, withdrawals could occur only at maturity (or before the end of the grace period). Notification of intent to withdraw could occur any time before the end of the grace period by the same procedure as for a notice account. If no notification were received by the end of the grace period, the deposit would automatically roll over.

Some DIDC staff urge that notification for withdrawal from notice or term account be permitted on an automatic and/or preauthorized basis. Federal Reserve staff note that such permissive regulation would facilitate the use of the account for transaction purposes, raising monetary policy concerns; it urges prohibition of such arrangements and indicates that the Federal Reserve Board might impose transaction reserve requirements on accounts with such withdrawal procedures. The Federal Reserve staff recommends that the Committee require that all notifications require specific action by the depositor and automatic, preauthorized, standing and similar withdrawal notifications be prohibited.

Withdrawals from any version of the new account could only be by (1) check or cash to the depositor or by the institutions to a third party and (2) by transfer to the depositors' checking or NOW account. No withdrawals by third party draft drawn directly on the account would be permitted.

Early Withdrawal Penalty. A majority of the staff recommend that, since the maturity or notice on the proposed account is so short,

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no early withdrawals be permitted under any circumstances. This approach would eliminate the need for early withdrawal penalties. If the committee chose to permit early withdrawals, it might authorize the following early withdrawal penalties: (1) loss of earned interest (as adopted on the 91-day account) or (2) the standard penalty (loss of 3-months interest, which would require invasion of capital). Of course, if early withdrawal is permitted any institution could adopt a more restrictive early withdrawal penalty or prohibit such withdrawals if it chose to do so.

Eligibility. The staff is unanimous in its recommendation that the proposed new account have no regulatory limitation on eligibility for all depositors.

Miscellaneous Restrictions. The staff recommends a regulatory prohibition on loans to depositors designed to meet initial or maintenance balances. Overdraft privileges would still be permissible on NOW or demand deposits to which the new account is transferable, but staff recommends regulations that require that the rates charged on such overdrafts must equal the rates charged on such overdrafts for depositors that do not hold the proposed account.

To assure that withdrawal before maturity or notice is not facilitated, or the early withdrawal penalty (if any) is avoided, the staff recommends that no loans be permitted using the account as collateral at interest rates less than the rate being earned on the deposit plus the institutions' lending rate to other customers using Government securities or other similar high quality collateral. For similar reasons, the staff recommends that the new instrument be issued only in non-negotiable form.

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Because of the money market nature of the proposed instrument, the Committee may also wish to consider prohibiting the offering of RPs to account holders of the proposed new instrument (or those planning to open such accounts) at a rate in excess of that offered to any other customer. The Committee may wish to do this particularly if the account is subject to a rate ceiling so as to assure that such a ceiling is not pierced. It may also wish to do so for a ceilingless account to avoid the payment of above market rates for short periods in order to attract customers before the effective date.

Finally, if the account is subject to ceilings, the Committee may wish to prohibit the payment of premiums since the existing premium rule--2 per year per account--does not lend itself to a short-term instrument. If the account is ceilingless, the staff recommends no prohibition since premiums are part of the interest received.

Effective Date. In order to provide a sufficient interval for institutions to plan marketing strategies and design systems, the staff recommends that the effective date of any new instrument be 60 days after announcement of the Committee's decision.

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BALLOT FOR SHORT-TERM DEPOSIT PROPOSALS

I. I am in favor of authorizing a new short-term deposit instrument at this time.

Yes _____

No _____

(If you vote no you may still wish to complete the rest of the ballot in order to affect the design of the instrument in the event that a majority favors authorization)

II. MINIMUM DENOMINATION

1. The minimum initial denomination should be (check one)

$25,000 _____

$20,000 _____

$15,000 _____

$10,000 _____

Other _____
(Please specify)

2. The minimum subsequent or maintenance balance should be (check one)

$25,000 _____

$20,000 _____

$15,000 _____

$10,000 _____

$5,000 _____

Other _____
(Please specify)

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III. MATURITY

1. The maturity of the new instrument should be (more than one category can be authorized)

5-days _____

7-days _____

14-days _____

Institutions may offer any maturity they wish in the 5- to 31-day range _____

Other _____
(Please specify)

2. The instrument must be in the form of (check one)

Time deposit open account with notice period equal to my vote in III-1 _____

Specific maturity equal to my vote in III-1 _____

Institutions may have their choice of either or both of the above _____

3. For term accounts (i.e., specific maturity), there should be a grace period of

No grace period _____

1 day _____

2 days _____

Other _____
(Please specify)

IV. RATE

1. Institutions should be authorized to pay (check one)

Any rate they wish (no ceiling) _____

An indexed ceiling rate _____

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(Even if you vote for a ceilingless account, you may wish to complete questions IV-2 through IV-7 to affect the design of the instrument in the event that a majority favors an indexed ceiling).

2. If there is a ceiling, the base rate should be (check one)

The 91-day bill auction average (discount basis) _____

Other _____
(Please specify)

3. If there is ceiling, thrifts should have a differential (if yes, there is a subsidiary question)

No _____

Yes _____

If there is a differential, commercial banks may pay _____ basis points less than thrifts.

4. If there is a ceiling, the highest ceiling rate should (check one)

Equal the base rate indicated in my vote on IV-2 _____

Be above the base rate by ____ basis points

Be below the base rate by ____ basis points

Other _____
(Please specify)

5. In determining the ceiling, the institution should be free to (check one)

Use the higher of the latest base rate or a 4-week average _____

There should be no 4-week averaging option _____

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6. If there is a thrift differential, the differential should be

Permanent (as long as there is a ceiling) _____

Temporary _____

If temporary, the differential should disappear

At the end of one year _____

Other _____
(Please specify)

Within this interval, it should disappear if

The base rate is below 9 percent for four consecutive weeks _____

Other _____
(Please specify)

And within the interval, it should reappear if

The base rate is at or above 9 percent for one week _____

The base rate is at or above 9 percent for four consecutive weeks _____

Other _____
(Please specify)

7. If there is a ceiling (choose one)

The ceiling rate in the initial week would apply to the entire term of the account _____

The institutions would have the option of varying the rate on outstanding deposits in line with the changing base rate _____

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8. Should there be regulatory restrictions on compounding (check one)

Yes, compounding should be prohibited _____

No, an institution should be free to compound any way it wishes _____

9. Regardless of the ceiling, if the balance in the account falls below the minimum specified in my vote on II-2 (check one)

A ceiling rate equal to the institutions' savings account ceiling should be imposed _____

The account must be closed _____

Other _____
(Please specify)

10. For purposes of calculating interest and minimum balances the institution may use average daily balances over (check one)

One day _____

One week _____

Two weeks _____

One month _____

Any interval not to exceed one month _____

Other _____

11. If there is a differential, commercial banks should be permitted to pay the thrift ceiling rate to IRA/Keogh account depositors and governmental units

Agree _____

Disagree _____

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V. ADDITIONAL DEPOSITS

1. There should be no dollar limit or frequency limit on additional deposits (check one)

Agree _____

Limitations should be imposed as follows _____
(Please specify)

2. For notice accounts, if additional deposits are authorized, the institution (check one)

Must adopt first-in-first-out accounting controls to assume that each additional deposit is maintained for the minimum notice period _____

No limitation should be imposed on the holding period for additional deposits (which could then be as short as overnight) _____ 1/

Other _____
(Please specify)

3. For term accounts, if additional deposits are authorized (check one)

Each deposit re-initializes the maturity of the original deposit _____

Each deposit is subject to first-in-first-out accounting to assure that each additional deposit is maintained for the term of the account _____

An institutions is permitted to set up an accounting cycle equal to the original term of the offered account. New deposits received after the accounting cycle has

---

1/ Likely to give rise to transaction account reserve requirements.

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begun will be regarded as maturing at the end of the next accounting cycle _____

The institution is permitted to use any or all of the above _____

No limitation should be imposed on the holding period for additional deposits (which could then be as short as overnight) _____ 1/

VI. WITHDRAWALS

1. Limitations on withdrawals (check one)

There should be no limitations on dollar size or number provided that the notice or maturity requirements are met _____

There should be limitations as follows _____
(Please specify)

2. Notifications for withdrawal from notice or term accounts (check one)

May be automatic and/or preauthorized _____ 1/

May not be automatic and/or preauthorized _____

3. Withdrawals by draft drawn on the account (check one)

Would be permitted _____ 1/

Would not be permitted _____

VII. EARLY WITHDRAWAL PENALTY

1. Early withdrawal penalties (check one)

There should be none; the deposit should be withdrawable only after notice or at maturity _____

1/ Likely to give rise to transaction account reserve requirements.

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Early withdrawal permitted at the cost of

Earned interest _____

Standard penalty of 3-months interest (with invasion of principal permitted) _____

Other _____
(Please specify)

VIII. ELIGIBILITY

1. Deposit may be offered (check one)

To all depositors without limit _____

Individuals only _____

NOW account eligibility only _____

Other _____
(Please specify)

IX. MISCELLANEOUS

1. Institutions may not make loans to depositors for the purpose of meeting or maintaining minimum balance requirements (check one)

Agree _____

Disagree _____

2. The rate charged on overdrafts on NOW or demand deposits may not be lower for holders of the new account than for other depositors (check one)

Agree _____

Disagree _____

3. Loans using the account as collateral may not be lower than the yield on the account plus the loan rate to other customers using similar high quality collateral (check one)

Agree _____

Disagree _____

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4. The account may only be offered in non-negotiable form (check one)

Agree _____

Disagree _____

5. RPs may not be offered to holders of the new account (or those planning to open such account) at a rate higher than those offered to other customers (check one)

Agree _____

Agree only if account subject to rate ceilings _____

Disagree _____

6. Premiums may not be offered to account holder (check one)

Agree _____

Agree only if account subject to rate ceilings _____

Disagree _____

7. Effective date will be 60 days after announcement

Agree _____

Disagree _____

I propose an effective date of _____

X. COMMENTS

_____
(Signature)

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DATE: April 1, 1982

TO: Chairman Volcker

FROM: EDWARD C. ETTIN

The attached has been circulated among the DIDC staff.

cc: Soss
Bradfield

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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

DRAFT

TO: Depository Institutions Deregulation Committee

DATE: March 31, 1982

FROM: DIDC Staff *

SUBJECT: Short-term Deposit Proposals

At its March 22 meeting, the Committee adopted a new 91-day $7,500 minimum, certificate with a ceiling rate tied to the 91-day bill auction average, and with a temporary 25 basis point differential in favor of thrift institutions. At that meeting, however, the Committee instructed the staff to prepare for Committee consideration additional proposals for a shorter-term deposit that would provide depository institutions with a more competitive vehicle vis-a-vis money market mutual funds (MMMFs) and other market instruments.

As discussed more fully in previous staff memoranda, 1/ the fundamental problem before the Committee is to design a deposit that will minimize potential high-cost internal shifts from savings accounts while simultaneously maximizing the competitive appeal of the new instrument and minimizing operational difficulties for issuing institutions. In balancing these parameters, the staff focused on four variables:

1. Minimum Denomination. The larger the minimum balance

---

* This memorandum was prepared primarily by Edward C. Ettin of the staff of the Federal Reserve Board.

1/ See particularly, "Short-term Instrument Proposals," March 15, 1982.

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requirements, the less potential for internal shifting and less competitive the new instrument. 1/

2. Liquidity. There is a presumption that savings account holders place extreme emphasis on instant liquidity. Withdrawal from the proposed new account only after a notice period, and/or a short fixed maturity, and/or some combination of the two might therefore serve to limit internal shifting. The resultant reduced liquidity relative to MMMFs might be offset by the convenience and insurance of the deposit instrument.

3. Rate. The staff assumed that the ability to offer a market rate is necessary, but that rate need not necessarily be as high as MMMF yields because of convenience and deposit insurance.

4. Operational feasibility. Limited staff discussion with depository institutions suggests that a notice period is generally feasible, but complicated. Some institutions were concerned about potential back-office problems and consumer understanding of notice limitations.

Balancing these variables and the Committee's objectives, the staff has designed three alternative instruments for Committee considera-

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1/ A substantial proportion of savings balances are in high balance accounts. In December 1981, the FDIC indicates that 75 percent of MSB savings accounts were in excess of $5,000 and 41 percent in excess of $15,000. In August 1980, the FHLBB indicates that 70 percent of S&L regular savings were in accounts with balances in excess of $5,000 and 45 percent in excess of $10,000. A small sample survey by the American Bankers Association in March 1982 indicated that at commercial banks about 60 percent of savings deposit balances were in excess of $5,000 and 38 percent in excess of $10,000. The latter survey also indicated that almost three fourths of total NOW balances were in excess of $5,000 and almost half in excess of $10,000.

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tion, each of which have variants on the size of the minimum denomination and rate. The three options are summarized in the table on the following page and each is described in considerable detail in the attachments to this memorandum. The details of the three proposals, of course, can be revised by the Committee.

In evaluating the three alternatives, the following observations might be useful to the Committee:

1) Both alternatives A and B have options on the minimum denomination. Should a relatively high minimum be selected--in order to limit the potential shifts from savings accounts--the Committee could consider indicating that it monitors the shift experience with the higher minimum denomination to determine the appropriateness of reducing the minimum denomination.

2) In evaluating the minimum denomination of alternatives A and B, the Committee may wish to consider the relative importance that a notice or a short-maturity may have in reducing internal deposit shifts. If it is felt that these limitations will significantly reduce shifts, the lower minimum denomination may be appropriate.

3) If the Committee believes that a ceiling rate is appropriate for alternatives A and/or B, the staff notes that such a ceiling need not equal a market rate in order to attract funds, given the insurance and convenience of deposits. Any judgment on the degree to which the nominal ceiling should be indexed below a market rate might be affected by the decision on permissible compounding. It would

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SUMMARY OF PROPOSED ACCOUNTS' MAJOR CHARACTERISTICS

Feature	Alt. A	Alt. B	Alt. C
Maturity	7-day notice	7- or 14-day fixed	Dual accounts; 30- or 90-day fixed plus 7-day notice or 7-day fixed.
Minimum Initial Deposit	$10,000 or $25,000	$10,000 or $25,000	$10,000 in 30- or 90-day account.
Minimum Subsequent Balance	$10,000 or $25,000	$10,000 or $25,000	$10,000 in the sum of both accounts.
Additional Deposits	No limit	No limit	No limit but each deposit goes first into 30- or 90-day account.
Withdrawals	No limit on dollar size. 7-days prior notice required. Withdrawal paid to depositor or third party, or transfer to NOW or demand deposit. No withdrawals by negotiable instrument.	Only at maturity. No limit on dollar size withdrawals paid to depositor or third party, or transfer to NOW or demand deposit. No withdrawal by negotiable instrument.	At the end of 30- or 90-days from first account. And funds not withdrawn from first account at maturity shift to 7-day notice or 7-day fixed maturity account, from which withdrawals are the same as under alternatives A or B.
Early Withdrawal Penalty	None since no withdrawal permitted without 7-day notice.	None since no withdrawals permitted until maturity.	Earned interest on 30- or 90-day account. Same as alternatives A or B for 7-day account.
Interest Rate	Related to 91-day bill rate or no ceiling. Savings rate if balance below minimum. Differential possible if there is a ceiling.	Related to 91-day bill rate or no ceiling. Savings rate if balance below minimum. Differential possible if there is a ceiling.	Related to 91-day bill rate. 30- or 90-day account fixed or floating. Differential possible. Savings rate if balance falls below $10,000 in the sum of both accounts.
Eligibility	All depositors.	All depositors.	All depositors.

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technically be difficult to effectively prohibit compounding on a very short-term instrument.[1/] As shown in Table 2, compounding adds 45 to 90 basis points to effective yields at current market rates.

4) As a technical matter, the staff notes that (a) a thrift differential will contribute to relatively more rapid deposit flows at thrifts, and (b) a competitive new instrument--even with a thrift differential--should contribute to greater deposit growth at commercial banks as well.

5) Some institutions have indicated potential operating problems with the alternative A notice account approach. The fixed maturity approach of alternative B would eliminate these operating difficulties but would add potential complexities for handling additional deposits. However, these could be minimized by permitting institutions their options as to procedures for accepting new deposits. Indeed, if the Committee is inclined to authorize a very short-term instrument, it might wish to consider authorizing both alternatives A and B--permitting institutions to choose to offer either or both a notice or fixed maturity account. Under this approach the staff would suggest the same minimum denomination and rate for both accounts.

1/ First, for a fixed-term account (even if automatically rolled over) institutions legally must pay out or credit interest at maturity. Second, while this would not be the case on notice accounts (since they have no maturity), if the Committee authorized both fixed-term and notice accounts and prohibited the crediting of interest on the latter any more frequently than, say, quarterly, the effective yields on the two similar accounts would be different. Third, as shown in the last two columns of Table 2 (which shows effective yields on instruments with a 13 percent nominal yield) the difference in effective yield between quarterly and continuous compounding is relatively small.

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Table 2

Effective Yields on a 13.0 percent Certificate
for Various Compounding Periods--365/360 Basis

	Type of Compounding	Formula	Effective Rate	Increased Yield Due to Compounding	Percent of the Continuously Compound Increase
1)	Continuous	$r = e^{\frac{365\ (.13)}{360}} - 1$	= 14.088	.907	100
2)	Daily	$r = \left(1 + \frac{1\ (.13)}{360}\right)^{365} - 1$	= 14.085	.904	99+
3)	Weekly	$r = \left(1 + \frac{7\ (.13)}{360}\right)^{\frac{365}{7}} - 1$	= 14.070	.889	98
4)	Quarterly (91 days)	$r = \left(1 + \frac{91\ .13}{360}\right)^{\frac{365}{91}} - 1$	= 13.847	.666	73
5)	Semi-Annual (182 days)	$r = \left(1 + \frac{182\ .13}{360}\right)^{\frac{365}{182}} - 1$	= 13.616	.435	48
6)	No within 1/ period compounding	$r = \left(1 + \frac{365\ .13}{360}\right) - 1$	= 13.181	--	0

1/ The fact that the effective rate is about 18 basis points higher than the nominal rate even with no within period compounding is due to the artificial year.

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6) Monetary policy considerations--particularly the need to separate transaction and investment balances--argue against both a shorter notice account than 7 days and the ability of deposit holders to draw negotiable drafts directly on any of the proposed new instruments. The Federal Reserve Board has the authority to regard any of the three proposals as time deposits for reserve requirement purposes and subject them to a zero percent reserve requirement.

7) The alternative C approach would be the most effective for limiting internal shifts, but also the least attractive competitively. Its operational mechanism appears complex but the staff believes it is workable.

8) The more limited potential for shifting under alternative C implies that a smaller denomination than alternatives A or B could be adopted. However, it also probably requires a higher ceiling rate than the two alternatives to make up for its more limited initial liquidity.

9) In order to prevent evasions by depository institutions the staff suggests that any new account prohibit loans to account holders to meet minimum balance requirements as well as tied RPs at a rate not available to all depositors.

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Alternative A

7-day Notice Account

Minimum Initial Deposit:	Option 1: $10,000; Option 2: $25,000
Minimum Subsequent Balance:	Same (institution has option of determining minimum balance as average for week or average for month).
Additional Deposits:	No regulatory limitation.
Maturity:	No specified maturity--time, open account; funds can be withdrawn only after 7-days notice.
Withdrawals:	No regulatory limitation on size of withdrawals. Withdrawals only after seven calendar days of the time the depository institution receives notification. Notice must actually be given before withdrawal (<u>not</u> optional to institution). No standing, periodic, automatic, preauthorized, repetitive, or prearranged notifications permitted. Notification for withdrawals possible by: a) Telephone or other telecommunication. b) Mail or messenger. c) In person (over the counter or through an ATM). Withdrawals can be by: a) Check or cash to depositor or to third party (if the depositor does not pick-up funds after giving 7-day notice, the funds may <u>not</u> be automatically redeposited to the proposed account). b) Transfer to checking or NOW account. No withdrawals by negotiable draft. "First-in-first-out" requirement applied to account balance for notification-withdrawals.

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Early Withdrawal Penalty:	None (no withdrawals permitted in any circumstances without 7-day prior notice).
Interest Rate:	Option 1: Ceiling rate related to auction average of 91-day bill rate (discount basis), effective the day after the auction. (No 4-week averaging option.) Ceiling rates would change weekly. Option 2: No ceiling. Under either option, rate falls to savings rate whenever balance in the account falls below minimum balance. Under option 1 if there is a differential, commercial banks can pay 25 basis points less than thrifts; differential disappears one calendar year after effective date of the instrument and, within that year, for any interval after auction average on the 91-day bill falls below 9 percent for four consecutive auctions. Compounding of interest permitted. No regulatory requirement as to whether interest is to be calculated on minimum or average balance.
Eligibility:	Available to all depositors.
Reserve Requirements:	Under the Federal Reserve's current Regulation D, the instrument would be subject to transaction account reserve requirements since the notice period is less than 14 days. The Federal Reserve Board could regard the account as a time deposit on the basis of the 7-day notice requirement and limited withdrawal features; if it did so, it could also establish zero percent reserve requirement on this category of time deposits. 1/
Other Restrictions:	1) Institution may not lend funds to depositor to meet minimum initial or maintenance balance or make any loan using the account as collateral. (Overdraft privileges permissible on NOW or demand balances to which the new

1/ The Board could also apply a reserve requirement to these accounts held by other than natural persons (currently 3 percent). In any event, member banks would still be subject to a small reserve requirement on time deposits during the current phase-down of reserve requirements under the Monetary Control Act.

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account is transferable; rate charged on such overdrafts must equal rate charged on overdrafts for those that do not hold the proposed account).

2) The account could only be issued in non-negotiable form. 1/

3) Institution may not offer RPs to account holders (or those planning to open such an account) at a rate in excess of that offered to any other customer.

Effective Date: June 1 (Tuesday), with any ceiling based on auction May 28 (Friday). (May 31 is a holiday.)

1/ The agencies could separately reduce the minimum maturity on large denomination time deposits from 14- to 7-days, permitting the issuance of large negotiable CDs with maturities of 7 days. Such an account would be separate from the proposed new account. Federal Reserve Board action to define 7-day CDs as time deposits would also be required to obtain time deposit reserve requirements.

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Alternative B

7- or 14-day Fixed Maturity Time Account

Minimum Initial Deposit:	Option 1: $10,000. Option 2: $25,000
Minimum Subsequent Balance:	Same (institution has option of determining minimum balance as average for week or average for month).
Additional Deposits:	No regulatory limit on the size of additional deposits. Institutions are permitted to use any or all of following for additional deposits: a) Each deposit re-initializes the maturity of the original deposit. b) "First-in-first-out" accounting to assure each addition is on deposit for 7- or 14-days. c) Accounting cycle established for (or 14) day intervals. New deposits received at any time during the 7-day interval will be regarded as maturing at the end of the next accounting cycle.
Maturity:	7 days with 1-day grace period or 14 days with 2-day grace period. If no instructions are received from depositor at or before maturity, deposit is automatically rolled-over at the then prevailing rate.
Withdrawals:	No regulatory limit on size of withdrawals, but withdrawals can only occur at maturity (or before end of grace period). Notification for withdrawal by depositor can be given: a) At maturity (or before end of grace period). b) Prior to maturity, but no standing, periodic, automatic, preauthorized, repetitive, or prearranged notifications permitted.

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Notification for withdrawal possible by:

a) Telephone or other telecommunication.

b) Mail or messenger.

c) In person (over the counter or through an ATM).

Withdrawal can be by:

a) Check or cash to depositor or to third party (if the depositor does not pick-up funds after giving notice, the funds may be automatically redeposited to the proposed account).

b) Transfer to checking or NOW account.

No withdrawal by negotiable draft.

Early Withdrawal Penalty: None since deposit must be held 7- or 14-days in all circumstances.

Interest Rate: Option 1: Ceiling rate related to auction average of 91-day bill rate (discount basis), effective the day after the auction. (No 4-week averaging option.) Option 2: No ceiling.

Under option 1, 14-day deposit can be fixed rate, with ceiling related to bill rate in the initial week, or may vary the ceiling in line with weekly bill auction. 7-day deposit ceilings would change weekly.

Under all options, if balance falls below minimum, the rate falls to the savings rate.

Under option 1, if there is a differential, commercial banks can pay 25 basis points less than thrifts; differential disappears one calendar year after effective date of the instrument and, within that year, for any interval after auction average on the 91-day bill rate falls below 9 percent for four consecutive auctions.

Eligibility: Available to all depositors.

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Reserve Requirements:	Under the Federal Reserve's current Regulation D, no reserve requirement would be applicable to 14-day accounts held by natural persons but 3 percent would be applicable for non-personal accounts. The Board could reduce the latter requirement to zero percent. The 7-day account would currently be subject to transaction account reserve requirements, but the Board could define the account as a time deposit and apply a zero percent reserve to both personal and non-personal accounts or just to personal accounts. 1/
Other Restrictions:	1) Institution may not lend funds to depositor to meet minimum initial or maintenance balance or make any loan using the account as collateral. 2) The account could only be issued in non-negotiable form. 3) Institution may not offer RPs to account holders (or those planning to open such an account) at a rate in excess of that offered to any other customer.
Effective Date:	June 1 (Tuesday), with any ceiling based on auction May 28 (Friday). (May 31 is a holiday.)

1/ In both cases, member banks would still be subject to a small reserve requirement for personal accounts during the current phase-down of reserve requirement under the Monetary Control Act.

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Alternative C

Dual Account: 30-day or 90-day Fixed Maturity Plus 7-day Notice or 7-day Fixed Maturity Account

Minimum Initial Deposit:	$10,000 in the 30-day or 90-day account.
Minimum Subsequent Balance:	$10,000 in the sum of two accounts--30- or 90-day fixed plus 7-day notice or 7-day fixed. (Institution has option of determining minimum balance as average for week or average for month.)
Maturity:	At 30- or 90-day maturity of first account (which could have a 5- or 7-day grace period), funds can be withdrawn. Balances not withdrawn are automatically transferred to one of two second accounts, at the depository institution's option (institution could offer either or both): a) A 7-day notice account, from which funds can be withdrawn only on 7-day's notice. b) A 7-day fixed maturity deposit (with 1 day grace period) that automatically rolls over funds that are not withdrawn by the end of the grace period.
Additional Deposits:	No regulatory minimum on the size of additional deposits, but all deposits must go first into the 30- or 90-day account.
Withdrawals:	Institutions are permitted to use either or both of the following for permitting withdrawals at the end of 30- or 90-days or transfers to the second account. a) "First-in-first-out" accounting to assure each addition is on deposit for 30- or 90-days. b) Accounting cycle established in 30-day intervals. New deposits received, after say, the fifth day of the accounting cycle begin their regulatory maturity cycle at the beginning of the next accounting cycle (and hence must be held on deposit in the first account for more than 30- or 90-days). Under this approach, funds in the first account could be on deposit, say, as short as 25 days or as long as 55 days if fixed maturity was 30 days or 85 to 105 days if fixed maturity was 90-days.

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No regulatory limitation on size of withdrawals from either account, but withdrawals from the first account can only be at end of 30- or 90-days or at the end of the appropriate accounting cycle, and from the second account only after seven calendar days of the time the depository institution receives notification or at the end of a 7-day maturity.

Notification for withdrawal by depositor from 30- or 90-day account (or 7 day fixed maturity account) can be given:

a) At maturity (or before end of grace period).

b) Prior to maturity, but no standby, periodic, automatic, preauthorized, repetitive, or prearranged notifications permitted.

Notification for 7-day notice account variant must be received by the institution 7-days before withdrawal. No standing, periodic, automatic, preauthorized, or repetitive prearranged notifications permitted.

Notification for withdrawals possible by:

a) Telephone or other telecommunication.
b) Mail or messenger.
c) In person (over the counter or through an ATM).

Withdrawals from first or second account can be by:

a) Check or cash to depositor or to third party (if the depositor does not pick-up funds at the appropriate time after giving notification, the funds may not be automatically redeposited to the proposed account).

b) Transfer to checking or NOW account.

No withdrawal by negotiable draft.

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"First-in-first-out" requirement applied to 7-day notice account balance for notification-withdrawals.

For 7-day fixed maturity variant institution could use one or both of the following:

a) "First-in-first-out" accounting to assure each addition on deposit seven days.

b) Accounting cycle established on 7-day interval. New deposits received after the beginning of any interval begin their regulatory maturity cycle at the beginning of the next accounting cycle (and hence must be on deposit in excess of 7-days).

Early Withdrawal Penalty: All accured interest earned on first account; no withdrawals permitted in any circumstances from second account without 7-day prior notice or at maturity, with depositor given the indicated grace period on the latter account.

Interest Rate: Option 1:

a) For 30- or 90-day term account: Ceiling rate related to auction average of 91-day bill rate (discount basis), effective the day after the auction. (No 4-week averaging option.) Institutions may offer on fixed-rate basis with ceiling related to the auction average in the initial week of the deposit, or may vary the ceiling weekly in line with weekly bill auction.

b) For second account: Same ceiling rate as 30- or 90-days account established weekly.

Option 2: No ceiling.

Under option 1, if there is a differential, commercial banks can pay 25 basis points less than thrifts; differential disappears one calendar year after effective date of the instrument and, within that year, for any interval after auction average falls below 9 percent for four consecutive auctions.

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Under either option, rate falls to savings rate on both accounts when the sum of balances in the account fall below $10,000 as defined under "minimum subsequent balance."

Compounding permitted on both accounts.

Eligibility: Available to all depositors.

Reserve Requirements: Under the Federal Reserve's current Regulation D, reserve requirements would not be applicable to the 30- or 90-days account held by persons, but the 7-day account would be subject to transaction account reserve requirements since the notice period is less than 14 days. The Federal Reserve Board could exempt the 7-day account from transaction reserve requirements on the basis of its maturity; if it did so, it could also establish zero percent reserve requirements on this category of time deposits. 1/

Other Restrictions:

1) Institution may not lend funds to depositor to meet minimum initial or maintenance balance or make any loan using the account as collateral. (Overdraft privileges permissible on NOW or demand balances to which the 7-day account is transferable; rate charged on such overdrafts must equal rate charged on overdrafts for those that do not hold the proposed account).

2) Both accounts could only be issued in non-negotiable form. 2/

3) Institution may not offer RPs to account holders (or those planning to open such an account) at a rate in excess of that offered to any other customer.

Effective Date: June 1 (Tuesday, with any ceiling based on auction May 28 (Friday). (May 31 is a holiday.)

1/ Member banks would still be subject to small reserve requirements on time deposits during the current phase-down of reserve requirements under the Monetary Control Act. The Board could also apply a reserve requirement to these accounts held by other than persons (currently 3 percent).

2/ The agencies could separately reduce the minimum maturity on large denomination time deposits from 14- to 7-days, permitting the issuance of large negotiable CDs with maturities of 7 days. Such an account would be separate from the proposed new account. Federal Reserve Board action to define 7-day CDs as time deposits would also be required to obtain time deposit reserve requirements.

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DRAFT

TO: Depository Institutions Deregulation Committee

DATE: March 29, 1982

FROM: DIDC Staff*

SUBJECT: Short-term Deposit Proposals

At its March 22 meeting, the Committee adopted a new 91-day, $7500 minimum, certificate with a ceiling rate tied to the 91-day bill auction average, and with a temporary 25 basis point differential in favor of thrift institutions. At that meeting, however, the Committee instructed the staff to prepare for Committee consideration additional proposals for a shorter-term deposit that would provide depository institutions with a more competitive vehicle vis-a-vis money market mutual funds (MMMFs) and other market instruments.

As discussed more fully in previous staff memoranda,[1/] the fundamental problem before the Committee is to design a deposit that will minimize potential high-cost internal shifts from savings accounts while simultaneously maximizing the competitive appeal of the new instrument and minimizing operational difficulties for issuing institutions. In balancing these parameters, the staff focused on four variables:

1. Minimum Denomination. The larger the minimum balance requirements, the less potential for internal shifting and the less competitive the new instrument.[2/]

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* This memorandum was prepared primarily by Edward C. Ettin of the staff of the Federal Reserve Board.

1/ See particularly, "Short-term Instrument Proposals," March 15, 1982.

2/ A substantial proportion of savings balances are in high balance accounts. In December 1981, the FDIC indicates that 75 percent of MSB savings accounts were in excess of $5,000 and 41 percent in excess of $15,000. In August 1980, the FHLBB indicates that 70 percent of S&L regular savings were in accounts with balances in excess of $5,000 and 45 percent in excess of $10,000. A small sample survey by the American Bankers Association in March 1982 indicated that at commercial banks about 60 percent of savings deposit balances were in excess of $5,000 and 38 percent in excess of $10,000. The latter survey also indicated that almost three fourths of total NOW balances were in excess of $5,000 and almost half in excess of $10,000.

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2. Liquidity. There is a presumption that savings account holders place extreme emphasis on instant liquidity. Withdrawal from the proposed new account only after a notice period, and/or a short fixed maturity, and/or a limitation on the number of withdrawals might therefore serve to limit internal shifting. The resultant reduced liquidity relative to MMMFs might be offset by the convenience and insurance of the deposit instrument.

3. Rate. The staff assumed that the ability to offer a market rate is necessary, but that rate need not necessarily be as high as MMMF yields because of the convenience and deposit insurance.

4. Operational feasibility. Limited staff discussion with depository institutions suggests that a notice period is generally feasible, but complicated. Some institutions were concerned about potential back-office problems and consumer understanding of notice and withdrawal limitations.

Balancing these variables and the Committee's objectives, the staff has designed four alternative instruments for Committee consideration. These are summarized in the table on the following page and each is described in more detail in the attachments to this memorandum. The details of the four proposals, of course, can be revised by the Committee and each proposal is self-explanatory.

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SUMMARY OF PROPOSED ACCOUNTS' MAJOR CHARACTERISTICS

Feature	Alt. A	Alt. B	Alt. C	Alt. D
Maturity	7-day notice	7-day notice	14-day fixed	Dual accounts: 30-day fixed plus 7-day notice
Minimum Initial deposit	$10,000	$25,000	$10,000	$10,000 in 30-day account
Minimum Subsequent Balance	$5,000	$25,000	$10,000	$5,000 in the sum of both accounts.
Additional Deposits	No limit	No limit	No limit but re-initializes 14-day maturity.*	No limit but each deposit goes first into 30-day account
Withdrawals	No limit on dollar size. 7-days prior notice required. Withdrawal paid to depositor or third party, or transfer to another account. No withdrawals by negotiable instrument. Maximum of three withdrawals per month.	Same as Alt. A except no limit on number of withdrawals.	Only at maturity.	None from 30-day account. At maturity of 30-day account, funds shift to 7-day notice account, from which withdrawals are the same as Alt. B.
Early Withdrawal Penalty	None since no withdrawal permitted without 7-day notice.	Same as Alt. A.	None since no withdrawals permitted until maturity.	Earned interest on 30-day account. Same as Alt. A for 7-day notice account.
Interest Rate	Equal to 91-day bill rate. Savings rate if balance below $5,000. Differential possible.	No ceiling or equal to 91-day bill rate. Differential possible. Savings rate if balance falls below $25,000.	Equal to 91-day bill rate. Differential possible.	Equal to 91-day bill rate. 30-day account fixed or floating. Differential possible. Savings rate if balance falls below $5,000 in 7-day account.
Eligibility	All depositors	All depositors.	All depositors.	All depositors.

* Alternatively, could accept new deposits but each deposit must be held 14 days.

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In evaluating the four alternatives, the following observations might be useful to the Committee:

1) The potential for internal shifting is reduced as one moves from alternative A to D, but so is the competitive attraction of each instrument.

2) In comparing alternatives A and B, the higher minimum balance of the latter suggests that its withdrawal features can be less restrictive--i.e. no limit on the number of withdrawals--without significantly exacerbating the potential for internal shifts. The higher minimum balance of alternative B also suggests smaller risks in authorizing a ceilingless account.

3) Alternative C, the least innovative instrument, would provide the least operational problems for institutions, but presents more difficulties than alternatives A and B for deposit additions.

4) Alternative D would probably be associated with the least volume of internal shifting, but be the least competitive of the four alternatives and the most complex operationally as well as the most difficult to explain to the public.

5) Monetary policy considerations--particularly the need to separate transactions and investment balances--argue against both a shorter notice account than 7 days and the ability of deposit holders to draw negotiable drafts directly on any of the proposed new instruments. The Federal Reserve Board has the authority to exempt any of the four proposals from transaction account reserve requirements, and could also exempt such account held by other than individuals from the non-personal time deposit reserve requirements.

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(Time deposits held by individuals are exempt from reserve requirements under the Monetary Control Act.)[1/]

6) In order to prevent evasions by depository institutions the staff suggests that any new account prohibit loans to account holders to meet minimum balance requirements as well as tied RPs at a rate not made available to all depositors.

1/ Member bank are subject to a small and declining reserve requirement on time deposits during the phase-down of reserve ratios under the Monetary Control Act. That ratio is currently 1.7 percent and is declining 0.4 percentage points semi-annually.

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Alternative A

Medium Balance 7-day Notice Account

Minimum Initial Deposit:	$10,000.
Minimum Subsequent Balance:	$5,000 (institution has option as to determining minimum balance as average for week or average for month).
Additional Deposits:	No regulatory limitation.
Maturity:	No specified maturity--time, open account; funds can be withdrawn only after 7-days notice.
Withdrawals:	Maximum of three per calendar month (or per statement cycled at least four weeks).

No regulatory limitation on size of withdrawals.

Withdrawal only after seven calendar days of the time the depository institution received notification (three per month withdrawal based on date notification received; notification, even if withdrawal not subsequently made, counts toward maximum number of withdrawals).

Withdrawals can be by:

a) Check or cash to depositor or to third party (if the depositor does not pick-up funds after giving 7-day notice, the funds may not be automatically redeposited to the proposed account).

b) Transfer to any other account.

No withdrawals by negotiable draft.

Notification for withdrawals possible by:

a) Telephone or other telecommunication.
b) Mail or messenger.
c) In person (over the counter or through an ATM).

No preauthorized notifications permitted.

"First-in-first-out" requirement applied to account balance for notification-withdrawals.

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Early Withdrawal Penalty:	None (no withdrawals permitted in any circumstances without 7-day prior notice and in excess of three per month).
Interest Rate:	Ceiling rate applicable to all balances equal to auction average of 91-day bill rate (discount basis), effective the day after the auction. (No 4-week averaging option.) Rate falls to savings rate whenever balance in the account falls below $5,000 as defined above under "minimum subsequent balance." Compounding permitted (if not, interest credited only once per 7-day period). No regulatory requirement as to whether interest is to be calculated on minimum or average balance. Can only advertise weekly discount rate. If there is a differential, thrifts can pay bill rate and commercial banks 25 basis points less; differential disappears one calendar year after effective date of the instrument and, within that year, for any interval after auction average falls below 9 percent for four consecutive auctions.
Eligibility:	Available to all depositors.
Reserve Requirements:	Under the Federal Reserve's current Regulation D, the instrument would be subject to transaction account reserve requirements since the notice period is less than 14 days. The Federal Reserve Board could regard the account as a time deposit on the basis of the 7-day notice requirement and limited withdrawal features; if it did so, it could also establish zero percent reserve requirement on this category of time deposits. 1/
Other Restrictions:	1) Institution may not lend funds to depositor to meet minimum initial or maintenance balance or make any loan using the account as collateral. (Overdraft privileges permissible on NOW or demand balances to which the new account

1/ Member banks would still be subject to small reserve requirements on time deposits during the current phase-down of reserve requirements under the Monetary Control Act. The Board could also apply a reserve requirement to these accounts held by other than natural persons (currently 3 percent).

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is transferable; rate charged on such overdrafts must equal rate charged on overdrafts for those that do not hold the proposed account).

2) The account could only be issued in non-negotiable form. 1/

3) Institution may not offer RPs to account holders (or those planning to open such an account) at a rate in excess of that offered to any other customer.

Effective Date: June 1 (Tuesday), with ceiling based on auction May 28 (Friday). (May 31 is a holiday.)

1/ The agencies could separately reduce the minimum maturity on large denomination time deposits from 14- to 7-days, permitting the issuance of large negotiable CDs with maturities of 7 days. Such an account would be separate from the proposed new account. Federal Reserve Board action to define 7-day CDs as time deposits would also be required to obtain time deposit reserve requirements.

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Alternative B

Large Balance 7-day Notice Account

Minimum Initial Deposit:	$25,000.
Minimum Subsequent Balance:	$25,000 (institution has option as to determining minimum balance as average for week or average for month).
Additional Deposits:	No regulatory limitation.
Maturity:	No specified maturity--time, open account; funds can be withdrawn only after 7-days notice.
Withdrawals:	No regulatory limitation on size of withdrawals. Withdrawal only after seven calendar days of the time the depository institution received notification. Withdrawals can be by: a) Check or cash to depositor or to third party (if the depositor does not pick-up funds after giving 7-day notice, the funds may not be automatically redeposited to the proposed account). b) Transfer to any other account. No withdrawals by negotiable draft. Notification for withdrawals possible by: a) Telephone or other telecommunication b) Mail or messenger. c) In person (over the counter or through an ATM). No preauthorized notifications permitted. "First-in-first-out" requirement applied to account balance for notification-withdrawals.
Early Withdrawal Penalty:	None (no withdrawal permitted in any circumstances without 7-day prior notice.)

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Interest Rate:	No ceiling. (If there is a ceiling it would be equal to auction average of 91-day bill rate (discount basis), effective the day after the auction, with no 4-week averaging option. If there is a differential, thrifts can pay bill rate and commercial banks 25 basis points less; differential disappears one calendar year after effective date of instrument and, within that year, for any interval after auction average falls below 9 percent for four consecutive auctions.) Rate falls to savings rate whenever balance in the account falls below $25,000 as defined above under "minimum subsequent balances." 1/ Compounding permitted (if not, interest credited only once per 7-day period). No regulatory requirement as to whether interest is to be calculated on minimum or average balance. Can only advertise non-compounded weekly rate.
Eligibility:	Available to all depositors.
Reserve Requirements:	Under the Federal Reserve's current Regulation D, the instrument would be subject to transaction account reserve requirements since the notice period is less than 14 days. The Federal Reserve Board could regard the account as a time deposit on the basis of the 7-day notice requirement and limited withdrawal features; if it did so, it could also establish zero percent reserve requirement on this category of time deposits. 2/
Other Restrictions:	1) Institution may not lend funds to depositor to meet minimum initial or maintenance balance or make any loan using the account as collateral. (Overdraft privileges permissible on NOW or demand balances to which the new account is transferable; rate charged on such overdrafts must equal rate charged on overdrafts for those that do not hold the proposed account).

1/ Alternatively, could reduce ceiling 1 percentage point for each $1,000 maintenance balance below $25,000 until passbook ceiling is reached.

2/ Member banks would still be subject to small reserve requirements on time deposits during the current phase-down of reserve requirements under the Monetary Control Act. The Board could also apply a reserve requirement to these accounts held by other than natural persons (currently 3 percent).

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2) The account could only be issued in non-negotiable form. 1/

3) Institution may not offer RPs to account holders (or those planning to open such an account) at a rate in excess of that offered to any other customer.

Effective Date: June 1 (Tuesday), with ceiling based on auction May 28 (Friday). (May 31 is a holiday.)

1/ The agencies could separately reduce the minimum maturity on large denomination time deposits from 14- to 7-days, permitting the issuance of large negotiable CDs with maturities of 7 days. Such an account would be separate from the proposed new account. Federal Reserve Board action to define 7-day CDs as time deposits would also be required to obtain time deposit reserve requirements.

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Alternative C

Medium Balance 14-day Fixed Maturity Time Account

Minimum Initial Deposit:	$10,000.
Additional Deposits:	No regulatory limitation other than each additional deposit would re-initialize maturity to the original 14-days. (Alternatively, each new deposit must be held 14 days.)
Maturity:	14 days with 3-day grace period.
Withdrawals:	No withdrawals except at maturity without early withdrawal penalty.
Early Withdrawal Penalty:	None since deposit must be held 14 days in all circumstances.
Interest Rate:	Ceiling rate applicable to all balances equal to auction average of 91-day bill rate (discount basis), effective the day after the auction. (No 4-week averaging option.) Compounding permitted (if not, interest credited only once per 14-day period). Can only advertise weekly discount rate. If there is a differential, thrifts can pay bill rate and commercial banks 25 basis points less; differential disappears one calendar year after effective date of the instrument and, within that year, for any interval after auction average falls below 9 percent for four consecutive auctions.
Eligibility:	Available to all depositors.
Reserve Requirements:	Under the Federal Reserve's current Regulation D, no reserve requirement would be applicable to accounts held by natural persons and 3 percent for non-personal accounts. 1/ The Board could eliminate the latter requirement.

1/ Member banks would still be subject to a small reserve requirement for personal accounts during the current phase-down of reserve requirement under the Monetary Control Act.

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Other Restrictions:

1) Institution may not lend funds to depositor to meet minimum initial or maintenance balance or make any loan using the account as collateral.

2) The account could only be issued in non-negotiable form.

3) Institution may not offer RPs to account holders (or those planning to open such an account) at a rate in excess of that offered to any other customer.

Effective Date:

June 1 (Tuesday), with ceiling based on auction May 28 (Friday). (May 31 is a holiday.)

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Alternative D

Dual Account: 30-day Fixed Maturity Plus 7-day Notice Account

Minimum Initial Deposit:	$10,000 in the 30-day account.
Minimum Subsequent Balance:	$5,000 in the sum of the two accounts (institution has option as to determining minimum balance as average for week or average for month).
Additional Deposits:	No regulatory minimum, but all additional deposits must be made to the 30-day account; after 30 days funds are shifted to the 7-day notice account on a "first-in-first-out" basis.
Withdrawals:	No withdrawals (without early withdrawal penalty) from 30-day account. No regulatory limitation on size of withdrawals from 7-day notice account, but withdrawals from that account can only be made after seven calendar days of the time the depository institutions receive notification. Withdrawals from 7-day notice account can be by: a) Check or cash to depositor or to third party (if the depositor does not pick-up funds after giving 7-day notice, the funds may not be automatically redeposited to the proposed account). b) Transfer to any other account. No withdrawals by negotiable draft. Notification for withdrawals from 7-day notice account possible by: a) Telephone or other telecommunication b) Mail or messenger. c) In person (over the counter or through an ATM). No preauthorized notifications permitted.

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	"First-in-first-out" requirement applied to 7-day notice account balance for notification-withdrawals.
Early Withdrawal Penalty:	All accrued interest earned on 30-day account; no withdrawals permitted in any circumstances on 7-day notice account without 7-day prior notice.
Interest Rate:	For 30-day term account: Ceiling rate applicable to all balances equal to auction average of 91-day bill rate (discount basis), effective the day after the auction. (No 4-week averaging option). Institutions may offer on fixed-rate basis with ceiling tied to auction average in the initial week of the deposit, or may vary the ceiling weekly in line with weekly bill auction. For 7-day notice account: Same ceiling rate as 30-day account established weekly. Rate falls to savings rate when balance in the 7-day notice account falls below $5,000 as defined under "minimum subsequent balance". Compounding permitted on both accounts. (If not, interest can only be credited at the end of 30-days in the first account for balances that have been held for 30 days, and at the end of 7-days on the second account). For the second account, no regulatory requirement as to whether interest is to be calculated on minimum or average balance. Can only advertise weekly discount rate. If there is a differential, thrifts can pay bill rate and commercial banks 25 basis points less; differential disappears one calendar year after effective date of the instrument and, within that year, for any interval after auction average falls below 9 percent for four consecutive auctions.
Eligibility:	Available to all depositors.

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Reserve requirements:	Under the Federal Reserve's current regulation D, reserve requirements would not be applicable to the 30-day account held by persons, but the 7-day account would be subject to transaction account reserve requirements since the notice period is less than 14 days. The Federal Reserve Board could exempt the 7-day notice account from transaction reserve requirements on the basis of its maturity and limited withdrawal features; if it did so, it could also establish zero percent reserve requirements on this category of time deposits. 1/
Other restrictions:	1) Institution may not lend funds to depositor to meet minimum initial or maintenance balance or make any loan using the account as collateral. (Overdraft privileges permissible on NOW or demand balances to which the 7-day notice account is transferable; rate charged on such overdrafts must equal rate charged on overdrafts for those that do not hold the proposed account). 2) Both accounts could only be issued in non-negotiable form. 2/ 3) Institution may not offer RPs to account holders (or those planning to open such an account) at a rate in excess of that offered to any other customer.
Effective Date:	June 1 (Tuesday), with ceiling based on auction May 28 (Friday). (May 31 is a holiday.)

1/ Member banks would still be subject to small reserve requirements on time deposits during the current phase-down of reserve requirements under the Monetary Control Act. The Board could also apply a reserve requirement to these accounts held by other than persons (currently 3 percent).

2/ The agencies could separately reduce the minimum maturity on large denomination time deposits from 14- to 7-days, permitting the issuance of large negotiable CDs with maturities of 7 days. Such an account would be separate from the proposed new account. Federal Reserve Board action to define 7-day CDs as time deposits would also be required to obtain time deposit reserve requirements.

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ABA CONSENSUS STATEMENT AS SUBMITTED

TO DIDC FOR ACTION

The American Bankers Association, through its Banking Leadership Conference, has carefully reviewed the actions over recent months of the Depository Institutions Deregulation Committee. We believe the Committee is to be strongly commended for taking action to substantially deregulate IRAs and Keogh Accounts at depository institutions beginning December 1. Without this action, banks and savings and loan associations would be hobbled in their attempts to compete with insurance companies, brokerage firms, and other uninsured financial intermediaries for this expanding market.

We cannot stress enough the need for the Deregulation Committee to maintain its commitment to the process of deregulation and to the significant first step that removal of interest rate ceilings on IRAs and Keogh Accounts represents. Our Banking Leadership Conference has strongly reaffirmed that interest rate deregulation of IRAs and Keoghs as approved by the Committee is essential at this time.

We have also reviewed the proposal by the Committee to establish new short-term deposit instruments. Our Association has been on record since May of this year as endorsing the need for more liquid deposit instruments to compete with money market mutual funds. While the Deregulation Committee has failed to act on this request, money market funds have been growing at the rate of almost $3 billion per week. We originally supported the creation of the new 30- and 91-day instruments indexed to comparable Treasury bill rates with a minimum denomination no greater than $5,000.

A strong consensus of the members of our Banking Leadership Conference, however, now believes that these instruments, while helpful and vast improvements over what is presently available, are still not sufficient to the continually changing competitive needs of depository institutions. They believe that the proposed interest-bearing transaction account with a $5,000 minimum deposit would best allow them to compete with money market mutual funds. Effective competition requires that this account have no ceiling rate of interest when the minimum balance is maintained (and the rate ceiling in effect on NOW accounts below the minimum) and that a method be provided, whether through limiting the number of transactions or otherwise, so that the account could be offered free of reserve requirements. This new instrument would have the virtues of being operationally simple, understandable to both bankers and their customers, and competitive with most offerings of money market mutual funds. Should the Deregulation Committee feel itself unable to approve this account, our Association would reaffirm its support, as a minimum response, the creation of new 30- and 91- day instruments with minimum denominations no greater than $5,000 and ceiling rates indexed to rates on Treasury instruments of comparable maturity.

The Leadership Conference also supports the proposed 1-day notice, $25,000 minimum denomination certificate of deposit with no interest rate ceiling. Many bankers feel that this instrument will provide for bank customers an account comparable to existing repurchase agreements without the paperwork burden and investment constraints incumbent on repos.

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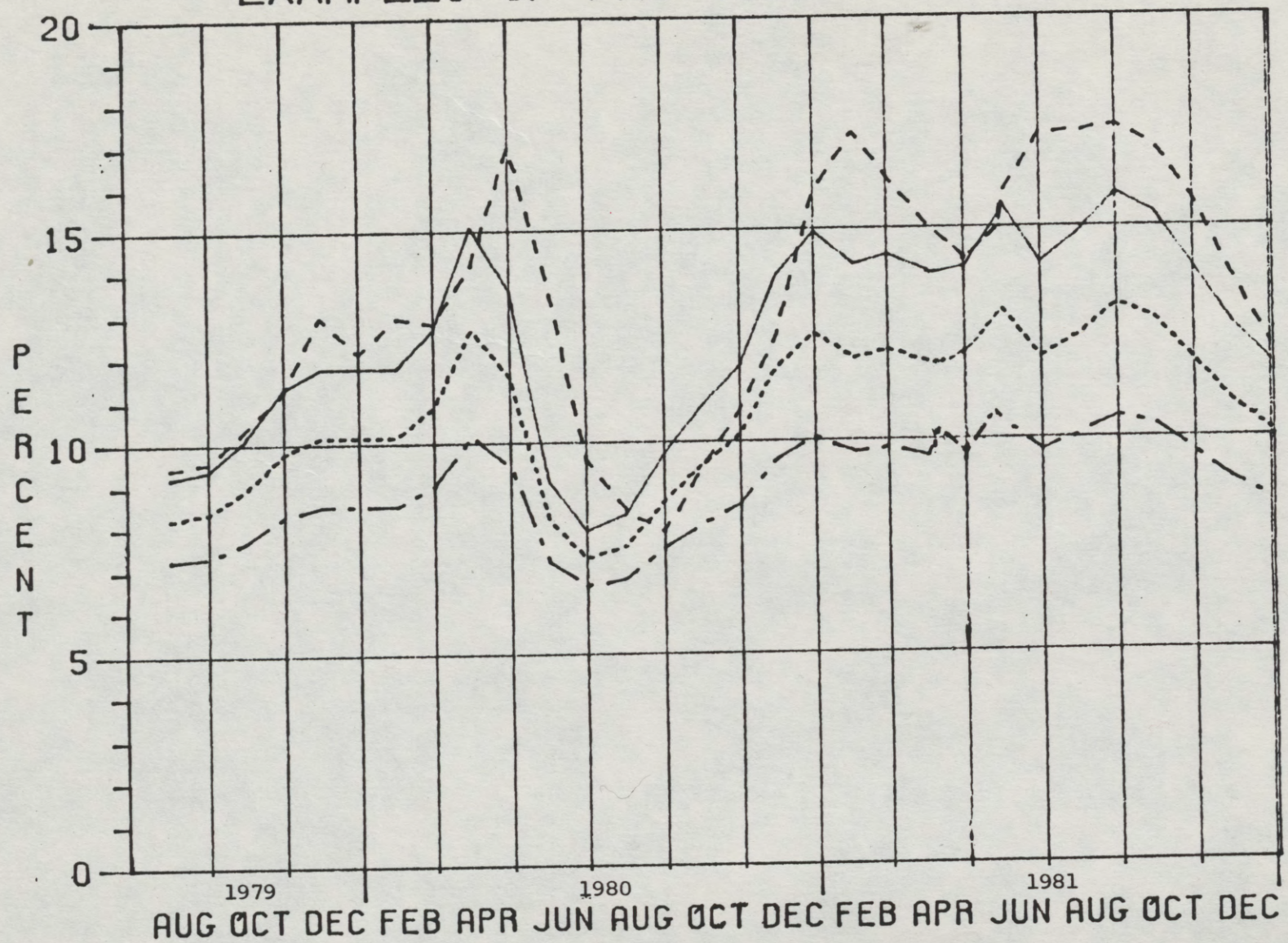
CHART 1
INTEREST RATE ON MMF'S, MMC'S AND TWO EXAMPLES OF PROPOSED INSTRUMENT 1/



1979-1981

Money Market Funds - - - - - - - - - - -

Money Market Certificates ————————

Proposed Account 10,000 Average Balance ----------

Proposed Account 5,000 Average Balance —·—·—·—·—

1/ Proposed instrument assumes everything over $2,500 earns interest equal to the money market certificate rate. Amounts up to $2,500 earns the NOW account rate.

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CHART 2
MARKET SHARE OF LARGE CD'S

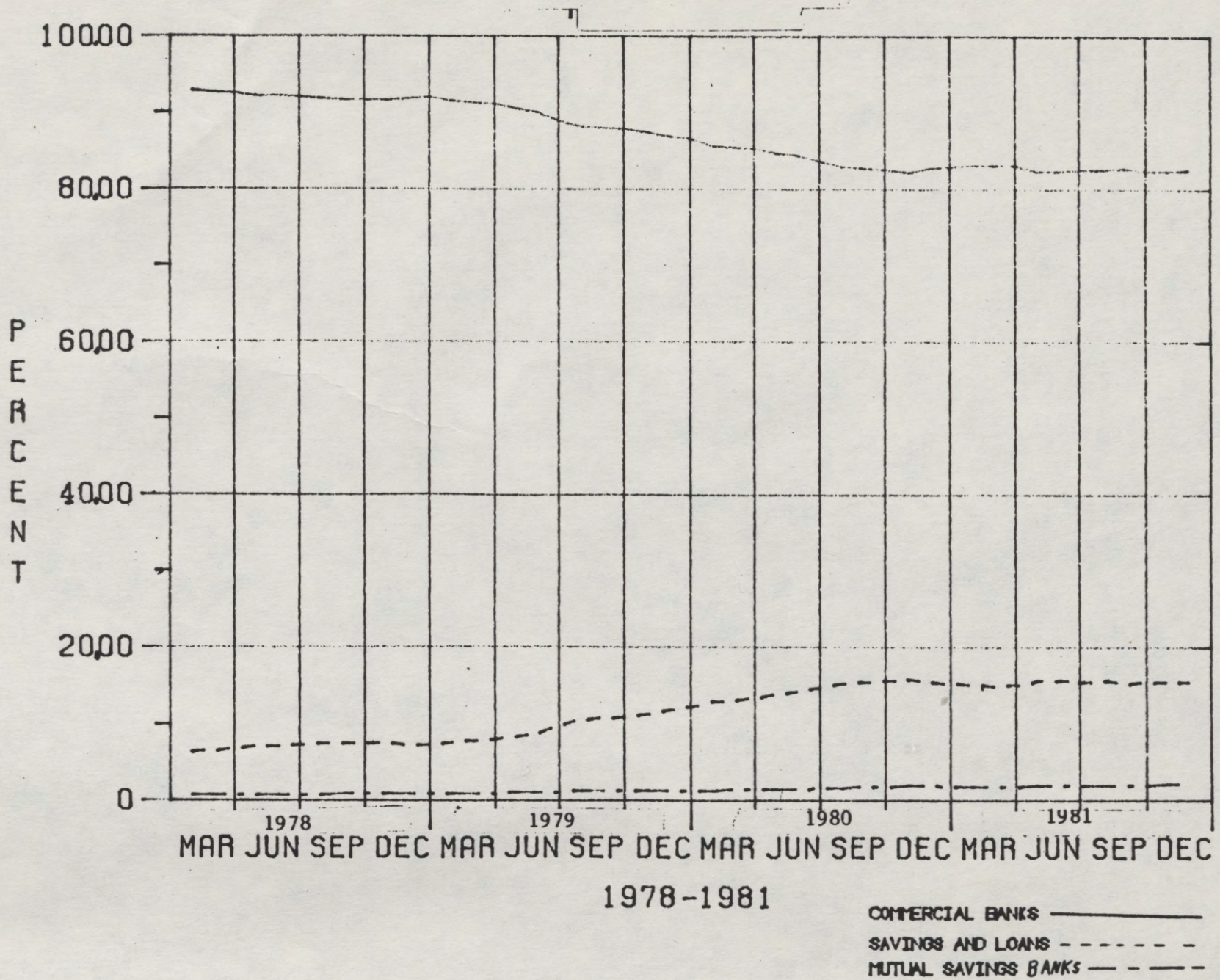

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CHART 3
DOLLAR AMOUNT OF LARGE CD'S

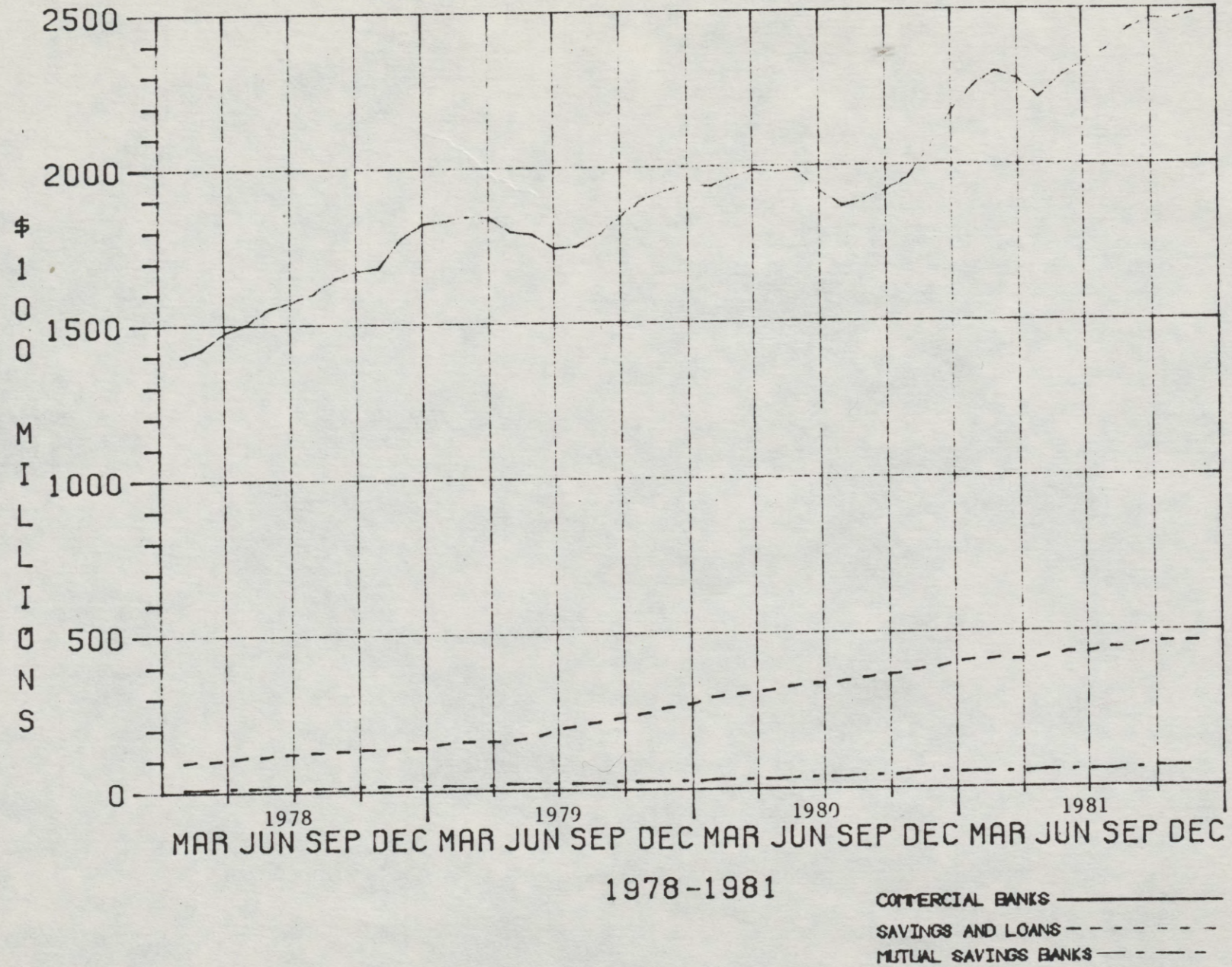

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CHART 4
MARKET SHARES. SUM OF SIX MONTH MONEY MARKET. SMALL SAVER AND ALL SAVER CERTIFICATES

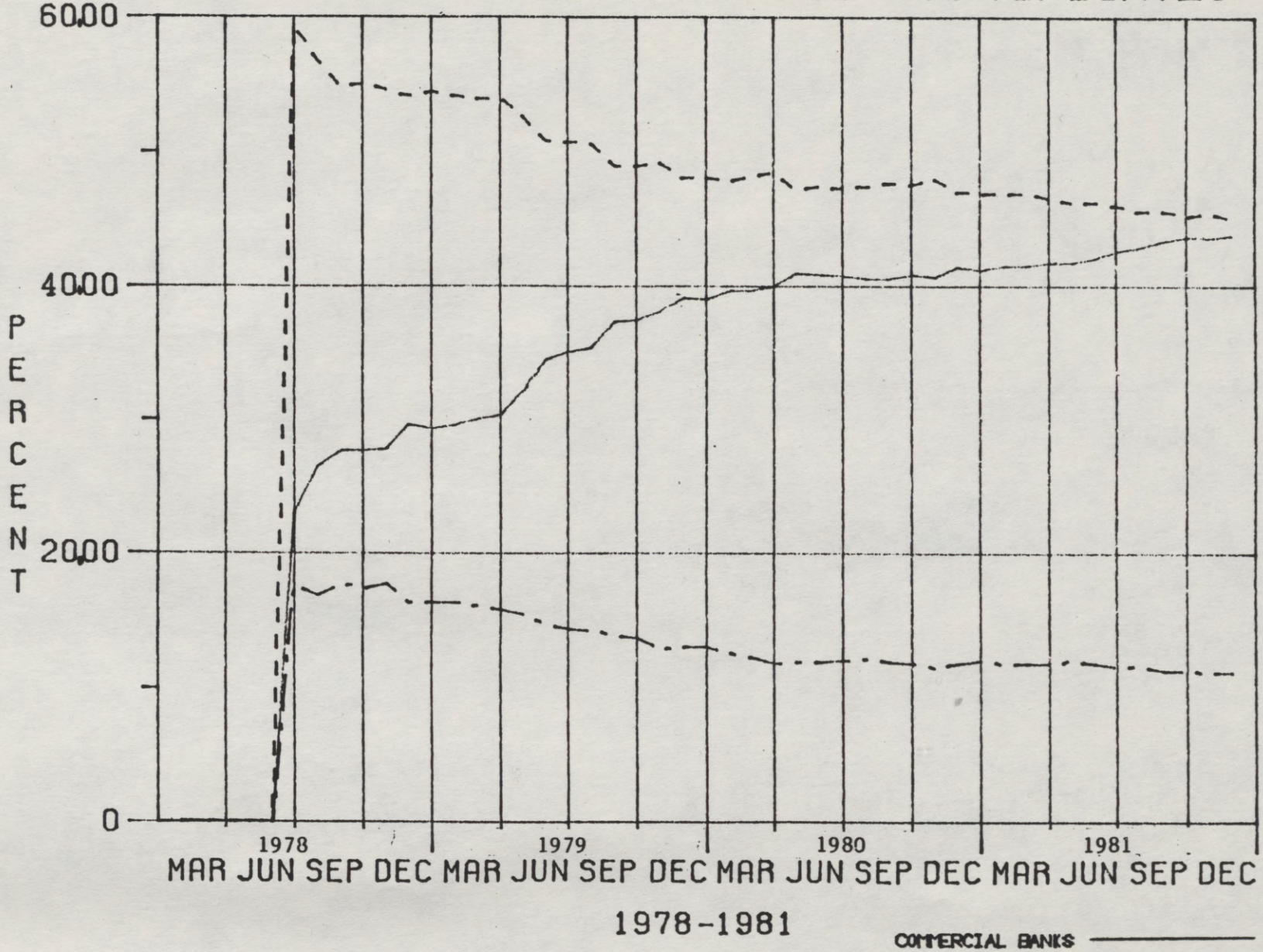

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CHART 5

DOLLAR AMOUNT. SUM OF MONEY MARKET.
SMALL SAVERS AND ALL SAVERS CERTIFICATES

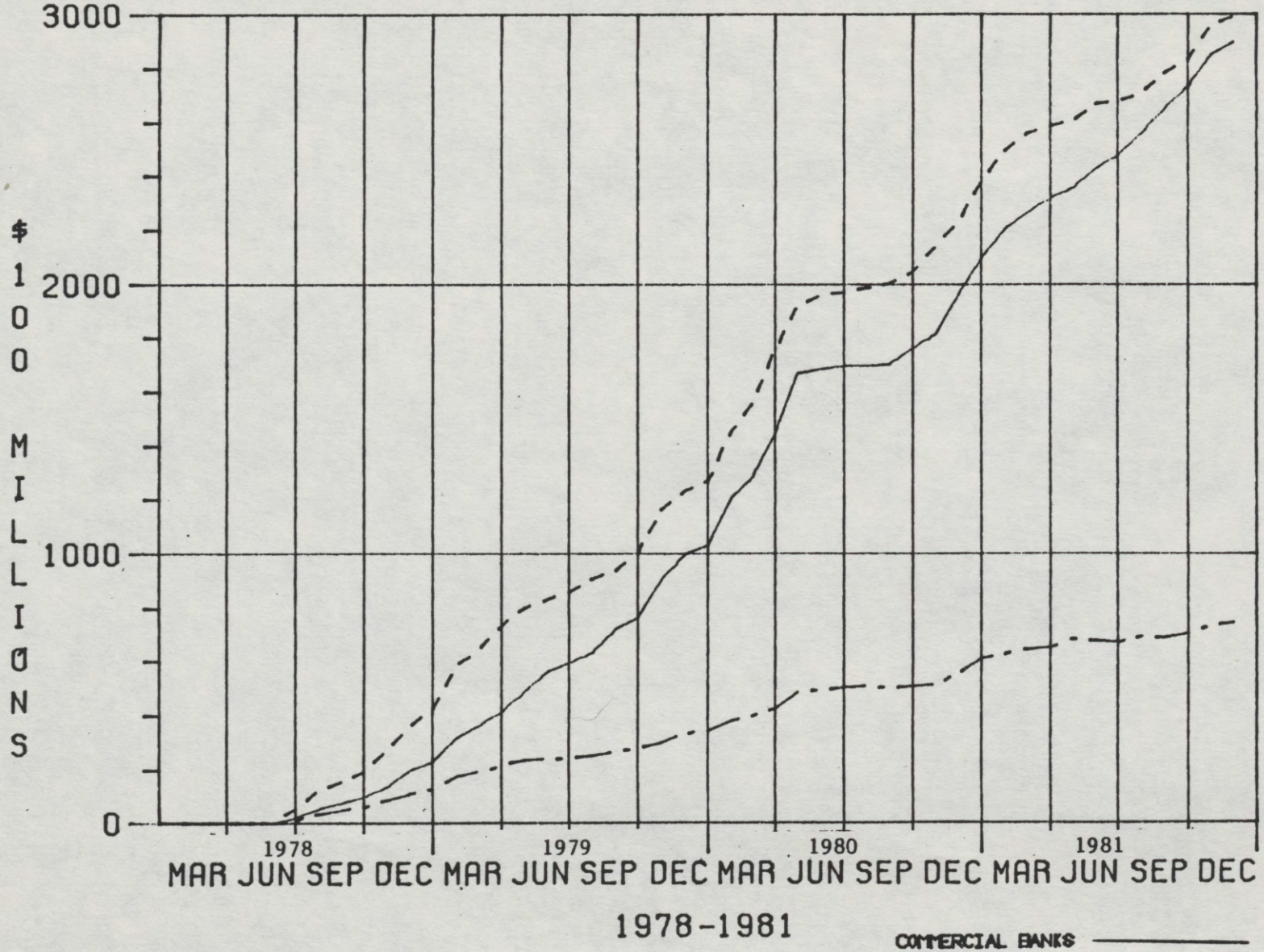

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CHART 6
MARKET SHARES
FIXED CEILING SMALL TIME DEPOSITS

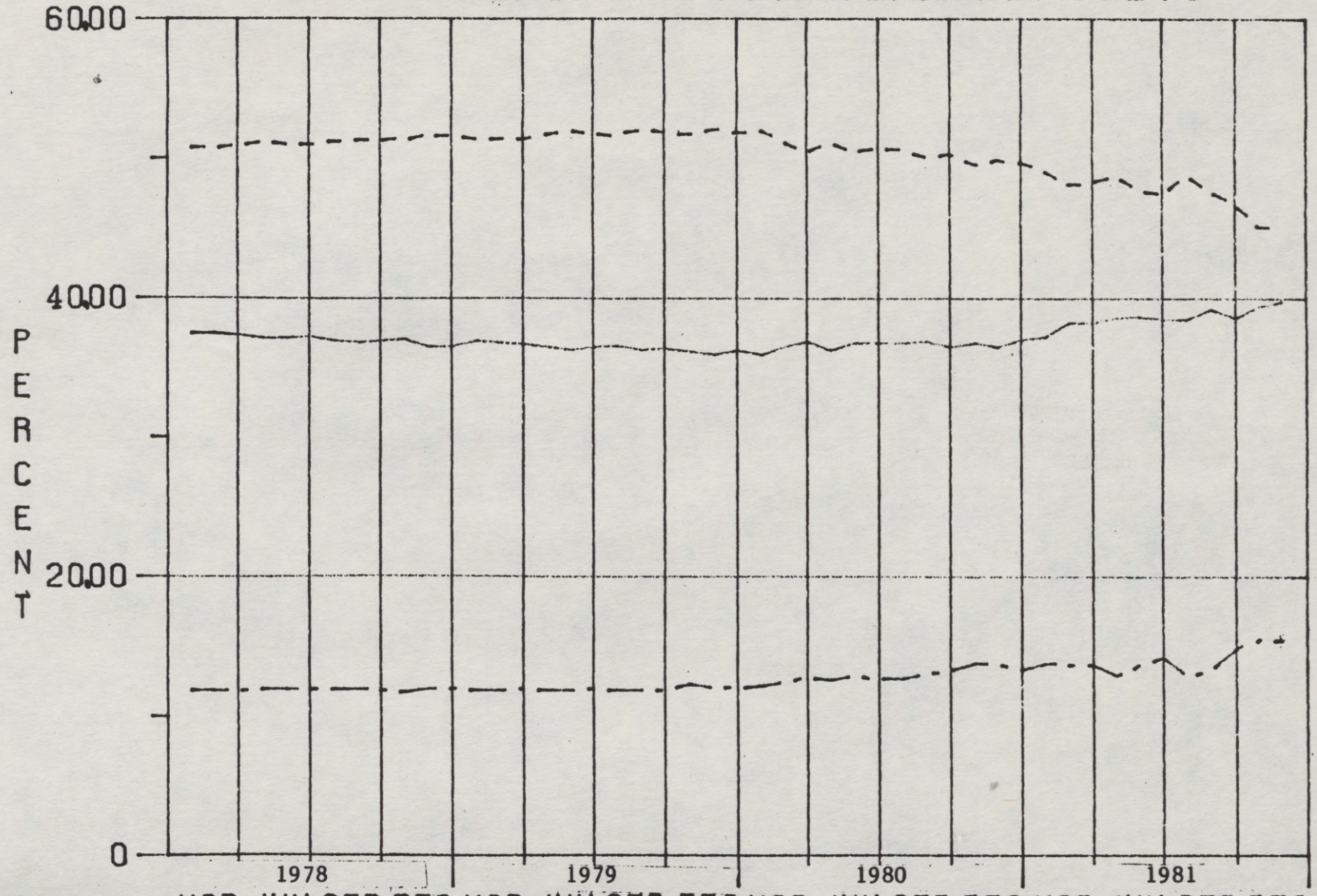

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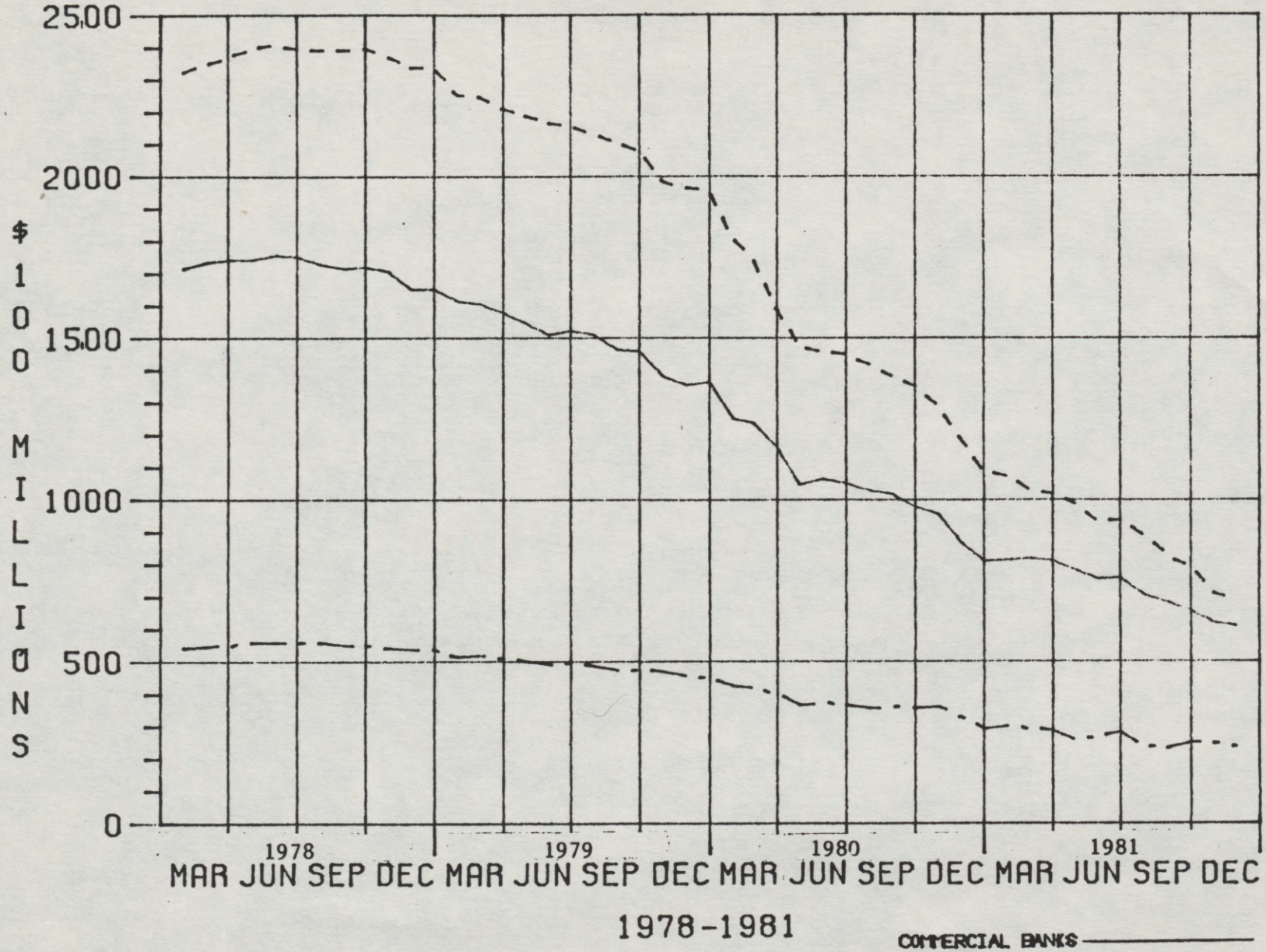
CHART 7
DOLLAR AMOUNT OF FIXED CEILING
SMALL TIME DEPOSITS



1978-1981

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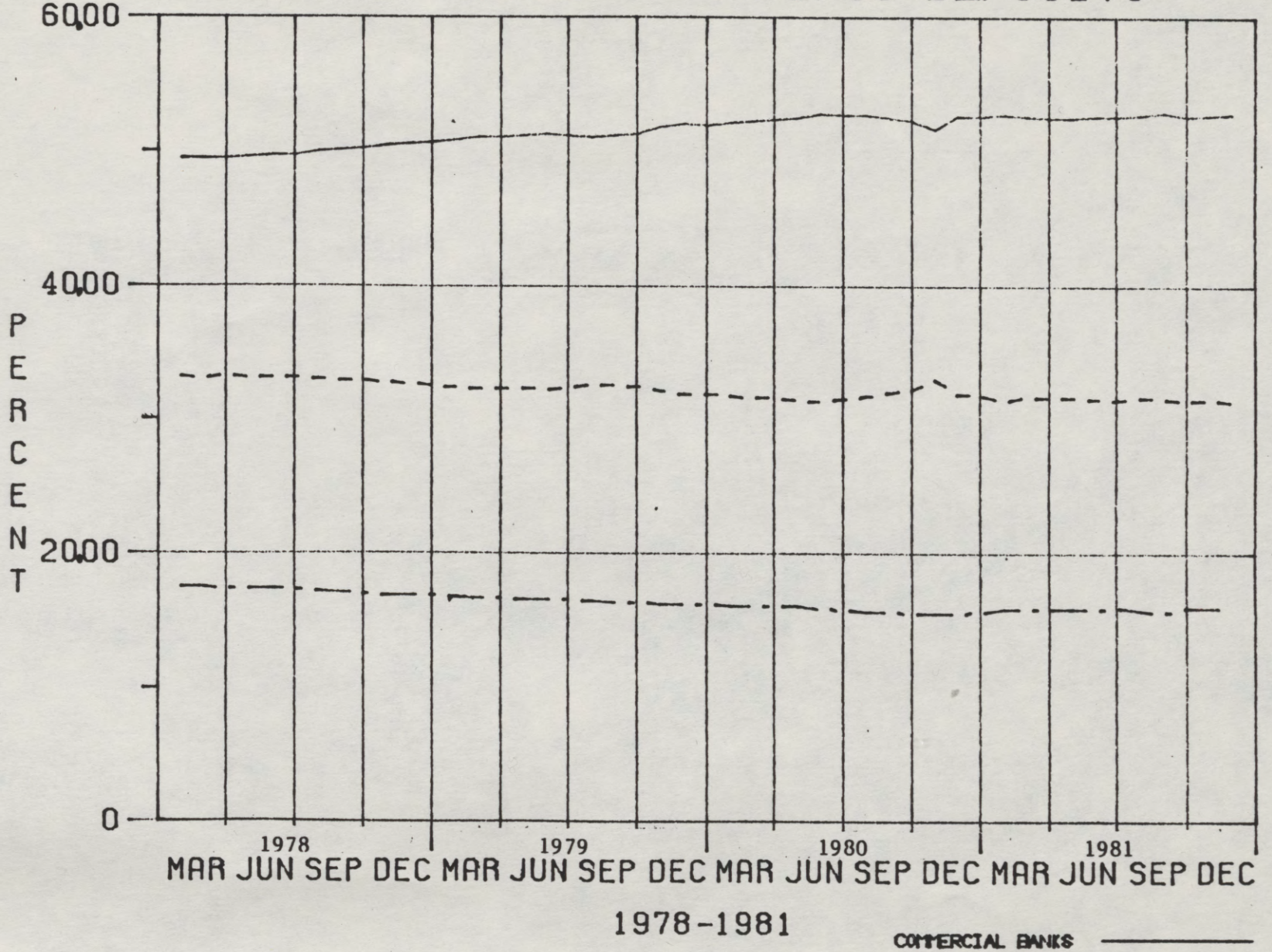
CHART 8
MARKET SHARE OF SAVINGS DEPOSITS



1978-1981

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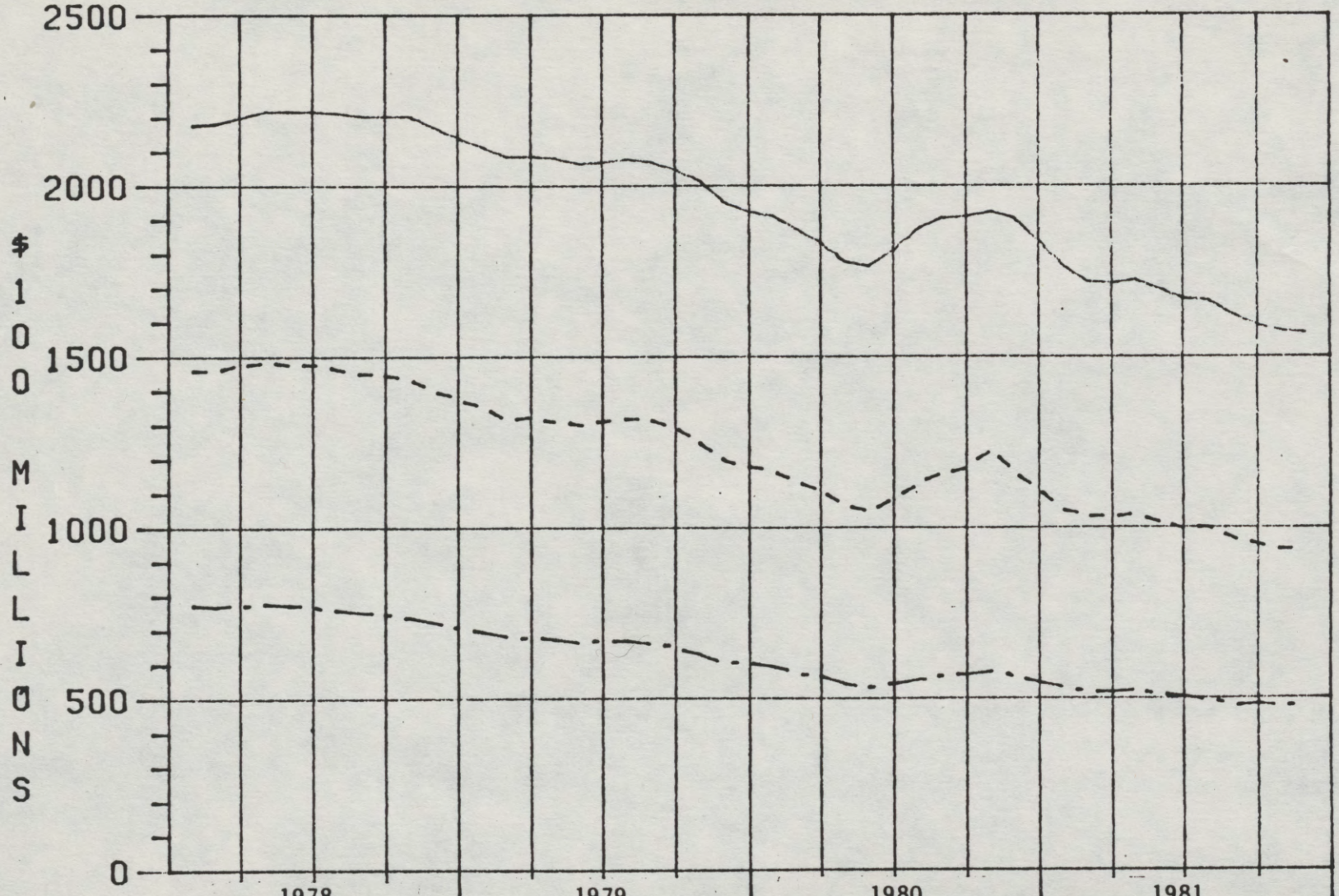
CHART 9
DOLLAR AMOUNT OF SAVINGS DEPOSITS



1978-1981

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Table 1

COMMERCIAL BANK TIME & SAVINGS HELD BY
INDIVIDUALS, PARTNERSHIPS, AND CORPORATIONS

(millions)

	1973			
	JAN 31	APR 30	JLY 31	OCT 31
Savings:	121,453	122,936	123,627	123,876
Time Deposits under 100,000				
under 1 year:	46,693	46,633	43,281	39,184
1-2½ years:	n/a	n/a	48,174	45,700
2½-4 years:	n/a	n/a	9,267	10,919
over 4 years:	n/a	n/a	3,181	9,563

SOURCE: Federal Reserve Bulletin, April 1974.

SAVINGS ACTIVITY AT SAVINGS AND LOANS

1973	Net New Savings Received (millions)
FEB	1,795
MAR	1,628
APR	724
MAY	1,763
JUN	890
JLY	- 291
AUG	- 1,186
SEP	- 340
OCT	835
NOV	1,166
DEC	406

SOURCE: Federal Home Loan Bank Board Journal, April 1974. Page 86.

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Table 2

SELECTED DATA ON DEPOSITS PLACED IN 4-YEAR ACCOUNTS

July 01, 1973 - October 31, 1973

Type of Institution	Deposits in 4-Year Accounts ($ billion)	Per Cent of total	Time Deposits * ($ billion)	Per Cent of Total	Estimated Average Rate Offered on 4-year accounts (in % per annum)
Commercial Banks	9.5	35	270.7	68.5	7.20
Savings and Loans	12.0	44	102.4	25.9	7.21
Mutual Savings Banks	5.7	21	22.1	5.6	7.32
TOTAL	27.2	100	395.2	100.0	---

SOURCE: E. Kane, "Getting Along Without Regulation Q," Journal of Finance, June, 1978, p.927.

NOTE: For commercial banks and Mutual Savings Banks, average rates paid are estimated by weighing the highest interest rate in each interest rate cell by the 4-year accounts outstanding in that interest rate cell. For Savings and Loans, the weights used are total savings capital paying more than the regular rate.

* Figures from January 01, 1973

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Table 3

TOTAL NONCOMPETITIVE BIDS ACCEPTED
FOR 91-DAY AND 182-DAY TREASURY
BILLS EACH MONTH IN 1973

Month	
January	1135
February	1062
March	1578
April	1336
May	1611
June	1635
July	2195
August	2810
September	2299
October	1761
November	2376
December	1935

Source: U.S. Treasury Department, Treasury Bulletin.

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TABLE 4

Money Market Certificates
by Size of Banks[1]
December 1980

	0-5	5-25	25-100	100-300	300-1B	1-5B	greater than 5	Total
Percent of Assets	17.5%	21.87%	19.88%	15.96%	12.13%	9.49%	4.88%	11.63
Percent of Deposits	20.79%	24.51%	22.50%	18.64%	14.77%	12.83%	7.30%	15.02

Source: Call Report Data

1 Banks acquired by mergers in 1981 have been aggregated with acquiring banks.

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ATTACHMENT 1

BANKING'S CONTRIBUTION TO HOUSING FINANCE

The home mortgage market represents the largest private capital market in the U.S., with over $150 billion in home mortgages originated annually by all lenders. Only the debt requirements of the Federal government exceed the annual credit requirements for home mortgages.

In order to raise the enormous capital required for mortgage lending, a complex network of lenders, government agencies, and investors has been developed to deliver mortgage loans to the millions of families and individuals buying a home each year. The two largest sources of mortgage credit funds are savings and loan associations (of which there are about 4,600 institutions) and full service banks (of which there are about 14,500 institutions). Other lenders are the mutual savings banks (500 institutions); mortgage bankers; and life insurance companies.

In the past, thrift institutions have garnered most of the credit for financing residential housing. But direct mortgage credit is not the sole requirement for providing decent housing. Housing also depends on the existence of streets and sewers, utilities, construction companies and industry to produce housing materials; each of these elements is financed by banks.

I. Residential Mortgage Loans

Banks held $184.7 billion in residential mortgages at the end of the third quarter of 1981, ranking second only to the savings and loan industry in these loans. Moreover, full service banks originated $16.9 billion in residential mortgage loans during the first three quarters of 1981, close to 20% of the total. 1/

Residential Mortgage Loans Outstanding by Type of Lender
Third Quarter 1981
(Billions of Dollars)

Lender	One-to Four Family	Pct. of Total	Multi-Family	Pct. of Total	Total	Pct. of Total
Savings & Loan Associations	433.1	42.9	38.3	27.3	471.4	41.0
Full Service Banks	171.6	17.0	13.1	9.3	184.7	16.1
Mortgage Pools or Trusts	132.4	13.1	9.4	6.7	141.8	12.3
Mutual Savings Banks	65.6	6.5	17.4	12.4	83.0	7.2
Federal & Related Agencies	65.7	6.5	14.8	10.5	80.5	7.0
Life Insurance Companies	17.9	1.8	19.9	14.2	37.8	3.3
All Others	124.1	12.3	27.4	19.5	151.5	13.2
Total	1010.2	100.0%	140.3	100.0%	1150.5	100.0%

Source: Federal Reserve Bulletin, December, 1981

1/ HUD News No. 81-309, December 7, 1981

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II. Secondary Mortgage Market

The secondary mortgage market has become an increasingly vital segment of the total residential financing system. Banks contribute significantly to the support of these secondary markets through ownership of their securities. As of the end of November 1981, banks held $14.8 billion in debt securities of the three sponsored secondary market agencies. Banks hold over 20% of the total outstanding debt issues of the largest of the agencies, the Federal National Mortgage Association.

In addition to these secondary mortgage market securities, banks also hold $14.2 billion in securities of the Federal Home Loan Banks, and $.4 billion in Farmers Home Administration notes. Thus banks hold a total of $29.4 billion in obligations of federal government agencies involved in housing.

Housing Related Securities Held by Banks
November 1981

(Billions of Dollars)

Secondary Mortgage Market	
Federal National Mortgage Association	13.2
Government National Mortgage Association	.5
Federal Home Loan Mortgage Corporation	1.1
Subtotal	14.8
Other housing related Agencies	14.2
Federal Home Loan Banks	
Farmers Home Administration	.4
Subtotal	14.6
Total	29.4

Source: Treasury Bulletin, January 1982, TSO 4 & 5

III. Mobile Home Loans

Banks are the major source of credit for purchasing mobile homes which have become the dominant factor in the low-cost housing market. Mobile homes accounted for 20.6% of the new single family dwellings sold in the U.S. in 1980 1/ and strong sales continue. Mobile homes are virtually the only kind of low-cost housing that is widely available to American families earning under $8,000 per year. As of October 31, 1981 banks had $10.3 billion in mobile home loans outstanding, 56.3% of the total. 2/

1/ Survey of Current Business, December, 1981

2/ Federal Reserve Bulletin, December, 1981

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IV. Residential Construction Loans

Banks are a major supplier of funds for residential construction, an essential base of housing finance. As of the third quarter of 1981, banks held $18.4 billion in residential construction loans, over 46% of the total.

Holdings of Residential Construction Loans by Type of Lender

Third Quarter 1981

(Billions of Dollars)

Lender	One-to-Four Family	Multi-Family	Total
Full Service Banks	12.1	6.3	18.4
Savings & Loan Associations	12.4	2.4	14.8
Federal Credit Agencies	.0	2.4	2.4
Mortgage Companies	.9	.6	1.5
Mutual Savings Banks	.6	.7	1.3
All Others	*	1.2	1.2
TOTAL	26.0	13.6	39.6

*Less than .05

Source: HUD News No. 81-309, December 7, 1981

V. Loans for the Infrastructure of Housing

The total shelter needs of families require more than just the direct financing of construction and final mortgages. Also needed are services to make a house usable -- for example, such private and municipal services as electricity, water, streets, and sewers. Considering all financing requirements to provide adequate housing and related facilities, banks rank near the top of the lending groups. Some of the most recent data available reveal that banks:

Provide $8.3 billion in home improvement loans. 1/

Provide credit assistance to the housing industry indirectly through the loans they make to other housing lenders, such as savings and loan associations, mortgage bankers, life insurance companies, and real estate investment trusts, totaling an estimated $20.1 billion. 1/

1/ Federal Deposit Insurance Corporation, June 30, 1981

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As of June 1981, banks held $145.4 billion in municipal securities, nearly 50% of the total. 1/ An estimated $99.0 billion or 68.1% of total bank holdings was issued to finance residential support facilities - schools, roads, utilities and hospitals. This estimate is based on the percentage of 1981 proceeds from new long-term security issues of state and local government used for such purposes.

Use of Proceeds of New Long-Term Security Issues
of
State and Local Governments

1981

Use of Proceeds	Billions of Dollars	Pct. of Total
Public Housing, Hospitals and other Health Institutions	12.1	26.1
Utilities and Conservation Water, Sewer, Electric & Gas and Pollution Control	10.1	21.8
Education Elementary, Secondary, Colleges & Universities	4.6	9.9
Transportation Roads, Bridges, Ports & Airports	3.4	7.3
Parks and other Recreational Facilities	.7	1.5
Fire Stations, Police Stations and other Public Safety and Service Facilities	.7	1.5
Industrial Aid	7.5	16.2
Other Purposes	7.2	15.6
TOTAL	46.3	100.0

Source: Municipal Market Developments, Public Securities Association, February, 1982

Note: Components may not add to totals due to rounding.

1/ FDIC and Federal Reserve Board Flow of Fund Accounts

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VI. Measuring the Banking Industry's Contribution to Housing

Residential Mortgage Loans	$184.7 billion
Mobile Home Loans	10.3
Residential Construction Loans	18.4
Federal Housing Agencies Obligations	29.4
Home Improvement Loans	8.3
Loans to Other Housing Lenders	20.1
Municipal Securities Supporting Housing	99.0
	370.2

The $370.2 billion commitment by the banking industry to housing is a rough estimate, but a conservative one. It does not cover an indeterminate amount of loans to contractors, building suppliers and other businesses engaged in housing construction, servicing, and supply. But by any standard of measurement, a $370.2 billion investment is a very significant commitment to the housing industry. This puts banks in a close second position to the savings and loan associations in the overall financing of the nation's housing needs.

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ATTACHMENT 2

BANKING'S CONTRIBUTION TO SMALL BUSINESS

Small businesses provide employment for more than one-half of the nation's work force, and produce almost one-half of the Gross National Product. More than nine out of every ten American businesses qualify as a small business, and the overwhelming majority of them obtain financing — seed capital, working capital, and funds for growth, diversification and expansion—from America's full service banks.

Based upon data received from a representative nation-wide sample of approximately 600,000 firms in April 1980, banks were the major source of credit for small businesses ranging in size from less than $50,000 to $3,000,000 or more in gross sales. Of the firms included in this NFIB survey, 83 percent claimed banks as the source of their most recent loan. No more than 5 percent of the firms reported obtaining their most recent loan from any other single source.

Similar information from a 1980 Greenwich Research Associates' survey of "middle market" companies shows the importance of bank credit to the growth of larger firms. Companies with sales of $5-9 million accounted for 32 percent of all bank borrowings in the $5-110 million sales range during the previous 12 months. Companies in that sales range also expected the largest percentage increase in bank borrowings (13.2 percent) in the next 12 month period.

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Small Business Finance

Source of Most Recent
Small Business Loan[1]
(April 1980)

Bank ----------83%

Private Person --- 5%

Government ------- 1%

Finance Co. ------ 2%

Insurance Co. ---- 1%

Factor ----------*

Co-op ---------- 1%

S & L ---------- 2%

Other ---------- 4%

1 non-borrowers and no answers excluded

* less than 0.5%

Source: National Federation of Independent Business

Bank Borrowings and Projected Bank Borrowings by Company Size

Company Size (sales)	Actual 1980	Percent of Total	Expected 1981	Percent of Total
$20-110 million	$30.2	36%	$32.8	35%
10-19 million	22.4	27	24.0	26
5-9 million	27.2	32	30.8	33
Total Companies	$84.3	100%	$92.4	100%

Billions of Dollars*

Note: Borrowings projected to the total 63,354 middle market companies nationwide in 1980.

Source: Greenwich Research Associates, 1981.

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ATTACHMENT 3

BANKING'S CONTRIBUTION TO AGRICULTURAL FINANCE

Close to 90 percent of the nation's 14,500 full service banks have assets of less than $100 million. Two-thirds of the nation's full service banks are in communities of less than 25,000 people, and half of these banks are in towns with fewer than 5,000 residents. Based on the latest estimate, nearly 60 percent of these community banks listed agriculture as the single most important source of income for their community.

According to a study published by the Department of Agriculture, farm sector debt, which increased from about $12 billion in the 1950's to over $150 billion in 1980, could be about $600 billion by the end of the decade. At the beginning of 1980, full service banks held nearly $40 billion in direct farm debt, ranking second only to the Farm Credit system among institutional holders of farm debt. Of that total, banks supplied $31 billion in direct farm non-real estate credit and $8.6 billion in farm real estate credit.

Additionally, at the end of 1980, banks held $12.9 billion in securities issued by the Farmer's Home Administration and the various entities of the Farm Credit Administration. Banks also supply a large but unknown volume of funds to agribusiness such as agricultural equipment makers and agricultural processing firms. Finally, banks also supply funds to finance rural agricultural communities. While a large portion of banking's contribution to agricultural finance cannot be quantified, the quantifiable contribution is $52.5 billion.

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Farm Debt Outstanding by Type of Lender
January 1, 1980

Lender Group	Billions of Dollars	Pct. of Total
Full Service Banks	$39.6	25.9%
Farm Credit System	48.6	31.8
Farmers Home Administration	15.5	10.1
Life insurance Companies	12.2	8.0
Individuals and Other Non-reporting Companies	36.9	24.1
Total	$152.8	100.0%

Source: Economics, Statistics and Cooperative Service, USDA

Full Service Bank Holdings of Farmers Home Administration and Farm Credit System Securities 1/
December 31, 1980
(Billions of Dollars)

Banks for Cooperatives	$0.4
Farm Credit Banks	7.7
Federal Intermediate Credit Banks	1.1
Federal Land Banks	3.1
Farmers Home Administration	0.6
Total	$12.9

Source: Treasury Bulletin, February 1981, TSO - 4 & 5

1/Also included in Government Finance (II-F)

Total Quantifiable Bank Contributions to Agricultural Finance
(Billions of Dollars)

Direct non-real estate loans to farmers	31.0
Direct real estate loans to farmers	8.6
Bank Holdings of Securities Issued by Farmers Home Administration and Farm Credit System	12.9
Total	$52.5

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ATTACHMENT 4

BANKING'S CONTRIBUTION TO CONSUMER FINANCE

In addition to making a significant contribution to household mortgage finance, full service banks supply the great bulk of other forms of consumer credit. This includes loans that are the basic support for the standard of living of the American family—automobile loans, mobile home loans, home improvement loans, and other general purpose loans.

At the end of 1980, full service banks held $145.8 billion in consumer instalment credit, close to twice the amount held by any other type of financial institution and 46.5 percent of the total outstanding. Of that total, $61 billion was for indirect paper or direct loans to finance the purchase of automobiles or to refinance debts incurred for such a purpose—this represented over 52 percent of the amount held by all holders of that type of credit. Full service banks held $30 billion in revolving credit (50 percent of the total outstanding) and $10.4 billion in mobile home credit (60.1 percent of the total outstanding). Moreover, banks held over $33 billion in single-payment loans for household, family, and other personal expenditures. Including $44.4 billion of other instalment credit outstanding, the banking industry's contribution to non-mortgage consumer finance was $179 billion as of December 1980.

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Consumer Finance
(Non-Mortgage)

Consumer Instalment Credit
by Holder
December 1980
(Billions of Dollars)

Holder	Amount Outstanding	Percentage of Total
Full Service Banks	$145.8	46.5%
Finance Companies	76.8	24.5
Credit Unions	44.0	14.0
Retailers*	29.4	9.4
Savings and Loans	9.9	3.2
Gasoline Companies	4.7	1.5
Mutual Savings Banks	2.8	.9
Total	$313.4	100.0%

* Includes auto dealers and excludes 30 - day charge credit held by travel and entertainment companies.

Source: Federal Reserve Bulletin, April, 1981

Banking's Contribution to Consumer Finance
(Non-Mortgage)
December 1980
(Billions of Dollars)

Type of Credit	Amount Outstanding
Auto Loans	$61.0
Revolving Credit	30.0
Mobile Home Loans 1/	10.4
Other Instalment Credit	44.4
Single-Payment Loans	33.2
Total	$179.0

Sources: FDIC and Federal Reserve Bulletin, April, 1981.

1/Also included in Housing Finance (II-A)

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