# Disintermediation

The process of disintermediation is older and less abstruse than the term used to describe it. Coined in 1966, the word disintermediation refers to the bypassing of financial intermediaries such as savings and loan associations, mutual savings banks, and commercial banks, by savers who are able to realize a higher return by investing directly in the money and capital markets. This is a phenomenon of high and rising interest rates. Rates paid to savers by intermediaries tend to lag behind a general increase in market rates, and the widening differential may lead to disintermediation. Another aspect of high and rising rates is the movement of funds from one intermediary to another, as savers seek to benefit from significant discrepancies among rates paid by the various institutions.

While some disintermediation accompanied the period of moderate credit stringency in 1959, that which occurred in 1966 was more extensive and produced the most striking effects to date on the mortgage and bond markets.

**The 1966 Experience** As short- and long-term interest rates rose to near record levels during the first three quarters of 1966, thrift institutions and commercial banks experienced varying degrees of slowdown in time and savings account growth. For savings and loans and mutual savings banks the slowdown was severe; for commercial banks, only moderate. For the year, savings and loans suffered a 58% decline in savings inflows from 1965, and the total inflow was less than the amount of dividends credited to their customers' accounts. Deposit growth at mutual savings banks fell off 28% from the previous year. While the growth in total time deposits at commercial banks was 33% less than in 1965, the effects of this slowdown were less dramatic than those caused by the diversion of savings from thrift institutions.

Savings and loans and mutual savings banks are adversely affected by rapidly rising interest rates because about 75-85% of their assets consist of mortgages. When market rates of interest rise, savings institutions must raise rates on *all* deposits in order to compete effectively for savings. Because their income is tied to relatively long-term investments with fixed returns, and because higher rates of return can be obtained only on *new* investments, these institutions are caught in a squeeze between rapidly rising costs and slowly rising income. Commercial banks do not face this problem to such a great extent. Their assets are widely diversified and generally of short maturity, with mortgages accounting for only about 13% of the total. Therefore, when interest rates rise they usually can adjust their investment portfolios to compensate at least to some extent, for the higher rates they must pay on savings. Statutory limits on interest paid on time and savings deposits are set forth for member banks by the Board of Governors of the Federal Reserve System in Regulation Q, and for nonmembers by the Federal Deposit Insurance Corporation.

These statutory ceilings played an important role in the redistribution of funds among financial intermediaries in the first half of 1966. Following a change in Regulation Q in December 1965, commercial banks were allowed to pay up to 5½% on all time deposits. As the simultaneous discount rate hike was expected to lead market rates up, the Regulation Q change was designed to enable large certificates of deposit (usually referred to as CD's) to compete effectively in the money market. By March most of the deposits in banks were paying 5% on large 1 to 3 month CD's, and by midsummer the ceiling rate was widely available on 30-day maturities. In order to avoid direct competition for small savings presumably attracted by thrift institutions, the passbook rate had been left at 4% by Regulation Q. This precaution was circumvented to some extent, however, as banks designed so-called consumer-type CD's, usually small denomination non-negotiable, savings certificates and bonds, which competed directly with savings institutions. These tactics probably contributed largely to a second quarter rise in commercial bank time deposits at a seasonally adjusted annual rate of $20.1 billion, up from $15.1 billion the first quarter.

The commercial banks' success was gained, at least partially, at the expense of the thrift institutions, par-



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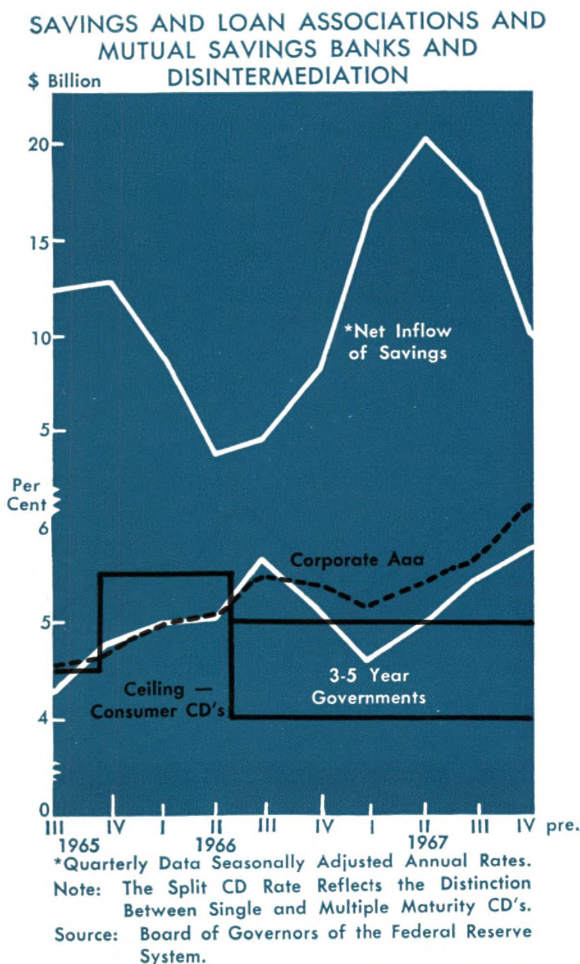
ticularly savings and loans. Between March and June, savings and loans were paying an average of 4.40% to savers, with California associations, usually the most aggressive, paying an average of 4.85% on passbook accounts. During this time the difference or spread between the average rate available on consumer-type CD's and the rate on savings and loan shares in California widened from 15 basis points to 65. By June, the spread favoring both 4-6 month commercial paper and 6-month Federal agency issues over California savings and loans had widened to at least 65 basis points. (A basis point is one-hundredth of one per cent.) Consequently, savings and loans were subjected to withdrawals by (1) smaller savers, who were attracted primarily by consumer-type CD's, and (2) larger savers whose highly interest-sensitive funds were shifted into large CD's and, later, other money market instruments. Withdrawals by small savers were probably heaviest in July following the dividend crediting date when the 5.50% ceiling rate was available on consumer-type CD's at many of the largest banks and before the ceilings on some types of these instruments were lowered by the Board of Governors of the Federal Reserve System on July 20. Nationwide, savings and loan associations experienced net losses of savings capital amounting to $1.5 billion in July and $800 million for the entire third quarter. It seems likely that during the last two months of this quarter, market instruments rather than the CD's of commercial banks became the chief competitors of the thrift institutions, and due to the large sums involved in money and capital market transactions, withdrawals were undoubtedly made by large savers. Spreads between most market instruments and savings and loan rates peaked in September, with 6-month bills and agency issues, 4-6 months paper, 1-year Treasury bills, and 3-year governments all yielding between 65 and 70 basis points more than the average California rate of 5.25%.



*Quarterly Data Seasonally Adjusted Annual Rates.
Note: The Split CD Rate Reflects the Distinction Between Single and Multiple Maturity CD's.
Source: Board of Governors of the Federal Reserve System.

As the rate of savings growth declined, and borrowing from the Federal Home Loan Banks became more difficult and costly, savings and loans were forced to curtail their mortgage investments. This, in turn, contributed to the drop in housing starts to the lowest level since 1946.

The pressure extended to commercial banks in the second half of 1966. With their consumer-type CD's no longer more attractive than savings and loan shares and deposits at mutual savings banks due to the rate rollback, only money market CD's continued to compete effectively for new savings funds. These, however, were rapidly rendered noncompetitive by rising short-term market rates. By August rates on both commercial paper and bankers' acceptances exceeded the 5.50% CD ceiling, and by September, the 6-month bill was about 30 basis points higher. New 9-month Federal Intermediate Credit Bank issues brought a 5.87% yield in August, and by October their return exceeded that on CD's by 70 basis points. From a peak of $18.6 billion outstanding at commercial banks in leading cities the week of August 17, large CD's tumbled 17% to a low of $15.4 billion the week of December 21. On the other side of the coin, corporations' holdings of short-term open market paper posted a third quarter increase of $6 million compared to a $1 million decline in the second quarter.

Just as reduced inflows at thrift institutions were reflected in the drying up of mortgage funds, so the runoff of CD's at commercial banks had strong repercussions in the market for state and local government bonds (often called municipals), and in the market for nonguaranteed Federal agency issues and participation certificates. In recent years banks had accelerated their purchases of these higher yielding instruments as time deposits were sought more aggressively. In the first half of 1966, banks' pur-

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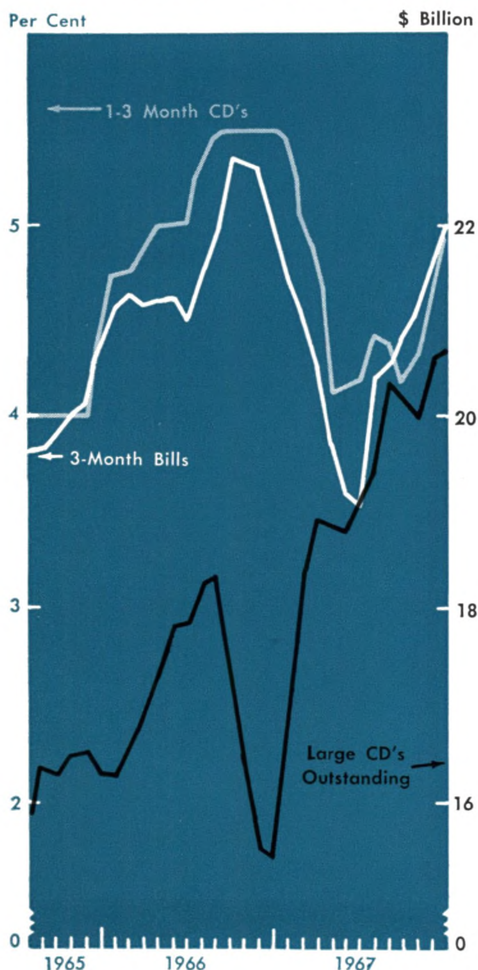
chases of municipals equaled 78% of the total new issue volume. Consequently, in the third quarter when banks became net sellers of municipals, bond dealers were faced with a sharp drop off in demand. Between early July and the end of September, municipal bond rates rose 33 basis points to 3.93% as measured by Moody's Aaa-rated bond average. Net sales of participation certificates by banks in the third quarter contributed to downward price pressures and to the temporary suspension of sales of participation certificates.

**The 1967 Experience** Most intermediaries received a steady and often increasing inflow of funds throughout the first three quarters of 1967. At savings and loans the net inflow was over three times greater than in 1966 despite some moderation in the fourth quarter. Mutual savings banks almost doubled their rate of savings inflow. Commercial banks in leading cities had recovered their 1966 losses of large CD's by the end of February and had pushed the total to about $21 billion by the year's end.

COMMERCIAL BANKS AND DISINTERMEDIATION




Source: Board of Governors of the Federal Reserve System, and the Federal Reserve Bank of New York.

Perhaps the most unexpected financial development of 1967 was the resumption of upward pressure on bond rates. This produced large differentials between rates paid by intermediaries and those available on intermediate- and long-term market instruments. By June, Aaa corporates were yielding 72 basis points more than the average savings and loan dividend rate, long governments were 14 points higher, and 3-5 year governments, 24 points higher.

Why did these rates fail to pull funds from financial intermediaries? First, short-term rates declined in the first half, creating spreads favorable to savings institutions. The divergent movement of long and short rates was due to the easy posture of monetary policy and to strong demand from corporations and other institutions seeking to rebuild liquidity positions from the extremely low levels of 1966. Second, long-term investments seemed less desirable, due both to the general demand for liquidity and to fears of accelerating inflation. Third, officials of savings and loans and mutual savings banks have expressed the opinion with some supporting evidence, that the "hot" or interest sensitive money was withdrawn from their institutions in 1966, and has never returned.

Some signs of imminent disintermediation appeared in the fourth quarter of 1967. By September Aaa-rated corporate bonds were yielding 85 basis points more than the average dividend rate paid by savings and loans, and 40 basis points above the highest savings and loan ceiling rate of 5.25%. Yields on medium-term governments rose from 5.46% in September to 5.72% in December. In addition, short-term rates had turned around by July and a steep ascent followed. By December most short rates were still 30 to 40 basis points below their 1966 highs, but once again they compared favorably with rates paid by intermediaries. Preliminary data reveal a slowdown in the annual rate of growth of savings and loan shares from a seasonally adjusted average of $12.3 billion in the first three quarters, to $5.6 billion in the final quarter. In addition, growth in deposits at mutual savings banks began to taper off in the third quarter, increasing at an average annual rate of $4.4 billion in the last half compared to $5.8 billion in the first half. Commercial banks were able to retain their large CD's by increasing rates on new offerings to the 5½% ceiling, but according to preliminary data overall time deposit growth slowed to $10.4 billion at seasonally adjusted annual rates in the fourth quarter compared to a $27.6 billion average annual rate during the first three quarters.

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