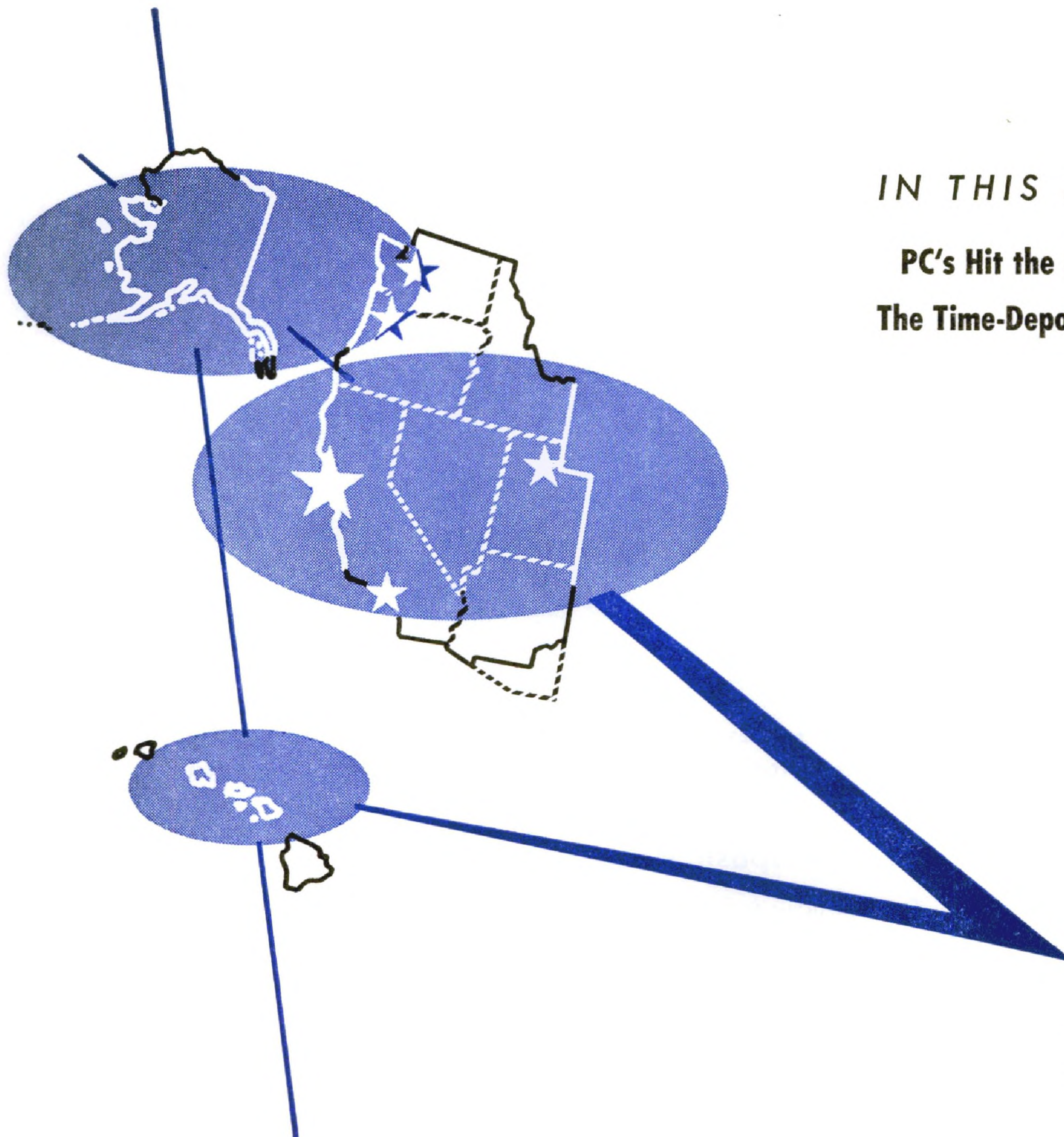
FEDERAL RESERVE BANK OF SAN FRANCISCO

MONTHLY REVIEW



IN THIS ISSUE

PC's Hit the Market

The Time-Deposit Scene

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PC's Hit the Market

. . . Federal agencies are pooling their loans and offering participation certificates for sale in the private market—$4.2 billion this year.

The Time-Deposit Scene

. . . Deposit flows responded dramatically to rate differentials in early 1966, thus setting the stage for official countermoves.

Editor: William Burke

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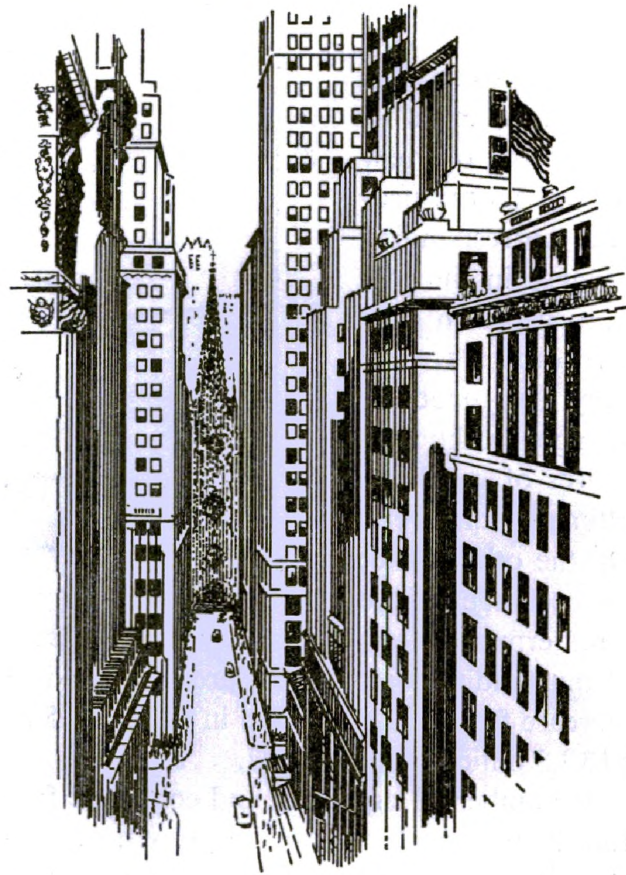
PC's Hit the Market

PC's—participation certificates—have begun to enter the credit market in force, and the money-market experts are still not quite sure what to make of them. What the experts are witnessing is the massive development of a technique whereby Federal agency loans are pooled and the pool participations are sold on the private market through FNMA (Federal National Mortgage Association).

PC's were rather unimportant until the passage this spring of the Participation Sales Act of 1966, but $4.2 billion of them are now scheduled to come to market in fiscal 1967, on the heels of the $1.8 billion sold last quarter alone. They are already exerting a significant impact on the credit market—but before evaluating that impact it is necessary to examine the rationale and the cost of the Federal credit programs which these credit instruments help finance.



What Federal credit does

Federal credit helps achieve Government objectives in the fields of private and public housing, agriculture, education, small business, and foreign economic development. Credit programs of this type supplement private credit in several different ways. They fill financing gaps by providing types of credit not otherwise available to borrowers; they assume or share risks which private lenders are reluctant to undertake; and they provide longer maturities, smaller down payments, and lower interest costs than are available in the private market.

Federal credit assistance has grown over time as Congress has broadened existing programs and initiated new ones. In fiscal 1967, for instance, such programs will support a number of new legislative advances—college-student loans at below-market interest rates, development credit for depressed areas, insured rural housing loans, and urban land-development mortgage insurance.

How much it costs

The expansion of new as well as existing programs is reflected in the rapid rise of new credit commitments. Federal agency commitments for direct loans are scheduled to rise to $8.0 billion in fiscal 1967, after increasing from $4.1 billion to $6.7 billion in the 1955-65 period, while commitments for the insurance or guarantee of private loans are scheduled to jump to $28.4 billion in fiscal 1967, after rising from $14.8 billion to $23.0 billion over the 1955-65 decade. About one-half of the direct loan commitments for 1967 are being made by the Export-Import Bank and by AID for foreign development purposes. Over one-half of the second, and larger, category represents FHA insurance of private mortgage loans, but the total also includes $4.2 billion for guarantee of the new participation certificates.

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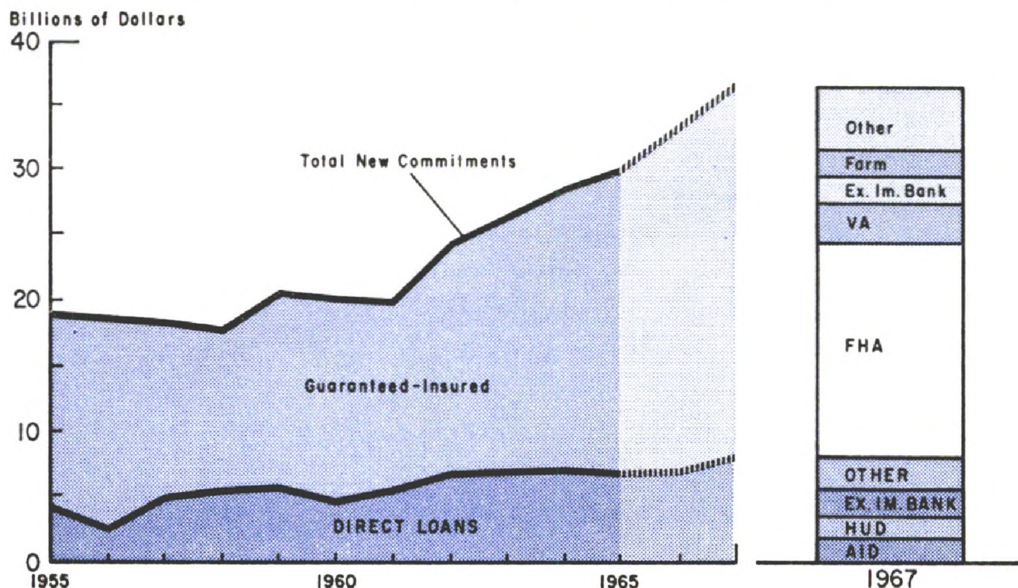

Commitment data give the best advance indication of the economic impact of credit programs. Changes in the level of new commitments precede corresponding changes in the volume of loan disbursements, and they also precede changes in the purchases of goods by ultimate borrowers. On the other hand, the best index of the long-term trend of credit programs is the level of outstanding loans. These are scheduled to increase from $124.5 billion in fiscal 1965 to $139.3 billion in fiscal 1967.

A number of legislative and economic factors have contributed to the growth of outstanding loans over the past decade. Direct foreign lending has grown from $7.9 to $15.3 billion in outstandings; farm loans have risen from $5.3 to $9.3 billion; and in the housing field, FHA-insured loans have jumped from $18.7 to $49.0 billion and VA-guaranteed loans have risen from $22.3 to $31.0 billion. But with the present substitution of private warehousing for public custodianship of governmentally-extended credits through sales in participation pools of loans, direct loans outstanding are budgeted to decline in the 1965-67 period, whereas guaranteed and insured loans are scheduled to increase sharply.

Congressional objectives

In the past, Federal credit programs have contributed substantially to the fulfillment of Congressional objectives, especially in the field of housing. The Federal insurance of amortized mortgages broadened homeownership, improved housing standards, and contributed to a healthy mortgage market. Through Federal sponsorship of a credit reservoir for the savings and loan industry and through Federal development of a secondary market for insured and guaranteed mortgages, the flow of new savings into housing was greatly facilitated.

Similar accomplishments have been reported elsewhere. Credit assistance helped hundreds of communities to finance land redevelopment, to provide housing for the poor, and to meet public-facility requirements. Federal credits to small firms expanded opportunities and competition in the small business sector. Long-term Federal loans helped universities to house their soaring enrollments and helped the students themselves to acquire scientific and technological training. In addition, Federal credit contributed to the recent rapid strides in farm productivity by broadening farmers' access to credit markets.

Expanding the scope

As one means of financing the expansion of such programs, Congress this spring expanded the scope of the participation-sales technique. The new law authorizes the sale of participations in a pool of outstanding direct

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loans. FNMA, as trustee, continues to administer the VA-FNMA pool of mortgage loans, but, in addition, it now administers and sells certificates of participations in loan pools set aside by the Small Business Administration, the Office of Education, the Farmers' Home Administration, and the college housing and public facility programs.

The idea of participation sales is not an entirely new one. FNMA and the Export-Import Bank have conducted such sales for several years—altogether, $1.7 billion in Eximbank sales and $1.6 billion in FNMA sales. Yet now, for the first time, other agencies are permitted to include loans in each pool—and they can even include loans with below-market interest rates by making supplementary payments to the trustee so as to permit a level of return on the pooled loans adequate to attract private investment. All in all, participation sales under the new legislation are scheduled to increase from $0.8 billion in fiscal 1965 to $4.2 billion in fiscal 1967.

The new law includes authorization for each Federal lending agency to enter a trust agreement with FNMA; specifically, to set certain loans aside on its books, to subject them to trust, and to guarantee the payment of principal and interest on such loans. The lending agency fulfills the guarantee by using appropriated funds as well as program funds to which the entrusted amounts are related.

FNMA as trustee issues and sells the loan participations, normally through some underwriting group. The participations are based on the pooled obligations and on the right to obtain principal and interest payments on such obligations. FNMA, in its corporate capacity, guarantees all payments due on the certificates and can borrow from the Treasury to make timely debt-service payments. The FNMA guarantee and the Treasury borrowing privilege may not be needed, however, in view of the lending agencies' guarantee and in view of their obligation to substitute loans for any defaulted loans in the original pool. The purpose of the FNMA guarantee and drawing authority is to provide extra safeguards to help assure a favorable market reception for participation certificates and thereby hold down interest rates to the greatest extent possible.

New features

With the extension of the participation technique to small business, college housing, and public facility programs, financing is centralized in FNMA to assure the orderly and economic sale of assets. If each agency conducted its own sales, problems could arise in the way of duplication of effort or more costly budget operations. But with sales conducted under FNMA's guidance, asset sales for newer and lesser known programs can gain the benefit of the seasoning and experience built up through FNMA operations in recent years.

The new legislation, moreover, surmounts the problem created when a number of sound loans carry rates far below the levels that private investors would be willing to invest in. Such loans ordinarily could be sold directly only at a big discount, but they can now be included in marketable pools as the agencies owning them make supplementary payments to the pool trustee to cover the interest insufficiency. These payments are subject to the regular appropriations procedures of Capitol Hill, since Congress authorizes the amounts of any participation issues on which supplementary payments would be likely to be required.

The new legislation, again, permits many more investors to become involved in the financing of public credit programs. Almost all investors are potential purchasers of pool certificates, while in contrast many dealers cannot deal in individual mortgages or buy individual business or college loans. Thus the sources that can be tapped to support any particular Federal credit program are con-

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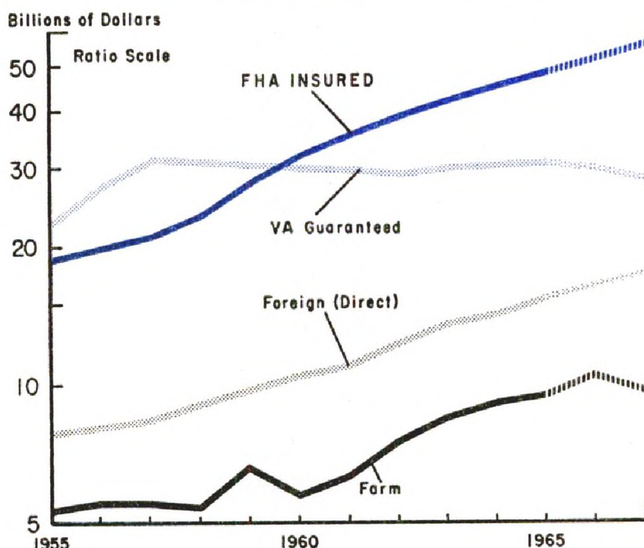
siderably enlarged. Meanwhile, individual segments of the capital market are protected from the disruption of heavy direct sales.

New budget figures

Participation sales will have an interesting effect on Federal budget figures. Credit disbursements are scheduled at $8.0 billion in fiscal 1967—the same as in fiscal 1965—but the net addition to total loans should switch from a *plus* $1.8 billion to a *minus* $2.1 billion over that period simply because of heavy "repayments" in the form of participation sales. Congressional critics, viewing these figures, charge that the Administration is "hiding" Federal expenditures from the budget, and is conducting a form of back-door financing which bypasses the Congressional appropriations process. Still, the Administration contends, Congressional appropriations committees must approve the package of loans that go into each sales pool, so Congressional procedures are not bypassed.

By selling a scheduled $4.2 billion in participation certificates this fiscal year, the Treasury will show only a $1.8-billion deficit in the administrative budget rather than the $6.0-billion deficit that would otherwise result. Although critics denounce this technique as a "budget-balancing ploy," the fact remains

Outstanding loans to foreigners and to FHA-homeowners increase



that the underlying credit programs would still be carried forward even if no participation sales were made, the difference being that these programs would be financed through direct Treasury borrowing rather than through PC operations.

How heavy an impact?

Disagreements may remain about the extent of the budget impact, but no one disputes the substantial impact now being exerted by participation sales and other Federal agency borrowing on the money markets. From only $2.1 billion in fiscal 1965, Federal agency borrowing rose to $7.1 billion in fiscal 1966, and it should nearly match that total in this fiscal year. Market congestion was most severe in the quarter just ended, when total sales amounted to $4.4 billion in direct agency and participation sales, but heavy pressures will continue throughout this new fiscal year, under the impact of $4.2 billion in PC sales and total agency borrowing of $7.0 billion.

Market interest recently has centered around the $530-million issue marketed by FNMA in early June, consisting of $350 million of certificates in Small Business Administration shares and $180 million of certificates in mortgage participations. This issue, although the first to be marketed under terms of the new Participation Sales Act, was the fifth issue of that type to be marketed by FNMA since late 1964. The four previous offerings, totaling $1.6 billion altogether, were based on $2.3 billion of loans in the Government Mortgage Liquidation Trust; these issues were of varying maturities and carried average interest rates ranging from 4.31 percent in late 1964 to 5.39 percent in April 1966. The latest issue, however, carried an average yield of 5.55 percent, and some portions of the package sold at yields as high as 5.75 percent.

Even so, the Administration argued that these rates were about the most favorable that the market could provide, partly because of

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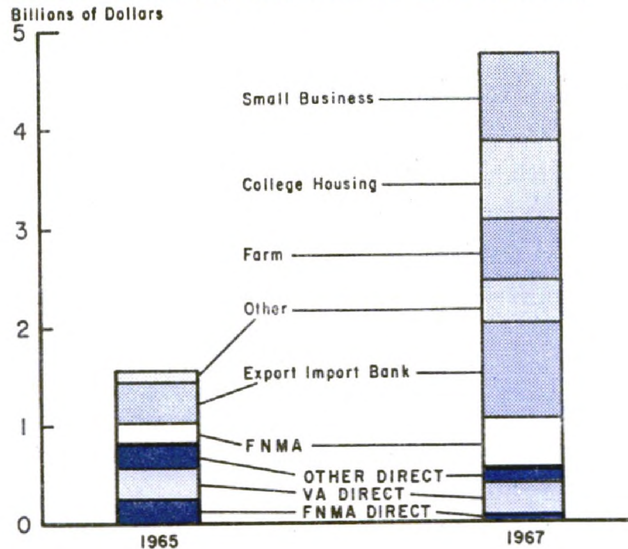
New law emphasizes participation sales of loans, instead of direct sales



the individual agency guarantee and loan-substitution provision, and partly because of the FNMA guarantee and Treasury-borrowing authorization. Moreover, yields on participation sales may move somewhat closer to those on direct Treasury obligations as the program increases in volume, as broader market familiarity is achieved, and as secondary trading develops in such issues. And, of course, FNMA's strong market acceptance permits it to market issues at rates lower than those available to the individual agencies for which it is now acting.

Nonetheless, participation-sales transactions are made at rates above those the Treasury could obtain on its own direct obligations. At a ¼-percent interest-rate differential, the extra interest cost on $4.2 billion of participation sales this fiscal year will amount to over $10 million. Moreover, judging from recent quote sheets, the spread between PC's and Treasury issues of like maturity may be even wider than ¼ percent, with a proportionate impact on interest expenses.

How important a place?

Beyond this, there is the issue of the market impact of participation issues in today's congested market. PC sales simply replace a comparable amount of direct Treasury financing and thus do not affect the total volume of funds to be raised in the market. They influence market conditions, however, since PC maturities tend to be longer than those on Treasury issues, thus commanding a higher rate on maturity grounds alone, and competing more closely with mortgages and other longer-term securities.

PC's thus appeal to those sectors of the market that have been traditional customers for long-term Treasury issues (in particular, bank trust departments, pension funds, and savings institutions), while marketable Treasury issues, presently restricted to the short end of the maturity spectrum by the Congressional interest-rate ceiling of 4¼ percent on longer-term securities, are forced to seek their market among commercial banks and other liquid-asset holders. So, although the proliferation of participation certificates would ordinarily create competition for regular Treasury issues, their freedom from the rate ceiling now permits the Government to tap sources of long-term funds to an extent which the interest-rate limitation would not otherwise permit it to do.

According to one newspaper account, "Planners envision FNMA assuming the queenly robes of a central capital bank, the sole broker for a growing troop of Federal agencies that now confound Treasury debt managers by their individual forays into the money market to finance projects ranging from public housing in Manhattan to power plants in the Tennessee Valley." Despite the journalistic embellishments, the fact remains that this established agency has now markedly simplified the financing problems of Federal credit agencies. For the seller, this is a notable accomplishment—and for the buyer, there is (at least currently) that 5.75-percent yield.

—*William Burke*

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The Time-Deposit Scene

The First Five Months

Savers withdrew $1,056 million from their passbook savings but added $1,506 million to other consumer-type time deposits at Twelfth District member banks between early December and early May. Business-type deposits, mainly the large-denomination certificates of deposit, meanwhile increased by $379 million during this five-month period. These shifts occurred in the wake of the early-December raising of interest-rate ceilings on all but passbook-savings deposits.

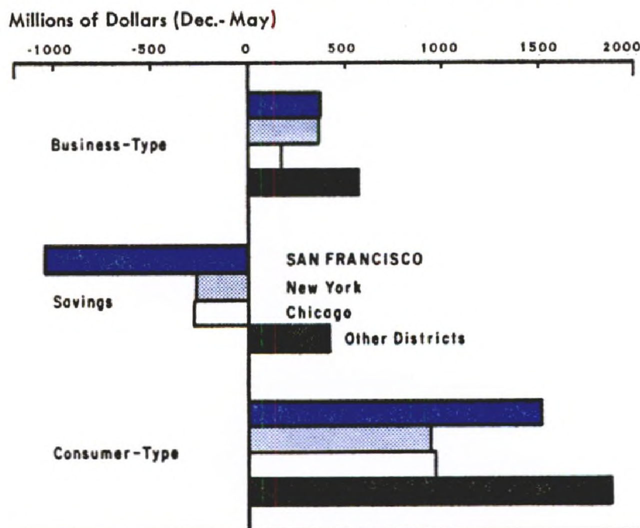
The net result of these widely divergent movements—a 6-percent reduction in passbook savings, a 95-percent jump in other consumer-type deposits, and a 22-percent gain in business-type deposits—was a modest 4-percent increase in total private time deposits of District member banks. New York banks, like Western banks, registered a 4-percent increase, but banks in every other district recorded gains of 5 percent or more over the December-May period. These figures reflect the relatively weak performance of the New York and San Francisco Districts in the deposit categories they have traditionally dominated—New York in business-type deposits and San Francisco in passbook savings. (Twelfth District member banks normally account for well over one-fifth of total commercial-bank savings deposits.)

In the consumer-type deposit category, New York followed the San Francisco pattern, with a large ($284 million) drop in passbook savings and an even larger ($940 million) increase in other consumer-type deposits. Chicago matched the New York pattern almost identically, but other districts as a group scored a substantial gain in passbook savings along with a sharp rise in other consumer-type deposits.

The survey definition of consumer-type deposits includes all categories of time deposits except negotiable certificates (CD's) of $100,000 and over and open-account deposits. Under this definition, the major shift of savings funds occurred at those Twelfth District banks which offered the largest rate differential between the two types of "savings" deposits—in this case, a maximum of over 5 percent on consumer-type deposits compared with the 4-percent permissible maximum on passbook savings. At those banks, $875 million flowed out of passbook savings and $1,154 million flowed into savings certificates and other consumer-type deposits. However, the District banks which accounted for the largest part of this shift offered rates of over 5 percent only on negotiable CD's, which generally were not available to individual savers.

New York's performance was similar to San Francisco's, although on a much smaller scale. The other districts, taken as a group, recorded the largest gains in consumer-type deposits at banks which paid no more than 4½ percent on such deposits.

Western banks show drop in savings but sharp rise in other time deposits



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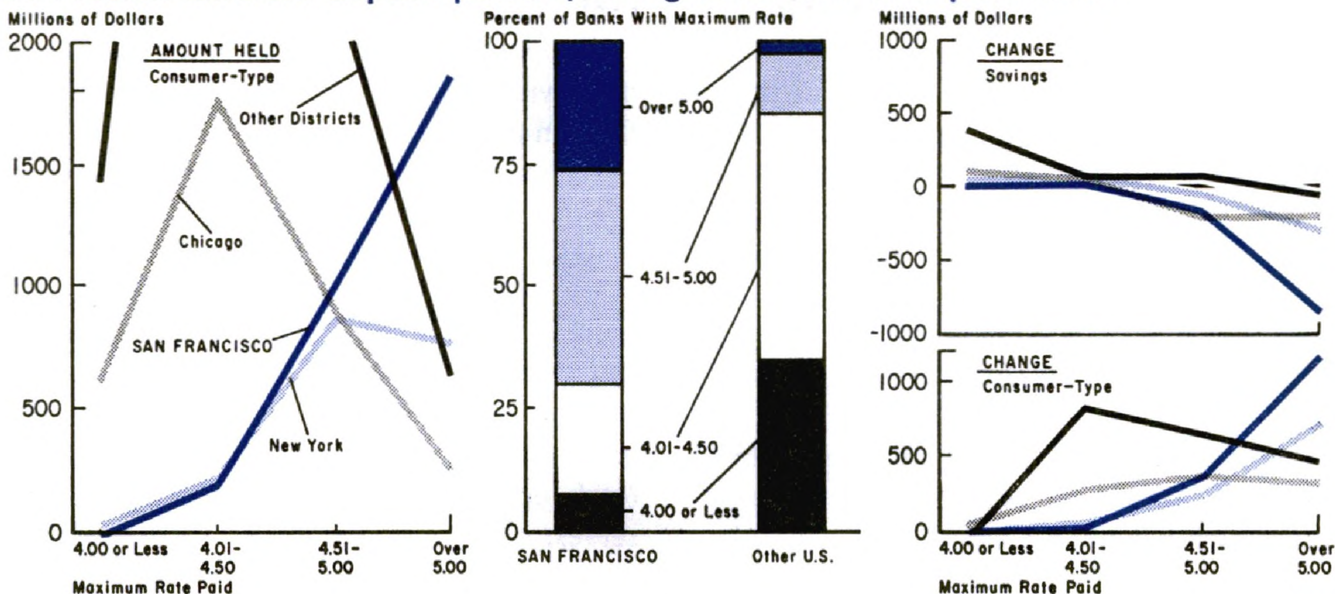
Western banks offer higher rates than others on consumer-type deposits . . . result: different deposit pattern, and greater shift in deposit flows



The relatively strong response of Western savers to rate differentials reflected the existence of a higher rate structure at Western banks than elsewhere. Even though all but a few District banks offered 4 percent on passbook savings—as against less than three-fifths of member banks elsewhere—they were still unable to stem a sharp decline in passbook savings. Funds shifted dramatically to other consumer-type deposits — not surprisingly, since 70 percent of District member banks, as against only 15 percent of banks elsewhere, offered maximum rates of over 4½ percent on such deposits.

These Western developments are the most obvious example of a nationwide agitation in savings markets resulting from the recent across-the-board rise in interest rates. In this as in earlier tight-money situations, the supply of funds in credit markets has fallen short of the demand for such funds, while the competition for the available supply has intensified. Thus, marketable securities traded in the money and capital markets have recorded a sharp increase in yields—and, in response, savings institutions have boosted their rates sharply in order to retain their funds.

Inflows into all types of savings institutions have slackened markedly since the turn of the year, while direct flows into securities markets have increased. As indicated above, total private time deposits grew about 4 percent in the West and about 5½ percent elsewhere during the December-May period—substantially below the year-ago growth rates—and the expansion pace slowed even more at savings and loan associations. In contrast, individual investment in marketable securities has soared, roughly quadrupling the early-1965 inflow.

The Western data show the close relationship between the slowdown in deposit growth and the absolute decline in passbook savings, under the constraint of the 4-percent rate ceiling maintained since early 1962. The availability of higher rates on other consumer-type deposits has facilitated the switch of funds out of passbooks into certificates and similar instruments. Increasingly since last December, when the amended Regulation Q permitted higher rates on such deposits, money flows have moved into this channel in response to the upward shift in rates.

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. . . . And at Midyear

On June 27, the Federal Reserve Board of Governors announced an increase in the reserves member banks must hold against time deposits other than savings. Under the amended Regulation D, reserve requirements will remain at 4 percent against passbook-savings deposits and the first $5 million in other time deposits at each bank. But, in the reserve computation week beginning July 14 for Reserve city banks and July 21 for country banks, reserves of 5 percent must be held against all time certificates and other forms of time deposits in excess of the initial $5 million at each bank.

The Board simultaneously announced an amendment of the definition of deposits as contained in Regulations D and Q to prevent circumvention of the statutory or regulatory requirements applicable to bank deposits. The effect of the amendment is to bring shorter-term bank promissory notes and similar instruments under the regulations governing reserve requirements and payment of interest on deposits. This action does not apply to federal funds transactions, interbank borrowings, transfers of assets with agreements to repurchase, or bank notes for capital purposes that have a maturity of more than two years and are subordinated to claims of depositors. This amendment becomes effective September 1, and will apply to all promissory notes covered by the action that are issued on or after June 27, 1966.

These several actions, which are designed to help moderate further growth in bank credit and to hold down the issuance of time certificates of deposit, will require member banks to set aside roughly $420 million in additional reserves. Most of the increase in required reserves will be borne by Reserve city banks; country banks will account for less than one-sixth of the total.

Because Twelfth District banks hold a relatively high proportion of total member-bank time deposits, the reserve-requirement amendment will have a greater impact on banks here than on those in any other district except New York and Chicago. On the basis of their mid-June time-deposit structure, Reserve city banks in the San Francisco District will have to increase their required reserves by approximately $75 million—about one-fifth of the total increase for all Reserve city banks. District country banks, on the other hand, will account for only about seven percent of the total increase in country-bank required reserves.

On July 16 the Board of Governors announced further "Q" amendments to be effective July 20, 1966. The purpose of these amendments is to decrease the rate of interest that member banks are permitted to pay on any "multiple maturity" time deposit—that is, any time deposit (1) that is payable at the depositor's option on more than one date, whether on a specified date or at the expiration of a specified time after the date of deposit, (2) that is payable after written notice of withdrawal, or (3) with respect to which the underlying instrument or contract of any informal understanding or agreement provides for automatic renewal at maturity.

For a multiple maturity time deposit from which the depositor can withdraw his funds only after a period of 90 days or more, the maximum permissible rate is 5 percent. (Formerly banks were permitted to pay up to 5½ percent per annum on any time deposit.) For a deposit from which the depositor can withdraw his funds after a period of less than 90 days, the maximum permissible rate is 4 percent.

These amendments apply only to "multiple maturity" time deposits received on or after July 20, 1966; they do not affect deposits made before that date. Moreover, these

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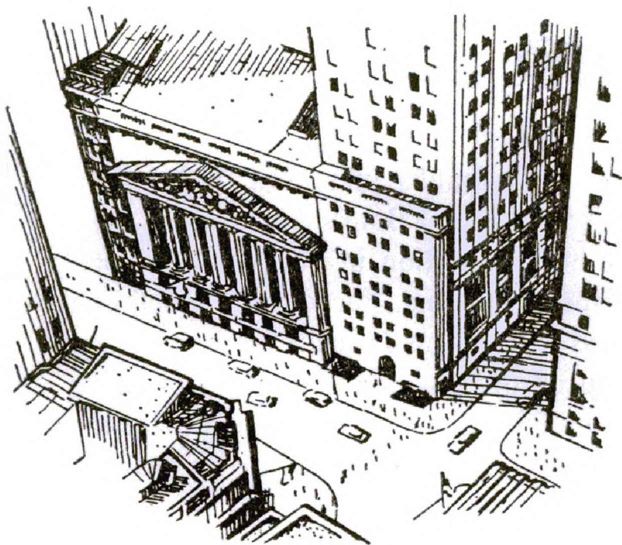

amendments do not affect any deposit with a single fixed date of payment (such as one payable only on a specified date), and such a deposit may continue to bear interest up to a maximum rate of 5½ percent. The 4-percent maximum rate permitted on passbook savings also remains unchanged.

The recent survey of time-deposit interest rates and savings flows, as described above, showed that Western banks accounted for the largest shift of funds of any district in the country. More recent data for District banks indicate that this shift continued throughout May and most of June. But in comparison to April, the more recent period witnessed a considerably smaller decline in passbook savings as well as a considerably smaller increase in consumer-type savings certificates. (In April, banks actually recorded a net decline in total private time deposits.)

District banks may find a growing proportion of their time deposits subject to the 5-percent reserve requirement, since the 4-percent rate ceiling on passbook savings will lead individuals to favor the higher rates (ranging up to 5½ percent) offered by banks on consumer-type time deposits. However, the net flow of funds into commercial-bank time deposits may be reduced in the third quarter because of intensified competition from savings and loan associations, many of which raised their dividend rates on July 1. The move to a higher rate structure accelerated on that date, after the Federal Home Loan Bank Board ruled that it would no longer restrict borrowing privileges of associations posting dividend rates in excess of 5 percent.

Many associations, particularly in California, are now paying 5¼ to 5½ percent on passbook savings, along with additional bonuses of ½ percent on larger savings certificates carrying longer maturities. Savings and loan associations have adopted these higher rates in an attempt to stem the large net withdrawals experienced in recent months, particularly in California.

Savings accounts at Western S&L's dropped sharply in April, but the May decline was somewhat smaller, and preliminary June figures showed some levelling off in accounts.

Ruth Wilson and William Burke

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Western Digest

Bank Lending

Total loans adjusted at District weekly reporting banks increased over half a billion dollars in the four-week period May 25-June 22. Banks financed at least a part of this loan expansion with a $132-million reduction in holdings of short-term U. S. Government securities. . . . Business firms, faced with declining liquidity and increasing needs for funds, relied heavily on District banks to meet their June 15 quarterly tax payments and the speed-up in withholding taxes effective June 20. The volume of their borrowing ($303 million) thus was more than twice the year-ago pace. . . . In the face of this increased credit demand and their own reduced liquidity, District metropolitan banks sharply increased the rates charged on short-term business loans. In the first half of June the average rate was 5.89 percent—up 35 basis points from the average rate in March.

Deposit Developments

In the May 25-June 22 period, District banks recorded a net increase of $192 million in demand deposits adjusted, but a gain of only $13 million in total time and savings deposits. . . . The net decline in passbook savings, which began in early March, continued into June, but this was much more than offset by a $196-million increase in consumer-type time deposits. However, greater than seasonal withdrawals in state-local time deposits ($134 million) also reduced the total net gain in the time-deposit category.

Aerospace Employment

After a year-long upsurge, Western aerospace employment reached 636,000 in May. The new figure is slightly higher than the earlier peak reached in late 1962, before employment went into a 15-percent, two-year-long decline. . . . Aerospace recruiters are reporting increased difficulty in finding qualified workers. Because of this manpower shortage, and because of military set-asides of scarce aircraft parts, commercial-jet manufacturers are postponing scheduled deliveries of some aircraft models until next year.

Farm Developments

Continued dry weather during May contributed to reduced production propects for nonirrigated field crops, especially in the northern part of the District. But production prospects for fruit remained favorable—especially favorable for Washington's apple crop and for California's pear and cling peach crops. . . . Two major labor agreements were signed in California's Central Valley during June. In the first of these negotiations, a farm union obtained a 35-cents-per-hour increase in wages and a union shop. A second union obtained bargaining rights for employees at another agri-business firm, but the election results were sharply challenged by competing unions, and eventually new elections were scheduled for August by a state-appointed mediator.

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