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April 10, 1981

FRBSF Weekly Letter

Deposit Deregulation

Just a year ago, Congress passed the Depository Institutions Deregulation and Monetary Control Act (MCA)—a major step in the deregulation of financial institutions. Perhaps the most important aspect of this far-reaching legislation was its call for the removal of legal deposit-rate ceilings. As a first step, the Act permitted nationwide interest-bearing checking (NOW) accounts, which most banks and thrifts now offer at a 5¼-percent ceiling rate. More importantly, the landmark legislation also mandated complete phaseout of all legally imposed deposit-rate ceilings by April 1986.

Today's legal ceilings stem from the Banking Act of 1935, which prohibited payment of explicit interest on demand deposits and gave regulatory agencies the authority to impose rate ceilings on bank time and savings accounts. In 1966, Congress extended the regulatory authority to deposits at thrifts (savings-and-loan associations and mutual savings banks). At present, rate ceilings apply to all categories *except* large-denomination sources of funds (such as certificates over $100,000, Eurodollar deposits, repurchase agreements, or other specialized borrowing by banks and thrifts). Ceilings thus apply to all of the following:

- Passbook savings at 5¼ percent for banks and (because of a required ¼-point ceiling differential) 5½ percent for thrifts;
- Nongovernmental time accounts from 5¾ percent to 7¾ percent at banks, depending on maturity (6 to 8 percent at thrifts because of the differential);
- Governmental accounts of all maturities at 8 percent at both banks and thrifts;
- IRA and Keogh (retirement) accounts of 3-year maturity or more at 8 percent for both banks and thrifts; and
- Special variable-ceiling accounts, such as 6-month "money market" and 2½-year or more "small saver" certificates, for which the ceilings move with rates on Treasury securities of comparable maturities—with a cap on small-saver certificates of 11¾ percent at banks and 12 percent at thrifts.

With the rise in open-market rates since the late 1960's, the ceilings have acted to limit funds flowing into depository institutions. Regulatory agencies first responded to these outflows by eliminating ceilings on open-market sources of funds in the early 1970s. But as outflows of consumer deposits accelerated, the regulators then created the 6-month and 2½-year variable-ceiling certificates, thereby allowing rates on such instruments to come closer to open-market rates. Thus, the structure of deposit-rate ceilings already became battered by the strains of rising open-market rates well before passage of the MCA.

MCA/DIDC

Throughout the 1970's, regulatory agencies tended to respond to deposit outflows by removing ceilings piecemeal under crisis conditions—and also by permitting a slight upward drift in the ceiling on passbook accounts (see chart). Congress finally developed the MCA to assure ultimate removal of the ceilings. Because various institutions would be affected in different ways by removal of deposit ceilings, the MCA called for the creation of a Depository Institutions Deregulation Committee (DIDC), composed of the Secretary of the Treasury; the chairmen of the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, and the National Credit Union Administration; and the Comptroller of the Currency (a nonvoting member).

This group is charged with orchestrating a plan for removing ceilings by April 1986. To this end the Committee already has brought the variable-rate ceilings on the "money market" and "small-saver" certificates closer to the effective open-market rates on comparable Treasury securities, and has requested comment on removing the cap on the

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small-saver certificate. But the larger task of removing the multitude of fixed-rate ceilings still lies ahead.

Optimistic "solution"

Obviously, the DIDC's task would be simplified if the inflation rate were to decline significantly, bringing interest rates down in tandem. Indeed the Committee already has taken a step to render the variable-rate ceilings (and the thrift differential) ineffective in an environment of low interest rates. Last May it declared floors on the ceilings for 6-month and 2½-year certificates such that if open-market rates were to fall below 7¼ and 9½ percent on comparable Treasury securities, respectively, the ceilings and the ¼-point differential would no longer be effective.

Inflation and interest rates would have to drop very steeply, however, for rate ceilings to become ineffective, either on these certificates or (especially) on passbook savings. The gap between open-market interest rates and the ceilings is just too great for that to happen soon (see chart). Since the Committee cannot wait indefinitely, it will have to develop a strategy for raising the ceilings.

Consensus

The DIDC faces a difficult task; it must reach a consensus on a strategy that probably will raise the average cost of funds for many institutions, and that will affect differently the various institutions represented by the Committee's members. Such a consensus will not come easily; indeed, the DIDC's plans could yet be thwarted by legislative attempts to alter the mandate of the MCA. Paul Horvitz (University of Houston) recently noted that the DIDC must develop a strategy that is "neither so cautious that ceilings are still with us in 1986, nor so bold or erratic that Congress steps in to reverse the deregulation process."

The MCA requires each member of the DIDC to file an annual report regarding whether removal of the bank-thrift differential will "... adversely affect the housing finance market or the viability of the thrift industry." This is indeed a major issue for the DIDC. The S&L's and savings banks believe that they will be badly hurt by the removal of ceilings—in part because they have a disproportionate (but rapidly waning) number of "interest insensitive" savers, and in part because they consider the ¼-point differential in the ceiling crucial for attracting deposits. Moreover, the thrifts believe that without relief for the asset side of their balance sheets, they simply can't compete on the liability side.

Both the National Savings and Loan League and the U.S. League of Savings Associations have expressed support for an orderly six-year phaseout of ceilings. But both have also expressed grave concerns about rapid removal. In a petition to the DIDC, the National S&L League recommended that the Committee allow financial institutions to offer "market rates" on the longest-maturity (8-year) certificates first (by July 1981) and work progressively toward the shorter-maturity accounts, finally arriving at removal of passbook ceilings in 1986. Moreover, the League defined "market rate" as a variable ceiling tied to the Treasury security of appropriate maturity plus a thrift differential, thereby implying a permanent role for the differential ceiling. The U.S. League also has emphasized maintenance of the differential during the six-year phase out period and furthermore has called for unanimity on all DIDC decisions, which would give veto power to any voting member of the Committee.

In its most recent meeting (March 26), the DIDC responded by asking for comment on two proposals: (1) removing the present 12 (11¾) percent cap on the variable ceiling for small saver certificates, and (2) establishing an overall approach for further deregulation. This overall strategy would remove ceilings on certificates with maturity of five years or more on July 1, 1981; four to five years on July 1, 1982; two to four years on July 1, 1983; one to two years on July 1, 1984; six months to one year on July 1, 1985. Remaining ceilings would then be eliminated on

April 1, 1986, the legal deadline. If implemented, the plan would help to stretch out the maturity structure of liabilities at depository institutions, which would be of particular interest to thrifts in particular because of the heavy concentration of their assets in long-term mortgage loans. If this approach seemed infeasible, the DIDCasked for comment on an alternative approach proposed by its staff: phase-in variable ceilings tied to appropriate Treasury security rates during the five-year period, which could mean the retention of the thrift differential during the period.

Market pressures

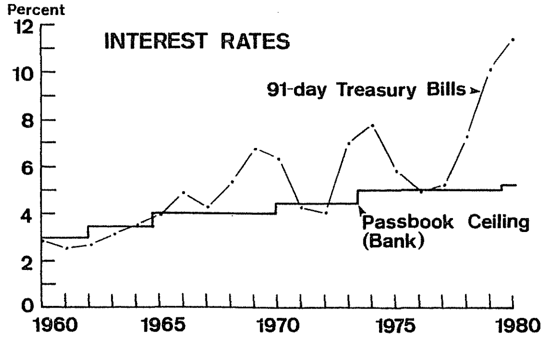
Market forces suggest that a slow phaseout of rate ceilings could still result in a continued flight of deposits. So long as open-market interest rates remain near their present lofty levels, a wide gap will persist between those rates and the ceilings on short-term deposits. Moreover, in the present environment of uncertainty about inflation, savers will view long-term deposits as risky assets, just as they do long-term bonds. Thus, rates on long-term certificates will have to parallel the high rates on bonds with comparable maturities if institutions hope to attract substantial amounts into such instruments.

The great popularity of money-market funds (MMFs) can be explained largely by depositor preferences to stay short and free of rate ceilings in an environment beset with inflation risk. (Other factors favoring MMFs are investor liquidity and the convenience of withdrawing by check.) By pooling their funds in an MMF, small depositors are able to access the same short-term money markets that corporations and institutions utilize, including $100,000 CDs at depository institutions. Thus, one can think of MMFs simply as vehicles for pooling deposit funds to circumvent the antiquated ceilings.

The spiraling growth of MMFs suggests that small depositors will not wait for a slow removal of ceilings. In response, the American Bankers Association is seeking permission for depository institutions to offer a new short-term instrument to compete with the funds. But some banks and thrifts are also pressing Congress to place restrictions such as reserve requirements and rate ceilings on the funds. Consumer groups in the meantime are fighting to maintain the MMFs and to remove deposit ceilings as rapidly as possible.

Market forces should not be discounted among all the various pressures now existing for more or less rapid removal of deposit rate ceilings. Throughout the 1970's, a crisis of deposit outflows preceded every decision to lift ceilings. In the 1980's, despite some signs of relief from presently high inflation and interest rates, consumers will seek market rates on deposits regardless. So long as the MMFs and other ceiling-free short-term savings vehicles exist—and such institutions would be extremely difficult to legislate away, given the many forms that they could take—deposits constrained by fixed ceilings will continue to run off (and be replaced by CDs and other purchased funds). Whether by fiat or flight, such fixed-rate deposits will become a relic of the past.

Jack Beebe



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FIRST CLASS

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 3/25/81	Change from 3/18/81	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	146,737	– 97	8,020	5.8
Loans (gross, adjusted) — total#	124,199	– 201	7,612	6.5
Commercial and industrial	36,288	– 353	2,386	7.0
Real estate	51,395	77	6,002	13.2
Loans to individuals	23,372	– 27	– 1,105	– 4.5
Securities loans	1,388	– 21	107	38.4
U.S. Treasury securities*	6,803	35	61	0.9
Other securities*	15,735	69	347	2.3
Demand deposits — total#	39,278	–1,691	– 2,436	– 5.8
Demand deposits — adjusted	28,420	– 393	– 1,956	– 6.4
Savings deposits — total	30,224	216	2,944	10.8
Time deposits — total#	76,233	–1,019	14,761	24.0
Individuals, part. & corp.	67,267	– 952	14,522	27.5
(Large negotiable CD's)	29,342	– 562	7,477	34.2

Weekly Averages of Daily Figures	Week ended 3/25/81	Week ended 3/18/81	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	n.a.	n.a.	0
Borrowings	139	30	198
Net free reserves (+)/Net borrowed(–)	n.a.	n.a.	– 198

* Excludes trading account securities.
# Includes items not shown separately.

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