

# The Administration of Regulation Q\*

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AT A TIME when market interest rates have soared to levels never before reached in this country, rates on deposits at banks and other financial institutions have been held much lower. The rate commercial banks charge on prime business loans has been 8½ per cent since early last June. Mortgage and many other market interest rates are currently about as high. On the other hand, payment of interest is prohibited on demand deposits, and the maximum rates permitted on time and savings deposits vary between 4.50 and 7.50 per cent.<sup>1</sup> The highest rate applies only to deposits in denominations of \$100,000 or more maturing in a year or longer. Smaller time and savings deposits are permitted to yield 4.50 to 5.75 per cent (see table below).

These ceilings were adopted January 21, 1970. During 1969 the ceilings were lower, with yields on small time deposits limited to 5 per cent or less, a rate which did not compensate savers for the 6 per cent decline in the purchasing power of their funds.

Interest rate ceilings on deposits at banks which are members of the Federal Reserve System are established under Federal Reserve Regulation Q. Ceilings at insured nonmember banks, which have been the same as for member banks, are set by a regulation of the Federal Deposit Insurance Corporation.<sup>2</sup> These Regulations stem from Banking Acts of 1933 and 1935, respectively.<sup>3</sup> Some states have at times imposed ceilings for state-chartered banks which are lower than those established by the Federal agencies. There were no explicit nationwide regulations on interest and dividend rates at mutual savings banks and savings and loan associations until 1966. Legislation in September of that year brought rates paid by Federally insured mutual savings banks under the control of the Federal Deposit Insurance Corporation, and rates paid at savings and loan associations which are members of the Federal Home Loan Bank Board under its control. That legislation also required the three regulatory agencies to consult with each other when considering changes in the ceiling rates.

This article examines changes in the maximum rates payable on commercial bank time and savings deposits. The maximum rate permitted on demand deposits has been zero since 1933.<sup>4</sup> Ceiling rates on time and savings deposits have been changed from time to time during the past 35 years, particularly during the 1960's. Two factors largely responsible for changes during the Sixties were the rising level of

**YIELD DIFFERENTIALS**  
(Per Cent Per Annum)

Type of Deposit	Regulation Q Ceiling Rate	Spread between Government Security Yield and Comparable Ceiling Rate*	
Savings deposits	4.50	(30 days)	2.64
Other time deposits			
Multiple maturity			
30-89 days	4.50	(3 - mo.)	3.57
90 days or more	5.00	(6 - mo.)	3.11
Single maturity			
Less than \$100,000			
30 days to 1 year	5.00	(6 - mo.)	3.11
1 year	5.50	(12 - mo.)	2.53
2 year	5.75	(2 yrs.)	2.40
\$100,000 or more			
30-59 days	6.25	(3 - mo.)	1.82
60-89 days	6.50	(3 - mo.)	1.57
90-179 days	6.75	(6 - mo.)	1.36
180 days to 1 year	7.00	(12 - mo.)	1.03
1 year or more	7.50	(12 - mo.)	0.53

\*On January 21, 1970, yields (bond-yield equivalents, see footnote 6) were 7.14 per cent on Treasury bills maturing in 30 days, 8.07 per cent on three-month bills, 8.11 per cent on six-month bills, 8.08 per cent on twelve-month bills, and 8.15 per cent on notes maturing in approximately two years (February 1972).

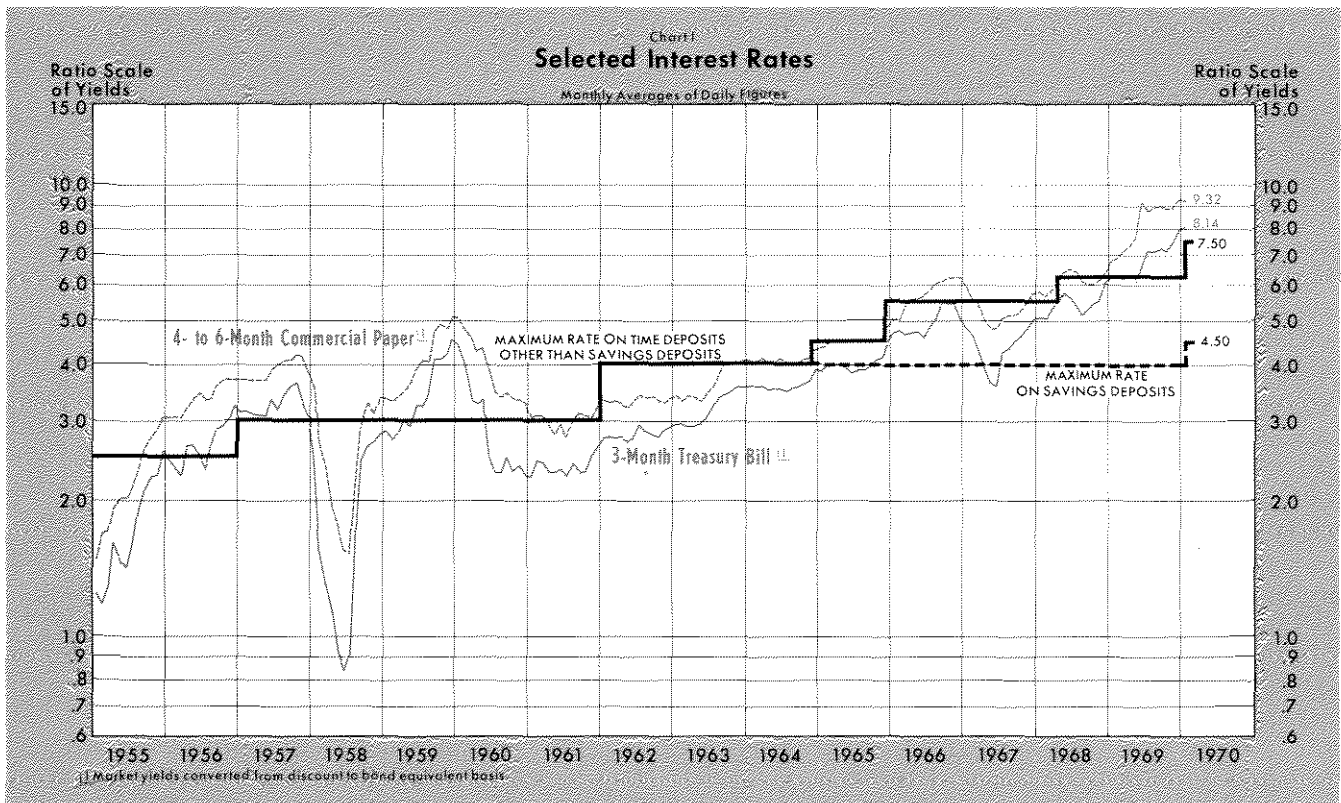
\* The author acknowledges the work of Elaine Goldstein, who initiated this study of the history of Regulation Q.

<sup>1</sup>Time deposits are defined in Regulation Q of the Federal Reserve to include "time certificates of deposit" and "time deposits, open account," both of which have maturities not less than 30 days or require 30 days written notice prior to withdrawal. Savings deposits are not subject to any maturity or withdrawal notice by the deposit contract, but the bank may at any time require 30 days notice prior to withdrawal. In this article, "time deposits" will be used to refer to deposits other than demand and savings; "time and savings deposits" will refer to the broad class of bank deposits which is distinct from demand deposits.

<sup>2</sup>Changes in maximum rates permitted at nonmember banks are given in the Annual Reports of the Federal Deposit Insurance Corporation. See for example, in *The Annual Report of the Federal Deposit Insurance Corporation* 1968, pp. 145-147.

<sup>3</sup>Historical background on interest rate restrictions, including developments prior to 1933, are summarized in "Interest Rate Controls—Perspective, Purpose and Problems" by Clifton B. Luttrell in the September 1968 issue of this *Review*, also available as Reprint No. 32. See also Albert H. Cox, Jr., *Regulation of Interest Rates on Bank Deposits*, Michigan Business Studies, Vol. XVII, No. 4 (Ann Arbor: University of Michigan, 1966), pp. 1-30.

<sup>4</sup>The implications of this interest rate ceiling for bank behavior have been analyzed by Donald R. Hodgman in *Commercial Bank Loan and Investment Policy* (Champaign: University of Illinois, 1963).



market interest rates and the growing importance of large certificates of deposit as a money market instrument. Use of negotiable certificates of deposit as a means of attracting large accumulations of money market funds began in February 1961, when the First National City Bank of New York announced it would offer large denomination negotiable CD's, and the Discount Corporation, a Government securities dealer, announced it would make a market for them.<sup>5</sup> The transferability of these CD's enhanced their desirability as a financial asset.

Changes in ceiling rates have usually been considered and made when ceilings were out of line with market interest rates. However, Chart I, showing market yields on a bond-yield equivalent basis and Regulation Q ceilings on two types of deposits, suggests that ceiling rates have sometimes remained out of touch with market conditions.<sup>6</sup> Changes in the structure of ceilings or in the relationship between market rates and the ceilings have, at times, been permitted in order to direct the flow of funds among

financial institutions, geographical areas, or sectors of the economy, or to accomplish stabilization objectives.

This article has three purposes:

- (1) to chronicle changes in ceiling rates;
- (2) to indicate reasons expressed by policymakers for making or dissenting from the changes; and
- (3) to evaluate the feasibility of achieving intended goals through deposit rate regulations.

The exhibit on pages 32 and 33 summarizes changes in the ceiling rates and the reasons behind them.

### *Emphasis on Prevention of Destructive Competition*

**November 1933** — As the Federal Reserve Board implemented its authority by adopting Regulation Q on November 1, 1933, the main theme was the prevention of destructive interest rate competition, which members of the Senate Committee on Banking and Currency, commercial bankers, and others believed to have been one cause of bank failures in earlier years. Possible destructive rate competition was often cited in later years as a reason for objecting to higher ceilings or as a justification for a particular structure of ceiling rates.

The Federal Reserve Board set a 3 per cent maximum rate on all time and savings deposits, effective

<sup>5</sup>Helen B. O'Bannon, "Certificates of Deposit," in *Money and Finance: Readings in Theory, Policy, and Institutions*, ed. by Deane Carson (New York: John Wiley & Sons, Inc. 1966), pp. 118-124.

<sup>6</sup>In this article interest rates on Treasury bills and commercial paper are quoted on a bond-yield equivalent (rather than discount) basis to make them comparable to rates on time and savings deposits.

November 1, 1933. On average for the year, the ceiling was above some short-term market rates, but below the rates apparently being paid on deposits at commercial banks, savings and loan associations, and mutual savings banks. Comparing total time and savings deposits at all commercial banks with interest expense of banks suggests that they were paying an "effective" average rate of 3.4 per cent in 1933. Similar measures for savings and loan associations and mutual savings banks indicate the same rate.<sup>7</sup> Market interest rates on high-grade short-term securities were far below 3 per cent. The three-month Treasury bill rate averaged .53 per cent in 1933, while rates on prime four- to six-month commercial paper averaged 1.77 per cent. The average rate banks charged on commercial loans in New York City fell from a peak of 4.79 per cent in March 1933 to 2.61 per cent in December.

**February 1935** — In early 1935 the Board lowered the ceiling rate to 2½ per cent, accepting a recommendation of the Federal Advisory Council (composed of commercial bankers):

... in view of the wide divergence in rates of interest now being paid on thrift and other time deposits in different sections of the country, and in view of the increasing difficulty of obtaining from suitable investments a yield sufficient to warrant payment of the maximum rate now fixed under provision of Regulation Q of the Federal Reserve Board, it is recommended that the Board give consideration to the advisability of lowering the present maximum rate.

In the opinion of the Council the present rate might well be lowered one-half of one per cent.<sup>8</sup>

**January 1936** — The Federal Reserve set different rates for time deposits with various maturities as of January 1, 1936, lowering the ceilings on short-term deposits. The maximum rate payable was changed to 1 per cent on time deposits maturing in less than 90 days, and to 2 per cent on those maturing in from 3 to 6 months. The Board stated "... that banks were not justified in paying as high rates of interest for time deposits having shorter maturities in view of their greater availability for withdrawals and therefore that

the rates fixed by the Board should be graduated according to maturities."<sup>9</sup> Discussions associated with the change pointed to the general downward trend of interest rates and the fact that many banks were finding it necessary to make further reductions in rates paid depositors because of decreased earnings. This comment suggests that banks were responding rationally to market forces and that any ceiling rate may have been superfluous. The lower ceilings, nevertheless, vindicated bank actions to their depositors.

Those favoring ceilings in order to limit "destructive competition" felt that free competition for deposits would force some banks to offer rates on short-term funds which were out of line with returns obtainable on assets "suitable" for banks to hold. In order to earn a return higher than it was paying on deposits, a bank might accept higher-risk and longer-term assets, thus impairing the liquidity and solvency of that bank and the banking system.

If the aggregate relation between interest expense and deposits adequately measures the rates banks pay, this argument seems to provide some justification for ceiling rates. In 1933 this measure shows banks paying rates higher than the rates on high-grade short-term securities. Banks were paying an average effective rate of 3.4 per cent, about twice the rate on prime four- to six-month commercial paper. The rates banks were paying do not appear significantly different from rates they were charging on short-term business loans. It could be argued that banks were offering strongly competitive rates to improve liquidity, which had fallen because of strong demands for currency and liquidity in the rest of the economy. This might be considered corrective behavior, while restraint on competition imposed by ceiling rates simply treated symptoms rather than the cause of the financial crisis.

Regulation Q ceilings do not appear to have encouraged or safeguarded bank liquidity. On the contrary, liquidity, in terms of the ratio of loans to deposits, has often dropped (the ratio rising) during periods when Regulation Q constrained competition for funds. For example, the ratio of loans to total deposits increased from 61.1 per cent in December 1968 to 67.8 per cent in December 1969, a period in which Regulation Q was the primary cause of a \$10.7 billion decline in time and savings deposits. Chart II, a comparison of the spread between the market yield on prime four- to six-month commercial

<sup>7</sup>This "effective" rate is calculated by dividing interest expense of all commercial banks by average balance of time and savings deposits for the year, and is a crude, but about the only, measure of rates banks were paying. The deficiencies of this measure are brought out by Albert H. Cox Jr., *op. cit.* p. 37. For one thing, it ignores maturity. For a listing of annual effective yields from 1930 through 1968, see United States Savings and Loan League, *Savings and Loan Fact Book*, 1969, p. 17.

<sup>8</sup>Federal Reserve Board, *Annual Report*, 1934, p. 203.

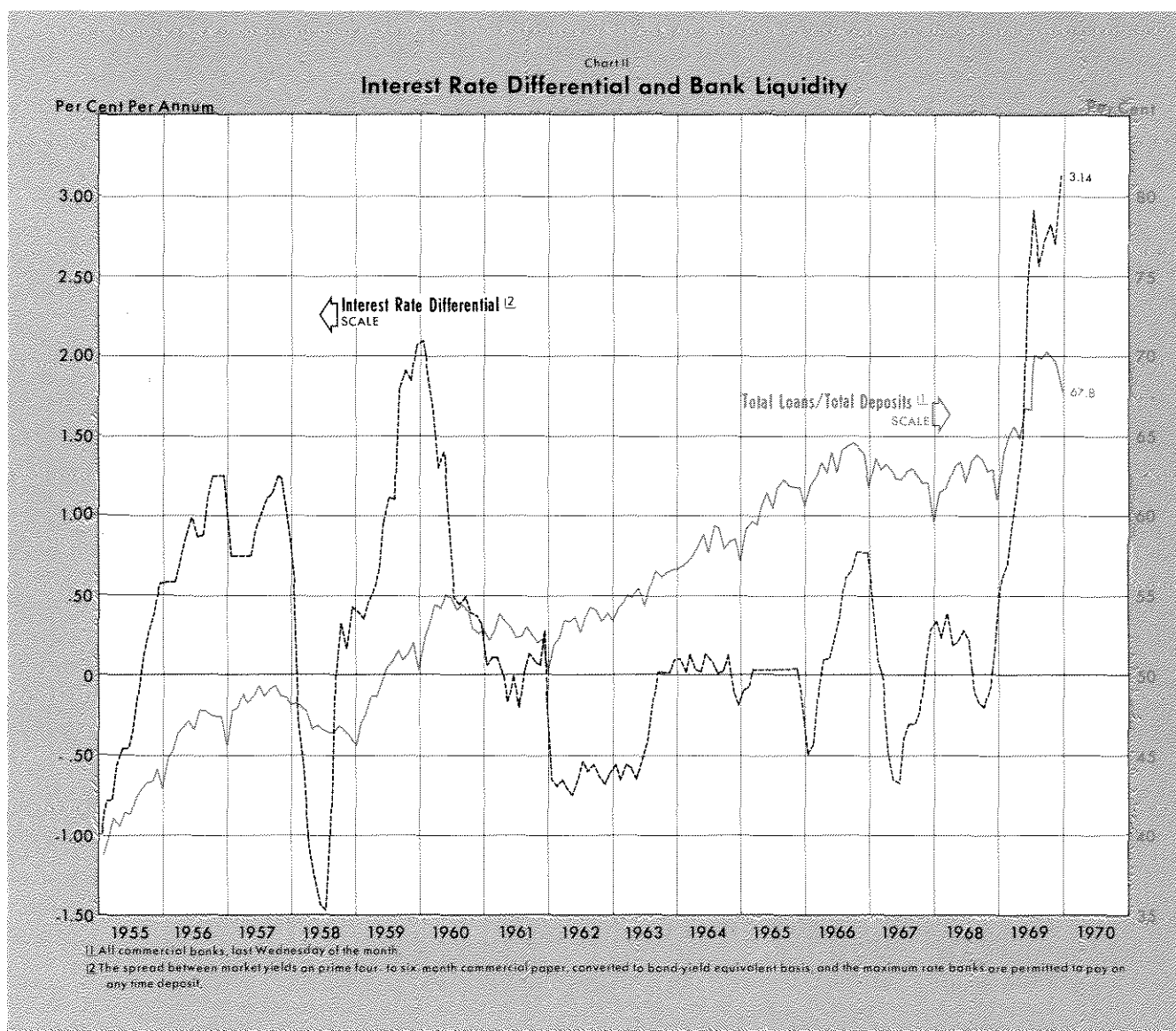
<sup>9</sup>Federal Reserve Board, *Annual Report*, 1935, p. 211.

## REGULATION Q CEILING RATES

<u>Date Effective</u>	<u>Ceiling Rates*</u>	<u>Reasons for Ceilings</u>	<u>Dissents</u>
Nov. 1, 1933	All time and savings deposits 3.00%	To prevent interest rate competition which might lead to bank failures.	
Feb. 1, 1935	All time and savings deposits 2.50%	Market rates had been declining. No investments suitable for banks offered ceiling rate. The increasing spread in rates being paid in different areas of the country was considered undesirable.	
Jan. 1, 1936	Savings deposits 2.50% Other time deposits Less than 90 days 1.00 90 days - 6 months 2.00 6 months or longer 2.50	Market interest rates had been declining; rates offered by banks had been reduced. Time deposits with shorter maturities should earn a lower rate of return.	
Jan. 1, 1957	Savings deposits 3.00% Other time deposits Less than 90 days 1.00 90 days - 6 months 2.50 6 months or longer 3.00	Market interest rates had risen above ceilings. Banks should have greater flexibility in competing for funds.	Robertson: Raising ceilings would impair bank liquidity and solvency as they sought higher yielding assets in order to pay higher rates.
Jan. 1, 1962	Savings deposits Less than 12 months 3.50% 12 months or more 4.00 Other time deposits Less than 90 days 1.00 90 days - 6 months 2.50 6 months - 12 months 3.50 12 months or more 4.00	To enable banks to attract longer-term savings and permit investment in longer-term assets needed for economic expansion. To enhance freedom of competition and efficiency of allocation. To enable banks to compete for foreign deposits.	King: Rate competition would have adverse effects on many commercial banks without making a significant contribution to solution of the U.S. Balance of Payments deficit, and present savings were adequate for economic expansion.
July 17, 1963	Savings deposits Less than 12 months 3.50% 12 months or more 4.00 Other time deposits Less than 90 days 1.00 90 days or more 4.00	To avoid outflows of funds to foreign competition. To prevent a run-off of bank time deposits, which might unduly tighten bank credit, given the discount rate increase. To eliminate bookkeeping in efficiency cause by splintered ceiling rates.	
Nov. 24, 1964	Savings deposits 4.00% Other time deposits Less than 90 days 4.00 90 days or more 4.50	To insure a sufficient flow of funds through banks to finance domestic investment. To avoid outflows of funds to foreign competition. Savings deposits rate was not raised higher because it might then disturb the relationship with rates of other thrift institutions and complicate Treasury financing. A higher rate on short time deposits might compel unwise competition.	Robertson—To the 4 percent ceiling on other time deposits: This increase would aggravate volatility of deposits. Shepardson and Robertson—To a 4 percent ceiling on savings deposits: It was discriminatory to small savers in view of the 4.5 percent rate permitted on some other time deposits.

Dec. 6, 1965	Savings deposits Other time deposits	4.00% <b>5.50</b>	To enable banks to attract and retain time deposits and therefore make more effective use of funds already in the economy to finance loan expansion. Market interest rates had risen since November 1964 under demand pressure.	Robertson: It would conflict with credit restraint hoped from the discount rate increase. Larger banks would be able to attract funds from smaller banks which rely on demand and time deposits. It would force smaller banks into higher risk positions.
July 20, 1966	Savings deposits Other time deposits Multiple maturity 30 - 89 days 90 days or more Single maturity	4.00%  <b>4.00</b> <b>5.00</b> <b>5.50</b>	To help forestall excessive interest rate competition among financial institutions at a time when monetary policy was aimed at curbing the rate of expansion of bank credit.	
Sept. 26, 1966	Savings deposits Other time deposits Multiple maturity 30 - 89 days 90 days or more Single maturity Less than \$100,000 \$100,000 or more	4.00%  4.00 5.00  <b>5.00</b> <b>5.50</b>	To limit further escalation of interest rates paid in competition for consumer savings. To keep growth of commercial bank credit to a moderate pace.	
Apr. 19, 1968	Savings deposits Other time deposits Multiple maturity 30 - 89 days 90 days or more Single maturity Less than \$100,000 \$100,000 or more 30 - 59 days 60 - 89 days 90 days - 6 months More than 6 months	4.00%  4.00 5.00  <b>5.00</b> <b>5.50</b> <b>5.75</b> <b>6.00</b> <b>6.25</b>	To supplement policy measures of monetary restraint. To give banks some leeway to compete for interest sensitive funds. To resist reduction in CD's while not promoting expansion of bank credit.	
Jan. 21, 1970	Savings deposits Other time deposits Multiple maturity 30 - 89 days 90 days or more Single maturity Less than \$100,000 30 days to 1 year 1 year 2 years \$100,000 or more 30 - 59 days 60 - 89 days 90 - 179 days 180 days to 1 year 1 year or more	<b>4.50%</b>  <b>4.50</b> <b>5.00</b>  <b>5.00</b> <b>5.50</b> <b>5.75</b> <b>6.25</b> <b>6.50</b> <b>6.75</b> <b>7.00</b> <b>7.50</b>	To bring ceilings more in line with market rates. To raise rate on small savings. To encourage longer-term savings in reinforcement of anti-inflationary measures. To increase the pool of savings for investment in mortgages.	

\*The ceiling rates which were changed are shown in boldface type.



paper and the highest Regulation Q ceiling with bank liquidity ratios, suggests that ceilings, when effective, have had an adverse effect on bank liquidity by forcing a run-off of deposits at the very time when credit demands at banks have been strongest.

### *Ceiling Rates Raised to Permit Freedom of Competition*

The ceiling rates remained unchanged for twenty-one years from 1936 to 1957. Market rates, too, were relatively stable until the late Forties. Beginning then, market rates increased somewhat but, in general, remained below the ceilings. Therefore, during this twenty-one year period, Regulation Q ceilings were virtually forgotten by both bankers and public policymakers.

During the late Fifties and early Sixties, market yields rose and interest rate ceilings were raised in actions reflecting the view that ceilings should be generally in line with market rates. In deliberations on the changes, prevention of undue restriction on competition was emphasized more than was prevention of destructive competition.

*January 1957* — In the mid-1950's short-term market interest rates rose above Regulation Q ceilings. The average rate on prime four- to six-month commercial paper was 3.41 per cent in 1956; three-month Treasury bills were trading at an average rate of 2.67 per cent; and savings and loan associations were paying, on average, an "effective" rate of 3 per cent. In contrast, commercial banks were paying an "effective" rate of 1.6 per cent on time and savings deposits,

while ceiling rates remained at the 1 to 2.5 per cent levels established in 1936.

Because banks were not offering competitive yields, time and savings deposits suffered a relative decline. From 1955 to 1956 time and savings deposits increased only 3.3 per cent, compared with a 7.2 per cent average annual rate in the previous four years. Deposits at savings and loan associations and at mutual savings banks rose 15.6 per cent and 6.4 per cent, respectively, during 1956, compared with rates slightly faster in the previous four years.

In view of this situation the rate ceilings on bank time and savings deposits were raised effective January 1, 1957, in order to give banks greater flexibility in competing for funds. The maximum rate payable on time deposits of less than 90 days remained 1 per cent, while rates permitted on other time and savings deposits were raised one-half of one percentage point. The specific reasoning behind the decision was that:

. . . there was insufficient reason to prevent banks, in the exercise of management discretion, from competing actively for time and savings balances by offering rates more nearly in line with other market rates. By increasing the rate limitations only on savings deposits and on time deposits with maturities longer than 90 days, the Board continued to recognize the special thrift character of savings accounts and to preserve a differential between longer-term time deposits and short-term time deposits representing essentially liquid balances.<sup>10</sup>

Governor Robertson voted against the change, going back to arguments presented at the hearings on the Banking Act of 1933. He held that it would increase bank operating costs, making it more difficult for banks to raise additional capital, that it would make banks seek higher yielding assets and impair the liquidity and solvency of the banking system, and that short-term funds "should be invested in open market paper, so that holders would have to bear the burden and risks of fluctuating rates and not shift that risk to the banking system."<sup>11</sup>

*January 1962* — In general the Governors took a more favorable attitude toward rate competition, and the ceilings were raised again on January 1, 1962. The change resulted in some further splintering in the classification of time and savings deposits, as the

Board distinguished maturities longer than one year from shorter maturities. Ceilings on savings deposits and on time deposits with maturities of six to twelve months were raised from 3 per cent to 3.5 per cent, and banks were permitted to offer a rate of 4 per cent on time and savings deposits held for twelve months or longer.

The Board of Governors felt that the resulting flexibility and freedom of competition would be useful for three reasons: (1) it would enhance economic growth; (2) it would contribute to improving the United States balance-of-payments position; and (3) it would have a healthy effect on the management of individual banks. The impact on growth was expected to come through encouraging the flow of bank funds to longer-term assets. "By permitting higher rates to be paid on deposits held for longer periods, the new limits would make it possible for banks to attract long-term savings, in contrast to volatile liquid funds, and thereby give banks greater assurance that they could invest a larger portion of their time deposits in longer-term assets."<sup>12</sup> This possible effect on the selection of bank assets was one reason Governor King dissented and Governor Mills questioned the action.

Another reason for raising the ceilings in 1962 was that it would permit competition for foreign deposits "that might otherwise move abroad in search of higher returns, thereby intensifying an outflow of capital or gold to other countries."<sup>13</sup> Balance-of-payments considerations also played a part in subsequent changes of the ceilings. In October 1962, legislation was passed which exempted deposits of foreign governments, and certain international institutions in which the United States was a participant, from the deposit rate ceilings for three years. Exempting legislation and exemption under Regulation Q were renewed in 1965 and 1968.

In discussing competition, most Governors emphasized the desirable rather than the possibly destructive effects. They felt that the higher ceilings would "enable each member bank to determine the rates of interest it would pay in light of the conditions prevailing in its area, the type of competition it must meet and its ability to pay."<sup>14</sup> Governor Robertson specifically expressed this thought — urging ceiling rates even higher than many banks might pay, in order to place responsibility for determining rates upon the individual bank. He noted that Regulation

<sup>10</sup>Federal Reserve Board *Annual Report*, 1956, pp. 52-53.

<sup>11</sup>*Ibid.*, pp. 54-55 contain a full statement by Governor Robertson, giving considerable detail on why there should be ceiling rates and why they should not be raised at certain times.

<sup>12</sup>Federal Reserve Board *Annual Report*, 1961, p. 103.

<sup>13</sup>*Ibid.*, p. 102.

<sup>14</sup>*Ibid.*, p. 102.

Q might impart the unintended and unwanted idea that ceilings indicated what the Federal Reserve thinks banks ought to be paying.<sup>15</sup> This view of competition seems to suggest that the ceilings were not essential in preventing undue concentration of funds and that, as a guide to banks, they may be undesirable.

*Reservation: Impact of Higher Ceiling Rates on Other Savings Institutions and on Housing*

One reservation about freer competition for commercial banks was its possible impact on other savings institutions. Governor Mills voted for the increase in ceilings in 1962, but questioned going above a 3½ per cent maximum, which would retain the usual spread between rates on commercial bank deposits and rates on deposits at other savings institutions.<sup>16</sup> The aggregate "effective" rates paid by both banks and savings and loan associations had continued to rise in the late Fifties and early Sixties. In 1961 savings and loans were paying an average "effective" rate of 3.92 per

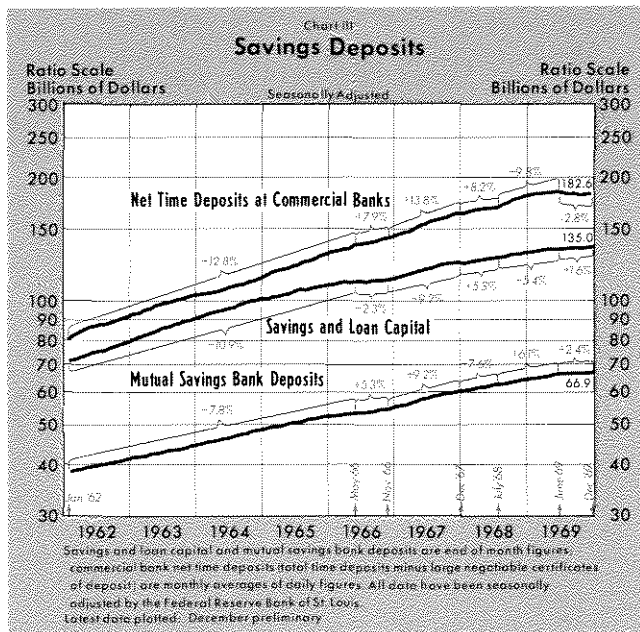
at least since 1962. It has been argued by many, including those associated with savings and loan associations and mutual savings banks, that, because these institutions enhance the availability of credit for housing, they should be given an advantage in the competition for consumer-type savings.

While it is important that there be an optimal flow of funds into the construction of housing, it should be considered whether regulation of bank interest rates accomplishes this goal, and whether this method involves costs which could be avoided.

The examples of 1966 and 1969, when interest rate ceilings effectively prevented both banks and other thrift institutions from competing for funds, seem to suggest that the ceilings alone cannot accomplish an optimal flow of funds into housing. From May to November 1966, growth of deposits at savings and loan associations was only a 2.3 per cent annual rate compared with an 11 per cent rate in the previous 4½ years. In the last half of 1969 the increase was at a 1.6 per cent rate, compared with 5.4 per cent in the previous year.

It has sometimes been argued that because savings and loan associations invest in longer-term assets than banks, they cannot adjust so easily as banks to changes in interest rates. Therefore, without differential ceiling rates, held stable even when market rates vary, savings and loan associations could not operate profitably. However, longer-term assets only imply that a savings and loan association requires a relatively large amount of reserves in order to pay a higher rate on deposits than the average rate earned on assets during a period of transition. As savings and loan associations adjust the rates charged on loans, they should be able to restore a workable relation between interest expense and interest earnings.<sup>17</sup>

Inability to attract and retain deposited funds is potentially as dangerous to savings and loan associations as is paying higher rates in the short-run than they are able to earn. During 1969, Government agencies tried to supplement savings and loan sources of funds by selling securities in the capital market at competitive rates and lending the proceeds to savings and loan associations. As a result savings and loan associations pay the higher competitive yield only on marginal funds, with fewer funds directed away from the housing market because of the rate ceilings than in 1966.



cent, compared with 2.71 per cent for commercial banks. In 1962, after the ceilings were raised, the rate at banks jumped nearly 50 basis points, compared with a 15 basis point increase at savings and loan associations.

Concern over nonbank thrift institutions has been behind resistance to raising Regulation Q ceilings

<sup>17</sup>See Norman N. Bowsher and Lionell Kalish, "Does Slower Monetary Expansion Discriminate Against Housing?" in the June 1968 issue of this Review, also available as Reprint No. 29.

<sup>15</sup>Ibid, p. 104.  
<sup>16</sup>Ibid, p. 103.



It appears that the interest rate ceilings have not accomplished the goal of encouraging housing. In fact, they probably have made credit for housing more difficult to obtain. On the other hand, they have encouraged the Government to protect a specific set of institutions and to provide services which regulations hinder private markets from providing.

### *Changes in Ceiling Rates to Influence Growth of Bank Credit*

Beginning with the change of ceilings in 1963, the influence of Regulation Q on the growth of bank credit has gradually become the focus in discussions of changing ceilings. The flow of deposits into banks is one factor influencing the ability of banks to expand loans and investments. The relation of interest rate ceilings to market rates is, in turn, an important factor influencing the amount of time and savings deposits which banks are able to attract. Therefore, through its influence on bank credit, Regulation Q has come to be considered a major tool of monetary stabilization policy.

**July 1963** — The change which took place in July 1963 raised the ceiling rates on all time deposits held longer than 90 days to 4 per cent, eliminating some of the previous splintering in the rates. While the balance-of-payments was cited as the primary reason for the change, Governor Robertson, who dissented from the concurrent discount rate increase from 3 to 3½ per cent, added that the increase in ceilings was necessary to offset any restrictive impact of the discount rate increase on bank credit.<sup>18</sup>

**November 1964** — In November 1964 ceiling rates were raised again, after some further increases in market interest rates and in conjunction with a discount rate increase to 4 per cent. The action adjusted the maximum rate on time deposits held less than 90 days from 1 per cent to 4 per cent, while raising that on longer maturities to 4.5 per cent. The differential ceiling rates on savings deposits were also eliminated by permitting a rate of 4 per cent on any savings deposit held longer than 30 days.

The principal reasons for raising the ceilings were to insure a sufficient flow of funds through banks to finance domestic investment and to avoid an outflow of funds which might worsen the balance-of-payments deficit. Again, Governor Robertson thought that

some change in the maximum interest rates permitted under Regulation Q was warranted by the need to prevent a run-off of time deposits. He dissented from raising the ceiling to 4 per cent on time deposits with maturities less than 90 days, however, because he expected it to "encourage the replacement of maturing certificates of deposit with new certificates of shorter original maturities, thus aggravating bank deposit volatility and pressures upon bank liquidity positions."<sup>19</sup>

Both Governor Robertson and Governor Shepardson thought that a 4.5 per cent maximum on savings deposits would be appropriate in that it would treat small savers more equitably. The majority of the Board of Governors, however, felt a 4 per cent rate would preserve the prevailing relationship between rates paid on savings deposits by commercial banks and those paid by savings institutions such as mutual savings banks and savings and loan associations, whereas a higher ceiling might encourage unwise competition and possibly complicate Treasury financing problems.<sup>20</sup>

**December 1965** — In December 1965 an increase in ceiling rates was intended to permit some continued orderly expansion in bank credit while other policy instruments exercised restraint. The maximum rate payable on time deposits, regardless of maturity, was raised to 5.5 per cent, while the ceiling on savings deposits remained 4 per cent. The discount rate was again raised — this time to 4.5 per cent. Most of the discussion reported concerned the discount rate action and the majority view that monetary policy should move promptly against inflationary credit expansion, at a time when market rates had been rising under demand pressures, resource-use had been intensifying, and the pace of Government expenditures was accelerating.

The increase in Regulation Q ceiling rates was intended to help stabilize the growth of bank time deposits and thereby permit banks to make more effective use of funds than when they are uncertain about retaining deposits. The general idea that regulated rates should be in line with market rates is reflected in the statement: "In addition, a pattern of interest rates that was accepted by borrowers and lenders as fully reflecting market forces should, it was thought, add assurance of a smooth flow of funds to all sectors of the economy."<sup>21</sup>

<sup>18</sup>Federal Reserve Board, *Annual Report*, 1964, p. 48.

<sup>20</sup>*Ibid.*, p. 48.

<sup>21</sup>Federal Reserve Board, *Annual Report*, 1965, pp. 64-65.

<sup>18</sup>Federal Reserve Board, *Annual Report*, 1963, pp. 39-40.

Governor Robertson, however, dissented on the grounds that the increase in ceilings would conflict with the credit restraint hoped for from the discount rate increase. The alternative action he suggested was to dampen bank issuance of promissory notes by defining them as deposits, while maintaining the current discount rate and interest rate ceilings on deposits. He also felt that higher ceilings would shift deposits from smaller to larger banks or force smaller banks into higher-risk assets.<sup>22</sup>

**July 1966** — The ceiling rate structure of 4 per cent on savings deposits and 5.5 per cent on time deposits lasted little more than six months. In July 1966 the Board of Governors took two actions influencing ceiling rates. For one thing they lowered the ceiling rate on multiple maturity deposits. A multiple maturity deposit was distinguished from single maturity as one: (1) payable at the depositor's option on more than one date; or (2) payable after written notice; or (3) subject to automatic renewal at maturity. Maximum rates on multiple maturity deposits were lowered to 5 per cent if held more than 90 days and to 4 per cent if held only 30-89 days. This lowering of rates was intended to inhibit competition between banks and thrift institutions "at a time when monetary policy was aimed at curbing the expansion of bank credit."<sup>23</sup>

The other action was to recommend legislation to facilitate distinction between consumer-type deposits and money market CD's. The Board considered the previous action of defining multiple maturity deposits only a partial attempt at this. They recommended that Congress broaden the authority of the Federal Reserve by allowing them to distinguish deposits by amount in regulating rates, and that it extend similar authority to the Federal Home Loan Bank Board to determine maximum rates at savings and loan associations.

**September 1966** — Public Law 89-597, passed September 1966, permitted time deposits under \$100,000 to be treated differently from larger ones in regulating maximum rates and authorized national regulation of maximum rates paid by savings and loan associations and mutual savings banks. On the same day the law was signed, the maximum rate on any time deposit less than \$100,000 (excluding passbook savings deposits) was set at 5 per cent. Like the previous reduction, this one was intended to limit rate increases caused by competition for household savings,

<sup>22</sup>*Ibid.*, p. 70.

<sup>23</sup>Federal Reserve Board, *Annual Report*, 1966, pp. 97-98.

<sup>24</sup>Federal Reserve Board, *Annual Report*, 1966, pp. 104-106.

and to keep the growth of bank credit at a moderate pace.<sup>24</sup>

During 1966 market interest rates continued their upward trend, culminating in the so-called "credit crunch." Yields on prime four- to six-month commercial paper reached 6.11 per cent and yields on three-month Treasury bills reached 5.08 per cent in August 1966. Rates paid at banks and savings and loan associations were not competitive with these other market instruments. As a result, the growth of time and savings deposits slowed substantially. In early 1967 market interest rates subsided somewhat, financial institutions could again attract funds, and growth of deposits quickly moved to the previous rapid trends.

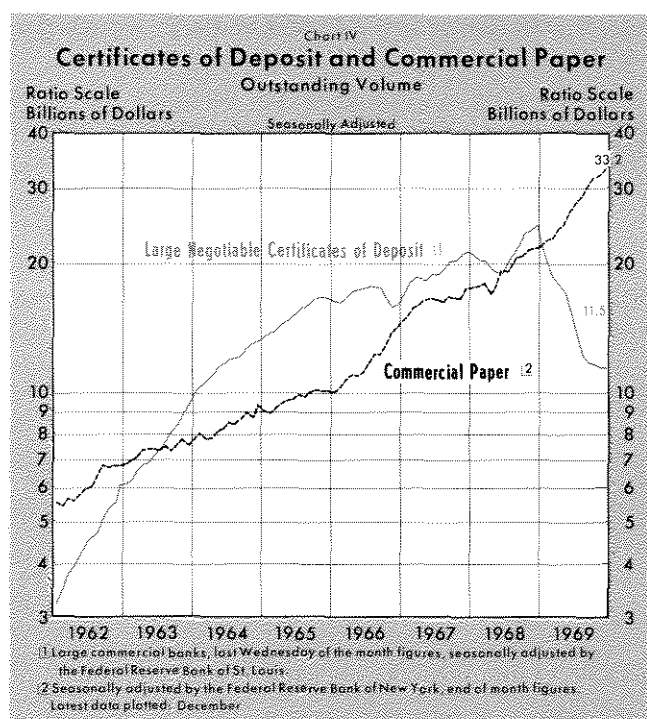
**April 1968** — In the spring of 1968, market interest rates climbed into the range at which ceilings prevented banks from competing for funds as effectively as before. In April the ceiling rates on large denomination CD's were raised "in order to give banks some leeway to compete for interest-sensitive funds." Rates on single maturity CD's in denominations larger than \$100,000 were raised to 5.75 per cent if held 60 to 89 days, to 6 per cent if held 90 days to 6 months, and to 6.25 per cent if held longer than 6 months. Ceiling rates on other time deposits were not raised; the resulting structure was considered sufficient to resist the run-off of CD's, while not promoting expansion of bank credit.<sup>25</sup>

**1969** — While the relationship between ceiling rates and market interest rates changed significantly in 1969, no change was made in ceiling rates. For example, the spread between yields on four- to six-month commercial paper and the ceiling rate on three- to six-month CD's was over 3 percentage points at the end of 1969. Prior to the last time ceiling rates were raised, in 1968, the spread was about one-half of one percentage point. As a result of the change in relative yields, by December 1969 banks had lost over half of the \$24 billion in CD's held in December 1968. Other time and savings deposits, savings and loan capital, and mutual savings bank deposits also stopped increasing or increased at substantially slower rates than in 1968.

Bank credit increased only 2.5 per cent in 1969, after rising 11 per cent in 1968. This slowing was due partly to slower growth of the monetary base and partly due to the impact of Regulation Q.

**January 1970** — The disintermediation in 1969 led to an upward revision in the ceiling rates effective January 21. The maximum rate on bank savings de-

<sup>25</sup>Federal Reserve Board, *Annual Report*, 1968, pp. 69-70.



posits became 4.5 per cent. Small certificates (less than \$100,000) are now permitted to yield 5.50 per cent if they mature in one year, and 5.75 per cent if they mature in two years. The ceiling on each maturity classification of large CD's was raised  $\frac{3}{4}$  of a percentage point, and a new classification, large CD's maturing in a year or more, is permitted to yield 7.50 per cent.

The changes were made to bring the structure of ceiling rates "... somewhat more in line with going yields on market securities," to permit a more equitable rate on small savings, and "... to encourage longer-term savings in reinforcement of anti-inflationary measures." Along with these reasons was the belief that higher rates on savings at institutions would increase the amount of funds available for mortgages. On the following day the Federal Home Loan Bank Board raised the maximum rates savings and loan associations are permitted to pay.

There was no explicit mention of bank credit in the press release which announced the change. However, it was pointed out that:

"The revisions in the Board's Regulation Q ceiling rates were held to moderate size, so as not to foster sudden and large movements of funds into the banking system that could cause distortions in traditional financial flows or lead to an upsurge in bank lending."

During the Sixties the idea that Regulation Q is a major instrument for controlling bank credit became

the predominant rationale behind the structure of the ceilings. Implicit in this view was the importance of bank credit as a target variable in monetary stabilization policy. It does appear reasonable that the growth of credit extended by banks is associated with the growth of spending in the economy, and that appropriate stabilization policy during a period of excessive spending would be restricting the growth of bank credit. It should be recognized, however, that there are alternative channels through which funds flow from savers to borrowers.

Savers, who are discouraged from putting their funds in banks or other thrift institutions because of low yields, have had alternative, higher earning assets available. Therefore, any slowing in the growth of bank deposits and hence bank credit, which is caused by restricting competition, is probably offset by a rise in the flow of funds through unregulated markets, leaving the growth of total credit unaffected. In 1969, for example, at the same time that the outstanding volume of large negotiable CD's declined \$13 billion, the outstanding volume of commercial paper increased by \$11.5 billion. A stronger demand by individuals for small denomination (\$1,000 and \$5,000) Treasury bills also developed, as savers sought higher returns than banks were permitted to pay.

The impact of Regulation Q has encouraged banks to find nondeposit sources of funds. During the past two years, they found supplemental sources of funds in the sale of commercial paper by bank subsidiaries and holding companies and in Euro-dollar transactions. The channelling of dollars through Europe to avoid interest rate restrictions increased the cost and distance of flows of funds and led to new regulations imposing reserve requirements on such borrowing. Regulations concerning the sale of commercial paper are pending, while commercial banks continue to seek ways to avoid the discriminatory impact of Regulation Q.

### Summary and Conclusions

The Banking Act of 1933 authorized the Federal Reserve Board to establish maximum rates which banks may pay for funds. In November of that year, the Federal Reserve Board adopted Regulation Q, which imposed a ceiling rate of 3 per cent on member bank time and savings deposits. The action was taken to help avoid unwise competition among banks and its detrimental effects on the soundness of banks. This reason has gradually received less attention.

While the ceilings have been raised on occasion in order to permit some competition for funds, changes in the spreads between the ceiling rates and market rates sometimes have been allowed to occur with the intention of increasing the flow of funds toward nonbank thrift institutions or influencing the growth of bank credit. The primary justification for the current structure of Regulation Q ceilings has been its presumed control on bank credit for purposes of economic stabilization. Given this goal, the adverse impact of Regulation Q ceilings on bank liquidity at certain times has probably been intended. However, Regulation Q cannot control total credit in the economy, since funds leaving bank time deposits are channelled through unregulated markets or return to banks through nondeposit sources of funds.

Though the growth of total credit probably is unaffected by Regulation Q, the allocation of credit is affected. At times when ceilings restrict the amount of funds available to financial intermediaries, borrowers in the unregulated markets are able to obtain funds more cheaply than if all markets were freely competitive, while borrowers who rely on banks or

other thrift institutions are forced to pay a higher price or may find funds simply unavailable. The situation is analogous for savers. Holders of large amounts of liquid funds with knowledge of capital markets can receive the highest return available, while those who must rely on regulated institutions to hold and accumulate savings receive a lower return than if banks were free to compete.

It appears that interest rate restrictions on financial intermediaries impose inequities on our economy, discriminating against housing, small savers, and the regulated financial institutions. They encourage inefficiencies as banks try to reroute funds, intermediaries try to compete through premiums, and Government agencies have to find both new regulations and ways to ease the burden on those most severely hurt. It further appears that interest rate restrictions are of little consequence in the control of total credit or total spending in the economy. At the same time, there is no evidence that the absence of Regulation Q would be detrimental to the equity of the economy, the solvency of the banking system, or the control of total spending.

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