Deposit Deregulation and Risk Management in an Era of Transition

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MANAGEMENT IN AN ERA OF TRANSITION

BY
KENNETH T. ROSEN

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comment. Therefore, they
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DEPOSIT DEREGULATION AND RISK MANAGEMENT
IN AN ERA OF TRANSITION

Kenneth T. Rosen
Professor of Business Administration

May 1982

Center for Real Estate
And Urban Economics

Working Paper 82-47

Institute of Business
And Economic Research
University of California
Berkeley, CA 94720
Deposit Deregulation and Risk Management in an Era of Transition

by

Kenneth T. Rosen

The piecemeal deregulation of the savings and loan industry during a period of increased rate volatility has created a dangerously unstable financial environment. This new environment threatens to turn the transition from a highly regulated to a market-oriented financial structure into a disruptive process subject to periodic crises. This potential transition crisis is a function of the piecemeal and nonsystematic deregulation of SLA's on both the deposit and asset side, the unprecedented interest rate volatility resulting from federal mismanagement of monetary policy, the mistakes made by the DIDC in the setting of interest rate ceilings on various deposit accounts, and the great increase in consumer sensitivity to interest rate and liquidity characteristics of retail savings deposits.

The combination of continued federal policy mismanagement of both the deregulation process and monetary policy, the increased sophistication of the retail saver, heightened competition from nonregulated financial institutions, the likelihood of an accelerated removal of deposit rate ceilings, and the continued volatility of market interest rates have created a radically different and highly unstable environment for thrift institutions. This environment will require management techniques that will be able to assess the impact of alternative economic and regulatory scenarios on the behavior of the retail savings
consumer. Concepts such as interest rate elasticities, maturity matching, "predatory" competition, and triple yield curve inversions will dominate management decisions. Management of the retail savings sector will become a critical element in the structure of the savings and loan functioning in the new economic environment.

Interest Rates and Federal Mismanagement of Monetary Policy

Federal mismanagement of monetary policy has, in the past several years, created unprecedented interest rate and monetary instability. The extreme volatility of interest rates and money supply growth rates in 1980 and 1981 must be viewed as unacceptable monetary policy. The implementation of the Federal Reserve's new monetary aggregates policy has been flawed in a number of ways.

The major cause of this mismanagement of monetary policy revolves around the Federal Reserve's failure to anticipate or comprehend some of the key linkages between its activities and the financial and real sectors of the economy. The Fed appears to have erred in several fundamental ways. First, it seems to have forgotten that Fed policy works with a substantial lag -- and so it appears to be reacting to current financial and economic conditions in a myopic way. This myopia has in part been accentuated by an underestimation of the market's response to exogenous economic stimuli and Fed activity. The Fed must anticipate and offset the market's overreaction to outside random shocks. While it must clearly focus on a long-run policy of slowing excessive growth of credit, it should not allow the violent short-term swings that might accompany its own release of statistically
suspect weekly money supply members.

The extreme volatility in the pattern of short and long term interest rates that has been apparent since October 1979 is a direct consequence of the Federal Reserve movement away from interest rate management. However, the Fed's movement away from an interest rate target led not only to unprecedented interest rate volatility but also to unprecedented instability in the growth of their so-called "control" variable, M1B. As Figure I shows, M1B has shown two giant surges and three enormous drops in the course of only two years. They have clearly been unable to control the M1B aggregate in any meaningful way. The Fed, however, would argue that the intra-annual fluctuations in M1B are unimportant and are distorting the fact that they have succeeded in decelerating the growth rate in M1B on average. On the contrary, I would argue that the volatility of both M1B and interest rates have greatly increased the uncertainty in the economic system and so caused investors to demand a large risk premium in interest rates -- leading to a large deadweight loss for the entire economy. Fed stop and go policy has led to violent fluctuations in both the real and financial sectors of the economy in 1980 and 1981. These fluctuations are themselves inflationary in that efficiency in the real sector is impaired, thus raising the cost of production. As a result, short-run, anti-inflationary, destabilizing actions of the Fed have actually contributed to long-run inflation. As a result, the Fed performance in the past two years must be viewed as completely unacceptable even if one agrees with their new goal of controlling monetary aggregates.

The second error in my view relates to this very question of
Figure I

GROWTH RATE IN M1B (CHANGE OVER PRECEDING 3 MONTHS)
monetary aggregates as a target of monetary policy and concerns the perceived way in which monetary aggregates affect economic activity. Monetary policy does not work through a black box (in which monetary aggregates go in one side and inflation emerges at the other side), but rather through real and nominal interest rates. Real interest rates are the ultimate determinant of investment and economic activity. Nominal interest rates are also of major importance in certain sectors of the economy, such as housing.

This black box monetarism treatment for inflation is akin to treating high blood pressure by draining blood from the patient. It may lower inflationary pressures in the economy but may also kill the patient. It is a dangerous and very risky game -- which is causing a costly worldwide recession approaching depression conditions for many industries and countries. Inflation has numerous causes, one of which is excessive monetary growth. A four year recessionary depression may solve the problem but is it worth the price?

As a consequence of this policy, real interest rates are today at the highest levels since World War II. As Table I and Figure 2 that follow illustrate, as of late 1981, real interest rates were in the 5-8% range, far above anything experienced in modern history. Only in periods of deflation and depression, during the depressions of the 1870s, 1921, and the 1930s, have real interest rates been at such unprecedented levels. The housing and thrift industry depression is a direct consequence of these real rates. If these rates persist, it is likely that the overall economy will experience a severe recession approaching a depression.

If we are to avoid a continuing stop and go performance of the
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Figure 2

REAL' INTEREST RATE

Source: Board of Governors of Federal Reserve System.

Average quarterly rate on 3-month Treasury bills minus average quarterly change in consumer price index, seasonally adjusted annual rate.

WALL STREET JOURNAL, Friday, October 2, 1981
American economy, and a transition crisis for the thrift industry, the Fed must alter its monetary policy course. The Federal Reserve Board must pursue a more moderate "real interest rate policy" during the transition period. The failure to adhere to even the middle range of its ML-B target is completely indefensible given the crisis it is producing throughout the economy. The Fed should abandon black box monetarism and pursue a "real interest rate" policy. Utilizing monetary aggregate targets in a period when the financial structure is changing so dramatically must be perceived as a major error.

It is in this environment of high and volatile "real" interest rates that the restructuring of the retail savings market is taking place.

The Restructuring of the Retail Savings Market

The major characteristic of the consumer deposit market from 1965 to 1978 was the near rigid interest rate ceilings placed on deposit accounts. Under Regulation Q and related provisions, the maximum interest rate that thrift institutions and commercial banks could pay on passbook and term deposits was set by the agency responsible for regulating each financial institution. Thus, the Federal Reserve Board, the Federal Home Loan Bank Board, and the Federal Deposit Insurance Corporation set the maximum rates that could be paid by commercial banks, savings and loan associations, and mutual savings banks, respectively. With the passage of the Depository Institutions Deregulation and Monetary Control Act in March of 1980, the authority to set maximum interest rates payable on deposits was transferred to the Depository Institutions Deregulation Committee (DIDC). The intent of the legislative act and the charge of the DIDC was to phase out all deposit interest rate ceilings by 1986 in an orderly and nondisruptive manner.
The rationale behind the initial imposition of deposit rate ceilings revolves around two areas. The first concerns the fear of "predatory competition" by which financial institutions would compete for consumer deposits without regard to profit and solvency constraints. This fear of competition goes against all economic theory and empirical evidence and is, in fact, merely a rationale for providing a sheltered low-cost, noncompetitive environment for regulated financial institutions. However irrational, this predatory competition argument was utilized in 1965 when interest rate ceilings were imposed on savings and loan deposit accounts. The proximate cause was the competition for funds which caused a number of financial institutions to experience a severe profit and liquidity squeeze. This squeeze led institutions to pressure regulators to impose rate ceilings which effectively prohibited interest rate competition on deposits.

The second rationale for the imposition of deposit rate ceilings on the housing finance system derived from the desire to encourage home mortgage lending by providing a differential interest rate for institutions investing primarily in residential mortgage loans. The differential interest rate for thrifts (originally 3/4 percent now down to 1/4 percent or zero depending on account type) was meant to create a captive source of funds for the housing industry. By paying a higher interest rate on deposits than commercial banks, the thrifts presumably would capture a larger share of household deposits which, in turn, would be lent as residential mortgages.

While these justifications for deposit rate ceilings are fairly dubious, the regulations were partially successful, at least during periods when market interest rates and interest rate ceilings were
fairly similar. The savings and loans' market share of deposits increased through the 1960s and early 1970s and on average mortgage credit was available at a surprisingly low cost relative to other long-term credit. There were, however, three periods of major disruption in the flow of mortgage credit which corresponded to periods when market interest rates were substantially above deposit ceiling interest rates. Cyclical instability in housing activity was substantially exacerbated by this regulatory environment — leading to both periodic over-building and credit crunches.

In the late 1970s this regulated financial structure began to look increasingly vulnerable. High and volatile interest rates and inflation rates made financial assets and particularly deposits at regulated financial institutions look increasingly unattractive. As Figure 3 shows, the first response of consumers was to dramatically reduce their savings in financial assets (although they did at that time increase savings in real assets such as houses). The reported savings rate dropped from 7-8% in the early 1970s to close to 5% by the late 1970s and early 1980s.

The second response of consumers was to move out of those assets which were highly regulated into assets paying the market rate of return (see Figure 4). The proportion of depositors becoming relatively sophisticated seemed to grow geometrically with each increase in market interest rates. Investments in Treasury bills and money market mutual funds became increasingly common. The major negative impact of the ceilings fall on unsophisticated, often elderly, savers. Thus, the increasing inequity of the Regulation Q tax became more apparent to both the public and politicians.
Figure 4

Consumer Savings Market
(Stock of Savings)

1970
Life Insurance
14.27
Savings Institutions
25.31
Commercial Banks
34.24
Pension Funds
26.18

1978
Life Insurance
Money Market Mutual Funds
0.53
9.65
Savings Institutions
29.71
Commercial Banks
34.28
Pension Funds
25.83

1981
Life Insurance
Money Market Mutual Funds
8.43
4.67
Savings Institutions
26.06
Commercial Banks
32.93
Pension Funds
27.91
The initial response of the regulators to the fast eroding effectiveness of Regulation Q ceilings has been a piecemeal deregulation of deposit accounts which attempted to prevent "sophisticated" disintermediation from the regulated financial institutions. In a classic case of price discrimination, regulators allowed financial institutions to offer roughly market rate of returns only on short-term larger deposit accounts. In June 1978 regulated financial institutions were authorized to offer money market time deposits (known as money market certificates -- MMCs). The interest rate on these certificates was tied to the rate on the most recent six-month Treasury bill auction -- and until March 1979 thrift institutions could pay 1/4% more than commercial banks. Since 1979 the differential has been eliminated when the Treasury bill rate is above 9%. The MMCs require a $10,000 minimum deposit for a six-month period.

The introduction of the MMC has represented the major piece of deregulation of the deposit market. In January of 1980 financial institutions were also authorized to offer variable-ceiling deposits with maturities of 2-1/2 years or more (SSC). Since March 1980, a temporary ceiling interest rate of 12% was placed on these accounts -- effectively making them a below-market account. In August 1981 these accounts were finally fully deregulated. If judged by consumer acceptance, it is clear that both the MMC and SSC have been a major success. As of October 1981, as Figure 5 shows, nearly 55% of all thrift deposits are in these accounts. This compares with the 98% of accounts that were in four year fixed certificate or passbook accounts in 1976 (see Figure 6). On the other hand, if judged in terms of providing an effective and equitable source of mortgage credit, the view is more mixed.
The introduction of the MMC succeeded in greatly educating and sensitizing the public to money market returns. This consumer education effect led not only to a rapid growth in MMCs, but also to an even more rapid growth in money market mutual funds. Figure 7 illustrates this rapid growth. Thus the MMC has had a mixed effect on the thrift institutions' deposit share. As Table 2 shows, the thrift institutions have during normal periods attracted about 50% of all consumer deposits. During 1979 and 1980 their share dropped to 34% despite the success of the MMC. Thus their deposit share was roughly similar to that of a typical disintermediation period such as 1973-1974. In 1981 the situation has deteriorated far more dramatically with the thrift share falling to less than 5%. This was due to the overwhelming dominance of the money market mutual funds which captured 59% of the deposit market in the first half of 1981 and to the "silent run" on thrifts that has taken place in 1981.

Thus, one must conclude that the introduction of the MMC and the SSC has not been the major tool for retaining deposits funds that many people had hoped. As a result, this piecemeal deregulation has not been successful in terms of retaining deposit share for the thrifts.

The partial deregulation of deposit accounts has also had, in the short run, some very negative consequences on the existing set of institutions. By raising the cost of funds and shortening the deposit maturities, thrift institutions have been put in a severe profit squeeze due to the predominance of fixed rate mortgages in their portfolios. This has obviously greatly reduced their effectiveness as mortgage lenders.
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*The figures do not add to 100 percent because of the decline in demand deposits and currency of 10 billion dollars.
Figure 8 shows the dramatic drop in the estimated maturity of deposit liabilities from the early 1970s.* The introduction of the money market certificate is the major factor behind the decline in the average maturity of deposit liabilities from 450 days in the early 1970s to less than 200 days in 1981. Since the MMC was the only consistently "deregulated account" yielding close to a market return, consumer deposits have become concentrated in this account, thus increasing the portfolio imbalance of savings and loans.

The other consequence of this deregulation process is that the cost of retail deposit funds has risen substantially as the proportion of unsophisticated savers willing to accept below-market rates of return declines. Figure 9 illustrates the percentage of deposits at savings and loans earning at least 2% less than market rates over the past decade. The sharp reduction in the percentage of deposits earning less than market rates during 1975 to 1978 was due to the low level of market rates rather than a change in the structure of deposits. By early 1982 less than 25% of deposits will be in below-market rate accounts (passbooks and old fixed rate certificates).

The extent of "subsidy" to thrifts from the continued existence of below market rate accounts is shown in Figure 10. As the share of deposits below market rate accounts decline, the "subsidy" to thrifts falls to the 100-150 basis point range by late 1982.

The one exception to the move to market-rate accounts is the All Savers Certificate. In the search for a mechanism to alleviate a complete collapse of the regulated thrift industry, the "All-Savers"

*The following maturity assumptions were made:

Passbook account = 1 day
all other accounts = 1/2 of stated, original maturity.
ESTIMATED MATURITY OF DEPOSIT LIABILITIES
"DUMB SAVER" ACCOUNTS
PERCENT OF DEPOSITS EARNING
SIGNIFICANTLY LESS THAN MARKET
RATES AT CALIFORNIA S&Ls
Figure 10

EXTENT OF "SUBSIDY"

PERCENT DIFFERENCE ON COST OF SAVINGS

%}

3.00

2.50

2.00

1.50

1.00

0.50

0.00

73 74 75 76 77 78 79 80 81 82 83
provision (ASC) was included in the tax bill signed in August 1981. The ASC is a one-year certificate of deposit, with the interest on the deposit tax-free up to a maximum of $1,000 for a single person and $2,000 for a married couple. Only regulated financial institutions can offer this certificate, thus excluding competition from money market mutual funds. The interest rate of the ASC is pegged to 70% of the latest "investment yield" on the most recent one-year Treasury note auction. The rate is fixed for the one-year holding period of the note. Early withdrawal of the principal results in a loss of tax exemption.

In essence, the ASC allows the thrifts and commercial banks to pay an above-market rate of return to upper-middle income taxpayers at below-market costs. It is our view this partial "reregulation" of the deposit market is a temporary and costly aberration in the deregulation process. Only extraordinary conditions would lead to its renewal at the end of 1982.

Deposit Rate Setting During the Transition Period

The DIDC has exacerbated the transition problem of the thrifts by a number of hastily implemented and often contradictory actions. The rates it has set for MMC, passbook, small saver, and IRA and Keogh accounts have all been subjected to controversy. While in some cases it has facilitated the deregulation process, in others the actions the DIDC has taken or neglected to take have been misguided, or at least subject to question.

The most obvious need for changes during the transition period revolve around the type of deposit accounts offered and the interest
rate that can be paid on these accounts. A major mistake made in
the deregulation process has been the failure of regulators to offer
long-term deregulated deposit accounts. Until the summer of 1981,
SLAs could not offer long-term market rate accounts resulting in a
substantial worsening of their asset-liability imbalance problem.
On the asset side, there has finally been major deregulation of the
mortgage instruments. However, this deregulation has come far too
late to allow savings and loans to support the volatile short-term
deposit structure forced upon them by regulators and market conditions.
Policymakers responsible for deregulation clearly should have proceeded
on asset-side flexibility prior to, or at least coincident with,
liability-side flexibility. They also should have encouraged and
deregulated long-term liabilities. Their failure to do so has in
large measure created the transition problem faced by thrift institu-
tions.

On the short-term end of the market the regulators also erred in
not letting the thrifts issue a money market mutual fund type account.
The reluctance to authorize such an account is primarily a result of
SLAs resistance because of their fears that existing below market
accounts will transfer to these new accounts. While there is an
element of truth to these concerns, the vast majority of rate sen-
sitive money has already moved to the money market funds, money market
certificates, or Small Savers Certificates. Thus in our view the SLAs
have little additional to fear from allowing a full range of market rate
accounts.

In terms of deposit rate setting the deregulation process has been
deficient in two ways. First, the long lag time used in setting
SSC and ASC rates has at times created major distortions in available
rates relative to current market conditions. This, in turn, has created at times inappropriate incentives for both institutions and individuals. In order to alleviate this pricing problem during the transition, we suggest that the DIOC set rates for all account types each week based on current government yield curves.

Another difficulty with the rate setting process relates to the way the All Savers Certificate is advertised and perceived by the consumer. Since it is a tax exempt account, emphasis on the net return presents the account in its worst form relative to other investments. It would be far better to highlight various "gross-up" returns, though this might require some legal rulings. The "gross-up" return provides a far more accurate comparison of the advantages of a tax free account.

As we move into 1982 it is quite clear that deposit rate competition will be substantially heightened with the introduction of the new "wild card" IRA accounts. The competition of regulated and unregulated financial institutions for these funds is likely to be fierce. Thrifts, without an interest rate differential on deposit accounts, and without the full range of investment alternatives of their unregulated competitors, are unlikely to gain a substantial part of this new pool of personal savings. Their share of IRA deposits is likely to be less than 25%, a poor performance when compared to their 43% share of the old IRA accounts. However, since the IRA account itself is likely to be extremely popular, a smaller share of a larger pool of savings, will still benefit the savings and loans.

Deposit Rate Setting Without Ceilings

As deposit rate ceilings are eliminated on various account types,
regulators and certain sectors of the financial community appear to fear the "predatory competition" that may result. While this argument has been discounted by most regulators and economists, it may, in fact, be an important policy consideration due to other federal interventions in the deposit market. The existence of federal deposit insurance, with rate premiums unrelated to the riskiness of institutions' liabilities and assets, may encourage excess risk taking and "predatory competition" for funds. On the other hand, deposit rate competition should improve the interregional and interinstitutional flow of funds and thus increase the efficiency of the financial intermediary function.

Retail Savings Market in the 1980s

The 1980s will mark the end of an era of cheap retail savings. There will be no more "dumb" savers who are willing to tolerate below-market rates of return. The 30 percent of S & L deposits that are far below market will disappear in the next several years. In part, this will be a result of the aggressive competition of nonregulated financial entities and nonfinancial organizations. The 1980s will see the emphasis of the retail savings market shift to marketing techniques tied to interest rate elasticities, tied sales, and specialized savings accounts (home loan, maxi-rate, and equity kicker accounts). In this environment, behavioral and strategic planning will be critical to the successful savings and loan.

Without interest rate differentials, with increased competition from a wide array of regulated and unregulated financial institutions, and with the advances in and the consumer acceptance of electronic fund transfer systems, the thrifts' retail deposit share will erode.
Their share of deposits at regulated financial institutions will drop from 35% to 31.2% in 1990. Thus, the savings and loan share declines only moderately, and indeed their nominal volume of deposits continues to expand. Table 3 shows the change in deposit shares of regulated financial institutions both historically and for our projection.

However, this measure may overstate the thrifts ability to compete as it excludes growth of money market funds. On the other hand, with the likely introduction of money market fund type accounts at thrifts and commercial banks in the next several years the growth of money market funds will slow.

The 1980s may also see the introduction of a number of new innovative deposit accounts. A floating rate account in which the interest rate is pegged to the Treasury yield curve plus one percent might be attractive to an array of consumers. Such an account might be redeemable prior to maturity at market value or at maturity at face value. Another account type might involve a contractual savings-guaranteed mortgage plan. In return for saving an agreed on sum over say four years at a fixed rate the household would obtain a guaranteed mortgage loan at a fixed rate. Alternatively the government might allow the existing IRA account to be used for first-time home purchase thus creating an Individual Housing Account (IHA).

In conclusion, the retail savings market in the 1980s will be highly competitive and innovative with retail deposit funds available only at a market rate of return. Thrifts, because of their loss of a sheltered environment will continue to lose their share of the retail savings market to their regulated and unregulated competitors.
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Summary

The early 1980s have become the period of the most substantial upheaval in financial markets since the 1930s. The piecemeal deregulation of the savings and loan industry combined with the unprecedented interest rate volatility due to federal mismanagement of monetary policy threatens to turn the deposit deregulation process into a transition crisis.

With this potential crisis looming on the horizon, how can policymakers respond? A strategy for the early 1980s could involve the following elements: 1) Regulators and policymakers must be made to understand the serious nature of the transition problem facing the housing finance system. The problem cannot be avoided by federal policymakers referring to "free market" principles. The problem was created in part by past federal regulations, and a large portion of the $150 billion portfolio loss of savings and loans represents a direct federal obligation due to federal deposit insurance; 2) The Federal Reserve must move away from black box monetarist policies and focus on stabilizing interest rates at reasonable "real" levels; and 3) the Federal government should seriously consider redefining the net worth constraint on SLAs, either by injecting reserves through capital certificates or a direct mortgage warehousing plan. Unless both short and long-term interest rates decline dramatically within the next six months, the promised land of deregulated asset and liability powers will not be seen by a vast majority of existing thrift institutions. If, however, the transition problem can be managed, then the thrift industry will have an important, though somewhat smaller role, in a restructured financial system.
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