

Disintermediation again?

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With interest rates rising since the middle of last year, the possibility of disintermediation has become a matter of growing concern. Disintermediation—the flow of savings out of depository institutions into market instruments—comes mainly from interest rates in money and capital markets rising higher than banks and thrift institutions can pay on time and savings deposits of comparable maturities.

Disintermediation affected savings and loan associations (S&Ls), particularly in 1969 and again in 1973 and 1974, reducing the availability of mortgage loans and curtailing the sale of housing. Large banks were also affected. But because they could draw on money markets for funds, the higher cost of funds was the main effect on them. Having to pay market rates themselves, they were less profitable.

Prospects for disintermediation

Though savings inflows to depository institutions have slowed over the past year—and there is no reason to expect the flow to pick up—effects are not apt to be as serious as four years ago. For one thing, rates are not expected to reach the levels of 1974. Corporate and household liquidity is higher, and the economy is not overheated. For another, with ceilings on rates they can pay on time deposits of six years or more and on government savings deposits up since the end of 1974, banks and thrift institutions like S&Ls are in a better position to compete for savings. In the event of further upward pressure on market interest rates, ceilings might be raised again. Furthermore, fewer deposits are likely to be

pulled out of these institutions than four years ago. More are now in time deposits. And being subject to interest penalty if withdrawn before maturity, time deposits do not flow out of depository institutions as fast as savings deposits. But even among savings accounts, growth of long-term individual retirement accounts authorized by the Employee Retirement Income Security Act of 1974 has increased the proportion of savings that are not likely to be withdrawn when interest rates rise.

Savers, however, have become more sensitive to differences in interest rates. Individuals, for example, absorb more Treasury offerings as rates rise. Also, new vehicles enable the small investors to participate more directly in the money and capital markets. Net sales of shares in money market funds increase, for example, when market rates rise above those paid on savings accounts. And municipal bond funds provide tax-exempt interest for investors in the higher income tax brackets.

Situation in the district

Here, then, is the situation in the Seventh Federal Reserve District since market rates began rising a year ago.

- There has been no net outflow in consumer-type savings at banks and S&Ls.

- The increase in passbook savings at member banks slackened to 8 percent last year, compared with an increase of 20 percent the year before.

- Savings flows to banks weakened before flows to S&Ls, the difference probably being due to the lower ceiling rates allowed at banks.

- Business passbook savings at large banks began declining in the second quarter last year, when rates on large CDs moved above the ceiling rate on passbook accounts.

- Savings flows to S&Ls weakened noticeably in the fourth quarter as the market yield on three-month Treasury bills moved above 6 percent.

- Savings flows to S&Ls dropped sharply in January, when Treasury yields moved up 27 to 37 basis points over December levels.

- Purchases of shares in money market funds have increased sharply since the end of the year.

- Purchases by individuals of Treasury note offerings have not increased markedly when average yields are below 8 percent.

Market interest rates

Treasury yield curves provide a useful indicator of the interest rates available to investors on alternative market instruments. Rates paid on Treasury securities can be compared with interest rates allowed on time deposits of comparable maturities.

Not only do interest rates rise and fall over the interest rate cycle, but the shape of the yield curve changes. At the low point in

the cycle, the yield curve usually slopes sharply upward. During recovery, short-term interest rates increase faster than long-term rates. The yield curve generally flattens, and may even become negative with short-term rates exceeding long-term rates.

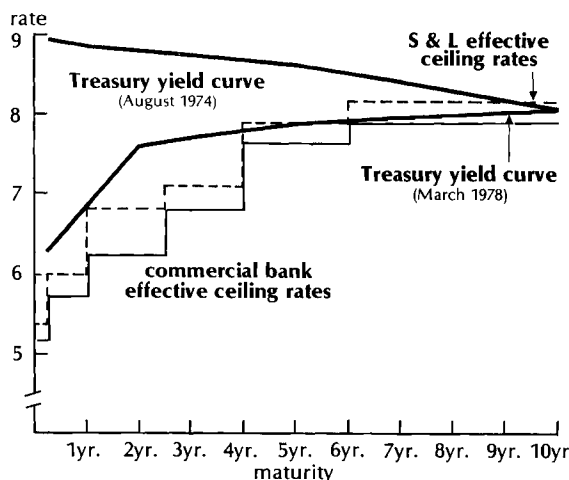
Given the ceiling on interest rates banks and thrift institutions can pay on time and savings deposits of specified maturities, rates on market instruments have to rise more to become competitive with rates on longer-term time certificates. The result is what might be called *fractional disintermediation*, meaning that when the maximum interest rate that can be paid on a specific maturity of time deposit at a depository institution is lower than the interest rates on market instruments of comparable maturity, savings deposits of that maturity become vulnerable to disintermediation.

Disintermediation in 1973-74

Of depository institutions in the Seventh District, large banks and S&Ls were affected most by the sharp rise in market rates in 1973 and 1974. In the 12 months ending October 1974, consumer-type savings deposits at member banks in the district rose only 2 percent. But at 30 percent of the banks with total deposits of \$100 million or more, there was a decline in this type of savings. More than two-thirds of the increase in total time and savings deposits at the big banks was in large certificates of deposit (CDs), which are exempt from rate ceilings. Over the same period, insured S&Ls in the five states of the district saw a net gain of 6 percent in savings accounts. All the increase, however, was in accounts paying more than the regular passbook rate, which rose 14 percent. The amount outstanding in regular passbook accounts declined 2 percent.

Despite the overall increase from October to October, S&Ls in most areas had substantial net outflows for several months. In almost all areas, the decline was in passbook savings, with the biggest and most prolonged outflow occurring in large metropolitan areas. Associations in the Chicago and Detroit

As market interest rates rise, more deposits become vulnerable to disintermediation



areas were particularly hard hit.

The big decline in savings deposits at S&Ls came in the third quarter of 1974. August showed the largest net outflow of any month in the period. The Treasury yield curve, having turned negative, was well above the ceiling rates on S&L savings and time deposits of all maturities.

Flows weaken early at banks

About mid-1977, as Treasury bill rates moved above the effective maximum rate of 5.20 percent that banks can pay on passbook accounts, savings flows into these accounts owned by households began to weaken at banks in the district. During the first half of the year, the amount outstanding at banks rose at an annual rate of 12 percent. In the second half, the increase was only 4 percent.

The weakening was more pronounced at the larger banks. At banks with deposits of less than \$100 million, household savings in passbook accounts were up at annual rates of 15 percent in the first half and 7 percent in the second. At banks with deposits of \$500 million or more, these savings were up at an annual rate of 12 percent in the first half but declined at a rate of 3 percent in the second half.

Weakness in the flow of business savings into passbook accounts became evident at the large banks in the second quarter of 1977. The total amount outstanding at banks with deposits of \$500 million or more began declining as rates on large negotiable CDs rose above the 5 percent passbook ceiling rate in May. At banks of less than \$100 million, where more of the business regular savings accounts are probably less than the \$100,000 required to buy a negotiable CD, which is exempt from ceilings, the amount outstanding increased all year. But the gains were slower in the second half.

The large weekly reporting banks in the district showed a decline in small time deposits (those less than \$100,000) starting with the third quarter. Although market interest rates had begun to rise, the early outflow primarily reflected the maturity of four-year so-called "wild card" certificates issued

during a four-month period in 1973 when ceiling rates were suspended. Interest-sensitive money that had come into banks for the higher rate in 1973 left in 1977 for the higher rate available at S&Ls. The decline in small time deposits continued through the end of the year as market interest rates rose. Holdings of large CDs at the weekly reporting banks rose rapidly in the last half of the year, moving up from the low reached in the second quarter as banks replaced declining savings and small time deposits with funds from money market sources.

Smaller banks in the district are less able to substitute money market funds for slower growing savings and small time deposits. Total time and savings deposits owned by individuals, partnerships, and corporations at district banks with deposits of less than \$100 million rose at annual rates of 14 percent in the first half and 8 percent in the second half. Being less able to turn to money markets for funds, banks of this size are probably affected more seriously by rising interest rates than large banks, especially if they have already had a substantial expansion of loans.

Strength in time deposits at S&Ls

Savings flows to S&Ls did not begin to slow noticeably until the three-month Treasury bill rate rose above 6 percent in the fourth quarter of 1977. Until then, effective ceiling rates were competitive enough with market interest rates, and S&Ls benefited from July to October from inflows from wild card certificates maturing at banks.

Since July 1973 S&Ls have been allowed to offer higher rates on time certificates of four years or more. For that reason, more of their savings inflows have been into higher rate time deposits, which are subject to penalty if withdrawn before maturity.

According to Federal Home Loan Bank Board (FHLBB) estimates, in June 1973 about half of the savings deposits at S&Ls nationwide were in accounts earning more than the regular passbook rate, and more than three-fourths of these deposits were in certificates with maturities of two years or more, which

made them eligible for the maximum rate of 6 percent. From mid-1973 through the end of 1977, total savings deposits at insured S&Ls increased 76 percent. Three-fourths of the increase, however, was in time deposits paying more than the regular savings rate. As a result, 62 percent of the total savings at S&Ls are now in time deposits subject to penalty if withdrawn before maturity.

The latest FHLBB semiannual survey of S&L account structure shows that last September more of the time deposits were in longer maturity accounts than before. Of the time certificates of less than \$100,000, 67 percent paid over 6.75 percent interest and, therefore, had original maturities of four years or more. Of all small time certificates, 56 percent were not due to mature for at least a year.

The higher ceiling rates since 1973 and the larger proportion of longer-term time deposits have reduced the vulnerability of S&Ls to disintermediation. Recent experience suggests, however, that savings inflows continue to decline as market rates move above the maximum rates allowed on additional maturities of time deposits. Savings gains at S&Ls dropped sharply in January 1978, when Treasury yields rose 27 to 37 basis points above December yields and rates on Treasury securities moved above the ceilings S&Ls are allowed to pay for maturities of less than four years. The amount outstanding in regular passbook accounts declined, and all the gain was in deposits earning more than the regular rate.

Where the money goes

Individuals have tended increasingly in recent years to invest in money and capital markets when interest rates rise. They have become more aware of the higher rates

available on alternative investments. And new vehicles have been developed to encourage savers to invest directly in the markets.

In the past, purchases of newly offered Treasury notes and bonds by individuals increased substantially when the average yield approached 8 percent. The preference at higher rates has been for seven- or ten-year notes. From August 1976 through the end of last year, the highest average yield on a Treasury note offering was 7.69 percent, and individual purchases of Treasury securities did not increase much. More recently, higher rates have generated additional individual participation.

When short-term interest rates rise, the purchase of shares in money market mutual funds provides an attractive alternative to savings at depository institutions. These funds expanded rapidly in 1974, increasing about \$360 million a month during the second half of that year and the first quarter of the next. The rate investors earned depended on the rates on the assets of the funds, primarily CDs, Treasury bills, bankers' acceptances, and commercial paper. Recently, as rates on these short-term instruments have risen, total assets of money market funds have again begun to strengthen. According to a survey by the Investment Company Institute, assets of money market funds on March 10, 1978 were up a total of \$1.27 billion since the first of the year. That was an increase of 15 percent.

Assets of municipal bond funds have also grown rapidly, spurred mainly by the pass-through of tax exempt interest authorized by the Tax Reform Act of 1976. Although a record \$45 billion in new issues was offered to the public in 1977, rates have risen much less than other long-term rates. Assets of municipal bond funds, nevertheless, increased \$1.7 billion last year, and they increased another \$250 million in January 1978.