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Recent Experience and the Traditional View

&
Upward Biases in Government Spending?

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A New Phase for Regulation Q

NOVEMBER-DECEMBER 1978
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A Commentary by Edward G. Boehne

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AND THE TRADITIONAL VIEW
Howard Keen, Jr.

... Recent studies show that cutting dividends may not hurt banks nearly as much as many bankers have feared.

UPWARD BIASES IN GOVERNMENT SPENDING?
Anthony M. Rufo

... In principle, cost-benefit analysis should improve government spending decisions, but difficulties in carrying the analysis through may produce a tendency toward overspending.

The BUSINESS REVIEW is published by the Department of Research every other month. It is edited by John J. Mulhem, and artwork is directed by Ronald B. Williams. The REVIEW is available without charge. Please send subscription orders, changes of address, and requests for additional copies to the Department of Public Services at the address or telephone (215) 574-6115. Editorial communications should be sent to the Department of Research at the same address or telephone (215) 574-6426.

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COMING:
A NEW PHASE FOR REGULATION Q

By Edward G. Boehne, Senior Vice President
Federal Reserve Bank of Philadelphia

The authority for placing interest rate ceilings on time and savings deposits at commercial banks and thrift institutions, generally referred to as Regulation Q, is due to expire in December. Although renewal has become almost routine, there is still a good deal of concern about what the longer run future holds. Will the differential be eliminated? Will ceilings be phased out? There is a tendency to forget that Regulation Q is not what it once was nor is likely to be in the future what it is today.

PHASE I

Phase I began with the inception of Regulation Q in the 1930s and runs to the 1950s. The original philosophy of interest rate ceilings was to protect the banking system from unprofitable rate competition by limiting what could be paid on deposits. "Destructive" rate competition in the 1920s was believed by many to have helped precipitate the bank failures of the 1930s, although later research has failed to substantiate this claim.

PHASE II

Phase II runs up to the mid-1960s. Regulation Q ceilings in this period were thought of more as an instrument of monetary control, a dusted-off tool for the new era of active countercyclical policy. Bank credit could be limited, it was reasoned, if banks were kept from competing for funds during periods of monetary restraint. Bank credit, indeed, could be limited, but total spending could not, because alternative sources of credit were used to circumvent Regulation Q. Mortgage credit, in addition, was hard hit by the combination of rising interest rates and rate ceilings, thus raising the social and economic cost of monetary restraint.

PHASE III

Phase III dates from these lessons of the
mid-1960s. Since then, interest rate ceilings on time and savings deposits have been associated more with helping housing by making mortgage money available at thrift institutions. A big step in the evolution of Regulation Q was the general realization that housing and homeowners could be helped more by letting ceilings rise rather than by holding them down during periods of credit restraint. Higher ceilings allow thrifts to pay more competitive rates and to increase the supply of funds to mortgage borrowers. Higher rate, available mortgages finance more houses than lower rate, unavailable mortgages.

Higher Q ceilings, however, raise costs for thrift institutions substantially faster than thrifts themselves are able to raise revenues. Unlike commercial banks, which generally have more diversified loan portfolios with shorter maturities, thrifts mainly have fixed-rate mortgages with lengthy maturities. The unhappy tradeoff with ceilings in Phase III has been between protecting the strength of thrift institutions and maintaining an adequate flow of mortgage funds. Too high a ceiling (or no ceiling), it is argued, weakens thrifts, and too low a ceiling causes mortgage funds to dry up.

Most of the changes in Regulation Q during the past dozen years, plus some other government programs to support home financing, have been aimed at trying to strike a better balance between ceilings that are “too high” and those that are “too low.” Ceilings have been raised (eliminated for large denominations), maturities for time deposits lengthened, special certificates introduced, direct lending to thrifts substantially increased, and a thriving secondary market for mortgages developed, among other actions. As a result, mortgage funds have not evaporated and housing has fared much better during the current period of rising interest rates than during similar periods in the past. In addition, the wider variety of savings instruments at thrifts and banks has enabled the small saver to take better advantage of higher yields.

**PHASE IV**

Phase III is fading into a new Phase IV as financial institutions become more homogenized. As now written, Regulation Q allows thrift institutions to pay a premium rate on most time and savings deposits. The justification for this differential is that thrifts need an advantage in order to compete with banks that traditionally have offered a wider variety of services. To the extent that thrifts gain broader lending powers and what amount to checking accounts, the case for preferential treatment diminishes. It would make more sense, if one is searching for a rationale, to grant preferential treatment on the basis of the share of residential mortgages in the loan and investment portfolio than on the legal type of institution. It is, after all, the availability of mortgage financing that society wishes to favor and not a particular competitive relationship between financial institutions whose differences are rapidly eroding.

**PHASE V**

Beyond the elimination or modification of ceiling differentials, some might envision a Phase V—the complete disappearance of interest rate ceilings. All this tinkering with ceilings has been anathema to those who favor unfettered markets. Perhaps the logic of market economics over the longer pull will prove compelling and Regulation Q will be dropped, especially as thrifts become more adaptable to fluctuating interest rates. When it comes to money and housing, however, people have a habit of placing less than full trust in the unregulated marketplace. Phase V would appear to be a considerable distance away.