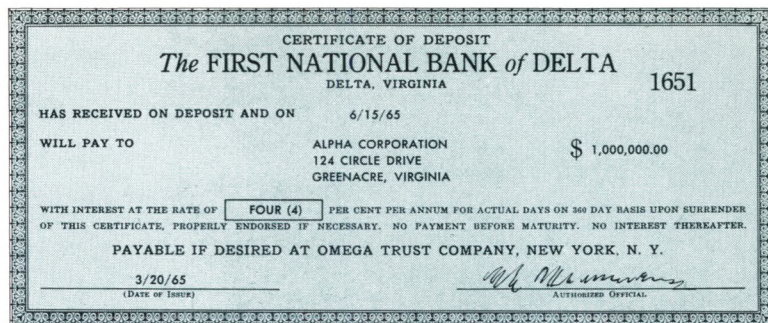


# NEGOTIABLE CERTIFICATES OF DEPOSIT



In February 1961, the First National City Bank of New York announced that it would issue negotiable certificates of deposit in large denominations, and that a major Government securities dealer had agreed to make a market in them. Other money market banks and dealers quickly followed suit, thus preparing the way for the spectacular growth of this new money market instrument.

A negotiable certificate of deposit, or CD, is a marketable receipt for funds deposited in a bank for a specified period at a specified rate of interest. The owner of the CD at the time of its maturity receives both principal and interest, while its readily salable feature enables the original purchaser to retrieve his funds before maturity by selling the instrument to another holder. Time certificates did not originate in 1961, but prior to that time they represented primarily savings-type deposits and were generally not negotiable due either to explicit or tacit agreement or to the absence of a secondary market. Before 1961, about \$2.7 billion of these instruments were outstanding at all member banks, with only about \$29 million representing obligations of New York banks. In contrast, today's CD market is dominated by the nation's largest banks, particularly those in New York, and their corporate customers.

**Background** Although traditionally loath to accept corporate time deposits, New York banks were forced by converging postwar economic and financial developments to reconsider their policy. The competitive position of these banks deteriorated during this period, partly because of the slower rate of population growth in the northeast than elsewhere and partly because of the trend toward industrial decentralization. Of still greater significance was the loss of demand deposits which resulted from the increasing sophistication of corporate treasurers in managing their cash balances. As short-term interest rates rose, the accumulation of temporarily excess cash in demand accounts became more and more costly. Consequently, corporations began economizing cash balances and seeking liquidity

through investments in such money market instruments as Treasury bills, commercial and finance paper, and repurchase agreements with dealers. This caused New York banks, which are the principal depositories of large corporations, to experience a further reduction in their share of total member bank deposits, which fell from 31% to under 17% between 1940 and 1960.

The negotiable CD was designed specifically to attract corporate deposits and to enable banks to compete more effectively for short-term funds. Hence its immediate popularity with the New York and other money market banks. Between December 1961 and the end of 1964, the volume outstanding at weekly reporting banks increased 352%. By the close of last year the volume outstanding was nearly \$13 billion, larger than the combined volume of bankers' acceptances and prime commercial paper, and second only to Treasury bills among money market instruments.

**CD Characteristics** CDs may be in registered or bearer form, although the latter is more convenient for secondary market trading. Denominations range from \$25,000 to \$10 million, depending on the size of the issuing bank and the type of CD customer it is trying to attract. Large New York banks seldom issue a CD of less than \$1 million. By setting a high minimum they hope to attract only those funds which are already destined for the money market. Smaller denominations could encourage the conversion of normal corporate demand balances to CDs, with no resulting benefit to the issuing bank. The CD maturity date is chosen by the purchaser to fit his cash needs and may range from one to about eighteen months. A survey taken last November showed that almost 74% of total CDs outstanding matured within the four months which included the December and March tax and dividend dates.

Interest is paid on the certificate's par value and accrues on a 360-day basis. The actual rate is, of course, determined by current money market conditions and is competitive with yields on other short



term instruments. In general, a CD must yield about 25 basis points more than Treasury bills of comparable maturity to attract investors. Certificates bearing popular maturity dates, such as tax and dividend dates, may yield as little as 10 basis points more, however. The size of the issuing bank and the denomination of the certificate also influence the rate. CDs smaller than \$1 million, for instance, will usually carry a higher rate than larger CDs of comparable maturity. The 20 or so largest, "prime-name" banks can ordinarily issue CDs bearing lower rates than those of smaller banks which are not widely known. The latter must usually pay  $\frac{1}{8}$  to  $\frac{1}{2}$  of 1% above the prime CD rate to attract funds.

**Regulation Q** The Federal Reserve's Regulation Q, which sets the maximum rates payable on time and savings deposits, is a fundamental consideration in the market for CDs. When short-term open market rates rise above, or even approach, the prescribed ceiling, CDs cease to be competitive. Bankers find it increasingly difficult to replace maturing certificates and are likely to experience large deposit losses as investors turn to higher yielding instruments. This in turn may compel banks to make compensating reserve and portfolio adjustments which may be especially costly in the face of rising interest rates.

Since 1957, however, Regulation Q has been revised three times in order to allow CD rates to keep pace with rising yields on other short-term investments. The latest revision, which was concurrent with the discount rate hike in November 1964, increased the maximum rate on maturities of 90 days and over from 4% to  $4\frac{1}{2}\%$  and boosted the maximum for 30-to-90 day instruments from 1% to 4%.

**Primary Market Supply** Many factors figure in bank decisions regarding the issuance of CDs. Among them are: (1) the profitability of investment outlets for the new funds, and (2) the outlook for renewals at maturity. Most banks establish a flexible limit on total CDs issued. This limit may be expressed in dollars or, more likely, as a per cent of total deposits.

Although a bank will often negotiate with a large or important lender, it usually has a set of "base rates," expressed in eighths, for various maturities. The bank adjusts these rates according to its eagerness for new deposits, and a very small change often results in appreciable increases or decreases in deposits. Most large money market banks will issue CDs to any corporation, bank, or organization, other than brokers and dealers, without having had any previous relationship with the depositor. Indeed,

CD sales may afford the bank the opportunity to acquire new customers. A bank may refuse to issue a CD if the deposit consists of funds which would otherwise constitute the corporation's normal demand account.

Although CDs are issued by banks of all sizes throughout the country, 67% of the total outstanding at the end of 1964 originated in the New York, Chicago, and San Francisco Federal Reserve Districts, which contain the majority of prime-name banks. New York City alone accounted for 36% or \$4,556 million. Federal Reserve surveys indicate that the CDs of New York and Chicago banks are widely held by corporations for tax and dividend reserve purposes.

**Primary Market Demand** Nonfinancial corporations dominate the demand side of the CD market. On December 5, 1962, for example, they owned an estimated 70% of the outstanding volume of CDs. States and political subdivisions held about 16%, and foreign governments, central banks, individuals, and others owned the rest. This distribution reflects the appeal of the CD to corporate treasurers who are interested in maximizing returns on their liquid balances.

Like banks, corporations usually set flexible ceilings on their CD holdings, often limiting them to a per cent—commonly 25% to 33%—of their Government security holdings. In addition, a corporation may set a limit on total holdings of a particular bank's CDs. Some corporations prefer the certificates of banks with which they maintain other important accounts or credit lines. Others seek a more impersonal approach and limit themselves largely to prime CDs. Purchasers try to avoid maturity dates falling on a weekend or holiday so that income will not be sacrificed before the funds can be reinvested.

**VOLUME OF SELECTED MONEY MARKET INSTRUMENTS OUTSTANDING AT YEAREND**  
(\$ millions)

Date	Negotiable Certificates of Deposit* (\$100,000 and over)	Prime Commercial Paper	Bankers' Acceptances	Treasury Bills
1960	796	4,497	2,027	39,446
1961	2,782	4,686	2,683	43,444
1962	5,442**	6,000	2,650	48,250
1963	9,579	6,747	2,890	51,539
1964	12,583	8,361	3,385	56,476
Percentage Increase	1,481%	86%	67%	43%

\* Data cover all weekly reporting member banks.

\*\* December 5 data.

Sources: Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York, and U. S. Treasury Department.



If a corporation is absolutely sure it will not need its funds prior to maturity, it may purchase CDs from a smaller regional bank and thereby obtain a higher rate. As a rule, corporations use Treasury bills in adjusting their cash positions, with certificates providing second-line liquidity.

**Secondary Market** Although most original purchasers hold their CDs to maturity, the existence of an organized secondary market is of vital importance to prime-name banks in attracting corporate funds. Participants in this market show a marked preference for prime CDs, chiefly because of their greater marketability. Corporations may enter the market at any time: on the selling side when they wish to raise cash or to realize a profit, or on the buying side when they want maturities shorter than can be acquired in new issues. The increasing importance of the secondary market is evidenced by its rapid growth in recent years. In 1964, dealers' daily positions in CDs averaged \$226 million, or almost 2% of the average volume outstanding, and daily transactions averaged \$57 million.

The heart of the secondary market is located in New York City. Since many of the largest corporations have accounts at New York banks, transactions between dealers and customers can be conducted with ease. CDs of out-of-town banks are frequently issued and redeemed through their New York correspondents. This saves the investor the trouble and expense of presenting them in another city and thus enhances their marketability. New York City money market banks will lend funds to dealers against CDs at the same rate as for call loans secured by Government securities. Regulation Q permits a bank to extend a loan against its own CD, but only at a rate 2% in excess of the rate on the instrument. In no case, however, may a bank purchase its own CD in the secondary market.

Dealers rarely trade in "non-prime" CDs or in those in smaller denominations than \$1 million. Rates fluctuate in response to money market conditions. Transactions may be either for immediate or regular delivery, but the former predominates since payment is usually in Federal funds. A dealer will bid more aggressively for CDs if he thinks rates will fall and this helps to narrow the spread between bid and asked quotations, as well as between certificate and bill rates.

It seems unlikely that the CD market can achieve the smooth functioning of the Treasury bill market at any time in the near future. A main reason for this is the large degree of heterogeneity among CDs as compared with bills. While large blocs of Treas-

ury bills represent a homogeneous asset type with common rates, maturities, denominations, etc., the CD is likely to come in a greater variety of contractual terms. Thus the feature that makes the CD an effective fund-raising device for bankers also impedes large-scale secondary trading. Issuing banks will rarely split or consolidate certificates to aid secondary market transactions.

**Effect of CDs on Other Interest Rates** The development and success of the negotiable CD has significantly increased the flexibility with which the aggregate stock of money market instruments can expand and contract in response to changing demands. This, in turn, contributes to greater stability of short-term rates. For instance, if an increase in corporate cash flow pushes short-term rates down, bankers may be willing to issue more CDs, thus increasing the supply and thereby mitigating downward rate pressures. This more or less automatic response of supply to rate trends would also occur in opposite circumstances, thereby lessening upward pressures.

The 50.7% increase in time deposits (excluding interbank) of all commercial banks in the last three years, compared with a 28.5% increase in the three preceding years, can be attributed in large part to the growing use of CDs. In order to maintain the profitability of these accounts, banks lengthened the average maturity of their portfolios of Government securities and turned to mortgages and tax-exempts. This, in turn, contributed to the maintenance of relatively stable long-term rates in the face of a concurrent rise in short rates.

**CDs and Reserve Adjustment** The growth and development of the CD market has provided banks with another means of reserve adjustment. In addition to borrowing from the Federal Reserve, buying Federal funds, or liquidating short-term assets, a bank may now acquire additional funds by simply raising its rate payable on CDs provided, of course, that there is room under the ceiling set by Regulation Q. Thus far, this technique has been used primarily by money market banks. Since owners of short-term funds are responsive to interest rate differentials, banks have been known to acquire millions of dollars of new deposits in a single day by this method. Normally this approach would be used to adjust only those reserve imbalances which do not seem to be of a strictly temporary nature. Banks also make use of the secondary market in adjusting reserve positions, by trading in CDs of other banks in much the same fashion as they trade in the markets for other secondary reserve assets.