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THE DEPOSITORY INSTITUTIONS DEREGULATION ACT

S. 1347

On April 20, 1979, the U.S. Court of Appeals for the District of Columbia ruled that the Federal Home Loan Bank Board, the National Credit Union Administration, and the Federal Reserve Board had exceeded their legal authority in promulgating regulations that allowed a) savings and loan associations to deploy remote service units (RSU's); b) federal credit unions to issue share drafts; and c) commercial banks to engage in automatic fund transfers. The court stayed the suspension of these bank services until January 1, 1980, and called for congressional review and legislative action in the interim.

On September 11, 1979, the House passed, by a 367-39 vote, the Consumer Equity Act of 1979. Introduced by Representative Fernand J. St. Germain (D-RI), H.R. 4986 permits commercial banks, savings and loan associations, and mutual savings banks to offer interest-bearing checking accounts, known as negotiable orders of withdrawal (NOW), beginning September 30, 1980. The bill also authorizes federally insured credit unions to offer share drafts, an equivalent of NOW accounts. In addition, the bill explicitly sanctions the remote service units and automatic transfer accounts ruled illegal earlier this year.

THE DEPOSITORY INSTITUTIONS DEREGULATION ACT

Senators Alan Cranston (D-Calif.) and William Proxmire (D-Wisc.) have presented the Senate with a similar bill, S.1347, the Depository Institutions Deregulation Act. Commercial banks, savings and loans, and mutual savings banks would be authorized to offer NOW accounts. Credit union share drafts would also be permitted. The Senate bill, just as H.R. 4986, limits the use of NOW accounts to individuals or non-profit organizations. Businesses would not be permitted to open NOW accounts.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

Unlike the House bill, S.1347 fails to address the questions of RSU's and automatic transfers raised by the Court of Appeals decision. The Depository Institutions Deregulation Act also calls for the gradual elimination of Regulation Q, a measure which permits the Federal Reserve to set a ceiling on the interest rate paid on savings deposits. Mark-up of S.1347 is scheduled for September 18.

This paper will focus primarily on the efficacy of the nationwide introduction of NOW accounts and the impact of the elimination of Regulation Q.

NOW ACCOUNTS

The payment of interest on checking accounts was first prohibited by the Banking Act of 1933. At that time it was believed that excessive interest rate competition between banks had helped precipitate the bank failures of the early 1930s. Although subsequent research has disproved this hypothesis, the ban on interest payments persists.

In response to intensive competition for deposits, financial institutions began to develop innovative programs to circumvent the proscription against interest-bearing checking accounts. Federal regulatory agencies often sanctioned these innovations through sympathetic rulings. Congress, in 1974, aided these efforts by authorizing NOW accounts in New Hampshire and Massachusetts. The rest of New England and New York were later included in the experiment.

The case for the extension of NOW accounts rests primarily on the question of equity. Opponents charge that, if permitted, NOW accounts would prove too costly for many banks. They anticipate that a few large banks, which can afford to offer NOW accounts, will eventually dominate the entire banking industry.

Savers and Equity

The current prohibition on interest-bearing demand-checking accounts deprives savers of the opportunity to earn the market value of their money. To illustrate, consider the fact that savers have approximately eighty billion dollars deposited in checking accounts. If they earn a five percent rate of interest per annum, they would earn four billion dollars of interest. The loss of this interest represents a real decrease in the goods and services that savers can command with their resources. In addition to this loss of income, savers suffer an opportunity cost when they forego the current use of their money. Inflation and service charges compound these costs so that savers actually earn a negative rate of interest.

There is little economic justification for the prohibition against the payment of interest on checking accounts. Depositors

provide the financial resources that financial intermediaries (banks, savings and loans, and credit unions) utilize to make loans and earn a profit. The ban on interest payments on checking deposits is in effect a subsidy to the banks. Federal regulation prohibiting interest payment on checking accounts not only deprives depositors of payment on the use of their personal resources but also protects inefficient financial institutions by ensuring a profit.

Both H.R. 4986 and S. 1347 are inconsistent in their treatment of depositors. Individuals and non-profit organizations are eligible for NOW accounts; businesses are not. Banks, however, utilize business deposits in the same manner as they do individual deposits. Just as individuals should be paid for the use of their resources, so should businesses.

Costs to Banks

The first of the objections raised by opponents of interest-bearing checking accounts is that such a practice would be prohibitively expensive for banks, particularly smaller ones.

It is important to realize that the bills would merely permit banks to offer NOW accounts. There is no requirement that they do so. It can be anticipated that the more efficient banks, earning larger profits, would be able to offer NOW accounts. Thus, NOW accounts would aid in directing financial resources to their most effective use.

Furthermore, although industry-wide date are not available, the experience of some New England institutions with NOW accounts is enlightening. First Federal Savings and Loan of Nashua, New Hampshire, has increased its profits from $34,493 in June of 1975 to $59,817 in December 1977 to $61,490 in May 1979. As of May 1979, the association had 7,063 NOW accounts with an average balance of $898 for a total of $6,339,242. It should be noted that the annual cost per account in 1979 was only $71.52.

A second criticism is that interest-bearing checking accounts will cause higher service charges which will result in greater costs to savers. The New England experience contradicts that charge.

Table 1
New England NOW Account Experience

Commercial Banks (New England)	$8,683,000	-- Interest Paid on NOW accts.
	$ 323,000	-- Imposed for Service charges
Municipal Savings Banks	$4,056,000	-- Interest Paid on NOW accts.
	$ 219,000	-- Imposed for Service charges
S & L's	$1,755,000	-- Interest Paid on NOW accts.
	$ 96,000	-- Imposed for Service charges

In November 1978, savers at New England commercial banks paid service charges of $323,000 and earned $8,683,000 in interest for net benefits of $8,360,000. At New England municipal savings banks and savings and loans savers earned a net of $3,837,000 and $1,659,000 respectively.

Although the minimum balance requirement of $300-500 that many New England institutions require may be too high for some depositors, NOW accounts are a supplement, not a substitute, for the current checking accounts. NOW accounts are simply an additional option available to both depositors and banks.

A third criticism is that the payment of interest on checking accounts will lead to wild swings in the money supply. This would disrupt Federal Reserve efforts to implement monetary policy.

Again the New England experience refutes the charge. From mid-1978 to the end of April 1979, interest rates in the open market were higher than the rates depository institutions were allowed to pay on time and savings deposits. The result was disintermediation -- the shifting of funds out of financial intermediaries into corporate, municipal and government securities.

During this time, NOW accounts were one of the most stable components of the deposit structure. Instead of a decrease in NOW accounts at savings and loans, the accounts increased by $200 million. This compares quite favorably with the drastic outflows in outstanding amounts in other types of accounts -- $10.7 billion in savings deposits and $5.3 billion in fixed rate time deposits.

Megabanks

The final criticism of interest-bearing checking accounts is that small banks will not be able to offer such financial services on a competitive basis. Critics foresee a future in which small community banks will be swallowed up by the banking giants.

Again, the New England experience suggests that this scenario is unlikely. There have not been an unusual number of failures among the New England depository institutions.

Secondly, if certain banks do fail because of the extension of NOW accounts, it will be because they are less efficient and unable to compete. Megabanks are feared not only because of their size but because it is believed that they are unresponsive to communities. Since there are few natural barriers to entry in the banking market, it can be expected that unresponsive megabanks will be challenged by new banks responding to the communities' needs. Competition may reduce the number of banks, but competition will also ensure the availability of valued services.

REGULATION Q

The authorization of NOW accounts is only a small part of the comprehensive plan for banking deregulation outlined in S. 1347. In addition, the bill provides for the gradual elimination of Regulation Q interest rate ceilings, expansion of asset powers for thrifts, permission for thrifts to act as fiduciaries, and preemption of state usury laws on mortgage loans.

Beginning January 1, 1982, Reg. Q ceilings will be escalated at the rate of 1/4 percent every six months, until January 1, 1999, at which time they will expire. During this period, regulators will have emergency powers to postpone escalation of ceilings in the event of a serious economic crisis, as well as powers to reinstate ceilings following the expiration date. Congress will monitor the effects of these provisions by requiring annual reports on the viability of thrift institutions, and notification by regulators if acceleration of rate escalation is deemed possible. The purpose of this provision is to improve the position of thrift insitutions in the struggle over loanable funds.

Mortgage loans and deposit accounts are exempted from state laws which limit interest rates. States can remove themselves from coverage by enacting a law to such effect within two years after the effective date of this bill.

Savings and loans will be given authority to make consumer loans, hold commercial paper, corporate debt securities and bankers' acceptance up to the point where the aggregate amount of such loans and investments does not exceed 10 percent of their assets. These new powers, in combination with the recently authorized ratification of alternative mortgage instruments - Variable Rate Mortgages (VRM's) and graduated rate mortgages - give thrifts more flexibility and increase their ability to compete.

<u>Origins of Regulation Q</u>

Although enacted in 1933, Regulation Q was not restrictive in practice until 1966. At that time the Federal Reserve, in an effort to protect the savings and loan industry from the inflation-inspired interest rate competition, lowered the interest rate ceiling below market rates. In addition, savings and loans, or thrifts, were granted a 1/4 percent differential on all accounts. These modifications indicate that the Federal Reserve has shifted its position from guardian of the banking system to guardian of the housing industry. As of 1966, the purpose of Regulation Q has been to insulate homebuyers from high mortgage rates, while preserving the viability of mortgage lending institutions.

Whatever the intentions, there are many reasons for dissatisfaction with the effects of Regulation Q. In periods of rising interest rates, these ceilings cause financial disintermediation -

the withdrawal of deposits form commercial banks and thrifts for direct investment in securities markets. They penalize low income depositors who do not have access to the large denomination investments available in the free market. Finally, since low rates on saving deposits translate into low rates on loans, Regulation Q provides a subsidy to borrowers at the savers' expense.

Small Savers

Regulation Q victimizes small savers who are unable to purchase the large denomination securities available in alternative markets. For example, Money Market Certificates (MMC's), which now pay over 10 percent, are available only in units of $10,000 or more. Certificates of Deposit (CD's) of $100,000 yield 10.20 percent. Short Term Treasury Bills in units of $10,000 to $1,000,000 pay 9.495 percent. The rates on passbook savings - available in denominations of $5.00 or more - are legally limited to 5.5 percent per year. It has been estimated that since 1968 this limitation has resulted in a loss of $42 billion to passbook savers, of which $19 billion was lost by people over the age of 65.[1]

Low income savers have no investment alternative to passbook accounts. They are forced to suffer losses. The 5.5 percent maximum permissible rate of return is entirely expropriated by inflation. At the current inflation rate of 13 percent, passbook savers are actually earning a negative 7.5 percent - on which they are required to pay taxes. A borrower's interest payments, on the other hand, are tax deductible. This, in combination with double digit inflation, makes the effective rate paid by borrowers negative. If, for example, one's tax rate is 30 percent, and inflation is 13 percent, the effective rate on an 11 percent mortgage is -5.3 percent.

By penalizing saving and encouraging borrowing, Regulation Q compounds the damages already inflicted by inflation. Escalating prices destroy the value of savings and reward current consumption independently, without the aid of special regulation. Savers discover that the money they put in the bank last year buys less than it would have bought then. In contrast, borrowers find themselves in the fortunate position of having enjoyed their purchases for a full year, then paying for them with devalued dollars. In this insidious manner Regulation Q compounds a redistribution of wealth which is not in accordance with any policy of the Congress.

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1. C. F. Muckenfuss, III, Senior Deputy Comptroller of the Currency for Policy, Statement before the Subcommittee on Financial Institutions of the Committee on Banking, Housing and Urban Affairs, United States Senate, June 27, 1979, p. 13.

Low Savings Rate

Regulation Q is destroying the incentive to save. The United States now has the lowest personal savings rate of all industrial countries. In 1978, the total private saving rate had reached a 30 year low of 5.1 percent of GNP. The difference between this figure and the long-run trend of 6-6.5 percent represents $15 billion a year in savings foregone.[2]

Insufficient saving inhibits investment. The creation of productive capacity requires the use of resources - labor, materials, energy. If all resources are used for current consumption, then none will be available for investment in future capacity. Investment in the U.S. has, in fact, been inhibited in recent years. The consequences of this inactivity are manifest. Productivity growth ranks lowest among industrial countries. Finally, because of inadequate research and development expenditures, the competitiveness of the U.S. in foreign markets is being jeopardized by lack of innovation in high technology industries.

Disintermediation

"Disintermediation" refers to the withdrawal of funds from financial intermediaries - banks, savings and loan associations, mutual savings banks, insurance companies - for direct investment in securities markets. It occurs when the market rate of return on securities exceeds the rate of return on comparable instruments at financial intermediaries. It is happening now, for example, when the current rate on passbook savings accounts at thrift institutions is 3.82 percentage points below the rate on comparable money market instruments. This enormous disparity is caused by Reg. Q interest rate ceilings on passbook accounts. Disintermediation reduces the supply of lendable funds to thrift institutions. This means a smaller supply of mortgage credit and thus higher rates than otherwise would be.

In addition, disintermediation impairs the efficiency of the financial system. When banks lose deposits, efforts to circumvent the regulations are inevitable. Because interest rate competition is prohibited, banks resort to such roundabout methods as offering prizes - bicycles, appliances, vacations - in order to attract deposits.

Other forms of non-interest rate competition which have recently emerged are free checking and bill paying services. These measures entail large advertising outlays and operating expenses. Direct interest payment involves smaller transaction

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2. "The U.S. Bias Against Savings Leads to High Inflation: Weak Dollar: Slow Growth: Declining Productivity," Business Week, December 11, 1978, p. 91.

costs and increases efficiency. By limiting interest rate payments on deposits, Regulation Q forces banks and thrifts to compete in a costly and inadequate fashion.

Proponents of Regulation Q defend interest rate ceilings on the grounds that they are necessary to preserve the viability of thrift institutions and to protect the housing and mortgage markets from the burden of high interest rates.

Viability of Thrifts

Thrifts fear that the lifting of Regulation Q ceilings will bring about their demise. Without the advantages of comprehensive interest rate ceilings, Regulation Q supporters claim that the cost of funds to thrifts will quickly exceed portfolio yields, and further, that deposits will be lost to commerical banks when they pay higher rates than those which thrifts can afford.

Thrifts are creatures of the regulatory system. Federal agencies restrict their assets to long-term instruments - particularly mortgages. Thus, when short-term interest rates are rising, the yields on mortgages which were negotiated in the past are low relative to the rates which must be paid on current short-term deposits. The earnings of thrifts, therefore, are less flexible than those of commercial banks, and in the absence of the differential, they feel disintermediation pressures first.

S.1347 addresses this problem by allowing thrifts to invest 10 percent of their assets in high yielding short-term markets. Traditionally, thrifts have dealt with the problem of "lending long and borrowing short" by selling mortgages in the secondary market. However, this was not always sufficient, as the rates of return in secondary markets do not adjust to the market as quickly as short-term liabilities adjust. The new assets permissible under S.1347 are highly responsive, and will therefore be effective in protecting the competitiveness of thrift institutions during periods of rising interest rates.

Skillful use of Variable Rate and Rollover Mortgages will also be instrumental in stablizing the earnings of thrift institutions. The rates on VRM's can be adjusted periodically to current market levels, and rollover mortgages are subject to renegotiation at specified dates subsequent to the original contract date.

Although ceiling escalation will be gradual, projections suggest that the resulting rate of increase in the cost of funds may, nevertheless, be too rapid. Over the past six years, annual portfolio yields at thrift institutions have risen at an average rate of 25.42 basis points per year. Assuming that interest rates remain at the present high levels, and that 20 percent of

the liabilities at thrifts are tied to the treasury bill rate[3], the cost of funds will rise by 40 basis points per year. To avoid a squeeze on loan spreads, the growth rate of portfolio yields must rise by at least 14.5 basis points a year -- an increase of 57 percent over current growth rates. The marginal expansion of earning power provided by the 10 percent asset allowance and new mortgage instruments cannot be expected to achieve such dramatic results.

However, these projections may understate the actual earning capacity of savings and loans. A recent study on the performance characteristics of savings and loans has determined that there are acute differences between high and low performers within the savings and loan industry, and that these can be accounted for by differences in managerial acumen.[4] Thus, an average mortgage portfolio yield across S&L's, because it includes earnings of low performers, reflects the status-quo, but understates the potential for growth in the industry. Moreover, S.1347 grants standby authority to regulators to postpone escalation of ceilings in case such a crisis should arise.

THE HOUSING MARKET

Opponents of deregulation voice concern that the lifting of more and more restrictions may follow these until thrift institutions are indistinguishable from commercial banks. If savings and loans and mutual savings banks lose their status as mortagage specialists, they fear that the nation's housing needs cannot be accommodated.

This fear is unwarranted. 90 percent of the assets of thrifts are still pegged for the mortgage market. Any changes in this ratio would require further legislation. Also, specialists in the mortgage industry do not wish to become commercial bankers. It is in their interests to maintain a market for their expertise. Furthermore, the volubility of the housing market is symptomatic of regulated interest rates. The housing crunches which accompany periods of monetary restraint are caused by the inevitable disintermediation away from mortgage lenders when these institutions are forced to pay lower than market rates. The elimination of Regulation Q would stabilize the housing market by increasing the flow of funds to all depository institutions, and relieving disintermediation pressures.

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3. Joe McKenzie, Federal Home Loan Bank Board. MMC's now comprise about 20 percent of liabilities at thrift insitutions. According to Savings and Loan News, (March 1979), this percentage may rise to 27.1 percent by December 1979. Among a sample of S&L's in California, MMC's averaged as much as 66.4 percent of liabilities. (Fortune, May 22, 1978)
4. See James A. Verbrugge and Steven J. Goldstein, "High Performers vs Low Performers", Savings & Loan News, November 1978, pp. 64-69.

CONCLUSION

Both the Senate and House bills are essentially attempts to eliminate a portion of the regulations encumbering and protecting the banking industry. Although inconsistent in the treatment of business deposits, the legalization of NOW accounts would permit the free market to determine the value of deposits and to test the efficiency of bank management. The gradual elimination of Regulation Q would achieve the same result while ensuring against any catastrophic disruptions in the financial system.

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