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Banking Deregulation

"Deregulation" today is one of the most topical issues in Washington. But the deregulation movement is not new, and, in fact, the Reagan Administration's deregulation program has yet to take shape. It remains to be seen just how sweeping such a program will become, for the prior Administration and Congress already had embarked on a deregulation program of their own, only to see regulations reviewed, rewritten, and simplified—but seldom dismantled.

Few industries are as thoroughly embellished with regulations as the banking industry. On the one hand, there is a host of laws and regulations that influence banks' internal operations and relationships with customers, such as Truth-in-Lending. These regulations are surrounded by controversy, but they are unlikely to be removed. In fact, new laws, such as the Community Reinvestment Act, have added to this type of regulatory burden in recent years.

On the other hand, there is an even more encompassing legal and regulatory net that circumscribes allowable prices (principally, deposit rates), product lines, and geographic markets of depository and other financial institutions. Many of these restrictions arose out of the financial collapse and banking panic of the early 1930's. With the intention of "establishing a sound financial system," Congress passed the Banking Act of 1933 (Glass-Steagall Act), the Banking Act of 1935, and the securities acts of 1933 and 1934. Taken together, these laws placed banking and securities markets under a comprehensive regulatory umbrella, which (among other things) prohibited explicit interest on demand deposits, created the authority for (Regulation Q) time-deposit rate ceilings, and drew a line between commercial banking and investment banking. (Restrictions on interstate banking and intrastate branching already were in place in the form of state laws that were federally sanctioned by the McFadden Act of 1927). Regardless of the original legislators' intent, this legislative amalgam in practice has tended to limit competition and to place a regulatory wrench in the efficient operations of the financial system.

Regulations and innovation

Quite naturally, financial institutions over time have innovated in an attempt to avoid such restrictions. For example, as a consequence of restrictions on geographic markets (McFadden Act and state laws), product lines (Glass-Steagall) and maximum deposit rates (Banking Act of 1935 and Reg. Q), banks have utilized the holding company device as the most effective means of increasing competition and services. But Congress acted to close off this avenue—first by passing the Bank Holding Company Act of 1956, then by adding amendments in 1966 and 1970, and then by enhancing these laws with complex regulatory structures. The situation has been similar with deposit rate ceilings: regulations have proliferated in pursuit of innovations.

Despite regulatory attempts to plug the dike, high and variable interest rates have rapidly eroded the effectiveness of deposit rate ceilings. While open-market rates have surged well above the ceilings on traditional deposits, variable rates have increased the risk of long-term financial commitments. Thus, savers are demanding ceiling-free short-term savings vehicles. But the vestiges of Reg. Q continue to distort price competition for consumer deposits, while the straightjacket of the Glass-Steagall Act prohibits banks from offering deposit-like securities to consumers. Although securities firms seemingly are freer to compete, they cannot offer primary transaction accounts and make unrestricted loans.

Thus, we have tended to create two layers of intermediation—a securities industry that avoids Reg. Q and geographic restrictions by prepackaging depositor funds, and a banking industry that sells "jumbo" certificates to the securities industry, offers primary transaction accounts, and makes loans. The ultimate solution should be relatively efficient, incorporating both national prepackagers of small deposits and local lenders who buy their funds in national money markets. While this process has yet to reach maturity, both national markets eventually should develop to the point where the small depositor and the small depository institution share fully in this relatively unconstrained two-tier process of financial intermediation. The market will have successfully circumvented Reg. Q, Glass-Steagall, and McFadden.

Monetary Control Act

Depository institutions, Congress, and regulators alike have become increasingly concerned about the fragmentizing effect of regulation on financial intermediation. The Depository Institutions Deregulation and Monetary Control Act of 1980 (MCA) represents a significant (although limited) step in dismantling this massive legislative and regulatory framework. Foremost, it called for phaseout of Reg. Q deposit-rate ceilings over a six-year period ending April 1986. (For specifics, see "Deposit Deregulation," the author's *Weekly Letter* of April 10, 1981.) The Act also allowed banks and thrifts to offer interest-bearing transaction (NOW) accounts nationwide as of the beginning of this year, overrode state mortgage usury ceilings, and somewhat expanded the lending powers of thrift institutions. Despite many other aspects of the Act, its most profound consequences will come from the expansion of checking privileges to thrifts, payment of interest on checking balances (eventually at market-determined rates), and (ultimately) payment of market-determined rates on all bank and thrift deposits.

But the MCA is silent on other crucial aspects of deregulation. It bypasses the issue of geographic restrictions on interstate banking and intrastate branching. And despite its expansion of thrift lending and deposit powers, it is also silent on other product-line issues facing banks and thrifts.

Glass-Steagall and McFadden

Reg. Q deposit ceilings and the resultant growth of money-market funds and bank-like brokerage services have brought product-line issues to the forefront. Accordingly, the ultimate removal of deposit ceilings will ease most of this pressure, for the real issue is not whether banks can offer securities, but whether they can offer market yields. But other issues remain—broader lending powers for thrifts, broader underwriting rules for depository institutions, and, most importantly, expanded opportunities for depository institutions to offer comprehensive personal cash-management services.

Under our fragmented structure, the consumer needs an intermediary to deal with the intermediaries. (Presently, the brokerage industry seems to have the legal and regulatory advantage in that it is relatively free to create bank-like services, while Glass-Steagall prevents banks from offering brokerage-like services.) While economic forces suggest that Glass-Steagall restrictions make little sense and will become increasingly fragile, political realities suggest that breakdowns in current product-line restrictions will occur slowly and only at the fringes, such as permission for banks to underwrite municipal revenue bonds. Both the regulated and the regulators will be tempted to form political coalitions to protect existing turfs if threatened with genuine redefinitions of boundaries.

The International Banking Act of 1978 called for a review of geographic restrictions in banking, and as a result, the Carter Administration early this year released its so-called "McFadden Act Report." The report proposed to expand interstate banking through the holding-company vehicle, largely because it would minimize the threat to the existing dual-banking system of state and nationally-chartered institutions.

In the context of the McFadden Act Report, what direction might geographic deregulation take in the 1980's? First, banking organizations might gain permission to bid for takeovers of failing banks or thrifts across state lines—a step that would ease the problems of regulators in their efforts to effect smooth transitions of failing institutions. Although some members of Congress have already introduced bills to this effect, the issue remains difficult. Second, holding companies or their banks might gain permission to expand or extend their deposit and loan facilities across state lines within metropolitan areas. (Such activities, however, might be restricted initially to deposits through automatic-teller machines.) Finally, we might eventually see interstate acquisitions in contiguous states or within special regions, through bilateral or multi-lateral changes in state laws (California-New York, for example), or by changes in the Douglas Amendment to the Bank Holding Company Act. As a political compromise, permission to cross state lines *through merger or acquisitions* might be limited to smaller institutions—which would limit large holding companies to *de novo* entry or perhaps to operating across state lines only in large metropolitan areas.

While complete deregulation would be desirable from an economic standpoint, even these limited changes are not likely to come about easily. But geographic deregulation will come eventually, largely because the banking industry already is effectively expanding nationwide (except for direct deposit and loan facilities), and still is losing ground to other industries that can expand nationally without restrictions.

Economic forces

High and variable interest rates are the single most important force promoting deregulation. In response to this problem, Congress included the phaseout of Reg. Q as a central part of the MCA. But changing technology also is a major force promoting deregulation. Automatic-teller machines (ATMs) and point-of-sale terminals already are economically viable, and are proving increasingly popular with consumers. Such technology will exert further pressure on branching laws and interstate restrictions, at least within metropolitan areas. Moreover, thrift institutions are experiencing the merits of ATMs and shared computer technology, and they will expand their consumer services through these means.

Technological change will intensify competition for comprehensive personal cash-management services. Money-market funds, brokerage houses, and large retailers all will be providing the type of service that depository institutions also would provide were it not for regulations. These developments are hastening the removal of Reg. Q ceilings and putting immense pressure on product-line restrictions. Even if desired, further regulations or laws probably could not halt this trend, since such banking substitutes could take on infinite forms. For example, if reserve requirements were placed on money-market funds, most could qualify as savings vehicles —by limiting withdrawals to three per month or by omitting checking—and as such would be subject to a zero reserve requirement. But the direction of deregulation argues for a different solution—extending to banks and thrifts the deposit powers to compete with money-market funds and other pseudo-banking institutions.

When all is said, the coming decade will be a difficult period for all financial institutions, especially small ones. The widespread development of electronic funds transfer is a certainty, and consumers increasingly will demand market returns on their savings and more unified personal cash-management services. These trends will occur whether or not banking regulations are relaxed. In this environment, our banking system will best be able to survive if deregulation proceeds rapidly. Swift removal of Reg. Q is the single most important step, for then Glass-Steagall restrictions will be of much less consequence. But changing technology, as it facilitates personal cash management, argues for even further deregulation of product-line and geographic markets.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 7/8/81	Change from 7/1/81	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	150,427	−1,142	13,064	9.5
Loans (gross, adjusted) — total#	129,061	−1,090	13,289	11.5
Commercial and industrial	38,897	− 669	5,449	16.3
Real estate	52,929	− 2	6,047	12.9
Loans to individuals	22,954	− 98	− 923	− 3.9
Securities loans	1,434	− 287	419	41.3
U.S. Treasury securities*	6,182	6	− 117	− 1.9
Other securities*	15,184	− 58	− 104	− 0.7
Demand deposits — total#	42,097	−2,067	− 2,764	− 6.2
Demand deposits — adjusted	30,238	571	− 2,156	− 6.7
Savings deposits — total	30,673	228	1,929	6.7
Time deposits — total#	81,907	761	19,925	32.1
Individuals, part. & corp.	73,200	670	19,625	36.6
(Large negotiable CD's)	32,755	721	10,744	48.8

Weekly Averages of Daily Figures	Week ended 7/8/81	Week ended 7/1/81	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	n.a.	n.a.	10
Borrowings	39	171	2
Net free reserves (+)/Net borrowed(−)	n.a.	n.a.	8

* Excludes trading account securities.
# Includes items not shown separately.

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