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ECONOMIC PERSPECTIVES

The Depository Institutions Deregulation and Monetary Control Act of 1980

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The enactment on March 31 of the Depository Institutions Deregulation and Monetary Control Act of 1980 has been widely hailed as a major legislative event. The implications of the act for financial institutions and their customers and for monetary control are profound and not yet fully understood. This issue of **Economic Perspectives** *is devoted to an effort to view the act from a broad perspective. In it are discussed the historical background of the act, the problems that led to adoption of its key provisions, and the basic thrust of each of the nine titles of the act. Those provisions of the act judged to be of major and lasting significance are analyzed in more detail in an attempt to discern their future effects.*

The issue was prepared as a joint effort of many members of the Research Department of the Federal Reserve Bank of Chicago. Those who contributed major portions of one or more sections of the article were: Elijah Brewer, Thomas Gittings, Anne Marie Gonczy, Randall Merris, Larry Mote, Dorothy Nichols, and Alan Reichert.

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The Depository Institutions Deregulation and Monetary Control Act of 1980

Landmark financial legislation for the eighties

"... the most significant banking legislation before the Congress since the passage of the Federal Reserve Act in 1913"—Senator William A. Proxmire

"... the most significant package of financial legislation since the 1930s"—Representative Henry S. Reuss

On March 31 the President signed into law the Depository Institutions Deregulation and Monetary Control Act of 1980 (the act). This legislation marked the culmination of many years of effort by members of the Congress, the regulatory agencies, and the financial industry to change some of the rules under which U.S. financial institutions have operated for nearly half a century. In many cases, these rules had been made obsolete by changes in the economy, the functioning of credit markets, technology, consumer demands for financial services, and the competitive environment.

At least five public and private studies, from the Report of the Commission on Money and Credit in 1961 to the FINE study in 1975, had recommended many of the reforms finally adopted in the act. In recent years the Federal Reserve Board has given strong support to two of them, the phase-out of deposit interest ceilings coupled with broader investment powers for thrift institutions and broader and more uniform application of reserve requirements. In adopting the new law, the Congress dealt with, or at least touched upon, most of the major issues that have been the subject of controversy over the years.

Several interacting factors finally precipitated legislative action on this massive set of reform measures. One was the high level of inflation and interest rates that magnified recognized problems under the old regulations and convinced participants that a piecemeal approach was unworkable. The attrition in Federal Reserve membership swelled from a trickle to a flood as high investment yields increased the penalty imposed on member banks by the requirement that they hold noninterest-bearing reserve deposits at the Federal Reserve; small savers were heavily disadvantaged in comparison with returns available to large investors; disintermediation again hurt the housing market as savers withdrew funds from mortgage lending institutions and invested them in high-yield money market mutual funds and other market instruments; the viability of thrift institutions was seriously threatened by the imbalance between the cost of funds and the return on long-term mortgage portfolios; and at times usury laws in some states effectively cut off credit to small businesses, farmers, and households.

Other factors were the promise of better customer service inherent in new technology such as electronic devices for funds transfer, the growing availability of payments services from depository institutions other than commercial banks, and the view that Federal Reserve credit should be available as an ultimate source of liquidity to all such institutions. Finally, increased emphasis on the monetary aggregates as intermediate targets of monetary policy focused attention on the need for changes that would permit better measurement and control of these aggregates. Under pressure due to the urgency of these problems, the Congress recognized the need for changing the ground rules for competition in the financial markets and for dealing with the many interrelated problems simultaneously in a coordinated and consistent manner.

The principal goals of the act include:

(1) improving monetary control and equalizing its cost among depository institutions, (2) removing the impediments to competition for funds by depository institutions and allowing small savers a market rate of return, and (3) expanding the availability of financial services to the public and reducing competitive inequalities between financial institutions offering them. The major elements of the law that are expected to contribute to these goals are:

- Imposition of uniform federal reserve requirements on similar classes of reservable liabilities at all depository institutions—including commercial banks, savings and loan associations, mutual savings banks, and credit unions.

- Authorization for collection of data needed to monitor and control the money and credit aggregates.

- Requirement that the Federal Reserve price its services and grant all depository institutions access to such services.

- Provision for the orderly phase-out of deposit interest rate ceilings.

- Preemption of state usury ceilings on certain types of loans.

- Nationwide authorization of NOW accounts and certain other interest-bearing balances at both banks and thrift institutions that can be used for transactions purposes.

- Broadening of the asset powers and permissible activities of thrift institutions.

The act will have far-reaching effects on financial markets for years to come. It calls for greater reliance on free market forces and less on regulatory decisions in the determination of interest rates and the distribution of financial services. It puts the burden on the Federal Reserve to prove its efficiency by forcing it to compete with alternatives available from the private sector. At the same time, the law will, to steal a phrase from the Senate Banking Committee Chairman, "create a level playing field" for competition between the various types of financial institutions. All depository institutions eventually will be subject to the same reserve requirements, will be permitted to pay competitive rates on savings and offer interest-bearing transactions accounts, and will have access to Federal Reserve services on equal terms. Thrift institutions will be permitted to provide a broader range of services to their savings customers—including transactions accounts, trust services, and nonmortgage credit—and to manage their assets in a more flexible way so as to offset the more volatile cost and changing effective maturity of their liabilities. Clearly, this means less functional specialization by various types of institutions.

But while the law opens many opportunities for both banks and thrift institutions to be more competitive, with attendant benefits to the consuming public, it also poses substantial challenges. With competition enhanced, less efficient institutions may find it difficult to provide quality service at competitive prices. Depository institutions will have to assess carefully the costs and benefits of doing business in the new environment and reexamine their pricing policies and service levels. It seems likely that, eventually, some will be eliminated through liquidation or merger.

Some consolidation may result in economies of scale or integration and make possible improved service and a better return to savers. However, to minimize the near-term risks of a sudden change in the competitive environment, the act provides for a gradual transition from old to new rules, especially in the areas of reserve requirements and interest rate controls. Both the eight-year phase-in of reserve requirements for nonmember banks and thrift institutions and the six-year phase-out of deposit interest ceilings will allow the institutions time to develop their ability to meet market competition on a new bundle of services. In addition, the Congress was careful not to require a specific schedule for the interest ceiling phase-out and mandated regular reports on the impact of the program on the economic viability of the various depository institutions and on housing finance.

Transitional problems are inevitable as the thousands of depository institutions bring their operations into conformity with the new rules. The 1980s will be a period of adjustment. But the direction of change wrought by this historic legislation on the financial structure should be apparent long before the phase-ins and phase-outs are complete.

Title I—Universal reserve requirements and pricing

Referred to as the Monetary Control Act of 1980, Title I of the new legislation is designed to enhance the Federal Reserve's ability to implement monetary policy. The new legislation also ensures that all depository institutions share equally whatever burden is necessary for an effective national monetary policy.

There are three major parts to Title I—reporting requirements, reserve requirements, and pricing of Federal Reserve services. With respect to the first two, which are directly related to monetary control, Title I:

- Requires all depository institutions to report their assets and liabilities at such intervals as the Board of Governors of the Federal Reserve System (the Board) may prescribe.

- Extends reserve requirements imposed by the Board to all depository institutions, including all commercial, savings, and mutual savings banks, savings and loan associations, and credit unions that are federally insured or eligible to apply for federal insurance.[1]

- Requires each depository institution to maintain reserves of 3 percent on its transaction accounts of $25 million or less, plus 12 percent, or such ratio that the Board may set between 8 and 14 percent, on the amount over $25 million. This $25 million "tranche" is indexed to change each calendar year beginning in 1982 by 80 percent of the percentage change in total transaction accounts of all depository institutions during the previous year ending June 30.

- Requires each depository institution to maintain reserves of 3 percent, or such ratio that the Board may set between 0 and 9 percent, on its nonpersonal time deposits. The Board may vary the reserve requirements on nonpersonal time deposits according to maturity.

- Provides for an eight-year phase-in to the new reserve requirements on transaction accounts and nonpersonal time deposits for nonmember banks and thrift institutions and a four-year phase-down (in some cases, a phase-up) to the new requirements for members. However, requirements on new types of accounts or deposits authorized under federal law after April 1, 1980, such as NOW accounts outside New England, New York, and New Jersey, will not be phased in.

- Entitles any depository institution in which transaction accounts or nonpersonal time deposits are held to borrow from the Federal Reserve discount window on the same terms as member banks.

- Permits the Board to impose reserve requirements on certain borrowings from foreign sources, sales of assets by depository institutions in the United States to their foreign offices, and loans to U.S. residents made by foreign offices of depository institutions in the United States. Such Eurocurrency reserve requirements would apply to foreign branches, subsidiaries, and international banking facilities of member and nonmember institutions uniformly.

[1]Reporting and reserve requirement provisions of the act also apply to industrial banks, cooperative banks, and homestead associations. In addition, under earlier amendments to the Federal Reserve Act, reporting and reserve requirements were applied to Edge Act and agreement corporations. The International Banking Act of 1978 extended them to the U.S. branches and agencies of foreign banks.

• Permits the Board, upon a finding by at least five members that extraordinary circumstances require such action and after consultation with the appropriate congressional committees, to impose any level of reserve requirements on any liability of depository institutions for up to 180 days.

• Specifies that reserve requirements may be satisfied by holdings of vault cash, reserve balances held directly at a Federal Reserve Bank, or, in the case of nonmember institutions, reserve balances passed to the Federal Reserve through a correspondent or other designated institution ("pass-through" balances).

• Permits the Board, upon an affirmative vote of five members and after consultation with certain federal financial regulatory authorities, to impose supplemental reserve requirements on every depository institution of up to 4 percent of its transaction accounts, but only if specified conditions are met, including that "the sole purpose of such requirement is to increase the amount of reserves maintained to a level essential for the conduct of monetary policy." The supplemental requirement is to be maintained either in an Earnings Participation Account at a Federal Reserve Bank, on which earnings will be paid quarterly at a rate not exceeding the rate earned on the Federal Reserve's securities portfolio during the previous calendar quarter, or in vault cash.

On August 15, 1980, the Board announced revisions in its Regulation D to implement the reporting and reserve requirement provisions of the act.[2]

Data reporting

Accurate and timely information on the monetary and credit aggregates is essential to the effective discharge of the Federal Reserve's monetary policy responsibilities. Current data estimates rely heavily on reports submitted by banks that are members of the Federal Reserve System. In the past, however, it was often necessary to make large revisions when nonmember institution data, such as for quarterly "benchmark" dates, became available. Some improvement in the quality and timeliness of monetary and credit aggregates data has been made possible by voluntary reporting of certain nonmember institutions, as when the monetary aggregates were redefined in early 1980. But even with these improvements, current data estimates are imprecise and subject to revision as additional data become available, often with a significant time lag.

In order to remedy these deficiencies, the new law authorizes the Board to require all depository institutions to submit reports of their assets and liabilities as needed or desirable for monetary policy purposes. Under the Board's Regulation D, member banks, as well as other depository institutions that have transaction accounts or nonpersonal time deposits, will report certain deposits data directly to the Federal Reserve.

The Board's authority to require data reporting is not to be used indiscriminately. The new law stipulates that every effort should be made to avoid imposing unnecessary burdens and duplicate reporting requirements on depository institutions. This provision of the law is consistent with other congressional initiatives in recent years to reduce regulatory paperwork.

In its regulation implementing the reporting and reserve requirement provisions, the Board classified depository institutions by size for reporting purposes. Because the deposits of small institutions constitute such a small portion of the money supply and frequent reporting could be a substantial burden to such institutions, the Board deferred reporting requirements and reserve maintenance for nonmember institutions with less than \$2 million in total deposits until May 1981 and allowed certain institutions with total deposits of \$2 million or more but less than \$15 million to report and maintain reserves on a quarterly rather than a weekly basis.

[2]Federal Reserve *Bulletin*, September 1980, pp. 758-73.

Reserve requirements

The reserve requirement provisions of the new law depart significantly from past U.S. experience. For the first time, all depository institutions will be subject to the same federally imposed reserve requirements. For many years, it had been argued that such universal extension of federal reserve requirements was needed both for monetary control purposes and to provide for greater competitive equality between financial institutions.

The membership problem. With few exceptions, only banks that were members of the Federal Reserve System were subject to federal reserve requirements before the new legislation was passed. Unlike nonmember commercial banks that could often satisfy state-imposed reserve requirements by holding interest-earning assets or compensating balances at correspondent banks, member banks were required to hold their reserves in noninterest-bearing balances at the Federal Reserve or in vault cash. The burden of holding these nonearning assets put member banks at a disadvantage relative to nonmember banks. This membership "tax" grew even more burdensome in recent years as interest rates rose to record levels. Consequently, an increasing number of member banks chose to withdraw from Federal Reserve membership, and most newly formed banks chose nonmember status. The proportion of deposits held by member banks, which had been declining for several decades, dropped at an accelerating rate in recent years.

The Federal Reserve argued repeatedly in recent years that the declining proportion of deposits subject to its reserve requirements weakened its ability to conduct monetary policy, in large part because of the greater difficulty in predicting the relationship between reserves and money. Considerable support was marshalled for the viewpoint that, besides helping to achieve competitive equality between depository institutions, universal application of federal reserve requirements would greatly enhance the Federal Reserve's ability to control the monetary aggregates.

The new reserve requirements, when fully implemented, will clearly reduce the burden on member banks. The Board's staff estimated earlier this year that, at current deposit levels and ignoring the transitional period, member bank required balances at the Federal Reserve would decline from about $32 billion to about $14 billion. In relative terms the burden on member banks would disappear as nonmember institutions will be subject to the same reserve requirements as member banks.

Money and reserve requirements. With membership no longer a problem, the focus will now be on the appropriateness of the new reserve requirement structure for monetary control. Among the features of an ideal structure would be a single—truly uniform—reserve requirement ratio applied only to those deposits included in the monetary aggregate to be controlled. When more than one ratio applies to the deposits under control, shifts in these deposits between institutions subject to different requirements affect required reserves even though there is no change in the total amount of these deposits. Similarly, when reserve requirements apply both to deposits that are included in the targeted monetary aggregate and to some that are not, shifts between the different types of deposits produce changes in the targeted aggregate that are only partially reflected by changes in required reserves. In either case, the Federal Reserve must predict the various types of deposit shifts in order to determine the appropriate level of reserves consistent with desired money.

The requirements of the act fall short of an ideal reserve requirement structure in several respects. Assume, for example, that the Federal Reserve seeks to control a transactions measure of money such as M-1B (currency, demand deposits, and other checkable deposits). The act imposes two reserve ratios on the deposits in M-1B (3 percent on the first $25 million at each depository institution and 8-14 percent on those in excess of $25 million), as well as a separate ratio (0-9 percent) on nonpersonal time deposits, which are not in M-1B.[3] The Board can eliminate one of these problems by setting the nonpersonal time deposit ratio at zero. Nevertheless, the problem of predicting deposit shifts between institutions with more and less than $25 million in transaction accounts, and therefore subject to different ratios (at the margin), will remain.

In practice, this problem is likely to be far less serious than under the former member bank reserve requirement structure. Under the former structure numerous ratios applied to transaction accounts, ranging from zero for nonmembers up to 16¼ percent on demand deposits at the largest member banks. In addition, numerous ratios also applied to nontransaction accounts at member banks. Thus, the new requirements move closer to an ideal structure, assuming that M-1B is the monetary aggregate to be controlled. The new requirements would be less appropriate for the control of some broader monetary aggregate, because, once they are fully implemented, they will no longer apply (except in an emergency) to personal time and nontransaction savings deposits. In its conduct of

[3]Technically, there are some minor definitional differences between the transaction accounts included in M-1B and those subject to reserve requirements. For example, U.S. government demand deposits, while subject to reserve requirements, are excluded from M-1B.

Comparison of old and new reserve requirement structures

Old requirements for member banks: Statutory range (percent)	Old requirements for member banks: Actual (as of 8/31/80) (percent)		Type of deposit or account		New requirements for all depository institutions[1]: Initial (under act) (percent)	New requirements for all depository institutions[1]: Statutory range[2] (percent)
			Transaction accounts[3]			
7 to 22[4]	7	$ 0-2 mil.	net demand			
	9.5	2-10				
	11.75	10-100				
	12.75	100-400		$0-25 mil.[5]	3	3
	16.25	over 400				
3 to 10	3		savings (NOWs, ATS, etc.)	over $25 mil.[5]	12	8 to 14
			Nontransaction accounts			
	3		other savings	personal	0	0
				nonpersonal[7]	3	0 to 9
		With original maturity of[6]	time deposits			
		30-179 days		personal	0	0
	3	$0-5 mil.				
	6	over $5 mil.		nonpersonal[7]	3	0 to 9
	2.5	180 days to 4 years				
	1	over 4 years				
0 to 22	0		Eurocurrency liabilities		*	*

*No initial ratio or range is specified in the act.

[1]Under the act, the new requirements are phased in according to various schedules for member and nonmember institutions.

[2]Under extraordinary circumstances, the Board can impose a requirement outside statutory ranges on any type of depository institution liability.

[3]The Board can impose a supplementary requirement of up to 4 percent on transaction accounts.

[4]Statutory range for reserve city banks was 10 to 22 percent; for other member banks it was 7 to 14 percent.

[5]The $25 million tranche is to be adjusted each year by 80 percent of the change in total transaction accounts at all depository institutions.

[6]A minimum 3 percent reserve was required, on average, against time and savings deposits.

[7]The Board can vary requirements on nonpersonal time deposits by maturity.

monetary policy, though, the Federal Reserve has generally placed considerable emphasis on the behavior of the narrower transaction aggregates, M-1A and M-1B. On balance, therefore, the new reserve requirement structure is a vast improvement over the old one.

Monetary control after the act

Nevertheless, those expecting an immediate and dramatic improvement in monetary control might be disappointed. For one thing, the complexity of the reserve requirement structure during the transitional period will add to slippage in monetary control. In addition, difficulties arise in controlling money not only from the structure of reserve requirements but also from certain institutional arrangements adopted in the past either to facilitate the smooth functioning of the payments system or to make it easier for member banks to manage their reserve positions.

For example, the ability of an institution to obtain funds from the discount window adds to the difficulties of controlling reserves. So does Federal Reserve float, which results from the availability schedules the Federal Reserve uses in granting credit to institutions depositing checks for collection. The program for reducing float announced by the Federal Reserve with its proposal for implementing the pricing provisions of the act is discussed in the next section.

Another important obstacle to accurate monetary control at the present time is the lagged reserve accounting system adopted by the Federal Reserve in 1968. Under this system, the reserves a bank is required to hold in one week depend on its deposits two weeks ago. Lagged reserve accounting was not a problem under the operating procedures followed by the Federal Reserve in recent years, which relied on influencing short-term interest rates, particularly the federal funds rate, as a means of controlling money. The real problem was the difficulty of predicting the relationship between interest rates and future money growth. Because money growth often deviated widely from the targeted paths, a growing number of economists, within the Federal Reserve and without, advocated the adoption of a reserves targeting procedure for controlling money.

On October 6, 1979, the Federal Reserve announced a new operating procedure that emphasizes reserves as a means of controlling money. Under a reserves targeting procedure, the structure of reserve requirements plays a crucial role since it is an important factor in predicting the reserves-money relationship. One might, therefore, expect the virtues of the new reserve requirement structure to become readily apparent under the new operating procedure.

But lagged reserve accounting presents certain difficulties for a reserves targeting approach that were not a serious problem under the former interest rate approach to monetary control. Because required reserves in any given week are based on deposits two weeks earlier, in any given week it may not be possible for the Federal Reserve to achieve a target level of total reserves. This is most obviously true when current-week required reserves exceed the total reserves target, because sufficient total reserves must be supplied to satisfy requirements based on the predetermined level of deposits.

What the Federal Reserve can do is affect the cost of these reserves to depository institutions. It does this by varying the mix of reserves between nonborrowed reserves supplied through open market operations and borrowed reserves supplied through the Federal Reserve's discount window. In effect, then, the Federal Reserve directly controls only nonborrowed reserves, which it varies in order to affect the cost of funds to institutions at the margin. This, in turn, influences institutions' willingness to expand deposits in the current week and, hence, their future required reserves. Thus, just as under the former operating procedure that emphasized interest rates, the Federal Reserve can bring cost pressures on depository institutions to move the money supply in the desired direction. Nevertheless, the linkage under lagged reserves is somewhat tenuous, and the resulting system is not what most economists had in mind when they urged the Federal Reserve to adopt a reserves targeting approach.

Proposals have been made to return to contemporaneous reserve accounting or to adopt some other system under which depository institutions would be required to adjust their deposits to a predetermined level of reserves supplied by the Federal Reserve, rather than the reverse as under lagged reserves.[4] The Federal Reserve is actively studying these proposals and has announced that it is disposed toward returning to contemporaneous reserve accounting, possibly by September 1, 1981. Adoption of such a change in institutional arrangements would necessitate substantial reprogramming costs by depository institutions, as well as some important changes in their mode of operation. But, to the extent it is desired to pursue a reserves targeting procedure, contemporaneous reserve accounting could be of considerable help in achieving the potential improvement in monetary control promised by the reporting and reserve requirement changes introduced by the act.

Pricing Federal Reserve services

In addition to improving monetary control, Title I of the new legislation is designed to limit the loss to the Treasury resulting from the general lowering of reserve requirements and to enhance the efficiency of the payments mechanism. To achieve these goals, it directs the Federal Reserve to impose explicit charges for services traditionally provided to member banks without charge. In brief, Section 107 of Title I:

- Requires the Board to publish no later than September 1, 1980, a set of pricing principles and a proposed schedule of fees based on those principles.

- Requires the Board to begin to implement the fee schedule no later than September 1, 1981.

- Specifies that the services to be priced include (1) currency and coin, (2) check clearing and collection, (3) wire transfer, (4) automated clearinghouse services, (5) settlement, (6) securities safekeeping, (7) Federal Reserve float, and (8) any new services which the Federal Reserve offers.

- Requires that all covered services be priced explicitly.

- Requires that all covered services be available to nonmember depository institutions on the same terms that they are available to member banks.

- Requires that fees be based on all direct and indirect costs of providing services, including interest at the federal funds rate on items credited prior to collection, overhead, and an allowance for the taxes that would have been paid and return on capital that would have been provided had the services been furnished by a private business firm, "except that the pricing principles shall give due regard to competitive factors and the provision of an adequate level of such services nationwide."

- Requires the Board to reduce the operating budgets of the Federal Reserve Banks, "commensurate with any actual or projected decline in the volume of services to be provided."

Background

Almost from its inception in 1913, the Federal Reserve has provided many services to member banks free of charge. Most of these, such as check clearing, the provision of coin and currency, etc., are basic payments services and their provision without charge was long defended as necessary to foster a more efficient payments system. However, many of these services can be supplied by private firms—indeed, some 60 percent of the

[4]In addition to contemporaneous reserve accounting, these proposals include Robert Laurent's reverse lag scheme ("Reserve Requirements: Are They Lagged in the Wrong Direction?" *Journal of Money, Credit, and Banking*, XI (August 1979), 301-10) and William Poole's 100 percent marginal reserve requirement plan ("A Proposal for Reforming Bank Reserve Requirements in the United States," *Journal of Money, Credit, and Banking*, VIII (May 1976), 137-47).

dollar volume of all checks in the United States is cleared outside the Federal Reserve System—and it has been argued that pricing Federal Reserve services will increase the incentives for the private sector to offer similar services. The resulting competition should increase the efficiency with which these services are provided.

Pricing and membership

The past reluctance of the Federal Reserve to price its services was largely attributable to the membership problem and the implications for monetary policy of the rapid erosion of the fraction of total deposits subject to federal reserve requirements. In this context, the provision of services without explicit charge partly offset the cost to member banks of holding noninterest-earning reserves and helped to prevent even more banks from leaving the Federal Reserve System.

The act eliminated this concern about pricing and its effect on the conduct of monetary policy. Member banks can no longer avoid the cost of holding sterile reserves by simply withdrawing from membership in the Federal Reserve System. Banks that withdraw must hold the same amount of reserves as member banks. Furthermore, the Federal Reserve is now legally required to charge for specific services and can no longer postpone this action. The issues of whether and when to price for services have been decided by the Congress. Nevertheless, as the discussion of the reserve requirement provisions of Title I made clear, the act does substantially reduce the burdens of membership.

Charging an explicit price will provide an incentive for the public to economize on the use of services that are now subsidized by the Federal Reserve. For example, the Federal Reserve processes without charge any number of checks that a member bank presents for collection. Aside from the fixed price of membership, the only costs to a member bank are the costs of presorting and encoding the checks before they are shipped to a Federal Reserve office. The Federal Reserve bears the costs of additional sorting and of any Federal Reserve float that is created.

This practice has had the effect of hiding the full costs of using checks for payments. Because member banks have not been required to pay an explicit price for check processing and because they must compete with other financial institutions for deposits, they have not charged their customers the full costs associated with paper checks. In turn, customers have had little economic incentive to economize their use of checks for payment. The results have been to encourage the "overconsumption" of the paper-based payments mechanism and to discourage the development of electronic payments systems.

Proposed fee schedule

On August 28 the Board, in compliance with the act, made public a proposed schedule of fees for its services together with a statement of the principles underlying the fee schedule. To the principles laid down in the act, the Board added four other ones: that over the long run, the fees should "recover total costs for all priced services;" that the fee structure should "avoid undesirable disruptions in service" and "facilitate an orderly transition to a pricing environment;" that it should be "administered flexibly in response to changing market conditions and user demands;" and that "fee and service level incentives" should be used to bring about desired improvements in the payments mechanism.

The proposed fee schedule and statement of principles dealt, in varying degrees, with a number of problem areas related to pricing that the Federal Reserve had recognized long before passage of the act. Among these problem areas are:

Private sector adjustment. The Federal Reserve is required to include in its fees an adjustment for overhead and the taxes and return on capital that would have been generated had the services been furnished by private business. In its proposed fee schedule the Board recommended that this markup be set initially at 12 percent, subject to annual review. This adjustment has come under criticism by private competitors as being too low.

Differential pricing. The proposed fee schedule that the Board released for public comment on August 28 included a variety of charges for different services. Some of these services, including coin wrapping, securities safekeeping, and noncash collection services, are to be priced at the District or office level. Services such as automated clearinghouse (ACH), net settlement, and on-line securities transfer, which are capital intensive and have similar costs across Federal Reserve Districts, are to be priced uniformly at the national level.

Incentive pricing. The only clearly promotional pricing in the Board's proposed fee schedule is for ACH services. In line with its longstanding policy of actively encouraging electronic payments, the Federal Reserve will price ACH services at levels reflecting System costs "in a mature volume environment"— i.e., lower than current costs could justify.

Federal Reserve float. The Federal Reserve is committed to reducing the level of its float and has adopted a three-phase program to achieve this goal. The first phase, which is already in progress, involves improvements in processing and transporting checks and other float-related items. The second phase calls for the use of fractional availability schedules based on actual collection experience. The third phase will be pricing whatever Federal Reserve float remains and will be implemented prior to mid-1982. This will give the System time to resolve the difficult problems of identifying the sources of float and determining who should be charged.

Clearing balances. A considerable number of member and nonmember depository institutions will maintain zero or negligible required reserve balances with the Federal Reserve because their normal vault cash holdings will exceed their reserve requirements. The Board's pricing proposal would allow such an institution to obtain Federal Reserve services by maintaining a special clearing balance with a Federal Reserve Bank. Alternatively, with prior authorization, charges and credits arising from the institution's use of Federal Reserve services could be posted to a correspondent's account or to the passthrough account maintained for the institution at the Federal Reserve by a correspondent.

Titles II and V—Interest rate deregulation

Title II of the act, titled the Depository Institutions Deregulation Act of 1980, provides for interest rate ceilings on time and savings deposits at depository institutions to be phased out over a period of six years. Title V of the act overrides existing state usury laws limiting the interest rate that may be paid on a number of specified types of loans. In removing longstanding impediments to the paying and charging of market interest rates, the act introduces a new era in the long evolution of public policy toward competition in financial markets.

Interest rates on deposits

The first section of Title II states briefly the findings of the Congress and the purpose of the title:

(a) The Congress hereby finds that—(1) limitations on the interest rates which are payable on deposits and accounts discourage persons from saving money, create inequities for depositors, impede the ability of depository institutions to compete for funds, and have not achieved their purpose of providing an even flow of funds for home mortgage lending; and (2) all depositors, and particularly those with modest savings, are entitled to receive a market rate of return on their savings as soon as it is economically feasible for depository institutions to pay such rate.

(b) It is the purpose of this title to provide for the orderly phase-out and the

> ultimate elimination of the limitations on the maximum rates of interest and dividends which may be paid on deposits and accounts by depository institutions by extending the authority to impose such limitations for 6 years, subject to specific standards designed to ensure a phase-out of such limitations to market rates of interest.

Except for details, this section contains all the substantive provisions of the title. Considerable discretion in implementing the title was delegated to the Depository Institutions Deregulation Committee, consisting of the heads of the major federal financial regulatory agencies. Essentially the only specific actions mandated to the Deregulation Committee are that it:

- Shall work toward providing all depositors with a market rate of return on their savings with due regard for the safety and soundness of depository institutions.

- May not raise ceilings on all deposit categories above market rates during the six-year phase-out period.

- Must vote within 18 months after the date of enactment on whether to raise the ceilings on passbook savings by at least ¼ of 1 percentage point.

- Must vote before the end of each of the third through sixth years after enactment on whether to increase the ceilings on all time and savings deposits by at least ½ of 1 percentage point.

In addition, each member of the committee is required to report separately to the Congress each year regarding the economic viability of depository institutions. Each report must assess the effect of removing any differential between the rates payable on deposits by banks and thrift institutions on housing finance and the viability of thrift institutions and recommend measures to encourage saving, treat small savers fairly, and promote housing finance.

Origins and rationale of interest rate ceilings

The prohibition of interest on demand deposits and the ceilings on interest rates on time and savings deposits established by Federal Reserve Regulation Q date from the passage of the Banking Act of 1933. That act declared that "[no] member bank shall, directly or indirectly, by any device whatsoever, pay any interest on any deposit which is payable on demand . . ." and empowered the Board of Governors of the Federal Reserve System to "limit by regulation the rates of interest which may be paid by member banks on time and savings deposits."

Demand deposits. The prohibition of interest on interbank demand deposits was originally proposed to prevent recurring liquidity crises that developed when rural banks attempted to withdraw temporarily surplus funds that they had deposited at large money center banks to take advantage of interest yields. When the prohibition of interest on demand deposits was finally adopted in 1933, however, it was largely for the same reasons that interest payments on time and savings deposits were limited.

The inequities and inefficiencies of the prohibition of interest on demand deposits of individuals (but not of corporations) were addressed in Title III of the act, which authorizes depository institutions to offer interest-bearing transaction accounts to individuals and nonprofit organizations. Because these new liability powers are so closely tied to the new asset powers authorized by Title IV of the act, they are considered together in the next chapter.

Time and savings deposits. The need for interest rate ceilings on time and savings deposits was perceived as being extremely urgent in 1933. In the wake of a decade in which the number of banks declined from a peak of over 30,000 in 1921 to about 24,000 in 1929, followed by an even more precipitous decline of over 9,000 between the end of 1929 and the Banking Holiday of March 1933, no stone was left unturned in the search for a villain.

The most widely accepted explanation of the failures was that excessive competition for deposits had forced banks to raise sharply the interest rates they paid on time and savings deposits. As the banks' costs rose and their profit margins were squeezed, they sought higher-yielding, but more risky, loans and investments to maintain their earnings. This made them more susceptible to failure when the economy weakened.

Though plausible and having a great deal of popular appeal, this explanation of the bank failures of the 1920s and 1930s has never been confirmed. In 1933 it was accepted largely on the basis of anecdotal evidence. Not until interest ceilings had been on the books for nearly 30 years did scholars finally get around to systematic and rigorous testing of the explanation. They found little evidence to support it.[5]

Whether valid or invalid, the original rationale for Regulation Q was a moot point during the next two and one-half decades. As economic activity continued weak after 1933, market interest rates continued to fall. They remained below the ceilings until the mid-1950s, held down by the depressed demand for credit during the 1930s and by the Federal Reserve's policy of supporting the government bond market during World War II. When rates finally pushed against the ceilings in the mid-1950s, the Federal Reserve responded by raising the ceilings, citing the desirability of increased competition.

The credit crunch of 1966

The policy of adjusting the ceilings to accommodate market forces continued until mid-1966. At that time, fueled in part by expenditures for the Vietnam War and more rapid monetary growth, inflation was accelerating from the 2-3 percent rates of the 1950s and early 1960s to a rate between 4 percent and 5 percent. The economy was overheated and was experiencing a boom led by investment expenditures financed, in large part, by loans from commercial banks.

To slow the investment boom without imposing further damage on interest-sensitive areas of the economy, the Federal Reserve refused to raise the rate ceilings established the previous December, precluding banks from selling new CDs and forcing them to cut back on their lending. The Board also sent to the Congress proposed legislation to broaden its powers to classify deposits for purposes of setting rate ceilings and to extend interest rate ceilings on deposits to savings and loan associations and mutual savings banks, to be administered by the Federal Home Loan Bank Board and the Federal Deposit Insurance Corporation, respectively.

The proposal was signed into law on September 21, 1966. The authorities moved quickly to implement their new powers. By setting ceilings on passbook savings at savings and loan associations and mutual savings banks higher than the 4 percent commercial banks were allowed to pay, they hoped to insulate thrift institutions and the mortgage market from commercial bank competition. This differential, which has since been narrowed to ¼ percentage point, became a major subject of controversy in the years preceding passage of the new act.

The events of 1966 constituted a landmark in the evolution of deposit interest rate ceilings. That year saw the first use of the ceilings as a tool of general monetary policy and also their first use as a means of influencing deposit flows between institutions in a selective way. These were major alterations, not only of the rationale of the ceilings, but of the way the ceilings were administered and the constituencies favoring their retention or elimination.

Evasion and avoidance

Not foreseen either at the time the ceilings were first introduced or when they were revised and extended in 1966 were the great

[5]See, e.g., the study by Albert H. Cox, Jr., of 285 national banks, some of which survived and some of which did not survive the years 1930-33, *Regulation of Interest on Bank Deposits* (Michigan Business Studies, vol. 17, No. 4, 1966).

ingenuity and effort banks and other financial institutions would bring to their circumvention. During the last half of the 1960s and much of the 1970s, banks kept several steps ahead of the regulators in devising new liabilities that, because they were not defined to be deposits, were free of both reserve requirements and Regulation Q ceilings. Most of these were belatedly defined as deposits, thereby becoming subject to interest rate ceilings, reserve requirements, or both.

Besides designing new forms of liabilities, financial institutions also sought other means to compete for deposits in the presence of interest rate ceilings. These included the establishment of more branch offices than would otherwise be built and offering depositors noncash premiums as an inducement to open accounts. The additional offices add somewhat to the convenience of the public, and the noncash premiums help to offset the loss in explicit interest due to the ceilings, but depositors would probably prefer to receive higher money interest returns. Although the Board long ago adopted regulations declaring that premiums did not constitute interest, their proliferation led the Board to place limitations on their cash value.

Cost of the ceilings

Such aberrations would be merely funny were it not true that they involve serious social costs. Aside from the basic inefficiency of paying for deposits with premiums rather than money interest, the constant search for new ways to avoid Regulation Q and the efforts of the authorities to monitor and plug any resulting loopholes have both been responsible for considerable expenditure of time and effort.

Time and experience have led many depositors to search for outlets for their funds that do not involve public regulation of their realizable rates of return. When ceilings were binding, large depositors turned from the negotiable CD market to Treasury bills, commercial paper, and other unregulated financial instruments. Eventual recognition of this fact by the Federal Reserve and the FDIC led, in 1970, to the suspension of the ceiling on short-term CDs over $100,000 and, in 1973, to the elimination of the rate ceiling on longer-term large time deposits.

Even small savers have gradually been led to seek more remunerative uses for their funds. Such recently developed institutions as money market mutual funds have enabled them to share in the higher returns available on otherwise inaccessible large-denomination securities previously available only to large investors. To enable banks and thrift institutions to compete better, the supervisory agencies authorized them in June 1978 to begin issuing money market certificates, savings certificates whose yield is tied to the rate on Treasury bills.

To be sure, some small depositors, because of ignorance or the small size of their savings or the convenience of keeping them in a highly liquid form, have not seen fit to withdraw their deposits from passbook savings accounts. In nominal dollars, the losses to small savers from rate regulation have been estimated at $5.2 billion for the years 1968-70.[6] More recently, as inflation carried interest rates up to double-digit levels, the real, or price-adjusted, rate of return to such savers declined sharply. During the past several years, it has been strongly negative. This state of affairs is widely perceived as being inequitable, as well as providing a disincentive to saving at a time when productivity and investment have been lagging.

Some of the other undesirable side effects of the ceilings have been much more subtle and are wholly unknown to most of the public. For example, in carrying out monetary policy, the Federal Reserve monitors and influences the growth rates of several measures of the money supply. But when interest rates rise rapidly and the ceilings become binding, some of the broader measures of money—such as M-2, which includes savings

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[6]David H. Pyle, "The Losses on Savings Deposits from Interest Rate Regulation," *Bell Journal of Economics and Management Science*, V (Autumn 1974), 614-22.

and small time deposits—show weaker growth than they otherwise would. Eliminating the ceilings will remove this source of cyclical distortion in the various measures of the money supply.

Disintermediation and the housing market

A primary obstacle to removal of the ceilings has been the fear that doing so would subject specialized mortgage lending institutions to repeated and severe bouts of disintermediation, with unfortunate consequences for the mortgage and housing markets. It has gradually become clear in recent years that it is not commercial bank competition—which the ceilings were designed to curb—that is the most serious threat to the mortgage and housing markets, but the competition of the open market and of the new, unregulated institutions like money market mutual funds. In the final analysis, the ceilings have fostered disintermediation from banks and thrift institutions alike by preventing them both from competing with the open market. Growing acceptance of this fact by the savings and loan industry, together with the greater flexibility offered by the enlarged asset powers for thrift institutions introduced by Title IV of the act, helped to overcome opposition to the elimination of the favorable treatment of thrift institutions under the present ceilings.

Problems of implementation

Given the controversial character of deposit rate regulation, the Deregulation Committee's task of phasing out deposit interest rate ceilings is unlikely to be easy. In its first action in late May, the committee raised the ceilings on six-month and 2½-year money market certificates and eliminated (under most conditions) the ¼ percent differential between rates payable on six-month certificates by thrift institutions and banks. Subsequently, the committee was sued by the U.S. League of Savings Associations for moving too quickly to deregulate deposit interest rates.

On the other hand, the committee proposed in early May that banks and thrift institutions be barred from offering gifts and premiums to attract new depositors. Some bankers have supported this proposal, citing the fact that it is illogical to continue to restrict competition in interest rates while allowing competition in premiums. However, others have sharply attacked the committee for imposing new restrictions in contravention of its mandate to deregulate.

Final rules issued by the committee on October 9 allowed the continued use of premiums, though restricting the amount that will not be regarded as interest, and defined finders fees as payment of interest to the depositor. The committee also established a 5¼ percent ceiling rate on 14- to 90-day time deposits at commercial banks and a 5½ percent ceiling at thrift institutions and set a ceiling rate of 5¼ percent on NOW accounts at all depository institutions, effective December 31, 1980. The controversy engendered by these decisions suggests that the next six years will be interesting, both for the committee and for those affected by its actions.

Usury laws

Title V is much more specific in what it requires than Title II. It overrides state usury provisions, constitutional or otherwise, on types of loans specified in the several sections of the title. In particular, the title:

- Exempts from state limitations on interest and other charges loans made after March 31, 1980, that are secured by a first lien on residential real property, by a first lien on stock in a residential cooperative housing corporation where the loan, mortgage, or advance is used to finance the acquisition of such stock, or by a first lien on a residential manufactured home and that meet certain other criteria specified by Section 527(b) of the National Housing Act.

- Gives states until April 1, 1983, to reinstate usury ceilings by adopting a new law or allowing the voters to adopt a provision stating explicitly and by its terms that the state does not want to be subject to the provisions of the title.

- Overrides state limitations on the interest rates payable on deposits or accounts at depository institutions. This simply completes the deregulation of deposit interest rates provided for at the national level by Title II.

- Exempts business and agricultural loans of $25,000 or more from state usury provisions until April 1, 1983, replacing them with the restriction that interest rates on such loans may not exceed "5 per centum in excess of the discount rate, including any surcharge thereon, on ninety-day commercial paper in effect at the Federal Reserve bank in the Federal Reserve district where the person is located."

- Provides for forfeiture of all interest on any loan on which the lender has knowingly charged a higher rate than allowed by the act and authorizes persons paying interest in excess of the permitted rate to recover in a civil action twice the amount of interest paid.

- Allows state-chartered banks and both federally and state-chartered insured savings and loan associations and credit unions to disregard state interest ceilings on other types of loans in those cases where the maximum rate prescribed by the state is exceeded by "a rate of not more than 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal Reserve bank in the Federal Reserve district where such State bank . . . is located. . . ."

- Allows small business investment companies to charge interest on business loans at a rate not exceeding the lowest of: the maximum rate prescribed by the Small Business Administration, the maximum rate authorized by state law which is not preempted by the act, and the Federal Reserve discount rate on ninety-day commercial paper plus 1 percentage point.

Although there have been few absolute prohibitions of the taking of interest since medieval times, most people retain strong convictions regarding the charging of what are seen as excessive or unfair rates of interest. State usury laws in the United States were patterned in many cases after the Massachusetts statute of 1641, which was repealed in 1867. The Massachusetts law, in turn, followed the English law of the early 17th century in prescribing a maximum lending rate of 8 percent.

Problems

The problems with usury laws are fairly straightforward. First, the costs and risks of lending small amounts to poor credit risks make such lending unremunerative at the statutory levels. Consequently, such borrowers will not be accommodated at all at the statutory rate. Secondly, the profit opportunities inherent in lending to such borrowers at an unrestricted rate give rise to a variety of devices, legal and illegal, to circumvent the ceilings. Exceptions to the usury ceilings have proliferated, making a tangled web of the statutes governing lending in many states.

Finally, even usury ceilings that have appeared reasonable in normal times, in the sense of allowing lenders a modest but competitive rate of return, have become wholly unrealistic as market interest rates have risen sharply in recent years. The most dramatic effects have been observed in the mortgage markets, as some lenders in states with exceptionally restrictive ceilings on mortgage rates—e.g., New York—have at times virtually ceased to lend to borrowers within the state.

The disruption to housing markets induced by the ceilings has led to frantic efforts to amend the usury laws in these states, sometimes in the face of determined opposition. In some cases, changing the ceilings required amendment of the state constitution, an inherently difficult process. Nevertheless, a number of states have succeeded in liberalizing their usury laws, in some cases tying the ceiling rates to a market rate.

However, other states have encountered serious difficulties in obtaining revision, and their consumers have suffered as a consequence. It was these difficulties that culminated in the adoption of Title V of the act, which overrides state usury laws with respect to the maximum allowable interest rates on a wide range of specified types of loans.

Titles III and IV—Nationwide NOW accounts and new thrift institution powers

New powers for banks and other depository institutions to extend and diversify their balance sheets are provided in Title III, designated the "Consumer Checking Account Equity Act of 1980," and Title IV. Title III provides the first permanent nationwide authorization for depository institutions to offer interest-bearing transaction accounts effective December 31, 1980, and expands other deposit offering and servicing capabilities of these institutions. Specifically, Title III:

- Authorizes most types of depository institutions to offer negotiable order of withdrawal (NOW) accounts.

- Authorizes banks to continue offering automatic transfer services (ATS) for shifting funds from savings to checking accounts.

- Authorizes all federally chartered credit unions to issue share drafts.

- Authorizes savings and loan associations to establish remote service units (RSUs) to facilitate debits and credits to savings accounts, loan payments, and related transactions.

- Increases deposit insurance from $40,000 to $100,000 at federally insured banks, savings and loan associations, and credit unions.

These provisions are designed to contribute to competitive equality among depository institutions by allowing all of them to offer interest-bearing transaction accounts.[7] They are also designed to benefit individuals and nonprofit organizations by allowing them eventually to receive a market rate of return on their checking account balances. However, the 1933 prohibition of the payment of interest on transaction accounts of corporations and governmental units remains in effect.

Title IV of the act focuses primarily on the asset holdings of nonbank thrift institutions. It aims at overcoming the existing maturity imbalance between the predominantly long-term asset portfolios, mainly fixed-rate mortgage loans, and short-term deposit and nondeposit liability structures of these institutions. Among the new powers conferred on federally chartered savings and loan associations by Title IV are:

- Investment of up to 20 percent of their assets in consumer loans, commercial paper, and corporate debt securities.

- Investment in shares or certificates of open-end investment companies that are registered with the SEC and that restrict their portfolios to the same investment instruments that savings and loan associations are allowed to hold directly.

- Investment of up to 5 percent of their assets in loans for education and community development and unsecured construction loans.

- Issuance of credit cards and extension of credit in connection with credit cards.

[7]The act removes uncertainties about the legality of interest-bearing transaction accounts dating back to 1972 when NOWs were first introduced by savings banks in Massachusetts and New Hampshire. Prior to congressional action in mid-1973, NOWs, and later ATS, were legally challenged on the grounds that they violated the prohibition of interest payments on demand deposits. After ATS was struck down in federal court in 1979, banks offered ATS under temporary powers until the act was passed. The act also supersedes court decisions declaring remote service units of savings and loan associations in violation of state branching restrictions and credit union share drafts to be in violation of the Federal Credit Union Act.

• Provision of trust and fiduciary powers under restrictions and protections similar to those applicable to national banks.

• Inclusion of shares of open-end management investment companies among the assets eligible to satisfy liquidity requirements.

• Issuance of mutual capital certificates to be included as part of general reserves and net worth.

For mutual savings banks with federal charters, new powers include:

• Investment of up to 5 percent of total assets in commercial, corporate, and business loans within the home state of the bank or within 75 miles of the bank's home office.

• Acceptance of demand deposits in connection with commercial, corporate, and business loan relationships.

In addition to specific new powers for thrift institutions, Title IV mandated that the President convene an Interagency Task Force with representation from the Treasury, HUD, and various federal regulatory and insuring agencies for banks and thrift institutions. This task force studied the asset-liability management problems of the thrift industry and submitted its findings and recommendations in late June.[8]

Why thrift institutions need new powers

The new powers for thrift institutions embodied in the act, and the recommendations of the Interagency Task Force, are aimed at alleviating the "thrift problem." Fundamentally, the thrift problem involves a maturity imbalance between the assets and liabilities of thrift institutions. The problem is rooted in the past high degree of specialization in mortgage lending by savings and loan associations and mutual savings banks.

Constrained by regulation, tax incentives, and management philosophy, thrift institutions have diligently marketed conventional and federally insured fixed interest rate loans with original maturities exceeding 20 years and an average effective life of more than ten years. For this to be profitable, the stable returns on outstanding fixed-rate loans had to exceed, over their effective lives, the costs of funding to support them. Until the mid-1960s, lenders were able to profit from the fairly stable spread between returns on their mortgage loan portfolios and interest costs on predominantly savings-account liabilities.

Since then, however, high rates of inflation, accompanied by rapidly rising and unpredictable market interest rates, have converted the advantage of a steady stream of interest and principal payments from fixed-rate mortgage loans into an overriding disadvantage. Several times in recent years the yield curve showing the relationship between yields and maturities on otherwise similar securities has been downward sloping. During these periods thrift institutions have had to pay more for some of their short-term funds than could be earned on mortgage loans, even at the margin. If such a situation were to prevail for a long period of time, thrift institutions would experience serious liquidity and solvency problems.

Thrift institutions suffered through their first major episode of financial disintermediation in 1966, as depositors shifted to higher-yielding alternative investments in the open market. As was noted in the discussion of Title III of the act, rate ceilings on thrift deposits precluded direct competition with the money market for funds. Even without rate ceilings, however, fixed returns on existing mortgage loans would have constrained the extent to which thrift institutions could compete for higher cost liabilities.

New sources of funds

More recently, thrift institutions have developed new funding sources to replace their eroded savings-deposit base for mort-

[8] For the full discussion of the issues and recommendations, see *The Report of the Interagency Task Force on Thrift Institutions*, House Committee Print 96-14, 96th Cong., 2d Sess. (Government Printing Office, July 1980).

gage lending. The Federal Home Loan Bank Board (FHLBB) has greatly extended the borrowing privileges of member institutions. In mid-1980 Federal Home Loan Bank advances plus direct borrowings from other sources amounted to almost $55 billion of indebtedness for savings and loan associations.

Deposit liabilities of thrift institutions, currently amounting to more than $475 billion for savings and loan associations and nearly $150 billion for mutual savings banks, have increasingly shifted into deposit instruments with market-related interest rates. Such deposits, which include six-month money market certificates, 2½-year certificates, and "Jumbo CDs" in denominations of $100,000 or more, accounted for almost half of the deposit liabilities of savings and loan associations as of September 1980. But while nondeposit liabilities and deposits with market-related rates of interest have helped to stabilize the flow of funds to thrift institutions, they do not solve the problem of increases in the average level of current funding costs or reduced predictability of future costs.

Pricing and promoting NOWs

The newly authorized NOW accounts are likely to be an important source of funds to thrift institutions in the future, as share draft accounts will be to credit unions. Indeed, the success of such institutions as full-service financial centers for consumers will largely depend on their ability to compete with commercial banks for NOW account business. Some key features of these NOW offerings will be the level of interest payments, the level and distribution of charges between draft-clearing fees and monthly maintenance charges, and the size of minimum balance requirements.

Interest payments. Most banks and savings and loan associations are likely to pay the maximum legally allowed interest on NOW accounts—currently set at 5¼ percent per annum. Experience in New England has shown that customers prefer explicit service charges and minimum balance requirements for pricing NOW services rather than interest forfeitures or reductions in interest rates paid on NOW balances.

Draft-clearing fees. To give consumers an incentive to economize on the number of NOW drafts used, many banks and savings institutions probably will charge clearing fees of 5 cents or 10 cents or more per item, at least for customers carrying small average NOW balances. The likelihood of such charges is suggested by the New England NOW experience, recent reversals in the trend toward free checking at banks, and the fact that, under Title I of the act, institutions offering NOWs themselves will be subjected to explicit per-item charges for NOW drafts cleared by the Federal Reserve or by the Federal Home Loan Bank System.

Monthly maintenance charges. Like per-item clearing fees, monthly charges will tend to reduce the number of NOW account depositors. Unlike per-item fees, however, monthly charges will not ration individual account activity. The crucial consideration for the institution offering NOWs is determining whether per-item or monthly fees (or both) lead to the broadest base of customer appeal.

Minimum balance requirements. Requiring minimum account balances—either absolute minimums or on average over a month—is of course an implicit method of pricing NOW services. Like explicit clearing fees and monthly charges, minimum balances will tend to reduce the number of consumers using NOW services, but will raise profitability per account. To strengthen and emphasize the "total customer relationship," some banks are likely to include deposit balances other than NOW accounts in the minimum balance requirement. At least initially, there is a strong possibility of promotional pricing by some aggressive institutions resulting in short-term losses.

ATS versus NOWs

A special issue for banks to resolve will be the immediate fate of automatic transfer services (ATS), which are an extremely close subsitute for NOW accounts. Banks have a strong incentive to replace ATS with NOWs to establish their market presence along with competitors offering NOWs. Switching from ATS to NOWs also reduces bank operating costs by eliminating transfers from savings to transaction accounts and the accompanying need to provide two-statement or joint-statement account records for internal use and customer mailings. Many banks will be able to switch from ATS to NOWs without incurring high-cost changeovers in computer software and other processing procedures. In fact, many banks originally designed their ATS accounts for such a transition in anticipation of nationwide NOWs.

New asset powers

Title IV of the act is aimed at bringing the asset side of thrift institution balance sheets up to date with the regulatory and market-induced innovations on the liability side. By allowing greater latitude in the deployment of funds, Title IV will enable thrift institutions to shorten the effective maturities of their asset portfolios, more closely matching liability maturities. Such asset maturity reduction will assume even greater importance once thrift institutions begin competing for NOW accounts and when deposit interest ceilings eventually are removed.

Among the major advantages of the new lending and investment powers are the increased opportunities afforded thrift institutions for diversifying their earning-asset portfolios. As a general rule, diversification allows reduced risk-taking per dollar of return or, conversely, greater dollar returns for any particular overall level of risk borne.

Taken separately, consumer loans tend to yield somewhat higher returns net of administrative costs, but have somewhat greater risks of borrower default, than mortgage loans. At the same time, consumer loan maturities are only a fraction of those for fixed-rate mortgages. Diversification strategy to incorporate consumer loans into their portfolios will dictate that thrift institutions hold a sufficient dollar volume and variety of these loans so as to take advantage of reduced default risk-taking per dollar of return *within* the consumer loan portfolio itself. The second step in their strategy will be to manage their consumer loans, their other newly authorized short-term investments (of minimal default risk), and their longer-term mortgage loans as a unified portfolio to take advantage of diversification between short- and longer-term earning assets.

New mortgage instruments

In addition to seeking overall portfolio balance, thrift institutions must also look toward revising their basic mortgage instruments to make mortgage loan returns responsive to money-market conditions. State-chartered savings and loan associations in California for some years have issued variable-rate mortgages—instruments which allow periodic interest rate adjustments in response to changes in the lender's average funding costs. In January 1979 the FHLBB authorized variable-rate instruments for all federally chartered savings and loan associations in California, and in July 1979 extended these powers nationwide. In April 1980 the FHLBB also authorized federally chartered associations to issue renegotiable-rate, or "roll-over," mortgages which allow interest rate adjustments every three, four, or five years with up to a 5 percentage point maximum revision over the full term of the contract.

The report of the Interagency Task Force recommended continued development and use of these "more flexible, cost-responsive mortgage instruments." These mortgage instruments should dramatically improve the flow of mortgage credit and bolster thrift institution profitability in tight money periods. To improve the liquidity of these mortgages, the Task Force also recommended that adequate secondary markets be developed along the lines of those already pioneered for fixed-rate mortgages by the Federal National

Mortgage Association and Government National Mortgage Association.[9]

Implications of new powers for mortgage lending

Clearly, one purpose of the new powers for thrift institutions was to increase the flow of funds to the mortgage and housing markets—or, at the very least, to prevent the wide countercyclical swings in mortgage activity and housing construction experienced in the past. However, one obvious effect of the thrift institutions' new lending powers will be to reduce the proportion of mortgages to total assets in their portfolios. Any net increase in the dollar volume of their mortgage lending must therefore be the result of growth in their total assets.

Under the new act, a federally chartered thrift institution can meet the consumer's transactions needs through a NOW account, provide investment outlets through regular savings and money-market instruments, and provide consumer credit for automobiles and home improvements and other purposes. The act also permits federal savings and loan associations to exercise trust and fiduciary powers.

To the extent that these new services attract new customers or help thrift institutions to retain deposits over the business and credit cycles, the benefits to these institutions should be enormous. In addition to more stability on the liability side, repayments on consumer instalment loans and holdings of short-term investments—such as commercial paper and open-end investment funds—should provide a liquidity cushion for thrift institutions during periods of tight credit. These cash flows can be used to help meet any deposit withdrawals that do occur or to add new mortgage loans to their portfolios. Conceivably, therefore, the effect of the new powers for thrift institutions could be both to expand and to stabilize their mortgage lending.

At present, there is no really convincing evidence bearing on this question. However, several of the deregulation provisions of the act—elimination of deposit rate ceilings, extension of third-party payment services and consumer lending powers to thrift institutions, and broadening of the thrift institutions' investment powers—were similar to those recommended by the Hunt Commission in 1971. In 1972 the effects of these changes on the mortgage and housing markets were simulated using a large-scale econometric model.[10] The overall conclusion was that the net effect of all the changes would be very small, on both mortgage lending and the housing market, with most of the positive impact attributable to the third-party payment and consumer loan services. Essentially similar conclusions were reached by another study done at about the same time.[11] Because of the many institutional changes that have occurred since the studies were carried out, these results must be taken with some reservations. But they do suggest that freeing thrift institutions to diversify their services is unlikely to have any disastrous effects on the mortgage and housing markets.

[9]The secondary mortgage market is discussed in Chapter III of *The Report of the Interagency Task Force on Thrift Institutions*, pp. 73-88.

[10]Ray C. Fair and Dwight M. Jaffee, "The Implications of the Proposals of the Hunt Commission for the Mortgage and Housing Markets: An Empirical Study," in *Policies for a More Competitive Financial System*, Conference Series No. 8 (Federal Reserve Bank of Boston, 1972), pp. 99-148.

[11]Paul S. Anderson and Robert W. Eisenmenger, "Impact of the Proposed New Financial Structure on Mortgage Markets," in *Policies for a More Competitive Financial System*, Conference Series No. 8 (Federal Reserve Bank of Boston, 1972), pp. 149-72.

Titles VI-IX—Other provisions of the act

The judgment was made in the preparation of this article that the key provisions of the act were those dealing with monetary control, deregulation of interest rates, and expanded powers for thrift institutions. Nevertheless, the last four titles of the act also contain some provisions that may have considerable significance for the future evolution of the financial system.

Title VI—Truth in Lending Simplification

Designated the Truth in Lending Simplification and Reform Act, Title VI revises the 1969 Truth in Lending Act to make it easier for creditors to comply with its disclosure provisions. The title requires the Federal Reserve to publish model disclosure forms, exempts agricultural credit from coverage by Truth in Lending, and permits lenders greater tolerance (one-eighth of 1 per centum) in disclosing the annual percentage rate.

The title also authorizes the enforcing agency to require reimbursements in cases where the annual percentage rate or finance charge is inaccurately disclosed, but releases creditors from civil liability for unintentional violations resulting from bona fide errors.

Title VII—Amendments to the national banking laws

Part A of this title contains a number of minor revisions of the national banking laws. It authorizes the Comptroller of the Currency or the Board of Governors to extend the five-year period that national banks or bank holding companies are currently allowed to dispose of lawfully acquired real estate, removes the limitation of dividends on preferred stock of national banks to 6 percent, provides for revocation of trust powers of national banks, and specifies new minimum ownership requirements for directors of national banks. It also imposes a moratorium until October 1, 1981, on interstate acquisitions of trust companies by bank holding companies, and directs the Board of Governors not to deny any application to form a one-bank holding company solely because it involves a bank stock loan which is for a period of not more than 25 years. Part B of the title terminates the closed receivership fund established for national banks closed on or before January 22, 1934.

Title VIII—Regulatory simplification

Designated the Financial Regulation Simplification Act of 1980, Title VIII complements the specific deregulatory provisions of other titles of the act. It calls upon the federal financial regulatory agencies to limit regulations to those for which a need has been established; to minimize the compliance costs and paperwork associated with any regulations imposed; to eliminate conflicts, duplication, and inconsistencies in regulations whenever possible; to obtain participation and comments from other federal, state, and local agencies, financial institutions, and consumers before establishing a regulation; and to make any regulation issued as simple and clearly written as possible. The title also requires the federal financial regulatory agencies to review existing regulations periodically to assure that they are in keeping with these policies and to submit annual reports of their progress in implementing the title to the House and Senate Banking Committees. The title is to terminate five years after its date of enactment.

Title IX—Foreign control of U.S. financial institutions

This title imposed a moratorium on takeovers of domestic financial institutions by foreign persons until July 1, 1980. Exception was made for cases in which the takeover was necessary to prevent failure of the institution, the application for the takeover was submitted on or before March 5, 1980, or the acquired institution has deposits of less than $100 million, and for certain other cases.

The moratorium was adopted to give the Congress time to consider new legislation in response to what has been viewed in some quarters as an alarming increase in foreign takeovers of U.S. financial institutions. A Federal Reserve staff study released June 13 concluded that such takeovers were not a serious problem at the present time and recommended that no new legislation be passed. Absent any action by the Congress, the moratorium was allowed to expire on July 1.