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The Garn-St Germain Depository
Institutions Act of 1982

A sweeping law

What a law says, and what it actually does, can be quite different things. When the authors began work on this special issue of ECONOMIC PERSPECTIVES in the fall of 1982, they knew that the Garn-St Germain Act was an important piece of legislation. But many researchers viewed it primarily as a rescue operation for a savings and loan industry that had experienced serious financial difficulties in recent years.

What was not anticipated was the stunning growth of the new accounts that were authorized by the act. From early December to late March, nearly $350 billion was placed in the Money Market and Super NOW accounts, an unprecedented movement of individual assets.

Where the money came from, and what its effects on the money aggregates and on economic growth will be, are not yet clear. Nor is it certain what effect the thrifts' new asset powers will have. These are questions to be addressed in future issues of ECONOMIC PERSPECTIVES. But, with funds still pouring into the new accounts, it is already clear that the Garn-St Germain Act will have important—and perhaps unexpected—ramifications for many years to come.

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The Garn-St Germain Depository Institutions Act of 1982

Gillian Garcia, Herbert Baer, Elijah Brewer, David R. Allardice, Thomas F. Cargill, John Dobra, George G. Kaufman, Anne Marie L. Gonczy, Robert D. Laurent, and Larry R. Mote

Preface

The Garn-St Germain Act has been called the most significant legislation for depository institutions since the 1930s. While this is an exaggeration, the act is important, particularly for thrift institutions. In the Seventh District, as in most of the Midwest, savings and loan associations, commercial banks, and bank holding companies are the principal competitors. This special issue of ECONOMIC PERSPECTIVES is devoted to summarizing the content of the law and assessing its impact on these institutions.

The issue was researched and written under the direction of Gillian Garcia, senior economist, Federal Reserve Bank of Chicago. Along with her general editorial duties of coordinating the work of a number of fellow economists, and reducing several hundred pages of material to a 32-page issue of ECONOMIC PERSPECTIVES, Garcia wrote the opening sections, which discuss the "History leading to the act" and "The main features of the act."

Chicago Fed economist Herbert Baer prepared the material on "The act's impact on S&Ls." Elijah Brewer, also an economist at the Chicago Fed, produced "The impact on commercial banks." "The impact on bank holding companies" was the work of David R. Allardice, senior economist and assistant vice president.

Thomas F. Cargill and John Dobra, professor and assistant professor, respectively, of economics, at the University of Nevada, Reno, wrote the section on "Due-on-sale provisions." George G. Kaufman, professor of economics, Loyola University, Chicago, wrote "A reexamination of deposit insurance."

"Implications for monetary policy" was written by Garcia, Fed economist Robert D. Laurent, and vice president Anne Marie L. Gonczy. Economic advisor and vice president Larry R. Mote prepared the final section, "What remains to be done."

The authors would like to thank Susan Krause, of the Office of the Comptroller of the Currency, Washington, D.C., for her help in providing background materials used in the preparation of this study.

History leading to the act

In the past, the savings and loan associations (S&Ls), mutual savings banks, and credit unions that constitute the thrift industry have been in the business of credit risk, denomination, maturity, and interest rate intermediation. That is, traditionally they have purchased small denomination, short-term deposits in order to make larger, longer-term fixed rate loans. Their intention has been to profit from this intermediation by charging a higher rate on their loans than that paid on their deposits.[1] It is this maturity imbalance aspect of the thrifts' business, together with a traditional inability to revise the interest rate or other conditions of their long-term loans on the occurrence of unforeseen events, that has produced the industry's recent serious problems.

Such intermediation exposes depository institutions to three risks. The first is the traditional and recognized risk of default. Coping with this risk has remained the responsibility of management, although the current problems facing commercial banks of potential default by several domestic corporations and foreign governments are testing this responsibility.

The second risk arises from the possibility that depositors may unexpectedly withdraw their deposits and the institution may not have enough liquid assets to meet the demand; this is liquidity risk. Central banks in general—and also the Federal Home Loan Bank (FHLB) in the U.S.—have long acted as lenders-of-last-resort to limit exposure to this risk.

The third danger occurs when market interest rates rise unexpectedly. In a world where depository institutions pay market interest rates on their liabilities, rising interest rates raise costs and put pressure on profits. This pressure is particularly acute for institutions that have made long-term loans at fixed rates, the traditional form of the mortgage contract in the United States since the 1930s. This predicament—interest rate risk—is particularly characteristic of the savings and loan industry. It has been exacerbated by an inability, in some states, to enforce due-on-sale clauses in mortgage contracts. This inability lengthens the contract beyond its expected life.

Avoiding undue exposure to this risk has remained management's responsibility. But a pervasive inability to handle interest-rate risk among savings and loan associations and mutual savings banks has caused Congress to intervene. During the past 2-3 years the position of the industry has deteriorated so severely as to provide the principal impetus for the current legislation.

Increasing pressure on thrift earnings, stemming from rising market interest rates, provided a persuasive argument for the 1966 extension of interest-rate ceilings on deposits to thrifts as well as commercial banks. The extension was intended to help thrift profitability by ensuring that their sources of low-cost funds would be channeled particularly to mortgage lending, thus sustaining demand in the housing industry. In time, however, deposit rates—fixed under Regulation Q in the face of rising market interest rates—led to the disintermediation that became a recurring problem at peaks of the interest rate cycle.

Sudden and rapid disintermediation can lead to a liquidity crisis. Liquidity crises are potentially life-threatening to depository institutions if the lender of last resort does not satisfy their liquidity needs. Then institutions are forced to sell assets. As the market value of assets has been reduced by the rise in interest rates, liquidation may not provide sufficient funds to pay off depositors and insolvency results.

One way to prevent disintermediation is to allow thrifts and banks to pay market rates on their liabilities. The problem here is that those institutions have followed customary practice and are, therefore, carrying a portfolio of fixed-

[1] As Kaufman (1972) has pointed out, it is not necessary that the mortgage loan rate exceed the institution's cost of funds at every moment in time. At certain stages of the business cycle short-term rates are likely to exceed long-term rates. Then losses will be made, which must be recouped and dominated over the full term of the loan by profits made during other stages of the cycle.

rate long-term assets acquired in an earlier period at low rates, so that they may not be able to afford the higher rates. If they are forced to pay such rates in order to prevent disintermediation, profits will be sharply reduced or eliminated, as they have been in recent years. An industry with too many successive years of negative earnings cannot remain viable.

The Congress and the regulators have made a succession of attempts to alleviate these problems. During the 1960s and 1970s large depositors, having ready access to alternative instruments paying market rates, were successful in getting banks and thrifts to pay market rates on large (over $100,000) certificates of deposits, repurchase agreements, etc. It has taken much longer for the smaller saver to gain the same opportunity.

During the 1970s, however, efforts were made to prevent small-saver disintermediation. Permission was granted for financial institutions to pay rates above the low, regulated passbook savings deposit rate. In this way, a hierarchy of Regulation Q rates for time deposits of increasing maturity was created. To obtain higher rates the saver was encouraged to extend the maturity of his certificate. The intention here was to lengthen the average maturity or, more precisely, the duration of the liability portfolio, to reduce the gap between assets and liabilities and also to discourage disintermediation by placing penalties on early withdrawals.[2]

Steps toward ending Regulation Q

As interest rates continued their trend upward, the regulators made several concessions toward permitting market interest rates to be paid to the small saver. The first step was the short-lived 1973 introduction of the "wild-card" certificate. For a short period this allowed uncapped rates to be paid on a limited amount of long-term certificates of deposit. The second attempt, resulting from court action that overruled the regulators' objections, was an experimental permission for negotiable order of withdrawal accounts (NOWs) in the New England States. This allowed interest (at regulated rates) to be paid on transaction accounts. Money market certificates (MMCs), were introduced in June 1978. Automatic transfer accounts (ATS) followed in November 1978.

The MMC allowed Treasury-bill-linked rates to be paid on certificates of 6 months' maturity. These certificates proved very popular and had the beneficial result of reducing depository institution exposure to disintermediation. However, they encouraged depositors to place their intermediate denomination ($10,000) deposits in relatively short-term accounts. This did nothing to help the S&Ls' duration and interest rate imbalance problem. Consequently, permission was given in 1979 for a small-savers' certificate (SSC) of 4-year and later of 2½-year maturity. This concession constitutes the fifth step toward deregulating deposit rates.

The Depository Institutions and Monetary Control Act of 1980 (DIDMCA) created an interagency committee, the Depository Institutions Deregulation Committee (DIDC) to oversee an orderly phase-out of interest rate ceilings by 1986. In January 1981, NOW accounts became available nationwide in implementation of the act. Progress toward permitting market-interest-related accounts was then stalled until the spring and summer of 1982, when two medium-denomination, short-maturity (7-31 and 91 day) accounts were authorized by DIDC and rate ceilings were removed on the longest-term accounts according to a phase-out schedule adopted by the committee.

Nevertheless, the disintermediation problem remained. The money market mutual fund industry began in 1972, but it was dormant until 1978. It then began to grow rapidly, as interest rates rose, because it offered a small-denomination, no minimum-maturity, market-interest-rate vehicle to consumers. By the fall of 1982, MMMFs held $230 billion of the nation's funds.

[2]While the maturity imbalance in depository institutions' portfolios is easy to comprehend, research workers have found that the concept of duration provides a more precise tool for analysis. The maturity of a security refers only to the date of capital repayment. Duration, on the other hand, considers the timing of *all* payments—of both capital and interest—due on a security. Duration, then, is a weighted average time of cash flow receipt. For a further discussion of the concept, see Reilly and Sidhu [1980].

Increased asset powers

Successive tinkerings with the unpopular (among small savers and academics) Regulation Q had raised depository institutions' interest costs but had eliminated neither the disintermediation nor the duration imbalance of thrifts' balance sheets. Profitability was thus jeopardized. Attention then turned, at the beginning of the 1980s, to encouraging interest responsiveness for assets as well as liabilities. While some states, such as California, already permitted their state-chartered institutions to offer variable-rate residential mortgage contracts, the regulatory agencies did not permit them for federally chartered thrifts and banks until 1979 and 1980. Even then the S&L industry position continued to deteriorate; Congressional action was needed to alleviate it.

Congressional response to the financial crisis

As the decade of the 1970s closed, it was increasingly evident that the patchwork of ad hoc regulatory concessions and adjustments to Regulation Q was not succeeding. Furthermore, there were other important deterrents to depository institution profitability that lay beyond the regulators' purview. The earnings and net-worth position of the thrifts, in particular, deteriorated in the high-interest-rate, accelerating-inflation, depreciating-dollar, gold, silver and commodity price-explosion environment of the winter of 1979-80. The crisis atmosphere prompted the two houses of Congress to reconcile their differences over legislation proposed during 1979 and to enact the Depository Institutions Deregulation and Monetary Control Act of 1980.[3]

DIDMCA aimed to strengthen deposit institutions' positions by permitting somewhat greater flexibility on both the asset and liability sides of their balance sheets. It was clear at the time of passage, however, that the act was not a panacea. In particular, it would take several years for the new asset powers to reduce the average maturity of the asset portfolio, to raise earnings, and to make them more responsive to rising market rates. The most immediate solution to the major S&L problem (the backlog of old, fixed, low rate mortgages) would be a sustained drop in interest rates. Such a fall occurred in the quarter following the passage of DIDMCA, but it was short-lived and in any case not caused by the act. During the summer of 1980 rates began to rise rapidly and did not fall significantly until the late summer of 1982. In the meantime, the position of the S&L industry had deteriorated so much that it was seen as the Achilles' heel of the financial system.[4] The actual and potential failure rate of individual institutions was reminiscent of the 1930s.

Legislation often derives from the Congress' perception of a crisis. Such is a description of the process leading to the Garn-St Germain Act. Previously, different bills had been introduced into the Congress but had been stalled by the interplay between political parties and lobbying forces. As the perceived severity of the thrifts' crisis increased, political differences were suppressed, compromises were reached, and action was taken.[5]

The resulting Garn-St Germain Act is primarily a rescue operation for the S&Ls and mutual savings banks. But the act also enlarges the options of other depository institutions. It gives regulators greater flexibility in handling crisis situations in which banks and/or thrifts cease to be viable. It provides greater equity for the small saver and is a step toward a more deregulated financial system.

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[3]The book, *Financial Deregulation and Monetary Control*, by Thomas F. Cargill and Gillian G. Garcia, gives the 1980 act's history, summarizes its content, and discusses its impact and the issues it leaves to be addressed.

[4]The extent of the crisis is described in Andrew S. Carron's important book, *The Plight of the Thrift Institutions* (1982).

[5]Fischer, Gentry, and Verderamo provide a succinct description of the bills that originated in the two houses of Congress and the reconciliation process that led to the present act.

The main features of the act

The 1982 act is complex, containing eight titles dealing in detail with different areas of financial reform. Minutiae will be passed over in the following discussion in order to emphasize those aspects considered most important. The discussion is divided into three sections: provisions permanently widening the sources of depository institution funds, and contributing toward the removal of interest-rate ceilings; provisions permanently expanding the uses of funds and other powers; and provisions that temporarily grant regulators emergency powers to deal with the current depository institution crises.

The sources of funds

The act makes four contributions to broadening the catchment area for funds.

(1) The best known provision of the Garn-St Germain Act is its authorization (in Title III) for the new money market deposit account (MMDA). The Congress, impressed by the recent rapid growth of MMMFs, amended DIDMCA to authorize depository institutions to offer an account "directly equivalent to and competitive with money market mutual funds." This account, which has been widely available since December 14, 1982, is federally insured, pays an interest rate restricted only by the discretion of the institution (on initial and average maintained balances of $2,500 or more), and has limited transaction features (six transfers per month: pre-authorized, automatic, or by telephone, of which no more than three may be by check, but unlimited personal withdrawals). On personal accounts it carries no required reserves; a 3-percent reserve requirement is imposed on nonpersonal accounts. If the average balance falls below $2,500, the NOW account ceiling is applicable.

This authorization is regarded as a major breach of the regulatory barriers that restrict competition for funds by depository institutions. It came as a surprise, therefore, that the DIDC acted quickly to authorize another new account, available beginning January 5, 1983. This Super NOW account is restricted to the NOW account clientele (see below), has a minimum initial and maintained average balance of $2,500, has unlimited transaction features, and unregulated interest rates (it pays a NOW rate on balances below the $2,500 level). But it carries a reserve requirement as a transactions account—presently 12 percent.

In December 1982, the DIDC requested public comment on still another proposed account. This Super MMD account would have unlimited transaction features, unregulated interest rates, would be available to all including corporations. The new account would presumably also carry a 12-percent reserve requirement. The committee also requested comment on a proposal to accelerate the existing timetable for rate deregulation. At its March 1 meeting, however, the committee decided against further action. These matters will be reconsidered at the June 28 meeting.

(2) Besides this major permission for market-interest-paying accounts, the act makes three other provisions to broaden depository institutions' ability to obtain funds. Title VII of the act permits federal, state, and local governments to hold NOW accounts. Previously these accounts had been limited

to persons and to nongovernment, nonprofit organizations.

(3) Federally chartered savings and loan associations are permitted to offer demand deposits to persons or organizations that have a business loan relationship with the association or that wish to receive payment due from nonbusiness customers (Title III). Previously, only commercial and mutual savings banks had been able to accept demand deposits.

(4) The DIDC is required to remove by the beginning of 1984 any existing differential in the Regulation Q rate permitted to banks and thrifts (Title III). Previously, thrifts were typically permitted to offer a rate ¼ percent above that of commercial banks on most types of deposits subject to ceiling regulation.

The uses of funds and other powers

Both thrift and bank institutions benefit to some degree from the act's provisions for expanded powers. However, the powers of federal savings and loan associations and savings banks (SBs) are enhanced most by the act. Five sets of provisions are discussed below.

(1) Title III authorizes federally chartered S&Ls and SBs for the first time to make overdraft loans; to invest in the accounts of other insured institutions; and importantly, to make commercial loans. The act also enhances their powers to invest in state and local government obligations; to make residential and nonresidential real estate loans; to make consumer and educational loans.[6]

(2) The existing state-imposed restrictions on the execution of the due-on-sale provisions of mortgage contracts are preempted in Title II for both federal and state institutions. The preemption is delayed for certain seriously affected ("window period") loans, and is prohibited in the case of within-family property transfers.

(3) Thrifts are given wide powers in Title III to alter their charters. They can convert from state to federal charter and conversely, where state law permits. They may switch between mutual and stock form and between savings and loan association and savings bank charters.

(4) State banks and thrifts are empowered in Title VIII to offer the alternative, variable-rate, mortgage instruments that are permitted to their federal counterparts.

(5) National banks receive some relatively minor adjustment of their powers. For example, the "safety and soundness" limitations on the size of loans made to a single borrower are relaxed. Previously, a bank could lend no more than 10 percent of its capital and surplus to any individual borrower. Now, that percentage is raised to 15 percent plus an additional 10 percent for loans secured by readily marketable collateral. However, these limitations will henceforth be applied to loans made to foreign governments and their agencies. Also, restrictions on bank real estate lending and on "insider" loans are relaxed. Banks are also permitted to charter "bankers' banks" and the scope of bank service corporation activities is broadened. However, new restrictions are placed on the large bank holding companies.

[6]S&Ls now have powers to take demand deposits and to make commercial loans. These are the critical elements necessary to meet the Federal Reserve's definition of a bank. Therefore, in order for S&Ls to avoid the restrictions incumbent on that classification, the definition of a bank has been amended to exclude institutions insured by the FSLIC or chartered by the FHLBB.

Emergency powers

Titles I and II of the act enhance, for three years, the powers of the Federal Deposit Insurance Corporation (FDIC) and Federal Savings and Loan Insurance Corporation (FSLIC) to aid troubled banks and thrifts.[7] The agencies can aid institutions which are closed, insolvent, in default or so endangered; or where severe financial conditions exist that threaten the stability of the financial system; or in order to reduce the corporations' exposure to loss. They are empowered to take six types of action. They can issue guarantees; purchase or assume an insured institution's assets or liabilities (but, to preclude nationalization, not its common stock); make loans and contributions to and deposits in a troubled insured institution or company that will acquire it; organize charter conversions; arrange extraordinary mergers and acquisitions; and issue net worth certificates to banks and thrifts with substantial residential real estate loans.

The act provides a framework for both the FDIC and FSLIC to arrange emergency acquisitions of failing institutions across geographic and institutional barriers. While many opposed these powers on the grounds that they would blur the distinction between banks and thrifts and open the door to interstate banking, the regulators argued successfully that they need these provisions to avert potential crises. In some particularly hard-hit regions, it had become increasingly difficult to find merger partners that fit the old rules. In fact, during 1982, the Federal Reserve Board (FRB) and the FHLBB had already authorized both interstate and interindustry mergers, including Citicorp's controversial acquisition of Fidelity Federal Savings and Loan Association of Oakland, Calif.

Under the new rules the FDIC can authorize the acquisition of a large, closed commercial bank, or a closed or endangered mutual savings bank (assets over $500 million) by another federally insured institution, in-state or out-of-state. The FSLIC may exercise such powers regardless of the size of the failing thrift. Further, any qualified purchaser, including out-of-state banks, holding companies, other insured institutions, or *any* other acceptable company may submit bids for the failed thrift. Any federally insured depository institution can bid for a failed large bank. If the lowest bid comes not from an in-state, similar-type institution, all within-the-ball-park bidders may bid again. Then the corporation must attempt to minimize its risk of loss subject to the following priorities:

i) like, in-state institutions
ii) like, out-of-state institutions
iii) different, in-state institutions
iv) different, out-of-state institutions
v) among out-of-state bidders, priority is to be given to adjacent state institutions
vi) the FSLIC, but not the FDIC, is to give priority to minority-controlled bidders when a minority-controlled thrift fails.

Provisions are made for consultation with state regulators where appropriate. The act's provisions are discussed in more detail in the sections that follow. The act's implications for S&Ls, commercial banks, and bank holding companies are examined, as well as the due-on-sale provisions, the call for a re-examination of deposit insurance, and the monetary policy implications of the new deposit instruments. A discussion of issues that remain to be addressed follows.

[7]The act gives similar powers to the National Credit Union Administration (NCUA) to aid troubled credit unions.

The act's impact on S&Ls

The preceding discussion of the savings and loan industry's problems suggests several areas where the act could help. For example, it authorizes asset portfolio changes that could reduce costs, increase earnings, and lessen exposure to risk through diversification. At the same time, the act authorizes new liability powers that will tend to increase costs, at least during the transition period.

The beneficial effects of these new powers will not be visible for several years. In the meantime it will be necessary to deal with the industry's earnings crisis. Unlike commercial banks, savings and loan associations in general were not able to overcome the problems presented by their exposure to interest-rate risk. As the data in Table 1 show, S&Ls' asset portfolios remained heavily concentrated in mortgage loans and securities throughout the period 1950 through 1981. Further, until very recently, most S&Ls were forced to make only fixed-rate mortgages. Similarly, savings and loan associations have shown greater rigidity than commercial banks in their liability portfolios.

This rigidity in portfolio composition has placed a heavy burden on thrift profitability. Work by Richard Kopcke [1981] suggests that thrifts were unprofitable at various points in the 1970s, although the industry reported accounting profits during this period. Moreover, the industry's returns on assets and net worth were more volatile than that of the commercial banking industry. And, as even the data in Table 2 show, the situation deteriorated rapidly in 1980. During 1981 both profit measures were negative and threaten to remain so in 1982. The following sections will discuss the long-term and emergency powers in turn.

Table 1

Percentage distribution of assets and liabilities of insured savings and loan associations

	1950	1964	1981
Assets			
Cash	5.9	3.3	1.0
U.S. govt. obligations	8.8	5.8	6.3
Mortgage loans and mortgage-backed securities	81.6	84.7	83.3
Other loans	n.a.	.9	2.9
Other assets	3.7	5.3	6.5
Total assets	100.0	100.0	100.0
Liabilities			
Demand and NOW accounts	0.0	0.0	1.3
Savings and time deposits	89.5	91.5	80.9
Borrowed money	6.2	5.2	14.2
Other liabilities	4.3	3.3	3.6
Total liabilities	100.0	100.0	100.0

n.a.—not available.

SOURCES: Federal Home Loan Bank Board, *Savings and Home Financing Source Book*, 1955 (Washington: Federal Home Loan Bank Board, 1955); and Federal Home Loan Bank Board, *Combined Financial Statements*, 1965 and 1981 (Washington: Federal Home Loan Bank Board, 1955).

Asset powers

Title III makes three significant and permanent changes to S&Ls' asset powers: 1) commercial lending, including commercial mortgage lending; 2) consumer lending; and 3) lending to government.

(1) While the 1980 DIDMC act had given thrifts some relatively minor access to commercial lending, the present act makes radical changes in this area.[8] For example, S&Ls can henceforth invest up to 55 percent of their assets in three types of commercial loans: i) loans secured by commercial real estate to 40 percent of assets; ii) secured or unsecured commercial loans to 5 per-

[8]The 1980 act had given S&Ls powers to make loans secured by commercial real estate to 20 percent of assets. They were required to have the first lien on the assets. This requirement is now removed, so that business may now borrow against their real estate in order to purchase capital goods or finance inventory.

Table 2

Profitability of insured savings and loan associations

Year	Net income as percent of Total assets	Net income as percent of Total net worth
1965	.64	9.41
1966	.49	7.00
1967	.45	6.61
1968	.58	8.40
1969	.66	9.29
1970	.54	7.71
1971	.66	9.84
1972	.71	11.45
1973	.72	11.61
1974	.52	8.38
1975	.44	7.58
1976	.59	10.53
1977	.71	12.90
1978	.77	14.00
1979	.64	11.63
1980	.13	2.45
1981	-.71	-16.51

SOURCE: Federal Home Loan Bank Board, *Combined Financial Statements*, 1975 and 1981 (Federal Home Loan Bank Board, 1975 and 1981).

cent of assets; and iii) leasing to 10 percent of assets.[9]

(2) The legislation increases the 1980 act's permission to invest in consumer loans to 30 percent (from 20 percent) of assets. Further, the range of permitted activities is increased by giving a broader interpretation to the meaning of consumer loans. This category now includes inventory and floor planning loans in addition to the more traditional kinds of consumer lending. This broader interpretation might allow S&Ls to make "consumer" loans while escaping many states' usury ceilings on consumer loans (which neither the present nor the 1980 act have removed).

(3) The act increases S&Ls' ability to lend to government. The 1980 act had given the industry unlimited power to invest in federal government and state and local general obligations. The present act also allows S&Ls to invest in revenue bonds.

The potential of asset diversification. These changes offer S&Ls the opportunity to increase net income and reduce the riskiness of that income. Net income will increase for two reasons. First, there is considerable variation in the efficiency of individual banks and S&Ls. Permitting S&Ls to enter commercial and consumer loan markets will provide relatively efficient S&Ls with an opportunity to take business away from those commercial banks that are relatively inefficient. However, these new activities do pose some challenges for the industry. Consumer and commercial lending are considerably different from mortgage lending. Loan processing costs are higher for consumer loans, and both consumer and commercial are subject to greater default risk and are less easily resold in secondary markets.

Second, asset diversification may enable thrifts to reduce their average interest costs. In the past, thrifts have often offered a higher interest rate than have commercial banks. This differential permitted thrifts to compensate depositors for the lack of transactions accounts, consumer loan services, commercial loans and trust services. When thrifts became subject to interest rate regulation, this differential was incorporated into the Regulation Q ceilings.[10] The removal of restrictions on thrift activities under the 1980 and current acts makes it increasingly possible for S&Ls to offer full-service banking. This will likely decrease the differential necessary for thrifts to attract funds. At the same time, operating costs may increase as the S&Ls move closer to full-service banking.

[9]DIDMCA gave S&Ls authority to invest up to 5 percent of their assets in construction loans. Through an error in drafting, this permission was canceled by the current act. An attempt to restore the authority died with the 97th Congress.

[10]These issues are discussed in greater detail in the staff working paper, Garcia et al [1983].

Regardless of the impact on expected profitability, asset diversification offers S&Ls another advantage—the opportunity to lessen their exposure to interest rate risk. Currently, the duration of S&L assets greatly exceeds the duration of their liabilities. When interest rates fall unexpectedly, S&Ls are able to reap large gains. However, when interest rates rise unexpectedly, as happened during the period 1979 to 1982, S&Ls are exposed to huge losses and possible failures. Shortening the duration of the asset portfolio will reduce the exposure to both gains and losses due to unexpected movements in interest rates.

Consumer resistance to variable-rate mortgages, which have been permitted to federally chartered institutions since 1979, has made it difficult for S&Ls to reduce the duration of their asset portfolios. The ability to make consumer and commercial loans gives S&Ls an alternative means of shortening the duration of their asset portfolios. Consumer loans are typically fixed-rate loans, but their duration is substantially less than that of fixed-rate mortgages. Commercial loans are typically both short maturity and variable in rate. The result of diversification into these new areas will be a savings and loan industry that is more effectively insulated from unexpected movements in interest rates and hence from failure.

Barriers to diversification. There is, however, a question whether S&Ls will take advantage of these diversification opportunities. State-chartered institutions which have previously held asset diversification powers have made little use of them.[11] There are several possible reasons for this neglect, but the most important of these are tax considerations.

At present, S&Ls that hold at least 60 percent of their assets in qualified form (mainly residential mortgages, cash, and federal securities), receive favorable tax treatment. They can reduce their corporate income tax payments by retaining a proportion of their earnings in a "bad-debt" reserve. The value of the tax deduction decreases as the S&L reduces the proportion of its qualified assets below 82 percent. The advantage disappears completely when the percentage falls below 60 percent. Researchers have pointed out that assets replacing mortgages in an S&L's portfolio typically do not have sufficiently higher interest rates to overcome that tax advantage.[12] This is an important reason why thrifts may not make dramatic changes in their asset composition, for the act does not change the tax incentives for S&Ls to invest in residential mortgages.

In this regard, the authority to invest in state and local government tax-exempt securities may be important. Recent research shows that a judicious use of the new powers to diversify into consumer and commercial loans to reduce asset duration, and simultaneously into state and local securities to shelter income from taxes, may be a successful way to avoid the current tax disincentive to diversification.[13] The effectiveness of such a strategy is shown to depend on the relative yields of tax-exempt securities and taxable assets of similar risk.

The new liability powers

The new liability powers could benefit S&Ls in four ways. They could: 1) reduce costs (in the long run; short-term costs will likely increase); 2) increase liability duration; 3) reduce the threat of disintermediation; and 4) allow liability volume to grow. The act's contributions in these areas will be discussed in turn.

All indications are that the new money market deposit and Super NOW accounts will increase interest costs. Forecasters predict that a substantial amount of funds deposited in the new accounts will come from existing deposits already housed elsewhere in the association at lower interest costs. Further, in the short run, the new accounts will probably augment operating costs, though in the long run the ability to offer market rates will permit thrifts to reduce non-monetary compensation to customers formerly affected by Regulation Q. Consequently, at least in the near term, the new

[11] Researchers have investigated portfolio composition in Florida, Maine, and Texas.

[12] See the U.S. Department of the Treasury [1980].

[13] See Garcia et al [1983].

accounts are expected to raise, rather than reduce, costs. Moreover, they are not expected to increase liability maturity, because both have instant availability rather than fixed terms to maturity.

The new acounts' contribution to S&L viability is expected to come in the third and fourth areas above. That is, they can reduce any vestigial threat of disintermediation and allow the liability base to grow. Henceforth, depository institutions will be able to overcome the remainder of the disintermediation problem by paying market interest rates on both transactions and savings accounts offered to small savers. Further, the ability to compete effectively with money market mutual funds offers the chance for depository institutions to regain funds that have fled the industry over the past three years. This inflow of funds will facilitate the diversification process. It is easier for associations to shift asset composition by expanding the asset base than by selling and reinvesting existing assets. By speeding the diversification into higher yielding, shorter duration assets, the new liability powers will reduce S&L exposure to possible unexpected future increases in interest rates. They also will make possible an earlier return to profitability.

The new asset and liability powers are potentially important for the long run resolution of the thrifts' problems. This long run solution can occur, however, only if the short-term crisis is avoided. In this respect, the act's emergency provisions are important.

The emergency provisions

If interest rates do not remain below their average 1981 and 1982 levels, many associations (and mutual savings banks) are threatened with failure in the near future. Titles I and II of the act provide industry regulators with powers to deal with such associations should the need arise. The act authorizes regulators to purchase assets from, make deposits in, or otherwise subsidize a failing institution. It spells out guidelines for interindustry and interstate acquisitons of failing institutions, and it empowers regulators to purchase net worth certificates from an association as a way to improve its book net worth.

The depth of the thrift crisis has been ably demonstrated by Andrew S. Carron [1982] in his important book, *The Plight of the Thrift Institutions.* Carron argues that there are many troubled thrifts, that ailing institutions are typically smaller, and rapidly growing, with above average operating costs, officer and employee compensation, interest expenses, and service costs. He argues that mergers would provide economies of scale and the elimination of managerial inefficiency for approximately half of the troubled associations. The other half, he believes, need an explicit subsidy to ensure survival.

A study of Seventh District savings and loan associations supports Carron's findings with two exceptions.[14] In 1981 in this district, the average low-profit association was larger than the average high-profit association (average assets of $227 million versus average assets of $60 million). Furthermore, this study suggests that profitable associations have been able to cope with interest-rate risk only because, either through good fortune or good management, they were able to take advantage of interest-rate ceilings, not because they managed their assets differently. Hence, it was not clear that mergers would improve managerial efficiency. There are also reasons to believe that economies of scale would be negligible.[15]

Problems with mergers. Prior to the act, even when it was clear that a merger would be beneficial, regulators were finding it increasingly difficult to obtain merger partners in the same state and of the same kind for failing thrifts. They needed both specific authority to allow interstate and interindustry mergers and also greater flexibility in the types of assistance given to facilitate those mergers. The remedy to this problem was clear: Congress responded by providing the framework (described in the preceding section) for interstate and interindustry mergers and by clearly setting out its priorities in this matter.

Prior to the act, problems were also created for the regulators by the use of book rather than

[14]See Brewer [1982].

[15]McNulty (1982) summarizes the literature on economies of scale in the S&L industry.

economic net worth as a criterion for forcing a merger. Regulators set a cut-off level for book net worth. This cut-off had been successively reduced to 4 and then 3 percent and was recently effectively near zero. With net worth below this level, regulators acted—typically by closing or merging the institution. Unfortunately, however, book net worth is not a good measure of the ultimate viability of an institution. Some institutions above the cut-off level can be recognized as doomed to ultimate failure. Their costs and revenues are such that losses will continue to deplete net worth over time. Other associations that are currently at or below the cut-off point have good chances of recovering to profitability.

Management reaction to approaching the cut-off rate is important. If managers decide that failure will ultimately happen, they can contribute to the process by appropriating remaining net worth in the form of enhanced salaries or by dissipating it on the futures market.[16]

Regulators needed a program that would allow them to distinguish between endangered institutions that were viable and those that were not. The former should be helped over their temporary problems and the latter prevented from misusing resources and exposing the FSLIC to loss.

The net worth certificate program. Where merger did not promise any benefit, the solution to the regulators' problem was less apparent. Carron had argued that an explicit cash subsidy would be necessary when dealing with severely troubled institutions. On the other hand, Congress was loath to take actions that would increase the budget deficit. The net worth certificate program emerged as a compromise solution.

Under it, the FSLIC and the FDIC are permitted to purchase net worth certificates from distressed real estate banks and thrifts in exchange for promissory notes. These certificates are treated as capital for regulatory purposes, much the way regulators treat some debenture issues or the income capital certificates previously introduced by the FSLIC. Since the coupon payment on the promissory note and the certificates are identical, no cash necessarily changes hands. Thus regulators are able to bolster the book net worth of distressed institutions, avoid the merger route, and dispense with cash outlays (unless an institution fails).

The net worth program promises a number of benefits. First, it will allow regulators to maintain a competitive financial services industry. The previous remedies, carried to their logical conclusion, would have greatly increased concentration in the industry, possibly causing a decline in competitive performance. Second, managers of economically viable institutions previously threatened with closure will have this threat reduced, improving their incentives to make good decisions and hastening the return to profitability.

Third, the net worth certificate program will permit regulators to "gamble" that interest rates, having fallen, will stay down so that cash outlays will not be necessary in either the short or long run.

A fourth potential benefit—to identify nonviable institutions and prevent management from dissipating their assets and passing losses over to the insurance agency—is more elusive. It is difficult to distinguish viable from nonviable institutions, so that it is inevitable that some unsound institutions will participate in the program. Indeed, losses from mismanagement represent the principal potential cost to the program, for the insurance agencies will eventually be forced to foot the bill.

The act attempts to deal with this problem by permitting institutions to only partially offset their losses through the net worth certificate program. For example, the program sets out guidelines that associations with net worth between 0 and 1 percent of assets can receive up to 70 percent of the previous year's losses. Associations with higher net worth up to 3 percent receive smaller percentage contributions. With losses only partially compensated, nonviable institutions will not be sustained indefinitely. Rather, they will eventually exhaust their net worth and fail. The Federal Home Loan Bank Board has chosen to supplement this discrimination process by introducing additional incen-

[16]See Baer [1982].

tives for good management. The Board has announced that S&Ls will only be allowed to offset 20 percent of losses due to operating expenses that are more than 10 percent above the mean for similar institutions. This will give managers additional incentives to control operating expenses. Further, the act itself specifies that losses due to speculation on the futures market will not be eligible for assistance. Institutions that do not respond to these incentives will exhaust their net worth.

Will the solution work? If interest rates remain at their current level, the net worth certificate program and the emergency powers will likely prove adequate for the immediate thrift "crisis". Time bought in this way may allow the long run powers to work. But will they?

On a previous occasion, they did not because the interest-rate respite was too short. The 1980 DIDMC act gave depository institutions broader asset and liability powers. It was recognized at the time that these could alleviate the industry's basic problems only if interest rates did not return to levels seen in 1979. But interest rates rose again beginning in the summer of 1980 and remained high during 1981 and well into 1982, provoking a wave of failures and forced mergers. Since the summer of 1982, however, interest rates have been falling. At the time of writing (January 1983) it is hoped that interest rates will fall further and stay down. If this hope is fulfilled, then the thrift problem should be resolvable. However, the same hope accompanied the March 1980 passage of DIDMCA, and that hope was not fulfilled. If interest rates rise sharply in the near future, the act's new asset and liability powers will not be given sufficient time to improve thrifts' earnings or risk exposure. In this event, the net worth certificate and merger powers may not be sufficient to deal with the situation. Then Carron's warning would become relevant. To avoid a severe financial crisis, a direct cash outlay subsidy could then become necessary.

The impact on commercial banks

In the decades since the Second World War, commercial banks have several times reevaluated and realigned their strategies in response to opportunities or problems that faced the industry. During the first half of the century, bank policies concentrated on matching specific sources of funds to selected uses.[17] In the 1950s these policies were replaced by efforts to actively manage the asset portfolio while taking for granted the supply of funds. This supply presented no problem because interest-rate ceilings were not binding. During the 1960s emphasis shifted further, to liability management. The shift became necessary when market interest rates rose above the ceilings and disintermediation became a problem as, for example, in 1966.

As a result of these realignments the composition of both asset and liability portfolios changed dramatically.[18] As the data in Table 3 show, nonearning assets, such as cash and bank reserves, grew only sluggishly in dollar value while earning assets grew vigorously. The share of nonearning assets fell from 23.9 percent in 1950 to 10.5 percent in 1981. The share of Treasury securities also fell. The proportion of earning assets rose, particularly those with short duration or those paying variable rates such as commercial loans; for example, loans increased from 30.9 percent to 56.0 percent during this period.

The composition of liability portfolios also changed. Demand deposits fell from 73.8 percent in 1950 to 23.9 percent in 1981, while time and savings deposits rose—from 24.9 percent to 57.6 percent. In general, greater reliance was placed on instruments that pay market-related interest rates. For example, in 1956 only 1 percent of liabilities paid unregulated rates; by the close of 1981, 50 percent of liabilities paid market rates.[19]

Table 3

Percentage distribution of assets and liabilities of commercial banks[1]

	1950	1964	1981
Assets			
Cash, reserves, and due from banks	23.9	17.4	10.5
Treasury securities	36.7	18.2	6.6
Other securities	7.3	11.2	14.0
Loans	30.9	50.6	56.0
Other assets	1.2	2.6	12.9
Total assets	100.0	100.0	100.0
Liabilities			
Demand deposits	73.8	56.3	23.9
Time and savings deposits	24.9	40.0	57.6
Borrowings[2]	0.0	0.8	12.5
Other liabilities	1.2	2.9	6.0
Total liabilities	100.0	100.0	100.0

[1]Includes all commercial banks in the United States except branches of foreign banks; included are members and nonmembers, stock savings banks, and nondeposit trust companies.

[2]Includes federal funds purchased and securities sold under agreement to repurchase, and other liabilities for borrowed money.

SOURCES: U.S. Board of Governors of the Federal Reserve System, *Banking and Monetary Statistics 1941-1970 (Washington: U.S. Board of Governors of the Federal Reserve System, 1976), pp. 27-30; and Federal Reserve Bulletin* 68 (April 1982), p. A17.

The changes in composition and the growth of asset and liability portfolios enabled the banking industry to remain profitable and to avoid undue exposure to interest rate risk [Flannery, 1981]. As the data in Table 4 show, the ratio of net income to assets varied cyclically over the period, ranging from a low of 0.66 percent in 1976-77 to a high of 0.84 percent in 1980. The

[17]The real bills doctrine argued that deposits are essentially short-term notice accounts and hence deposit funds should be used for short-term, self-liquidating loans. For discussion of this point see Robinson [1962, pp. 93-115] or Shaw [1950, pp. 122-184].

[18]For a more detailed discussion of bank profitability and changes in bank asset and liability composition, see Garcia et al [1983].

[19]During the 1950s, Regulation Q ceilings were generally not binding. As market interest rates rose, and ceilings became binding with increasing frequency, banks devised ways to circumvent the ceilings.

Table 4

Profitability of insured commercial banks

Year	Net income as percent of Total assets[1]	Total net worth[1]
1960	.78	9.69
1961	.72	9.02
1962	.68	8.44
1963	.69	8.50
1964	.66	8.32
1965	.67	8.41
1966	.67	8.47
1967	.70	9.24
1968	.68	9.35
1969	.82	10.95
1970	.84	11.36
1971	.82	11.16
1972	.77	10.74
1973	.79	11.38
1974	.78	11.20
1975	.76	10.56
1976	.66	10.14
1977	.66	10.44
1978	.71	11.53
1979	.76	12.44
1980	.76	12.30
1981	.73	11.86

SOURCE: U.S. Federal Deposit Insurance Corporation, *Annual Report* (Washington: U.S. Federal Deposit Insurance Corporation), various issues.

NOTES: 1. Based on year-end figures. 2. Includes equity capital, subordinated notes and debentures.

return on equity rose consistently from 9.69 percent in 1960 to 11.86 percent in 1981. In the fall of 1982, the banking industry was not facing the crisis that confronted the S&L industry. This conclusion remains true for large and small banks [Flannery, 1981, and Hanweck and Kilcollin, 1982] and also, as Eisenbeis and Kwast [1982] have shown, for banks which, like S&Ls, specialize in residential real estate lending.

This does not mean that commercial banks have not faced problems. Rather, their managers and regulators provided the flexibility for the commercial banks to evolve as necessary. At the time of the act's passage four concerns faced the industry: 1) the recently increased level and volatility of interest rates had raised exposure to interest rate risk; 2) the worldwide recession had increased actual and potential default rates on both domestic and international loans; 3) the enhanced S&L powers under DIDMCA and the current act increased the competitive ability of the S&L industry; 4) nondepository institutions were increasingly encroaching on what had traditionally been bank-reserved territory.

Nevertheless, the banks were less in need of immediate legislation than the thrifts so that much of the Garn-St Germain content is not directed specifically at the banking industry. However, the act does have important implications for commercial banks.

First and foremost, the new MMD and Super NOW accounts enable depository institutions, including banks, to compete directly with money market mutual funds. This opportunity is important to retail banks that can now offer market rates in order to retain their depositors. It is also important to small banks that had previously been unable to replace funds lost to MMMF accounts by selling large CDs to those funds. While the new accounts offer smaller banks the opportunity to assure the portfolio growth conducive to portfolio flexibility, they also raise the specter of increasing banks' interest costs and reducing their profitability, at least in the short-run. Both marketing and utilizing funds from the new accounts will provide a test of managements' skills.

Secondly, while the act significantly increases the S&L industry's ability to compete with commercial banks in asset deployment, the removal of any Regulation Q differential by January 1, 1984 will assist banks' competition for funds.

The act gives a third advantage—the ability to organize bankers' banks and a greater opportunity to utilize bank service corporations. Concurrent legislation also enables large commercial banks to invest in export trading companies. Service corporations may also provide an easier organizational answer than the formation of a bank holding company to the question how commercial banks may take advantage of the permission to engage in limited brokerage activities granted by the Comptroller of the Currency to national banks and the Federal Reserve to state-chartered banks.[20]

Fourth, banks are given greater flexibility in lending. For example, the safety and soundness percentage limitation on national bank lending to individual borrowers is relaxed. This should assist small agricultural banks, particularly those that wish to concentrate rather than diversify their portfolios. Previously these banks have needed to organize loan participations or sales to correspondents. Henceforth they will have less need for these potentially costly resorts.

Specialization involves risk, so that the efficacy of a legislative change that encourages concentration of risk may be questioned in times of severe recession and falling commodity prices—the economic situation existing at the time of the act's passage. Further concentration of their loan portfolios could jeopardize the safety of agricultural (and other) banks. Indeed, it is the banking system's heavy exposure to losses from international loans that is responsible for the extension of the safety and soundness provisions to loans made to foreign governments and their agencies.

It is not clear, at this time of writing, whether the emergency powers contained in Titles I and II will be much utilized for commercial banks. It would appear that few real estate banks will need to utilize the capital assistance or net worth certificate programs. The merger and acquisition alternatives are likely to prove less costly to the FDIC in those cases of failure in the banking industry attributable to management error.

With regard to asset powers, commercial banks did not receive what they sought from Congress. They were not, for example, explicitly given the power to engage in full service brokerage activities nor to underwrite municipal revenue bonds, corporate bonds, or equities.

[20]This potential usage is argued by Hawke, Sweet, and Mierzewski [1982].

The impact on bank holding companies

The Garn-St Germain Act has four features that will influence the activities of bank holding companies (BHCs). They are: 1) the act's emergency interstate and across-industry acquisition provisions; 2) the revisions of regulations that govern BHCs' insurance activities; 3) a relaxation of the constraints governing transactions between subsidiary banks and their holding company; and 4) an expansion of powers permitted to bank service corporations.

Interstate and cross-industry acquisitions

Before the act's passage a BHC was prevented from acquiring a commercial bank in other than its home state by the Douglas Amendment to the BHCA. Further, de facto holding companies were prevented (until the acquisition of Scioto Savings Association of Columbus, Ohio, by Interstate Financial Corporation, Dayton, Ohio, was approved by the Federal Reserve Board in April 1982) from acquiring savings and loan associations by the Federal Reserve Board's reluctance to approve such acquisitions without explicit Congressional authorization.

The Garn-St Germain Act makes only limited progress toward deregulation in these areas. Title I, Section 116, gives the FDIC authority to seek, or to permit, interstate and/or cross-industry mergers of troubled, large, insured commercial banks and mutual savings banks. Title I, Section 123, of the act explicitly grants permission for the emergency acquisition of troubled, insured S&Ls. However, both sections order merger priorities so as to discourage mergers among different types of institutions within and across state lines. These priorities and the requirement that the FDIC limit merger assistance to commercial and mutual savings banks having $500 million assets or more will severely limit the number of acquisitions by BHCs under the act. There are, however, no such size restrictions on assisted acquisitions of S&Ls.

Insurance activities of BHCs

Title VI of the act amends the Bank Holding Company Act by preventing BHCs from providing insurance as principals, agents, or brokers. The provision is one of the very few areas where the act works to increase restrictions rather than to promote deregulation. However, the act lists seven exceptions to the restrictions. As originally written, these exceptions held the potential for increasing the insurance activities of small BHCs. However, later amendment to the act restored Congress' intention to restrict insurance activities as *not* closely related to banking.

Other activities of BHCs

The act allows virtually unlimited financial transactions between affiliated banks in a multibank holding company and liberalizes collateral requirements on bank loans to affiliated companies. An exception is made to prevent the transfer of low quality assets. [See Rose and Talley, 1982.] It retains, however, the traditional separation of banking from commerce.

Bank service corporations

Since 1962, commercial banks have been able to form service corporations. Such corporations could, however, provide services only to commercial banks. Under the Garn-St Germain Act, bank service corporations can undertake three different categories of activity. They may render: 1) "depository institution" services; 2) those non-depository institution services that are permitted to commercial banks; and 3) other activities found by the Board of Governors to be "closely related" to banking. In this regard, the recent finding by the Federal Reserve that discount brokerage activities are both "closely related" and a "proper incident to" banking in response to the request by Bank of America to purchase Charles Schwab, opens the door for commercial banks to enter the discount brokerage (if not the underwriting) business. There are no geographical limits to the provision of such services as long as state branching laws are not violated. Further, these services may be provided to depository institutions, to nondepository institutions, and to the general public.

Due-on-sale provisions

Title III-Part C ends the legal controversy that emerged in the late 1970s over the due-on-sale clause in mortgage loan contracts. The due-on-sale clause is a provision of many conventional mortgage loan contracts that gives the lender the option to declare the loan due and payable if all or part of the property securing the loan is sold or transferred before maturity. Prior to the period of rising interest rates in the 1970s, the clause was used primarily to protect the security of the loan in the event the mortgage would be transferred to a high risk borrower. During the 1970s, mortgage lenders began to employ the clause as a portfolio management tool.[21] The issue received national attention when the California Supreme Court in 1978 ruled in the case of *Wellenkamp* v. *Bank of American et. al.* that the clause represented an "unreasonable restraint on alienation."

California courts extended the prohibition against the clause to noninstitutional lenders and interpreted the Wellenkamp decision to apply equally to state and federal institutions operating within California. Some 16 other states also had laws prohibiting the enforcement of the clause along the lines of the Wellenkamp decision. The California courts explicitly ruled that laws restricting the clause were not superseded by federal regulation. This decision set up a classic confrontation between federal and state regulatory goals.

The United States Supreme Court in June 1982 heard the case of *Fidelity Savings and Loan Association of Glendale, California* v. *de la Cuesta* and decided that the clause in a loan contract in favor of federally chartered institutions could be enforced despite the existence of state law to the contrary. This case was decided exclusively on the issue of federal preemption.

The act specifically carries the matter further by providing for a federal override of state-imposed restrictions on the clause. Title III-Part C of the act is relatively short; however, it will go a long way toward ending the controversy over the use of the clause in property loan contracts. The act provides for a federal override of state-imposed restrictions on the use of the clause by a broad range of lenders in real property loan contracts. The term "lender" refers to a person, financial institution, or government agency, and "real property loan" refers to a loan, mortgage, advance, or credit sale secured by a lien on real property. "Real property" is defined to include manufactured homes. The act specifies that all rights and remedies for both the lender and borrower are defined and fixed by the loan contract.

There are two important qualifications to the general federal override. First, the act defines a "window period" in which mortgage contracts created during the window period are subject for three years to any state law or ruling prohibiting the enforcement of the clause for reasons other than protecting the security of the loan. The window period covers the period from the date on which the state prohibited the clause to the date the act was enacted (October 1982). Some loan contracts created during this period are thus subject to state restrictions on the clause, if they exist, until October 1985. Second, the act forbids enforcement by federal S&Ls and savings banks in the case of property transfers to close family members. (See Fischer, 1982.)

The Supreme Court ruling and the 1982 Act are best viewed, from an economic perspective, as making significant progress toward settling a dispute over the windfall gains to owners of mortgaged properties and to windfall losses to lenders in those situations where the clause cannot be used to adjust the mortgage interest rate.

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[21]When setting a fixed interest rate on a mortgage, the lender must price the loan above the average cost of funds expected over the term of the loan to make a profit. As mortgages are often repaid before maturity, lenders set the interest charge according to the expected life of the mortgage. When interest rates rise unexpectedly, the life of the mortgage increases, also unexpectedly, because the borrower has an incentive to retain the mortgage. If he wishes to sell he can charge a higher price for the house if he can avoid any due-on-sale provision and pass the mortgage on to the buyer along with the house. As this situation recurred repeatedly during the 1970s, lenders sought to recoup their funds when a house was sold in order to relend the funds at a higher rate.

A re-examination of deposit insurance

At the beginning of the Great Depression, between 1929 and 1933, more than one-third of the commercial banks failed and either closed or were merged with other institutions. Thrift institutions fared only slightly better. Many of the failures occurred when large numbers of frightened depositors simultaneously attempted to withdraw their deposits. Because the cash banks hold at any one time is only a small percentage of their deposit liabilities, they were forced to sell loans and investment securities to meet withdrawals. With many more sellers than buyers, the prices of loans and securities declined sharply, and some banks were unable to pay off in full. As a result, these banks were forced into bankruptcy and many depositors experienced losses.

In 1933, the United States introduced Federal deposit insurance that guarantees depositors that they will receive the full par value of their insured deposits, up to some specified amount (presently $100,000). By any measure, deposit insurance has been a success. The number of bank failures declined from almost 4,000 in 1933 to under 100 per year immediately after its introduction. Thereafter failures rarely exceeded 10 per year until 1982. In 1982, 42 commercial banks were closed by the Federal Deposit Insurance Corporation (FDIC).

The Garn-St Germain Act requires the three federal deposit insurance agencies—the FDIC for commercial and most mutual savings banks, the Federal Savings and Loan Insurance Corporation (FSLIC) for savings and loan associations, and the National Credit Union Administration (NCUA) for credit unions—to conduct studies of the insurance system. In particular, the questions to be considered are: 1) how the current system affects bank structure and operation: 2) the possibility of depositors purchasing additional voluntary insurance; 3) the potential for private insurance; 4) basing insurance premiums on risk; 5) the implications of increased insurance coverage; 6) increased public disclosure of the financial condition of the banks; and 7) consolidating the three deposit insurance agencies. The studies are to be completed and submitted to Congress no later than April 15, 1983. Discussed briefly here are only two of these issues: risk-sensitive insurance premiums and the extent of insurance coverage.

Risk-sensitive premiums

By law, premiums for deposit insurance are levied on the insured depository institutions in proportion to their total deposits, even though all deposits are not insured and all institutions are not equally risky and likely to become insolvent. Thus, larger banks that tend to have a smaller proportion of insured to total deposits and more conservative banks effectively subsidize smaller and/or more risky banks. This not only appears inequitable but also encourages institutions to assume additional risk, in an attempt to reap additional rewards from the higher yields that riskier projects typically offer, at no additional insurance cost.

To discourage such behavior, the deposit insurance agencies have regulated appropriate operating behavior and monitored compliance. These constraints have interfered with the ability of the banks to provide all the services that they believe are in their best interests and it has long been suggested that the insurance premiums be related to the risk characteristics of the bank balance sheet. This would make the premiums comparable to the premium structure for most other types of insurance. Riskier banks would pay higher deposit insurance premiums than less risky banks, just as race drivers pay higher life insurance premiums than university professors.

The major barrier to introducing such premiums has been the difficulty of measuring default and interest rate risks with sufficient precision. Although difficult, recent advances, such as the ready availability of data on computers, have made quantifying risk somewhat easier and risk-sensitive premiums more feasible. In addition, because the higher premiums would discourage banks from engaging in riskier activities, shifting to a risk-sensitive premium structure would permit a significant reduction in the degree of bank regulation and supervision.

Deposit insurance coverage

Future changes in the percentage of deposits insured resulting from the study's proposals could have significant implications both for the likelihood of runs on banks by depositors and for the risks incurred by the banks. For example, the lower the maximum amount of the depositor's account that is insured, the greater is the number of depositors potentially imperiled by bank failures and the more likely is a widespread attempt by these depositors to withdraw their deposits in times of crisis. This may encourage runs on banks. On the other hand, with lower coverage at least some depositors, particularly larger ones, will be more careful about the banks they use. By choosing those they consider least risky, they implicitly exert pressure on all banks to avoid assuming undue risks and operate more soundly. This should reduce the need for depositors to shift their funds quickly out of the banks. Private market discipline on the risk behavior of the banks is diminished as the percentage of deposit accounts insured increases and disappears altogether when deposit accounts are insured in full.

Implications for monetary policy

The introduction of Super-NOW and money market deposit accounts poses two major problems for the Federal Reserve in its conduct of monetary policy, at least in the near term future. One problem concerns the extent to which continued emphasis on monetary aggregate growth will enable the Fed to achieve the desired impact on the economy. Another problem concerns the Fed's ability to control monetary aggregate growth.

The two problems reflect the two-stage process inherent in the present conduct of monetary policy. At the first stage, the Federal Reserve establishes ranges of growth for a set of intermediate targets that are deemed consistent with achieving desired economic goals expressed in terms of employment, inflation, and GNP. At the second stage, the Federal Reserve uses its policy instruments (the supply of reserves provided through open market operations, the discount rate, and reserve requirements) to control the set of intermediate targets. At present, these intermediate targets include various monetary and credit aggregates. Primary emphasis was given to M1 as an intermediate target until fall 1982, when emphasis was shifted to the broader aggregates because of distortions caused by the new accounts and other factors.

The two-stage process describing the current conduct of monetary policy can be summarized as the impact from reserves, R, to money, M, to GNP:

$$R \longrightarrow M \longrightarrow GNP.$$

Influence over the final economy

The Federal Reserve's influence over the economy via use of the monetary aggregates, that is, the transmission of the effects of changing the growth rate of money to the real economy, is best understood in the context of the income velocity of circulation. Income velocity (V) measures the relationship between the level of nominal GNP and the quantity of money as a ratio. If the monetary aggregate rises faster than GNP, velocity falls. Conversely, velocity increases to the extent that GNP growth is greater than money growth. This relationship summarizes the money to GNP stage of Federal Reserve influence over the economy:

$$MV = GNP.$$

In order to maintain that influence, the Federal Reserve needs to anticipate what effect the new accounts will have on the velocities of the various monetary aggregates.

The evidence suggests that MMDAs are extremely popular, and that shifts of funds into MMDAs from non-M2 sources contributed to the recent rapid growth in M2. Thus, it is highly likely that M2 velocity in the first quarter of 1983 will be lower than it would have been without the new accounts. It is not so easy to predict what will happen to M1 velocity, however. Shifts into Super NOW accounts from non-M1 sources will raise M1 growth, while shifts into MMDAs from M1 sources will lower M1 growth. What the net impact will be is unclear. However, while Super NOW accounts have not been as popular as MMDAs, the limited evidence available suggests more funds have been shifted into M1. Thus, M1 velocity in the first quarter of 1983 may be lower than it would have been without the new accounts.

Once the transition phase is over, the Federal Reserve will be able to recognize the new velocity relationships and use them in formulating policy. In the interim, however, it will be difficult for the Fed to know, for example whether faster growth in M2 results from a stimulative policy on its part or from an increase in the public's desired holdings of that aggregate reflected by a fall in velocity. In the latter case, holding the growth of M2 during the transition period to its previous rate would exert a depressing effect on economic activity, because the public, in order to satisfy its increased desire to hold money, would decrease expenditure levels. With this difficulty in mind, the Federal Reserve has decided to calculate the 1983 targeted growth range for M2 from a February/March average base instead of the usual fourth quarter average base, in anticipation that the bulk of the money shifts will have occurred by then. Also to allow for some further shifts, the Fed also raised the M2 growth projected for 1983.

In the past, when transactions balances earned no interest, or, since NOW accounts became available nationwide in January 1981, regulated interest rates, the public's demand for the various monetary aggregates fell whenever market rates rose. This made velocity a function of interest rates. In this situation, when judging what target money growth rates to set, the Fed needed to take into account the variability in the relationship between money and income caused by changes in interest rates. Now that money holders can receive market rates without foregoing their money holdings, the interest elasticity complication in policy should be less important.[22]

Thus, after the transition period is over and the new relationships are established and recognized, it may become easier to conduct monetary policy by setting intermediate targets for money. However, the transition period is likely to be difficult. This fact has been acknowledged by the Federal Reserve in its current shift toward greater flexibility in policy implementation.

Control over the aggregates

Federal Reserve control of any particular monetary aggregate requires that the Fed know the relationship between its policy instruments and the aggregate to be controlled. This relationship can be summarized as

$$M = mR$$

where M is the monetary aggregate to be controlled, R is the level of reserves, and m is the multiplier. Imagine that the Federal Reserve wished to control the level of transactions balances in an ideal situation in which the following conditions prevail: transactions balances are clearly distinguishable from other deposits; all and only transactions balances are included in M1; all and only M1 components carry the same reserve requirement; and the Federal Reserve controls the supply of reserves precisely. In such a world, the multiplier relationship m between M1 and R would be known exactly and the Federal Reserve could control the quantity of M1 precisely.

In the real world, however, the multiplier relationship is not known exactly. There are many ways in which the ideal situation does not quite hold. For example, reserve requirements are imposed on nonpersonal time deposits and Eurocurrency liabilities as well as on transactions accounts. In addition, reserve requirements on transactions accounts are graduated—3 percent on the first \$26.3 million and 12 percent on transactions accounts above this amount at each depository institution. Further complicating this situation is the act's provision exempting the first \$2 million of reservable liabilities at each institution. Moreover, the Federal Reserve's control of the supply of reserves is imprecise because other factors that are difficult to predict such as float and Treasury balances also affect the supply of reserves.

Furthermore, financial innovations have made it increasingly difficult to distinguish transactions accounts from other balances. Money market mutual funds, repurchase agreements, and other new instruments have some transactions features, for example, but are not included in M1 and are not subject to reserve requirements. The existence and growth of these instruments have complicated the Federal Reserve's conduct of monetary policy by raising questions concerning the appropriateness of the current M1 definition as a measure of transactions balances. All of these factors serve to make the multiplier relationship less predictable, thereby impairing the Fed's ability to control the monetary aggregates.

How will the latest accounts affect this situation? Because of its unlimited transactions features, the Super NOW account has been classi-

[22]In this context, the phrase "market interest rates" does not refer to Treasury bill rates. Rather, the phrase means rates that are set by market forces and are appropriate to instruments of immediate liquidity, small and easily divisible denomination, high security, substantial convenience, and no transaction cost. Such rates are expected to be *below* Treasury bill rates.

The New Accounts and Money Market Mutual Funds

Average for week ending	MMDAs	Super NOWs	MMMFs*
	(billions of dollars, not seasonally adjusted)		
Dec 1	—	—	241.8
8	—	—	239.8
15	8.8	—	235.0
22	59.1	—	226.4
29	87.5	—	219.7
Jan 5	119.8	n.a.	216.2
12	160.6	11.7	215.2
19	192.8	15.4	212.3
26	217.6	17.4	210.7
Feb 2	242.8	19.5	209.0
9	261.3	21.6	207.0
16	276.2	22.7	204.6
23	289.5	23.5	203.5
Mar 2	300.4	24.6	202.4
9	310.6	25.8	199.9
16	318.8	26.6	198.4

SOURCE: Federal Reserve Board Statistical Release H.6.

NOTES: *Estimate for weekly average balances in all taxable and tax-exempt money market mutual funds excluding individual retirement (IRA) and Keogh accounts.

— MMDAs not authorized before December 14, 1982 and Super NOW accounts not authorized before January 5, 1983.

n.a. Data not available.

Since their introduction, money market deposit accounts have grown rapidly, while Super NOW accounts have been less popular. At the same time, money market mutual funds, the chief competitor for MMDAs, experienced 15 consecutive weeks of decline and by March 16, assets of taxable MMMFs had dropped almost 20 percent from their December 1, 1982 peak. It is difficult to determine, however, how much of this decline represents movements of funds into the new accounts at banks and thrifts versus how much has gone into other kinds of mutual funds, the bond and stock markets, or been spent as MMMF interest rates also have declined over this period. While the new deposit accounts may have worsened the outlook for the MMMF industry, they are not expected to destroy it. In fact, as Salamon [1983] pointed out, at the same time that the total value of money market mutual funds has been declining, the number of funds has been growing. At the end of November, 1982, before the introduction of the new accounts, there were 270 MMMFs. This number had increased to 304 by the end of February, 1983.

fied as a transactions account for reserve requirement purposes, and has been included in M1. Because a market rate is earned, however, it is possible that some nontransactions funds might be placed in Super NOW accounts as well. The MMDA is more difficult to classify because it has limited transactions features. Furthermore, the act mandates that MMDAs not be subject to transactions account reserve requirements. Personal (0 percent) and nonpersonal (3 percent) time deposit reserve requirements have been imposed on MMDAs, and they have been included in M2 along with other savings and small time deposits and money market mutual funds.

As the public adapts to the new accounts, funds are shifted from other sources that may be subject to different or no reserve requirements. Such shifts make predictions of the multiplier relationship more uncertain than usual. For example, balances in MMDAs have grown very rapidly, exceeding $300 billion by early March. It is difficult for the Federal Reserve to know where these funds have come from and to anticipate what effect they will have on the multiplier relationship.

Once the transition period nears completion, however, the Fed will be able to review the situation, recognize the new multiplier relationship that exists between the chosen monetary aggregate and the level of reserves, and restore its control over the quantity of money. In the meantime, however, the introduction and growth of the new accounts make monetary control more difficult.

What remains to be done

The thrust of the present act, the DIDMCA of 1980, and the several Congressional studies of the U.S. financial services industry before them, is toward deregulation. Together, the two acts take so large a step toward deregulation that they rival in importance the banking legislation of the 1930s, much of which they repeal.

Is deregulation a good thing?

Why is it a good idea today to remove regulation initiated during the 1930s? The movement toward the deregulation of depository institutions is not an isolated phenomenon: deregulation has earlier been applied to the airline, trucking, and brokerage businesses. The generality of this process suggests that a change has taken place in the theoretical underpinnings of the regulatory impetus.

Theory of regulation

The imposition of regulations can be justified in situations where external economies or diseconomies exist. In these cases, the actions of industry participants pursuing their own interests will not best achieve society's goals. Rather participants must be shepherded into modifying their behavior to achieve the social optimum.

The shepherding influence can be applied by a governmental authority in one of two ways. The actions giving rise to external diseconomies can be explicitly forbidden (or rationed) by regulation or they can be implicitly discouraged by imposing a tariff on unwanted behavior. Conversely, where external economies exist, society can encourage the activity either by requiring it to be done or by making it financially rewarding. Ultimately then the choice is between: 1) establishing regulations which impose hidden costs or rewards on the economy, 2) directly altering the price system to achieve the desired objective. The legislation of the 1930s adopted the first regulatory approach.

Historical background

The regulations of the 1930s arose as a reaction to contemporary analysis of the Great Depression. It was, for instance, believed that excessive competition had weakened depository institutions and contributed to the widespread banking failures. In turn, bank failures spread and imposed unreasonable costs on others; that is, they carried (and still carry) external diseconomies. After the Great Depression, safety and soundness were to be insured by eliminating the opportunities for both excessive competition and concentration. In this way originated Regulation Q, placing restrictions on interest payable on savings deposits and forbidding the payment of interest on demand deposits; restrictions on portfolio composition; restraints on permitted product lines, underwriting and dealing in securities; and stringent standards to be met in chartering new entrants to the industry. While these new restrictions limited competition, the Congress relied upon longstanding limits to geographic expansion to prevent undue concentration of economic power.

These regulations have been in force since the 1930s or, in some cases, even earlier. But times have changed: higher and more volatile interest rates, greater ease of travel, and of information storage and processing, have rendered many of the old regulations obsolete and/or unduly costly to industry participants.[23] In turn, the high incentives to avoidance have also raised the governmental costs of enforcing compliance so that a "regulatory dialectic" has developed.[24]

In this situation it has been judged time to deregulate and to replace, wherever possible,

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[23]The arguments for and against deregulation are discussed in greater detail by Kaufman, Mote, and Rosenblum [1982].

[24]The phrase "regulatory dialectic" was coined by Professor Edward J. Kane. See, for example, Kane [1981].

explicit decree by a system of price incentives. Nevertheless, it is appropriate to check in each instance of deregulation whether society's objectives can best be attained in this way. Further, it may be necessary henceforth to apply the anti-trust laws to prevent undue concentration in the financial services industry as in others. Finally, it is necessary to know how to price the targeted activities. Recent advances in the theory of financial economics make pricing now feasible.

Progress toward deregulation

Taken together, the DIDMCA Act of 1980 and the current Garn-St Germain legislation constitute an enormous step toward the deregulation of the financial services industry. Nevertheless, if the direction of these acts—toward the achievement of a highly competitive, minimally regulated system—is accepted, some issues remain to be addressed.

Geographic restrictions

Perhaps the most obvious area in which further liberalization would be desirable—one dealt with only tangentially in the act—is the geographic confinement of commercial banking. For example, there remain geographic restrictions on branching both within and across states. Further, the Douglas Amendment to the Bank Holding Company Act prohibits interstate acquisitions of banks by bank holding companies. Given the legislation's exhortation to a "level playing field," it is odd that banks should remain more restricted than S&Ls in this regard. In general, federal law defers to state law in these matters, and the laws of most states are highly restrictive, particularly where interstate banking is concerned.

The Garn-St Germain Act deals with these geographic restrictions only in its emergency powers section. Title I and II authorize the acquisition of closed or endangered insured commercial banks and thrifts by out-of-state insured institutions. These provisions expand financial institutions' interstate branching capabilities by permitting them to operate deposit-taking offices in more than one state. Clearly designed for exceptional circumstances, the sections of the act allowing limited interstate acquisitions are subject to a sunset provision calling for their repeal after three years. Thus, the act modifies the deference of federal branching law to state legislation only to a limited degree, and only temporarily, except that branches acquired under the act's emergency authority may be retained after that authority expires.

Adopted for a variety of reasons in the past, but having the primary effect of protecting narrow, parochial interests, state branching laws have Balkanized the banking industry to a degree not experienced by any other industry. The kinds of arguments used to justify these restrictions—states' rights, the protection of small institutions, the preservation of personal service, the desire to keep money in the local community, the failure of many studies to demonstrate any clearcut superiority of branch bank performance, and so on—have been rejected as bases for protectionist legislation in most other industries. With some exceptions, students of the issue strongly favor the dismantling and eventual elimination of state geographical restrictions on branch and holding company banking. One way to achieve this objective would be to amend the National Bank Act to allow national banks to branch nationally and to repeal the Douglas Amendment to the Bank Holding Company Act.

That these restrictions have been rendered largely ineffectual—except, perhaps, in the case of deposit-gathering through local offices—by the establishment across state lines of Edge Act corporations, loan production offices, and the other, many, and various nonbank subsidiaries of holding companies, is irrelevant. The restrictions still constitute a constraint on the choice of the most efficient form of organization, a form that many banks and thrifts would choose if given the option. Anti-trust legislation could still be applied to prevent undue horizontal integration in the industry.

Chartering

Another fundamental area of regulation that neither the DIDMCA nor the current act deals with explicitly is entry. While the two acts reduce barriers to entry into specific service lines by existing institutions, except in the emergency titles they are silent on the issue of chartering *new banks*. The traditional chartering process used by the Comptroller of the Currency, the FHLBB, and most state banking departments gave considerable weight to the financial conditions of existing institutions and the "convenience and needs of the community". It is now recognized that such an approach is basically incompatible with a competitive financial system. Therefore, the chartering agencies, within the broad range of discretion granted them by legislation, are working to adjust their entry criteria to the changing environment.

At some point, nevertheless, it may become necessary to amend the National Bank Act to liberalize further the criteria that are applied in judging bank charter applications. Asymetrically, the FHLBB has been given the necessary flexibility when chartering S&Ls and savings banks. Title III Section 311 of the act empowers the Board to create and charter S&Ls and savings banks, "giving primary consideration to the best practices of thrift institutions in the U.S.". Most state governments are expected to respond by liberalizing their entry requirements for state-chartered institutions, in order to avoid giving any advantage to federally chartered institutions.

Product line restrictions

The original Garn bill would have liberalized restrictions on the securities activities of banks, allowing them both to underwrite all types of municipal revenue bonds and to manage money market mutual funds. These provisions were eventually dropped in one of the compromises necessary to secure passage of the act. The legislative history of the act also makes it clear that while permitting diversification, Congress wishes S&Ls to continue as major providers of funds for residential housing. In recognition of this, immediately on passage, the FHLBB withdrew its proposals to permit S&L service corporations to engage in a wide range of activities including real estate brokering, the manufacture of mobile homes, insurance underwriting, securities activities, and the operation of mutual funds.

During the pre-act hearings, commercial banks sought powers to underwrite all municipal revenue bonds and to offer full brokerage services. While the act does not explicitly grant these powers, rulings by the Comptroller of the Currency, the FDIC, and the Federal Reserve Board henceforth will enable banks, their holding companies, or service corporations, to offer limited discount brokerage services. They do not, however, have authority to act in general as dealers or underwriters. Further, William Isaac, the chairman of the FDIC, has recently questioned the legitimacy of nonbanks' (such as Sears Roebuck's and Merrill Lynch's) entrance into the banking industry. Consequently the question of competition between banks and nonbanks (and in particular the securities industry) is likely to surface again soon, and with greater urgency.

Nevertheless, the restrictions on, for example, securities activities of banks are one of the areas that need, in particular, to be carefully reconsidered in light of their original rationale, the possible inefficiencies they may create, and any advantages they provide. While such restrictions originated in the 1930s in response to abuses perceived at that time, the contribution of the securities abuses of a relatively few banks to the banking debacle of the 1930s has never been clearly isolated from that of other events occurring at the same time. The importance of these abuses—though not their egregiousness—may have been exaggerated. Moreover, there may be means short of divorcement to achieve the ends intended by the Glass-Steagall Act, means that do not sacrifice the potential efficiencies of combining banking and underwriting in the same institution.

On the other hand, it is also possible to exaggerate the benefits of such a recombination of commercial and investment banking. In the first place, the legal separation restricts entry into investment banking only by a single class of institutions—banks; all others are free to enter.

Secondly, it has not been clearly demonstrated that potential conflicts of interest arising from a bank's fiduciary relationships with two sets of clients (the company needing to raise capital and depositors) can be eliminated simply by restructuring the bank's internal operations. To the extent that this result is achieved by the erection of a "Chinese Wall," analogous to that separating bank lending and trust department activities, the synergism alleged to inhere in such a combination of activities would be lost. The benefits to be derived from commercial bank entry into municipal revenue bond underwriting appear miniscule, although this remains a point of considerable controversy.

Third, there is little or no evidence on the convenience to customers of being able to bank and carry out securities transactions at the same institution. On balance, the close matching of advantages and disadvantages suggests the need for a much more fundamental reappraisal of the Glass-Steagall restrictions than has been undertaken to date.

Depository institution powers

Both DIDMCA and the Garn-St Germain Act do much to expand the asset and liability powers of nonbank depository institutions, particularly in the areas of consumer and commercial lending, the offering of transaction accounts, and—since DIDC's actions in late 1982—the offering of a savings deposit instrument (almost) free of reserve requirements and interest rate restrictions and a transactions account paying market interest rates. These changes greatly lessen, but do not eliminate, legally enforced specialization by depository financial institutions. To achieve complete elimination would require not only the removal of all maximum percentage restrictions on various types of assets that thrift institutions may acquire, but also the repeal or further pruning of the bad-debt deduction provisions that gives savings and loan associations such an enormous incentive to concentrate on residential lending. If the country still wishes to subsidize housing construction, it would be preferable to make such subsidies direct and explicit, so that their costs can be more clearly perceived and evaluated. Here, the intention is to allow thrifts, in particular, to diversify their portfolios in order to reduce their (and, ultimately the FSLIC's) exposure to interest rate risk. However, use of these powers may at the same time increase thrift and corporation exposure to default risk. While the balance of advantage has been judged in favor of deregulation at this time, that balance may not always be so.

A less dramatic, but, as the discussion of the act's effects on savings and loan associations suggests, potentially effective way to achieve the risk-reducing benefits of diversification while continuing an emphasis on residential housing, would be to add state and local securities to the list of assets qualifying for the bad-debt deduction.

Ending Regulation Q

Interest rate deregulation, though a central purpose of DIDMCA and one pushed still farther by the Garn-St Germain Act's authorization of the new money market deposit and Super NOW accounts, is still incomplete. At the time of writing, the DIDC has called for public comment on an acceleration of the ceiling-removal process and in particular, on the extension of the MMD account to permit unlimited transactions for customers not eligible to hold Super NOWs. Until such a provision is adopted, the prohibition of interest on corporate demand deposits will continue to be circumvented by such devices as repurchase agreements, subsidized loan rates and so on. It should be noted however, that while a business market-interest-paying deposit would be useful to small business, it would not prove attractive to larger corporations. Transactions accounts carry reserve requirements. RPs do not and therefore earn a higher rate. Consequently, even though RPs must be collateralized by government securities, they may remain a preferred instrument for larger corporations. Nevertheless such circumventions are inherently clumsy and RPs, for example, give rise to unresolved legal issues concerning ownership of the securities subject to repurchase. Moreover, they have destructive implications for the meaning and accuracy of M1 and pose at least transitional difficulties for the conduct of monetary policy.

Allowing depository institutions to set unregulated rates on their liabilities will not involve them in excessive and unsafe competition. Further, removal of Regulation Q will not more than transitionally interfere with the conduct of monetary policy. In the long run, it should facilitate monetary policy by eliminating cyclical shifts of funds from one aggregate to another as ceilings alternatively become binding and nonbinding with changes in market interest rates.

Emergency powers

Those provisions of the Garn-St Germain Act that are clearly of a transitional nature—in particular, those authorizing the issuance of net worth certificates to troubled thrift institutions—will take some time to work themselves out. Whether the great majority of those certificates can be retired within a reasonable time is questionable at best: repayment provisions are not specified in the act. The FHLBB has, however, recently issued guidelines for repayment. The current provisions buy some time for further scrutiny of the problem, for the natural healing process to occur as assets are repaid and reinvested on better terms, or, most importantly, for interest rates to fall. Absent these events, the thrift problem will recur.

Deposit insurance

The establishment of deposit insurance for banks and thrifts has largely removed the external diseconomy arising from runs on depository institutions. Although accounts are currently insured only to $100,000, prior to 1982 no depositor had incurred a loss as a result of a large bank failure in recent decades. Secure in this knowledge, some banks have undertaken risky operations in the past, and will again in the future. As deposit insurance premiums do not reflect risk, risk-takers expose the insurance agencies (and ultimately other depository institutions) to loss. In the past, unacceptable degrees of risk-taking have been prevented largely through regulations that preclude unacceptable behavior. As the deregulatory process successfully removes restraints on depository institution behavior, new ways must be found to forestall unacceptable behavior, possibly by pricing insurance according to risk exposure.

Conclusion

The Garn-St Germain Act takes a second, important legislative step towards the deregulatory objective of efficiency and equity set forth for the earlier DIDMCA of 1980. Neither that act, nor the current one is a panacea. Progress has been made but much remains to be done.

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