Research Department
Federal Reserve
Bank of
San Francisco

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Business & Financial Letter

Towards Unbundling

Like other businesses, banks prosper or fail depending on the spread between the prices they obtain for their products and the prices they pay for their various inputs. Yet unlike other businesses, banks are frequently able to obtain one major input—namely, money—at below-market prices because of regulatory ceilings on deposit interest rates. (For example, the explicit rate ceiling is zero on demand deposits.) Banks in turn are able to offer many services at below-market prices as a means of improving their own competitive standing.

This complicated situation has gradually begun to unravel, especially during the past decade of inflation and high interest rates. Economically rational corporations and households have found ways of improving the return on deposits, particularly by reducing their utilization of demand deposits. Banks have responded to these moves by taking steps to improve their own rates of return.

The situation logically would seem to demand a movement towards "unbundling"—that is, the explicit pricing of each bank charge and each bank service at market prices. The securities industry has been going through just such a process during the past year or so, under pressure from the Securities and Exchange Commission. But many banks and thrift institutions, seeing only one side of the equation, fear unbundling for the impact it may have on their own earnings, and they forcefully remind Congress of their preference whenever legislation is proposed to change the situation—for example, the proposal to lift the Depression-era prohibition against payment of interest on demand deposits.

Financial innovations
Major changes in financial markets, reflecting the post-Depression, post-World War II rise in the price of money, have served to reduce reliance on noninterest-bearing deposits for handling monetary transactions. As far back as the early 1950's, rising interest rates led some large corporations to begin investing spare cash in Treasury bills. Subsequently, more and more firms developed better systems of cash management, and then individuals began to emulate these business practices by shifting idle funds into liquid market securities or savings deposits.

In the early 1960's, the innovational process picked up speed as large commercial banks began to bid aggressively for loanable funds. In particular, they worked hard to attract corporations' highly interest-sensitive funds by selling large-denomination certificates of deposit. Later, as interest rates soared in the early 1970's, the financial community developed an array

(continued on page 2)

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of new financial instruments and practices to meet the public's demand for ways to minimize holdings of noninterest-bearing assets.

Today, the public's transactions balances are increasingly held in interest-bearing form. NOW accounts—negotiable orders of withdrawal—have grown steadily in the New England states, serving effectively as checking accounts for many individuals. Under newly granted authority, smaller businesses and state-and-local governments hold a significant part of their cash balances in the form of commercial-bank savings accounts. Many individuals utilize savings accounts for transactions purposes by making payments through third-party transfer arrangements, or by telephonic transfers of funds from savings to demand deposits to cover newly written checks. Others accomplish the same purpose through overdraft arrangements with banks, or through checkwriting on funds kept with money-market mutual funds. Moreover, those utilizing noninterest-bearing checking accounts frequently receive an implicit return in the form of free or below-cost services, such as travellers' checks and safe-deposit boxes.

Cost of unbundling

Against this background, the Federal Reserve Board of Governors this month released a major staff study, *The Impact of the Payment of Interest on Demand Deposits,* which considers the various consequences of Congress' removing or modifying its 44-year-old ban on deposit interest. The staff argues that if banks begin to pay explicit interest on such deposits, they undoubtedly would also move to price checking and other services more nearly in line with costs. On the plus side, this would tend to curtail uneconomic use of certain bank services and would encourage an allocation of resources to uses more highly valued by the public.

However, the payment of explicit interest would temporarily reduce bank earnings—perhaps by as much as 5 to 20 percent of 1975 pretax earnings during the worst year of the transition. The largest transitional impact would be felt if interest were paid on all demand deposits and if thrift institutions were also empowered to offer such deposits. The hardest hit would be those banks with both relatively low earnings and a relatively large amount of deposits newly eligible for interest, especially household demand deposits. Roughly 370, or 2½ percent, of all commercial banks—mostly very small banks—fall into such a category.

The impact on depository institutions could be limited if interest payments were paid only on consumers' NOW-type accounts instead of on all demand deposits. The volume of demand deposits that could be converted to NOWs probably amounts to about $80 billion, as opposed to the roughly $320 billion found in all checking accounts.

The staff study argues that if explicit interest were paid on demand deposits, banks and other institutions would probably raise charges for checks and other bank services now offered free or below cost. This would tend to equalize rates of return for all depositors, provided that they all received the same interest rate and that services were priced more in line with costs. But it would be difficult to judge who would gain or lose the most from payment of explicit interest and from a probable increase in the cost of checks and other services. Some small depositors who write a large number of checks might be worse off than they are now, unless they economized on their check writing. The largest gainers would appear to be those depositors with large and relatively inactive accounts.

Interest on reserves?

In the Fed staff's view, cost pressures resulting from demand-deposit interest payments could be partially offset by the payment of interest on member-bank reserve balances held at Federal Reserve Banks. Such interest payments would tend to promote competitive balance between member banks and other depository institutions, since the latter are now permitted to maintain the bulk of their reserves in interest-bearing form.

Interest on reserve balances also would provide a compensating adjustment for the loss in revenue that nonmember institutions would experience if they were required to hold reserves against transactional balances at the Federal Reserve. As the central bank has argued on earlier occasions, "From a monetary policy viewpoint, it would be desirable to require all institutions offering transactional accounts to hold reserves against such deposits either in vault cash or as balances at the Federal Reserve, and to set such requirement on a uniform basis."

Summing up, the staff study said, "If explicit interest were paid on demand deposits, the most significant potential problem would lie in the transitional adjustments of banks and other institutions to the new competitive environment. Adjustment difficulties could be mitigated by payment of interest on reserve balances; by a gradual phase-in through regulatory actions, such as use of a low, and perhaps gradually rising, ceiling rate; and by a delay in the effective date for interest on demand deposits following enabling legislation so as to permit banks to plan effectively for the new competitive environment." No one knows how Congress, the financial community and the general public will react to this study and the Board of Governors' forthcoming recommendations, but the long-term movement towards unbundling seems unmistakable.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 2/09/77	Change from 2/02/77	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	92,271	- 630	+ 4,483	+ 5.11
Loans (gross, adjusted)—total	70,236	- 1,276	+ 5,188	+ 7.98
Security loans	1,344	- 189	+ 540	+ 67.16
Commercial and industrial	22,891	- 65	- 502	- 2.15
Real estate	21,808	+ 63	+ 2,214	+ 11.30
Consumer instalment	12,368	- 9	+ 1,660	+ 15.50
U.S. Treasury securities	8,833	+ 322	- 1,255	- 12.44
Other securities	13,202	+ 324	+ 550	+ 4.35
Deposits (less cash items)—total*	91,985	+ 254	+ 4,502	+ 5.15
Demand deposits (adjusted)	26,375	+ 415	+ 2,479	+ 10.37
U.S. Government deposits	251	- 48	- 73	- 22.53
Time deposits—total*	64,137	+ 75	+ 2,188	+ 3.53
States and political subdivisions	5,846	- 122	- 1,125	- 16.14
Savings deposits	30,939	+ 102	+ 6,477	+ 26.48
Other time deposits‡	25,370	+ 93	- 2,471	- 8.88
Large negotiable CD's	9,040	+ 31	- 3,802	- 29.61

Weekly Averages of Daily Figures	Week ended 2/09/77	Week ended 2/02/77	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (-)	+ 62	+ 1	+ 53
Borrowings	2	1	14
Net free(+)/Net borrowed (-)	+ 60	+ 0	+ 39
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales (-)	+ 921	- 95	+ 1,592
Transactions with U.S. security dealers			
Net loans (+)/Net borrowings (-)	+ 146	+ 135	+ 224

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

Editorial comments may be addressed to the editor (William Burke) or to the author. . . .
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