Research Department
Federal Reserve
Bank of
San Francisco

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FRBSF Weekly Letter

Pseudo Intermediaries

Disintermediation could again become a threat to financial intermediaries in 1978, as we discussed in our most recent *Weekly Letter*. With open-market interest rates rising above the maximum rates that banks and thrifts can offer on savings accounts, many dollars could leave these accounts and end up in investments that pay the open-market rates. Hence, funds that otherwise might be channeled through the usual intermediaries may now be channeled instead into market instruments through money-market funds and bond funds — pseudo intermediaries, as it were.

Impact of Reg Q

The growth of these new institutions reflects the influence of the Federal Reserve's Regulation Q, which implements a section of the Banking Act of 1933 limiting the payment of interest on commercial-bank deposits. Congress passed the Act originally to stabilize the banking industry, primarily by limiting competition — but as is often the case in the regulatory arena, Reg Q has since taken on a life of its own. Over the years, the Federal Reserve has developed a complex array of rate ceilings to cover deposits of different types and maturities, and in 1966, Congress extended similar ceilings to savings-and-loan associations.

During the 1966 and 1969 "credit crunches," the regulatory authorities managed to curb bank and thrift-institution lending by utilizing Reg Q ceilings to restrict the flows of funds into such institutions. To this end, the Fed used rate ceilings on large certificates of deposit (CDs) to restrict these funds, and in 1969 also placed reserve requirements on non-deposit sources of funds such as Eurodollar borrowings. The combination of generally tight credit conditions and specific controls on intermediaries resulted in rampant disintermediation.

A number of changes have occurred since 1970 to reduce the danger of another bout of severe disintermediation. Between 1970 and 1973, the authorities raised — and then removed — all ceiling rates on CDs over $100,000, and they also eliminated ceilings on some longer-term consumer deposits. Banks can now pay market rates of interest on these funds even when rates are high. Furthermore, thrifts have more leeway now to attract funds from large depositors and to pay competitive rates on longer-term deposits of small savers.

However, Reg Q ceilings remain in force on all passbook accounts and on most small-denomination time deposits. For example, the maximum allowable rate on passbook savings is currently 5 percent at banks and 5¼ percent at S&Ls, while open-market rates are significantly higher at 6.4 percent for 3-month Treasury bills, 6.8 percent for 90-day commercial paper, and 6.8 percent for 90-day CDs over $100,000. Reg Q thus represents a "tax" on the small saver who cannot find a way to shift from a passbook-savings account into one of these alternative investments. But Treasury bills require a $10,000 minimum purchase

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and entail some transaction costs, either through a service charge or through a trip to a Federal Reserve Bank. Large CDs, and commercial paper generally, require a $100,000 investment. These instruments thus are beyond the grasp of most individuals.

Money-market funds

For many savers, however, there are indirect means of purchasing such instruments, through such vehicles as money-market and bond funds. These funds represent only a fraction of the size of the typical financial intermediaries, but they have already exerted a significant impact on the market. For instance, their mere existence has helped lead to relaxed Reg Q ceilings.

Money-market funds are investment vehicles that accept short-term savings from individuals and businesses, and pool these savings to effect economical purchases of large-denomination Treasury bills, commercial paper, CDs, and other short-term investments of one-year maturity or less. (They are also called money funds or cash management funds.) Typically, they don't involve "load" (purchase) fees, but require an initial minimum purchase amount of $1,000 and subsequent purchase amounts as small as $50. They generally provide free checking privileges, although checks typically must be at least $500 in amount. The saver earns a return that is equal to the fund's return, say about 6.6 percent today, less a management fee of roughly 0.3 percent.

Money-market funds are not large in the aggregate, but they expand rapidly whenever interest rates rise. They grew from practically zero in 1973 to $3.7 billion in late 1975. Then, as open-market rates declined throughout 1976, they contracted somewhat, only to rise sharply again in late 1977 and early 1978. According to Donoghue's *Money Fund Report*, assets were up to $4.4 billion by late January and were increasing by approximately $125 million *per week*.

Large corporations often invest in money-market funds, but small businesses and individuals can do the same. For all such investors, money-market funds offer a low-cost and convenient method of investing $1,000 or more in a diversified portfolio of Treasury bills, commercial paper, bank CDs, and other short-term assets. And paradoxically, although banks lose some funds that are subject to Reg Q ceilings, they have the option of buying the funds back *at open-market rates* in the form of CDs of over $100,000 denomination. In fact, bank CDs constituted 50 percent of all money-market funds' assets at the end of 1977. Thus, to a large extent, money-market funds are simply a vehicle for circumventing Reg Q.

Bond funds

A host of bond funds are also available to individual or business investors—indeed, they swamp the money-market funds in aggregate size. Bond funds do not limit themselves to short-term investments, but instead invest in a diversified array of U.S. government and corporate debt. Several new bond funds invest only in state- and municipal-debt issues, paying interest that is exempt from Federal (and some state) income taxes.

Bond funds, unlike money-market funds, are by no means new. However, in the last few years they have taken on new characteristics that make them similar to savings and even checking accounts. In the past, open-end bond funds normally charged "load fees" (initial purchase fees) of perhaps 5 or 6 percent. The front-end fee thus tended to make these instruments long-term investments. Recently, however, a number of funds (both new and old) have chosen no-load status, charging the investor only a management fee of perhaps 0.3 percent to 0.6 percent of asset value per year. Thus the individual can get in and out of the funds with no transaction charge. In addition, many funds are now offering free checking privileges, free telephone transfers, and wire-transfer services.

A bond fund may invest in corporate and U.S. government bonds and pay taxable interest, or it may invest in state and municipal bonds and pay tax-exempt interest. Initially, funds that paid tax-exempt interest were required to be limited partnerships—a restriction that created a costly paperwork and reporting burden. But a change in Federal law in late 1976 permitted them to adopt the corporate form of organization, thereby making no-load tax-exempt funds a feasible alternative for small investors. Since that time, at least half a dozen such funds have appeared, totaling almost $3 billion in the aggregate.

For the bond fund aimed at attracting liquid savings, there are minimum initial investments ($1,000 and up), minimum subsequent investment amounts ($50 and up), and minimum withdrawal amounts (normally $1,000 and up). Because of the high minimum restrictions on withdrawals, the individual who wishes to use the checking privilege will move funds from the bond fund to his or her checking account, and then write smaller checks for consumer transactions. Thus, the minimum-withdrawal restriction makes these funds close substitutes for saving accounts rather than for checking accounts, at least for individuals.

No-load bond funds with free checking privileges—like money-market funds—are excellent vehicles for the relatively small saver to obtain open-market rates during periods of high interest rates. The funds advertise daily in financial journals and newspapers, and have come to be recognized by many individual savers as a more convenient vehicle for their funds than passbook accounts. For higher-income individuals, the tax-exempt option offers an especially appealing combination of liquidity and tax-free yield.

Money-market and bond funds will never approximate in size such major intermediaries as banks and savings-and-loan associations. However, they have already carved out an important niche among financial institutions. Furthermore, they pose but one more threat to the already fragile viability of Reg Q.

Jack Beebe

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 2/22/78	Change from 2/15/78	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	105,161	− 510	+ 12,957	+ 14.05
Loans (gross, adjusted) — total	83,282	− 374	+ 12,836	+ 18.22
Security loans	1,722	− 139	+ 166	+ 10.67
Commercial and industrial	25,537	− 56	+ 2,514	+ 10.92
Real estate	28,185	+ 110	+ 6,191	+ 28.15
Consumer instalment	14,874	+ 10	+ 2,512	+ 20.32
U.S. Treasury securities	7,668	− 28	− 1,085	− 12.40
Other securities	14,211	− 108	+ 1,206	+ 9.27
Deposits (less cash items) — total*	102,180	− 592	+ 10,812	+ 11.83
Demand deposits (adjusted)	27,551	− 1,317	+ 2,250	+ 8.89
U.S. Government deposits	584	+ 195	+ 270	+ 85.99
Time deposits — total*	72,057	+ 342	+ 8,017	+ 12.52
States and political subdivisions	6,487	+ 20	+ 719	+ 12.47
Savings deposits	31,452	+ 34	+ 347	+ 1.12
Other time deposits‡	31,683	+ 212	+ 6,460	+ 25.61
Large negotiable CD's	13,295	+ 196	+ 4,603	+ 52.96

Weekly Averages of Daily Figures	Week ended 2/22/78	Week ended 2/15/78	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves(+)/Deficiency (−)	+ 38	+ 6	+ 61
Borrowings	22	11	2
Net free(+)/Net borrowed (−)	+ 16	− 5	+ 59
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales(−)	+ 1,535	+ 1,949	+ 716
Transactions with U.S. security dealers			
Net loans (+)/Net borrowings (−)	+ 285	+ 1,023	+ 67

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

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