Research Department
Federal Reserve
Bank of
San Francisco

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FRBSF Weekly Letter

Historic Legislation

The Depository Institutions Deregulation and Monetary Control Act of 1980, which was signed into law this week by the President, is an historic piece of financial legislation. Over time, it should help accomplish three major goals; namely,

* Promoting greater competition in the financial markets, primarily by phasing out deposit interest-rate ceilings and by broadening the asset and payment powers of banks and thrift institutions;
* Supporting equity and improving monetary control, by extending reserve requirements to all depository institutions with transactions (check-type) accounts and non-personal time deposits; and
* Solving the problem of declining Federal Reserve membership, by reducing the cost of reserve requirements for member banks.

A major feature of the new legislation is its increased reliance on market forces to determine future levels of deposit interest rates. The entire process may require six years to complete, but in the meantime, the Federal regulatory agencies have the authority to initiate a gradual phase-out of rate ceilings. Also, during the transition period, thrift institutions may retain their present 1/4-percentage point rate differential on many time and savings deposits, in relation to commercial-bank rates.

Phasing-out ceilings
The new policy reflects the inability of rate ceilings, in an era of inflation and high interest rates, to prevent outflows of funds (disintermediation) from depository institutions. This phenomenon had occurred despite partial rate decontrol, as evidenced by the removal of ceilings on "jumbo" ($100,000 and over) time certificates a decade ago, and by the effective removal of ceilings on large ($10,000 and over) money-market certificates almost two years ago. Moreover, the effective removal of rate ceilings on large time deposits has carried a political handicap, because such deposits recently have been paying almost three times as much interest as the passbook savings held by millions of small savers.

Still, Congress has ordained a slow phase-out of rate ceilings because of the difficulties created for depository institutions—principally thrift institutions—by a mismatch between the rates they currently pay on short-term sources of funds and the rates they earn on long-term mortgages. Perhaps one-half of the $475 billion in mortgages held by savings-and-loan associations carry yields of 7½-percent or less—while only about one-fifteenth of S&L mortgage loans carry yields approximating those on the money-market certificates which now account for more than one-third of all S&L deposits. Recognizing this problem, Congress in the new law mandated a study of the subject by the financial regulatory agencies, the Treasury, and the Department of Housing and Urban Development.

Improving the asset mix
Going further, Congress took several steps to improve the asset mix of thrift institutions. It authorized S&L's to issue and extend credit on credit cards, to exercise trust powers, and to invest up to 20 percent of assets in consumer loans and in various types of corporate debt. Also, it authorized mutual savings banks to offer checking accounts to business customers and to place as much as 5 percent of their assets in commercial loans to institutions located in the same market area.

Again, the new legislation eased limitations on lending rates at depository institutions. Congress increased the interest-rate ceiling on credit-union loans from 12 to 15 percent, and authorized the Credit Union National Administration to impose further short-term increases when required by money-market conditions. Moreover, Congress pre-empted state usury ceilings on mortgage loans and

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on business and agricultural loans over $25,000—and on the latter, permitted an interest rate of not more than 5 percent above the Federal Reserve's discount rate, including surcharge. The pre-emption would be permanent for mortgage loans and would cover a three-year period for commercial loans, but in both cases could be overridden by state legislative action.

Broadening payments powers
Congress also broadened depository-institution payments powers, by legalizing certain innovations which had been developed by the industry in recent years, but which had been ruled illegal by a Federal court last year. (This gave a certain urgency to passage of the legislation, because interim authority for these activities was scheduled to expire on March 31.) Commercial-bank automatic-transfer (from savings) accounts, credit-union share drafts, and thrift-institution remote service units may operate henceforth without legal restriction. NOW accounts (negotiable orders of withdrawal) for individuals and non-profit organizations will receive permanent authorization nationwide next December 31, broadening the foothold which they now hold in New England, New York and New Jersey.

While broadening thrift-institution powers, Congress also recognized that they had already begun to offer deposits similar to commercial-bank deposits—and thus decided that they should conform to similar ground rules, for both equity and monetary-control purposes. Hence, it made transaction accounts and non-personal time accounts of all depository institutions subject to Federal Reserve reserve requirements. "Transaction" accounts include bank demand deposits, interest-bearing NOW's, share drafts, ATS accounts, and phone transfers and other accounts subject to transfer to third parties.

Imposing reserve requirements
On transaction accounts, the reserve requirement after a phase-in period will be 3 percent on the first $25 million and, initially, 12 percent on larger amounts. (The $25-million base will be indexed at 80 percent, i.e., increased at a rate equal to 80 percent of the annual growth rate of aggregate transaction accounts at all depository institutions.) On non-personal time deposits, the initial reserve requirement will be 3 percent. The Federal Reserve will have the power to change reserve requirements within a range of 8 to 14 percent for transaction accounts, and within a range of 0 to 9 percent for non-personal time deposits. Under certain conditions, the Fed can impose a supplementary reserve up to 4 percent on transaction accounts, which will earn interest at the average yield earned by the Fed's portfolio of securities during the preceding quarter. Also, under certain emergency conditions, the Fed will have standby authority to impose reserve requirements outside the normal limits, or to impose requirements on any liability.

For most depository institutions which aren't Federal Reserve members, the reserve provisions will be phased-in over an eight-year period, starting six months from now. (However, NOW accounts will be subject to full reserve requirements after next December 31.) Federal Reserve members can expect reductions in reserve requirements, as noted below, and these will be phased-in over a four-year period.

Shifting the burden
Roughly 17,000 institutions will be subject to reserve requirements, including about 5,400 member banks, 9,000 nonmember banks, and initially, about 3,400 S&L's and mutual

savings banks. Somewhat over two-fifths of all these institutions, as well as a number of large credit unions, will have to hold balances at Federal Reserve Banks, over and above the portion of their reserve requirements met by holdings of vault cash—which means that vault cash alone will satisfy reserve requirements at the other institutions. Based on December 1979 data, required reserves held at the Fed (when fully phased-in) would amount to about $13½ billion for member banks and about $3 billion for other institutions.

Member banks will benefit considerably from the new reserve structure, which will result in a 43-percent reduction in their aggregate reserves, and a 58-percent reduction in reserves at the Fed. This action came not a minute too soon, however, because the Federal Reserve has been subject to heavy attrition recently, reflecting financial innovation, shifting competitive patterns, and strong inflationary pressures with their related high interest rates. Thus, many banks have found it progressively more costly and more difficult to justify continuation of membership, since they (unlike their non-member competitors) could not earn interest on their reserves. In late 1979 and early 1980, 69 banks dropped their membership, and about 670 other banks reportedly were considering withdrawal—altogether, more than 11 percent of the System's membership. If all had actually withdrawn, deposits of banks holding reserves with the System would have fallen to 64 percent of total banking-system deposits —compared with a 73-percent share held three years ago.

Access and pricing rules

Nonmember institutions, being subject to reserve requirements for the first time, in return will receive access to certain Federal Reserve services, including access to the Fed's discount window. Any depository institution with transactions or non-personal time deposits will be entitled to the same discount and borrowing privileges now open to member banks. Moreover, in administering the discount window, Reserve Banks will take into consideration the special needs of savings and other depository institutions.

Another far-reaching change will be the implementation, no later than 18 months from now, of pricing schedules for most Federal Reserve services. These would encompass the provision of currency and coin, check clearing, wire transfers, automated clearinghouse services, securities safekeeping, float (checks in process of collection), and "any new service which the Federal Reserve provides." These services shall be made available to non-member depository institutions at the same prices available to member banks. The fees would cover all direct and indirect costs actually incurred in providing services, including the taxes and return on capital that would have been incurred by a private firm providing similar services—but with due regard to competitive factors and the provision of an adequate level of services nationwide.

The new law covers a great deal more, including a Congressional mandate to simplify the mass of regulations stemming from earlier Congressional legislation. But Congress' main purpose has been to reduce competitive barriers and to institute a "more level playing field" in the American financial system, while broadening and strengthening the Federal Reserve's monetary-control procedures. In these respects, it is truly the most far-reaching piece of financial legislation of the past generation.

Verle Johnston

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 3/19/80	Change from 3/12/80	Change from year ago Dollar	Percent
Loans (gross, adjusted) and investments*	138,540	− 72	+ 15,882	+ 12.9
Loans (gross, adjusted) — total#	116,414	− 49	+ 16,192	+ 16.2
Commercial and industrial	33,798	+ 159	+ 4,442	+ 15.1
Real estate	45,202	+ 220	+ 8,943	+ 24.7
Loans to individuals	24,506	+ 10	+ 3,488	+ 16.6
Securities loans	1,340	+ 50	− 183	− 12.0
U.S. Treasury securities*	6,725	− 11	− 1,047	− 13.5
Other securities*	15,401	− 12	+ 737	+ 5.0
Demand deposits — total#	43,475	− 519	+ 4,445	+ 11.4
Demand deposits — adjusted	30,698	−1,317	+ 1,872	+ 6.5
Savings deposits — total'	27,321	− 290	− 2,509	− 8.4
Time deposits — total#	61,080	+ 708	+ 10,671	+ 21.2
Individuals, part. & corp.	52,462	+ 706	+ 11,629	+ 28.5
(Large negotiable CD's)	21,601	+ 187	+ 3,660	+ 20.4

Weekly Averages of Daily Figures	Week ended 3/19/80	Week ended 3/12/80	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	20	11	− 44
Borrowings	263	182	34
Net free reserves (+)/Net borrowed(−)	− 243	− 171	− 78
Federal Funds**			

* Excludes trading account securities.
# Includes items not shown separately.
** The revised series on Federal Funds and Repurchase Agreement Borrowings (FR 2415) is available on request from the Statistical and Data Services Department of the Federal Reserve Bank of San Francisco.

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