Research Department
Federal Reserve
Bank of
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FRBSF Weekly Letter

Some Implications of Deposit Deregulation

Deposit deregulation, mandated by the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Act of 1982, has resulted in the almost complete removal of interest rate ceilings imposed under the Interest Rate Adjustment Act of 1966. In December 1979, approximately 60 percent of all time and savings deposits were in accounts subject to fixed rate ceilings. Now, less than 20 percent of these deposits are subject to such ceilings. Moreover, proposals to allow the payment of interest on demand deposits, which have been introduced in the 98th Congress, would virtually eliminate deposit rate regulation for banks and thrifts. These changes have important implications for the way depository institutions raise funds as well as for the way their regulators attempt to control risk-taking. This *Letter* discusses two aspects of deregulation: the growth of brokered, insured deposits and the increased volatility of deposit costs.

Brokered deposits

Deposit rate deregulation, combined with an increase in deposit insurance coverage from $40,000 to $100,000, has given depository institutions additional incentives to expand their deposit draw beyond their own geographically limited service areas. Deposit brokerage represents one means by which banks and thrifts can mobilize funds from a broadening national deposit market. The deposit broker obtains funds from investors throughout the country and channels them to the client depository institutions, assigning title for the deposit (in separate units of up to $100,000) to a number of different investors. An increasing number of banks and thrifts are finding that this is an economical way to raise additional funds. From an economist's perspective, it represents an efficient deposit-gathering mechanism that enables funds to flow to uses for which the demand is greatest.

The practice of deposit brokering, however, has been attacked by some legislators and bank regulators for increasing the risks insured institutions might undertake, and it has provoked various schemes intent on regulating it. The regulators' primary concern is that, because of deposit insurance, it is possible for institutions in poor condition to raise large quantitites of funds from the national deposit market. For example, the Chairman of the Federal Deposit Insurance Corporation (FDIC) recently told a Congressional sub-committee that "many of the 72 commercial banks that failed between February 1982 and October 1983 had substantial brokered deposits. Overall, brokered deposits constituted 16 percent of the total deposits held by the 72 banks that failed." In the past, the existence of deposit rate ceilings and lower insurance coverage (i.e., $40,000) tended to limit weak institutions' ability to tap the national deposit market through deposit brokers. Thus, the growth, if not the risk-taking proclivities, of weak institutions was restricted. With deregulation and brokered deposits, this check on the riskier institutions has been lost.

However, it is not the availability of funds per se, but their insured status that causes problems. The existence of insurance on brokered deposits enables weaker institutions to raise such deposits at a cost that is not commensurate with the risks they are undertaking. On the one hand, deposit insurance lessens investors' incentives to evaluate the health of the institutions with which they place their funds. On the other hand, the flat-rate deposit insurance premium structure does not require *individual* institutions to pay higher rates for the higher risks they undertake. Instead, the costs are spread among the insuring agencies—FDIC and FSLIC (Federal Savings and Loan Insurance Corporation)—and all other insured

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institutions in the forms of higher liquidation expenses and lower premium rebates.

Under these circumstances, deposit brokerage may supplant the Federal Reserve's discount window as the lender of last resort for institutions in difficulty. Given a choice between borrowing at the Fed, which requires that an institution put up good collateral, and raising brokered funds, weaker institutions may find it cheaper to choose the latter. In effect, the federal insurer guarantees the repayment of uncollateralized purchased funds at a rate that does not cover the risk, while the Fed implicitly charges a higher rate by requiring collateral to cover the risk.

A second concern of bank and thrift regulators is that brokered deposits may be used to exploit the federal deposit insurance guarantee even when the issuing institution is in no apparent danger of default. It is widely recognized that the current system, which charges a uniform deposit insurance premium, provides an incentive for insured institutions to engage in more risk-taking than they otherwise would. The costs of increased risk-taking are shared with the federal insurer, while the rewards accrue to the owners of the depository institution. Deposit rate ceilings tended to constrain depository institutions' ability to respond to these risk-taking incentives by restricting their ability to raise additional deposits. However, without rate ceilings, institutions that want to take advantage of riskier investment opportunities (such as making more and/or risker loans) need not wait for local deposit growth to provide the funds. They can turn to brokers to tap the national market. Of course, they may have to pay a higher rate than they would for local deposits, but they do not incur the costs of additional branch offices and ancillary services to obtain these funds—and the rate will certainly be below the rate on uninsured deposits.

Clearly, then, the growth in insured deposit brokerage is an important concern of bank and thrift regulators. However, the direct or brokered sale of "uninsured" deposits that are *implicitly* insured ought to be a source of concern as well. After all, deposit brokerage is not a new phenomenon. Large banks have tapped the money market for some years both by direct and brokered placement of negotiable large CDs. These CDs have generally been traded in lot sizes well in excess of the $100,000 deposit insurance limit. With the notable, and probably very special, exception of the Penn Square failure, the holders of these uninsured deposits have not suffered significant losses when some of the issuers failed. In fact, it was widely believed (at least until the Penn Square failure) that the insuring agencies would never pay off only the insured deposits of a failed large bank, but would, instead, arrange a purchase that would also protect large deposits. This view, supported by FDIC and FSLIC practice, has resulted in less than full risk-pricing of large-bank CDs, leaving the insuring agencies to share the cost of deposits that are not fully insured by statute.

The problems with deposit brokerage should, therefore, be considered symptomatic not of deposit deregulation, but of a more general problem with the deposit insurance system. The system as it is currently structured provides incentives for greater risk-taking whether a bank uses deposit brokers or not. Therefore, plans to restrict insured deposit brokerage do not get to the heart of the problem, but instead, risk cutting off an economically efficient mechanism. Instead of trying to restrict deposit brokerage, it would be more useful and equitable to address the thorny problem of deposit insurance reform.

An analogy may help make this point: When banks began to use large computers, it was suggested that scale economies in computing would drive small banks out of business. This hasn't happened since a small bank need not own a large computer to be able to take advantage of its capabilities. Instead, a small bank can purchase computer services

from the owner of a large computer, who can pool the demands of a number of banks. Competition among such owners results in competitively priced services. Similarly, by pooling the deposit offerings of a number of banks, a deposit broker can offer smaller banks the advantages of the large banks' access to national deposit markets.

Deregulation and deposit costs

At the same time that deregulation has opened opportunities for deposit brokerage, it has also changed the nature of banks' and thrifts' costs. When deposit rate ceilings were binding, banks and thrifts were forced into "non-rate" competition, such as the provision of extensive branch networks and large staffs. As shown in the chart, bank and thrift offices per capita increased throughout the 1970s along with bank and thrift employees per capita. Now that the ceilings are gone, we are seeing an expected reversal of the trend toward more branches and more employees. A number of banks have announced branch closings and employee reductions, as is clear in the chart as well.

In the long-run, the elimination of rate ceilings will mean that depositors will receive larger interest payments and lower payments in the form of free or underpriced services, and depository institutions will have to manage new marketing trade-offs among interest payments, services, and service fees. One of the tricky problems for existing banks is that they must do this in competition with new entrants that are not weighed down with personnel and facilities more suitable to the period of deposit rate ceilings.

Deregulation also means that deposit costs will become more volatile. This is the mirror image of the volatility in deposit quantity—"disintermediation"—that occurred when fixed rate ceilings prevented depository institutions from paying rates comparable to those available from non-depository institutions. More volatility in bank costs is not a bad thing if depository institutions are prepared to manage this volatility. But as was the case with deposit rate ceilings and disintermediation, there will be problems for undercapitalized institutions with too many fixed rate and/or non-performing assets. Instead of facing a liquidity crisis caused by withdrawals, weak institutions now will more likely face an earnings crisis caused by a negative spread between the yield on assets and cost of funds. This distinction has important implications for the way regulators monitor the condition of banks and thrifts, particularly those that are in danger of failing. With access to national markets through deposit brokers, weak institutions are now less likely to encounter liquidity problems and thus, may be able to continue in operation longer than they should.

Ironically, deposit deregulation may make the regulators' task of enforcing capital adequacy standards easier. The elimination of deposit rate ceilings undermines the argument that deposits are a cheaper source of funds than capital and other non-deposit liabilities. When deposit rate ceilings were binding, deposit costs seemed, and perhaps were, lower than that of other liabilities, at least on the margin.

Now, however, any difference in the cost of deposits and substitute liabilities is not an economic cost to the issuer, but a reflection of differences in riskiness. For example, liabilities that are subordinated to deposits should bear a higher cost because they are riskier, just as equity's greater riskiness carries a higher return than debt. Thus, if deposits are truly bargains without deposit ceilings, it is because some bank markets are not fully competitive or because deposit insurance premiums are insufficient, on the margin, to cover the insurer's deposit guarantee liability. Regulatory policies regarding capital adequacy standards should not allow depository institutions to take advantage of these sources of deposit "cheapness."

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

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/25/84	Change from 1/18/84	Change from year ago	
			Dollar	Percent
Loans, Leases and Investments[1] [2]	173,881	− 471	1,018	0.6
Loans and Leases[1] [5]	153,598	− 307	2,342	1.5
Commercial and Industrial	45,069	55	− 389	− 0.8
Real estate	58,897	− 7	865	1.4
Loans to Individuals	26,650	54	2,073	8.4
Leases	5,039	− 11	− 248	− 4.7
U.S. Treasury and Agency Securities[2]	12,139	− 135	682	6.0
Other Securities[2]	8,144	− 29	NA	NA
Total Deposits	181,947	−2,550	4,249	2.4
Demand Deposits	40,852	−2,337	2,520	6.5
Demand Deposits Adjusted[3]	28,138	−1,177	NA	NA
Other Transaction Balances[4]	11,700	− 369	NA	NA
Total Non-Transaction Balances	129,395	156	NA	NA
Money Market Deposit Accounts—Total	39,688	52	NA	NA
Time Deposits in Amounts of $100,000 or more	38,456	141	− 9,716	− 20.2
Other Liabilities for Borrowed Money[5]	19,133	−1,782	− 5,699	− 23.0

Weekly Averages of Daily Figures	Week ended 1/25/84	Week ended 1/18/84	Comparable year-ago period
Reserve Position, All Reporting Banks			
Excess Reserves (+)/Deficiency (−)	75	266	393
Borrowings	10	22	0
Net free reserves (+)/Net borrowed(−)	65	244	393

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately

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