
FRBSF WEEKLY LETTER

November 8, 1985

Shopping Pays

The phase-out of interest rate ceilings and payment of interest on transaction accounts significantly increased the interest income consumers earned on deposits. While this benefit of deregulation was well-publicized during the early stage of deregulation, attention has recently focused on another effect: higher fees for deposit services that have offset some of the consumer gains from increased interest income. Indeed, as a recent Wall Street Journal article suggested, "Since deregulation, consumer groups say it costs more to put money in a checking account and more to take it out."

New charges, higher monthly fees and use charges, and larger minimum balance requirements have given rise to concerns about the affordability of basic banking services such as transaction accounts. Moreover, the increased use of charges and fees has made it more difficult for depositors to compare and evaluate the returns on the wider variety of accounts now available. Concerns over fees and disclosure have led consumer groups and some legislators to push for "baseline" banking services and full disclosure of the costs, as well as the interest yields, of various bank accounts.

Legislation along these lines has already been introduced in California and New York, as well as at the federal level. Regulatory agencies are also concerned, as evidenced by the Comptroller of the Currency's August banking circular urging national banks to provide a basic transaction account and written disclosure of all fees, services and terms associated with it. Furthermore, such industry organizations as the American Bankers Association (ABA) have entered the discussion by recommending that banks continue to offer, or make plans to offer, a low cost basic banking account.

Baseline services and disclosure

As typically proposed, baseline banking legislation or regulation would require banks to offer a basic checking account to depositors at either reduced costs or without cost, even though such an account may have to be subsidized by the banks' other checking customers or other operations. This is not to say that many banks do not already offer such an account. A recent ABA study indicated that 45 percent of the largest banks and 60 percent

of the smaller ones either offer, or plan to offer, low cost basic banking accounts. Such accounts presumably would be most attractive to "low income" customers. The important features of the account include a small initial deposit, either low (\$100) or no minimum balance requirement, reduced (\$1 to \$3) or no monthly account fee, and small or no per check charges. However, the typical plan also limits the customer's number of checks per month (10 to 12) and provides only basic checking services.

Legislated "disclosure" would require that banks provide depositors with information on monthly fees, use charges, minimum balance requirements, interest yields, and other terms and charges associated with a deposit account. Such disclosure could help consumers evaluate the net yield (after costs are subtracted from earnings) of the various types of accounts offered at a bank, as well as compare the accounts offered at different banks. Standardizing this information could reduce depositors' costs of "shopping around" for the best yield in the same way that Truth in Lending laws provide for standardized information on loan costs. Such a plan would be more appropriate now than it would have been a few years ago because 95 percent of banks now charge for services.

Deposits and banking services

In return for the deposits that consumers and businesses place with banks and thrifts, they receive a combination of direct interest payments and/or indirect service payments. In the past, ceilings on explicit interest payments normally have determined the trade-off between how much interest was paid explicitly and implicitly. During periods when ceilings restricted banks' ability to pay interest, banks typically offered services without charge as compensation.

Banks provide both savings and transaction services — check clearing and cashing, automated teller machines (ATMs), teller services, account statements, etc. Banks can charge for these services through a combination of monthly fees, per item charges, service charges, minimum balance requirements, and/or by paying below-market interest rates. When ceilings prevented explicit interest payments, banks competed with one

FRBSF

another and with nonregulated institutions by reducing the charges or offering services without charge in lieu of explicit interest payments. Once ceilings were removed, banks could pay higher interest rates and hence no longer had to offer "low cost" services to attract deposits. Thus, removal of the ceilings resulted in more efficient pricing and production of banking services, which allowed banks to pay and consumers to receive higher interest rates. Still, this transition caused many depositors to face dramatically increased service charges and fees, which banks used to cover the cost of offering interest-bearing accounts.

Trade-offs

The current structure of account maintenance fees, per item charges, and minimum balance requirements illustrates the trade-offs between explicit interest and implicit interest (underpriced services) that still exist between noninterest-bearing and interest-bearing accounts. Sheshunoff and Company, in a study entitled *Pricing Bank Services and Loans 1985*, gives data for rates paid, average fees, charges, and minimum balances based on a sample of nearly 1700 banks. These data provide a very useful indication of average charges for the banks sampled as well as the wide range and varied combinations of charges across banks.

Transaction accounts that still have interest ceilings in effect, such as personal checking and NOW accounts, have lower overall fee structures (fees and minimum balances necessary for free services) than accounts without ceilings. This indicates that banks are constrained as to the interest they can pay explicitly and are providing implicit service returns in addition.

On personal checking accounts (for which explicit interest still is not allowed), the monthly average maintenance fee was \$2.70. On average, banks provided 15 free checks and charged 15¢ per check above that number. Depositors, on average, needed to maintain an average minimum balance of \$431 in their personal checking account for banks to waive fees and charges. Also, because personal checking accounts pay no explicit interest, the depositor foregoes explicit interest income on the balances held with the bank.

NOW accounts had a regulated maximum interest rate of 5.25 percent, and generally paid that rate during the survey period. Super NOWs, for which interest payments are not regulated but for which minimum balances of \$1000 are presently required by regulation, yielded 7.81 percent during the

same period. Both had much higher fees and minimum balance requirements than personal checking accounts. The average monthly maintenance fee on the NOW account was \$6.07, and the minimum balance necessary to qualify for free services was \$1,073. On the ceiling-free Super NOW, the monthly charge was \$7.64 to maintain an account; the average minimum balance across banks to qualify for free services was over \$3,300. If a depositor does not meet the minimum for free checking with NOW or Super NOW accounts, he or she will often find that the cost of these accounts exceeds the interest earned, and, in fact, that the net yield may even be below that of a personal checking account.

Higher charges

By 1984, evidence of the rising cost of bank services had led the Federal Reserve's Consumer Advisory Council (CAC) to ask the Federal Reserve staff to examine changes in the cost and availability of bank deposit services. For depositors, perhaps the most important factor in determining the cost of maintaining an account is the minimum balance requirement necessary to waive fees and charges. Federal Reserve Staff Study #145 indicated that, for the period from 1980 to 1983, rates of increase in the minimum balances necessary to waive service charges were similar to the increase in the Consumer Price Index. This suggests that service charges had not risen as sharply as some were suggesting.

However, the study also found evidence that there was a large increase in bank charges if one examined the level of charges imposed when depositors' balances fell below the minimum necessary to avoid service charges. According to the staff report, such charges rose two to four times faster than the general price level, reflecting the elimination of the need to provide services in lieu of interest. Yet, this increase may overstate the effect of rising charges and fees because the prices studied were the stated or listed charges that banks set. Many depositors avoid these charges either by maintaining balances sufficient to waive fees or by shifting their deposits to an institution with lower fees.

Moreover, looking only at banks ignores competitive accounts offered by other types of institutions. Savings and loans and credit unions may now provide interest-bearing transaction accounts (NOWs and Super NOWs) to their customers. Surveys indicate that, on average, the annual cost to a depositor of an account at a savings and loan is about half

that at commercial banks. Furthermore, a recent survey of credit unions, which benefit from a tax-exempt nonprofit status, indicated that three-quarters of credit unions have no monthly fees or per check charges on their interest-bearing checking accounts.

Although it may require some shopping on the part of depositors to find the "best" deal, there are "lower cost" services available. Because of these alternatives, the impact of rising bank charges may be avoided by many depositors even though the Sheshunoff survey indicated that about half of the banks surveyed raised charges within the last year.

Measuring the impact

Households typically state that the cost of transaction services is far less important to them than are such factors as convenience, available services, or interest rates in selecting a bank. One reason for this is that even at banks, most customers appear to be able to avoid charges by maintaining minimum balances that qualify them for free or low cost services on personal checking, NOWs, or Super NOWs. The Federal Reserve's 1984 Currency and Transaction Account Usage Survey found that 57 percent of households sampled were able to avoid charges on their bank accounts. For some groups, such as seniors, the figure was much higher — nearly 90 percent normally did not pay directly for banking services.

Evidence on the importance depositors attach to fees is also consistent with deposit ownership behavior. The Federal Reserve Staff Study suggests that about the same percentage (nearly 90 percent) of households held checking or savings accounts in 1983 as held them in 1977, before deregulation began. Indeed, nearly 80 percent of households continue to hold checking accounts of some type, and about half of the 20 percent without checking accounts maintain savings accounts that they use because such accounts are fairly convenient if transactions are limited.

Still, by 1983, there was a reported decline of ten percentage points or more in the ownership of checking accounts among some very low income households and households headed by persons under 25. However, that decline could have resulted from the adverse effects of the two recessions that occurred between 1979 and 1983 rather than from rising charges. Overall, the figures show that there does not appear to have been a decline in the ownership of deposit accounts by the public

over the period of deregulation when charges and fees were rising most rapidly.

Bank profitability

Did the increases in fees and charges over the period from 1978 to the present increase the profitability of personal transaction accounts at banks? Or was the trade-off such that banks used higher fees and charges to increase service income and reduce unprofitable volume in an effort to offset the higher interest costs associated with attracting deposits directly? The Federal Reserve's annual Functional Cost Analysis (FCA) surveys provide no evidence that the profitability of transaction account services has risen under the combined effects of higher interest payments and higher fees and charges. Instead, FCA data indicate that, had there not been an offsetting increase in fee and service income, the increase in the explicit interest cost of attracting transaction balances caused by deregulation would have led to a decline in the profitability of transaction accounts. Thus, at least for the sample of banks in the FCA survey, these combined effects of deregulation did not appear to increase the profitability of providing checking services.

Conclusion

Since deregulation, there has been a significant change in how banks price their deposit services. This change, in turn, has led to some confusion and concern about how explicit pricing would affect the affordability of banking services.

While there is now some confusion about why service charges have risen and some concern about how they should be disclosed, the transition to more explicit pricing does not appear to have caused a reduction in the overall percentage of households using checking or other liquid accounts at banks. Moreover, more than half of all depositors at banks continue to hold sufficiently large balances to avoid most service charges or fees.

While consumers now may have to pay directly for the deposit services they use — a practice that promotes the efficient use of those services — they are, on the whole, benefiting from deregulation. Deposits are paying more interest; a larger number of institutions are supplying banking services; and there is now a wider array of deposit products. Finally, for accounts with low activity, consumers can still find attractive alternatives in the marketplace if they shop for them.

Gary C. Zimmerman

Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.

Editorial comments may be addressed to the editor (Gregory Tong) or to the author Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

Alaska Arizona California Hawaii Idaho
Nevada Oregon Utah Washington

San Francisco Bank of Federal Reserve Research Department

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding	Change from	Change from 10/17/84	
	10/16/85	10/9/85	Dollar	Percent ⁷
Loans, Leases and Investments ^{1 2}	194,803	- 328	11,148	6.0
Loans and Leases ^{1 6}	175,769	- 300	10,668	6.4
Commercial and Industrial	50,526	- 557	111	0.2
Real estate	65,234	70	3,824	6.2
Loans to Individuals	35,910	- 13	5,620	18.5
Leases	5,392	- 13	346	6.8
U.S. Treasury and Agency Securities ²	11,786	- 37	161	1.3
Other Securities ²	7,248	9	319	4.6
Total Deposits	204,087	4,478	13,803	7.2
Demand Deposits	51,834	4,659	7,437	16.7
Demand Deposits Adjusted ³	30,630	- 2,151	1,488	5.1
Other Transaction Balances ⁴	14,159	- 61	1,843	14.9
Total Non-Transaction Balances ⁶	138,094	- 120	4,522	3.3
Money Market Deposit Accounts—Total	45,433	131	7,372	19.3
Time Deposits in Amounts of \$100,000 or more	38,387	- 183	2,935	7.1
Other Liabilities for Borrowed Money ⁵	22,793	264	4,004	21.3
Two Week Averages of Daily Figures	Period ended 10/7/85	Period ended 9/23/85		
Reserve Position, All Reporting Banks				
Excess Reserves (+)/Deficiency (-)	- 62	61		
Borrowings	82	39		
Net free reserves (+)/Net borrowed(-)	- 144	23		

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

⁷ Annualized percent change