Research Department
Federal Reserve
Bank of
San Francisco

December 3, 1976

The Yellow Brick Road

To some observers, Congress' efforts toward a legislative restructuring of the nation's depository institutions evoked memories of the difficulties faced by Dorothy and her varied companions in following the Yellow Brick Road to Oz. There were, for example, the perils of the dark forest—perils largely unseen, but the more to be feared because of this. Then too, there was the constant threat of danger from the Wicked Witch of the East, who wanted to augment her already formidable powers by acquiring the magic shoes which alone protected Dorothy from harm.

The characters in the Frank Baum stories and the Broadway musicals based on them quickly learned that cooperation was essential to the attainment of their objective. In contrast, this year's travellers soon parted company, variously accusing one another of lacking courage, heart, and even brains, of deliberately setting up straw men, and of not having any real interest in actually reaching the Emerald City—in this case a more viable and competitive financial structure.

Off to see the Wiz

As the year commenced, the prospects for reform appeared fairly good. In December the Senate had passed the Financial Institutions Act—a somewhat distant descendant of the Hunt Commission report of 1971. On the House side, legislative proposals evolved out of the late-1975 FINE study (Financial Institutions and the Nation's Economy). The FINE study incorporated a set of tentative "Principles" which, in the view of some observers, had a stronger pro-competitive thrust than the Senate's bill.

The FINE Principles included the Senate's proposals regarding uniform tax treatment, the payment of interest on demand deposits, consumer lending, and the extension of third-party payment powers to all depository institutions. But in addition, the Principles called for reduced restrictions on branching and the definite termination of Regulation Q interest-rate ceilings after five years. In the interests of both equity and the effective implementation of monetary policy, the FINE study also advocated the imposition of Federal Reserve reserve requirements on the deposit liabilities of *all* federally insured depository institutions.

Forks in the road

In response to the clamor of the prospective travellers, the design of the Yellow Brick Road began to change almost immediately. The first mark-up of a House bill (The Financial Reform Act of 1976) witnessed the elimination of a number of the key Principles. Some changes were made at the insistence of builders and the building trades, who opposed a substantial diversification of thrift institution powers because they feared a possible reduction in the flow of funds to housing. As a result, the removal of

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interest-rate ceilings was again conditional on circumstances existing at the end of 5½ years. The thrifts also have insisted that even with broadened lending and deposit powers, they still need to offer a ¼-percent differential over the banks' ceiling to be able to compete for savings, and thereby to maintain an adequate flow of funds to housing.

For their part, commercial banks were unhappy at the prospect of groundrules that would confer many of their traditional powers upon their competitors while allowing the latter the continued protection of an interest-rate differential. In addition, many banks (small banks in particular) became worried about one specific proposal—the payment of interest on demand deposits. They felt that, on balance, this proposal would raise the average cost of bank funds significantly, with an attendant increase in costs to bank customers, while lowering the average cost of funds to the thrifts. (According to the American Bankers Association, a 2-percent interest rate on demand deposits—assuming no change in service charges—would mean a 23-percent decline in earnings, which could only be offset by a 1.2-percentage point increase in either loan rates or service charges, or by some combination of the two.) Yet significantly, major S&L groups, early in the year, reversed their traditional stance in favor of checking-account powers. They did this partly to strengthen their argument for retaining their ¼-percent differential on savings, but also in the belief that potentially expensive accounts were not needed so long as they had the prospective power to offer NOW accounts at a lower average cost than present savings accounts.

The equity thrust of the original FINE Principles was weakened by a revision which would permit thrifts to offer third-party payment services of any type (checking accounts, NOWS, etc.) where permitted by state law. Also, the Principles' potential for strengthening monetary control was weakened by a revision which would exempt institutions with less than $15 million in third-party accounts from System reserve requirements. When the bill finally was sent back to committee, it looked like such Ozian characters as the Shaggy Man and the Patchwork Girl. Nevertheless, Chairman Reuss of the House Banking and Currency Committee has made it clear that the reform proposals "are not dead," and that the new Congress will be focusing more intently on the problem of asymmetry between the thrifts' asset and liability structures. He has also noted that the groundrules even now are being rapidly altered at the state level, a situation that cannot be left "to the chaotic action of the 50 states."

Hectic activity

This spate of legislative action at the state level has involved the conferring of some form of checking-account authority upon thrifts in New England, New York, Illinois, Wisconsin and Oregon. In several cases, these new powers have included authority to offer overdrafts.

Activity in the area of electronic funds transfers also is having an impact, notwithstanding the Supreme Court's recent ruling that bank electronic terminals (CBCT's) are "branches" within the meaning of the McFadden Act, and thereby subject to state branching laws and restrictions. A large California S&L now makes it possible for its savings-account customers to pay for groceries with a simultaneous electronic debiting and crediting procedure. Such developments are rapidly eroding the traditional distinction between different types of accounts, and are reshaping competition among financial institutions and also altering the linkages of monetary control.

Both of these forces for change—state legislative actions and the new EFT developments—have strong consumer overtones, and herein may lie the means for unraveling the gordian knot that has tied up the restructuring of the nation's depository institutions. For example, some consumer groups appear to be increasingly disenchanted with the view that savers should be forced to subsidize certain borrowers because of the Reg Q ceilings on their savings deposits. Others claim that Reg Q fails to meet its primary social justification—housing—because in an era of growing consumer awareness of investment alternatives, interest-rate ceilings will become progressively less effective in forestalling future disintermediation of deposit funds. Consumers also are becoming more aware that inflation itself is the chief enemy of housing—contributing to a doubling of home prices in nine years—and that unless inflation is curbed, housing will not be protected by any number of Dorothy's magic shoes.

Increasingly, consumers also may demand an explicit rather than an implicit return on their funds—including demand deposits, whose distinction vis-a-vis savings deposits even now is being altered by NOW accounts and preauthorized transfers from savings deposits, as well as proposed telephonic transfers to demand deposits. Yet consumers will have to realize that increases in the cost of funds to lenders may mean higher costs to borrowers; in the real world there is no such thing as a "free lunch," such as Dorothy and the Tin Woodsman were able to pluck from the lunch-pail tree.

In the area of EFTS, a more consistent attitude on the part of consumers and bankers alike may be necessary towards both liberalized branching and EFTS—including the use of CBCT's by banks. Hostility may be not only anti-competitive but also self-defeating, simply because the thrifts are not subject to the McFadden Act. In fact, EFTS holds considerable potential for the development of consumer and small-business services, which traditionally have been the stock in trade of the small banks. If the banks don't take advantage of this potential, the thrifts and other competitors very likely will, and small banks in particular may be left behind in Munchkin Land.

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