

Proposals for Reform of the Financial Structure and Regulation in the United States*

Introduction

The American financial system operates under a regulatory structure which is aimed at the twin objectives of safety and competition. This structure evolved over many years, often in response to financial crises; and some of its most durable features were enacted during the crisis years of the 1930's. The regulatory structure which was designed to protect against the ravages of a depression period developed serious strains under the pressure of the inflationary forces which prevailed during the latter part of the 1960's. One of the most disturbing consequences was the serious interruption in the flow of funds into financial institutions and in the availability of funds to the residential mortgage market, small business borrowers, and state and local governments. The savings and loan associations, which borrow short but lend long, were particularly vulnerable during a period of high short-term rates and a negatively-inclined yield curve.

It was against this background that, on June 16, 1970, the President announced the appointment of a Commission on Financial Structure and Regulation. The 20-man commission, with a membership drawn from the ranks of business, financial institutions, labor, and universities, was given a broad mandate to "review and study the structure, operation, and regulation of the private financial institutions in the United States, for the purpose of formulating recommendations that would improve the functioning of the private financial system".¹ On December 22, 1971, the Commission sub-

* The research for this paper was partly supported by a grant from the Witter Foundation.

¹ *Report of the President's Commission on Financial Structure and Regulation* (hereinafter cited as *Report*), p. 1. The reader will note that the mandate did not mention the Federal Reserve System.

mitted its report to the President in a document of 173 pages with 89 recommendations on a wide range of topics.

The Commission limited its inquiry and recommendations to six financial intermediaries — commercial banks, savings and loan associations, mutual savings banks, credit unions, life insurance companies, and pension funds.² One set of proposals would remove some of the regulatory restraints on the conditions of competition — a prime example is the proposal to abolish ceiling rates on time and savings deposits and on certificates of deposit. A second set of proposals dealt with the functions of depository financial institutions. The deposit thrift institutions³ would be granted a significant expansion in their loan and investment powers — e.g., authority to make a limited amount of consumer loans and a limited amount of investments in real estate equities, high-grade private and government debt, equity securities, and “leeway” investments; greater deposit flexibility, especially third-party payment services,⁴ including checking accounts and credit cards for individuals and nonbusiness entities; and more scope for the operations of their holding company affiliates. Commercial banks would also receive wider loan and investment powers and more freedom to manage their liabilities in response to market forces.

A third set of recommendations aims to improve competition by altering the structure of financial markets. One important recommendation would authorize commercial banks and the deposit thrift institutions to branch on a statewide basis. Another recommendation, designed to eliminate compulsory specialization among financial institutions, would give any insured depository institution the right to change its charter to another institutional type.⁵

² It excluded nonlife insurance companies, finance companies, the operations of the equity markets, the international operations of American banks, the problems of bank mergers, and bank holding companies. See *Report*, p. 11.

³ In the Report, the term “deposit thrift institution” refers to savings and loan associations and mutual savings banks. See *Report*, p. 18, No. 1.

⁴ This term includes “any mechanism whereby a deposit intermediary transfers a depositor’s funds to a third party or to the account of a third party upon the negotiable or non-negotiable order of the depositor. Checking accounts are one type of third party payment service. Escrow accounts incidental to loan agreements are not included as third party payments”. *Report*, p. 23, No. 1.

⁵ *Report*, p. 89. The Commission did not want to inhibit the right of institutions to specialize but rather to abolish specialization forced by statute and by regulation. Under this significant proposal, the door would be open for approximately 6,500 deposit thrift institutions to become full-service commercial banks.

A fourth set of proposals would abolish reserve requirement differentials. On demand deposits, the Commission would extend uniform deposit reserve requirements to all commercial banks and to all depository institutions which offered third-party payment services. In addition, legally required deposit reserves would be abolished for time deposit, savings deposits, share accounts, and certificates of deposit. The Commission also recommended a uniform tax formula for all depository financial institutions in order to terminate differential tax treatment and to place competing institutions on an equal footing.

The Commission further proposed extensive revisions in the regulatory structure (including the Federal Reserve System, the Comptroller of Currency, the Federal Deposit Insurance Corporation, Federal Home Loan Bank) and recommended some new regulatory agencies. These changes are intended to ensure that the laws and regulations are applied uniformly to competing institutions and to improve the efficiency of the examination and supervisory functions. Two important features of the present regulatory structure would be preserved: the dual system of chartering, examination, and supervision; and the Federal Reserve’s “independence” in the conduct of monetary policy.

The Commission’s recommendations are intended to make financial markets more competitive and to improve the ability of financial institutions to adapt to economic and technological change. The Commission is aware that the resulting allocation of resources may not accord with social goals, especially in the area of housing; but it has strongly rejected the idea of bending the financial structure to achieve the desired goals — e.g., by requiring specific types of institutions to invest percentages of their portfolios in particular types of investments, or by providing tax credits against reserve requirements based on holdings of specific assets for those institutions required to hold reserve balances. It believes that such an approach would be wasteful, inefficient, and largely unsuccessful. The Commission has focussed instead on a number of proposals to improve the functioning of mortgage markets — e.g., variable-rate options on government-guaranteed mortgage loans or removal of all statutory interest rate ceilings on residential mortgages. In order to “avoid the warping of financial institutions”, the Commission would have the Congress authorize direct subsidies to consumers and tax credit

programs if the resulting mortgage flow was not adequate to achieve national housing goals.⁶

In the words of the Report, "Increased competition within and among the institutional types is a prime objective of the Commission".⁷ This is, indeed, apparent from some of the most important of its far-reaching proposals for reform of the American financial structure — e.g., proposals to make it easier for different types of financial firms to cross bank and bank-related product lines, to make geographic areas less protected, to remove reserve requirement differentials and advantages stemming from regulatory disparities, to provide for more nearly identical tax treatment, etc. The fundamental question the Commission had to confront was where to strike the balance between reliance on market competition or reliance on administrative regulation to influence the financial system. The Commission's answer is foursquare in favor of greater emphasis on market competition. Accordingly, in the balance of this paper, I have considered some of the consequences and implications of this emphasis on more competition in financial markets. The present regulatory regime, with its reliance on administrative regulation, has had a long history, and its consequences are reasonably familiar. The proposals for more competition would move the financial system onto less familiar terrain. It is the purpose of the analysis which follows to explore the nature of the choices proposed in the Report.

Proposal for Statewide Branching

Relation to entry condition. In industrial organization, the entry condition is recognized as a major influence on the extent of actual competition, especially in concentrated markets. The Commission clearly accepted this view with respect to banking: "Restrictions on entry of new banks and new branches into an area may cause the level of competition in that market to be abnormally low, reducing the benefits to the public of stronger price and service competition".⁸ Both in unit-bank-states and in statewide branch banking states, the need criterion is the single most important regulatory barrier to

⁶ Report, p. 86; cf. also pp. 117-118.

⁷ Report, p. 121.

⁸ Report, p. 45.

entry by new banks or new branch offices.⁹ Hence, in any set of proposals to achieve more competition, one would expect to find a prominent role ascribed to the need condition of entry. The Commission did, indeed, call attention to the possibility that a chartering agency "may become over-zealous in protecting existing firms, with the result that entry by new firms is effectively foreclosed".¹⁰ Similarly, the Commission noted that "Current laws sometimes limit charter and branches on the basis of population density, geographic area or proximity to other institutions or branches".¹¹ Notwithstanding, none of the 89 recommendations in the Report specifically recommended a general relaxation of the need criterion for new banks or branch offices.

This does not mean that the Commission ignored the entry condition. As noted earlier, the Commission would grant the deposit thrift institutions expanded powers (on loans and investments, on time and savings deposits, and on third-party payment services) to "enable any savings and loan association or mutual savings bank to be a competitor of the commercial banks by offering similar services".¹² In addition, any insured depository institution would be able to change its charter to that of another institutional type. The latter proposal would significantly modify the entry condition into commercial banking since it would deny the regulatory authorities the possibility of invoking the need criterion to impede entry by insured nonbank deposit institutions. This could result in a potentially significant increase in the number of entrants. Moreover, a bank which entered by the charter conversion route would have the advantage of entry as an established financial institution in the community. Nevertheless, this is not a complete substitute in all markets for a general relaxation of the need entry barriers for all potential entrants.

In another important recommendation also designed to increase competition in financial markets, the Commission proposed that "the power of commercial banks to branch, both de novo and by merger,

⁹ For a discussion of the need criterion for entry, see DAVID A. ALHADBEF, "A Reconsideration of Restrictions on Bank Entry", *Quarterly Journal of Economics*, May 1962, pp. 247-252.

¹⁰ Report, p. 60.

¹¹ *Ibid.*, p. 61.

¹² *Ibid.*, p. 37.

be extended to a statewide basis...".¹³ This recommendation has different implications in different states. In unit-bank states, the proposal for statewide branching would change the admissible forms of bank organization (i.e., branch or unit) and at the same time define the maximum geographical scope for branch offices. In limited branch bank states, the proposal would not alter the admissible forms of bank organization but it would extend the permitted area for branching. For our purposes, the important point is that the Commission's proposal for statewide branching is not an attack on the need doctrine as such but rather on the special regulatory barriers which have been aimed at branch banks, i.e., to deny them the right to exist (in unit-bank states) or the right to branch statewide (in limited branch bank states).

In recommending statewide branching, the Commission believed that it was making an important proposal related to competition, because "Restricting branching by statute to an arbitrary number or restricting branches geographically prevents firms from entering the markets of others".¹⁴ As noted above, however, since the Commission did not directly challenge the need criterion, the latter would presumably continue to be an important regulatory barrier to entry for both branch and unit banks. In short, although the proposal for statewide branching seems like a proposal for an easier entry condition, the proposal per se would simply remove the special restrictions on entry by branch banks, i.e., branch bank entry would not be disadvantaged *as compared with unit banks*. It follows that the improvement in competition anticipated from statewide branching per se must be predicated on the substitution of branch banks for unit banks. As shown below, the competitive effects of this substitution can be examined in the context of zero net entry or a fixed amount of net entry. In addition, the competitive effects can be analyzed in terms of market structure or market performance. Each will be considered in turn. In all cases, the connection between statewide branching and competition will be examined for local

¹³ *Ibid.*, pp. 61-62. The Commission further recommended "that all statutory restrictions on branch or home office locations based on geographic or population factors or on proximity to other banks or branches thereof be eliminated". (*Idem.*) This almost sounds like an attack on the need doctrine, but since there is no comparable statement for unit banks, it is probably intended to get at the special restrictions on branch banks as such.

¹⁴ *Ibid.*, p. 60.

markets, because the Commission believes that statewide branching is particularly pertinent to competition in local markets.¹⁵

Effects on market structure. In gauging the effect of statewide branching per se on market structures, it is necessary to neutralize any entry effects. Accordingly, the first question we ask is whether local markets in a unit-bank state would become more competitive if the unit banks were absorbed (merged) by a system of statewide branch banks.¹⁶ The answer is that a first-time branch entry into a particular local market would not affect the existing concentration in that market — a branch bank would simply be substituted for a unit bank. The situation would be quite different if a given branch bank established more than one office in a given local market. Except for the first unit-bank acquisition, all subsequent unit bank acquisitions by the same branch bank would necessarily increase market concentration in the local market. Since it is common under statewide branching for branch banks to establish multiple branches in a given city, our conclusion is that statewide branching would increase concentration in (at least some) local markets.

It is important to emphasize that this conclusion does not depend upon the assumption of zero net entry, i.e., that a branch bank will replace a unit bank by means of merger. Suppose we assume instead a fixed amount of net entry, i.e., that no unit banks were merged and that branch banks entered *de novo*. Under that assumption, if a unit-bank state were to allow entry by *de novo* (statewide) branching, the change in the market structure of local markets would depend upon the joint effect of the particular *form* (i.e., branch rather than unit bank) of the entering bank organization as well as upon the fact of entry. In order to filter out the competitive effect due solely to the branch form of the entering bank, we can compare the competitive effects of a given amount of new entry under statewide branch banking with the effects of the same entry under unit banking.

A unit bank entry into a particular local loan market would, of course, reduce concentration in that market. The same result would

¹⁵ In the Commission's view, "Consumers will be helped if the states... relax branching and holding company laws to permit greater competition. In many states branching restrictions so limit entry into *local markets*... that competition is stifled". See *Report*, p. 113, emphasis added.

¹⁶ As noted above, the Commission advocated statewide branching accomplished by merger as well as by *de novo* entry.

be obtained if instead a branch were opened de novo in that market. In the latter case, however, market concentration would fall only after a first-time entry by a particular branch bank into a particular local market. Subsequent entries, although de novo, would increase market concentration. In short, for a given amount of entry, the market structure of local markets would not be more competitive under branch banking than under unit banking, and it would probably be less competitive (i.e., more highly concentrated).¹⁷

Finally, in order to assess the probable market structure effects of statewide branching, it is necessary to consider whether branch banks would enter in larger numbers (open more offices de novo) than unit banks, if the legal condition of entry were equal for both.¹⁸ There are a number of theoretical reasons for believing that branch banks could open offices in areas where it was not profitable and perhaps not possible for unit banks to do so.¹⁹ As expected, there are typically more banking offices in branch bank states than in unit bank states; but it is surprising to discover that the differences are due primarily to the proportionately greater number of banking offices in metropolitan areas — there are also more banking offices in nonmetropolitan areas of branch bank states, but the differences are not so large as might have been predicted in terms of the presumed advantages of branch banks.²⁰ In terms of market structure, however, the important figure is not the number of banking offices as such but rather the number of independent alternatives ("banks") in particular local markets. When branch bank states and unit bank

17 Statewide branching would not increase concentration in local markets if branch banks were limited to one branch per local market. Moreover, in those cases where the state boundaries approximate a geographical market area for bank customers whose mobility extends beyond their local area but falls short of the national market, the introduction of statewide branching could even reduce concentration in the statewide market, provided that there were no mergers among banks operating in the statewide market. Cf. DAVID A. ALHADEFF, "California Banking and Competition", in HYMAN P. MINSKY, editor, *California Banking in a Growing Economy: 1946-1975*, pp. 180-181 and 186-187. (The Report did not refer to any statewide markets.)

18 In fact, there is some reason for believing that the regulatory barriers to entry may be lower for branch banks than for unit banks. Cf. BERNARD SHULL and PAUL M. HORVITZ, "Branch Banking and the Structure of Competition", *National Banking Review*, March 1964, pp. 338-339.

19 See DAVID A. ALHADEFF, "Bank Mergers: Competition versus Banking Factors", *Southern Economic Journal*, January 1963, p. 227.

20 See JACK M. GUTTENTAG and EDWARD S. HERMAN, "Banking Structure and Performance", *New York University Bulletin*, February 1967, pp. 56-57, 158-162 and 167. Also see Federal Reserve *Bulletin*, March 1970, p. 206.

states are compared on this basis, the evidence shows that branch bank states typically have fewer "banks" than unit-bank states in the local markets of metropolitan areas; and there is no great difference between them in the local markets of nonmetropolitan areas.²¹

Effects on market behavior. Let us next consider whether the introduction of statewide branching into a unit-bank state would promote more competitive market behavior in terms of price competition. There is some basis for expecting different market behavior in branch bank states and in unit-bank states, because statewide branch banking tends to pull together the different local markets in the state. Under statewide branch banking, therefore, small-town customers could benefit from the competitive pressures in major-city local markets. On the other hand, there are typically fewer independent banking alternatives in the major cities of branch bank states than in comparable cities where branch banking is limited or prohibited.²² Ultimately, the question of comparative performance must be answered on empirical grounds, but the statistical evidence on the comparative market performance of branch banks and unit banks is not very reliable.²³ In any case, the evidence is inconclusive. In some cases, branch banks appear to act more competitively than unit banks; in other cases, they do not. As Herman and Guttentag have observed, "Viewed broadly, the available evidence does not suggest that branch banking has either a marked or consistent effect on the prices charged for bank services... insofar as the criterion is the impact on prices, a strong case cannot be made for or against branch banking."²⁴

Another aspect of market behavior concerns the possibility of a relation between banking structure and the allocation of resources. The question is not whether the allocation under branch banking

21 See GUTTENTAG and HERMAN, *op. cit.*, pp. 54-55 and 59-60. Also see Federal Reserve *Bulletin*, March 1970, p. 206. One important qualification should be noted. The preceding evidence is derived from the existing state of affairs in branch bank states and unit bank states. Therefore, it reflects a particular entry situation and a particular merger situation in the two kinds of states. It is possible, at least in principle, to have a different pattern of market concentration in the local markets of the two kinds of states under different assumptions about entry and merger conditions.

22 For a fuller discussion, cf. ALHADEFF, "California Banking and Competition", *op. cit.*, pp. 176-179.

23 See GUTTENTAG and HERMAN, *op. cit.*, pp. 80-81.

24 *Ibid.*, p. 104.

would be more (or less) efficient in an economic sense than under unit banking, but how it would accord with social priorities.²⁵ Specifically, how would the introduction of statewide branch banking into a unit-bank state affect the supply of credit for small business firms? Governments have typically been concerned about the supply of credit to small business because of its implications for industrial concentration.²⁶

Those who believe that small business firms would receive less bank credit under statewide branch banking note that large banks can lend to both large and small customers whereas small banks are not in the same position. To clinch the argument, surveys of bank loan portfolios are cited to show that "large banks make a large fraction of their loans to large business and a small fraction to small business. The opposite is true of small banks".²⁷ Critics have replied that the statistics on this point are deceptive. While it is true that the ratios of loans to small business to total business loans are lower in large banks than in small banks, it is also true that the ratios of total business loans to assets are higher. When the matter is examined in this light, there is some evidence that statewide branching might work both ways — i.e., there is some evidence that the percentage of loans to small business increases with bank size in certain bank-size ranges but decreases in other bank-size ranges.²⁸ If this evidence is correct, the effects of statewide branching on loans to small business would depend critically on the size distribution of banks before statewide branching was approved. In addition, however, the evidence is tentative. Hence, the question remains unresolved.²⁹

²⁵ This is analogous to the question of whether the reformed financial structure envisaged by the Commission would direct as much resources to the housing sector as society might desire.

²⁶ In Italy, for example, it is government policy to maintain a size structure of banks which includes large banks, medium-size banks, and small banks in order to assure a supply of bank credit to business firms of different sizes. Cf. DAVID A. ALHADEFF, *Competition and Controls in Banking*, p. 20.

²⁷ DONALD P. JACOBS, "The Interaction Effects of Restrictions on Branching and Other Bank Regulations", *Journal of Finance*, May 1965, pp. 344-345. Since the introduction of statewide branching would raise the level of bank concentration, the result would be a reduced supply of bank credit to small business (or higher loan rates for small business loans).

²⁸ Cf. GUTTENTAG and HERMAN, *op. cit.*, pp. 144-146. Cf. also GUTTENTAG and HERMAN, "Do Large Banks Neglect Small Business?", *Journal of Finance*, September 1966.

²⁹ The Commission did not examine the question of the possible relation between bank organization and the supply of bank credit to small business, but it did express concern about another aspect of credit for small business. The Commission noted that

Proposal to Abolish Rate Ceilings on Deposits

Ceiling rate on time and savings deposits. According to the Commission, one objective of the ceiling rate controls since 1966 has been to "insulate deposit institutions from forces in the money markets that might drain funds from them".³⁰ The ceiling rates cannot, however, affect an outflow of funds from financial institutions to the open market. During the 1966 credit crunch, for example, rate ceilings did not prevent outflows by rate-conscious large depositors; and they were not necessary to prevent outflows by small savers who are comparatively immobile. On the other hand, rate ceilings on deposits can limit the competition between banks and savings and loan associations. One result, as the Commission correctly noted, has been adverse discrimination against small savers.³¹ Hence, in proposing to eliminate the rate ceiling, one of the Commission's objectives was to eliminate the adverse discrimination against small savers.

The removal of the rate ceiling is a necessary but not a sufficient condition for achieving this goal. Whether the small depositors would benefit or how much would also depend on the strength of the competitive forces in the deposit markets — and that in turn is related to the market structures of the deposit markets. Government can influence market structures by its policy on entry, by its policy on mergers, and by its policy on branching. On the matter of entry, the Commission did not recommend any change in the need barrier for banks or deposit thrift institutions. On the matter of mergers, the Commission took the position that "the legislation of 1966 and 1970 made it unnecessary to focus on problems of bank mergers and bank holding companies".³² On the matter of branching, the Commission proposed statewide branching for commercial banks.

small and medium-size business firms were affected disproportionately by the tight money policy in 1966 and again in 1969-70, and it made a number of proposals to ease this uneven impact. Cf. *Report*, pp. 49-50 and my later discussion of proposals for more freedom to manage assets and liabilities.

³⁰ *Report*, p. 24.

³¹ *Report*, pp. 26 and 113. In the long-run deposit rate ceilings could indirectly lead to disintermediation by small as well as by large savers, because rate ceilings may stimulate market innovations designed to lure small savers away from the depository institutions. Cf. *Report*, pp. 25-27.

³² *Report*, p. 11.

The introduction of statewide branch banking per se would almost certainly raise the level of concentration in local deposit markets, and this tendency would be reinforced by the Commission's recommendation in favor of statewide branching for savings and loan associations as well.³³ Since there is not a one-to-one correspondence between the level of market concentration and the level of competitive performance of banking markets, it is possible in principle for competitive performance to be improved in spite of an increase in market concentration. This is not likely, however, either on theoretical grounds or on the basis of empirical studies.³⁴ For these reasons, the abolition of ceiling rates per se may not be sufficient to end the adverse discrimination against small savers.

Ceiling rate on demand deposits. In contrast with its recommendation on time and savings deposits, the Commission would retain the ceiling rates on demand deposits. The Commission acknowledged that the demand deposit ceiling rate misallocates resources by promoting non-price competition (e.g., more branches and "free" services in lieu of interest payments). It was more concerned, however, that removing the ceiling would provoke an outflow of funds from savings and loan associations to commercial banks with the result that the savings and loan associations might be rushed into offering third-party payment services without benefit of the orderly transition envisaged by the Commission.³⁵

The seriousness of any outflow would depend on the size of the rate differential between demand deposits and share accounts and on the rate sensitivity of savings and loan association depositors. Since

³³ As noted earlier, the Commission has also proposed greater asset and liability flexibility for savings and loan associations. Those changes would make it possible for them to be more effective competitors in the deposit markets; but only a competitive market structure could compel (i.e., assure) more competition.

³⁴ The statistical studies which have investigated the relationship between market structure and market performance in banking markets have produced conflicting results. For a discussion of these studies, cf. LARRY R. MOTE, "Competition in Banking: The Evidence", in Federal Reserve Bank of Chicago, *Commercial Banking: Structure, Competition and Performance* (August 1967). Mote's own conclusion (p. 14) is that "with the possible exception of interest rates on business loans, the evidence so far available is consistent with the view that differences in the degree of banking concentration may be responsible for at least a part of any differences observed in performance in banking markets".

³⁵ Cf. *Report*, pp. 27-28.

these variables would not be the same for all depositors at deposit thrift institutions, the abolition of rate ceilings on demand deposits would probably have a different impact on the placement decisions of different size depositors. In the present context, however, this is a secondary consideration. Since the Commission was concerned about the bad effect of an immediate abolition, it is not clear why this objection could not have been met (as it was in other cases)³⁶ by a provision for an "orderly phasing-out of the old system and phasing-in of the new".³⁷ Significantly, the Commission stated that its "recommendations against the removal of the prohibition should be reviewed in the future".³⁸

As in the case of time and savings deposits, the competitive effects of abolishing the ceiling rate on demand deposits would depend upon the nature of the market structure in different deposit submarkets. In the large depositor market, the zero ceiling rate has not insulated banks from competition — although it has undoubtedly influenced the particular form of the competition. In the small-depositor demand deposit market, concentration is typically high and would almost certainly go higher under the Commission's proposal for statewide branch banking. The proposal to allow the savings and loan associations and mutual savings banks to convert into commercial banks could have an opposite effect on concentration. Accordingly, the net competitive effect could be different in different local markets, depending on two unknowns: First, how many deposit thrift institutions would become commercial banks? Second, to what extent would the converted banks branch on a statewide basis?

Proposals on Legal Reserve Requirements

Effect on monetary control. The literature on banking reform contains many proposals to change the nature of reserve requirements. One of the most prominent would abolish legal reserve requirements entirely. The Commission approved this reform for time and savings deposits but rejected it for demand deposits. In the latter case, the Commission held that abolition would make

³⁶ For example, in connection with the recommendation to abolish the ceiling rate differentials between savings and loan associations and banks. *Ibid.*, pp. 23-24.

³⁷ *Ibid.*, p. 9.

³⁸ *Ibid.*, p. 27.

monetary management less efficient.³⁹ Open market operations can control the monetary base without compulsory reserves as long as banks hold a reasonably stable proportion of deposits for clearing and transactions purposes; but legal reserve requirements can provide greater precision.

The Commission recommended that the legal reserve requirements on time and savings deposits should be abolished because "Time and savings account reserves do not intimately affect the efficiency of monetary policy instruments".⁴⁰ The importance of the level of reserve requirements on time and savings deposits hinges particularly on the possibility of shifts between demand and time (including savings) deposits.⁴¹ As interest rates rise during a tight money period, some individuals and business firms will reduce their holdings of demand deposits in favor of interest-bearing time (or thrift) deposits. When time (or thrift) deposits have lower reserve requirements than demand deposits, the shift to interest-bearing time and thrift deposits could weaken the impact of a restrictive credit policy by increasing the supply of loanable funds (credit). If the public's preference for time and thrift deposits over demand deposits were a strictly secular phenomenon, the Federal Reserve could put additional pressure on the supply of money to take account of the increase in velocity — i.e., it could produce the desired restrictive effect by a larger volume of open market operations. On the other hand, if the deposit shift exhibited a pronounced cyclical pattern, the effectiveness of monetary policy could be seriously undermined. For example, if the Federal Reserve pursued a restrictive monetary policy and interest rates (including time deposit rates) rose, some savers would reduce their holdings of demand deposits in favor of time deposits. In spite of the slippage in the tight policy, the central bank could be constrained from pressing further on the money supply to avoid accelerating the shift and further impairing the effectiveness of the tight credit policy.

In his examination of the efficacy of monetary policy in the late 1950's, Warren Smith noted that rising interest rates in 1957

³⁹ It should be noted that the Commission's chief reason for retaining legal reserve requirements on demand deposits was not its effect on monetary policy but its windfall effect on bank stockholders. Cf. *Report*, p. 67.

⁴⁰ *Ibid.*, p. 68. In this case, the Commission ignored the windfall gain consideration.

⁴¹ This matter was widely discussed during the 1950's, partly as a result of the writings of Gurley and Shaw and partly because of the problems encountered by monetary policy especially during the latter part of the decade.

had induced a shift from demand to time deposits at commercial banks,⁴² but he did not find any evidence that such shifts were likely to become important systematic destabilizers. He also did not find evidence of systematic destabilizing shifts between demand deposits and the deposit thrift institutions.⁴³ It remains to be seen whether past experience with respect to cyclical shifts of deposits will be repeated in the future. In the past, the shift between demand and time deposits in response to higher interest rates on time deposits was due to the sophisticated large savers.⁴⁴ This will probably be different in the future. In part as a result of the tight-money episodes during the latter part of the 1960's, many smaller savers are now more knowledgeable about alternative outlets for their funds and more sensitive to rate differentials. Deposit shifting in the future could also be encouraged by the Commission's recommendations to increase competition. In particular, the proposal to abolish the rate ceilings on time and savings deposits would eliminate an important legal barrier to deposit-rate competition. In addition, the proposal to expand the investment powers of commercial banks and deposit thrift institutions would enable both institutions to be more competitive on deposit rates during tight money periods. In short, the Commission's recommendations would tend to keep rates on interest-bearing deposits more in line with open market rates in future cyclical fluctuations. This, too, would encourage cyclical deposit-shifting.

Effect on competitive equality. Considerations of competitive equality also influenced the Commission's recommendations on legal reserve requirements. To enhance competitive equality, the Commission proposed to extend legal reserve requirements on demand deposits to all commercial banks and to those deposit thrift institu-

⁴² He cited this as "an instance of the interest elasticity of demand for transactions balances". WARREN L. SMITH, "Financial Intermediaries and Monetary Controls", *Quarterly Journal of Economics*, November 1959, p. 544, No. 8.

⁴³ Cf. SMITH, *op. cit.*, pp. 551-552. In his study for the Commission on Money and Credit, Smith reviewed this evidence and reported that "Although the evidence about the deposit shifts was not conclusive and that further study was needed, there are some indications that the shifting does not have a specifically cyclical character". WARREN L. SMITH, "Reserve Requirements in the American Monetary System", in Commission on Money and Credit, *Monetary Management*, pp. 312-313. Accordingly, he recommended that reserve requirements against time deposits be eliminated (p. 315).

⁴⁴ For example, on the shift from demand to time deposits during 1957, cf. SMITH, *Quarterly Journal of Economics*, *op. cit.*, p. 544.

tions which offered third party payment services. This would end the present advantage of nonmember banks — in many states, they enjoy more favorable reserve requirements than member banks;⁴⁵ and it would prevent the deposit thrift institutions from having a competitive advantage with respect to third party payment services.

In the interest of competitive equality, the Commission further proposed to abolish the present system of differential reserve requirements according to bank location. The present system of geographically-differentiated reserve requirements had its roots in the National Banking Act of 1864 when banks in reserve cities and central reserve cities held the deposits of other banks and were required to maintain higher cash reserves than the country banks. This geographical basis for classification has long been outmoded, and the Board of Governors of the Federal Reserve System has repeatedly recommended that it be abolished. Unlike the Commission, the Federal Reserve would preserve that feature of the present system which puts lower requirements on smaller banks;⁴⁶ and it has pressed for a system of reserve requirements graduated according to the size of a bank's demand deposits.⁴⁷ It is worth noting that uniform reserve requirements would achieve more competitive equality than graduated reserve requirements, but probably less competition as well, because the graduated system acts like a subsidy for the smaller banks.

The Commission's recommendations on reserve requirements for time and savings deposits would also be conducive to competitive equality among deposit institutions. At present, commercial banks must maintain legal reserves on time and savings deposits whereas savings and loan associations do not maintain the same kind of reserves on substantially similar deposits. This unequal competitive situation could be equalized by extending the commercial banks'

⁴⁵ For example, most states allow interbank deposits to be counted as part of the legal reserves and some allow the requirements to be met in part by holdings of government securities.

⁴⁶ There are lower requirements on small banks partly because the "country" banks tend to be smaller than reserve city banks, but also because the Federal Reserve presently allows many small banks in reserve cities to maintain country bank reserve requirements. Cf. W. L. SMITH, *Monetary Management, op. cit.*, p. 179.

⁴⁷ Cf. Board of Governors, Federal Reserve System, *Annual Report for 1964*, pp. 200-202. The Federal Reserve has continued to support this idea in all of its later Annual Reports to date. The idea was also recommended by the President's Commission on Financial Institutions, 1963.

reserve requirements to the savings and loan associations,⁴⁸ or by abolishing reserve requirements on time and savings deposits. If legal reserve requirements on time and thrift deposits were made uniform at an appropriate level, competitive equality would be achieved without impairing an effective monetary policy; it remains to be seen (for reasons noted earlier) whether that will also be true for the Commission's preferred alternative.

Proposal on Deposit Insurance

The present system of deposit insurance violates the Commission's principle of competitive equality. The Federal Deposit Insurance Corporation assesses a flat rate against a bank's average total deposits, but it does not insure individual deposit accounts in excess of \$20,000. In practice, therefore, the premiums of large banks subsidize the small banks. The Commission considered two ways to reform the present system of deposit insurance.⁴⁹ Either could overcome the competitive inequality of the present system, but both were rejected.

One rejected possibility involved variable insurance rates. Under this plan, each insured bank would determine its own default risks and would pay an insurance premium based on the character of the risk relative to the bank's capital. The Commission rejected this plan on practical grounds. First, it believes that risk differences cannot be evaluated with sufficient precision to be adequately reflected in insurance assessments. Second, it was concerned that new and different functions might be regarded as high-risk activities and be penalized accordingly. Finally, the Commission feared that the public might lose confidence in a bank which paid higher-than-average insurance assessments.

The Commission also rejected the possibility of 100 per cent insurance of deposits. In the Commission's opinion, large depositors are generally qualified to judge whether a bank is well-managed and soundly capitalized.⁵⁰ In fact, this is probably a considerable overstatement. The treasurers of large corporations may be qualified

⁴⁸ Cf. JOHN GURLEY and EDWARD SHAW, *Money in a Theory of Finance*, p. 291.

⁴⁹ The Report commented on four proposals, but only two are related to the question of competitive equality. Cf. *Report*, p. 74.

⁵⁰ *Ibid.*, pp. 74-75.

to make these judgments, but it is doubtful whether this is true of most individuals or business firms with total deposits (i.e., in all banks or all accounts) in excess of \$20,000.⁵¹ The Commission also believes that the present system acts as an incentive for good management precisely because it does not insure large deposits. This seems reasonable, but is it an important influence on bank management? Has substantially full insurance coverage acted as a spur to poor management among small banks? In any case, this incentive is not a reliable substitute for detailed regulation and supervision by the regulatory authorities.

In the short run, 100 per cent insurance of deposits would raise a conflict between equality and competition. Specifically, 100 per cent coverage would achieve competitive equality because it would remove the subsidy to small banks. It would also impair competition in the short-run, however, because some small banks probably could not afford the higher premiums which would be necessary under 100 per cent coverage. In the long-run, competition among banks probably would be increased, because the present system of limited insurance coverage of deposits is a handicap to small banks in trying to attract large deposits. Moreover, this handicap is a function of the depositor's large size relatively to the bank's small size — it is not related to the small bank's efficiency or the competence of its management. Under 100 per cent coverage of deposits, small banks could better overcome this serious disability to aggressive growth.

Proposals to Lift Technical Restrictions on Banks

The Commission believes that bank operations are unnecessarily constrained by a number of technical restrictions on banks. The following are examples: First, when commercial banks use their loan portfolios as a source of liquidity, the liabilities incurred must be treated like deposits with respect to reserve requirements and interest rate ceilings. Second, commercial banks cannot issue acceptances in excess of 100 per cent of their capital. Third, the regulatory authorities restrict the commercial bank's freedom to change their

⁵¹ It is estimated that perhaps 99 per cent of depositors and about 64 per cent of commercial bank deposits are covered by the present deposit insurance. There is no publicly available information on the number of insured accounts which are commonly owned and are held to \$20,000 in order to come under FDIC (or FSLIC) coverage.

capital structure (e.g., to introduce various kinds of subordinated debt).

In keeping with its objective of removing unnecessary constraints on banks, the Commission has recommended a number of changes which would increase competition among banks and make it possible for them to manage their affairs in response to market forces instead of administrative regulations. For example, the Commission proposed the following changes in the restrictions cited above: First, that "liabilities of any term incurred by commercial banks through the temporary or contingent sale of assets should not be defined as deposits of the bank"; second, that "statutory limitations on the aggregate amount of acceptances that commercial banks may create be removed and that the supervisory authorities determine appropriate limitations for particular banks with due consideration to the character and location of the bank and the needs of its customers"; and, third, that "commercial banks be permitted to issue subordinated debt instruments of all maturities provided that maturities and yields, conditions of subordination, the lack of insurance and other differences between the debt instruments and deposit liabilities are clearly and fully disclosed to all purchasers, and provided that these issues be evaluated and approved as bona fide capital prior to issue by the appropriate supervisory authority".⁵²

In the Commission's opinion, these changes would not impair bank safety or the interests of potential holders of bank debt and would have beneficial effects on the supply of credit to small business and on the transmission of the effects of monetary policy.⁵³ It is also possible, however, that the proposed changes could have adverse effects on monetary policy. This is an old problem for the Federal Reserve. During the fifties, the commercial banks were able to blunt the impact of a restrictive Federal Reserve policy because they possessed a large volume of U.S. government securities which could be sold to the private sector in order to increase the volume of bank lending. Since these securities were purchased mostly from idle funds, the change in bank reserves was partly offset by changes in velocity.⁵⁴ During the latter half of the sixties, the commercial banks again wanted to increase their lending to the private sector in the

⁵² Report, p. 42.

⁵³ *Ibid.*, pp. 50-51.

⁵⁴ See W. L. SMITH, "On the Effectiveness of Monetary Policy", *American Economic Review*, September 1956, p. 601.

face of a Federal Reserve policy to restrain credit expansion. As in the fifties, the banks sold securities (mostly municipal bonds — and often at sizable capital losses) to private holders. In addition, they borrowed Euro-dollars, sold commercial paper through bank-holding companies, sold participations in their loan portfolios under repurchase agreements, sold subordinated debentures, and used acceptances as a straight substitute for unsecured loans.

In order to thwart these bank actions which threatened to undermine the effectiveness of Federal Reserve policy, the authorities issued a number of rulings which brought the bank actions under the constraint of legal reserve requirements and Regulation Q. At present, for example, a capital note is not exempted from reserve requirements and interest-rate ceilings (i.e., it is classified as a deposit) unless it is issued with a minimum maturity of seven years and in an amount of at least \$500.⁵⁵ This restriction is clearly more than a purely technical matter with implications for capital adequacy and the protection of noteholders; it is also protection against a potentially serious slippage in the implementation of a tight money policy. Similar considerations apply (*mutatis mutandis*) to the other examples of restrictions cited above.

Concluding Observations

The Commission on Financial Structure and Regulation has proposed a number of fundamental reforms of the American financial system. In contrast to a general trend towards greater regulation of economic affairs, the Commission has made a decisive thrust towards less regulation and more competition in the financial structure.⁵⁶ The Commission's weltanschauung is best expressed in the words of the Report:

The Commission's objective, then, is to move as far as possible toward freedom of financial markets and equip all institutions with the powers necessary to compete in such markets. Once these powers and services have been authorized and a suitable time allowed for implementation, each institution will be free to determine its own

⁵⁵ In addition, each capital note must state that "This obligation is not a deposit and is not insured by the Federal Deposit Insurance Corporation".

⁵⁶ For a similar development in major European countries, see DAVID A. ALHADEFF, *Competition and Controls in Banking*, p. 364.

course. The public will be better served by such competition. Markets will work more efficiently in the allocation of funds and total savings will expand to meet private and public needs.⁵⁷

The purpose of this paper has been to examine some of the implications and consequences of the proposals for greater reliance on competition. In particular, it has been shown that competition is not necessarily assured by removing constraints on the conditions of competition,⁵⁸ that some structural reforms which would increase the scope for bank action may have an anticompetitive effect, and that the costs (in terms of other social objectives) of some of the Commission's proposals have not been fully evaluated.

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⁵⁷ Report, p. 9.

⁵⁸ For a further discussion of the interrelation between the rules on banking structure and those on the conditions of bank competition, see ALHADEFF, *Competition and Controls in Banking, op. cit.*, pp. 363-364.