Financial industry deregulation in the 1980s

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The 1980s have been characterized as the decade of deregulation in the financial industry. Two major national legislative bills and numerous state proposals have been approved permitting banking activities that were previously disallowed. This special issue of *Economic Perspectives* looks at the impact of legislative mandates for industry deregulation. More precisely, it reviews and evaluates issues directly addressed in the 1980 Depository Institutions Deregulation and Monetary Control Act (DIDMCA), and the 1982 Garn-St Germain Act. Not intended as a detailed evaluation of the various provisions of the acts, the articles presented here describe and analyze some of the acts' most important and topical issues.

Market pressures and the resulting impetus for change have been strong in the U.S. financial industry for the past twenty-five years. However, the industry evolved within a regulatory framework that restricted products, prices, risk, and means of product distribution. In addition to these restrictions, the regulatory control of the industry was somewhat fragmented. Different types of institution (e.g., Federal Reserve member banks, nonmember banks, S&Ls, and credit unions) had different reserve requirements, service and price constraints, and other limitations. As these institutions responded to the demands of the marketplace, they frequently sidestepped the intent of existing regulation—though technically remaining within the "letter of the law." These evasions frequently induced new regulations that sought to preclude the undesired activity. Since the regulatory structure was somewhat fragmented to begin with, the industry soon became one regulated by stop-gap measures.[1] The incentives to elude regulatory constraints intensified during the 1970s as inflation increased significantly. Interest rate limitations became binding, the opportunity cost of holding idle reserve balances and below-market interest-bearing assets rose sharply, and traditional deposit options frequently failed to fullfill customer needs.

At the same time that financial institutions were trying to circumvent regulatory constraints, the Federal Reserve was encountering difficulty in maintaining its membership and in managing the money stock. The introduction of new money substitutes and a shrinking reserve base caused the central bank to seek legislative changes to improve its ability to implement monetary policy.

In the spring of 1980, DIDMCA was enacted and was immediately perceived as major legislation having significant potential impact on the future of the financial industry. Legislators and industry participants hailed it as the most significant banking legislation since the 1930s or, perhaps even since the Federal Reserve Act of 1913.

Two years later the Garn-St Germain Act was passed. It broadened the powers of thrift institutions and created a means of dealing with that portion of the industry that had become insolvent. It also allowed other institutions to offer new deposit services bearing market rates of interest and mandated a review of the existing deposit insurance system.

Together, these two pieces of legislation provided a framework for the development of the financial services industry throughout the coming decade. While some may argue that deregulation was not extensive enough, the legislation incorporated many of the recommendations of previous congressional commissions and numerous proposals suggested by policy researchers.[2]

The specific details of the two legislative mandates have been adequately addressed elsewhere and will not be repeated here.[3] The thrust of the acts was to eliminate many of the barriers to competition and allow market mechanisms to establish deposit and loan rates, service offerings, and to influence behavior and decisions of customers and industry personnel. Additionally, the acts expanded the reserve base, equalized the reserve burden, and were expected to aid in monetary policy implementation. Toward achieving these goals, six provisions of the acts can be delineated. These

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provisions will be the topics evaluated in the articles in this issue of *Economic Perspectives*. The major provisions include the following:

1. Articles in DIDMCA set new reserve requirement ranges on various deposit accounts, and imposed them uniformly across all depository institutions. This would enable the Fed to collect deposit data on a significantly larger number of institutions, and was intended to improve the control of the monetary aggregates as a result of the larger portion of industry members holding reserves directly with the Fed.

2. DIDMCA also provided for a phasing out of interest rate ceilings on all federally-insured deposits except demand deposits. This would encourage institutions to compete for deposits on explicit price terms and would allow depositors to receive a market rate of return. The phasing out was to be implemented by the Depository Institutions Deregulation Committee and was aimed at eliminating the need for some of the creative means utilized by institutions to pay higher implicit rates on deposits. It also curbed the process of directing funds toward particular sectors of the economy (e.g., housing) by eliminating the protected differential in allowable deposit rates. Deposit rate deregulation could have unintended monetary policy implications as it affected the public's demand for "money" balances.

3. To continue the interest rate deregulation process, Title V of DIDMCA overrode state usury law provisions for specific types of loans.

4. Both acts permitted institutions to introduce new services and allowed for investments in areas not previously acceptable. For example, thrifts were allowed to invest significantly in commercial activities; an area from which they had been previously excluded.[4]

5. To limit the loss of treasury revenues resulting from lower reserve requirements, and to encourage efficiency in the payments mechanism, Title I of DIDMCA required the Federal Reserve to price its correspondent services and to make them available to all depository institutions. These services had previously been provided free to member banks.

6. DIDMCA raised the deposit insurance coverage from $40,000 to $100,000 at federally insured institutions. Garn-St Germain required the three federal deposit insurance agencies to evaluate the structure of deposit insurance programs and recommend modifications.

To analyze and address the impact of these provisions seven related articles are presented here. The first two address monetary policy issues resulting from deposit rate deregulation and the implementation of universal reserve requirements. The phasing out of deposit ceilings and the authorization of interest-bearing transaction account services were introduced to provide customers a market rate of return on their deposits. However, they also had monetary policy implications.

In "Is deposit rate deregulation an Rx for M1?", Paul Kasriel considers the effects of complete deposit rate deregulation on the public's demand for money and the monetary authority's ability to control the money stock. These effects have implications for the desirability of using the money stock as an intermediate target in achieving desired levels of macroeconomic activity. In "Universal reserve requirements and monetary control," Robert Laurent considers the DIDMCA provision specifically aimed at improving monetary control—uniform reserve requirements. He evaluates the impact of various central bank operating procedures on the monetary control benefits resulting from the application of universal reserve requirements.

The next two articles consider specific provisions of DIDMCA and describe their impact on the industry to date. Donna Vandenbrink reviews the reasons for the preemption of state usury ceilings in "Usury ceilings and DIDMCA." She also discusses the initiative taken by state legislators to override the preemption in DIDMCA. In "Priced services: The Fed's impact on correspondent banking," the author reviews events in the correspondent banking industry resulting from the presence of a quasi-governmental agency as an active competitor.

Because of the recent surge in the bank and thrift failure rate, and as a result of a direct mandate in Garn-St Germain, numerous new

deposit insurance programs have recently been proposed. A common, and logical, theme in most of these proposals is to incorporate risk-based premiums. In "Private prices, public insurance: The pricing of deposit insurance," by Herbert Baer, the problems involved with risk based premiums are discussed, and a number of recent proposals are reviewed. An alternative proposal is then offered which benefits from both public and private sector involvement.

Diana Fortier and Dave Phillis discuss the impact of deregulation on the performance of banks and thrifts in "Bank and thrift performance since DIDMCA." While the new service offerings and investment options resulting from deregulation were numerous, the most important element is how they enabled institutions to better generate and utilize funds, and how this affected performance. This article quantifies that behavior and performance.

The final article discusses a number of specific provisions in the 1980 and 1982 acts and puts them into historical perspective. It is common for most students of the industry to view the deregulation trends as novel approaches to industry problems. In "A deregulated rerun: Banking in the Eighties," Randall Merris and John Wood present significant parallels between the situation after the recent legislative changes and that in the early 1900s.

Although the topics discussed in this special issue of *Economic Perspectives* are quite varied, a number of comprehensive conclusions can be drawn. First, there was significant market pressure for the legislative changes that were implemented, and most would argue that the changes should positively affect the financial industry. However, the two acts were not a panacea. Indeed, there is significant disagreement on whether the provisions aimed at improving monetary control will be as successful as many originally assumed. There is also disagreement on whether further deposit rate deregulation will aid or hamper the central bank's ability to control the money stock. Many of the new provisions can probably better be labeled as re-regulation or temporary stop-gap measures instead of true deregulation. In many cases, the industry has also been slow in exercising the new legislated powers, and, as with many legislative changes, there is disagreement as to whether the regulatory agencies are properly interpreting and implementing the new provisions.

However, the restructuring of an industry requires significant time, and more legislation and further deregulation will probably be forthcoming. The new provisions can be expected to address the issues discussed here.

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[1] For a more detailed discussion of this "regulatory dialect" see Edward Kane, "Good Intentions and Unintended Evil: The Case Against Selective Credit Allocation," *Journal of Money, Credit and Banking,* 9 (February 1977), pp. 55-69; and "Accelerating Inflation, Technological Innovation, and the Decreasing Effectiveness of Banking Regulation," *Journal of Finance,* 36 (May 1981) pp. 355-366.

[2] For the recommendations of previous commissions see *Report of the Committee on Financial Institutions to the President of the United States* (Washington D.C.: U.S. GPO, 1963); and *The Report of the Presidents Commission on Financial Structure and Regulation* (U.S. GPO, 1971).

[3] See *Leveling the Playing Field: A Review of the DIDMCA of 1980 and the Garn-St. Germain Act of 1982,* Chicago: Federal Reserve Bank of Chicago, 1983.

[4] For a discussion of allowable thrift commercial investment activities, and the fragmentation of commercial bank product lines, see Harvey Rosenblum, M.K. O'Brien, and John J. Di Clemente, "On Banks, Nonbanks, and Overlapping Markets: A Reassessment of Commercial Banking as a Line of Commerce," *Tennesssee Law Review* 51 (Spring 1984), pp. 401-443; particularly pp. 422-428.