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THE CHANGING WORLD OF FINANCIAL INTERMEDIARIES AND RELATED INSTITUTIONS: SURVEY OF MAJOR DEVELOPMENTS AND THEIR IMPLICATIONS FOR PUBLIC POLICY

by

Julius W. Allen
Consultant

Economics Division

CRS

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ABSTRACT

Inflation, high and variable interest rates, and new electronic technology have had a profound impact on financial institutions throughout the world. This report surveys how the various kinds of financial institutions in the United States have been affected by these developments, how they have reacted, what major legislative action has been taken, and what policy issues remain.

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INTRODUCTION

That the financial institutions of the United States are undergoing profound changes, both in their functions within the economy and more specifically in their relationships to one another, is becoming more widely apparent every day. This fact is reflected in the following three statements.

Roger F. Murray, past president of the American Finance Association, noted in 1981 "the broad tendency of financial institutions to become increasingly similar in their functions, and one can expect that specialization will continue to diminish among intermediaries of all types." 1/

Finn Casperson, chief executive officer of the Beneficial Corporation, a major consumer finance company that has rapidly expanded into other markets, said in 1981: "The well-defined market for each of these [financial] institutions no longer exists.... There is rapid amalgamation and homogenization in every area." 2/

In a speech delivered on March 22, 1982, Lyle Gramley, member of the Board of Governors of the Federal Reserve System, declared: "We are on the verge of a virtual revolution in electronic payment transfers, which will permit instantaneous flows of funds between financial institutions at very low cost." 3/

1/ Murray, Roger F. Investment-Type Intermediaries [in] Polakoff, Murray E., and Thomas A. Durkin. Financial Institutions and Markets. 2d ed. Boston: Houghton Mifflin, 1981. p. 200.

2/ Wines, Michael. The Financial Supermarket Is Here, and Congress is Trying to Catch Up. National Journal, Nov. 21, 1981. p. 2056.

3/ Gramley, Lyle E. Financial Innovation and Monetary Policy. Federal Reserve Bulletin, July 1982. p. 395.

The revolution that Gramley refers to is far more than just a technological one. While new communication and computer technology has vastly expanded the capabilities of financial institutions, it has been the economic climate of inflation and high and variable interest rates, at times abetted by changes in Federal regulations, that appears to have been the predominant force triggering the revolutionary changes that have occurred. The scope of these changes includes: greater attention by business to improved management techniques that enable firms to get along with less and less cash, and the development of a wide range of financial instruments, in and out of depository institutions, that make it much easier for consumers to earn market or close to market rates of interest on their savings.

Much of this change has focused on the large and growing money markets in the economy. This has led to the enormous growth of money market funds, which were first publicly offered late in 1971, little more than a decade ago. Nonbank depository institutions, especially savings and loan associations, have experienced severe strains, as higher interest rates for savings became generally available. With or without the insurance provided by depository institutions, these rates proved attractive to many savers. While lower interest rates and reduced inflation will shift the impact of money flows among various financial institutions (e.g., adversely affecting money market funds while aiding savings and loan associations), the financial revolution now underway may be expected to continue with undiminished fervor.

Many financial institutions, such as brokerage houses, insurance companies, and mutual funds, and a considerable number of non-financial companies, such as Sears Roebuck, have developed packages of financial services of varying degrees of comprehensiveness, some of which, such as transactions (check-like) accounts, had once only been offered by depository institutions. The competitive response of depository institutions has taken several forms, among them: (1) attempts. to some extent successful, to have some of the regulations restricting their ability to compete removed or relaxed--approval of higher interest rates and of new financial instruments, for example; (2) attempts, generally less successful, to impose greater restrictions on the functions of their non-depository competitors; (3) steps designed to better meet the competition of non-depository institutions, some of which may be considered to overstep the intent if not the actual provisions of legislative and regulatory restrictions; (4) attempts to enter such areas as brokerage services and underwriting corporate stock and bond issues from which they have been legally excluded. Some of these moves have been opposed by nondepository institutions. The competition among the various types of depository institutions, such as between commercial banks and savings and loan associations, continues to be significant.

This turmoil among the ranks of financial institutions has, of course, had legislative repercussions. Pressures to modify the regulations affecting both depository and non-depository institutions has been intense. Major legislation has already resulted, notably the Depository Institutions Deregulation and Monetary Control Act of 1980 (P.L. 96-221) and the Garn-St Germain Depository Institutions Act of 1982 (P.L. 97-320).

Further legislative initiative in such areas as bank authority to underwrite municipal revenue bonds, tightening regulation of money market funds, and authority of banks to become involved in such enterprises as security brokerage and insurance and to extend operations beyond State boundaries may be considered in the 98th Congress.

This report describes the nature of the changes among financial institutions that have occurred in the past two decades, the factors bringing about these changes, and the key public policy issues that continue to confront the Congress.

Following this introduction, the first section sets forth an overview of the changing functions of the principal financial institutions in the economy today, and their major relationships to one another. This is followed by a review of the impact of technology on financial institutions and transactions, the rise of new financial instruments, and recent legislation and legislative proposals. The conclusion makes a few tentative assessments of winners and losers of the financial revolution.

Outside the scope of this report is the large and significant role of international financial markets. Clearly they are a major factor in the health of U.S. financial institutions, notably the large commercial banks, and thereby the entire American banking system. However, it is an area that does not seem to have as direct a bearing on the competition between the various segments of the U.S. financial community and their relationships to one another, as do the domestic factors dealt with in this report.

I. OVERVIEW OF FINANCIAL INSTITUTIONS AND THEIR FUNCTIONS

A principal purpose of this paper is to provide an overview of the many institutions which provide the broad range of financial services upon which the economy of our Nation depends. These institutions have evolved continously throughout the history of this country and at an accelerating rate in recent decades. In order to understand the principal functions of the most important of these institutions, which will be outlined below, an overview of their relationship to each other may be helpful. Such a classification is attempted in Chart 1 (see page 6). This chart obviously requires a great deal of simplification and generalization; various qualifications will be introduced later. Particularly in recent years many institutions have taken a broad range of functions, any one of which heretofore had been the relatively exclusive domain of a particular kind of financial institution. The blurring of these functions continues apace and may even accelerate, thanks in part to technological developments facilitating transfer of funds and information.

An indication of the growth of most of these financial institutions in the last two decades is shown in Table 1 (see page 7).

Since this paper is concerned with financial institutions, it may be well, at the outset, to distinguish between financial institutions and nonfinancial institutions that together make up our economic universe. The major distinction between the two is that the bulk of the assets of nonfinancial corporations is in the form of real assets, such as plant, equipment, and inventories of goods, while most of the assets of financial corporations take the form of paper claims. 4/

Financial corporations can, in turn, be divided into financial intermediaries

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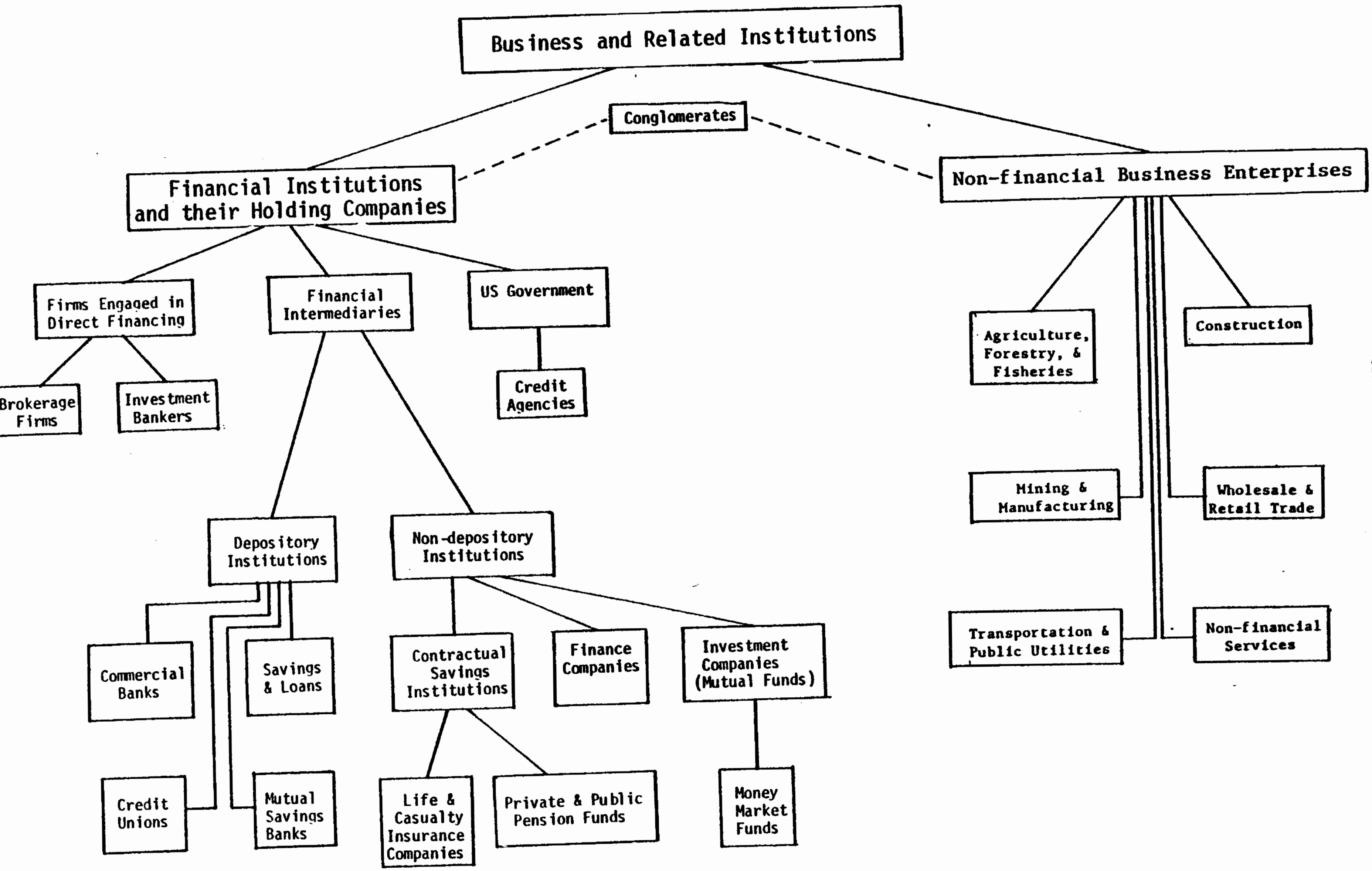
4/ Paper (or financial) claims are various forms of written promises to pay a specific sum of money plus an interest rate fee for the privilege of borrowing this money over a period of time. Paper claims vary according to maturity, risk of default, marketability, and tax treatment. See: Polakoff, Murray E. Institutionalization of Saving and Financial Markets [in] Polakoff and Durkin. Financial Institutions. p. 6; and Kidwell, David S., and Richard L. Peterson. Financial Institutions, Markets and Money. Hinsdale, Illinois: Dryden Press. p. 29, 658.

Chart 1: Principal Kinds of Business and Related Institutions in the United States: A Schematic Outline



Note: Various qualifications to this schematic outline are indicated in Chapter I, p. 5-46.

Table 1. Distribution of Total Credit Market Assets, 1961-1981.

	1961		1971		1981	
	$ Billions	% of Total	$ Billions	% of Total	$ Billions	% of Total
Total Credit Market Assets	827.9	100.0	1,753.9	100.0	5,200.0	100.0
Private Domestic Nonfinancial Sectors	209.8	25.3	335.3	19.1	972.4	18.7
Households	155.1	18.7	248.1	14.1	741.1	14.3
Nonfarm Noncorporate Business	6.3	0.8	9.8	0.6	21.7	0.4
Nonfinancial Corporate Business	29.5	3.6	43.7	2.5	70.6	1.4
State and Local Governments	18.9	2.3	33.6	1.9	138.9	2.7
Rest of the World	13.0	1.6	53.2	3.0	207.6	4.0
U.S. Government	28.5	3.4	59.9	3.4	187.8	3.6
Financial Institutions	576.6	69.6	1,305.6	74.4	3,832.3	73.7
Sponsored Credit Agencies	12.4	1.5	54.5	3.1	341.6	6.6
Federal Reserve System	28.9	3.5	71.1	4.1	140.5	2.7
Commercial Banking	212.5	25.7	497.8	28.4	1,347.1	25.9
Private Nonbank Finance	322.7	39.0	682.2	38.9	2,003.1	38.5
Savings Institutions	121.8	14.7	293.6	16.7	812.0	15.6
Savings and Loan Associations	76.3	9.2	193.6	11.0	594.4	11.4
Mutual Savings Banks	40.6	4.9	82.8	4.7	155.8	3.0
Credit Unions	4.9	0.6	17.2	1.0	61.8	1.2
Insurance	169.6	20.5	305.3	17.4	826.6	15.9
Life Insurance Companies	110.9	13.4	182.8	10.4	421.1	8.1
Private Pension Funds	21.2	2.6	35.0	2.0	105.5	2.0
State, Local Govt. Retirement Funds	21.1	2.5	52.9	3.0	169.6	3.3
Other Insurance Companies	16.5	2.0	34.6	2.0	130.4	2.5
Other Fianance	31.3	3.8	83.3	4.7	364.5	7.0
Finance Companies	27.0	3.3	66.5	3.8	220.0	4.2
REITs	0	0	6.2	0.4	3.1	0.1
Open-end Investment Companies	2.3	0.3	6.0	0.3	25.7	0.5
Money Market Funds	0	0	0	0	102.3	2.0
Security Brokers and Dealers	2.0	0.2	4.6	0.3	13.3	0.3

Source: U.S. Board of Governors of the Federal Reserve System. Flow of Funds Accounts, 1949-1978. Washington, 1979; and Flow of Funds Accounts, Second Quarter 1982. Washington, 1982.

and firms engaged in direct financing. Financial intermediaries are firms that place themselves between ultimate lenders and ultimate borrowers by purchasing the primary securities of the latter and issuing claims against themselves for the portfolios of ultimate lenders. Direct financing involves the marketing of primary securities in such forms as stocks, bonds and mortgages to those desiring to purchase such securities. The principal direct financing institutions are brokerage firms and investment bankers.

Financial intermediaries can further be divided into depository and non-depository institutions. The four kinds of depository intermediaries are commercial banks, mutual savings banks, savings and loan associations, and credit unions. Non-depository financial intermediaries consist of contractual saving institutions, on the one hand, and other financial intermediaries on the other. Of the contractual savings institutions, the most important are life insurance companies, casualty insurance companies, private pension funds and government pension funds. The remaining intermediaries include finance companies and mutual funds (or investment companies), of which the most rapidly growing component has been money market funds.

A quick overview of the principal liabilities and principal assets of these financial intermediaries is shown in Table 2 (see page 9). More detailed discussion is given below.

Finally there are two major components of the financial community which are difficult to classify. The first is the Federal Government itself which is massively involved not only in a broad range of lending and insurance programs, but through its issuance of securities to finance the public debt and its Federal Reserve monetary operations has a major impact on the economy of the country. Except peripherally, however, such Federal activities lie outside the scope of this paper.

Table 2. Principal Financial Claims Issued and Owned by Major Financial Intermediaries

	Type of Intermediary	Principal Liabilities (indirect securities sold)	Principal Assets (direct securities purchased)
I.	Deposit-Type Institutions:		
	Commercial banks	Demand deposits Savings deposits	Business loans Consumer loans Mortgages Government securities
	Savings & loan associations	Savings deposits	Mortgages
	Mutual savings banks	Savings deposits	Mortgages
	Credit unions	Savings "shares"	Consumer loans
II.	Contractual Saving Institutions:		
	Life insurance companies	Life insurance policies	Corporate bonds Mortgages
	Casualty insurance companies	Casualty insurance policies	Municipal bonds Corporate stocks Corporate bonds
	Private pension funds	Pension fund reserves	Corporate stocks Corporate bonds Mortgages
	State & local government pension funds	Pension fund reserves	Corporate bonds Corporate stocks
III.	Other Financial Institutions:		
	Finance companies	Commercial paper Bonds	Consumer loans Small business loans
	Mutual funds	Shares in fund	Corporate stocks Corporate bonds
	Money market funds	Shares in fund	Money market securities
	Government-sponsored credit agencies	Agency bonds and notes	Mortgages

Source: Adapted from Kidwell, David S., and Richard L. Peterson. Financial Institutions, Markets, and Money. Hinsdale, Ill., Dryden Press, 1981. p. 42.

The second is the conglomerate firm which has been growing rapidly and receiving a great deal of public attention. Many companies, some originally in a particular financial business, such as insurance, and others even primarily in nonfinancial businesses, have diversified into a range of financial services. Sears Roebuck, Prudential Insurance, American Express, and Merrill Lynch and Company are among the most prominent examples of this kind of firm, that by its nature transcends the more traditional categories mentioned above. Much of this diversification has been accomplished by the establishment of holding companies, particularly in the areas of banking, savings and loan associations, and insurance.

A. <u>Depository Intermediaries</u>

While the primary focus of this paper is on non-depository financial intermediaries and other financial institutions, it is important to examine at the outset the primary characteristics of depository intermediaries and the basic functions of each of the four types of such intermediaries.

Basically depository intermediaries are empowered to accept a variety of checking, savings, and time deposits. They use the funds received to make consumer, business, and mortgage loans and to hold such assets as U.S. Treasury securities. The maximum interest paid on such accounts has traditionally been severely limited, although such limitations are in the process of being eliminated, and the accounts themselves are insured by one of several federally sponsored insurance agencies. Thus, for practical purposes, deposits up to $100,000 are devoid of risk of any loss of principal. The deposits are highly liquid because they can be withdrawn on short notice, usually upon demand. Depository institutions announce conditions for the "sale" of the deposit and fully supply the quantity demanded by the depositors under those conditions. They provide financial assets that can be purchased in small amounts. 5/

5/ Information in the paragraph is derived primarily from: Bennett, Robert L. Deposit-Type Intermediaries: Bank and Nonbank [in] Polakoff and Durkin. Financial Institutions. p. 105; and Kidwell and Peterson. Financial Institutions. p. 36.

While some non-depository intermediaries have undertaken to assume some of these functions, such as transactions accounts, or, in the case of life insurance companies, making mortgage loans, they do not receive funds in the form of insured deposits. As a recent CRS Issue Brief has stated:

> Depository institutions "are the only intermediaries authorized to accept and maintain the public's financial assets in the form of deposits.... The deposit structure is the principal channel through which monetary policy operates and the mechanism though which financial transactions are ultimately settled. Because of their importance to the Nation's monetary and payments system as well as their central role as providers of credit and holders of savings, depository institutions are more closely regulated than other forms of financial institutions.... In exchange for the greater regulation to which they are subject, depository institutions enjoy certain regulatory benefits other financial institutions do not, including deposit insurance and access to governmental credit." 6/

1. Commercial banks. The range of personal and commercial banking services typically supplied by a commercial bank can be seen from Table 3 (see page 12).

The key roles of commercial banks to the economy can hardly be overemphasized. 7/ First, they are the primary source of demand deposits which constitute the most important ingredient of the U. S. money supply, as narrowly defined. Second, they are the largest suppliers of short-term loanable funds to business and consumers, and they supply over half of the external funds needed by State and local governments. Third, they are the managers of most monetary transfers. For those of their customers who seldom borrow, the bank's acceptance of deposits, against which checks can be written, is the most obvious function of the bank.

6/ U.S. Library of Congress. Congressional Research Service. Banking and Depository Institutions: Legislative Issues in the 97th Congress [by] Jean Wells. Washington, D.C., June 3, 1982. p. 1-2. (Issue Brief No. 82029) See also: U.S. Library of Congress. Congressional Research Service. Depository Financial Institutions: Background on Their Characteristics and Regulation [by] William Jackson. Washington, D.C., December 29, 1980. p. 39. (Report No. 81-11E)

7/ Information in this paragraph is derived principally from Haslem and Hempel. Commercial Banking [in] Polakoff and Durkin. Financial Institutions. p. 57-58.

Table 3. Services Provided by a Sample Commercial Bank

Personal Banking Services	Commercial Banking Services
Deposit Services	**Deposit Services**
Personal Checking Accounts	Commercial Checking Accounts
Statement Savings Accounts	Commercial Night Depository
Regular Savings Accounts	Lock Box Service
Christmas Clubs	
Automatic Investment Service	
Loan Services	**Loan Services**
Installment Loans	Commercial Loans
Tuition Helper Loans	Leasing
Check Command	Construction Loans
Visa/Mastercharge Credit Cards	Retail Installment Financing for Dealers
	Floor Planning
	Credit Card Financing
Trust Services	**Trust Services**
Executor under Will	Pension and Profit Sharing Plans
Trustee under Will	Self-Employed Retirement Plans
Living Trusts	Trustee of Charitable Trusts and Foundations
Investment Management Accounts	Corporate Trust Services
Custodianship Accounts	
Other Services	**International Banking Services**
24 Hour Teller	Foreign Exchange
Safe Deposit Boxes	Travelers Letters of Credit
Travelers Checks	Commercial Letters of Credit
	Foreign Collection
	Letters of Introduction
	Foreign Loans
	Foreign Trade Information
	Foreign Market Conditions
	Foreign Credit Data

Source: Adapted from Haslem, John A. and George H. Hempel. Commercial Banking as a Business [in] Polakoff and Durkin. Financial Institutions, 2nd ed., p. 58.

Fourth, most banks perform a variety of fiduciary services, such as trust department services and safe deposit boxes. They have also become major issuers of credit cards.

For many of the large commercial banks, lending abroad is a major part of their business, and can be an important factor in the health of the American banking system and the American economy in general. 8/

Commercial banks are limited in important respects in the functions they are permitted to perform and are closely regulated by Federal and State regulatory agencies. 9/ Many of these restrictions derive from provisions of the Glass Steagall-Act. 10/ Technically, the Glass-Steagall Act is the same as the Banking Act of 1933 (48 Stat. 162). However, the Glass Steagall Act has, for practical purposes, been limited to the four sections of the act, Sections 16, 20, 21, and 32, all of which prohibit banks from engaging in most securities activities. Section 16 prohibits banks from purchasing any equity securities for their own accounts, imposes additional limitations on banks' investment authority with

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8/ For further information on this aspect, which is not considered further in this report, see: U.S. Library of Congress. Congressional Research Service. Background Information on U.S. Export Trade Associations and the Separation of Banking and Commerce [by] Raymond Ahearn and William Jackson. Washington, D.C., June 30, 1980. 31 p.; U.S. Library of Congress. Congressional Research Service. International Banking Facilities and the Eurocurrency Market [by] William Jackson and Arlene Wilson. Washington, D.C., January 8, 1982. 39 p. (Report No. 82-27E); and U.S. Library of Congress. Congressional Research Service. The Stability of the International Banking System [by] Arlene Wilson. Washington, D.C., October 13, 1982. 11 p. (Issue Brief No. 82107)

9/ For details of such regulations, see, for example: Shull, Bernard. Economic Efficiency, Public Regulation, and Financial Reform: Depository Institutions [in] Polakoff and Durkin. Financial Institutions. p. 671-679.

10/ For more detail on the Glass-Steagall Act, see: U.S. Library of Congress. Congressional Research Service. The Glass-Steagall Act: A Legal Overview [by] Henry Cohen. Washington, D.C., November 19, 1982. 72 p. (Report No. 82-189A) This paragraph is derived from Henry Cohen's report.

respect to debt obligations, and prohibits banks from underwriting and dealing in securities except for obligations of the United States or other State and local jurisdictions. Sections 20 and 32 relate to prohibitions of commercial banks from engaging in the securities business. In their trust departments, banks' dealing in securities is strictly as a trustee or in a fiduciary capacity as agent for their customers.

Under the McFadden Act of 1927 (12 USC 36), national banks are restricted to branch offices in locations permitted within each State to State banks.

2. Bank holding companies. A significant result of these restrictions in Federal and State law on bank activities has been the development of bank holding companies. Such companies are defined as "firms that hold controlling interests in one or more commercial banks and often in "nonbanking" enterprises." 11/ They have developed in two forms, multi-bank holding companies and one-bank holding companies. Multi-bank holding companies were formed largely to get around state branching law restrictions, in order to achieve economies of scale and greater geographic diversification. One-bank holding companies, on the other hand, were organized primarily to permit banking organizations to engage in a wider range of business activities than those granted individual banks under the Act of 1933 (12 USC 24). The Bank Holding Company Act of 1956 placed the responsibility for control of multi-bank holding companies with the Federal Reserve System, but excluded one-bank holding companies. Under this law, bank holding companies were authorized only in States which did not prohibit them. They were not permitted to acquire bank affiliates across State lines unless the State they enter specifically permits the entry of out-of-State bank holding companies. Only three States--Maine,

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11/ U.S. Library of Congress. Congressional Research Service. Bank Holding Company "Nonbanking" Activities: Regulatory Issues [by] William Jackson. Washington, D.C. p. 1. (Report No. 80-149E)

New York, and Alaska--have enacted legislation to permit their banks under certain conditions to be acquired by out-of-State banks, while Delaware and South Dakota allow out-of-State banks to establish new banking institutions, with some limits on their powers.

The Bank Holding Company Amendments of 1970 (P.L. 91-607) put one-bank holding companies under the control of the Federal Reserve System. Under the regulations implementing this legislation, bank holding companies own leasing companies (leasing airplanes, automobiles, and other business equipment), finance companies, and mortgage banks, and have provided portfolio investment and money management advice, data processing and management consulting services, and have sold and in some instances underwritten insurance. These subsidiaries may operate across State lines. In September 1982, the Federal Reserve Board, for the first time, approved the acquisition of a savings and loan company by a bank holding company across state lines, specifically the acquisition by Citicorp (New York) of the Fidelity Savings and Loan Association of San Francisco. Some believe that this action sets a precedent that will increase the number of potential takeover partners for failing savings and loan associations and that it strikes a blow against the ban on interstate banking.

3. Savings and loan associations. Savings and loan associations issue passbook savings shares to depositors and offer them a variety of savings certificates. They use these savings primarily to purchase residential mortgages. Whereas historically savings and loan associations invested almost exclusively in mortgages on the family residences of their shareholders, they are now permitted to lend to non-depositors, and most may purchase mortgages on property outside the immediate locality of the association. Associations are now also permitted to make consumer loans on the security of their savings deposits. Since passage of the Depository Institutions Deregulation Act of 1980, federally chartered savings and loan associations have authority to invest up to 20 percent of their

assets in consumer loans, commercial paper, and corporate debt securities. They are also authorized to offer trust services. Their powers were expanded further by the Garn-St Germain Depository Institutions Act of 1982. 12/

4. Mutual savings banks. Mutual savings banks are in several respects similar to savings and loan associations, but are of more limited scope nationally, since about 95 percent are concentrated in the northeastern section of the United States. As of early 1980 a few applied for Federal charters under enabling legislation passed in 1978. Mutual savings banks have a more diversified portfolio of assets than savings and loan associations, including corporate bonds, and apartment house mortgages. There are fewer restrictions for mutual savings banks also in the location of mortgages acquired.

5. Credit unions. The distinguishing characteristic of credit unions is the requirement that their depositors and borrowers have some common bond, such as their place of employment, occupation, or residence. Traditionally credit union assets have been limited almost exclusively to consumer loans, although loans have been extended to other credit unions and some deposits made in other institutions for liquidity purposes. In recent years, credit unions have been permitted to make mortgage and home improvement loans.

B. Contractual Financial Intermediaries

Contractual financial intermediaries are those providing contractual arrangements for long-term use of savings, with little leeway for change once the commitment has been made, or where a change in the decision would involve significant costs. As already noted, insurance companies and pension funds are the principal forms of contractual financial intermediaries.

1. Life insurance companies. Among the contractual financial intermediaries, the largest are life insurance companies. Life insurance companies provide over 80

12/ See also: Pratt, Richard T. The Savings and Loan Industry: Past, Present, and Future. Federal Home Loan Bank Board Journal, v. 15. November 1982. p. 3-8.

percent of all families in the U.S. with financial protection in the case of the death of a member, offer other forms of insurance, including health, accident and disability insurance, and provide a means of saving through annuities and other insurance policies. In addition they provide pension plans for over half of the employed labor force covered by private pension plans. Because their premium rates are based on actuarial experience, life insurance companies can calculate fairly accurately the amounts of insurance and pension benefits to be paid at any one time. Thus, liquidity is less of a factor than with depository institutions; as a result they are able to concentrate investments on long-term assets. Life insurance companies are typically regulated by the States in which they operate. Life insurance companies have long been the major institutional investor in corporate bonds, and have been active in the commercial and multifamily mortgage market. Historically, life insurance companies have not been important investors in common stocks, partly because of legal restrictions, but also because some companies have maintained that common stocks were not an appropriate investment against fixed-dollar liabilities. Many life companies, however, have come to view common stocks as a useful form of diversification and as a means of increasing the total return on investments in the long run. The growth of pension fund business and the sale of variable annuities have added further impetus to life insurance company acquisition of common stock.

2. Property and casualty insurance companies. Property and casualty insurance companies are those that sell property and casualty insurance and such related lines as inland marine coverages, and surety and fidelity bonds. Of the various kinds of property insurance, automobile insurance is the most important. While less important as a force in capital markets than life insurance companies, they do provide a market for State and local securities, which offer tax-exempt income.

3. Pension funds. Pension funds have become a major form of savings in the United States and are, in terms of organization, sufficiently diverse to overlap several other financial institutions. They have been among the fastest growing financial intermediaries during the last two decades. The United States has a complex retirement system, involving the Federal Government, State and local governments, private employers, unions, fraternal organizations, and individuals.

Affecting the most individuals is the Old Age, Survivors and Disability Insurance System of the Federal Government, known as Social Security. Other major Federal retirement systems are the Railroad Retirement System (the only pension fund administered by the Federal Government that covers a private industry) and the Civil Service Retirement System. The Social Security and Railroad Retirement Systems, contrary to virtually all other public and private employee pension systems, do not rely on asset accumulation and therefore have relatively little impact on capital markets.

State and local government pension funds usually have stricter limitations on the kinds of investments permitted than do private pension funds. As a rule they are administered by private trustees, such as bank trust departments and investment advisors. 13/ Private employee pension funds include insured pension funds, issued by life insurance companies, and noninsured pension funds, which are usually placed with a trustee. Of the private noninsured pension funds, about two-thirds, measured by market value of the funds, are managed by banks and trust companies, one-fifth by investment advisors, one-sixth self-managed by non-financial companies, and the small remainder by other investment advisors.

13/ See: Andrews, Victor L., and Peter C. Eisemann. Insurance-type Intermediaries: Pension Funds [in] Polakoff and Durkin. Financial Institutions. p. 166.

Because of their small need for liquidity and their exemption from Federal income taxes, most pension fund investments are long-term in nature and include few tax-exempt securities. The investment earnings of pension funds are of great importance because the greater these earnings the lower the supporting contributions can be; obviously the rate of return must be weighed against the degree of risk involved. The Employee Retirement Income and Security Act of 1974 (P.L. 93-406), better known as ERISA sets standards for pension fund management and provides protection for its participants.

Finally of growing importance are pension plans for self-employed and other persons, commonly known as individual retirement accounts (IRAs) and Keogh Plans. Under both of these plans, taxes on annual contributions and related investment incomes are deferred until benefits are received in retirement. They are usually administered by insurance companies or banks, although other firms, such as brokerage houses, may set them up. P.L. 97-34 allows almost all taxpayers to deduct $2,000 or $2,250 of contributions to IRAs each year, thereby stimulating their growth appreciably.

C. Other Financial Intermediaries

The other financial intermediaries can be divided into two general groups: (1) finance companies, consisting of consumer finance companies, some tied to sales of products of a particular producer, and business finance companies, providing a broad range of commercial and industrial financing and leasing; and (2) such investment-type intermediaries as mutual funds (of which money market mutual funds have exhibited the most spectacular growth), closed-end investment companies, and real estate investment trusts. In addition, as already noted, bank trust departments offer similar investment services for a limited clientele under narrowly defined circumstances.

1. Finance companies. Finance companies are the largest providers of personal installment loans in the United States. They extend short- and intermediate-term credit to individuals and businesses that cannot obtain credit as cheaply or easily elsewhere. About half of their lending consist of loans to consumers and the other half of loans to business plus leasing and purchases of business accounts receivable. Consumer finance companies primarily make cash loans to consumers; sales finance companies primarily buy consumer credit contracts from dealers; and factors buy accounts receivable from business firms. In terms of business structure, finance companies range from small proprietorships and partnerships to large publicly owned corporations and subsidiaries of manufacturers, bank holding companies, insurance companies and other corporate entities. Some, like General Motors Acceptance Corporation (GMAC), primarily finance sales of products made by their parent organization.

Finance companies, especially consumer finance companies, are closely regulated by States, but have been largely free from Federal regulation. In contrast to most banks, they have been able to operate across State lines.

The distinction between the various kinds of finance companies has, however, became increasingly blurred, as sales finance companies have started making cash loans, while at the same time, consumer finance companies have expanding into commerical financing. A good example of this kind of shift is that of the General Electric Credit Corporation (GECC), which has moved to a large extent away from financing of GE household durable goods for consumers to a broad range of commercial and industrial financing and leasing. 14/ These new financing activities have brought decided tax advantages to its parent company, and have helped to make

14/ For further details on GECC, see: General Electric Credit. Business Week, August 30, 1982. p. 54-59.

it the Nation's third largest finance company, ranking just behind GMAC and Ford Motor Credit.

Part of the reason for the shift from consumer to business lending has been competition from bank-related credit-card companies. By offering lines of credit to qualified card holders, they have shrunk the demand for personal loans of up to $2,500 which were the bread and butter of personal finance companies. Automobile financing, which once was a major market for personal loan and finance companies, has declined in importance as commercial banks and credit unions have entered the field, and automobile company financial subsidiaries, such as GMAC and Ford Motor Credit, have retained their lead in financing of new cars.

The shift from consumer to business lending has been accelerated in part because of stricter regulation of consumer financing than of business financing under State usury laws. 15/ Within consumer lending, second mortgages have become increasingly important since 1976. Leasing and revolving credit are other areas into which finance companies have expanded their operations. All of these are areas that are less subject to regulation and where financial and technical innovations can be successfully adopted.

As a result of regulatory restrictions and rising interest rates, combined with binding loan rate ceilings, many small finance companies have found themselves unable to operate profitably. They have in many cases merged with larger finance companies, become affiliated with bank holding companies, or gone out of business.

2. Investment-type intermediaries. Investment-type intermediaries provide individuals with an alternative to direct investment in primary securities. The principal types of such intermediaries are mutual funds (or open-end investment

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15/ See: U.S. Library of Congress. Congressional Research Service. An Economic Analysis and Brief Legislative Overview of Usury Ceilings [by] William Anderson. Washington, D.C., 1981. 17 p. (CRS Report No. 81-172E) companies), closed-end investment companies, and real estate investment trusts. Such intermediaries offer superior diversification to reduce risk, and provide access to capital-market sectors not otherwise open to investors of modest means, professional management, knowledgeable supervision and management of specific portfolio holdings, safekeeping, accounting and tax services, and economies of scale in these functions. 16/

As Roger F. Murray points out, investment type intermediaries are distinctive in at least three major respects:

(a) They do not create fixed liabilities as an underwriter, guarantor, borrower, or issuer of deposit liabilities. (b) They do not promise any particular rate of return to asset holders, who instead receive whatever the portfolio produces after the deduction of their share of management and administrative expenses. (c) They receive compensation from a defined fee which is typically related to the market value of assets, rather than from a spread between the earnings on assets acquired and the return to be paid on liabilities. 17/

Historically, an investor in such an intermediary in essence agreed to forego liquidity he could expect if he had invested in a depository institution in the expectation of earning a higher average total return. Such a choice of course was associated with greater risk. More recently, many investment-type intermediaries offer instruments with a high degree of liquidity.

Mutual funds. Of the investment-type intermediaries, mutual funds (or open-end investment companies) are the most significant, and among them, the money market mutual funds have exhibited spectacular growth in the last six years. The first mutual fund in the United States was founded in 1924. Mutual funds are attractive to many investors because they are a relatively simple way

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16/ Murray, Roger F. Investment-Type Intermediaries [in] Polakoff and Durkin. Financial Institutions. p. 185.

17/ Ibid., p. 185-186.

for investors, especially small and inexperienced investors, to achieve specific investment goals without the risk inherent in buying and selling stocks directly, and with the prospect of greater gain than funds deposited in depository intermediaries. Many mutual funds have been designed to achieve particular investment goals such as current income or appreciation of capital. Some invest in specific industries, such as energy or high technology, others in particular kinds of securities, such as municipal bonds and money market instruments. Many investment companies manage a number of mutual funds with varying objectives and permit transfer privileges among them. Mutual funds are subject to the Investment Company Act of 1940 and thus to regulation by the Securities and Exchange Commission.

While mutual funds have grown very substantially since 1950, their growth has been uneven, and has been largely influenced by the trends in the stock market. During the 1973-1981 period, there was significant disinvestment in most mutual funds, due largely to the poor showing of equity shares during that period compared to other investments with comparable or lower risk.

Some analysts have argued that mutual funds do not perform appreciably better than unmanaged portfolios, in some periods showing better returns and in others poorer. However, as Roger Murray notes, "The average fund will still provide a useful bundle of financial services and protection from the aberrations of an inadequately diversified portfolio that occur when the art of security selection has been practiced without discipline and experience." 18/

Money market mutual funds. 19/ As already noted, money market mutual funds are by far the most rapidly growing segment of the mutual fund industry,

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18/ Ibid., p. 193.

19/ An excellent summary of information on money market mutual funds is: U.S. Library of Congress. Congressional Research Service. Money Market Mutual Funds [by] William Jackson. Washington, D.C., July 2, 1982. 10 p. (Issue Brief No. 81057) a growth that is having lively repercussions throughout the economy. This growth is dramatically evident in Table 4 below.

The first money market fund was offered to the public in November 1971. However, the real spurt in growth began in 1978, when interest rates rose significantly. By the end of 1979, the assets of money market mutual funds ($45 billion) were still less than those of all other mutual funds combined ($49 billion). By the end of 1981, the total assets of money market mutual funds had

Table 4. Assets and Number of Accounts of Money Market Mutual Funds, December 1974 - November 1982.

End of Month	Total Assets (Billions of $)	Number of Accounts (Millions)
Dec. 1974	1.7	not available
Dec. 1975	3.7	0.2
Dec. 1976	3.7	0.2
Dec. 1977	3.9	0.2
Dec. 1978	10.9	0.5
Dec. 1979	45.2	2.3
June 1980	76.2	3.9
Dec. 1980	74.4	4.7
June 1981	126.5	7.6
Dec. 1981	181.9	10.3
June 1982	201.8	12.1
Sept. 1982	223.2	12.9
Dec. 1982	210.9*	not available

* Reflects transfers into Money Market Deposit Accounts authorized by P.L. 97-320 (December 1982).

Source: Adapted from CRS Issue Brief 81057, p. 2. From Investment Company Institute, Research Department.

risen to $182 billion, or more than three times the total assets of all other mutual funds ($55 billion). There are now over 250 money market mutual funds with an aggregate of thirteen million accounts and assets of over $230 billion. By comparison, at the end of 1981, total assets of all credit unions were $78 billion. 20/

Money market funds are invested in such money market instruments as U.S. Government securities, bank certificates of deposit, and commercial paper. These are for the most part short-term debt issues with less risk than many other uninsured investments. Such instruments are characterized by high investment safety and, in recent years, by high interest rates. Thus, money market funds have become attractive to many individuals and businesses. The money market portfolio average of interest rates in recent years has been sufficiently above the legally permissable rates of return of depository financial institutions as to induce a substantial diversion of resources into money market funds that otherwise would have gone into these institutions. Money market funds have of course pointed to this differential effectively in extensive advertising and publicity. Similarly, many businesses have found such funds useful as places to put temporary cash surpluses where they can earn substantial interest. In addition, many bank trust departments find money market funds appropriate for short-term investment of trusteed funds at high and relatively safe returns. They are also utilized by pension funds, insurance companies, foundations and other types of institutions.

Money market funds now have a broad variety of sponsors including insurance companies, conglomerates such as American Express, brokerage houses, such as Merrill Lynch, and specialized membership organizations such as the American Association of Retired Persons and the American Automobile Association.

20/ See Table 1 for comparison with other financial institutions.

Money market funds represent, in a sense, an outgrowth of Government regulation of interest rate ceilings on insured deposits, generally referred to as Regulation Q. 21/ High market interest rates on deregulated instruments such as $100,000 and larger certificates of deposit represented a new opportunity for mutual funds to offer small savers the high short-term yields previously available only to large holders of liquid assets. In addition to their high interest rates and their management skills in money market transactions, money market mutual funds have provided two additional advantages to individuals and small corporations. Most money market funds give investors the right to obtain same day wire transfers of funds from their mutual fund to their bank account, and may allow these investors to write checklike drafts against their mutual fund assets, usually for minimum withdrawals of $500 or more. Further, many money market mutual funds also allow costless transfer of funds to be made to accounts in other funds managed by the same mutual fund advisor or management company.

The success of money market funds is also due in no small measure to computer capability which permits daily calculation of account values and crediting of interest.

The net impact of money market funds on other financial institutions is uncertain. There have been substantial withdrawals not only from thrift institutions and commercial banks but from stock and bond markets as well. As far as commercial banks as a whole are concerned, it is entirely possible, as William F. Ford, president of the Federal Reserve Bank of Atlanta, has noted, that "the money funds are putting more money into the banking system by purchasing CDs and bankers acceptances of the large banks than they are taking out of all of the

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21/ "Regulation Q: Financial shorthand for the entire body of laws and regulations that set ceilings on the interest rates on deposits at federally-insured commercial banks, savings and loan associations, and mutual savings banks."--A Reference Guide to Banking and Finance. p. 32. See also: U.S. Library of Congress. Congressional Research Service. Deposit Interest Rate Regulation [by] William Jackson. Washington, D.C., 1982. 14 p. (Issue Brief No. 81130) banks." 22/ This would not preclude losses to smaller banks nor, especially, to savings and loan companies, since almost no money market funds are invested in savings and loan instruments of any kind. On the other hand, declines in interest rates and the development of various new financial instruments by depository institutions, in particular the new accounts authorized by the Garn-St Germain Depository Institutions Act of 1982 (see pp. 51-54) may significantly limit possibly adverse effects of money market funds on these institutions.

The other two principal kinds of investment-type intermediaries, closed-end investment companies and real estate investment trusts, can be commented upon more briefly.

Closed-end investment companies. A closed-end investment company is an investment company that holds a portfolio of assets but does not stand ready to redeem its shares at net asset value. Its shares are traded on a securities exchange or in the over-the-counter market. As Roger Murray has noted, "The investment company becomes closed, therefore, in the sense of not being open to the sale or redemption of shares." 23/

Although closed-end investment companies are the oldest kind of investment company, they have grown little, especially when compared to mutual funds. According to Wiesenberger Financial Services, at the end of 1981 combined assets of all investment companies totalled $237 billion. Of this total, money market mutual funds accounted for $175 billion (74%), other mutual funds, $55 billion (23%), and closed-end investment companies, $7 billion (3%). Wiesenberger Financial Services notes that there are at least eleven closed-end investment companies of sufficient size and availability to warrant general investor interest.

22/ Ford, William F. Banking's New Competition: Myths and Realities. Atlanta Federal Reserve Bank Economic Review, January 1982. p. 8.

23/ Murray, Roger F. Investment-Type Intermediaries [in] Polakoff and Durkin. Financial Institutions. p. 193.

Six of these are listed on the New York Stock Exchange; the shares of five others are traded in the over-the-counter market. In general, shares of closed-end investment companies have been selling at a discount from their net asset value, in part at least because of less flexibility than is available for investors in mutual funds.

Real estate investment trusts. Real estate investment trusts (REITs) are related to closed-end investment companies; they hold most of their investments in the form of real estate loans and securities. Their assets are used to acquire mortgages on income generating properties, finance real estate development and construction, provide interim financing to builders, and acquire and lease property to real estate developers. They grew rapidly in the late 1960s and early 1970s, reaching a peak in 1974 ($18 billion in financial assets as of Dec. 31, 1974). This rise resulted from favorable tax treatment, Federal encouragement of real estate investment, and rising real estate market activity and prices. However, the decline since the mid-1970s to $3 billion in financial assets at the end of 1981 has been almost as drastic as the earlier rise. Many REIT investments were risky, highly leveraged or speculative, and resulted in losses when interest rates rose rapidly in 1973-74 and builders were unable to complete construction projects profitably, or to find sufficient buyers or leasees. As Kidwell and Peterson have noted:

> Because of their decline, REITs do not play a major role as financial intermediaries. While many individual REITs own very sound assets, the bad publicity that REITs, in general, experienced in the mid-1970s has made it difficult for them to attract new shareholders and lenders." 24/

D. Brokerage Firms and Investment Bankers

Brokerage firms and investment bankers are important financial institutions but not intermediaries, as described above, p. 8. They are both institutions engaged in direct financing, that is in bringing together borrowers

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24/ Kidwell and Peterson. Financial Institutions. p. 382.

who issue primary securities, such as stocks, bonds and mortgages, with lenders wishing to acquire such securities; they then receive commission fees for this service. Brokerage houses differ widely in size, geographic scope, kinds of securities handled, and other services provided, such as research and the underwriting of new issues. The latter is a function undertaken primarily by investment bankers.

For purposes of this paper, the principal interest in brokerage houses is the extent to which they have expanded their functions, in part through acquisition of subsidiaries, or have been taken over by other financial or non-financial businesses. In either case, a wider array of financial services becomes available from a single corporate firm. This kind of expansion is dealt with in more detail in the section of this paper on conglomerates.

Investment bankers perform some of the same functions as brokerage houses, but the emphasis tends to be different. The most widely recognized function of an investment banker is the underwriting of corporate securities, i.e., guaranteeing the sale of financial claims and marketing the new issues to investors. Often this is accomplished by a syndicate involving several different investment bankers and brokerage houses. A related function is the maintenance of a secondary market in these securities. A secondary market is a "second-hand" market for previously sold securities. Trading in bonds and stocks and negotiating mergers and acquisitions are also major investment banking functions.

E. The Federal Government as a Financial Institution

To what extent the Federal Government should be considered a financial institution, or a complex of financial institutions, may be a matter of some difference of opinion. There is no question that through its power to obtain funds through taxation and borrowing and to spend appropriated funds it inexorably exerts a tremendous impact on the economy. The Treasury, as by far the largest borrower and debtor in the United States credit markets, has a major influence on the availability and cost of credit throughout the Nation. The regulatory actions of the Federal Reserve System include establishing reserve requirements on bank deposits, setting the discount rate, and undertaking open-market operations in Government securities. These actions in the aggregate constitute the Government's monetary policy and thus have a major influence not merely on the financial system, but on the entire business community. In this broad sense, the financial operations of the Federal Government are well beyond the scope of this report.

However, if we view the role of the Federal Government more literally as a financial intermediary, that is an institution that transfers funds from ultimate lenders to ultimate borrowers, we find certain Government credit and mortgage operations that are sufficiently similar to those of private financial intermediaries to warrant at least a summary overview.

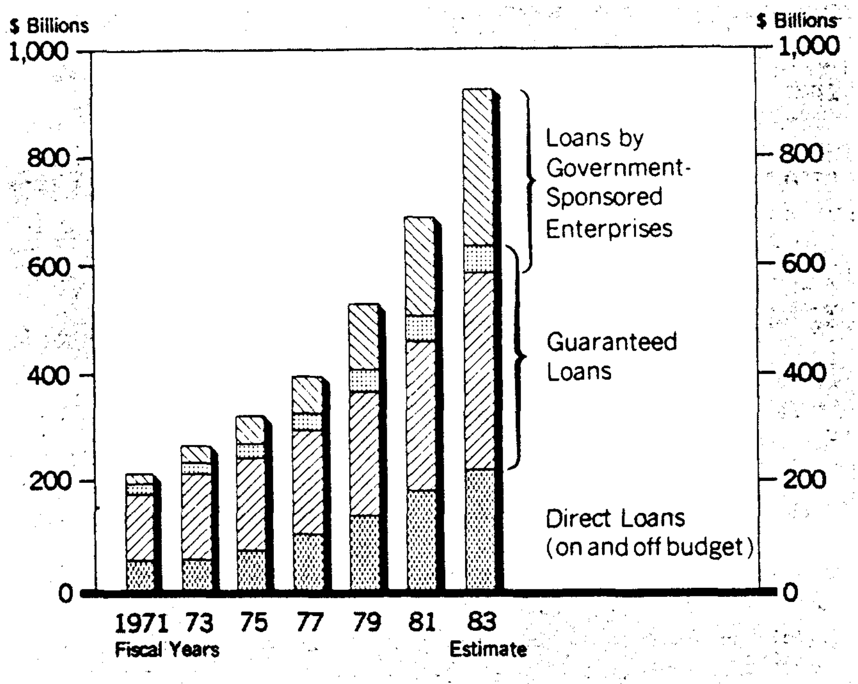
There are at present more than 350 credit programs, involving Federal loans or loan guarantees that serve mainly housing, agriculture, education, small business, and international trade. Of these, 204 are direct Federal loan programs, while 154 provide Federal guarantees or insurance for loans made by the private sector. 25/

Federal and federally assisted loans outstanding reached a total of $676 billion by the end of fiscal year 1981, compared to $217 billion ten years earlier. This growth is shown in Chart 2 (see page 31).

The Office of Management and Budget in its Special Analysis F, Federal Credit Programs, classifies government assisted loan programs in three categories:

25/ McMurtry, Virginia A. Improving Federal Debt Collection Practices. Congressional Research Service Review, v. 3, December 1982. p. 10.

Chart 2. Federal and Federally Assisted Credit Outstanding. Fiscal Years 1971-1983



Source: U.S. Office of Management and Budget. The Budget of the United States Government, 1983. Special Analysis F. Federal Credit Programs. p. 9.

direct loans, guaranteed loans, and loans by Government-sponsored but privately owned enterprises. The Office of Management and Budget defines these three categories as follows:

> Direct loans are payments of cash, secured by a promise to repay the Government. The promise to repay may be in the form of a mortgage, a bond, a debenture, or a promisory note. Loan guarantees are agreements in which a Government agency pledges to use Government funds, as necessary, to secure a lender against default on the part of the borrower. The loan guarantee is the Federal Government's contingent liability, which may be less than the full face value of the loan.... The major use of loan guarantees has been to support housing, but in recent years guarantees have increasingly been used for other purposes. Government-sponsored enterprises have been established and chartered by the Federal Government to perform specialized credit functions. They are financial intermediaries, designed to facilitate the financing of selected kinds of economic activity.... They are all privately owned and most are independent of Federal control to a substantial degree.... They are all subject, however, to some form

of Federal supervision, and by law or by custom they consult with the Treasury Department in planning the marketing of their debt. 26/

Table 3 (see page 33) lists the debt outstanding of the major credit programs in each of these three categories. Individual programs are then described briefly.

The Federal National Mortgage Association ("Fanny Mae") is a major government-sponsored but privately owned credit agency. It is under the regulation of the Department of Housing and Urban Development, and the Treasury Department. Five of its directors are appointed by the President. Its primary purpose is to improve the liquidity of the mortgage market by providing secondary market facilities. 27/

The Federal Home Loan Bank System, created in 1932, provides a flexible credit reserve for member savings institutions engaged in home mortgage lending, thereby providing liquidity to mortgage lenders. The Federal Home Loan Bank Board charters and supervises all Federal savings and loan associations. Membership in the system is open to three major types of mortgage lending institutions: savings and loan associations, insurance companies, and mutual savings banks. Over 95 percent of the members are savings and loan associations. The most important function of the system is that of lending funds to member institutions.

The Federal Home Loan Mortgage Corporation ("Freddie Mac") was created in 1970 to serve members of the Federal Home Loan Bank System. It purchases conventional mortgages, including participations as well as whole mortgages, and markets mortgage-backed securities, thereby encouraging a private secondary market in such mortgages.

The three groups that comprise the Farm Credit System under the Farm Credit Administration are: (1) the Federal Land Banks which make long-term loans on

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26/ U.S. Office of Management and Budget. The Budget of the United States Government, 1983. Special Analysis F, Federal Credit Programs. Washington, February 1982. p. 29, 39.

27/ Hand, John H. Government Lending Agencies [in] Polakoff and Durkin. Financial Institutions. p. 218.

Table 5. Principal Federal and Federally Assisted Credit Programs: Loans Outstanding as of September 30, 1981

	(in billions of dollars)
I. Government-Sponsored Enterprises:	
Federal Home Loan Banks	64.3
Federal National Mortgage Association	44.5
Federal Home Loan Mortgage Corporation	22.3
Farm Credit Administration:	
Federal Land Banks	44.5
Federal Intermediate Credit Banks	21.9
Banks for Cooperatives	9.4
TOTAL	182.3
II. Direct Government Loan Programs:	
Export-Import Bank	15.8
International development assistance	11.9
Other international security assistance	5.2
Commodity Credit Corporation	6.2
Public Law 480 long-term agricultural export credits	7.7
Government National Mortgage Association	4.3
Other Housing and Urban Development Department programs	8.7
Foundation for Education Assistance	5.7
Small Business Administration	9.1
All other	16.8
TOTAL	102.1
III. Guaranteed Loan Transactions--Loans Guaranteed:	
Federal Housing Administration	131.2
Veterans Administration (housing)	105.9
HUD-subsidized low-rent public housing	17.5
Farmers Home Administration	54.9
Rural Electrification Administration	15.5
Foundation for Education Assistance	17.7
International security assistance	9.4
Small Business Administration	10.0
Federal ship financing fund	6.6
Export-Import Bank	7.0
All other	16.2
TOTAL	392.0
GRAND TOTAL (I, II, and III)	676.3

Source: U.S. Office of Management and Budget. Budget of the United States Government, 1983. Special Analysis F. Federal Credit Programs. Washington, February 1982. Tables F-3, F-6, and F-8.

farm or rural real estate through local Federal Land Bank Associations; (2) the Federal Intermediate Credit Banks which provide short- and intermediate-term loan funds to production credit associations and other institutions financing farmers, ranchers, rural homeowners, owners of farm-related businesses, and commercial fisherman; and (3) Banks for Cooperatives which make loans of all kinds to agricultural and aquatic cooperatives. These institutions obtain funds primarily through the sale of securities to investors in the nation's capital markets.

The Student Loan Marketing Association was created in 1972 and is empowered to buy and sell issued student loans guaranteed by the Department of Health, Education and Welfare. However, since the Federal Financing Bank (part of the Treasury Department) was established in 1974, Sallie Mae has borrowed exclusively from it. (The Federal Financing Bank was established by an act of Congress (P.L. 93-224) on December 29, 1973, to assure efficient financing of guaranteed loans and to reduce borrowing cost. It serves as a financial intermediary for Federal credit agencies.)

In contrast to the Government-sponsored credit agencies described above, the Federal credit agencies are owned by the Federal Government, which provide direct loans and guarantees of private loans, often involving a subsidy to borrowers and a loss to the Treasury.

Of these, as in the case of Government-sponsored credit agencies, the largest program involves housing. The Government National Mortgage Association (Ginnie Mae) was created in 1968 when the Housing and Urban Development Act split the Federal National Mortgage Association into two parts: one, Fannie Mae, the privately financed agency, already described above; the other, Ginnie Mae, the Federal agency given responsibility for subsidized housing programs under the Department of Housing and Urban Development. Ginnie Mae's mortgage-backed securities program provides secondary market financing for most FHA-insured and VA-insured home loans. This is done to a large extent by issuance of pass-through securities, so called since they pass through all payments of interest and principal received on a pool of mortgage loans insured by Ginnie Mae. Pass-through securities have proved to be popular instruments in the capital markets. By the end of 1981, GNMA had about $106 billion in pass-through securities outstanding.

The remaining credit agency programs can be mentioned more briefly. Farmers Home Administration operates a broad range of rural credit programs, of which the most significant are farm ownership and farm operating loans. It makes loans from three revolving funds (Agricultural Credit Insurance Fund, Rural Housing Insurance Fund, and Rural Development Insurance Fund).

The Federal Housing Administration administers many loan guarantee, direct loan, and mortgage loan insurance programs. Its mortgage and loan insurance programs were designed primarily for families who may be unable to obtain a mortgage without Federal insurance. However, they insure mortgage loans for all comers, provided standards are met and the loans are within legal mortgage ceilings.

Similar in some respects are the Veterans Administration programs of direct mortgage loans and guaranteed and insured loans for home purchase, renovation, and repair, for eligible veterans.

The Small Business Administration operates two principal loan programs. Its disaster loan program provides loans and loan guarantees for victims of natural disasters. Its business loan program provides direct loans, participation in loans made by private lenders, and guarantees of private credit. It also makes loans to Small Business Investment Companies which in turn assist small business concerns.

The Export-Import Bank facilitates U.S. export trade by making direct loans and guaranteeing private loans for this purpose.

The Rural Electrification Administration provides low interest loans to cooperatives, power companies, municipalities and other qualified suppliers of power and telephone service in eligible rural communities.

The Commodity Credit Corporation makes short term loans to farmers who pledge their crops as collateral. It also provides loan guarantees to help finance the sale of U.S. agricultural commodities to developing nations.

The extent and breadth of this range of Federal and federally sponsored credit agencies suggest that they have had a major impact on the structure and operations of the private financial institutions of the country. Certainly in some areas, notably housing, the entire financial segment of the industry has been radically altered by the Federal involvement in mortgage lending, mortgage guarantees, and mortgage insurance. The net impact of Government involvement in credit and credit insurance programs remains difficult to assess. Clearly certain segments of the community have benefitted from being able to obtain more favorable credit terms than were available to them in the private sector. On the other hand, the costs of these programs in which a subsidy is involved represent a burden to the taxpayer and to competitive segments of the economy which do not receive the subsidy. As a recent Congressional Research Service Issue Brief concludes:

> In summary, the reallocation of credit resulting from Federal credit programs imposes substantial credit access costs and higher interest costs on unassisted potential borrowers. Furthermore, higher interest costs on U.S. Government securities occur since Federal credit programs raise the total demand for loanable funds and thus interest rates. 28/

Another factor to be considered is that Federal lending programs which prevented the collapse or deterioration of particular businesses or segments of the economy may have had a stimulating effect in preventing or minimizing the costs of business failure and the depths of business recession and in providing a stimulus for economic growth and recovery. More specifically, the following conclusions, by John H. Hand, may be warranted:

> The usual case for intervention is that government can alleviate recessions, correct imperfections in the market, encourage activities

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28/ U.S. Library of Congress. Congressional Research Service. Federal Credit Budget [by] James Bickley. Washington, D.C., October 7, 1982. 10 p. (Issue Brief No. 82055) that have values transcending economic rewards, and redistribute income. All four justifications have been used at one time or another in support of existing and proposed government credit programs.

The role of federal credit agencies in the financial system is significant: at the end of 1978, they had provided $296 billion in direct credit to the private sector and guaranteed $211 billion of private credit. However, these magnitudes do not necessarily prove that federal credit programs either add to gross national product or even reallocate credit to the favored sectors. Extension of credit cannot have the same effect as a gift or a purchase of goods and services. In fact, if no subsidy is involved, federal credit programs probably have no effect on the economy at all beyond that provided by private financial institutions. Some of the largest programs offer only the implicit subsidy of passing on the government's lower borrowing costs to their private-sector customers. Even if a significant subsidy is offered, there are many possibilities for the effects to be dissipated before they reach the intended beneficiary. They include the following: the program will benefit many who would have borrowed and spent without any subsidy, and so provides no stimulus to spending beyond that induced by the income transfer; government credit agencies sell many of their securities to institutions making loans in the area to be subsidized or to individuals with deposits in such institutions; some programs aid lending institutions and not ultimate borrowers, allowing the institutions to use the funds for liquidity or other purposes not related to credit aid; sector spending may not be sensitive to changes in credit conditions; and increased spending in a sector receiving credit aid may come at the expense of spending in other sectors, resulting in no increase in GNP. Empirical studies of federal credit in the housing sector suggest that the effects of the programs, while tangible, are still quite small given the size and subsidization of the programs." 29/

F. Conglomerate Firms

A large number of firms overlap the specific types of businesses described above. For purposes of this report, they will be grouped together under the general heading of conglomerates, that is businesses with subsidiaries, branches, or functions that transcend one of the categories mentioned above. In considering financial conglomerates, four kinds may be distinguished: (1) those that have long been engaged in a multiplicity of enterprises, including

29/ Hand, John H. [in] Polakoff and Durkin. Financial Institutions. p. 236-237. See also: U.S. Library of Congress. Congressional Research Service. Capital, Credit, and Crowding Out: Cycles and Trends in Flows of Funds over Three Decades [by] William Jackson. Washington, D.C., Aug. 1, 1982. p. 41-54. (CRS Report No. 82-142E) financial enterprises, probably the chief examples being American Express and Gulf and Western; (2) those companies that are primarily in non-financial businesses but which by acquistions and mergers have undertaken major functions that parallel those of financial institutions; this is a large and rapidly growing group that includes such firms as Sears Roebuck, National Steel, Xerox, and American Can; (3) non-depository financial institutions which have by merger or acquisition entered into financial activities that had once been the prerogative of other kinds of non-depository institutions, such as Merrill Lynch, Prudential Insurance, and Beneficial Corporation; and (4) depository or non-depository institutions that have expanded their operations into areas of other depository and nondepository financial institutions. This categorization is necessarily somewhat arbitrary. Several firms could arguably be allocated in a different, or more than one, category. Examples of each of these four kinds of conglomerates will be described.

This trend towards conglomeration is continuing at a rapid pace with announcements of mergers, acquisitions, take-overs, and new packages of financial services appearing almost daily. Some of the impetus for merger comes from the belief that it is both profitable and technically feasible to offer within a single institution a much broader range of financial services than has been available heretofore, particularly for savers and investors of relatively modest means. Non-depository institutions such as brokerage houses and mutual funds have begun providing such services as interest-bearing check-like accounts, loans, and installment credit, that had traditionally been offered only by depository institutions. In addition to investment of consumers' funds in stocks or money market or other mutual funds, non-depository institutions have had the advantage of being exempt from interest rate ceilings, reserve requirements, geographic limits or restrictions on the types of business in which they may engage. 30/

This trend has, not unexpectedly, led to counter moves by depository institutions to get laws and regulations amended to permit higher interest rates, expansion of operations on an inter-state basis, entry into brokerage services, and direct entry into the money market field. Obviously these trends have been both cause and effect of regulatory changes, which have occurred in recent years and which can be expected to continue.

1. Long-existing conglomerates of financial and non-financial businesses. Perhaps the best-known companies in this category are the American Express Company and Gulf and Western Industries, Inc. American Express Company, with its subsidiaries, is a worldwide service organization primarily providing travel related services, insurance services, international banking services and investment services. Its wholely owned subsidiary, Shearson/American Express, which resulted from the acquisition of Shearson Loeb Rhoades, Inc. in 1981, services the investment needs of individual, institutional, corporate and government clients and is the second largest investment banking and brokerage firm in the United States, in terms of capital. Through its ownership of the Boston Company, a one-bank holding company, it controls the Boston Safe Deposit and Trust Company, a State-chartered trust company that accepts deposits but does not make commercial loans. It offers a Financial Management Account, similar to Merrill Lynch's Cash Management Account. 31/

Gulf and Western Industries, Inc. is a diversified firm operating in seven major areas: manufacturing, consumer and agricultural products, leisure time,

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30/ For a survey of links between banking companies and non-banks divided into nonbank competitors and service firms, see: Gross, Laura. Bank Links with Nonbanks Boom in Experimental Craze to Compete. American Banker, Aug. 20, 1982. p. 1-58, passim.

31/ See p. 43 below.

apparel and home furnishings, automobile and building products, natural resources, and financial services. Financial services accounted for 22.5 percent of its operating income in fiscal year 1981. Its financial services are provided primarily through two subsidiaries, Associates First Capital Corporation and Providence Capital International Insurance, Ltd. The former, through subsidiaries, engages in industrial and consumer loan services, the latter in a broad range of insurance and pension services on a worldwide scale. In 1980, Gulf and Western acquired the Fidelity National Bank of Concord (Calif.) which still provides usual banking services, except for commercial loans. It has major stock holdings in other banks as well.

Baldwin-United Corporation, established originally in 1862 as a major American piano manufacturer, has since become a diversified financial company with musical instruments accounting, in 1981, for less than 5 percent of its total revenues. In 1981, 78 percent of its revenues came from insurance operations, 5 percent from savings and loan activities, and 12 percent from other financial services, including leasing, real estatge mortgages, trading stamps, and specialized software, computing and consulting services. In 1974 and 1975 it acquired nine Colorado banks and obtained an interest in three more. As of Dec. 31, 1980, it divested itself of these banks but retained a 92 percent non-voting interest in the partnership which acquired these banks. In 1982, it acquired Mortgage Guarantee Insurance Corporation, the Nation's largest private insurer of mortgages.

2. Non-financial companies which have by acquisition or otherwise become major financial firms as well.

Of these, Sears Roebuck is probably the most conspicuous. It is the Nation's largest retail chain and now appears to be well on its way to becoming the Nation's leading financial department store as well.

Its subsidiary, Allstate Insurance Company, has long been one of the Nation's largest insurance companies, offering life, property and casualty insurance as well as automobile, and other secured installment consumer loans. Coldwell Banker & Co., acquired in 1981, was the Nation's largest independent real estate broker. It offers services in real estate brokerage, mortgage banking, and real estate and capital management services. Dean Witter Reynolds, a major brokerage firm also acquired in 1981, engages in a broad range of financial services. It has promoted an Active Assets Account similar to Merrill Lynch's Cash Management Account, 32/ including a money market and two other mutual funds, free check-writing privileges, a VISA card, and access to investment counselors. Sears' subsidiary, Allstate Savings and Loan Association, conducts savings and loan operations in 50 branches in California. Sears also has a credit card business with more than 20 million customers, a nationwide network of more than 1,000 offices and ready access to the commercial paper market. In July, 1982, Sears Roebuck opened financial service centers in eight of its stores, offering insurance, real estate and brokerage services in each center.

Another retailer, tending in the same direction, although of course on a much more limited scale, is Kroger Company, a leading retail food chain. It announced in September, 1982, that it will offer a variety of financial services at selected stores to be managed as a joint venture with Capital Holding Corporation. Capital Holding Corporation would offer automobile, homeowner, renters and condominium insurance and three kinds of life insurance. By subcontract with the Vanguard Group of Investment Companies, Capital Holding Corporation would also offer two money market funds, three bond mutual funds, and two common stock mutual funds.

32/ See p. 43 below.

In 1980, the National Steel Corporation acquired a major savings and loan holding company, the United Financial Corporation of California. National Steel also bought the West Side Federal Savings and Loan Association in New York and Washington Savings and Loan Association in Florida. Using the common name, First Nationwide Savings, the National Steel thrift units offer most bank services, including savings and consumer checking accounts.

American Can Company entered the insurance business in 1982 by acquiring the Associated Madison Companies, a general insurance company, and the Transport Life Insurance Company, and has announced an agreement to acquire Penncorp Financial Inc., also a general insurance company. If the Penncorp acquistion is approved by directors and stockholders of both companies, American Can's financial service sector would rank it among the top 35 life insurance firms in the country and its insurance sector would account for over 25 percent of its net income, according to William S. Woodside, chairman and chief executive officer of American Can.

Phibro Corporation, a leading international merchant supplier of industrial raw materials, merged with Salomon Brothers in October 1981 to become Phibro-Salomon. Salomon Brothers is a leading investment firm whose services include managing public and private financing in the debt and equity markets, and acting as financial advisor to corporations and sovereign governments.

Xerox Corporation, on September 21, 1982, announced its acquisition of Crum and Forster, the nation's 15th largest property-casualty insurer with 1981 premium volume of $1.6 billion.

RCA Corporation acquired C.I.T. Financial Corporation, effective in 1980. C.I.T. Financial is one of the leading consumer finance companies of the Nation with 741 offices, and is also engaged in insurance and manufacturing.

3. Non-depository financial institutions that have expanded into new financial areas, by acquisition or otherwise. Merrill Lynch and Co. through its wholly owned subsidiary, Merrill Lynch, Pierce, Fenner & Smith is the largest U.S. firm in the securities industry. Merrill Lynch, Pierce, Fenner & Smith has entered such quasi-banking activities as money market funds and cash management accounts. Its Cash Management Account, introduced in 1977, combines conventional brokerage services, a checking account at Bank One of Columbus (Ohio), a VISA card at the bank, and a money market fund, available to customers with a minimum of $20,000 in cash and/or securities on deposit. Its Cash Management Account has been widely imitated in 1981 and 1982, as already noted above. Merrill Lynch and Co. is also involved in life insurance, real estate, investment banking, employee relocation services, and management consulting services. In the unregulated overseas market, Merrill Lynch has entered the commercial banking business.

The Prudential Insurance Company of America is the largest insurance company in the world in terms of admitted assets. It has numerous subsidiaries involved in real estate ownership, development and leasing, health care, housing rehabilitation, buying, selling and operating farmland, and brokerage services. The latter resulted from the acquistion of the Bache Group, a major brokerage firm. Bache offers its own version of a cash management service.

Household International Inc., formerly Household Finance Corporation, in addition to providing consumer loans and other financial services, also is a major retailer, manufacturer, and car rental company. Among its financial operations, it owns: (1) 99 percent of Valley National Bank, with seven offices in northern California; (2) Household Federal Savings and Loan Association, with 15 offices in Southern California; and (3) 31 thrifts and industrial banks in three States and Canada.

Beneficial Corporation, primarily a consumer finance company, through subsidiaries also leases equipment, owns a commercial bank in Wilmington, Delaware, and a large savings and loan company in Texas, has an extensive insurance business and is also involved in retail trade, particularly through its subsidiary, Western Auto Supply Company.

4. Depository institutions that have expanded, or are in the process of expanding, into other financial areas. Some of these expanded activities, in part made possible by new legislation and amended regulations, have already been mentioned. Some of this expansion may be considered to be contrary to the spirit, if not the letter of the Glass-Steagall Act. 33/

Citicorp, the holding company that owns Citibank, the second largest bank in the United States, measured by deposits, also owns Diners Club, Carte Blanche and Choice credit cards, as well as Nationwide Financial Services Corporation, a finance company with 480 offices operating in forty States and the District of Columbia. It has established a mortgage lending office in metropolitan Washington, D.C., and has set up travel planning services available to its 7.5 million credit card holders. It has obtained the approval of both the Federal Home Loan Bank Board and the Federal Reserve Board to acquire Fidelity Savings and Loan Company of San Francisco, the 21st largest savings and loan company in the United States. 34/

BankAmerica Corporation, the one-bank holding company owning Bank of America N.T.&S.A., the largest commercial bank in the United States, has announced its intention to acquire the discount brokerage firm Charles Schwab & Co.,

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33/ See p. 13-14 above.

34/ See: Hector, Gary. Citicorp Goes West. Fortune, November 1982. p. 83-90.

subject to regulatory approval. Other subsidiaries of Bank America are engaged in consumer finance, data processing, computer leasing, investment advising and management, mortgage banking, small business investing, credit related insurance, recreational homesite financing, securities transfer and register services, and issuance of travelers checks.

The attempt of banks and savings and loan associations to provide brokerage services to their customers appears to be growing. Union Planters National Bank of Memphis has acquired the discount brokerage firm, Brennen Steed. Security Pacific National Bank has been buying and selling stocks for customers throughout California and now has permission from the Comptroller of the Currency to go nationwide in the operation. Chemical Bank in New York has started a brokerage operation.

Some two dozen banks and savings and loan association have begun offering discount brokerage services through Fidelity Brokerage Services, a unit of the Boston-based Fidelity group of mutual funds, which manages about $15 billion in assets.

Thirty savings and loan associations, including the two largest in Maryland (Baltimore Federal and Loyola Federal) have joined to buy a brokerage service called Invest, that is expected to start operations in January 1983. The Boston Five Cents Savings Bank is reported to be planning to start its own money-market mutual fund. Thus savings and loan associations and banks are joining the institutions prepared to offer stocks, bonds, mutual funds, and investment advisory services to their customers.

On November 2, 1982, in a split decision, the Federal Appeals Court for the District of Columbia ruled that commercial banks may market short-term commercial paper, in large denominations and under Federal Reserve guidelines. The court ruled that such paper is not a security for purposes of the Glass-Steagall Act. This would give banks an additional area in which to compete with security dealers. The ruling is likely to be appealed. 35/

35/ Wermiel, Stephen. Commercial Paper Is Ruled Not a Security. Wall Street Journal, November 3, 1982. p. 2.

II. TECHNOLOGY

While inflation and the accompanying high and uncertain interest rates have been the dominating cause of the upheaval among financial institutions with which this report is concerned, 36/ the nature of this upheaval has depended very largely on technological developments in electronics, communication, and data processing. These developments have made economical instantaneous transfer of funds, and the ability of institutions to handle vastly increased volumes of data at lower costs. They have made it economically feasible, for example, for a single financial institution to compute interest daily for a large number of accounts.

A few of the more important of the applications of this new technology may be noted. 37/

Automatic teller machines (ATMs) allow an individual to transact business, even at remote locations, without having to talk with a representative of a financial institution. With an ATM, one only needs a communications line to connect with the financial institution's internal computerized accounting system. Some experts expect ATMs to handle over half of the transactions in the banking industry by 1990.

Electronic funds transfer systems (EFTS) permit, for one thing, customers to have their funds in a financial institution transferred instantly to a seller's account. In broader terms, they permit instantaneous transfer of funds between two financial institutions and make possible automatic clearinghouses

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36/ See: Jackson, William. Depository Institutions, Financial Innovations, and Economic Activity: Cycles and Trends since the Accord [in] Joint Economic Committee. The Business Cycle and Public Policy, 1929-80. (96th Cong, 2d sess.) Joint Committee Print. Washington, U.S. Govt. Print. Office, 1980. p. 282-298.

37/ Derived largely from Kidwell and Peterson. Financial Institutions. p. 408-417.

(ACHs). Automatic clearing houses process information on computer tapes to clear and settle accounts. They can provide credit transfers, such as automatic deposits of payroll and social security, and debit transfers such as pre-authorized bill payments.

The new communications and information technology has not only had a major impact on the ability of financial institutions to meet the needs of their customers and to expand the scope of their services, often thereby increasing competition in the financial arena, but it is having a major impact on business and individual households as well. Businesses are finding this new technology a useful tool to minimize the holding of cash, an objective the importance of which has increased greatly as a result of inflation and high interest rates. As Lyle E. Gramley recently said:

> The financial sophistication of business firms has increased profoundly. Management of cash positions has assumed an important place in the duties of financial managers.... Considerable effort and investment have gone into the development of information systems, cash-forecasting methods, and techniques for transferring funds that enable firms to minimize their holdings of cash and, in the process, to maximize earnings on working capital." 38/

Similar changes in savings patterns of individual households--such as increased resort to money marked funds--have occurred more recently, but are equally significant.

The adoption of this new technology has, of course, raised various issues, which are under discussion and which are, to varying degrees, being resolved. They include such questions as the following:

Who should own and control electronic funds transfer systems?

What should be the role of the Federal Government in the development of such systems?

38/ Gramley, Lyle E. Financial Innovation. p. 394.

Which financial institutions should have direct or indirect access to electronic funds transfer systems?

How is the pricing of such systems to be determined? What, if any, should be the role of the Federal Communications Commission on other Federal regulatory agencies?

How is confidentiality of transactions to be preserved?

How can the security of the system be assured to prevent erroneous or fraudulent transfer of funds or loss of relevant data?

What procedures need to be developed for correcting mistakes?

How is liability for losses resulting from mistakes to be established?

How can proof of payment be obtained in an electronic funds transfer system? 39/

39/ Kidwell and Peterson. Financial Institutions. p. 414-417.

III. THE DEVELOPMENT OF NEW FINANCIAL INSTRUMENTS BY DEPOSITORY INSTITUTIONS

As could be expected, the prevailing high interest rates in the market place led to efforts by many depository institutions to devise ways to offer rates sufficiently competitive to stem the diversion of funds from banks, savings and loan associations, and credit unions that threatened to endanger their operations. Among the more significant of these arrangements are negotiable certificates of deposit (CDs), money market certificates, small saver certificates, negotiable orders of withdrawal (NOW accounts), automatic transfer services (ATS) accounts, credit union share drafts, all savers certificates, repurchase agreements (repos), sweep accounts, money market deposit accounts, and Super NOW accounts, Each of these financial instruments served as a way to circumvent the prohibition of the payment of interest on demand deposits and other regulations putting ceilings on allowable interest payments on other deposits. These instruments may be described briefly. 40/

Negotiable certificates of deposit (CDs) were one of the first instruments devised to permit commercial banks to attract corporate liquid balances in competition with other money market instruments. First devised by a New York commercial bank in 1961, certificates of deposit are a form of time deposit offered by depository institutions, paying market rates of interest, and actively traded on a well-organized secondary market. They are most often issued in denominations of $100,000 or more, and since 1973 have been exempt from Federal Reserve interest rate ceilings. The major investors in CDs have been corporations.

40/ Much of the information on these instruments is derived from the glossary in: U.S. Library of Congress. Congressional Research Service. A Reference Guide to Banking and Finance. (U.S. Congress. House Committee on Banking, Finance and Urban Affairs. Committee Print 97-3.) Washington, 1981. p. 1-39. See also: U.S. Library of Congress. Congressional Research Service. Comparison of Short Term Financial Assets Available to Households with Proposed All Saver Certificates [by] William Jackson. Washington, D.C., July 8, 1981. 7 p.; also: A Roadmap through the Savings Maze. New York Times, October 24, 1982. p. F27.

Small Denomination Savings Certificates, sometimes called "small CDs," are a form of time deposit at commercial banks and thrift institutions whose interest rates are subject to "Regulation Q" now administered by the Depository Institutions Deregulation Committee. 41/ They include money market certificates, small saver certificates, and fixed-rate certificates maturing at fixed intervals. Money-market certificates were authorized in June 1976. They are 6-month certificates originally offered in a minimum denomination of $10,000 with an interest rate based on the 26-week U.S. Treasury bill rate. The minimum denomination was lowered to $2,500, effective January 5, 1983. Small saver certificates were authorized in January 1980, with an interest rate based on the average yield of 2 1/2-year U.S. Treasury certificates, originally with a cap of 12 percent at thrift institutions and 11 3/4 percent at commercial banks; this cap has since been repealed. They can be issued in any denomination with a minimum maturity of 30 months.

NOW accounts are, in essence, interest-earning checking accounts available to individuals and nonprofit institutions. Originally limited to New England, NOW accounts have been offered nationally by commercial banks and thrift institutions since 1981.

Credit union share drafts are similar to NOW accounts. Credit union members can draw on their accounts by these check-like drafts. Such drafts have also been permanently authorized by the Depository Institutions Deregulation Act of 1980.

All Savers Certificates, first issued in October 1981, were a form of tax-exempt certificate available from depository institutions with an interest rate set at 70 percent of the average investment yield on 52-week U.S. Treasury bills. Up to $1,000 in interest ($2,000 for a married couple filing a joint return) was exempt from Federal income taxes. The program expired on Dec. 31, 1982.

41/ See page 26 above.

Repurchase agreements (repos) are a form of loan in which the borrower sells securities (usually money market instruments) to the lender but simultaneously contracts to repurchase the same securities, either on demand or at some stated date in the future, at a price that will produce the agreed effective yield. Agreements with fixed maturities range from one day to several months.

As Kidwell and Peterson note:

> The 'repo' transaction is attractive to the corporation because, unlike demand deposits, 'repos' pay explicit interest. Also the net yield on 'repos' may be higher than the equivalent money market investments because of lower transaction costs, and it may be difficult to locate a one-day maturity government security. From the bank's perspective, the 'repo' transaction is attractive because conversion from deposit debt to 'repo' debt increases the bank's loanable funds since reserves are required on demand deposits but not on 'repos'. 42/

"Repos" have been offered to households by more and more depository institutions to compete with money market mutual funds.

The legal status of repurchase agreements, which assumes significance in the case of the bankruptcy of issuers or dealers in repos, is still not fully resolved. It has been argued on the one hand that a repo is a secured loan, but on the other that it is a set of independent contracts for the selling and rebuying of securities. 43/ It is not clear under law whether dealers in repos are acting as an agent, or as a principal in the transaction.

Sweep accounts are among the newest of these financial instruments. 44/ In such accounts, banks agree to "sweep" the funds above a minimum balance

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42/ Kidwell and Peterson. Financial Institutions. p. 165.

43/ See: Matthews, Gordon. In Wake of Lombard-Wall Collapse Creditors Ask: What is a Repo? American Banker, August 20, 1982. p. 3, 62.; and Welles, Chris. Drysdale: What Really Happened. Institutional Investor, v. 16, September 1982. p. 78-81.

44/ U.S. Library of Congress. Congressional Research Service. Depository Financial Institution Distribution and Sponsorship of Money Market Mutual Funds [by] William Jackson. Washington, D.C., June 15, 1982. p. 9-11, 31-32. (Report No. 82-120E) from the accounts of deposit holders (e.g. NOW accounts) at the end of each banking day into such investment accounts as money market funds, repurchase agreements, and Treasury bills. This provides additional interest to the depositor and permits the banks to lower their transaction balances, and thereby lower the reserve levels they are required to maintain. Originally designed for large accounts, sweeps are being increasingly offered for smaller deposit accounts.

However, there are some misgivings within and outside the banking industry both as to the legality and the profitability of sweep accounts. Such accounts shift funds from a regulated and insured institution to a less regulated and uninsured one, and thereby increase the risks to the financial system. 45/

Starting December 14, 1982, banks and thrift institutions are authorized to offer a new type of account called a money market deposit account, designed to compete directly with money market mutual funds. Such accounts will have a minimum balance of $2,500 and will be insured up to $100,000. Interest rates will be set by the individual depository institution and can be high enough to meet the competition of money market mutual funds. They may offer a guaranteed rate for up to 30 days, whereas money market fund rates can vary daily. Regulations for these new accounts are promulgated by the Depository Institutions Deregulation Committee as authorized by the Garn-St Germain Depository Institutions Act of 1982.

Effective January 5, 1983, a new Super NOW account has been authorized, with the same features as the money market deposit accounts described above, except that it will permit unlimited transactions.

45/ See also: U.S. Library of Congress. Congressional Research Service. Depository Financial Institution Distribution and Sponsorship of Money Market Mutual Funds [by] William Jackson. Washington, D.C., 1982. p. 9-11. (Report No. 82-120E)

IV. RECENT LEGISLATION AND LEGISLATIVE PROPOSALS

Many of the new financial instruments that have just been described have been an outgrowth of Federal legislation expanding the powers of depository financial institutions and reforming some banking and monetary regulation. As noted in the introduction, p. 3, such legislation has principally been in the direction of deregulation of depository financial institutions, with very little increase in regulation of non-depository institutions. Two legislative acts are particularly significant, the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982.

The Depository Institutions Deregulation and Monetary Control Act of 1980 (P.L. 96-221) is probably the most important and comprehensive financial legislation since before World War II. Sometimes also called the Omnibus Banking Act of 1980, it was a major factor in the ability of depository institutions to cope more effectively with the impact of inflation and high interest rates and their less regulated competitors. Provisions of the bill, in summary, include the following:

1. As of Jan. 1, 1981, banks and thrift institutions nationwide are permitted to offer NOW accounts, the equivalent of interest-paying checking accounts as noted above (p. 52).

2. There is to be a gradual phase-out of interest-rate ceilings imposed on savings instruments offered by all depository institutions, to be completed by March 1986. The timetable for the phase-out is to be determined by the Depository Institutions Deregulation Committee.

3. The insured deposit limit is increased to $100,000.

4. Federally chartered savings and loan associations are authorized to expand their consumer loan operations, offer credit cards and trust services, and

invest in commercial paper and corporate bonds, up to a maximum of 20 percent of their assets. 46/

The Garn-St. Germain Depository Institutions Act of 1982 (P. L. 97-320) is a further legislative response to problems of depository institutions, in particular thrift institutions. 47/ For the purposes of this report, three titles of the act are particularly worth noting.

1. Title I, the Deposit Insurance Flexibility Act, provides additional flexibility to the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation to assist depository institutions under their jurisdiction that are in financial difficulty.

2. Title II, the Net Worth Certificate Act, provides for capital assistance to depository institutions that specialize in home mortgage lending, when they are in financial difficulty. The amount of aid available to a specific institution would depend both on the level of its net worth and its actual losses.

3. Title III, the Thrift Institutions Restructuring Act, is the provision which most directly relates to the competition between depository institutions and non-depository financial institutions, notably money market funds. It broadens the power of thrift institutions to increase, to 10 percent of their assets, the amount they put into commercial loans and to accept demand deposit accounts from commercial loan customers; and it establishes a new type of account

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46/ U.S. Library of Congress. Congressional Research Service. Major Legislation in the 96th Congress in the Field of Money and Banking: P.L. 96-221, Depository Institutions Deregulation and Monetary Control Act of 1980 [by] F. Jean Wells. Washington, D.C., 1980. 8 p. (Report No. 80-107E)

47/ For a convenient, concise explanation of the act and the problems it is designed to address, see: U.S. Library of Congress. Congressional Research Service. P.L. 97-320, Garn-St Germain Depository Institutions Act of 1982: A Brief Explanation [by] F. Jean Wells. Washington, D.C., 1982. 9 p. (Report No. 82-177E) to be "directly equivalent to and competitive with" money market mutual funds. 48/

How much these new accounts will adversely affect money market funds is still highly uncertain. While this new kind of account will help depository institutions be more competitive with money market funds, there are some possible offsetting disadvantages. The cost of money to them will go up while yields on a large part of their mortgage portfolio remain low. Large banks may be able to offer market rates that smaller banks and thrift institutions may be unable to afford.

There is some concern that the kind and extent of deregulation resulting from these two major pieces of legislation may have unforeseen results. The impact on financial markets may be adverse. Allowing interest rates to be determined more exclusively by market forces may have a detrimental impact on some kinds of interest-sensitive industries, such as housing, that many believe should have a high social priority.

At a Securities and Exchange Commission's Major Issues Conference on October 7 and 8, 1982, C. T. Conover, Comptroller of the Currency, suggested that banking deregulation, by placing greater responsibility for discipline on the marketplace, will require additional disclosure of information, "if the marketplace is to function efficiently and provide adequate safeguards against excessive risk." 49/

What additional legislative proposals will receive major attention in the 98th Congress is, of course, speculative.

Removal of remaining restrictions on interstate banking is being sought by several bankers and banking associations. However, in view of the *de facto* removal of many of these restrictions through the use of bank holding companies

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48/ Described above, p. 54.

49/ Bureau of National Affairs. Daily Report for Executives, No. 199, October 14, 1982. p. A-11.

(see p. 14-15 above), the likelihood of legislation in this area in the 98th Congress is remote. 50/ In addition, the Federal Reserve Board has authorized U.S. banks, bank holding companies, and Edge Act subsidiaries, which are corporations authorized to engage in international banking or other international and foreign financial operations, to purchase up to 25 percent interest in a foreign bank having a U.S. branch in another State, provided that the foreign bank derives most of its business from sources outside the U.S. A considerable number of banks, and bank holding companies, have already made investments in securities of banks in other States and have taken other steps in anticipation of the elimination of interstate banking restrictions such as forming joint ventures of shared automated teller machines operating across State borders. 51/

Legislation has also been advocated by some who believe that commercial banks should now have the authority to underwrite State and municipal revenue bonds and, perhaps eventually, corporate securities.

With the widening of types of accounts offered by commercial banks and thrift institutions, some believe that there should be a revision of deposit insurance premiums to be more closely tied to the degree of risk involved in such accounts, instead of having a blanket coverage up to a certain amount.

Some believe that barriers to mergers of commercial banks with thrift institutions should be lifted. However, the trend towards consolidation of savings and loan associations and banks has led to some concern about undue

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50/ P.L. 97-290 expanded permissible financial service activities across State lines to include investments in "export trading companies." P.L. 97-320 conversely limited these activities by specifying that only certain insurance activities will be allowed.

51/ See: Whitehead, David D., and Pamela Frisbee. Positioning for Interstate Banking. Economic Review. Federal Reserve Bank of Atlanta. September 1982. p. 15-22.

concentration among these institutions and the belief that a reexamination of antitrust legislation as it applies to them may be in order to see if present laws are effective and adequate.

While most of the legislative effort concerning financial institutions has been to relax the restrictions and regulations adversely affecting depository institutions, 52/ there has also been some attempt to increase regulation of non-depository financial institutions, with a particular eye on money market mutual funds. The shift of substantial funds from depository institutions to money market funds and other financial instruments, a large proportion of which is readily available for transaction purposes, has increased the difficulty of the Federal Reserve in controlling the money supply. Some authorities, therefore, suggest that legislation to impose uniform reserve requirements on all financial institutions offering transaction balances should be enacted. Alternatively, a consistent system of paying interest on balances that are in effect reserves might be required. 53/

The suggestion has also been made that legislation be adopted that would provide for regulation by function rather than by industry classification. Thus, for a firm engaged in a range of financial services, for example, its securities business would be subject to securities regulators and regulations, its insurance business to insurance regulators, and its banking services to appropriate banking authorities. 54/

52/ See: U.S. Library of Congress. Congressional Research Service. The Regulatory Climate for Depository Financial Institutions [by] F. Jean Wells. Washington, D.C., October 13, 1982. 8 p.

53/ See, for example: Edwards, Franklin R. Financial Institutions and Regulation in the 21st Century: After the Crash? Columbia Journal of World Business, v. 17, Spring 1982. p. 82-87.

54/ See: Schreyer, William A. The Future of the Financial Services Industry. Financial Analysts Journal, July-August 1982. p. 54.

Similarly there is the perennial call for legislation to simplify and rationalize regulation of financial institutions, which is often seen as excessive, overlapping, and contradictory. Opposed to such a call is the view that the present system of specialized regulation of the various financial institutions has served the Nation well and that the overall structure of such regulation should not be tampered with.

These kinds of regulatory reform are reflected in the establishment in December 1982 of a Task Force on Regulation of Financial Services. The task force, to be chaired by the Vice President, includes the heads of all Federal financial regulatory agencies. It is to recommend to Congress changes in the regulation of financial institutions within six to nine months. 55/ Among possible approaches are the following: having bank examinations done by a single agency, rather than the three currently performing this task; consolidating the three deposit insurance funds currently maintained for banks, savings and loan associations and credit unions; and combining the Securities and Exchange Commission and the Commodity Futures Trading Commission.

Most of the financial legislation of the past decade and the proposed legislation, as sketched in this section, has been focused on preserving or assisting particular financial institutions, changing thereby the competitive balance among them resulting from new technology, impact of regulations, managerial and entrepreneurial initiatives, and changed economic conditions, such as inflation and high and fluctuating interest rates.

One school of thought holds that such governmental intervention is detrimental and that preservation of existing institutions often interferes with the optimum benefits which the community can gain from new technology and enterprise.

55/ U.S. Vice President. Office of the Press Secretary. Press Release of December 13, 1982.

This was expressed by Almarin Phillips, Professor of Economics at the University of Pennsylvania and member of the President's Commission on Financial Structure and Regulation (commonly known as the Hunt Commission) which issued its report in 1971, in testimony before the House Committee on Banking, Finance and Urban Affairs on December 10, 1981:

> It is now clear that today's deposit institutions, as a group, cannot be generally modified to accommodate inevitable changes in the payments system, the methods and modes of financial transactions, and the techniques of household and business asset/liability management. It is not ordained that all or most commercial banks, savings and loan associations, mutual savings banks, credit unions, insurance companies, investment bankers and others of the old forms of financial institutions will persist. It is more clearly ordained that they will not. The particular institutions that do survive will do so only because they successfully innovate out of their historic roles. 56/

There is in fact some consensus that the number of financial institutions, in particular savings and loan associations, mutual savings banks and smaller commercial banks, is likely to decrease in the coming decade.

As David Kidwell and Richard Peterson stated in 1981:

> It is highly unlikely that the 40,000 financial institutions that exist today will be needed. Instead, about half that many will exist, with several hundred very large nationwide financial institutions dominating national banking markets.... However, we doubt seriously that face-to-face consumer transaction will be dominated by a few nationwide firms.... There will still be a place in the market for specialized institutions tht can generate customer loyalty which their larger competitors are either unable or unwilling to provide. 57/

56/ Phillips, Almarin. Testimony in U. S. Congress. House Committee on Banking, Finance and Urban Affairs. Financial Institutions in a Revolutionary Era. Hearing, December 10, 1981. Washington, U.S. Govt. Print. Off., 1982. p. 44.

57/ Kidwell, David S., and Richard L. Peterson. Deregulation and the Growing Competition among Financial Institutions. Review of Regional Economics and Business, v. 6, April 1981. p. 22.

V. CONCLUSION

As this report has documented, the expansion in functions of many financial institutions, both depository and non-depository, the proliferation of financial instruments, and the technology which has made many of these changes feasible have in combination created what can, without hyperbole, be called a revolution in the financial world. When it comes to pointing to "winners" or "losers" of this revolution, the conclusions are more difficult to draw with any degree of confidence, with relatively few exceptions. This is only partly due to the limited time frame during which these changes have occurred.

Thus, for example, from the evidence presented above on p. 23-27, the dramatic rise in money market mutual funds would suggest that such funds and investors in them have been clear winners. And thus far this is largely true. However, there is considerable doubt that this favorable condition would be sustained in a period of falling interest rates and a booming stock market, particularly after new accounts in depository institutions directly competitive with money market funds become available to the public.

At the other end of the scale, mutual savings banks and savings and loan associations in the aggregate have been the most obvious losers in the past few years because of the diversion of funds from savings accounts, their being saddled with a sizable portfolio of relatively long-term low-interest mortgages, and their need to pay higher rates to depositors. 58/ As already noted, 1980 and 1982 legislation was designed to help these thrift institutions in particular, but how much and when their profitability will improve remains uncertain. Fundamentally their profitability depends on the spread between loan and deposit interest, which can be expected to improve with lower interest rates.

58/ U.S. Library of Congress. Congressional Research Service. Commercial Banks, Thrift Institutions and Their Federal Insurance Funds: Selected Charts Illustrating Financial Conditions [by] William Jackson. Washington, D.C., March 24, 1982. p. 7-8, 10-11, 15-16.

The evidence on banks is more ambiguous. This is, of course, in part due to the broad spectrum of commercial banking institutions in the nation, ranging from giant banks, the ten largest of which on June 30, 1982, had deposits ranging from $24 billion to $96 billion, to small local banks in rural communities.

On the one hand, bank-like functions have been increasingly assumed by non-banking institutions, as the above section on conglomerates in particular points out. There has been a substantial public preference shift away from bank accounts to money market funds and other forms of investment. There have been a few well-publicized bank failures and, recently, more reports of potential banking difficulties due in part to the recession and in part to loans to foreign countries, especially to some of the larger less developed countries that are facing serious economic difficulties and debt problems, such as Mexico, Brazil, and Argentina. 59/

On the other hand, there is much evidence that the banking system is strong and profitable. Bank earnings have grown during the past two decades more than earnings in the industrial sector on a percentage basis, and have in fact outpaced inflation during this period.

In spite of being more heavily regulated in some respects than their close competitors, commercial banks, as noted by William Ford, president of the Federal Reserve Bank of Atlanta, "have--in reality--outperformed Sears, the stockbrokers, property and casualty insurors, the thrifts, and most of their other most feared competitors." 60/

59/ See, for example: Rowan, Hobart. Nine Major Banks Highly Exposed on Third World Loans. Washington Post, October 24, 1982. p. F1, F6; U.S. Library of Congress. Congressional Research Service. The Stability of the International Banking System [by] Arlene Wilson. Washington, D.C., 1982. (Issue Brief No. 82107); and U.S. Library of Congress. Congressional Research Service. Mexico: Current Debt and Devaluation [by] Patricia Wertman. Washington, D.C., 1982. 9 p.

60/ Ford, William F. Banking's New Competition: Myths and Realities. Economic Review (Federal Reserve Bank of Atlanta), January 1982. p. 11.

Standard & Poor's Industry Surveys' Basic Analysis for Banking, dated July 29, 1982, states: "Commercial banks for the most part are faring quite well under deregulation, demonstrating their ability to cope with and adjust to highly volative interest rates and equally volatile money markets, as well as their flexibility in meeting new challenges." Bank credit cards have grown faster than proprietary cards of individual stores, oil companies, etc.

The extent of the drain of money market funds on the banking industry is uncertain. However, again quoting William Ford, "it is entirely possible that the money market funds are putting more money into the banking system by purchasing CD's and bankers acceptances of the larger banks than they are taking out of all of the banks." 61/

From the point of view of the individual saver, the increase in options for his savings and the increased ease with which he can transfer funds from one financial instrument or institution to another and in and out of savings appears to be a major plus. This increase in options has had as a by-product a substantial increase in consumer sophistication about money matters and heightened sensitivity to interest rate changes and relative risks of various kinds of investment.

There are, however, offsetting considerations that need to be taken into account. The proliferation of choices may result in periods of confusion and uncertainty, and perhaps open the door for less scrupulous dealers and institutions. More significant, at least in the opinion of some, are the increasing risks which have accompanied this period of innovation and increased competition among financial institutions. As this increased competition narrows profit margins, it may well lead institutions to accept greater risks than they

61/ Ibid., p. 8.

otherwise would. Greater risks may also be taken as a result of fluctuating interest rates. It also follows that the financial innovations of the past decade make more difficult the ability of the Federal Reserve System to exercise a moderating or restraining monetary policy without provoking financial crises or severe recessions. Finally, as Lyle Gramley has pointed out:

> The risks stemming from financial innovation have spread beyond financial institutions to the nonfinancial sectors of the economy. Interest rates in the U.S. economy have been more volatile in recent years--partly, in my judgment, because innovation has affected the way financial markets function. Interest rate movements have also become less predictable. As a consequence, banks and other lenders are seeking to avoid, or at least to minimize, interest rate risk--risk that they once accepted willingly. In the process, they have shifted the risks of fluctuating interest rates to other sectors, which may be less able to bear them. Futures markets for financial assets may help eventually to shift the burden of interest rate risk to those most willing and best able to bear it, but those markets are not as yet well developed. 62/

Further speculation on the future of the financial revolution that has been central to this report will not be attempted here. We may only say with some confidence that the turmoil that has afflicted virtually all financial institutions in the past decade cannot be expected to subside, given the ongoing worldwide forces of technological and economic change that will unavoidably have a major impact on the way financial transactions are undertaken and on the actors on the financial stage.

62/ Gramley, Lyle E. Financial Innovation. p. 400.

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