FINANCIAL DEREGULATION: CURRENT STATUS AND LEGISLATIVE ISSUES

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ISSUE DEFINITION

Federal and State laws provide the framework for the regulation of depository financial institutions (commercial banks, savings and loan associations, mutual savings banks, and credit unions). In the past two Congresses, two massive pieces of legislation affecting the regulation of depository institutions have been enacted: P.L. 96-221, the Depository Institutions Deregulation and Monetary Control Act of 1980, and P.L. 97-320, the Garn-St Germain Depository Institutions Act of 1982. Together they encompass the most sweeping regulatory changes for depository institutions since the 1930s. They point to a significant new direction for the regulation of financial services -- toward more reliance on marketplace forces as a self-regulatory mechanism than was previously the case. Questions of interest to the 98th Congress include how deregulation is working, and what policy issues it raises. This issue brief reviews deregulation to date and its effects on financial markets. Current policy issues are also identified.

BACKGROUND AND POLICY ANALYSIS

What is Deregulation, Why Has It Occurred, Why Is It Important?

Financial deregulation may be defined as the "loosening of regulatory constraints" on depository institutions. Major deregulation has occurred both by actions of regulators and legislators these past few years. This has given depository institutions more flexibility to determine their own pricing schedules, both for deposits and loans, and has provided them with greater latitude to determine the mix of deposit, lending, and fee-producing services they wish to offer.

Regulation stems from the importance of depository institutions as holders of savings and providers of credit, as well as their role in channeling funds throughout the society. The process of regulation recognizes the importance of a smooth functioning financial system to the Nation's economy. Since the 1930s, depository institutions have been heavily regulated on both the Federal and State levels, not only with regard to services and prices but with regard to organizational arrangements as well -- entry and branching, for example.

The high interest rate environment, technological developments, and increasing competition from less regulated institutions have all contributed to the decision to deregulate because it was widely felt that the regulatory system in place was too rigid to give depository institutions the ability to adapt readily to change. The recent financial problems of some types of depository institutions are widely attributed to this combination of circumstances. Deregulation attempts to provide a new balance between providing for market efficiency and assuring the safety and soundness of the financial system.

How to effect deregulation, keeping in mind the various and sometimes conflicting regulatory goals, is a difficult task. The deregulation of deposit interest rates now in progress illustrates this point. Loosening constraints on deposit interest rates became a major focus of deregulation because of savers' demands for interest rates approximating market rates.

The resulting deregulation has benefitted savers in this regard. However, it has posed a dilemma for institutions. Paying higher rates enables depository institutions to attract funds, thereby contributing to the liquidity and market share of depository institutions -- which, in turn, contributes to their long term viability. But, raising the costs of doing business also adds to operating costs. The higher operating costs can cause problems that may overwhelm institutions in the short run.

One means of assessing deregulation is to look at its effects on savers, borrowers, and institutions. Deposit deregulation, because it is a matter of particular interest at the present time, is emphasized below. Since deregulation is a continuing process, the legislative issues section of this issue brief identifies some of the questions relating to deregulation that the 98th Congress may wish to consider.

What Has Deregulation Meant to Depository Institutions and Their Customers?

Impact on savers: Over the short run, individuals have found that deregulation has meant higher rates of return on savings. It has also meant more choices, both as to savings instruments and institutions in which to place savings. This increased choice has created confusion as well as opportunity. The diversity of savings alternatives means that savers must acquire a greater degree of financial sophistication than was required earlier if they are to make intelligent decisions about how to place their funds.

The recent introduction of Money Market Deposit Accounts (MMDAs), a form of savings account, and Super NOW accounts, a hybrid savings and checking account, illustrate these various effects. P.L. 97-320 authorized the establishment of what have become known as MMDAs to be "directly equivalent to and competitive with" money market mutual funds. Following enactment of the legislation, the Depository Institutions Deregulation Committee -- the regulatory body established by P.L. 96-221 to administer deposit interest rate deregulation -- wrote regulations for the accounts and permitted them to be offered by depository institutions effective Dec. 14, 1982. Almost simultaneously, the Depository Institutions Deregulation Committee authorized the Super NOW account, a variant of the MMDA, effective Jan. 5, 1983.

The introduction of the new forms of accounts enhances savings opportunities. The MMDAs are intended to be competitive with money market mutual funds which had attracted substantial amounts of new monies during the past 2 years because of features of the accounts that could not be matched by depository institutions. Typically, money market mutual funds offer liquidity, fairly low minimum denomination requirements for investment, rates of return near market interest rates, and money transfer services. They are exempt from reserve requirements, interest rate ceilings, and other regulations applicable to many types of depository institution accounts. By November 1982, just prior to the introduction of MMDAs, individuals and institutions had almost 13 million accounts totaling over $230 billion with money market mutual funds. Since then, however, balances had dropped to approximately $182 billion for the week ended Mar. 30, 1983.

MMDAs match many of the features of money market funds. In fact, they have two important characteristics that favor depository institutions over money market funds. First, MMDAs are generally covered by Federal deposit insurance whereas money market funds are not; secondly, depository institutions may offer rates guaranteed up to one month whereas money market fund rates change daily depending on the experience of a fund with its investment portfolio. However, many money market funds continue to require lower opening and minimum balances than those required for MMDAs, which are set by regulation at $2,500.

At the same time, the plethora of accounts, and the variety of terms and conditions they may have, can contribute to a saver's confusion. The individual account holder must be aware of details of the account structure to receive maximum benefit from it. For example, a depositor must be aware of possible charges or penalties -- typically applied when an account balance falls below the required minimum -- when evaluating possible costs and benefits of a particular type of account. The interest on an account paying a high rate of return is soon diminished if account charges are levied.

How will all this come out? Ultimately, much of the confusion will resolve itself as customers declare their preferences for certain types of accounts. Already, the popularity of MMDAs and Super NOW accounts is demonstrated by the fact that by mid-March 1983, balances in MMDAs totaled almost $319 billion and in Super NOW accounts about $26.6 billion. These balances reflect both funds transferred from other types of accounts at depository institutions and funds new to the institutions.

In addition, the Depository Institutions Institutions Deregulation Committee is continuing its deregulation mission. Currently, for example, it is considering proposals to proceed with faster deregulation than scheduled earlier and/or to simplify regulations on existing accounts. However, until deposit deregulation is completed, the confusion as well as the opportunities it is creating will undoubtedly continue to raise vexing problems. (For more information on actions of the Depository Institutions Deregulation Committee and about money market mutual funds, see CRS archived issue brief 81130 and CRS issue brief 81057.)

Impact on borrowers: Many of the elements of deregulation for loans are the same as for deposits -- higher interest rates, as well as more choice of debt instruments and institutions from which to seek particular types of loans.

The results are likely to be less favorable for certain classes of borrowers. This is especially the case with regard to mortgage loans. By the 1970s, savings and loan associations' holdings of residential mortgage loans totaled over 50% of the amount outstanding in the private market. The high percentage was encouraged through regulatory arrangements then in existence. Individuals could obtain a mortgage at a reasonable price, since, among other reasons, savings and loan associations' cost of funds was held down by deposit interest rate ceilings. In effect, savers were subsidizing borrowers.

Now, with deregulation, housing is a much less protected sector. Thus, borrowing to buy a house is likely to cost more, relative to other market interest rates, than used to be the case. New methods of financing are being developed to help individuals cope with the high cost of home ownership and various types of financial institutions are more active in mortgage finance than earlier; nonetheless, it can also be expected that this new situation will deter some home purchases that depend on mortgage financing.

At the same time, deregulation should free up funds for other purposes; in the aggregate, therefore, the borrowing mix is expected to change.

Impact on institutions: Ultimately, deregulation is intended to stabilize the financial condition of depository institutions, primarily by allowing them to diversify their activities. Removing regulatory constraints is intended to give institutions the flexibility to adapt their businesses successfully to changing conditions as circumstances require.

Even so, some institutions are having difficulty surviving the transition period. Greater competition, as well as the weak financial condition in which some institutions find themselves, are leading to consolidations. Since the beginning of 1981, for example, the number of savings and loan associations has declined by almost 17%, from approximately 4,600 to slightly more than 3,800 institutions (end of January 1983 data). Many small banks are also choosing to merge rather than continue to operate independently in the new, more competitive environment.

Deregulation is also decreasing the specialized nature of the institutions. Savings and loan associations, for example, will now be able to offer a range of consumer and commercial services rather than be restricted to the mortgage-related services which they have traditionally offered. At the same time, commercial banks, credit unions, and non-depository institutions such as Merrill Lynch & Co. Inc. are becoming more active in the mortgage market. More non-traditional providers of financial services such as Sears, Roebuck and Co. are also expected to be increasingly active in the financial industry.

When the transition period is completed, we are likely to have a more homogeneous financial system than exists today. Fewer institutions are likely to exist. By that same token, the remaining institutions will probably be larger and cover wider geographic areas than is now the case.

LEGISLATIVE ISSUES

The rapid changes under way in the financial system as a result of deregulation will mean that the 98th Congress may wish to maintain oversight of these developments, especially as they affect deposit and credit flows, and the financial condition of depository institutions.

Deregulation also suggests several questions about regulatory control, which can be expected to be of congressional interest. For example, deregulation has raised the question of whether the Federal deposit insurance system should be changed. Currently, all institutions of a like kind pay fixed insurance premiums. Yet, with deregulation, they will experience different levels of risk depending on the kind of loan portfolios and funds-gathering strategies they choose to employ. Recognizing this, P.L. 97-320 provides for studies of the insurance mechanism by the Federal insurance agencies. Options to be explored include variable insurance premiums based on risk, additional insurance coverage for large depositors, and even greater protection for small depositors relative to large depositors. The Federal insurance agencies are to report on their studies to Congress by Apr. 15, 1983.

As depository insitutions have become more alike, renewed interest has been expressed in proposals to restructure the Federal financial regulatory agencies either through consolidating them or realigning functions among agencies. Questions of this kind are being examined by the Administration's Task Group on Regulation of Financial Services, headed by the Vice President. This task group was formed in December 1982 and expects to submit recommendations concerning the financial regulatory structure within 6 to 9 months.

In addition, deregulation of deposit accounts is of interest as it is affecting the conduct of monetary policy by the Federal Reserve. The shifting of deposit funds among various types of deposit accounts as new account forms are introduced has provided the Federal Reserve with short term problems in monetary control. Such shifts are currently distorting M-1, the narrowly defined money supply, making it difficult to interpret the significance of its growth path. It is unclear how much of the recent growth in M-1 represents changes in people's spending intentions and how much simply represents shifts of savings balances to newly available account forms. In turn, this is causing adjustments in the Federal Reserve's monetary policy operating techniques. M-2, a broader measure of the money supply, has also experienced exceptional growth since the introduction of money market deposit accounts. Financial deregulation is therefore of interest in connection with the Federal Reserve's periodic reports to Congress on monetary policy.

Congress may also examine whether more deregulation is desirable. The Glass-Steagall Act continues to separate commercial and investment banking. In the 97th Congress, the Senate Banking Committee debated whether the restrictive language of the Act should be relaxed, although no action was taken. Members of the committee indicated they would reexamine the issue in the 98th Congress.

The regulation of commercial banking organizations may also be affected by developments in the international monetary system. For information on the international banking situation, see CRS issue brief 82107.

LEGISLATION

96th Congress

P.L. 96-221, H.R. 4986

Depository Institutions Deregulation and Monetary Control Act of 1980. Facilitates the implementation of monetary policy, provides for the gradual elimination of all limitations on the rates of interest which are payable on deposits and accounts, and authorizes interest-bearing transaction accounts, among other purposes. Enacted Mar. 31, 1980.

97th Congress

P.L. 97-320, H.R. 6267

Garn-St Germain Depository Institutions Act of 1982. Revitalizes the housing industry by strengthening the financial stability of home mortgage lending institutions and ensuring the availability of home mortgage loans. Enacted Oct. 15, 1982.

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