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Financial Deregulation: It's Been Good for Us, But What Has It All Been About And, Is It Over?

By John O. Bornhofen

Financial deregulation could turn out to be a will-o'-the-wisp. By the time, many figure out what is happening, it could be over, and there could be talk of reregulation. Let's look back to see what financial deregulation was, why it occurred, and what is left.

Only ten years ago, if you wanted a safe, relatively liquid, interest-bearing asset for reserves, you went to your local bank or savings and loan association and received 5 or 5.5% in a passbook savings account. Now, however, there are any number of financial institutions with which to deal, and there is a large array of possible instruments, each with its own interest rate.

A number of forces have converged on the banking and financial systems in the last 10-15 years, and while they often go under the rubric "deregulation," deregulation was really the follower of these events rather than the leader. Deregulation meant that the Federal government and its agencies loosened control over depository financial institutions (DFI's) such as commercial banks and thrift institutions (savings and loans and mutual savings banks) and allowed them to engage in business practices that they were not authorized to do before—setting price structures, raising funds from different sources, developing new "products" and moving into different markets.

Prior to these developments, banks and thrifts had been among the most regulated businesses. For the past ten years or so, however, this has been changing. Why did the government loosen its grip on what DFI's could or could not do? Power is not given up lightly.

Why Deregulation Happened

It was not out of the goodness of their hearts that government bureaucrats finally said, "Let the market do it." It was a set of circumstances that came together and brought home that message. What were these circumstances?

The forces that brought about the massive change we have seen in the financial system, and that we loosely refer to as deregulation, were the products of the 1970's and early 1980's: high and ris-

ing inflation, high and volatile interest rates, technological change, institutional change, increased competition, and increased financial sophistication on the part of consumers. To be sure, one could argue that the increased financial sophistication was brought about, to some extent, by the other forces—was, indeed, made necessary by them. Nonetheless, these other influences were very real and very powerful.

Throughout the post-war period, computers, perhaps the epitome of technological change, were improving rapidly in capacity and speed and declining in price. Their impact was increasingly felt in the financial system, where the need was heaviest for the ability to store large

This volatile, unprecedented inflation brought about and was mirrored in similar behavior in interest rates. Treasury-bill rates rose from 5% in early 1977 to over 15% in 1980. After falling back sharply to 7% for a very brief period in the mid-1980's, Treasury-bill rates peaked at over 16% in 1981.

As if the volatility of interest rates (and of stock and bond prices, for that matter) wasn't enough, much of the period since the late 1960's on saw interest rates on highly liquid, short-term, safe securities, like U.S. Treasury bills exceed the maximum rates the Government agencies allowed the banks and thrifts to pay on savings accounts. At times, the margin was ten percentage points. Those max-

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amounts of data and swap it between accounts. This development eventually led to the introduction of accounts at DFI's, whereby depositors maintained zero balances in their checking accounts until checks were presented for collection. At that point, the computer moved the depositor's funds out of interest-bearing savings and into the checking account in the right amount at the right time to cover checks presently against the account. This was the NOW account—Negotiable Order of Withdrawal account. It was, in fact, an interest-bearing checking account. It was something that banks had not been legally able to offer since the Banking Act of 1935. This development made some deregulation inevitable.

The Inflation Roller Coaster

But there were other forces at work as well. Inflation, for instance, increased to over 12% in 1974, then fell to 4.8% in 1976, and accelerated back up to over 13% in 1979. It has since fallen to less than 4%. This inflation roller coaster brought about massive change in the financial system as well as in other parts of the economy as people attempted to protect their assets and incomes from being ravaged.

imum rates became known as Regulation Q because they fell under the Federal Reserve's Regulation Q.

The high money market rates, formerly available only to big investors, prompted small savers to get a piece of the action. As expected, the market responded. Not only did new types of deposits and securities appear but new institutions emerged as well. Money market mutual funds came on the financial scene and provided savers with convenient, safe, liquid ways to earn the high rates on T-bills, certificates of deposit, commercial paper, and other short-term securities, which heretofore small savers otherwise couldn't touch due to the high denominations involved (usually \$100,000 and up).

From Savings Accounts To Money Market Accounts

Not surprisingly, savers reacted to the high rates and new alternatives by pulling funds out of low-yielding savings accounts in DFI's in droves. This became known as "disintermediation," and it occurred every time market interest rates went significantly above the Regulation Q ceiling rates. A major part of these

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withdrawals went to the "money funds." Balances in money-market funds shot up from less than \$4 billion in 1977 to well over \$200 billion in 1982. Finally, the complaints of banks and thrifts were heard by the regulators, and in 1982 they allowed the DFI's to offer their own brand new Money Market Deposit Accounts (MMDA's) on which they could pay the higher market rates and attract deposits. That deregulation was in the form of a new Federal law—the Garn-St. Germain Act of 1982. Balances in MMDA's promptly went from zero in August 1982 to over \$320 billion by the end of March 1983—a massive consumer response to the most successful financial innovation ever. The 1982 Act also authorized savings and loans to accept deposits from, and make loans to, businesses, and it allowed the thrift institutions to increase their consumer lending.

The gyrations and record levels of interest rates alarmed consumers and businesses alike, and by the time the prime rate passed 19% in late 1979, almost everyone, both in and out of government, decided that something had to be done. What had to happen, among other things, was deregulation. This process of financial reform that had been in progress for several years culminated in the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA). DIDMCA was the most massive change in our financial structure since the banking reforms of the early 1930's. Among other things, it mandated the phasing-out of all interest rate ceilings on all deposits at DFI's by April 1986. It authorized NOW accounts on a nationwide basis for all DFI's. And it pre-exempted or wiped out state usury laws on consumer-type and mortgage loans unless the states affected specifically re-enacted the laws. And there was still more deregulation.

In 1983, interest rate ceilings were removed from the rest of the time deposits at DFI's, and super NOW's came in. The latter carry market rates and have unlimited checking privileges but can have relatively high minimum balances.

Competition in the Market

Another force working for deregulation at times, but resulting from deregulation at other times, was increased competition in the various financial markets. Other companies invaded the banking field. The cash management account (CMA) at brokerage firms is a prime ex-

ample. Soon, banks decided they too wanted to be brokers, as did S & L's. Then some S & L's decided to become banks, and some banks wanted to acquire insurance companies. It seemed that every financial institution wanted to offer every financial service, a far cry from the days when only banks issued checking accounts and made unsecured business loans, and S & L's issued only savings accounts and made home mortgage loans. And that wasn't all. Non-financial companies wanted a piece of the financial action. Sears got into brokerage, and a steel company got into banking. In short, the financial players all wanted to play in each other's back yard.

The next big move was to open up shop in someone else's market, sometimes even crossing state lines—another taboo that banks and S & L's had lived with for years. The regulatory restraints on interstate banking started to crumble, a process which is still going on.

The factors we have cited have forced massive change on the financial system—in fact, the largest since the cataclysmic changes that took place after the collapse of the financial system in the early 1930's in the early years of the Depression. Then, in response to the thousands of banks and other financial institutions that went under, Congress enacted laws and formed agencies and programs to correct the problems that supposedly led up to the crash, and to prevent its reoccurrence.

Summary of Change

Eventually, it was these reforms that put the DFI's into the straitjackets that finally were broken a half century later by the forces cited above: high and volatile inflation and interest rates, technological change, increased competition, and institutional change. In time, the banks and thrifts found that they had to avoid and circumvent government regulations or be left behind to stagnate. The combination of these events forced the hand of the government regulators, and what unfolded was deregulation.

The reduction in the heavy hand of government regulation came sporadically and in several forms. There was deregulation of pricing, of products offered, and of entry into geographical markets. Pricing deregulation means the removal of many of the interest rate ceilings DFI's paid on deposits and charged on loans. Although some state usury laws still re-

main, all Federal interest rate ceilings were done away with in April 1986. Individuals can now receive, and pay, rates set by the market rather than by government agencies.

The products of DFI's are primarily the types of loans they make and the types of deposits they accept. While banks have had wide asset powers for years and have made most kinds of loans—from consumer loans, to business, agricultural, and security loans—the thrifts, especially the S & L's, had very restricted loan powers. That has now changed. They too can make many types of consumer and business loans as well as their traditional fixed-rate home mortgage loans. In some states, S & L's have wider asset powers than do commercial banks.

On the deposit side, there have been changes too. Both kinds of DFI's can now offer many types of deposits that didn't exist a dozen years ago. Today there are Negotiable Order of Withdrawal, NOW accounts, Super-NOW's, MMDA's and time deposits with numerous maturities up to eight years and more. The thrifts can also now offer checking accounts to the public.

Geographical and market deregulation has come more slowly and more sporadically than the other types, but it has been equally complex. Many of the geographical and market entries have been through merger, whereby a bank or S & L in one state buys a bank or S & L in another state. But the action hasn't been limited to mergers among like institutions. Banks have acquired S & L's and S & L's have acquired banks, and both have been acquired by companies that are neither banks nor thrifts.

The Future of Deregulation

There is one strand left in the fabric of deregulation. That is nationwide banking. The odds are that we will see Citibank and the offices of other out-of-town banks in west Michigan in a few years. Aside from that, the types of deregulation that were possible have occurred.

The cycle of deregulation is not over, however. We are seeing increased bank and thrift failures due to excesses, poor judgment, adverse markets, and the like. While some of that was to be expected, it may also mean that deregulation may have gone too far. But that's another story.