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IMPACT OF REGULATION ON ECONOMIC BEHAVIOR

Accelerating Inflation, Technological Innovation, and the Decreasing Effectiveness of Banking Regulation

EDWARD J. KANE*

IN THE U.S. and other countries, experience indicates that bank managers who are left to their own devices energetically pursue opportunities to diversify their firm's activities and to increase its' asset size.¹ Both to tax and to stabilize the financial system and to make it hard for large banks to monopolize various kinds of local and national markets, state and federal officials have traditionally imposed restraints on individual-bank efforts to grow and diversify. Authorities have focused their efforts particularly on reducing individual banks' capacities for deposit-gathering and for taking over other firms. Since the early 1960s, such restraints have grown increasingly less effective. This paper attempts to explain why. It also discusses why in 1980 opportunities for deregulating banking markets are finally being seized.

Our explanation proceeds within the framework of the *regulatory dialectic* (Kane [1977]). This concept embodies an interpretive vision of cyclical interaction between political and economic pressures in regulated markets. It treats political processes of *regulation* and economic processes of *regulatee avoidance* as opposing forces that, like riders on a seesaw, adapt continually to each other. This alternating adaptation evolves as a series of lagged responses, with regulators and regulatees seeking to maximize their own objectives, conditional on how they perceive the opposing party to behave.

Market institutions and politically imposed restraints reshape themselves in a Hegelian manner, simultaneously resolving and renewing an endless series of conflicts between economic and political power. The approach envisions repeating stages of regulatory avoidance (or "loophole mining") and *re-regulation*, with stationary equilibrium virtually impossible. In particular, a completely deregulated state, if achieved, would almost certainly contain unexploited opportunities for an individual sector to benefit from accumulating and exercising political power. Our dialectical approach emphasizes the tensions, paradoxes, and ambiguities inherent in efforts for regulators either to impose restraints on persons and institutions that function in what is otherwise a free society or to let markets impose extraordinary hardships on groups that are politically strong.

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¹ Marris and Mueller [1980] survey research in industrial organization tending to support the hypothesis that in all industries corporate managers pursue growth and diversification, sometimes even to the detriment of stockholder wealth.

To explain the evolution of U.S. deposit institutions and markets in the 1960s and 1970s, we feed into the regulatory dialectic assumptions about the objectives of federal banking regulation and about outside forces that disturb the adjustment process. The disturbing exogenous forces are accelerating change in the technological and market environment of commercial banking and increasing uncertainty concerning the future speed of environmental change. We hypothesize that, in the face of these environmental changes, the adaptive efficiency shown on average by deposit-institution managers is greater than that shown by managers of the several competing banking agencies. Incorporating this differential adaptive capacity into the regulatory dialectic helps us to understand how increases in the pace of environmental change and in the degree of environmental uncertainty led regulatee responses to come more quickly and regulatory responses to come more slowly. The bottom line is that, when the environment changes rapidly and becomes more uncertain, traditional forms of U.S. banking regulation can be overwhelmed by technological and regulation-induced innovation.

1. Traditional Forms of U.S. Banking Regulation

Banks compete for financial contracts to borrow and to lend. In accumulating asset and liability contracts, banks act essentially as arbitrageurs. Their business consists of borrowing funds to lend them out again at a higher interest rate.

Net spreads between bank borrowing and lending rates survive in equilibrium to reward banks for two types of pooling services they perform (Gurley and Shaw [1960]). First, a bank arbitrages transactions costs by cumulating small-denomination deposit and nondeposit liabilities into sums that can be invested economically in the large-denomination securities that trade in organized capital markets. Second, because securities are imperfectly divisible, a bank provides diversification services to its depositors, debtholders, and stockholders. It allows them to participate indirectly in a large diversified portfolio of loans and securities in which pooling diminishes the effective risks of individual investments. In addition, when the intermediaries choose to borrow *via* instruments whose maturities are longer or shorter than the assets on which they lend, allowances for interest-rate risk come into play as well.

Bank regulators close off selected contract opportunities either by direct prohibitions or by balance-sheet and interest-rate restrictions. The restraints abridge opportunities for profit, asset growth, and diversification open to an expansion-minded domestic banker, much as burdening an athlete with weights or shackles would reduce the accomplishments he could achieve in a competitive sport.

Over the years, the thrust of U.S. banking regulation has changed from merely discouraging unsafe banking practices and policing abuses to differentially handicapping broad classes of banks to benefit politically powerful competitors or customers. Although targeted beneficiaries are usually economically disadvantaged in some way (as, e.g., very small deposit institutions), this is not always the case. Traditionally, the beneficiaries of banking regulation were existing competitors (Stigler [1971]). However, during the 1970s, and largely as a reaction to discrimination fostered by traditional forms of regulation, customer-oriented

regulations mandating that banks engage in “fair credit practices” moved strongly onto the scene.

Traditional forms of banking regulation constrain strategic elements in deposit-gathering and interpose barriers to bank entry into “nonbanking” activities. Traditional regulations limit means for entering or expanding operations in particular markets, often in the hopes of preventing specific financial-contract opportunities from being arbitrated away from politically favored firms. Formal regulations have focused on restricting a bank’s access to the following strategies for asset growth and diversification:

1. Expansion in the geographic area spanned by office locations
2. Expansion through merger or *de novo* entry into related and unrelated lines of business
3. Expansion through price competition for deposits.

Early efforts to limit individual-bank access to the first two strategies for expansion took the form of prohibitions on specific activities and restrictions on merger activity and on the number and locations of a bank’s branch offices. State laws limit the number or locations of branches operated by banks organized in each state, while the 1927 McFadden Act prohibits interstate branching. Bank mergers are governed by federal antitrust statutes enforced by the Justice Department (which apply as well to holding-company activity) and by Bank Merger Acts of 1960 and 1966 administered by the federal banking agencies.

Because the bank-holding-company form offered opportunities for inexpensively circumventing restrictions on bank mergers, branching, and diversification into nonbanking lines of business, the Banking Act of 1933 eventually brought bank holding companies (BHCs) under the federal regulatory umbrella. In 1956, 1966, and 1970, further legislation extended the boundaries of BHC regulation. Since 1956, BHCs have been forbidden to establish or acquire banking subsidiaries located in a different state.

Explicit price competition for deposits is regulated directly through interest-rate ceilings and indirectly through the imposition of balance-sheet requirements (especially, reserve and capital requirements). These restrictions shift the focus of competition to exempt institutions and contracts and from explicit to implicit methods of competition. Interest ceilings and balance-sheet requirements may be interpreted as a 100-percent tax levied on the income a bank would have earned in the absence of the regulation (Posner, 1971). As any other tax, the level and structure of statutory rates are ultimately shaped by political opportunism and by pressure to correct horizontal and vertical inequities. In virtually every case, political activity ultimately results in a differentiated structure of requirements. Once they are in place, differential rates of implicit taxation establish economic incentives for banks and their customers to renegotiate pre-existing contracts to reclassify them from instruments whose implicit tax rates are burdensome to forms that are taxed less heavily.

2. Innovation as Arbitrage

Distinguishing between invention and innovation helps to clarify that regulatory avoidance merely enforces a higher form of law: the Law of One Tax-Adjusted Price. Invention is the act of finding new ways to do useful or profitable

things—usually cheaper and more efficient ways of doing them. Innovation is the act of putting an invention into practice. Invention is a technical or scientific activity; innovation is an implementation of some business decision. Every invention makes one or more innovations feasible, but we can always identify an *innovation lag*. Before an invention can be adopted commercially, the opportunities it opens up must promise enough profits—after making allowance for applicable implicit and explicit taxes—to counterbalance the costs of overcoming institutional inertia and the management and employee resistance typically associated with changing established ways of doing things.

The burden of bank regulation increases the rewards for doing things differently *per se*. Whether or not a particular innovation is technically advantageous, rearranging a bank's formal organization (e.g., through affiliating with a holding company) or its product lines tends to render obsolete particular elements and concepts of pre-existing regulation. For this reason, regulating an industry tends to reduce its innovation lags, while ongoing acts of innovation tend to lengthen and exploit parallel *regulatory lags* that develop as regulators contemplate the unexpected problems created by specific innovations and decide what (if anything) to do about the situation.

In an *unregulated* firm, an innovation can only be justified by its *technical productivity*. Until an invention can accomplish a task more efficiently (i.e., better or more cheaply) than existing arrangements, the invention has no hope of getting off the shelf. However, in a regulated firm, an innovation can be justified as well, or even instead, by its *productivity in regulatory avoidance*: its ability to release pent-up competitive pressure. When a large number of potential competitors exist, the heavier an industry's regulatory burdens become, the more its managers become oriented toward change, rather than resistant to it. Innovations may be searched out eagerly and adopted in full awareness that they are now, and will probably long remain, technically inferior to pre-existing arrangements.

Regulation-induced innovation is a predictable economic response to attempts to use legal force to change market solutions. We can liken the evolutionary interaction of political and economic activity to a struggle between a visible and an invisible hand to determine the shape of a clay statue. Far from acting in concert, the two hands work almost completely at cross-purposes. Each hand sets out to undo what the other has just accomplished. The invisible hand is the marketplace and the visible hand is that of regulatory activity. Regulation seeks to "carve" (i.e., to impose) visible burdens on particular sectors to promote identifiable ends. The goals of U.S. banking regulation themselves have evolved from primarily prudential ones (safety, soundness, and integrity) to increasingly protective ones (to aid politically strong sectors who may or may not also be economically weak).

It is easy to see why regulators' intentions are seldom realized in full. Regulated sectors' opportunity sets include unexplored opportunities for reducing or circumventing the burden regulators intend to impose on them. Hence, any new regulation kicks off an immediate search for feasible avoidance or circumvention activities. As the word circumvention etymologically implies, individual regulatees and unregulated competitors "blow around" new regulations, much as a football team with a strong running game might blow around a weaker football team's defensive line.

In banking markets, circumvention typically occurs by acts of *product substitution* no more imaginative than installing parallel but formally different production processes and relabeling regulated products. Because legal obligations may be defeated by relying on implicit distinctions, regulated firms and their competitors have only to substitute unregulated (or less regulated) ways of serving their markets for ones on which applicable regulations have become excessively burdensome. In banking, this can often be accomplished by rearranging operative financial contracts or systems for delivering services.

Demonstrating that the Law of One Price has greater force than banking regulations, U.S. banks and competing institutions (including U.S. offices of foreign banks) have developed a host of regulation-induced substitutes for traditional elements of banking operations: intrastate branch offices; interstate branch offices; explicit interest; checks; deposit accounts; equity capital; loans; and reserve balances at the Fed. Table 1 lists prominent substitutes for each of these traditional constituents of banking operations.

3. Accelerating Inflation, the Computer Revolution, and Avoidance Incentives

Banking regulation is a form of taxation. When the costs of avoiding traditional forms of regulations are low, regulatory intentions are easily frustrated. In the 1970s, loophole mining and fabrication became the main business of modern depository institutions (Kane [1979]). It was the main avenue left along which bankers could exercise old-time yankee ingenuity. Their innovative behavior stands as a convincing contemporary manifestation of the can-do spirit that made our country great.

Managerial substitution is altering the face of contemporary banking and sharply changing the macroeconomic meaning of traditional monetary aggregates. Banks and other retail deposit institutions now look far more like appliance stores than sturdy treasure houses. During the last two decades, our "money stores" turned increasingly to barter. Bank windows became full of ads and displays promising tableware, cooking utensils, radios, TV sets, luggage, and even discount coupons redeemable at local department stores. Bank advertisements seldom mentioned anything as old-fashioned as differences in explicit interest. One wonders whether even a burglar could collect much money plying his craft at such an institution.

During the same interval, institutional balance sheets also changed drastically. With each passing year, regular passbook accounts constituted a smaller and smaller percentage of total assets. For S&Ls, the percentage has fallen from 77 percent in 1968 to below 25 percent today. The trend is even sharper for large S&Ls in California.

These and other changes in the nature of the S&L and banking business are the unintended consequences of regulating deposit-institution activities, prices, and office locations, in the face of accelerating inflation and ongoing revolutions in communications and information processing. Accelerating inflation is important because, by raising nominal rates of interest, it tends to increase the opportunity-cost *burdens* associated with pre-existing regulations. Exogenous technological change is important because it lowers the marginal *costs* of avoiding regulatory burdens. With the marginal benefits of avoidance activity rising while

Table 1

Selected Substitutes for Regulated Banking Activities, Contracts, and Organizational Elements Developed by U.S. Banks and Competing Institutions

Regulated Item	Bank Substitutes	Substitutes Available <i>Only</i> from Competitors
1. Interstate branch office	a. BHC bank affiliates established in another state before 1956 b. Nonbank BHC subsidiaries i. Wholesale banking operations: Edge Act affiliates; loan-production offices; leasing companies ii. Retail banking operations: finance companies, industrial loan and investment companies	Establishment of multistate branches by foreign banks
2. Intrastate brick-and-mortar branch	Bank subsidiaries; off-premises EFT terminals; telephone and cable connections to customer premises; mobile offices	
3. Bank mergers	BHC affiliation	Acquisitions by foreign banks
4. Prohibited activities	Nonbank BHC subsidiaries, e.g., service corporations, mortgage-banking companies	
5. Interest payments in cash	<i>Implicit interest</i> : merchandise premiums; customer-service improvements and expanded entitlements, ranging from convenience items (such as bigger parking lots, longer hours, drive-in windows, additional office locations and electronic accessibility) through preferential loan treatment and bank-sponsored social and educational activities	
6. Checks	Negotiable orders of withdrawal (NOWs), remote electronic access to deposit balances; automatic, preauthorized, telephone, or cable transfers of time or savings funds	
7. Demand-deposit accounts	a. Deposit substitutes: automatic-transfer savings accounts; NOW accounts; automatic surplus-transfer accounts linked to domestic or Eurodollar certificates of deposit (CDs) b. <i>Nondeposit substitutes</i> : automated repurchase agreements; credit-card overdraft facilities that are accessible at cash-dispensing machines or points of sale.	a. credit-union share-draft accounts b. cash-management accounts at brokerage firms; money-market funds (MMFs) with check or toll-free-telephone redemption privileges
8. Passbook Savings Accounts	<i>Financial producers</i> : "small-denomination" CDs (including 30-month CDs, various forms of money-market certificates, and CDs that pay stock-share dividends), repurchase agreements, asset participations and BHC notes; finance-company certificates; demand-deposit substitutes listed above	<i>Nonfinancial producers</i> : corporate and municipal minibonds; "investment certificates" to be sold over the counter at Sears stores; interest-bearing credit balances at utility firms; real-estate investments; bullion participation accounts; land trusts; precious metals; coins and other collectables
9. Large-Denomination Time Deposits	<i>Deposit-institution nondeposit contracts</i> (Liability Management): offshore borrowing; Federal funds; repurchase agreements; borrowing from Fed discount window; BHC debt (including floating-rate notes, rising-rate notes, and commercial paper); mortgage-backed bonds; asset participations	
10. Equity capital	Subordinated bonds and debentures; contingency reserves; sales of risky assets to BHC parent or nonbank affiliate; increased FDIC insurance limits; implicit insurance provided by government bailout activities	Mutual capital certificates
11. Loans to customers	Bank guarantees of customer notes: documented discount notes, ineligible acceptances, unconditional credit facilities	Customer issues of commercial paper
12. Reserve balances at the Fed	Balances at correspondent banks; implicit and explicit options to purchase federal funds.	

its costs declined, it should not be surprising that the unintended consequences of traditional forms of banking regulation became increasingly more important than their intended effects, both for the economy as a whole and for regulators charged with making the rules stick.

Accelerating inflation and exogenous technological change open up arbitrage opportunities for regulated institutions. Substituting innovative techniques, prod-

ucts, and organizational forms for more traditional counterparts lets regulatees increase their after-tax incomes. They can earn much the same revenues while lightening their implicit tax burdens. As an innovation spreads, the need to defend a firm's market share against invasion by successful innovators forces laggard institutions to become alert to their own opportunities for circumventing regulation. In the private sector, as the pace of innovation increases, avoidance activity tends to increase and innovation lags tend to shrink.

4. Effects of Innovation on Regulator Incentives

Regulatory agencies are maximizing entities, whose activities are subject to political and economic constraints. Niskanen [1971] hypothesizes that a government bureau maximizes its budget, subject to the constraint that it supplies on average the level and quality of service demanded by incumbent politicians. Agency leaders communicate institutional objectives and constraints to individual employees *via* a system of career incentives. Every banking innovation that even partially circumvents a pre-existing regulation confronts bank regulators with an unpleasant dilemma.

On the one hand, few bureaucrats (especially politically appointed short-timers that head most federal agencies) seek to discover yet-unfelt problems. Except in an agency's research department, until the political system demands that a problem be addressed, it merely promises to complicate the bureau's mission and absorb agency time without promising to increase budgetary rewards. The uncertain political impact and ultimate profitability of most innovations tempt regulators to tread water as long as they can get away with it. Treating each innovation as a brave and socially promising experiment that deserves a chance either to prove itself or to fail on its own is no more controversial than favoring the idea of progress *per se*. Unless a regulatory crisis threatens, officials prefer to postpone a definitive regulatory response until a large body of information accumulates. However, participation in market competition gives the institutions they regulate better access to the flow of relevant information. Finally, because banking regulators compete for clients, they must be at least mildly sympathetic to the welfare of their regulatees (Stigler [1971]). Also, in many cases, an official's post-government career prospects may lie almost entirely in the regulated industry. Federal banking agencies are disposed to overlook some side-stepping of regulatory burdens, particularly when these burdens have been unintentionally intensified by accelerating inflation.

On the other hand, regulators are also concerned with defending their bureaucratic turf. They know full well that an unchallenged regulatory circumvention rapidly earns squatters' rights. When such an innovation is eventually re-regulated, the new restrictions may be assigned to a different agency and are usually introduced gradually and made less burdensome than the regulations that had applied to pre-innovation arrangements. Although the agency could ultimately lose some budget funds, individual regulators face few penalties for letting a regulation's effectiveness erode in this way. The political system is far more forgiving of excessive delay than it is of hasty and ill-considered action.

5. Pre-existing Regulations Greatly Accelerated the Spread of EFT

Developments in computer technology, telecommunications, and information storage open up a variety of new ways to use electronic devices and connections to perform basic financial services. Because they move electronic records rather than pieces of paper (cash and checks) between transactors, these alternative delivery systems and services have come to be known collectively as electronic funds transfer or EFT.

Banker and regulator decisions about EFT must take account of economies of scale. One of the hardest questions concerns regulatory policies about the possibility of either forcing or allowing competing institutions to share the use of EFT machinery. Although EFT equipment is costly to install and maintain, it stands idle much of the time. This makes the marginal costs of additional transactions very low. Still, high fixed costs and attendant uncertainties may render these facilities unprofitable for low-volume institutions. Because of scale economies, EFT installations provide attractive opportunities for financial institutions (especially small ones) to share connections, much as telephone users in neighboring households might share a party line. Besides allowing fuller use of individual pieces of equipment, sharing can avoid socially wasteful duplication of costly facilities. However, it can simultaneously foster anticompetitive behavior.

Along with issues raised by uncertainty regarding the ultimate shape of regulatory attitudes toward sharing, decisions about whether and when to adopt EFT are complicated by technological and marketing uncertainties. Successive generations of machines have proved consistently cheaper and more capable than their predecessors. On the marketing side, merchants have been reluctant to plug customer accounts into a system controlled by another firm and households value the float and proof of payment they have traditionally received from checks.

These factors and the bankers' legendary circumspection should by themselves have retarded deposit-institution adoption of EFT. Against them, stands EFT's scope economies (i.e., economies of jointly producing an array of financial services) and its enormous loophole productivity. Since EFT makes it cheaper to process customer transactions and to centralize the resulting records, it reduces the marginal cost to banks of offering additional customer services. By extending the range of a bank's feasible product mix, EFT simultaneously opens up vast possibilities for substituting away from regulated contracts and organizational forms and for making lightly burdened categories of time and savings accounts do the work of heavily regulated checking accounts.

In combination with the holding-company form of organization, EFT is turning banking from a regional into a national industry and slowly obliterating the distinction between bank and nonbank financial activities (Eisenbeis [1980]). The alphabet soup of BHCs and EFT is making physical distance an increasingly less effective barrier to banking competition. The resulting geographic and product diversification is changing the functional structure and integrative strategy of the typical banking firm, multiplying the operative levels of supervisory authority (Caves [1980]). In substituting capital for labor, bank use of EFT is changing importantly the nature of the productive process itself. First, it is raising the average skill level of bank employees. Second, it is moving transactions accounting

and interest computation for loan and deposit accounts from a discrete-time batch-processing pattern to a continuous-flow technology.

6. *Emerging Patterns of Re-regulation*

Just as regulation calls forth regulatee avoidance, circumvention activity generates political pressure for re-regulation. This third stage in the original process becomes simultaneously the first stage in a fresh cycle of regulation and avoidance.

Re-regulation occurs because the political coalition that sponsored the regulation and the regulators required to act in their stead inevitably become aware of developing circumvention. This awareness leads them to examine possibilities for controlling each and every new-found substitute for the activities originally targeted for regulation. By what we could call the principle of revealed political preference, no regulation can be installed in a democracy unless its avowed purposes receive the political support of an effective majority. An "effective majority" need not also be a numerical majority. It needs only to command a majority of votes in the forum where regulatory choices are made. Often the pivotal forum reduces to the leadership of a 10-person Conference Committee charged with working out differences in legislation passed separately by the House and Senate.

For some time after a truly new class of regulations is adopted, its sponsoring coalition is apt to remain powerful enough to respond to circumvention by increasing penalties, by enforcing more-extensive reporting requirements, and by insisting that important substitute activities be brought into the control network. As long as the sponsoring coalition retains its force, the extent of the government control tends to expand like Br'er Rabbit's involvement with the Tar Baby. Trying to close loopholes tends to transform what may have appeared initially as a simple and tightly targeted set of regulations into a complex and wide-ranging network of governmental interference. Expansion in the control network cannot go on forever, primarily because it steadily increases the social costs of enforcing the desired regulations. The rising budgetary expense, social inconvenience, economic waste, and distributional inequity of a growing network of controls generates new coalitions that demand countervailing regulation on their behalf. The combined social costs of regulation and countervailing regulation eventually make some form of deregulation appear increasingly attractive all around.

a. Re-regulation of Deposit-Rate Ceilings 1966–1979. From 1966 right through the 1970s, adjustments in the network of deposit-rate ceilings were intended to confer benefits on interests associated with the thrift industry, the housing industry, and construction unions. The underlying regulatory strategy attempted to cartelize competition for household savings deposits to assure a substantial flow of low-cost funds to deposit institutions (savings-and-loan associations and mutual savings banks) which were restrained by regulatory requirements and tax incentives to hold a high proportion of their assets in the form of mortgages. To control household substitution against both the favored deposit institutions and traditional deposits, federal regulators had to engage in massive re-regulation. They awarded differentially higher ceilings to thrifts than to banks and extended

deposit-rate ceilings and other forms of regulation to previously unregulated institutions (most notably, to credit unions). They cooperated with the sponsoring coalition in convincing the Treasury to raise minimum denominations on its marketable debt (most notably, on Treasury bills in 1970) and to maintain below-market returns on U.S. savings bonds. Similarly, they took action to dissuade bank holding companies and several large nonfinancial corporations from issuing small-denomination debt. On the other hand, they selectively relaxed deposit-rate ceilings on large accumulations of funds and, backed-up by government-enforced penalties for early withdrawal, on funds pledged to remain on deposit for substantial periods of time. Taken together, this pattern of re-regulation allowed banks and thrift institutions to *discriminate* effectively between their interest-sensitive and interest-insensitive depositors. It allowed the regulated institutions to tailor posted interest rates, across accounts and over time, to individual customers' ability to negotiate a better deal elsewhere. In effect, the ceilings were redesigned to make the penalty that they imposed on a given household fall rapidly with family members' wealth and sophistication. Hence, the burden of these regulations fell particularly hard on the young, the old, and the poor (Kane [1980]), whose adaptive efficiency to financial change is inherently low.

While this strategy of re-regulation protected the flow of funds to regulated institutions and their profit margins in the short run, it maintained incentives in the long run both for implicit rate competition and regulation-induced innovation. Banks continued to expand service subsidies to deposit customers, including favorable interest rates on loans and commitments to accommodate their requests for loan funds even at times when additional lending might prove inconvenient for the bank. Moreover, innovative use of nondeposit instruments and the spread of money-market funds and minibonds continually expanded the set of households who could hold out for a decent return on their wealth.

On the political front, the blatant discrimination against small savers and borrowers enhanced and legitimized by these regulatory actions generated consumerist political pressure to get even. Exploiting this pressure, public-interest lobbyists have called down upon banks a veritable plague of what we may call financial *fair-play regulation*. To discourage banks and other institutional lenders from discriminating "unfairly" among individual customers, Congress has passed a series of laws that add important social objectives to regulators' responsibilities:

1. Federal Truth in Lending Act (1968)
2. Fair Credit Reporting Act (1970)
3. Fair Credit Billing Act (1973)
4. Equal Credit Opportunity Act (1974)
5. Real Estate Settlement Procedures Act (1974)
6. Fair Credit Billing Act (1974)
7. Home Mortgage Disclosure Act (1975)
8. FTC Holder-in-Due Course Rule (1975)
9. Consumer Leasing Act (1976)
10. Fair Debt Collection Practices Act (1977)
11. Community Reinvestment Act (1977)

12. Financial Institutions Regulatory Act (1978)
13. Right to Financial Privacy Act (1978)
14. Electronics Funds Transfer Act (1978)

These well-intentioned and hard-to-avoid regulations, which promise to be with us long after deposit-rate ceilings have gone to regulation heaven, threaten to impose huge compliance costs on the financial system.

Besides distorting institutional balance sheets and production processes and politicizing ordinary citizens, deposit-rate ceilings changed longstanding household patterns of allocating accumulated wealth. For traditional savings instruments, all but the wealthiest U.S. households substituted food inventories and leveraged purchases of housing, investment real estate, consumer durables, and collectables. Small savers' efforts to protect their real wealth from being eaten away by unfairly low deposit rates simultaneously reduced the proportion of aggregate personal income flowing through deposit institutions, increased total household debt, and fed a speculative boom in housing. By increasing household demands on productive resources, this pattern of saving tended to crowd out business investment and to increase the rate of inflation. In a well-publicized effort to disrupt this process, in March, 1980, the Federal Reserve imposed a series of temporary controls on consumer credit.

b. Depository Institution Deregulation and Monetary Control Act of 1980. On March 31, 1980 a new re-regulation strategy was formally adopted. This decision was specifically spurred by two crises. First, Congressional action was required by that date to prevent a court order from outlawing three popular and well-established demand-deposit substitutes (automatic-transfer savings accounts, credit-union share accounts, and off-premises terminals for S&Ls). In an election year, Congress did not want to risk alienating voters and institutions who valued the options provided by these instruments. Second, an unprecedentedly sharp four-month run-up in market interest rates had turned the thrift industry once again into a collection of financial basket cases. This event and the rapid disintermediation it induced provided dramatic support for those who argued that deposit-rate ceilings were killing the thrift business in the long run, while thrifts' short-run need to keep open the option of potentially massive government aid made it difficult for them to lobby effectively against any promising long-term solution.

The solution adopted legitimizes the threatened demand-deposit substitutes, introduces NOW accounts nationwide (after a nine-month waiting period), provides for a six-year phase-out of interest ceilings on time and savings accounts, and greatly expands the investment and trust powers of federally chartered savings institutions.²

To shield itself from short-term political fall-out, Congress handed over the responsibility for administering the designated six-year phase-out of deposit-rate ceilings to a new Depository Institutions Deregulation Committee (DIDC). The voting members of the DIDC are the Secretary of the Treasury, the Chairman of

² The Act also imposes Fed-administered reserve requirements on all deposit institutions, overrides state-imposed usury ceilings on a variety of loans, and provides for a simplification of the requirements of the Truth In Lending Act. These provisions are not considered here.

the Federal Reserve Board, the Chairman of the Federal Deposit Insurance Corporation, the Chairman of the Federal Home Loan Bank Board (FHLBB), and the Chairman of the National Credit Union Administration. (The Comptroller of the Currency is an additional nonvoting member.) Responsibility for administering the rate of expansion in S&L portfolio powers was delegated to the FHLBB. While S&Ls can count upon the FHLBB for sympathetic regulation of their authority to undertake new activities and to enter new markets, banking interests greatly outweigh those of thrift institutions on the DIDC.

This arrangement simultaneously gives S&Ls a strong political voice in determining the future scope of their portfolio activities, while making it politically difficult for them to fight off the demise of differential deposit-rate ceilings. It encourages individual thrift institutions to accept the loss of the industry's interest differential and to concentrate instead on broadening the scope of business operations.

Thrift-institution lobbying activity to influence the DIDC has so far proved ineffective. In late May, the DIDC raised ceilings on 6-month and 30-month CDs and narrowed the range of interest rates over which the thrift-industry rate advantage applied. Despite massive pressure, S&Ls were unable to persuade Congress either to rebalance the DIDC in their favor by adding the Secretary of the Department of Housing and Urban Development to the list of members or to declare that the DIDC was proceeding too fast in eliminating the differential on thrift certificates. At the committee's first Congressional oversight hearing before the Senate Banking Committee in August, 1980, it was scolded not for going too fast, but for taking two backward steps: tightening early-withdrawal penalties on CD accounts and proposing to ban the practice of offering depositors merchandise premiums on deposit accounts.

c. Pressure to Relax Federal Restrictions on Interstate Banking. Pressure against deposit-rate ceilings traces ultimately to waste and inequities associated with the discriminatory use of deposit and nondeposit instruments and of techniques for paying implicit interest. Similarly, pressure against the prohibition of interstate banking is being generated by the waste of not being able to achieve the scale and scope economies possible with integrated interregional EFT operations and by the inequities associated with foreign-bank and BHC ability to circumvent existing rules. It is widely believed that, to compensate ABA lobbyists for accepting expanded portfolio powers for S&Ls, the next Congress will act at least to allow branching over multistate metropolitan areas and to authorize interstate mergers of domestic banks when a failing institution is involved. On the state level, officials' desire to expand their state's employment base encourages them to permit out-of-state BHCs to operate local subsidiaries.

7. Implications for Future Structure of Banking Competition

Financial re-regulation is turning loose competitive forces that threaten to destroy longstanding patterns of institutional specialization in U.S. capital markets. Successful financial institutions are steadily spreading their operations into new geographic regions and additional product lines. After decades in which the emphasis lay on inventing new elements of nonprice competition, differences in

explicit interest rates have become the focus of interinstitutional competition for deposit and loan customers. Increasingly, accountholder service departments will have to generate sufficient fee income to support themselves. In particular, a good many "conveniently located" branch offices should have to be consolidated. In the future, a deposit institution's explicit interest margin will play the key role in determining its rate of return on shareholder capital. To exploit economies of scale and scope, average deposit-institution size will have to become much larger, with many individual firms merging themselves out of existence. Politically, as small deposit institutions lose political muscle and as securities firms such as Merrill Lynch improve their foothold in retail banking markets, the lines of financial-institution lobbying pressure will adapt accordingly.

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