Interest Payments on Demand Deposits: Historical Evolution and The Current Controversy

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Federally insured commercial banks have been legally prohibited from paying interest on demand deposits since the 1930's. The effectiveness of **the** prohibition, though, has been progressively eroded as banks have devised indirect methods of providing returns on checking account funds. The rise in the general level of interest rates in recent years has provided impetus to the development of these indirect methods for attracting demand deposits. In light of this increasing evasion of the intent of the original prohibition, some have suggested that the prohibition be repealed. Sentiment for deregulation has been strengthened by recent financial innovations that permit interest payments on demand-type balances. Innovation has progressed furthest in New England, where Congress has authorized a wide variety of financial institutions to offer interest-bearing accounts subject to negotiable orders of withdrawal (NOW accounts).

This article examines the arguments both for and against allowing interest payments on demand deposits and provides an historical perspective to the current debate. In the first section, the events leading up to the prohibition of interest on demand deposits are discussed. The next section reviews the current controversy regarding the advisability of retaining the prohibition. The final section clarifies issues relating to the possible effects of allowing explicit payment of interest on demand deposits.

HISTORICAL DEVELOPMENTS

The Banking Act of 1933

In the crisis atmosphere that resulted from the stock market collapse in 1929 and the ensuing wave of bank failures, legislation to reform the banking system was introduced in 1933. One of the provisions of the law that became known as the Banking Act of 1933 was that interest be prohibited on demand deposits. Although concern about the effects of paying interest on demand balances had been expressed intermittently since the middle of the 19th century, there had been no prior attempt to legislate prohibition.

Historically, apprehension concerning interest payments on demand deposits had focused on the effects of paying interest on interbank balances.[1] It was often alleged that the common practice of country banks holding interest-earning balances at New York City

[1] For an excellent discussion of the history of the debate regarding regulation of interest rates on bank deposits, see Charles M. Linke, "The Evolution of Interest Rate Regulation on Commercial Bank Deposits in the United States," National Banking *Review,* June 1966.

banks resulted in a drain of funds from rural areas which was detrimental to the agricultural economy. In retrospect, this argument does not seem persuasive. Due to the seasonality of agricultural loan demand, country banks needed short-term repositories for excess funds during certain periods of the year. Interest-earning balances at New York banks were among the most attractive short-term investments available. Moreover, the rate paid on these interbank balances was substantially lower than rates on agricultural loans. Thus, it appears doubtful that interest payments on bankers' balances caused a drain of funds from rural areas which reduced the ability of country banks to meet agricultural credit needs.

There was, nevertheless, a valid source of concern associated with interbank deposits. The New York banks often used the funds obtained from country banks to make call loans to stock market investors. When seasonal increases in agricultural credit needs coincided with a downturn in the stock market, the New York banks—unable to call the loans collateralized with stocks—found it difficult to meet the requests of country banks for deposit withdrawals. In this way, the effects of liquidity crises originating on Wall Street were transmitted to the rest of the economy. Interest on interbank deposits was thus believed by many to have contributed to the recurrent financial crises that had plagued the banking system for nearly a century. It was thought that prohibiting interest on interbank deposits would help separate the fortunes of the banking system from the vagaries of the stock market.

Another argument that appears to have contributed to adoption of the prohibition on interest on demand deposits was that prohibition would help prevent excessive competition among banks.[2] At the time the Banking Act was being considered, much of the discussion of the causes of the recent bank failures centered on the effects of intense rate competition for deposits during the 1920's. Many observers believed that the unconstrained ability of banks to compete for funds by bidding up rates paid on deposits had encouraged banks to acquire risky assets. To cover the high cost of deposit funds, it was argued, banks had been forced to acquire higher yielding, albeit riskier, assets. Banks' vulnerability to adverse economic developments was, therefore, believed to have been partly attributable to intense rate competition. Imposition of ceilings on the rates banks could pay for deposit funds, it was thought, would lead to a more stable banking environment.

Another reason given for prohibiting interest on demand deposits was that the prohibition would reduce banks' expenses. The concern for bank earnings arose in connection with a separate provision of the Banking Act requiring banks to pay a subscription fee equal to .5 per cent of their total deposits for Federal deposit insurance.[3] The reduction in costs resulting

2 Senator Steagall, one of the sponsors of the Banking Act, emphasized the need to establish interest rate ceilings on time deposits in order to preclude unsound banking practices. This emphasis has been interpreted by some as indicating that he believed the chief benefit of regulating interest rates on bank deposits was prevention of excessive rate competition. See Like, p. 466.

3 The major New York banks opposed this plan for two reasons. First, they believed that the financial instability which the measure was designed to alleviate was a problem only in rural areas. Perhaps more importantly, the New York banks considered it unfair that they be required to pay a subscription fee based on their total deposits when only a small Fraction of those deposits would have been covered by Federal insurance. These same banks favored prohibition of interest on demand deposits, and the fact that the money market banks' opposition to the Federal deposit insurance program coincided with the decision to include the provision prohibiting interest on demand deposits in the Banking Act has been interpreted as an indication that a deal was made. See Carter H. Golembe Associates, Inc., "Memorandum re: Interest on Demand Deposits," reprinted in ***Studies on the Payment of Interest on Checking Accounts.*** American Bankers Association, 1976, p. 61. Whether or not there was a *quid* pro *quo* relation between the two occurrences, it is undeniable that some considered the prohibition of interest on demand deposits as a method by which to recompense the banking industry for the subscription payments to the Federal deposit insurance program.

from prohibition of interest on 'demand deposits would, it was argued, increase the depressed level of bank earnings enough to enable banks to pay the insurance subscription fee.

Some combination of these disparate arguments in favor of prohibiting interest on demand deposits must have proved persuasive. The section of the Banking Act containing this provision was passed with very little discussion and has remained an important part of the financial environment for more than 40 years.

The impact of the Prohibition

Because the yield on financial assets remained comparatively low for nearly 3 decades after the Banking Act was passed, the prohibition of interest payments on demand deposits had little impact during that period. In the past 15 years, however, the general level of interest rates has risen substantially, and wealth owners have become more sophisticated in managing their asset portfolios. Banks have thus found it increasingly necessary to offer some inducements to attract demand deposit funds. In part because explicit monetary interest on demand deposits is illegal, banks have relied on various nonmonetary returns to attract these funds.

In the **1960's,** many banks began to offer reduced fee or "free" checking account plans, often in return for the maintenance of a prespecified minimum or average balance in the account. Since a bank incurs substantial costs in maintaining an account **and clearing** the checks written on that account, provision of these services without charge amounts to payment of implicit interest on demand deposits. There are numerous other methods of making deposits attractive without paying interest explicitly: establishing extensive branch facilities, maintaining longer banking hours, providing ancillary services at reduced cost, and allowing customers to make telephone transfers from their savings accounts. Studies indicate that the implicit rate is both substantial and directly related to market interest rates.[4] Thus, banks have been able to circumvent the prohibition of interest on demand deposits by paying interest in various nonmonetary forms, thereby frustrating the original intent of the prohibition.

Other developments have diminished the effectiveness of the original prohibition. Direct payment of interest on interbank deposits has been replaced by interest on balances sold in the Federal funds market and by provision of various services by correspondent banks at reduced cost. Large corporations are able to earn interest on short-term funds by buying securities from a bank with the agreement that they be resold to the bank at a specified price (so-called "repurchase transactions"). In the past 5 years, individuals in parts of New England have been able to write negotiable orders of withdrawal on interest-bearing accounts at commercial banks and thrift institutions.

THE CURRENT DEBATE REGARDING REPEAL OF THE PROHIBITION

Against the background of increasing evasion of-the intent of prohibiting interest on demand deposits, some have suggested that the prohibition be repealed. In a 1975 report issued by the House Committee on Banking and Currency entitled ***Financial Institutions and the Nation's Economy*** (FINE), for example, it was recommended that the prohibition of interest on demand deposits be phased out within 5 years following authorizing legislation. One aspect of the debate relates to the implication of allowing explicit interest payments on demand deposits for the effectiveness of monetary and fiscal policy. Although this is a

[4] *See, for example, R. J.* Barro *and Anthony* **Santomero,** *"Household Money Holdings and the Demand Deposit Rate," Journal of Money, Credit, and Banking,* May 1972, *and "The Impact of Payment of Interest on Demand Deposits," A Study of the Staff of the Board of Governors of the Federal Reserve System. January 1977.*

legitimate concern, it will not be discussed here. Rather, this article focuses on those arguments related to the potential impact on depositors and financial institutions of repealing the prohibition of interest on demand deposits.

The Case for Retaining the Prohibition

The view that unregulated rate competition for deposits would cause instability in the banking system remains a cornerstone of the argument for retaining Federal control of deposit rates. Those who oppose repeal of the prohibition of interest on demand deposits, for instance, allege that the loss of earnings and erosion of capital positions that would result from repeal might cause many banks to fail. Such widespread bank failures, it is argued, would seriously threaten the stability of the financial system.

There is, indeed, reason to believe that bank earnings would decline in the short run if explicit interest payments on demand deposits were allowed. Banks have made decisions, many of which involve long-range commitments that are irreversible in the short run, based on a financial environment that includes the legal prohibition of interest on demand deposits. One reason for establishing extensive branching facilities, for example, may have been to provide convenience to depositors in lieu of paying interest on their checking accounts. In the short run, these and similar long-range commitments would make it difficult for banks to reduce noninterest expenses as rapidly as interest expenses would increase if the prohibition were repealed.[5] Faced with analogous problems, however, banks in New England appear to have adjusted quite successfully to the introduction of interest-bearing demand-type balances.[6]

Another aspect of the argument that interest payments on demand deposits causes financial instability relates to bank portfolio behavior. The view that paying interest on demand deposits leads to excessive competition and makes banks more susceptible to failure is as prevalent today as it was in the 1930's. A number of authors have investigated the validity of this claim, but the results are inconclusive.

Two empirical studies published in the mid-1960's cast doubt on the contention that excessive rate competition in the 1920's led to unsound banking practices which contributed to the wave of bank failures during the Depression.' Neither of these studies found a significant relation between the rates paid on deposits and the probability of failure. Indeed, one of these studies found that the probability of a bank failing was inversely related to the rate it paid on demand deposits.[8] This seemingly anomolous result was interpreted as indicating either (1) that explicit interest payments were more effective in stemming deposit outflows than were less direct methods of payment or (2) that banks paying explicit interest were better able to reduce their costs when outflows actually occurred. In either case, the study found that banks which relied primarily on interest incentives to attract deposits were less likely to become insolvent

[5] See John D. Paulus, "Effects of 'NOW Accounts on Costs and Earnings of Commercial Banks in 1974-75," *Staff Economic Studies,* No. *88,* Board of Governors of the Federal Reserve System, Summer 1976, for an additional reason why bank earnings might decline in the short run if interest payments on demand deposits were allowed. Paulus argues that earnings of commercial banks in New England dropped following introduction of NOW accounts due to intense competition for market shares.

[6] *Zbid.*

[7] George J. Benston, "Interest Payments on Demand Deposits and Bank Investment Behavior," *Journal of Political Economy,* October 1964, and Albert M. Cox, Jr., "Regulation of Interest on Bank Deposits," *Michigan Business Studies,* Vol. *17,* No. 4, Bureau of Business Research, Graduate School of Business Administration (Ann Arbor: University of Michigan, 1966).

[8] See Benston, p. 445.

during the financially troubled times of the 1930's.

The evidence pertaining to the **1930's,** however, is not conclusive proof that increased rate competition would not, in different circumstances, lead banks to engage in practices which could increase financial instability. Indeed, many observers still believe that competitive pressures arising from abolition of interest rate ceilings on deposits would result in acquisition of riskier assets by banks. The credibility of this view has been bolstered by recent theoretical and empirical evidence. One study has demonstrated that, under certain conditions, it is rational for banks to adjust their portfolios by acquiring riskier assets as a result of paying higher interest for deposit **funds.**[9] Another study found empirical evidence that banks had indeed shifted toward riskier asset portfolios as a result of the increase in ceiling rates on time deposits in the early **1960's.**[10]

In judging whether eliminating ceiling rates on bank deposits would increase or decrease financial stability, evidence that the riskiness of banks' assets is positively related to the rate of interest paid on deposits must be weighed against evidence that the flexibility of meeting deposit withdrawals is also positively related to the deposit rate. To some extent, the answer will depend on whether bank failures are more likely to result from deposit withdrawals or from losses on assets.

The remaining arguments against repealing the prohibition of interest on demand deposits relate to the adverse impact repeal might have on certain bank customers. One of the ways that banks might 'respond to an increase in interest costs is to attempt to increase revenues by raising lending rates and service charges. If so, loan customers and depositors with small but active checking accounts might be adversely affected by repeal. It is uncertain, however, whether banks could increase revenues by charging higher rates on loans. The credit market in most areas is sufficiently competitive to ensure that borrowers have the opportunity to choose among alternative loan sources. The decline in the number of loan customers which would result from the increase in a bank's lending rate might be so great that the **net** effect would be a decline in loan revenues rather than the anticipated increase. If so, banks would find it unprofitable to maintain the higher lending rates.

Even if loan rates and service charges were to increase somewhat because of the payment of interest on demand deposits, many would deny that these increases would necessarily be undesirable. They could be considered adverse, these observers maintain, only to the extent that it is appropriate to subsidize banks' lending rates by forcing checking account customers to accept lower than a market rate of return on their demand deposits.

It is important to note the arguments which are not among those currently given in support of retaining the prohibition of interest on demand deposits. No one currently maintains, as some did in the **1930's,** that payments for Federal deposit insurance are a threat to the solvency of the banking system. Similarly, developments have rendered obsolete the concerns about interest payments on bankers' balances. Deposit insurance has reduced the probability of financial panics, and the Federal Reserve restricts the extent to which money market banks can finance stock market activity. Moreover, the Federal funds market allows banks to earn interest on short-term funds, and the Federal Reserve's seasonal borrowing privilege for member banks has been established to alleviate the problems associated with seasonal fluctuations in credit demand.

9 Carl Gambs, "Interest Bearing Demand Deposits and Bank Portfolio Behavior," Southern Economic *Journal,* July 1975.

10 Stanley C. Silverberg, "Deposit Costs and Bank Portfolio Policy," Journal of Finance, September 1973.

The Case Against Retaining The Prohibition

The arguments against prohibiting explicit payment of interest on demand deposits have come primarily from economists. They object to the prohibition because it restricts the free operation of competitive market forces. At least since the time of Adam Smith, it has been a basic tenet of economic analysis that competition is conducive to efficient allocation of society's scarce resources. Accordingly, economists argue that restrictions on the operation of competitive markets tend to result in waste and inefficiency. Economists have identified two distinct sources of inefficiency stemming from the prohibition of interest payments on demand deposits: (1) the waste of resources resulting from provision of banking services which are of little value to depositors and (2) the waste of resources resulting from socially unproductive efforts to economize on demand deposit balances.[11]

Economists maintain that the prohibition of interest on demand deposits tends to cause too many resources to be devoted to provision of banking services. This inefficiency results from the fact that banks have responded to the prohibition by offering services to depositors below cost. The numerous methods devised by banks to make checking accounts attractive to the public are, in effect, ways of paying interest implicitly on those accounts. The most straightforward method of providing a nonmonetary return on demand deposits is remission of service charges—e.g., "free checking."

In its purest form, free checking is a plan whereby depositors can write as many checks as they wish regardless of the size of their balances without paying any service charges. Despite the costliness to the banking system of processing checks, depositors have no price incentive to economize on the number of checks they write. As a result, they tend to overutilize the check processing facilities of the banking system. Thus, the divergence between the cost to the banking system of providing services and the cost to depositors of utilizing those services leads to an inefficient allocation of resources. Society's scarce resources are devoted to producing services which would not be demanded if individuals were required to pay the cost of producing those services.

The second way in which prohibition of interest on demand deposits leads to inefficiency is that it encourages depositors to waste resources on socially unproductive efforts to economize on their demand deposit balances. Individuals allocate their wealth among alternative assets primarily on the basis of the relative yield on those assets. Whereas the yield on most financial assets is in the form of cash payments which can be used to purchase a wide variety of goods and services, the yield on demand deposits is constrained to take the form of banking services. Since some of these services may be of little value to depositors, individuals may perceive the return on demand deposits to be quite low.[12] This leads to an exaggerated disparity between individuals' perception of the yield on demand

11 See Harry G. Johnson, "Problems of Efficiency in Monetary Management," *Journal of Political Economy* (September/October 1968), pp. 972-81, for a thorough discussion of the sources of economic inefficiency which result from prohibition of interest payments on demand deposits.

12 A major source of confusion in evaluating the potential gains from paying interest on demand deposits arises from failure to distinguish between the costs to banks of providing services and the valuation of those services by depositors. Some have argued, for instance, that repealing the prohibition of interest on demand deposits would not benefit depositors since banks already pay the equivalent of a market rate on checking accounts in the form of implicit interest. Even if banks incur the same costs in providing free services as they would if interest were paid explicitly, however, individuals may value the two types of return quite differently. Moreover, an explicit monetary return might benefit depositors if it facilitated comparison between the yields offered by different financial institutions on demand-type balances.

deposits and the yield on alternative assets and creates an incentive for depositors to economize on the amount held in checking accounts. They can do this by transferring funds from interest-bearing assets into their checking accounts only when necessary to do so in order to prevent a deficiency of their balance. The amount of depositors' resources devoted to effecting these transfers would be reduced if explicit interest were paid on demand deposits.[13]

In summary, economists' criticism of the prohibition of interest on demand deposits is that the prohibition discourages competition and causes an inefficient use of resources. Valuable resources are expended both by banks and depositors in efforts to circumvent the prohibition. Lest it be thought that the potential gains to society from correcting the misallocation would be negligible, it is important to note that the cost of operating the nation's payment mechanism is considerable. It has been estimated that the cost of processing checks in 1972, for instance, was over $8 billion.[14] Thus, even minor improvements in the efficiency of the payment system could yield substantial resource savings.

THE POTENTIAL IMPACT OF ALLOWING EXPLICIT INTEREST ON DEMAND DEPOSITS: A REEVALUATION

Explicit interest probably would not completely supplant implicit interest as a method of attracting demand deposits if the legal prohibition of explicit interest were removed. Despite the apparent presumption to the contrary by many of the proponents and opponents of repeal, free checking and other methods of paying implicit interest do not result solely from the legal prohibition of explicit interest. Indeed, there is reason to believe that many depositors would prefer to receive some portion of the yield on their checking account balances as implicit interest rather than to receive the entire return in the form of money income. If so, banks would find it profitable to continue to offer implicit interest as part of the total yield on demand deposits. It is necessary to take this possibility into account when analyzing the potential impact on economic efficiency and financial stability of repealing the prohibition of interest on demand deposits.

The desire by some depositors to receive implicit interest stems, in part, from the structure of the tax system. With few exceptions, the income tax laws apply only to money income. There is, therefore, an incentive to reduce one's tax liability by receiving payment in nonmonetary form whenever convenient to do so. Implicit interest on checking accounts is one case in which the potential gains from avoiding taxable income may outweigh the inconvenience of receiving nonmonetary payments. It is possible, in other words, that receipt of free banking services in lieu of' monetary interest income maximizes the aftertax return (net of service charges) in some instances. Thus, it is not always true, as is often alleged, that "The sum expended [by banks] in providing free services . . . would be more valuable to depositors if received in cash than when received in kind for the usual reason that the depositors could, if they wished, buy precisely the same services with cash but would undoubtedly choose not to do so."[15]

To illustrate this point, assume that the cost 'of providing free services to a depositor is $100

13 These transfers are costly to banks as well as depositors. The increasing use of telephone transfers from time deposits to demand deposits, for instance, imposes costs on banks which could be reduced if banks were allowed to pay interest directly on checking account balances.

14 Carl Gambs, "The Cost of the U.S. Payments System," *Journal of Bank Research* (Winter 1976), pp. 241-42.

15 Milton Friedman, "Controls on Interest Rates Paid by Banks," *Journal of Money, Credit, and Banking* (February 1970), p. 27.

per year and that additions to the depositor's income are taxed at a rate of 40 per cent. If, instead of spending the $100 to provide free services, the bank paid the $100 directly to the depositor as monetary interest on his checking account, the depositor would be required to pay $40 of the interest income in taxes and would have only $60 left with which to purchase goods and services. Even if he chose to spend the entire $60 increment to his disposable income for banking services, the depositor would not be able to purchase as many services as he received free of charge when the yield on his checking account was in the form of implicit interest.

This is not to say that depositors would never choose to receive any of the yield on their checking accounts in the form of explicit interest. Suppose, for instance, that individuals find it so convenient to make certain types of payments by check that they would write a given number of "essential" checks even if charged the full cost of clearing those checks but that there are additional checks which are "optional," and would only be written if they were provided free of charge. In these circumstances, the individuals might well prefer to receive part of the total yield on their demand deposits as reduced fees for those checks which are deemed essential and the remainder as an explicit monetary interest payment.[16]

In the context of the previous example, assume that the hypothetical depositor would buy only $50 of banking services if required to pay for them—that is, it would cost the bank $50 to provide those services which the depositor deems "essential." In this case, a $100 expenditure by the bank might be most valuable to this depositor if divided equally between implicit and explicit interest. The $50 of implicit interest enables the depositor to obtain the banking services that he would have used in any event without paying tax on the nonmonetary income; and the $50 of explicit interest yields $30 $[=(1-.40) \times (\$50)]$ of disposable income, which is presumed to be more valuable to the depositor than an additional $50 of banking services. Although this example is highly simplified, it demonstrates why depositors might prefer to receive part of the yield on their checking accounts in the form of remitted service charges. Since depositors would benefit from arrangements involving implicit interest, provision of banking services at reduced cost might be expected to continue even if the prohibition of explicit interest were repealed.

In general, a depositor's preferences between implicit and explicit interest would depend, in part, on his marginal tax rate and need for banking services. The higher the rate at which monetary income is taxed, for instance, the greater is the incentive to receive implicit interest. Obviously, banks could not negotiate with each depositor to determine the optimal banking plan for his personal needs. In an effort to make checking accounts as attractive as possible to a wide segment of depositors, however, banks might be expected to offer a variety of checking account plans which combine explicit interest and remission of service charges in varying degrees. One possible plan might entail remission of service charges in direct proportion to the size of the minimum balance and payment of explicit interest on the amount held in excess of that minimum.

Since implicit interest would remain part of the banking environment even if all legal constraints on interest payments on demand deposits were removed, some of the inefficiency associated with implicit interest payments would remain even if interest rate ceilings were

16 More precisely, an individual would maximize the return on his checking account by having charges remitted on those services that would have been utilized if the depositor were required to pay the full cost of providing those services.

abolished.[17] Removing the constraint on the way in which banks can compete for deposit funds would, however, allow greater flexibility in designing programs to meet the needs of depositors. This would be expected to reduce the disparity between individuals' valuation of the yield on demand deposits and their valuation of the yield on alternative assets. There would, therefore, be less incentive for depositors to engage in socially wasteful activities in attempts to minimize the amount held in demand deposits. Similarly, depositors would be less prone to overutilize banking services if given greater opportunity to choose a desired mix of implicit and explicit interest. Thus, repeal of the prohibition of interest on demand deposits would be expected to result in some improvement in economic efficiency; the potential benefits, however, are not as great as some have claimed.

By the same token, though, the potential costs of repeal are not as great as many have predicted. Because depositors will not uniformly prefer accounts whose total yield is in the form of monetary interest, banks would not be forced to convert totally to a new method of attracting checking account funds. Thus, the impact of repeal on banks' earnings and portfolio behavior might not cause the degree of financial instability that some fear.

CONCLUSION

The general belief that interest payments on demand deposits had contributed to financial instability resulted in the total prohibition of interest on demand deposits in 1933. Subsequently, banks have devised numerous methods of paying interest implicitly on checking account funds by providing services below cost to their customers. A number of recent financial innovations have contributed to reconsideration of the desirability of repealing the initial prohibition. The proponents of repeal allege that interest ceilings distort resource allocation and lead to inefficiency. The opponents of repeal fear that the possible gains in efficiency would be far outweighed by the general disruption to customary banking procedures and the adverse effects on certain classes of bank customers. Both the proponents and opponents of repeal have exaggerated the effects of allowing explicit interest on demand deposits. Because the tax system would remain as an incentive for implicit rather than explicit yields, repeal of the legal prohibition of interest on demand deposits might result in relatively minor changes from prevailing practices.

17 It should be noted that receiving some portion of the yield on demand deposits as implicit interest may actually be beneficial. To the extent that both payment of monetary interest to depositors and payment of service charges by depositors involve transactions' costs, economic efficiency would be enhanced by netting out service charges from the monetary interest payable to depositors, thereby avoiding unnecessary reciprocal payments.