

# The Depository Institutions Deregulation Act of 1980: A Historical Perspective

By Robert Craig West

The uneven performance of banking in the United States down through the 1930s meant that the public was often faced with a breakdown of the institutions on which it depended for the ordering of its financial affairs. This explains in part the strong public demand throughout U.S. history for legislation designed to prevent financial instability.<sup>1</sup> Due to this demand, there has been over time a large volume of banking legislation, resulting in a continual regulation by the federal government of the activities and powers of commercial banks and other depository institutions.

The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) has been hailed as the most important piece of

banking legislation since the 1930s. As a bill deregulating important aspects of the depository sector of the financial system, it is in marked contrast to previous financial legislation in the United States.<sup>2</sup>

This article examines why there has been an increase in banking regulation and control over time in the United States and why the financial environment of the past few years has changed so as to induce a reversal of that trend. In the examination, three sections of DIDMCA dealing with deregulation are discussed in the context of their historical development. These three areas pertain to interest payments on transactions accounts, interest rate regulation, and the nature of financial institutions. As a background to the discussion of the three deregulatory areas, the first section of the article provides a broad overview of the history of U.S. banking and financial legislation.

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<sup>1</sup> An excellent discussion of the political and social milieu of banking in the early 19th century is Bray Hammond, *Banks and Politics in America from the Revolution to the Civil War*, Princeton, N.J.: Princeton University Press, 1957. Since 1860, many important political movements have had strong elements of antibank, antifinancial system feelings, including the Greenbackers, the Populists, the Progressives, and at many times the Democrats.

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<sup>2</sup> Many people feel that DIDMCA represents "reregulation" rather than deregulation. It is true that the bill is not completely deregulatory. For example, it subjects all depository institutions to the reserve and reporting requirements of the Federal Reserve System. However, it is important to distinguish between regulations aimed at improving monetary control in a macro sense and regulations aimed at limiting the activities of individual financial institutions. It is in the latter sense that DIDMCA is deregulatory.

## OVERVIEW OF THE HISTORY OF FINANCIAL LEGISLATION

Commercial banks and other depository institutions appeared very early in the history of the United States. While there were no such institutions in the colonies, following independence, commercial banks were quickly established in the major commercial centers of the new nation. Also, the federal government moved in 1781 to charter a commercial bank, the Bank of North America. Mutual savings banks and savings and loan associations have an almost equally long history. Mutual savings banks, created to promote thrift, date from the early 1800s. The first savings and loan, also created to promote thrift but with a close tie to the housing industry, dates from the 1830s.

Federal banking regulation also made an early appearance in the United States. In the early years, regulation was undertaken indirectly by the First (1791-1811) and Second (1816-36) Banks of the United States. While these banks were federally chartered, the government was only a minor stockholder in them, and neither was a true central bank. However, the two banks were very influential because of their size. They were conservative institutions and usually were the creditors of state chartered banks.<sup>3</sup> Because they held the banknotes of state chartered banks, the threat of redemption limited the banknote expansion and thus the loans of state banks.<sup>4</sup> The history of banking during the existence of the two Banks of the United States is one of generally sound expansion and stability. Despite their success, neither of the two federal banks was

rechartered, due mainly to the resistance of state bankers who resented their limiting influence and of politicians who believed they were unconstitutional.

From the demise of the Second Bank of the United States in 1836 until 1863, there was no federal regulation of the banking industry. This period has often been characterized as a period of financial instability due to widespread abuses.<sup>5</sup> Many banks were established with insufficient capital and disappeared soon after their first notes were issued. The popular perception was that because of these abuses, control and regulation of the banking sector were needed. This perception was a major reason for the passage in 1863 of the National Banking Act. This act allowed for the creation of a new class of bank, chartered and regulated by the federal government, and the issue of a new banknote, whose supply was closely regulated.

Over the next 50 years, from 1863 to 1913, economic growth and development combined with financial innovation to alter the structure of the financial system. Those years also saw recurring financial and economic dislocations that had their origins not only in sharp changes in the level of real economic activity, but in the shakiness of the financial structure as well. As a result, pressure for additional banking reform grew, culminating in the passage of the Federal Reserve Act in 1913.<sup>6</sup>

The financial sector performed much better for most of the first two decades of the Federal Reserve System's existence. However, the onset of the Great Depression showed that the Federal Reserve was not prepared to deal with

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<sup>3</sup> For an excellent discussion of these two banks, see Hammond, chapters 5-8 and 10-14.

<sup>4</sup> For a discussion of the policies of the First and Second Banks of the United States and the reaction to them, see Hammond; and Peter Temin, *The Jacksonian Economy*, New York: Norton, 1969.

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<sup>5</sup> See Hammond, chapters 15-19.

<sup>6</sup> The reform movement after 1863 is discussed in Robert Craig West, *Banking Reform and the Federal Reserve, 1863-1923*, Ithaca, N.Y.: Cornell University Press, 1977.

severe economic dislocations, and that the safety of the financial system was still suspect.<sup>7</sup> The virtual collapse of the banking system in the early 1930s led to a demand for quick action. As a result, between 1932 and 1935, 20 separate bills were passed amending the Federal Reserve Act.

Among the most important was the Banking Act of 1933, commonly known as the Glass-Steagall Act. This act extensively revised eight sections of the Federal Reserve Act and, among other things, prohibited the payment of interest on demand deposits, gave the Federal Reserve authority to establish ceilings on interest rates member banks could pay on time and savings deposits, and created the Federal Deposit Insurance Corporation (FDIC). Also, the Federal Home Loan Bank Board (FHLBB) was established in 1932 to supervise savings and loan associations, and in 1934 the Federal Savings and Loan Insurance Corporation (FSLIC) was created. In addition, the Banking Act of 1935 reorganized the Federal Reserve System, granting increased authority to the Board of Governors.

The legislation passed during the 1930s provided the framework for the regulation of the banking system from the mid-1930s to 1980. Although it was believed that the changes made by the legislation of the 1930s would provide for a long-term stable financial environment, during the post-World War II period a reevaluation of that legislation emerged. The impetus for this reevaluation came partly from those who wanted the financial institutions regulated more tightly and partly from those who wanted less regulation. The result was the creation in 1958 of the Commission on Money and Credit (CMC), which developed into a far-

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<sup>7</sup> See Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867-1960*, Princeton, N.J.: Princeton University Press, 1963.

ranging study of the U.S. financial system. While the commission drew up no legislation, it proposed many changes. Its final report advocated increased regulation and control, particularly concentration of regulatory and supervisory authority in the Federal Reserve System. It specifically recommended that the prohibition on the payment of interest on demand deposits be retained, that the authority of the Federal Reserve to regulate the rate paid on savings and time deposits be changed to a standby authority, that thrift institutions be given greater flexibility to acquire long-term debt obligations other than mortgages, and that commercial banks be allowed the same flexibility in investing their time and savings deposits.<sup>8</sup>

Another commission to study the financial system was created in 1970. Known as the Hunt Commission, it made recommendations regarding the payment of interest on demand deposits, ceilings on interest rates, and increased investment flexibility for thrifts and commercial banks. These recommendations were similar to those of the CMC.<sup>9</sup>

No legislation resulted from the Hunt Commission report, but Congress continued to consider changes in financial regulation. In 1975, the House Banking Committee stimulated the discussion of financial regulation with hearings on a document called *Financial Institutions in the Nation's Economy (FINE) "Discussion Principles."*<sup>10</sup> In 1977, the Senate Banking Committee held a series of meetings on the con-

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<sup>8</sup> For a report of the commission's findings, see its *Money and Credit*, Englewood Cliffs, N.J.: Prentice Hall, 1961.

<sup>9</sup> The Hunt Commission's recommendations can be found in *The Report of the President's Commission on Financial Structure and Regulation*, Washington, D.C.: Government Printing Office, 1971.

<sup>10</sup> U.S. Congress, House, *Financial Institutions and the Nation's Economy (FINE) "Discussion Principles," Hearings*, before a subcommittee of the Committee on Banking, Currency, and Housing, 94th Cong., 1st and 2nd Sess., 1975.

dition of the banking system.<sup>11</sup> Finally, in 1980, congressional deliberations produced DIDMCA. The 1980 act contained deregulatory measures in regard to three areas: the payment of interest on transactions accounts, interest rate ceilings, and the nature of financial institutions. The remainder of this article focuses on the history of regulation in these three areas.

### INTEREST PAYMENTS ON TRANSACTIONS ACCOUNTS

The practice of paying interest on demand deposits began in the early 19th century. Following the development of financial markets in New York City after 1825, some New York banks began to pay interest on bankers' balances. Country bankers and even bankers in other cities found it advantageous to keep balances in New York banks for reserve and investment purposes and for check clearing. Over time, the New York banks that paid interest on demand deposits attracted the greatest amounts of correspondent balances. Also, they often paid interest on the accounts of large nonbank depositors.

Almost from the beginning it was widely believed that the practice of paying interest on demand accounts was destabilizing. It was argued that the practice led banks to acquire higher yielding and thus riskier investments in order to offset the increased costs of obtaining funds. A related problem, it was further argued, was the tendency of New York banks to place their demand deposit funds in call loans on the stock exchange. While call loans were normally highly liquid, when a number of New

York banks came under pressure from correspondents to remit funds, calling loans meant the liquidation of stock holdings. However, since calling the loans would drive down the price of collateral, call loans were not liquid when there was pressure on all New York banks.

In 1858, following a severe panic in the preceding year, the New York Clearinghouse began to agitate in favor of a prohibition on interest payments on demand deposits. Bankers were divided on the issue, however, and the initiative failed. Even though the federal government did not act to ban interest payments on demand deposits, it acted to ameliorate the effects of such payments by passing the National Banking Act in 1863. It was believed that the National Banking System created by the act would solve the problem of instability in the banking system. However, the periodic crises in the last third of the 19th century proved this belief false.

During each of the financial crises that occurred in the late 1800s, the call for a prohibition of interest payments on demand deposits was renewed. But the government was still reluctant to propose prohibitory legislation. However, in another effort to deal with the problem of instability, Congress created the Federal Reserve System in 1913. For a decade and a half after 1913, the financial sector performed very well. However, the financial crisis which accompanied the depression of the 1930s was even more severe than those of the 19th century, with banks failing rather than merely suspending payments. Again the practice of paying interest on demand deposits was alleged to be a major abuse. The prevailing view, as before, was that in seeking additional income to pay interest on demand deposits, banks had undertaken risky investments that they would otherwise have avoided.

In 1933, Congress passed the Glass-Steagall

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<sup>11</sup> See U.S. Congress, Senate, *First Meeting on the Condition of the Banking System, Hearings*, before the Committee on Banking, Housing, and Urban Affairs, 95th Cong., 1st Sess., 1977.

Act which banned the payment of interest on any deposit payable on demand. Even though the desirability of such a provision was widely accepted, many now believe that it was passed into law not to end a longstanding abuse but as a *quid pro quo* for bank acceptance of the premiums required by the deposit insurance system created by Congress.<sup>12</sup>

Passage of the prohibition did not end the argument surrounding interest payments on demand deposits, although the debate remained quiescent until the late 1950s. It was then taken up by economists who argued that there was little theoretical reason to believe that interest payments on demand accounts were destabilizing.<sup>13</sup> In support of this theoretical objection to the prohibition, studies showed that there was little empirical evidence that the practice was destabilizing. Data from the 1930s showed that banks which paid high rates of interest on demand deposits were actually less likely to fail than other banks.<sup>14</sup> In addition to the arguments and evidence that paying interest on demand deposits was not destabilizing, there was a strong opinion that the prohibition interfered with the optimal allocation of resources.

The prohibition also was undermined by developments in financial markets. The most important of these developments was the upward trend in interest rates that developed in the post-World War II period. As interest rates began to rise, banks became more willing to pay interest on transactions accounts because the

funds acquired were increasingly valuable. Because they were denied the ability to make interest payments on transactions accounts, banks developed new practices which allowed them to avoid the prohibition. These practices demonstrated the willingness of financial institutions to compete for deposits by paying a market rate of interest. Basically, the practices fell into two categories: payments in kind and institutional rearrangements.

The first category included services provided to respondent banks holding correspondent accounts. Correspondent banks offered a host of services, mostly free, to other generally smaller banks which kept balances with them. A second practice was free checking provided by commercial banks to their individual customers. Over time, however, both of these practices proved to be increasingly costly and banks became less willing to continue them. This became a particular problem as both institutions and individuals, responding to higher market interest rates, made increased efforts to economize on the size of their deposit balances at any given time.

The second category included a number of different practices and arrangements, such as the sale of federal funds, the use of repurchase agreements, overnight Eurodollars, NOW accounts, ATS accounts, credit union share drafts, and telephone drafts. The sale of federal funds was a partial substitute for interest payments on bankers' balances. Instead of holding large correspondent balances on which interest is paid, as was common before 1933, banks with excess funds could lend them in the federal funds market. Overnight repurchase agreements (repos) and overnight Eurodollars allowed banks and corporations to lend funds while maximizing liquidity. Large corporations that could estimate closely their cash flows sold excess funds one day and received them back the next, thereby minimizing their idle

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<sup>12</sup> For a discussion of this view, see Bryon Higgins, "Interest Payments on Demand Deposits: Historical Evolution and the Current Controversy," *Monthly Review*, Federal Reserve Bank of Kansas City, July-August 1977.

<sup>13</sup> See George Benston, "Interest Payments on Demand Deposits and Bank Investment Behavior," *Journal of Political Economy*, October 1964; Milton Friedman, *A Program for Monetary Stability*, New York: Fordham University Press, 1959; and Friedman and Schwartz.

<sup>14</sup> See Benston.

balances. Sweep accounts, a relatively new innovation, allowed banks to pay interest on transactions accounts. Banks offered to "sweep" the funds from the accounts of large deposit holders at the end of the banking day, placing them in repos, money market funds, or other interest-bearing assets. This practice benefited both parties. Depositors had the use of their funds during business hours, but received an effective interest payment on demand accounts, and banks, by eliminating deposits before the close of the day, reduced their reservable liabilities.

As a result of these practices and arrangements, banks had been able for some time to pay interest on the transactions deposits of large firms and other banks. All that remained was for financial institutions to develop some effective method of paying interest on small individual accounts. Both banks and thrifts developed methods that allowed them to avoid the prohibition of interest payments on demand accounts. Savings and loans and mutual savings banks developed NOW accounts, credit unions developed share drafts, and banks developed ATS accounts. These methods allowed depositors to draw on funds in savings accounts which paid interest, directly in the case of thrifts and by way of a zero or low minimum balance checking account in the case of commercial banks. The development of these practices was slow, however, as NOW accounts were limited to New England by an act of Congress and the development of the other accounts was retarded by various lawsuits.<sup>15</sup>

Because of these changes, it became increasingly difficult to justify the prohibition of interest payments on transactions accounts. Congress faced three choices: reregulate to encom-

pass the new practices which avoided the prohibition, remove the prohibition altogether, or take some intermediate step. The first reaction would have been judged most likely based on historical experience, and the second would have been the choice of those who argued that such regulation is inefficient. It was the third choice, however, that was made.

DIDMCA does not, strictly speaking, remove the prohibition of interest payments on demand deposits created in the Glass-Steagall Act. Instead, it authorizes banks and thrift institutions to offer a different kind of account payable on demand, the NOW account. NOW accounts are available to individuals and certain specified not-for-profit organizations only. Corporations and partnerships operated for profit may not hold NOW accounts, but single proprietorships, where there is no distinction between the person and the firm, are allowed to hold them. DIDMCA also legalized ATS accounts and share drafts.

### **INTEREST RATE REGULATION: USURY LAWS AND CEILING RATES ON DEPOSITS**

While the origins of usury restrictions are principally religious and lie in the dim past, over the last 200 years they have been based on a belief that borrowers needed protection from predatory lenders. Most usury limits are state imposed, but the federal government also has limited the rate of interest to be charged by financial institutions. The First and Second Banks of the United States and all national banks were limited regarding the interest they could charge on loans.<sup>16</sup> Glass-Steagall also

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<sup>15</sup> See Frederic H. Karr, *Interest Payments on Third-Party Accounts*, New York: Praeger, 1980.

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<sup>16</sup> For the charters of the two Banks of the United States and the National Banking Act, see Herman E. Kroos and Paul Samuelson, *Documentary History of Banking and Currency in the United States*, New York: McGraw-Hill, 1969, pp. 307-15, 460-77, 1381-1412.

fixed the usury limit for national banks at either the state limit, 7 percent, or one percentage point greater than the Federal Reserve's discount rate, whichever was highest. In general, federal usury laws have been aimed at allowing national banks to be at least competitive with state banks. While the statute has been changed several times, it is now almost identical to the wording used in 1933.

Ceiling rates on deposits trace their origins to the same source as the prohibition of interest payments on demand deposits. It was widely believed that banks, in their competition for deposits, would be tempted to offer interest returns that would require them to increase their income. An increase in average return, it was held, could come only with an increase in risk, which would increase the probability of failure. Accepting this argument, the Glass-Steagall Act gave the Board of Governors of the Federal Reserve System the power to regulate the maximum interest rates paid on the deposits of member banks. In 1935, the regulation was extended to all federally insured commercial banks.

As was the case of the prohibition of interest on demand deposits, developments after World War II led to a reevaluation of the desirability of usury laws and interest rate ceilings. The basic argument against interest ceilings and usury laws was the same one used against the prohibition of interest payments on demand deposits—that is, the absence of these restrictions would not cause instability, and their existence causes inefficiencies and the misallocation of resources. There also was reason to believe that interest rate ceilings had served to subsidize financial institutions and borrowers at the expense of savers. Smaller savers in particular found it difficult to get the market rate of return as interest rates rose during the 1960s and 1970s.

Similar to the prohibition of paying interest

on demand deposits, the rationale for ceiling rates and usury laws was undermined by the post-World War II rise in interest rates. Before 1957, ceiling rates were high enough that they were not binding. Between 1957 and 1966, market rates pushed on regulated rates, but the latter were always raised. Fundamental change occurred in 1966, when ceiling rates became binding and were not increased. Instead, the system of ceiling rates was extended. The Interest Rate Adjustment Act of 1966 brought thrift institutions under regulation as well. Mutual savings banks came under the regulation of the FDIC and savings and loans came under the FSLIC. Thrift institutions were given an interest rate advantage over commercial banks, but they too began to face the problem of rising market interest rates.

The imposition of binding constraints had three effects. First, financial institutions developed new practices aimed at avoiding the limitations. The difficulties in 1966, for example, led commercial banks to begin to use the Eurodollar market. The depositors of banks placed funds in the overseas branches of banks, then banks borrowed the funds from their branches. Institutions also began to promote certificates of deposit because by offering CD's with longer maturities they were able to increase the rates they were allowed to pay. New methods of compounding interest also increased the effective rate. Many institutions used noninterest inducements as well, offering merchandise to depositors for opening new accounts or adding to existing accounts.

Second, the changed situation altered the activities of the Federal Reserve System. Additional resources were expended to police the ceilings, and the Federal Reserve had to take the existence of binding interest rate constraints into account whenever it changed policy. Ceilings were raised from time to time, and the ceilings on CD's over \$100,000 were removed in

1973. By and large, though, between 1966 and the present, ceilings on smaller accounts have been binding with only a few exceptions. The regulations also have become more complex due in part to the increasing number of options offered by institutions.<sup>17</sup> Among these options are multiple maturity deposits, which were eliminated in 1973, and the increasing differentiation of maturities and denominations.

Third, because the ceilings proved more effective than the attempts at avoidance, financial institutions have been increasingly plagued by disintermediation. Disintermediation occurs when depositors withdraw their funds from depository institutions and invest them directly in market instruments. Disintermediation was most severe during periods when market rates were most out of line with the regulated rates. In particular, 1966, 1969-70, 1973-74, and 1979-80 were periods of exceptional difficulty for financial institutions. Thrifts and small banks found it especially difficult to maintain their deposit flows because they relied so heavily on individual depositors.

Rising market rates also posed problems for usury ceilings. When financial institutions were able to attract funds at market rates, they sometimes found that their return on loans was limited by usury laws. Not surprisingly, the existence of a ceiling price encouraged financial institutions to develop practices designed to reduce its effect. One example is the imposition of "points" on mortgage loans. Points require mortgage borrowers to pay some of the interest up front in order to get the loan.

The existence of these problems—disintermediation, merchandise gifts to depositors,

points, and the like—created additional arguments for the deregulation of interest rates. The same three choices faced Congress regarding interest rate regulation as faced them regarding the prohibition of interest payments on demand deposits. Again, Congress chose an intermediate path.

DIDMCA does not undertake a wholesale elimination of interest rate regulation, but it does move the financial sector further toward market-determined interest rates on deposits and loans. In Title II, DIDMCA sets in motion a process which will eliminate interest ceilings on time deposits over a six-year period. Title II creates the Depository Institutions Deregulation Committee (DIDC), which is charged with carrying out the process of deregulation of ceiling interest rates. The act also preempts state usury laws with regard to home mortgages, although it allows the reinstatement of such laws by the individual states. Usury ceilings also are eliminated for business and agricultural loans over \$1,000. Existing ceilings are replaced with a floating ceiling based on the Federal Reserve discount rate, a provision that will expire no later than April 1, 1983.

## THE NATURE OF FINANCIAL INSTITUTIONS

Traditionally, the chartering or incorporation of financial institutions in the United States has been based on the notion of specialization. Two types of depository institutions have existed side by side since the early 19th century: commercial banks and thrift institutions. Commercial banks in the United States are direct descendants of English commercial banks. Historically, such institutions have been expected to engage in financing of production and trade, using short-term loans. They were to avoid engaging in investment activities, which are longer term and include such

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<sup>17</sup> For a discussion of Regulation Q, see Scott Winningham and Donald C. Hagan, "Regulation Q: An Historical Perspective," *Economic Review*, Federal Reserve Bank of Kansas City, April 1980.



things as loans for plant and equipment, and residential construction, as well as the purchase of corporate securities, both common stock and corporate bonds. Because of the existence of a ready market and relatively stable values, government securities have over time become acceptable investments for commercial banks, but banks were expected to concentrate on the short end of the spectrum.<sup>18</sup>

Thrift institutions in the United States, including savings and loans and mutual savings banks, are the descendants of the English building societies. These institutions have placed the bulk of their loans in mortgages, although the percentage has always been larger for savings and loans than for mutual savings banks. Mortgages, of course, are long term, and thrift institutions could lend long term because their deposits, representing the savings of individuals, were expected to be stable and turn over slowly. Credit unions, which have experienced rapid growth since 1960, accept savings deposits and concentrate on consumer loans. As in the case of other thrift institutions, the deposits of these institutions are expected to be stable.

The differing nature of the liabilities of depository institutions is the basic reason behind their specialization in lending. Commercial banks were expected to depend to a large extent on demand deposits for their funds. These deposits are highly liquid and turn over frequently. Commercial banks, therefore, were expected to be careful about the liquidity of their assets. The principal liabilities of thrift institutions, time and savings deposits, were held to be relatively illiquid. Thus, it was expected that assets of thrifts would be relatively long term and illiquid.

Historically, federal banking legislation

reflected the view that commercial banks should be limited in their activities. For example, the charters of the First and Second Banks of the United States placed limits on their mortgage loan and real asset holdings, and they were forbidden to purchase government debt. The National Banking Act of 1863 also restricted nationally chartered banks in their holdings of mortgage loans and real estate, and the Federal Reserve Act of 1913 did the same thing for member banks.

Federal legislation, however, failed to prevent national banks from engaging in investment activities because they found ways to avoid the limitations placed on their assets. The most common method of avoidance was the creation, under state law, of "captive" trust companies that were closely tied to the national bank. These trust companies undertook investments forbidden to their affiliated national banks. However, whenever the trust companies came under pressure, the national banks often felt obligated to attempt to support them, frequently bringing down both institutions. This was particularly true during the 1929-33 period, when the securities affiliates of many commercial banks came under stress. The banks, realizing that their own prestige was connected to that of their affiliates, often risked failure attempting to save the affiliates.

Portions of the Glass-Steagall Act were a direct response to this type of activity on the part of commercial banks. The Glass-Steagall Act limited the investment activities of national banks and specified the type of relationship national banks were to have with their affiliates. The result was to reduce sharply the investment and speculative activities of national banks.

Glass-Steagall also allowed mutual savings banks to join the Federal Reserve System and placed them under the new deposit insurance program. Other legislation passed during the 1930s brought thrift institutions under in-

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<sup>18</sup> See Hammond, pp. 680-85.

creased government regulation. Thrifts, because of their specialized role in housing finance, were tax exempt until 1951. Since that time the principal tax break open to them has been the bad-debt deduction. The favorable tax treatment now received by thrifts is linked directly to the proportion of their portfolios invested in mortgages and other qualifying investments, mainly cash and government securities.<sup>19</sup> Credit unions remain exempt from federal taxes because of their cooperative purpose and mutual organization. Recently, however, they have been exposed to increased regulation just as have other financial institutions. The clear intent of the law with respect to both thrifts and banks has been to reinforce the traditional specialization of depository institutions.

Changes that have occurred in the financial sector since World War II have greatly affected both the views about the nature of financial institutions and the actual practices of the institutions. One development has been that both commercial banks and thrifts have expanded into each other's area. Attracted by the increase in time and savings deposits held by the public and by the rapid growth of the savings and loan industry, commercial banks began to tap the market for savings and time deposits and to make mortgage loans, thereby taking deposits and business from thrifts. At the same time, thrift institutions offered transactions deposits and in some cases (mutual savings banks) invested in municipal securities, encroaching in

areas historically associated with commercial banks.

A second development is that attempts to enforce the maintenance of the traditional specializations did not prevent the emergence of financial instability. While commercial banks have been relatively free of the liquidity problems which plagued them in earlier years, thrift institutions have recently experienced such problems. Thrifts have seen their short-term liabilities (savings and time deposits) withdrawn because of higher interest returns offered on other investments, but have been unwilling to liquidate their portfolios because of the capital loss involved in selling fixed-rate mortgages after a substantial rise in interest rates. In other words, the maturity differential between their assets and liabilities has put them in a liquidity bind.

The difficulties experienced by thrift institutions and the increased competition between them and commercial banks created strong pressures for change in the regulation of the financial system. When commercial banks were subjected to liquidity crises in the 1930s, the response was to limit their activities. The response now that thrift institutions face similar difficulties is to expand their powers. Under DIDMCA, thrift institutions are given the opportunity to become more like commercial banks. DIDMCA allows savings and loans to put up to 20 percent of their portfolios in a basket of assets made up of consumer loans, corporate debt securities, and commercial paper. This will allow the return on a thrift institution's assets to reflect market rates more closely, protecting them somewhat from rising market interest rates. Federal mutual savings banks, whose portfolios already contain corporate and government securities, are allowed to invest 5 percent of their assets in commercial loans and accept demand deposits from businesses in connection with such activity.

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<sup>19</sup> There has been considerable controversy over the actual tax rates paid by different financial institutions. For a discussion of the tax treatment of thrift institutions, see Kenneth R. Bierderman and John A. Tuccillo, *Taxation and Regulation of the Savings and Loan Industry*, Lexington, Mass.: D.C. Heath, 1976. For a discussion of this topic in general, see Margaret E. Bedford, "Federal Taxation of Financial Institutions," *Monthly Review*, Federal Reserve Bank of Kansas City, June 1976.

## SUMMARY AND CONCLUSIONS

This article has traced the history of financial regulation in three areas: interest payments on transactions accounts, ceiling interest rates, and the nature of financial institutions. In the 1930s, interest payments on transactions accounts were prohibited and regulatory authorities were given the power to set ceiling interest rates for commercial banks—a regulation later extended to thrift institutions. The nature of financial institutions has been regulated throughout most of U.S. history, reflecting the view that financial institutions should have specialized functions.

Regulations in all three areas had their origin in the belief that they would promote financial stability. Since World War II, however, the arguments against these regulations have become more compelling, and developments in the financial sector have tended to undermine their effectiveness. As a result, their removal was begun when DIDMCA was passed in 1980. DIDMCA authorizes the payment of interest on personal transactions accounts through the use of NOW accounts, ATS accounts, and share drafts. The act also eliminates some usury ceilings and sets in motion the elimination of ceilings on deposit interest rates. Under the new legislation, savings and loans are allowed to diversify somewhat out of their traditional con-

centration on mortgage lending, and the investment powers of mutual savings banks are expanded.

Despite its break with the past, DIDMCA leaves a large body of regulatory authority untouched. The act recognizes some important trends in the economy and legitimizes them, but is silent regarding some important areas, particularly the direction of future regulation regarding the nature of financial institutions. Nevertheless, DIDMCA may be a portent of future legislation regarding financial deregulation. Few voices are raised nowadays in favor of more regulation. It is in vogue to favor deregulation in general—in energy, communications, transportation, and many other areas.

The primary argument for deregulation is a belief that it will foster increased competition and greater efficiency. The issue of stability no longer receives the emphasis it once did, even from the opponents of deregulation. This is due in part to the belief that, through its monetary policy, the Federal Reserve System is able to provide for overall stability. But it is also due to the stabilizing impact of some of the regulations passed in the last half century—deposit insurance, for example. Thus, it is possible that the removal of certain regulations may lead to instability. In the period that lies ahead, the difficult task that faces deregulators is determining the optimal set of regulations.