

The Cost of Price Control in Banking*

FRANK E. MORRIS

President, Federal Reserve Bank of Boston.

The banking industry in the United States is unique in its regulatory treatment in that, while banking has none of the characteristics of a public utility which would render competition socially wasteful, competition in banking is restrained under Federal law, both, geographically, and in terms of the interest rates that may be paid on deposits.

Geographic restraints on banking competition go back to the earliest days of our Republic and reflect a fear of concentration in finance. The followers of Hamilton wanted a strong national banking system which they felt was essential for the development of a vigorous manufacturing industry. However, the followers of Jefferson, the farmers and the people of the frontier states, felt that such a system would leave their destinies in the hands of Eastern money-center bankers. The Jeffersonians won the issue and the uniquely decentralized banking system of the United States resulted. The pattern in all other industrial nations is that ten or fewer commercial banks control 90 percent or more of commercial bank deposits.¹ In the absence of restraints on competition geographically, there is little reason to suppose that our banking structure would have developed much differently.

The national political climate of concern about concentration in banking led to the primacy of the states in determining the structure of banking within their boundaries

*Invited address at the Fifth Annual Meetings of the Eastern Economic Association, Boston, Mass., May 1979.

¹In the United States, the top ten banks control only 35 percent of commercial bank deposits.

and to the passage of restrictive state laws, some of which had the effect of encouraging local monopolies.² We have seen in recent years the beginnings of some new thinking in the Congress questioning whether, in seeking to avoid banking concentration nationally, we have allowed too many restraints on competition and whether a position somewhere between Jefferson and Hamilton might produce better results for the consumer of banking services. Politically, this issue is closely related to the issue of restraints on price competition in banking.

Restraints on price competition have a much briefer history, dating only to the early 1930s. They were the product, not of any social or economic philosophy, such as we find in the history of geographic restraints on competition; they were, instead, the products of reaction to crisis—the commercial banking crisis of the early 1930s and the crisis of 1966 in the case of the thrift institutions.

A mythology developed during the 1930s to the effect that the massive bank failures of that era were caused by excessive price competition for deposits. The subsequent research on this issue has not lent support to this thesis.³ Nevertheless, myths have their uses. This one gave the Congress a basis for moving against our most fundamental eco-

²Typical of these is Connecticut's Home Office Protection Statute which prohibits any bank from establishing a branch in any town which is the home office of another bank.

³See George J. Benston, "Interest Payments on Demand Deposits and Bank Investment Behavior," *Journal of Political Economy*, October 1964, and Albert H. Cox, Jr., *Regulation of Interest on Bank Deposits* (*Michigan Business Studies*, Vol. XVII, No. 4, 1966).

conomic instincts and passing legislation restraining price competition for deposits. The real rationale for the legislation was quite different. One of the principal objectives of the Administration and the Congress was to pass legislation establishing deposit insurance. The original deposit insurance plan enacted in 1933 was very expensive to the banks. It called for an assessment of one-half of one percent per dollar of deposits. It was particularly expensive in an era when short-term money rates had fallen to very low levels. The average 90-day Treasury Bill rate in 1933 was 0.52 percent. To accept this sizable new burden when their earnings were so depressed and their capital had been seriously eroded by loan losses, the banks required some *quid pro quo*. The political tradeoff for deposit insurance was the acceptance of legislated restraints on price competition.⁴

Restraints on price competition among thrift institutions were not imposed until 1966, when the vulnerability of those institutions to sharply rising interest rates was first exposed. Oddly enough, the objective was not so much to prevent excessive price competition among thrifts, but to protect the thrifts from the competition of commercial banks.

Whenever restraints on competition are imposed by government, certain costs must be incurred. In the case of price control in banking, the costs are of two sorts: first, the banking system operates less efficiently than it would in the absence of price controls—less efficient in the sense that the essential body of banking services is produced at a higher cost; and second, the controls discriminate against the small depositor.

Some useful analogies may be drawn between the stock brokerage business, which prior to 1975 operated under minimum

commission restrictions, and the banking business.

Whenever minimum prices are established for the services of an industry (as was formerly the case in the brokerage industry) or whenever maximum prices are established for the raw materials used by an industry (such as in the banking industry today), a shelter is created under which the inefficient firm may be able to survive. Removing that shelter is likely to result in some decline in the number of organizations operating in an industry, with the survivors operating at a lower average cost.

From 1968 (the peak year for the stock market) to 1977, the number of member organizations on the New York Stock Exchange declined by almost 27 percent.⁵ Much of this decline would have occurred even if the minimum commission system had survived as the long bear market in common stocks produced a much reduced participation of individuals in the market. Indeed, most of the decline occurred before competitive rates actually began in 1975. However, I think there is little doubt that part of the decline represented the weeding out of a sizable number of firms that could not survive in an environment of competitive rates. With fewer firms, transactions on the New York Stock Exchange are now being carried out at a substantially lower average cost than in the pre-1975 era.

We have seen in the years since World War II a fairly steady growth in the number of commercial banks.⁶ I would expect this trend to be reversed if the shelter of restraints on price competition were removed. The reversal would be even more marked if some of the restraints on geographic competition were also to be loosened. However, the major

⁴See "Interest on Demand Deposits," *Golembe Reports*, Vol. 1975-10 (Carter H. Golembe Associates, Inc., Washington, D.C.).

⁵New York Stock Exchange, *Fact Book*.

⁶From the end of 1945 to the end of 1978, the number of commercial banks increased by 5 percent.

improvement in the efficiency of the banking industry is not going to come from the elimination of inefficient banks, but from the elimination of socially wasteful forms of competition which always arise when price competition is restrained.

When price competition is restrained, competition is likely to be expressed in other forms. In the case of the banking industry, it is expressed primarily in giving away costly services and in adding branch offices to compete by offering greater convenience.

The most important example of costly services given away is the free checking account. Since it costs about 30¢ to clear a check,⁷ while to the customer it is a free good, it is clear that the value of the check-writing service to the marginal user is going to be substantially less than the cost of production. The average consumer would be better off with an unbundled system under which he is paid a market rate of interest on his deposit and is charged a fee for writing checks based on the cost of producing that service.

Prior to the establishment of competitive brokerage rates, the rates paid on large transactions were so extremely profitable that brokers offered all sorts of free services to institutional investors for so-called "soft dollars." The fact that the cost of production of these services vastly exceeded their value to the marginal user is demonstrated by the fact that few of these services have survived the initiation of competitive brokerage rates.

Another socially wasteful form of competition in banking under a price control regime takes the form of a proliferation of branch offices. From 1957 to 1977, the number of commercial banks in the United States grew by about 6 percent, but the number of branches more than quadrupled from about

8,000 to more than 32,000.⁸ Since the country grew substantially during those years, there was undoubtedly an economic need for some additional branches, but the quadrupling of the number of branches must largely reflect an uneconomic form of competition.

A study recently published by the Federal Reserve Bank of Boston attempted to identify the increase in branching that was associated with the imposition of restraints on price competition.⁹ Because most of the savings banks in Massachusetts are not Federally insured, they did not become subject to interest rate ceilings until January 1970. A model was constructed describing the behavior of the Massachusetts savings banks during the decade of the Sixties. The model generated, among other things, the interest rates paid relative to market rates, the growth in branches and the growth in operating expenses.

The model estimated that, in the absence of restraints, Massachusetts savings banks would have paid an average deposit rate in 1975 of 6.73 percent, rather than the actual average rate of 5.73 percent. The estimated interest loss to depositors at mutual savings banks in Massachusetts during the years 1970-1975 amounted to \$527 million. The branching practices of the Massachusetts savings banks changed almost immediately following the imposition of rate ceilings. During the period 1970-1975, 84 more branches were established than the model would have projected based on the pre-control experience of the 1960s. These 84 branches constituted almost 16 percent of total savings bank offices in 1975. In large part due to the additional branches, total operating expenses

⁸Federal Deposit Insurance Corporation, *Annual Report*.

⁹Rogert A. Taggart, Jr and Geoffrey Woglom, "Savings Bank Reactions to Rate Ceilings and Rising Market Rates," *New England Economic Review*, Federal Reserve Bank of Boston, September-October 1978.

⁷See Paul S. Anderson, "The Costs and Profitability of Bank Functions," *New England Economic Review*, March/April 1979.

for the period 1970–1975 were \$93 million higher than the model would have estimated. The additional operating expenses in the year 1975 equaled 25 percent of total operating expenses.

I think it is clear that the removal of restraints on price competition would lead to a substantial decline in the number of branch offices of both commercial banks and thrift institutions. There is another, independent force which is also pushing in this direction; that is, electronic funds transfer which is likely to make the grocery store a more convenient place to bank than the branch bank.

In addition to its negative impact on the efficiency of the banking business, price control in banking has, in effect, mandated discrimination against the small depositor. The large depositor has many options open to him which assure his ability to get the going market rate on his funds; the small depositor does not and, consequently, it is the small depositor that must bear the cost of rate ceilings. If he happens to be a depositor in a commercial bank, he receives an extra dose of discrimination due to the one-quarter of one percent differential on ceiling rates enjoyed by the thrift institutions.

The dependence of the poorer segment of our society on the ordinary savings account as an investment medium is documented in recent work by Edward Kane. He found that 88 percent of the wealth of households with total wealth of \$1,000 or less is lodged in rate-regulated financial assets. This percentage drops to 40 percent for households with \$1,000–\$5,000, to 20 percent for those with wealth of \$5,000–\$10,000, and ultimately, to 5 percent for those enjoying wealth in excess of \$250,000.¹⁰

It may seem surprising that this legislated

discrimination against the small saver could have persisted so long without some consumer group rising in protest. Yet until 1978, when the Gray Panthers took up the issue, consumer groups were silent. The answer, it seems to me, lies in the fact that rate ceilings produced one significant benefit—lower mortgage rates than a free market would have produced.

To return to the study of the behavior of Massachusetts savings banks cited earlier, you will remember that it was estimated that the interest loss to depositors due to controls during the 1970–1975 period was \$527 million. It was also estimated that operating expenses were \$93 million higher than they would have been in the absence of controls, due in large part to the proliferation of branches. What happened to the remaining \$434 million? Since there was no above-trend rise in the earnings of Massachusetts savings banks during this period, it seems clear that the \$434 million was primarily reflected in lower mortgage interest rates.

Thus, the savings depositor was subsidizing the home buyer. While this would be difficult to defend on equity grounds, particularly since it has been shown that the average income of the savings depositor is substantially below the average income of people who take out mortgages,¹¹ it was a result that the housing lobby applauded. Whether explicitly or implicitly, consumer groups (until the Gray Panthers came along) sided with the housing lobby.

In the case of minimum commission rates for brokers, controls were first eroded by the action of the market, and legislation followed eliminating the controls. It appears that the same sequence is likely to be followed with price controls in banking.

In the case of stock trading, the principal

¹¹See Projector and Weiss, *Survey of Financial Characteristics of Consumers*, Board of Governors of the Federal Reserve System, Washington, D.C., 1966.

¹⁰Edward J. Kane, Testimony before the United States Senate Committee on Banking, Housing and Urban Affairs, April 12, 1979. The numbers quoted above pertain to male-headed white households.

market response was the development of the “third market” in which large transactions were executed off the exchanges at commission rates substantially below the minimum schedule. The strains generated by the “third market” were such that Congress ultimately responded by outlawing the minimum commission schedule.

The market has been responding gradually to price controls in banking for many years; but the pace of the response has accelerated in recent years and it has so eroded the control system that Congressional action is likely to be forthcoming in the not too distant future.

In the case of the prohibition of the payment of interest on demand deposits, banks have long offered to large corporate customers the device of the repurchase agreement—the sale of a security by a bank with an agreement to buy it back at a set price—a device which enables the bank to pay interest on overnight money. Nonbank corporate repurchase agreements totalled some \$42 billion at the end of March 1979. The corresponding figure for March 1975 was \$13 billion.

In the case of individuals, the market (sometimes with and sometimes without the blessings of the regulatory authorities) has created various ways of transforming a savings account on which interest can be paid into a transactions account. The first of these devices was the NOW account, which emerged in 1972. This was followed by the credit union share draft, the automatic transfer account and the so-called “remote services unit” of the savings and loan association, all of which have had the practical effect of paying interest on individual transaction accounts.

Challenging the ceilings on savings and time deposit rates are a growing variety of nonbank institutions which are offering attractive investment alternatives to consumers. The largest of the alternatives at the

moment are the money market mutual funds which currently have some \$20 billion in funds. Among the other emerging alternatives are: the Merrill Lynch Cash Management Plan and other similar plans offered by brokers; the action of the State of Massachusetts in offering state bonds with denominations as low as \$500, an action which other states might emulate; and the proposed move of Sears Roebuck to offer small denomination securities to its millions of customers. The Sears proposal was followed just this week by the Green Mountain Power Company of Burlington, Vermont which plans to offer its securities in denominations as low as \$500 to Vermont residents at rates substantially higher than Regulation Q ceilings.

Undoubtedly, the greatest catalyst for Congressional action was a recent decision of the United States Court of Appeals for the District of Columbia¹² in which the Court ruled that automatic funds transfers, credit union share drafts and the savings and loan associations “remote service units” were all in violation of existing Federal statutes. The Court stayed the execution of its order until January 1, 1980 so that the Congress would have time to deal with these issues.

Since the Congress rarely takes away a valued privilege which the consumer has been enjoying for some time and since the Congress usually acts to eliminate controls that have been badly eroded by the action of the marketplace, it is possible that we will see this year Congressional action to eliminate the prohibition of interest on demand deposits and action to phase out, probably over a period of several years, ceiling rates on savings and time deposits. When and if this takes place, market forces will be set in motion which will generate a more efficient banking system and one which will no longer discriminate against the small depositor.

¹²September Term 1978, Civil Action No. 77-2102.