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THE REPORT OF THE PRESIDENT'S COMMISSION ON FINANCIAL STRUCTURE AND REGULATION

(DECEMBER 1972)

INCLUDING RECOMMENDATIONS OF DEPARTMENT OF THE TREASURY

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

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AUGUST 1973

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STATEMENT OF THE CHAIRMAN

Since December 22, 1972, when the President's Commission on Financial Structure and Regulation submitted its report, the interest of all concerned has been such that copies are almost exhausted.

Early in the month of August, the President sent to the Congress a narrative summary of legislation to be proposed later that is "designed to strengthen and revitalize our financial institutions."

Most of these recommendations are similar to those of the Hunt Commission proposals. This committee print will again make available to the Congress and all interested parties these important studies and deliberations.

This committee print includes the original report of the President's Commission on Financial Structure and Regulation and the "Recommendations for Change in the U.S. Financial System" issued by the Department of the Treasury on August 3, 1973.

JOHN SPARKMAN.

COMMISSION ON FINANCIAL STRUCTURE AND REGULATION

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Washington, D.C. 20036

The President
The White House
Washington, D.C.

December 22, 1972

Dear Mr. President:

The President's Commission on Financial Structure and Regulation herewith submits its report.

The Commission was charged with undertaking a thorough analysis of the structure and regulation of financial institutions. This task completed, we propose a number of fundamental changes in the nation's financial system.

The Commission viewed the financial sector as a unified whole. In its studies and deliberations it took account of the interdependence of the various institutions. The recommendations should therefore be considered and implemented in the same manner. The recommendations, taken together, would produce a structural and regulatory system which will efficiently and equitably serve the financial needs of the country in the coming decades.

The report reflects a consensus of the views of Commission members. Individual Commissioners, however, may not agree with all of the recommendations. The signatures of the Commissioners should be interpreted as an indication of their general agreement with the thrust of the report, not as full accord on the many issues discussed in it.

We respectfully submit our report in the hope that it will assist you, the Congress, other officials of the Government, and all Americans interested in improving the performance of the financial system.

Sincerely,

Reed O. Hunt
Chairman

THE COMMISSIONERS

Reed O. Hunt
Chairman
Retired Chairman of the Board
Crown Zellerbach Corporation

Atherton Bean
Chairman of Executive Committee
International Multifoods Corporation

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Professor of Economics
Barnard College, Columbia University

Robert H. Stewart, III
Chairman
First National Bank in Dallas

*Resigned September 1, 1971 to become a member of the Council of Economic Advisers.

The members of the Commission, though identified by title and principal occupation, have served and signed this report as individuals.

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Foreword

President Richard M. Nixon disclosed his plans to appoint a commission to study the nation's financial structure in the *1970 Economic Report of the President.* On February 19, 1970, then Secretary of the Treasury David M. Kennedy informed the Joint Economic Committee of the President's plans, emphasizing the long-range nature of the proposed commission's study.

My appointment as Chairman of the Commission on Financial Structure and Regulation was announced by the President on April 22, 1970. On April 28, the Treasury Department held a meeting to help identify issues deserving Commission attention and the approaches and methodology the Commission might use in dealing with them.

The Treasury meeting was led by Henry C. Wallich, Senior Consultant to the Treasury, with Under Secretary Charls E. Walker in attendance. Those invited included representatives from the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, the Office of the Comptroller of the Currency, the Bureau of the Budget and the Council of Economic Advisers. Leading scholars from universities and financial institutions also attended.

The meeting produced many valuable suggestions. Under Secretary Walker and I asked Samuel P. Chase, Donald P. Jacobs and Almarin Phillips to distill these suggestions and prepare a proposed study agenda for the first meeting of the Commission.

On June 16, 1970, President Nixon announced the names of the outstanding citizens who had agreed to serve as members of the Commission. The President gave them a broad mandate: to "review and study the structure, operation, and regulation of the private financial institutions in the United States, for the purpose of formulating recommendations that would improve the functioning of the private financial system."

The first meeting of the Commission was held in Washington on June 27, 1970. At this first meeting, it was agreed that the Commission would focus primarily on problems relating to commercial banks, mutual savings banks, savings and loan associations, credit unions, private pension plans and reserve life insurance companies. For these institutions, the Commission elected to study in detail their functional specialization, the effects of deposit rate regulations, chartering and branching, problems of deposit insurance, reserves and taxation, the effects of regulations on mortgage markets and residential construction, competitive problems and the framework of the financial regulatory agencies. As this report shows, these plans were little altered at subsequent meetings.

The Commission elected to operate as a committee-of-the-whole rather than divide into specialized groups. Materials relating to topics of meetings were mailed to the Commissioners in advance of each meeting. These consisted of statements and letters from individuals, trade groups and government agencies, articles from journals, books, government agency and Congressional hearings and reports, and 19 papers prepared specifically for the Commission by outside experts. Early meetings were devoted to general discussions of broad problems and policy alternatives. The development of an integrated set of recommendations occupied the meetings after March, 1971.

There were 15 meetings, and each was attended by all or nearly all of the Commissioners. At first the meetings were for one day, but as the drafting of the report progressed, meetings were extended. In the final two meetings, in November and December, 1971, the Commission met for several consecutive days in order to complete the report on schedule.

The report represents a consensus of views. Individual Commissioners may have somewhat divergent opinions on some issues but, considering the report as a whole, there is broad support among the Commissioners for its recommendations.

The roles played by members of the staff are gratefully acknowledged. Donald P. Jacobs and Almarin Phillips, the Co-Directors, gave intellectual direction to the Commission's work by providing alternative approaches for our consideration and preparing drafts of the report as the consensus of views emerged. They maintained continuous contact with Commission members and assumed a liaison role with government agencies and other parties interested in the Commission's progress. The absence of a single director may have violated conventional organizational practice, but Professors Jacobs and Phillips worked well together in tandem.

The Co-Directors were aided immeasurably by Lucille S. Mayne, who summarized and indexed the reading materials and prepared drafts of some sections of the report. Bertwing C. Mah also served as an economic expert, providing data and memoranda on many of the topics on the Commission's agenda. Neil B. Murphy was staff economist during the summer of 1971, the period when the first drafts of a complete report were being prepared.

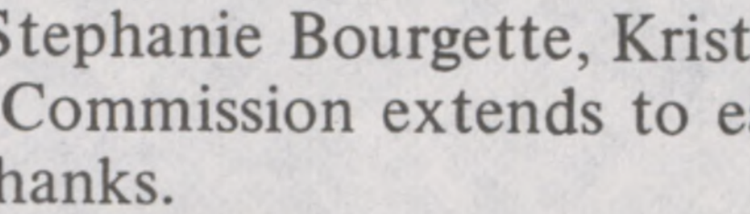
Allen R. Rule served as Special Assistant to the Chairman, counsel and legal researcher. Mr. Rule was of great assistance to the Chairman, and most helpful in opening and staffing the Commission's offices in Seattle and Washington, D.C. He also helped in drafting the report. James T. Lynch also acted as counsel, did much of the legal research underlying the recommendations, and helped in drafting the report. Henry M. Shine, Jr., became Director of Government and Industry Relations in May, 1971. Mr. Shine was appointed to augment relations with the Congress, executive agencies, consumer groups and the financial industry as well as to provide continuity after the Commission's report was completed.

The support staff, too, has been exceptionally helpful. The Washington Office was headed by Clarence H. Scruggs. Mr. Scruggs handled administrative matters for the Commission and made arrangements for all the meetings. He was assisted during the first year by Patricia Watts and, from December, 1970, by Francine Oreto. The Washington Office has also included Veachel Ambrose, Patricia Bennett, Sheryl Kemerling, Patricia Sagon and Linda Winkler.

The staff of the Seattle Office included Maureen E. Hallgrimson, assisted by Stephanie Bourgette, Kristine Fransen, and Marilyn Meyer. The Commission extends to each member of the staff its profound thanks.

Finally, a word about the Commission members. After working closely with these gentlemen for over 18 months, I can only say they were well-chosen. They brought broad experience to the assignment and every meeting reflected their preparation, diligent work and keen interest.

It was a tremendous experience to act as Chairman for this group. We conclude with a strong hope that we have suggested changes which will be helpful to our country.



Reed O. Hunt
Chairman

PART I

INTRODUCTION

A. The Commission's Approach

The American financial system is unique in the modern world. Made up of tens of thousands of highly diversified individual units, ranging from general purpose to specialized institutions, its structure mirrors the decentralized free enterprise economy which it serves.

The system did not evolve through happenstance. For well over a century the American public has insisted that its financial institutions be both competitive and sound. The two objectives are not easily reconciled, and yet both must be achieved if we are to avoid, on the one hand, a highly concentrated financial structure and, on the other, a system unable to withstand the vicissitudes of economic change. The public is entitled to the benefits of a dynamic and innovative system responsive to shifting needs. Yet the public also should be able to rely on the strength and soundness of the system.

Inevitably, difficulties are encountered in balancing these objectives. Sometimes change occurs too swiftly for adequate safety; at other times desirable change is held back by regulations that interfere with the ability of the system to meet public requirements as expeditiously and efficiently as possible. The latter circumstance helped give birth to the Commission on Financial Structure and Regulation. Tomorrow's requirements will be different from today's, and it is necessary to see that the system will be responsive to new needs.

Indeed, such concerns prompted the Council of Economic Advisers to observe in their *1970 Report:*

> Financial services required by tomorrow's economy will differ in as yet undefinable ways from those appropriate today. The demands on our flow of national savings . . . will be heavy in the years ahead, and our financial structure must have the flexibility that will permit a sensitive response to changing demands.[1]

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1 Report of the Council of Economic Advisers (February 1970), p. 104.

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Behind the Council's concern for the performance of financial institutions and the flexibility and soundness of our financial structure were the deficiencies of the system revealed during the latter 1960's. These were years of inflation and drastic shifts occurred in the pattern of the nation's flows of funds. The liquidity of many financial institutions was reduced, causing them to restrict loans to their customers. Particularly disadvantaged were residential mortgage borrowers, small businesses and state and local governments. Interest rates fluctuated violently, imposing unnecessary risks and costs on consumers already suffering from the costs of inflation. Moreover, the overall flow of savings was inadequate to meet all of the demands, public and private, placed on it without further contributing to the inflationary process.

The Commission's recommendations are intended to improve the future performance of the nation's financial institutions, regardless of the economic climate. But it is unrealistic to expect any financial system to function smoothly in, and emerge unscathed from, the economic and monetary conditions experienced in the United States in recent years. The Commission urges the adoption of more responsible fiscal policies and, in the private sector, more responsible price and wage behavior so that moderation will be possible in the conduct of monetary policy. Such moderation would make it easier to generate the capital necessary for a growing, high-employment economy at reasonable rates of interest.

In addition to the necessity of controlling inflation, the Commission believes that greater flexibility and operational freedom in the financial structure will improve the allocation of resources to the nation's economic and social needs. Within the limits necessary for soundness and safety, the Commission seeks to remove unworkable regulatory restraints as well as provide additional powers and flexibility to the various types of financial institutions.

Very generally, the recommendations authorize depository institutions to engage in a wider range of financial services. At the same time, the recommendations require that after a transitional period, all institutions competing in the same markets do so on an equal basis. It is essential, for example, that all institutions offering third party payment services have the same reserve requirements, tax treatment, interest rate regulations, and supervisory burdens. The critical need for competition on equal terms causes the Commission to emphasize the interdependence of the recommendations and warn against the potential harm of taking piece-meal legislative action. When financial institutions compete on equal terms, with respect to

reserves, taxes, rate regulations, and supervision, there should be no need for *ad hoc* protective policies in future periods of economic stress.

The recommendations are interrelated and the Commission urges that they be considered as a package, even though some of the proposed changes, if enacted separately, would improve the financial system. The Commission believes that piece-meal adoption of the recommendations raises the danger of creating new and greater imbalances.

In recommending increased freedom for the financial system, the Commission recognizes that precipitous action is inappropriate. The existing structure and regulatory framework must be changed in an orderly manner to achieve and maintain competitive balance between institutions, and to assure the system's proper functioning during the period of transition. Accordingly, several of the Commission's recommendations contain guidelines that would provide for an orderly phasing-out of the old system and phasing-in of the new.

The additional powers recommended by the Commission are not to be imposed on the institutions. The Commission seeks to abolish specialization forced by statute and by regulation. The Commission in no way seeks to inhibit the right of institutions to specialize if they so wish.

The Commission views the granting of new operating freedoms as a first step in an evolving process leading ultimately to the complete removal of socially harmful regulatory and statutory protection for particular types of institutions. Thus, institutions that choose to specialize in the climate of greater operational freedom must recognize that, after a limited transition period, the protective regulations accompanying the enforced specialization of the past will cease to exist.

The Commission's objective, then, is to move as far as possible toward freedom of financial markets and equip all institutions with the powers necessary to compete in such markets. Once these powers and services have been authorized, and a suitable time allowed for implementation, each institution will be free to determine its own course. The public will be better served by such competition. Markets will work more efficiently in the allocation of funds and total savings will expand to meet private and public needs.

B. Financial Institutions and the Regulatory Framework

The Commission on Financial Structure and Regulation has focused its attention on regulatory problems relating to six types of financial intermediaries: commercial banks, savings and loan associations, mutual savings banks, credit unions, life insurance companies and pension funds.

Non-life insurance companies were excluded primarily because their limited role as an intermediary does not involve any significant deposit or thrift function. Finance companies were excluded from detailed consideration because the National Commission on Consumer Finance is currently examining these institutions. The operations of the equity markets were not covered because a number of investigations of these markets were underway.

The recent *Institutional Investors Study* by the Securities and Exchange Commission gave attention to pension funds. Banks and life insurance companies are the major managers of these funds, and consideration of their activities required giving attention to so-called private pension funds as well.

The expanding international operations of American banks in recent years have had an important impact on domestic money and capital markets. The Commission included aspects of international banking in its early deliberations, but concluded that it had no recommendations to improve the performance of these markets. Similarly, the legislation of 1966 and 1970 made it unnecessary to focus on problems of bank mergers and bank holding companies.

The financial intermediaries covered by the report perform important economic functions. They gather savings and distribute the funds to numerous borrowers, thus affecting the allocations of real resources—what is produced, how it is produced, and to whom it is distributed. By accepting liabilities in the maturities desired by depositors and making loans in the maturities desired by borrowers, the intermediaries provide an essential service as well as a convenience. They assume risks as

they shift the maturity structure. An effective system of intermediaries is an indispensable element in promoting a high level of economic growth. It increases investment by lowering charges for credit; it raises the rate of return to savers above what would otherwise be available, thus promoting savings; and it makes funds available to borrowers at lower costs than would otherwise prevail.

Regulation of the operations of financial intermediaries influences the relative interest costs of various forms of investments and hence the amount and distribution of the real capital that is created for society's use through the saving process. The current regulatory framework under which financial institutions operate has been fashioned over the years by acts of the federal and state governments. Most of these acts, especially those relating to the depository institutions, came as responses to financial crises—particularly those during the Civil War years, the period from 1907 to 1914, and between 1927 and 1935. Significant changes recently have been made at both state and federal levels, but the framework still closely resembles the structure left at the end of the 1930's.

In contrast to this fairly stable regulatory framework, financial institutions and the markets they serve have undergone great changes over the past three decades. Since the 1930's the economy has grown rapidly, the technologies used by financial institutions and their customers have undergone fundamental changes, new financial institutions have emerged, and to the concern of economic policy for combating underemployment has been added the need to offset persistent, long-term inflationary forces. In many respects, the changes that have occurred in private institutions and in the markets they serve reflect efforts by the financial system to adapt to fundamental economic changes in a regulatory climate that has not adapted to these new conditions.

Ideally, well-functioning financial intermediaries should be able to accommodate themselves to periods of inflation or deflation. Yet the basic architecture of the current regulatory framework was developed to meet the distressed economic conditions of the 1930's. The resulting system was poorly suited to cope with the inflationary conditions of the past decade.

The Commission's recommendations for changes in financial structure and regulation, while they may not yield a system able to withstand a hyperinflationary situation, are intended substantially to improve the present framework. However, as already noted, the desired results cannot be fully achieved unless strong inflationary pressures are contained.

The recent period of sustained high interest rates had severe effects. Not only was the solvency of a large number of firms threatened, but many borrowers who traditionally relied on financial institutions for loans found them unwilling or unable to lend adequate funds, even at historically high rates of interest.

Efforts were made to curb the differential effects of the monetary restraint. Ceilings on deposit rates were used to shelter deposit thrift institutions from the rise in market rates of interest and thus to sustain the flow of funds into mortgage markets. Through their use it was hoped that the institutions threatened by the effects of high rates would not only be able to survive, even with relatively low yields on their portfolios, but also would continue to attract funds to enable them to grow and expand their mortgage loan portfolios.

Deposit rate regulations helped to ease the serious financial difficulties affecting thrift institutions in 1966 and 1969. This protection, however, caused acquisitions of deposits by these institutions to decline drastically during both years, with inhibiting effects on mortgage extensions and residential construction.

In addition, deposit rate regulations had other adverse effects. As the disparity between market rates and officially fixed ceilings increased, banks, under pressure to repay the funds acquired through sales of large, negotiable certificates of deposit, resorted to borrowing dollars from European sources. This substantially increased their costs and had serious effects on European money markets. At the same time, because of the inability of banks to supply credit, business borrowers turned to new channels. This combination of economic conditions and an outdated regulatory framework led to the swift development of new markets and new modes of operation. Corporations that normally would borrow from banks made it a common practice to issue commercial paper. Commercial paper outstanding rose from $8.4 billion at the end of 1964 to almost $39.2 billion by mid-1970.

As the period of tight money reached a climax in 1970, several large corporate borrowers contemplated direct placement on a nationwide basis of long-term obligations in denominations small enough to attract funds that would ordinarily be held in the deposit accounts of individuals. If this had occurred, the effectiveness of deposit rate regulations would have been further reduced and the deposit intermediaries, including those supplying the major share of residential mortgage funds, might have faced serious outflows of deposits.

The unexpected insolvency of the Penn Central Trans-

portation Company, a major corporation which had sold commercial paper, demonstrated the weaknesses that had developed in the system. The bankruptcy disrupted the money markets and threatened a financial crisis. Only prompt intervention by the Federal Reserve averted the crisis.

During the period of tight money, significant institutional changes occurred. Real estate investment trusts grew rapidly, pension fund and insurance fund managers developed new investment concepts, credit unions altered their service and asset mixes, and various other lending and borrowing arrangements developed. Thus, the regulators were, on the one hand, finding it increasingly difficult to accomplish their objectives and, on the other, they were decreasing the role and effectiveness of the institutions they aimed to preserve. Most importantly, savers, borrowers, and consumers were bearing unnecessary risks and costs.

Well-functioning financial intermediaries should be able to develop and use technological opportunities without significant strain on the system. It is widely believed that the financial sector has entered a period of rapid change. Technology is expected to influence the operating methods and structure of financial institutions in important but as yet uncertain ways. In the next few decades, technology may well have a more pervasive impact on financial structure than inflation has had in recent decades. The Commission is concerned with achieving a regulatory framework that allows adequate freedom for financial firms to adjust to new technological possibilities, encourages new types of financial firms to emerge, and at the same time assures that the resulting benefits will flow to the public.

Another manifestation of outmoded regulatory constraints was the tendency of commercial banks to grow through new corporate structures, particularly holding companies. This development was fostered by inflation and monetary restraint, since the new forms provided access to new sources of funds. In addition, the less visible new technologies had altered the efficiency of all financial institutions, and helped them to service enlarged geographic and product areas. In this environment, managers of financial enterprises used new forms of congeneric and conglomerate organization to achieve growth.

The financial system weathered the strains of 1966-70. By late 1970 deposit thrift institutions regained the ability to attract funds and to place them into the mortgage markets. Insurance policy loans, which had risen sharply in 1969 and 1970, leveled off. Commercial paper and Eurodollar borrowings declined. New legislation clarified the ways holding company devices could be used by commercial banks to attain

growth. Other changes in federal policies mitigated the impact of tight money on residential construction.

Yet none of these problems is finally solved. The easing of monetary policy relieved the immediate strain on financial institutions. Temporary wage-price controls were established, indicating reduced reliance on monetary policy in curbing inflationary forces. Nonetheless, when expectations of inflation have abated and controls are abandoned, monetary policy will again have a major role. In future periods of monetary restraint, however, older methods may work even less effectively than in the past. Deposit rate maximums will surely be less effective in maintaining the supply of mortgage funds, and in protecting financial institutions from disintermediation. Thus, even if monetary policy is used more moderately, the problems of liquidity and solvency encountered by financial institutions could be as severe as those experienced during 1966, 1969 and 1970. Modifications in the structure and regulation of the financial system are urgently needed.

C. Society's Goals and the Financial Intermediaries

In our free society, although Congress may establish national goals, the marketplace must, in one fashion or another, provide the means to pursue these objectives. When additional funding is needed to attain such objectives, the Commission favors open and direct subsidies or, alternatively, the use of tax credits. In this way, real costs are apparent to Congress and the public, the funding is included in the budgetary process, planning and control are improved, and money markets are not distorted. Financing through control of the portfolios of financial institutions is a costly and inefficient means of allocating resources.

A shift in the allocation of the nation's resources implies a corresponding shift in financing. New tax revenues may be applied or existing tax revenues may be transferred from one government program to another. Alternatively, governments may preempt real resources through the issuance of debt instruments. But, when the federal government borrows, the flow of savings to other borrowers is reduced and interest rates tend to rise.

To forestall a rise in interest rates and accommodate the displaced borrowers, the monetary authorities come under pressure to expand money and credit. Persistent monetary expansion in excess of real growth is inflationary. In the end, this process allocates real resources through the hidden tax of inflation.

When federally sponsored debt issues are financed outside the unified budget, significant increases in the public indebtedness are obscured. The ultimate effects on the allocation of real resources, however, are the same as direct federal financing and have the same inflationary impact.

A suggestion sometimes made for financing socially desirable objectives is to regulate directly the portfolios of financial institutions. This shifts real resources by altering

demand among types of debt instruments and imposes a hidden tax on the depositors of the affected institutions.

An example of the difficulty of attaining goals set by Congress through portfolio regulation may be seen in the recurrent housing crises of 1966 and 1969-70. The deposit thrift institutions were, in effect, compelled to maintain large holdings of residential mortgages.[1] Earnings on these holdings were insensitive to changes in market interest rates, and when these rates rose, the institutions were incapable of bidding for new funds. Attempts to alleviate the crises by regulation resulted in discrimination and substantial disintermediation. Although the financial system was warped into uneconomic patterns, funds did not flow in the desired manner. The public bore heavy costs, visible and concealed, but housing goals were not attained.

The Commission favors the use of direct subsidies or tax credits because they are less inflationary, do not warp financial institutions, and bring market forces into play in pursuing the nation's goals.

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1 Although all of the institutions covered in this report are thrift institutions in that they contribute to the savings process, the term "deposit thrift institution", following conventional usage, refers to savings and loan associations and mutual savings banks.

D. The Organization of the Commission Report

Part II of this report presents the Commission's recommendations. Sections A and B deal with regulations on interest rates payable on deposits, and with regulations on the functions which savings and loan associations, mutual savings banks, commercial banks and credit unions may perform. Section C treats chartering and branching laws and regulations at both the state and federal level. Sections D and E cover required reserves on deposits and the taxation of financial institutions. Section F presents some proposals for changes in deposit insurance.

The recommendations relating to interest rate ceilings and the functions of savings and loan associations and mutual savings banks would affect the supply of mortgage funds and the means by which national housing goals are reached. Section G reviews these problems and makes several additional recommendations. Section H suggests a number of changes in the federal regulatory and supervisory agencies that the Commission believes would improve their operation.

Life insurance companies, largely regulated at the state level, are considered in Section I. Recommendations in Section J, for improvement in the supervision and required reporting by bank trust departments and pension funds and for extending tax deferment opportunities, conclude Part II.

Part III summarizes the anticipated effects of the Commission's recommendations on the consuming public and on the likely attainment of social goals. It also views the recommendations from the vantage points of regulators and institutions in the regulated industries.

PART II
RECOMMENDATIONS *

* Recommendations are numbered consecutively within each lettered section of the report.

A. The Regulation of Interest Rate Ceilings on Deposits

TIME AND SAVINGS DEPOSITS AND CERTIFICATES OF DEPOSIT

The Commission recommends that:

1 **the power to stipulate deposit rate maximums be abolished for time and savings deposits, certificates of deposit and share accounts of $100,000 or more**

2 **the power to stipulate deposit rate maximums on time and savings deposits, certificates of deposit and share accounts of less than $100,000 at commercial banks, mutual savings banks, savings and loan associations, and credit unions be given to the Board of Governors of the Federal Reserve System for use on a standby basis, to be exercised only when serious disintermediation is threatened**

3 **the Board have discretionary power to reduce the $100,000 cut-off amount for the standby power**

4 **the standby power of the Board to establish interest rate ceilings on time and savings deposits, certificates of deposit and share accounts include the power to:**

a **establish for a period of five years ceiling differentials between institutions providing third party payment services and institutions not providing such services** [1]

b **establish for up to two years from the date these recommendations are adopted rate ceiling differen-**

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1 Third party payment services, as here defined, include any mechanism whereby a deposit intermediary transfers a depositor's funds to a third party or to the account of a third party upon the negotiable or non-negotiable order of the depositor. Checking accounts are one type of third party payment service. Escrow accounts incidental to loan agreements are not included as third party payments.

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tials between commercial banks and deposit thrift institutions then offering third party payment services

c establish for up to two years from the date of inauguration of third party payments rate ceiling differentials between commercial banks and individual deposit thrift institutions that inaugurate third party payment services subsequent to the date these recommendations are implemented

5 after the limited period stipulated in recommendation 4a above, the Board may only establish uniform interest rate ceilings for depository institutions under its jurisdiction with no differentials based on whether or not third party payment services are provided or on the time such services were inaugurated

6 the standby power of the Board to establish interest rate ceilings be abolished at the end of a ten-year period following the implementation of these recommendations

Federal regulation of maximum rates that commercial banks can pay for time and savings deposits was first imposed by the Banking Act of 1933. The intent of the legislation was to reduce interest rate competition among banks, which was believed to increase bank costs and encourage banks to purchase high yielding, risky assets. The view at the time was that holdings of such assets had been a major factor in bank losses and failures after the crash of 1929.

Federal maximums for savings and loan associations and mutual savings banks were established in 1966. Since then, the regulation of maximum interest rates on time and savings accounts has had an entirely different purpose. These ceilings have been used since 1966 to protect the liquidity positions of the deposit thrift institutions, life insurance companies and some commercial banks during periods of rising interest rates. One objective has been to hold down deposit rates and insulate deposit institutions from forces in the money markets that might drain funds from them. Another has been to maintain a differential between the rates paid by commercial banks and deposit thrift institutions in order to prevent a shifting of deposits among the intermediaries.

For extended periods of time between 1966 and 1971, deposit rate maximums were below the market interest rates. During such periods, depositors who left their funds with commercial banks or deposit thrift institutions received a lower

return on their funds than they might have received through direct investment. This fact gradually became known to an increasing number of depositors, a learning process assisted by borrowers who developed instruments attractive to depositors and other holders of funds. Funds that otherwise would have remained as deposits, or would have been deposited with intermediaries, were withdrawn or withheld because of the availability of higher yielding direct investments. As a result, the regulations failed to achieve a primary objective.

The disintermediation between the institutions and other parts of the money and capital markets had several undesirable consequences. As deposit thrift institutions became unable to attract funds, the private mortgage market shrank and interest rates rose, adversely affecting consumers. The housing crisis prompted direct federal intervention on a massive scale in the mortgage market.

Large commercial banks that had relied heavily on large certificates of deposit and time and savings deposits were faced with redemptions and deposit withdrawals. Smaller banks, although less drastically affected, also felt a liquidity pinch as depositors became more aware of competing returns. The loss of deposits limited the ability of all banks to serve their customers' credit needs. Large businesses with the skill and the credit rating to borrow in the commercial paper market continued to have access to credit. Small and medium sized businesses did not have attractive alternatives to borrowing at banks and therefore found their ability to acquire funds restricted.

Because of the enlarged borrowing through the commercial paper market and the reduced importance of intermediaries in credit flows, the liquidity position of an important segment of business was weakened. The loss of liquidity caused serious concern to many businesses. Even more important, sharp market.fluctuations raised fears of a liquidity crisis which might well have produced a collapse of confidence and serious financial losses throughout the economy.

The disintermediation also affected the ability of the Federal Reserve to control credit through conventional monetary policy techniques. With large and increasing credit flows moving outside the commercial banking sector, the Federal Reserve's restrictive policies were required to become more and more stringent even as they became less and less effective.

Depositors who withdrew their funds and invested directly received a yield higher than the deposit rates. If intermediaries could have paid the market value for these funds and handled the investment process they would have fared

better. There is a positive relationship between the size of a deposit and the rapidity of disintermediation; therefore, interest rate regulations have discriminated against small savers. In addition, since a growing number of depositors have learned of ways to take advantage of alternative direct investments and borrowers have developed new instruments that lessen the difficulties of direct investments, the regulations afford diminishing shelter.

The Commission believes for these reasons that rate regulations on time and savings deposits should be removed. Their precipitous removal, however, would cause harm to the deposit thrift institutions, life insurance companies and many banks. These firms have substantial holdings of long term investments and, in the case of insurance companies, have contracts with their policyholders to make loans at low fixed rates. These commitments make them sensitive to the interest rate risks of a fully de-regulated market. Thus, except for deposits of $100,000 or more, the Commission's recommendations aim at a gradual phasing-out of these ceilings, with the Board of Governors of the Federal Reserve System having the power for a period of ten years to impose ceilings in case of future emergency conditions (Recommendations 1, 2 and 6).

The maximums on large certificates of deposit and on large deposits—those of $100,000 or more—should be removed immediately. The Board of Governors should be given the power to reduce the size of the deposit in this category. Large depositors are almost certain to disintermediate when market rates go above the maximum rates. Retention of these maximums would force disintermediation from the deposit intermediaries and would encourage funds to be redirected through less efficient channels (Recommendations 1 and 3).

The additional powers recommended for deposit thrift institutions in the next section of Part II should eliminate the necessity of a differential between rate ceilings for the thrift institutions and commercial banks. But a period of transition is required. The authority for a differential would be maintained for two years after third party payment services are inaugurated by a deposit thrift institution; and, for those currently offering the services, for two years after the implementation of these recommendations. After the two years it is recommended that no differential be permitted for such institutions. In five years, all of the deposit thrift institutions and other intermediaries should have made asset and liability adjustments. Whether or not third party payment services have been introduced by individual deposit thrift institutions, it is recommended that the authority for maintaining any differential be removed after five years (Recommendations 4 and 5).

After a period of time, all institutions will have had the incentive as well as the opportunity to alter their mix of assets, liabilities and services. The regulations, especially if they have been used several times, will probably be unable to prevent disintermediation of even small deposit accounts. Accordingly, the Commission recommends that the standby authority to establish rate ceilings be abolished in ten years (Recommendation 6).

DEMAND DEPOSITS

The Commission recommends that:

7 the prohibition against the payment of interest on demand deposits be retained

The prohibition of interest payments on demand deposits, imposed by the Banking Act of 1933, was intended to achieve the same purpose as the interest rate ceilings on time deposits. The problems involved with prohibition of interest payments on demand deposits are somewhat different, however, and the Commission recommends against the removal of the prohibition at this time.

The regulatory changes recommended by the Commission imply extensive changes in the operations of the depository institutions. A phasing-in process will be needed to provide for an orderly transition to the new system. Immediate abolition of the prohibition of interest payments on demand deposits, with all the other changes recommended, would create a situation that might cause deposit thrift institutions to experience disintermediation. This would have adverse effects on the flow of mortgage funds. To combat this, the deposit thrift institutions might be forced to shift to extensive third party payment services more rapidly than many are capable of doing in an orderly way. The phasing-in process necessary to the success of the Commission's recommendations would be lost.

Nonetheless, the Commission believes that its recommendation against the removal of the prohibition should be reviewed in the future. There are important trends in the use of demand deposits and other third party payment services that should be noted. Large businesses have improved cash management techniques in recent years and reduced the amount of deposit balances held for given levels of transactions. Deposit balances have been shifted into short-term, highly liquid interest bearing instruments. Because of the strong competition for business accounts, banks have encouraged this trend by

aiding in the investment of corporate funds in commercial paper, bankers acceptances, government bills and similar money market instruments. In effect, large businesses now receive interest on assets serving the same purpose that demand deposit balances served a few years ago. The accounts of smaller businesses and individuals cannot be so easily transferred to interest bearing assets.

Some banks have experimented with devices to transfer funds from savings accounts to checking accounts as required when checks written by depositors are presented for payment. These devices generally have been ruled evasions of the prohibition of interest payments on demand deposits. Still, the accepted practice of permitting withdrawals from savings accounts on demand and of paying interest on savings accounts from day of deposit to day of withdrawal blurs any clear distinction between demand and time deposits. The ingenuity of bankers seeking ways for customers to receive interest on demand balances will continue to be shown in the future, especially if interest rates are high and customers' options are the liabilities of institutions other than commercial banks.

Some savings and loan associations and mutual savings banks currently offer non-negotiable third party payment services using customers' interest bearing accounts. A number of states permit mutual savings banks to offer checking accounts. Again, it is likely that these institutions will find ways to pay interest on what are really transactions balances. Technical changes may make these methods more efficient and thereby more widespread.

Many credit unions provide third party payment services for their members through variations of the negotiable order service. The State of Rhode Island has passed legislation allowing credit unions to offer checking accounts, though the act specifically prohibits interest payments on checking account balances.

Finally, there is the problem of "non-price" competition. Interest payments are means by which financial institutions attract funds. When interest is prohibited or limited, substitute rewards for depositors are found. The substitutes are in the forms of convenience—especially branching in states where it is permitted—and in the provision of "free" services. Non-price competition in convenience and services leads to uneconomic increases in operating costs and forces some customers to use services when they would prefer interest payments. The interest rate prohibition, therefore, causes resources to be misallocated.

Even so, the Commission concluded the potential deleterious effects of the immediate abolition of prohibition of interest on demand deposits would be larger than the costs imposed by its continuation (Recommendation 7).

B. Regulation of the Functions of Depository Financial Institutions

SAVINGS AND LOAN ASSOCIATIONS AND MUTUAL SAVINGS BANKS

The Commission recommends that:

1 **savings and loan associations and mutual savings banks be granted a widened range of loan and investment powers, including authority to:**

a **make mortgage loans on all types of residential and non-residenital properties without statutory or regulatory restrictions**

b **make construction loans in the same manner as commercial banks**

c **make loans on mobile homes, without restrictions on sizes and types**

d **make direct investment in real estate and participate directly with other organizations in the ownership of real estate, including participation through stock ownership, in amounts to aggregate, for mutual savings banks and mutual savings and loan associations, not more than 3 percent of total assets or 30 percent of total reserves and undivided profits, whichever is less, and for stock associations, 3 percent of total assets or 30 percent of capital, surplus, reserves and undivided profits, whichever is less**

e **participate directly in real estate through loan agreements to receive rental and other non-interest income, whether or not the institution holds an equity interest in the same property**

f make secured and unsecured consumer loans in amounts not to aggregate in excess of 10 percent of total assets

g invest in a full range of investment-grade U.S. Government, state and municipal, and private debt instruments of all maturities

h invest in equity securities in amounts not to aggregate, for mutual savings banks and mutual savings and loan associations, in excess of 10 percent of assets or 100 percent of total reserves and undivided profits, whichever is less, and for stock associations, 10 percent of assets or 100 percent of capital, surplus, reserves and undivided profits, whichever is less, provided that:

(1) no investments be made in the equity securities of commercial banks, savings and loan associations, or holding companies of commercial banks or savings and loan associations

(2) no more than 2 percent of any issue be held by any individual mutual savings bank or savings and loan association

(3) the securities be listed on a national exchange

(4) the limitations imposed by this recommendation not apply to the equity securities of subsidiary corporations otherwise complying with the law, and

(5) the limitations imposed by this recommendation not require the divestiture of previously acquired equity securities acquired in compliance with the law

i invest, via a "leeway provision" and in addition to other specific powers, in any assets, except equity securities of commercial banks, savings and loan associations, and holding companies of commercial banks and savings and loan associations, in amounts to aggregate, for mutual savings banks and mutual savings and loan associations, not more than 3 percent of total assets or 30 percent of total reserves and undivided profits, whichever is less, and for stock associations, not more than 3 percent of total assets or 30 percent of capital, surplus, reserves and undivided profits, whichever is less

2 savings and loan associations and mutual savings banks be permitted to offer a wider variety of time and savings deposits and certificates of deposit, varying with respect to interest rate, withdrawal power, and maturity

3 under specified conditions, savings and loan associations and mutual savings banks be permitted to provide third party payment services, including checking accounts and credit cards, to individuals and non-business entities only [1]

4 savings and loan associations and mutual savings banks be permitted to make equity investments in community rehabilitation and development corporations engaged in providing housing and employment opportunities for low and moderate income persons in aggregate amounts not to exceed, for mutual savings banks and mutual savings and loan associations, 5 percent of total reserves and undivided profits and, for stock savings and loan associations, 5 percent of capital, surplus, reserves and undivided profits

5 savings and loan associations and mutual savings banks be permitted to issue subordinated debt instruments of all maturities, provided that maturities and yields, conditions of subordination, the lack of insurance, and other differences between the debt instruments and deposit liabilities are clearly and fully disclosed to all purchasers, and provided that these issues be evaluated and approved as bona fide capital prior to issue by the appropriate supervisory authority

6 savings and loan associations and mutual savings banks be permitted to make loans anywhere within any state of the United States, the District of Columbia, any territory of the United States, Puerto Rico, Guam, American Samoa, or the Virgin Islands

7 savings and loan associations and mutual savings banks, and subsidiaries of savings and loan associations and mutual savings banks and holding company affiliates of savings and loan associations be permitted to manage and sell mutual funds, including commingled agency accounts, subject to regulation by the Securities and Exchange Commission

8 after public hearings by the appropriate regulatory agency and application of the same criteria as apply to

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1 See Recommendations 5 and 6 in Section A, 1 and 2 in Section D, 1 in Section E and 1, 2, and 9 in Section H.

bank holding companies, savings and loan associations and mutual savings banks, and subsidiaries of savings and loan associations and mutual savings banks, and holding company affiliates of savings and loan associations be permitted, upon individual application, to engage in a variety of financial, fiduciary or insurance services for individuals and non-business entities of the type, but not more extensive than those approved for bank holding companies by the Board of Governors of the Federal Reserve System under the Bank Holding Company Act

9 federally chartered mutual savings banks located in states where Savings Bank Life Insurance is now authorized be permitted to offer this service

At present, savings and loan associations may be chartered in all states as mutual organizations and in many states as stock concerns. They may receive a federal charter for the mutual form only. Mutual savings banks are chartered in 18 states; there is no provision for federal chartering.

The principal business of federally chartered savings and loan associations is to make loans secured by residential real estate and share account loans. State regulations vary greatly, but the lending powers of state-chartered institutions are also generally restricted to real estate and share account loans. At the end of 1970, real estate loans comprised more than 85 percent of total assets of savings and loan associations. The preponderance of real estate loans in other years is seen by comparing the total assets shown in Appendix Table 1 with the mortgage loans shown in Appendix Table 3.

Mutual savings banks have more liberal loan and investment powers than savings and loan associations. Generally they may hold corporate debt instruments and some equity issues. In 12 states they may make consumer loans. In six states they may accept demand deposits. Nonetheless, at the end of 1970, real estate loans comprised more than 73 percent of the total assets of mutual savings banks. Between 1945 and 1970, this varied from a low of 24 percent in 1946 to a high of 77 percent in 1966 (Appendix Tables 1 and 3).

During the period 1945 to 1965 deposit thrift institutions had higher growth rates than commercial banks. The total assets of all savings and loan associations increased from about $9 billion to nearly $130 billion, an increase of almost 1400 percent, or a compounded annual growth rate of over 14 percent. Total assets of all mutual savings banks increased from less than $17 billion to over $58 billion, an increase of 242

percent, or a compound annual increase of over 6 percent. For this same period, total assets of insured commercial banks increased from about $158 billion to $375 billion, an increase of 170 percent, or a compound annual increase of only 4 percent. In this period, the proportion of the assets of all deposit institutions held by commercial banks fell from 86 percent to less than 67 percent; the proportion held by savings and loan associations rose from less than 5 percent to 23 percent, and the proportion held by mutual savings banks rose slightly, from just over 9 percent to just over 10 percent.

From the end of 1965 to the end of 1970, however, the total assets of commercial banks grew by 53 percent while the assets of savings and loan associations and mutual savings banks increased by 36 percent. In these five years the growth of thrift institutions was less than that of commercial banks. The annual rates of change are shown in Appendix Table 1.

The changes in relative growth rates of the institutions reflect differing market conditions between 1945 and 1970. In the 1945-1965 period, non-financial corporations—the traditional customers of commercial banks—held substantial liquidity positions in cash and marketable securities. These liquid assets reduced their need to borrow from commercial banks. Commercial banks held large amounts of liquid assets, particularly government securities, which they were willing to sell whenever suitable commercial loans could be made. Until early 1951, sales of government securities were facilitated by the Federal Reserve policy guaranteeing holders the ability to sell their holdings at no less than par.

After March, 1951, the Federal Reserve no longer rigidly supported the prices of government securities. It was not until the late 1950's, however, that commercial bank holdings of government securities were reduced to the point where the overall availability of funds was an important consideration in their lending decisions. These forces are reflected in the rising ratio of commercial bank loans to total commercial bank assets shown in Appendix Table 3. The ratio of loans to total assets rose from less than 17 percent at the end of 1945 to more than 54 percent in 1965. Given a plentiful supply of lendable funds and a relatively weak demand for loans, business loan rates remained low through the 1950's and into the mid-1960's.

During the same period the demand for mortgage credit was strong. The homebuilding industry was operating at high levels to make up the deficit in the nation's housing stock caused by the virtual cessation in building during the war years. It was also stimulated by the high rate of new family formation and the growth of the economy. Because of differences in

market demands for and supplies of credit, yields on loans and debenture borrowing of corporations were substantially below those prevailing on high grade mortgage loans from 1946 to 1960. Also, since this was a relatively non-inflationary period, the prevailing term structure of interest rates had a positive slope.

Up to 1965 conditions continued to be favorable for deposit thrift institutions. The demand for their funds was strong, and they received relatively high yields on their long term investments. Since they purchased short term funds, and since the term structure of rates was positively sloped, they had a wide spread between the price they paid for their funds and the yields they received from lending. The deposit thrift institutions, whose rates at this time were not regulated, paid rates on savings accounts above those offered by commercial banks (Appendix Table 4). While regulations on interest rate ceilings on deposits did apply to banks, many of them were paying less than the ceiling rates. Even with the higher rates on deposits, thrift institutions still realized gross margins that allowed substantial additions to their reserves (Appendix Table 5).

After 1965, conditions grew less favorable for the thrift institutions. Interest rates rose and the term structure changed adversely, sometimes having a negative slope. The asset yields of thrift institutions lagged behind the upward movement of rates because of long term mortgage contracts in their investment portfolios. In addition, the downward sloping term structure made it costly for thrift institutions to meet open market rates on their savings accounts.

The regulations setting maximum rates of interest on savings and time deposits prevented deposit intermediaries from freely bidding for funds. Nonetheless, the average rate paid by commercial banks on total savings deposits tended to rise relative to the rate paid by the deposit thrift institutions. In 1960, for example, savings and loan associations paid on the average a premium of 130 basis points over commercial banks. Mutual savings banks paid an average premium of 91 basis points. By 1965, the year prior to regulation of the rates of savings and loan associations, these premiums had declined to 56 and 42 basis points, respectively.

By 1969, as Appendix Table 4 shows, the average rate for commercial banks was actually higher than that for savings and loan associations, and only 2 basis points below the average of mutual savings banks. The 1969 rate differences reflect, in part, a larger fraction of banks' liabilities being in larger, higher interest certificates of deposit than those of the thrift institu-

tions. On the same types of savings accounts, such as passbook accounts, the regulations enabled savings and loan associations and mutual savings banks to maintain a positive differential over commercial banks. But even in this case the actual differential tended to narrow to the limit permitted by regulations.

The flow of new savings into deposit thrift institutions declined from 1965 to 1970. The regulatory maximums were often below market yields, and new funds from savings were going to other markets. Instead of producing profits and growth, the combination of deposit rate regulation and economic conditions permitted only slow growth and marginally profitable operations for the deposit thrift institutions. From 1965 to 1970 the deposit thrift institutions faced a market situation that, at times, caused great concern for their continued strength.

Projections of economic conditions in the United States indicate a continued shortage of capital. When problems of inflation arise, monetary policy will be used to restrict the availability of credit. Occasional periods of high interest rates will occur in the future. A continuation of the constraints that force deposit thrift institutions to invest their funds in long-term assets will cause a repetition of their recent experience.

Without changes in their operations, there is serious question about the ability of deposit thrift institutions to survive. The power of the rate ceilings to isolate deposit markets from the rest of the short-term money market has eroded with continued reliance on this regulation. In time, they will probably have little effectiveness. Thus the major deterrent to losses of income and liquidity and the possible failure of thrift institutions during past periods of rising interest rates will not provide the same protection in the future.

This combination of circumstances and the desirability of increased competition are the basic reasons for the Commission's recommendations. The recommendations, including those made in Section C, below, will enable any savings and loan association or mutual savings bank to be a competitor of the commercial banks by offering similar services. For those who wish to specialize in loans and services relating to real estate and personal finance, both the regulatory framework and the permissive powers recommended by the Commission make this a feasible choice. Indeed, the Commission's recommendations make this choice possible in an environment of high and variable interest rates, whereas existing regulations force the choice in a way that threatens the existence of institutions specializing in long-term real estate financing.

The deposit thrift institutions should possess broadened and liberalized mortgage lending powers. The needed supply of mortgage funds is not restricted to those for single family, owner-occupied residences. Demands for long-term real estate financing may change among different types of housing and non-residential properties in unpredictable ways. Savings and loan associations and mutual savings banks should have the opportunity to operate in real estate finance in ways which reflect market conditions and the particular abilities of the organizations themselves. In mortgage lending they should be restricted only by considerations of safety and soundness (Recommendation 1a).

Instead of restricting construction lending by deposit thrift institutions to properties for which the institutions also supply permanent mortgage financing, the Commission believes such institutions should have broad powers to make construction loans on residential, commercial and industrial properties. On the one hand, these powers would allow thrift institutions to shorten the average maturity of their loans while remaining specialized; on the other hand, free entrance into the entire field of construction lending would increase competition (Recommendation 1b).

Modern mobile homes, which often permanently occupy a site, represent innovation in the supply of housing against which the Commission does not wish to discriminate. Special problems concerning loans on mobile homes exist, including such basic ones as whether they constitute chattels or realty. The Commission is not prepared to resolve these issues but does wish to minimize problems of mobile home financing which stem from unnecessary restrictions on lending powers of financial institutions (Recommendation 1c).

The need to permit thrift institutions to participate directly in real estate development and to receive rental or other non-interest income from property arises from market responses to inflation, a problem which may be less severe in the immediate future than it has been in the recent past. When inflation is anticipated, long-term debt instruments involve much uncertainty. The interest rates eventually realized by both borrowers and lenders depend on the rate of inflation compared to the contractual interest rate. Lenders and borrowers may find that the only mutually acceptable form of long-term financing involves giving the lender a share in ownership and income. Lenders' expectations of inflation discourage granting long-term loans except at exorbitant interest charges; on the other hand borrowers' uncertain expectations of future prices, income and expenditures inhibit borrowing at such rates.

Investments in real estate itself, or in equities whose values vary with earnings from real estate, are hedges against inflation and, accordingly, should tend to stabilize somewhat the flow of funds to housing (Recommendations 1d and 1e).

Both savings and loan associations and mutual savings banks have historically been tied to residential real estate. Consumer loans, particularly for purchases of consumer durables, fit easily into the loan mix of an institution seeking such a clientele. In addition, higher proportions of consumer loans in the assets of institutions would improve their ability to survive periods of rising interest rates (Recommendation 1f).

The Commission's views on investments in high grade private and government debt instruments arise mainly from considerations of earnings and improvements in flows of funds into real estate financing and other socially desirable areas. Savings and loan associations and mutual savings banks are, in general, permitted to purchase government obligations of all maturities. The savings and loan associations, however, are more restricted in their authority to purchase special agency obligations and are prevented from purchasing private debt instruments. By urging the removal of these restrictions, the Commission seeks to give deposit thrift institutions access to the liquidity they require and, at the same time, to provide them with options to improve their earnings. This should produce some marginal improvements in the markets for these obligations. At the same time, it should increase the ability of the institutions to adapt to a market of high and variable interest rates in which yield curves are occasionally negatively inclined (Recommendation 1g).

Most states have granted mutual savings banks the authority to invest in equity securities. The Commission recognizes that this power may increase total returns over time. Where interest rate risk is pronounced, this power could also enhance the liquidity position of other deposit thrift institutions, with favorable effects on mortgage markets. Such investments should be restricted in relation to total capital in order to minimize the possibility of losses from fluctuations in the market price of equities. Conflicts of interest are avoided by limiting the types of stock purchased. Accordingly, the Commission endorses the states' practice for mutual savings banks and, on the ground that parity in treatment is desirable recommends similar powers for savings and loan associations (Recommendation 1h).

The provision for "leeway" investments recognizes the difficulty of foreseeing future market conditions and market instruments. Such a provision will encourage innovative invest-

ments and facilitate credit flows to new users, particularly during inflationary periods. Strict limitations are recommended for investments in equity securities since, in addition to conflict of interest problems, such investments could cause either earnings or liquidity problems if unrestricted investments in them were permitted (Recommendation 1i).

Deposit thrift institutions are restricted in their ability to offer a full range of time and savings accounts and certificates of deposit with varying interest rates, withdrawal powers and maturities. No inhibition on these powers should exist to prevent savings and loan associations and mutual savings banks from attracting savings from all sources, or to place them at a competitive disadvantage relative to commercial banks. Savers are benefited by a variety of deposit instruments. The Commission believes that limits on the mix of maturities of deposits and certificates of deposit, in a market of uncontrolled deposit rates, are unnecessary (Recommendation 2).

Deposit thrift institutions should be permitted to offer third party payment services, including checking accounts and credit cards, for households and non-business entities only. Those institutions that do so will compete for a type of deposit which generally has been reserved to commercial banks. The Commission believes that institutions providing the same services should compete under the same conditions. Consequently it recommends that deposit thrift institutions be permitted to offer such services to individuals and households only under conditions of equality with commercial banks in taxation, ceilings on interest rates for time deposits, reserve requirements, and regulatory supervision. Recommendations to establish these conditions of equality are made in Sections A, D, and E of this Part.

The Commission believes deposit thrift institutions should not be permitted to offer third party payment services for business and professional purposes. Such powers should be obtained and exercised only under a commercial bank charter. Accordingly recommendations are made in Section C to provide for conversion to mutual or stock commercial bank charters by thrift institutions desiring to offer these services (Recommendation 3).

Bank holding company subsidiaries have special authority to make limited equity investments in projects designed to foster employment and housing for low and middle income persons. The Commission recommends similar authority for deposit thrift institutions (Recommendation 4).

Deposit thrift institutions may issue subordinated debt instruments under current regulations, but these may not

always be regarded as capital for regulatory and supervisory purposes. Any such restriction denies them access to debt funds, which should serve as equity from the view of the regulatory agencies as it does for commercial banks and stock savings and loan associations. Subject to full disclosure provisions, it is recommended that subordinated debt issues be approved as capital by the regulatory agencies (Recommendation 5).

Geographic limits on real estate loans by thrift institutions originated in a desire to have funds loaned in the locale in which they were generated. The current restrictions impede operations of the institutions and unnecessarily divide an already overly-segmented market (Recommendation 6).

Finally, savings and loan associations and mutual savings banks should have powers to offer additional finance-related services to their customers. Of course, the services these institutions offer should be determined by following the same procedures as are applied to commercial banks, and bank holding companies, including the requirement for hearings and individual applications to the appropriate regulatory agencies. One reason for granting such authority is to remove regulatory and statutory impediments to the ability of these institutions to attract customers. Restrictions preventing them from engaging in individual and non-business services are, in the Commission's view, without justification. The expansion of services by the deposit thrift institutions will add to competition and customer convenience and, especially with respect to the sale and management of mutual funds, it will be an advantage to low and middle income families and smaller communities (Recommendations 7 and 8).

In those states where mutual savings banks may now offer Savings Bank Life Insurance, the Commission recommends that federally chartered mutual savings banks also be allowed to offer such services (Recommendation 9).

COMMERCIAL BANKS

The Commission recommends that:

10 **the Federal Reserve Act be amended to permit discounts of, or advances against, any class of asset held by member institutions at Federal Reserve Banks at discount rates to be determined by the Board of Governors and the respective Federal Reserve Banks**

11 **special statutory and regulatory restrictions on real estate loans by commercial banks be abolished**

12 commercial banks be permitted to value unrated securities at book value if the examiner determines on the basis of records kept in the banks' files that the securities in question are of investment grade despite the lack of rating

13 commercial banks be permitted to make equity investments in community rehabilitation and development corporations engaged in providing housing and employment opportunities for low and moderate income persons in aggregate amounts not to exceed 5 percent of capital, surplus and undivided profits

14 via a "leeway provision" and in addition to other specific powers, commercial banks be permitted to invest in any assets in amounts to aggregate not more than 3 percent of total assets or 30 percent of capital, surplus and undivided profits, whichever is less, provided that no equity securities other than those of their own subsidiaries and equity investments that are directly ancillary to and simultaneous with a particular lending operation may be acquired, and further provided that this "leeway" not be used to circumvent lending limits on loans to any one person, copartnership, association or corporation or restrictions on loans to bank examiners, executive officers or bank affiliates

15 liabilities of any term incurred by commercial banks through the temporary or contingent sale of assets should not be defined as deposits of the bank

16 statutory limitations on the aggregate amount of acceptances that commercial banks may create be removed and that the supervisory authorities determine appropriate limitations for particular banks with due consideration to the character and location of the bank and the needs of its customers

17 commercial banks be permitted to issue subordinated debt instruments of all maturities provided that maturities and yields, conditions of subordination, the lack of insurance and other differences between the debt instruments and deposit liabilities are clearly and fully disclosed to all purchasers, and provided that these issues be evaluated and approved as bona fide capital prior to issue by the appropriate supervisory authority

18 commercial banks and their subsidiaries and holding company affiliates be permitted to manage and sell

mutual funds, including commingled agency accounts, subject to regulation by the Securities and Exchange Commission

19 **commercial banks and their subsidiaries, in addition to the authority granted by the Housing Act of 1968 and existing authority to underwrite revenue bonds classified by the Comptroller of the Currency as general obligations, be permitted to underwrite revenue bonds secured by revenues from essential public services with (1) an established record of annual earnings sufficient to cover prospective annual principal and interest charges with a satisfactory margin, or (2) rated "A" or better by established rating services**

20 **after public hearings by the appropriate regulatory agency and application of the same criteria as apply to bank holding companies, commercial banks and their subsidiaries, be permitted, upon individual application, to engage in a variety of financial, fiduciary or insurance services of the type, but not more extensive than those approved for bank holding companies by the Board of Governors under the Bank Holding Company Act**

In terms of total assets and number of offices, commercial banks are the largest financial intermediary in the United States. Although the operations of commercial banks are subject to many regulatory restrictions, their operating powers are the broadest of any of the financial intermediaries. They are now the only type of institution generally permitted to offer unrestricted third party payment services. That is, they operate the mechanism for check funds transfer and, in their lending and investing operations, create money. In all other activities they compete with other financial or non-financial institutions.

The regulatory framework within which commercial banks operate began with the nation's founding, but the major elements of existing regulations were imposed during the 1930's. The provisions of the major legislation of the period—the Banking Acts of 1933 and 1935—were aimed at curing a number of weaknesses that appeared in the commercial banking system during the preceding decade.

As stated above, the Commission believes that the public would benefit from increased competition within the financial system. Viewed from the vantage point of 35 years' experience with the Banking Acts of 1933 and 1935, the Commission believes that the existing regulatory system is, on balance, too restrictive.

Although the 1920's were generally prosperous, three moderate cycles in business activity did occur. More than 5,300 banks suspended operations during the decade. With the severe economic decline beginning late in 1929, more than 9,000 additional banks failed before the end of 1933. From the end of June, 1929, to the end of June, 1933, the number of commercial banks in the United States declined from 24,970 to 14,208. In this same period, total capital accounts of all commercial banks declined from $8.8 billion to $6.3 billion.

The many failures and weakened capital condition of the banking industry in the 1920's and 1930's caused many observers to conclude that commercial banking was inherently more risky than was desirable. Reflecting this assumption, the 1933 and 1935 banking acts sought to minimize the risk associated with banking. The risk to the public was reduced by deposit insurance. Competition among banks was mitigated by interest rate regulations. Potential losses on loan and investment activities were diminished by circumscribing the types of investments allowed. The right of banks to underwrite equity and corporate debt securities and to purchase equity securities was withdrawn. Banks could underwrite state and local securities bearing the full faith and credit of the issuing body but could not distribute revenue bonds. The scope of lending activities was diminished, mainly through restrictions on real estate loans. Congress also imposed additional restrictions on the granting of National bank charters, making entry into the banking business more difficult.

The introduction of deposit insurance, which halted runs on banks, was by far the most important reform of the period. Although the restrictions imposed on bank operations and more stringent requirements for entry into the banking business also reduced the risk to depositors and bank stockholders, the Commission believes that these were less important and were made largely redundant by deposit insurance. The influence of deposit insurance is evident in statistics on bank failures and depositor losses. During the economically depressed second half of the 1930's, only 304 insured banks failed, a failure rate much below that of the relatively prosperous second half of the 1920's. In the 31-year period 1940 through 1970, bank failures were very limited, amounting to only 181 banks. After 1935 and the introduction of deposit insurance, when banks failed, the vast majority of depositors were paid in full.

The small number of bank failures and the low level of losses to depositors since 1935 should not be interpreted as evidence that commercial banks currently operate under ideal

regulation. This judgment must be made in light of the many roles and functions of the banking system.

Banks create a substantial portion of the nation's money supply. Their liabilities constitute a large fraction of the nation's liquidity. Banks are the major source of financing for small and medium sized business, and an important source for state and local governments. They operate the critical segment of the nation's mechanism for the transfer of funds. Banks also provide a wide range of services. Because of these functions, when a bank fails, the losses incurred by the stockholders are only a part, and socially the least consequential part, of the total losses involved. Also harmed are depositors, those who borrow, and the community as a whole.

Some aspects of bank regulation can be justified by the social benefits arising from avoidance of these financial and social losses. Yet other aspects of regulation may produce social losses greater than their benefits. For example, restrictions on entry of new banks and new branches into an area may cause the level of competition in that market to be abnormally low, reducing the benefits to the public of stronger price and service competition. Similarly, restrictions on the payment of interest on deposits cause banks to compete for deposits in other ways. As a result, banks use resources to produce and distribute a mix of products and services that bank customers would not purchase if they were explicitly charged the prices needed to cover the costs of resources used.

Restrictions on allowable holdings have prevented banks from purchasing some types of assets, which distorts relative yields on different types of securities and reduces competition between banks and other financial intermediaries. Banks' production costs for some products and services they are currently prohibited from supplying may be below those of the industries that presently supply these goods. Thus, consumers may be denied the opportunity to purchase products from the suppliers with the lowest costs.

The optimum framework of regulation cannot be precisely defined. Alternative patterns of regulation involve a choice of trade-offs. That is, the social cost from possible bank failure must be compared to the social costs imposed because banks do not supply services in which they have low production costs and because financial markets are not as competitive as they could be.

During the early 1960's the regulatory authorities relaxed the environment surrounding commercial banking through administrative interpretations. Regulations issued by the Office of the Comptroller of the Currency revised capital

adequacy formulas, allowed the issuance of capital notes, enlarged permissable real estate lending, eased restrictions on the services offered, and modified the provisions for chartering. These changes were followed and in some instances expanded by the other regulatory agencies. In addition, the Federal Reserve raised the ceiling rates on time and savings deposits and a new money market instrument, the negotiable certificate of deposit, was instituted. These changes permitted banks to compete somewhat more aggressively for funds.

There were shifts in the views and objectives of bank management during the same period, mainly reflecting changes in economic conditions and in the technology available to the banks. During the late 1950's and early 1960's, bankers became increasingly aware of the persistent erosion in the portion of total financial intermediation handled by commercial banks. In the fifteen-year period prior to 1960, the ratio of bank assets to the total assets in all deposit intermediaries declined from 86 percent to less than 70 percent. The ratio of bank assets to assets of deposit intermediaries, plus assets of life insurance companies and pension funds, declined from 68.1 percent to 48.7 percent. The post-1960 change in regulatory climate is reflected, among other ways, in the rise in both ratios after 1965. In the period 1965-70 commercial banks' proportion of deposit intermediary assets rose from 66.6 percent to 69.8 percent and the ratio for all intermediaries rose from 47.4 percent to 49.9 percent.

Meanwhile, important changes were occurring as a result of improved technology. After 1955, banks introduced computers for the repetitive production tasks of money transfers through checks and deposit accounting. Computer functions soon expanded to additional bank operations and the trend is expected to continue. The computer-oriented technology has widened the range of services banks can efficiently perform while increasing the geographic area in which a bank can competitively operate, with or without branch facilities. The ability to service wider geographic areas decreased the concern over branching restrictions, a long-standing controversy within the banking industry and among the general public. For example, the issuance of bank credit cards has allowed commercial banks to extend consumer credit into areas not serviced by their branches. By the mid-1960's, the rapid development of new financial services, largely computer-based, had begun to enable banks to compete with a broad array of non-bank vendors of these services.

Between 1966 and 1970, destabilizing changes in monetary and fiscal policies occurred. The price level rose at an

accelerating pace. Interest rates, peaking in the summer of 1966, declined again in 1967, and then once more rose sharply in 1969 and 1970.

The banking system had severe problems coping with the ensuing market changes. The large money market banks had acquired a substantial fraction of their lendable funds through the sale of negotiable certificates of deposit. As money market rates rose, the regulated rate maximum on certificates became lower than other market rates and banks were forced to repay large dollar volumes of maturing certificates. Savings deposits were also withdrawn, though in smaller amounts. To take advantage of higher returns, potential purchasers of CD's and, to a lesser degree, savings depositors invested their funds directly in other money market instruments.

The larger banks responded by borrowing funds in the Eurodollar market and developing new ways to finance their lending operations from domestic sources. Holding companies issued commercial paper and purchased loans from their bank affiliates; banks sold loans to other non-bank institutions and their own deposit customers. The deposits of smaller banks were less seriously affected than those of larger institutions, but they did not have as many alternative sources of funds. Thus, the relative impact on many smaller institutions was as great as that on larger banks.

On the borrowing side, large companies that were denied or received only limited credit from commercial banks sold commercial paper. Commercial paper borrowings rose from $8.4 billion in December, 1964 to $14.2 billion in November, 1966 and reached a peak of $39.7 billion in May, 1970. The disintermediation of deposits adversely affected the borrowing ability of small businesses which do not have access to the commercial paper market or other sources of low cost financing.

In some respects the unsettled conditions had beneficial effects, including a number of innovations in financial instruments and improved attitudes toward innovations in funds acquisition. But in other respects the conditions led to less productive use of resources. Inefficient methods of financing were sometimes used. Further waste of this kind will occur if deposit interest rate ceilings continue to be relied on in periods of high market interest rates.

A high level of disintermediation also weakens the financial market's ability to absorb the uncertainty associated with major disturbances. For example, the bankruptcy of the Penn Central Transportation Company, resulting in large losses to commercial paper holders, caused a liquidity crisis that had

serious consequences on money markets. If a larger proportion of the short term credit to businesses had been in the intermediary system, the loss could have been absorbed with less pronounced secondary effects.

The Federal Reserve Act declares that only certain assets are eligible for discount without a penalty. When the Federal Reserve System was established, self-liquidating short-term loans formed the bulk of commercial bank portfolios. But changes in the scope of banking have resulted in a decline in the proportion of bank assets held in this form. Penalties on all but a narrow range of assets eligible for discounting artificially impede the flow of credit into desirable areas. The Commission urges that statutory restrictions on discount eligibility be removed, and that the Board of Governors and the several Federal Reserve Banks have discretion concerning which assets may be discounted and the appropriate discount rate (Recommendation 10 above).

Since the impact of restrictive monetary policy on the mortgage market was one factor prompting the establishment of the Commission, it is important to note that real estate lending by commercial banks is encumbered by prohibitions on the maturity of the loan, the type of asset securing the loan, the repayment provision and the proportion of the asset portfolio made up of mortgage loans. The Commission believes that bank management can adequately assess risk characteristics of various specific loans, and it recommends that real estate loans be subject only to safety and soundness tests. This will allow banks to compete more vigorously as mortgage lenders and will improve the flow of funds to that market (Recommendation 11).[1]

As interest rates rise, the market value of securities held in portfolios declines. Because commercial banks have a low ratio of equity to liabilities, any loss in market value of the securities in their portfolios causes concern about the capital position of banks. This often occurs during periods of rising economic activity. Requiring banks to value securities at market prices at such times reduces bank equity and the ability of banks to meet credit needs. Moreover, since long maturity securities are affected more than short maturities, banks tend to avoid investments in the former when securities must be counted in capital at market values.

In 1938, the banking agencies agreed to use amortized book values for U.S. Government securities and those state and

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1 The recommendations in Section B, above, concerning the powers of thrift institutions and recommendations in Section G, below, are intended to strengthen institutions wishing to specialize in mortgage lending and to make such lending more attractive to all financial institutions.

municipal securities given high ratings by credit rating agencies. But the securities of many local governments, especially of smaller communities with small issues, are not rated by any agency. Fewer than 20,000 of the more than 91,000 local bodies capable of issuing municipal bonds have been assigned a rating. In addition, the recent decision of the rating agencies to charge municipal governments for their ratings is likely to increase the proportion of unrated issues. Commercial banks are in many cases the principal market for such issues. The Commission believes that bank management and bank supervisory agencies can adequately assess the risk involved in most of these unrated issues. This will, at the same time, improve the market for credit-worthy municipals which banks otherwise would not buy (Recommendation 12).

Congress has recently enacted laws authorizing programs for community rehabilitation and to assist in providing housing and employment for low and moderate income persons. Under present regulations, commercial banks may not provide financial assistance to these programs because of prohibitions on equity participation. Holding company affiliates of banks may invest in these projects. If direct participation by banks and other deposit institutions were permitted on a limited scale, based on the equity position of the institution, the risks involved should not jeopardize bank solvency. Banks, along with the thrift institutions, would be able to take an active role in community programs (Recommendation 13).

A "leeway" investment provision was recommended for the thrift institutions in order to encourage innovative investments and to permit more effective adaptation to market conditions during inflationary periods. A similar recommendation, with appropriate safeguards relating to equity investments, is made for commercial banks (Recommendation 14).

The tight money conditions of 1966 and 1969-70 fell with uneven weight upon the various sectors of the economy. Small and medium sized businesses, state and local governments, and individual mortgage borrowers found that credit was disproportionately scarce and expensive. The selective impact of monetary restraint, as reflected in these two periods, has been recognized for many years. Nevertheless the inequities remain, in part because commercial banks are limited by legislative and regulatory constraints on the kind of assets which they may use for liquidity purposes. Among traditional bank borrowers, only the federal government and large businesses have relatively easy access to alternative sources of funds.

Business loans make up a significant portion of most commercial banks' assets. The selective impact of tight money

on small and medium sized borrowers would be eased if banks had the ability to use these assets more freely. In the past banks have been able to sell a limited amount of business loans as banker's acceptances. The limit, however, has been imposed not by management's decisions or by market acceptability but rather by regulation. No bank may issue acceptances in excess of 100 percent of its capital. During periods of monetary restraint, this has forced banks to liquidate a much larger portion of their holdings of state and local debt than would otherwise be necessary. In addition, this regulation has prevented banks from assessing and assuming the risk attached to loans to small business and, therefore, has continued to exclude all but the largest commercial borrowers from the commercial paper market.

The Commission believes that no rigid rules can be formulated to cover adequately the many differences among banks and among the credit standings and credit needs of bank customers. It recommends that supervisory authorities exercise their judgment with respect to safety and soundness in setting limits on the acceptances created by individual banks. This is in line with modern methods of assessing bank capital adequacy, where the examiner takes into account the ability of management and the risk incurred in determining capital adequacy (Recommendation 16).

Even if the 100 percent limit on bankers' acceptances were raised or removed another constraint on the effective utilization of this device would remain. Past attempts by commercial banks to use their loan portfolios as a source of liquidity have been rendered either illegal or unfeasible by the Federal Reserve Board and the Federal Deposit Insurance Corporation interpretation which defined the liability incurred as a "deposit" for purposes of reserve requirements and interest rate ceilings. This action was appropriate in the mid-1960's when some banks issued unsecured promissory notes. However, it is inappropriate to apply the term "deposit" to the liabilities incurred in agreements concerning the sale and repurchase of bankers' acceptances and other marketable assets. The Commission recommends that this ruling be reversed. Identical agreements covering the sale and repurchase of U.S. Treasury and federal agency securities are classified as "borrowings" and are not subject to reserve requirements and interest rate regulations.

Allowing banks to compete directly in the full spectrum of the money markets should have another result: improved transmission of the effects of monetary policy actions. Furthermore the general quality of other short-term money market instruments should be improved by competition in the open

market from two-name paper which has satisfied an accepting bank's credit standards (Recommendation 15).

The restrictive monetary conditions of the 1966 and 1969-70 periods led to innovations in the techniques of acquiring funds. Banks used various types of certificates of deposit, savings certificates, special notice accounts, and other maturity-rate-denomination combinations to attract funds. This aggressive competition resulted in improved service to the public and also permitted banks to manage their deposits in a manner consistent with their liquidity needs. In acquiring capital, banks turned to the use of debt instruments, but regulations allowed fewer innovative techniques. Supervisory judgments about capital adequacy limit the aggregate amount of subordinated debt a bank may issue; debt instruments issued with a maturity of less than seven years are regarded as deposits, not capital. Reserve requirements and interest rate regulations apply to these shorter-term liabilities.

Bank capital adequacy is, of course, a proper concern for supervisory authorities. And bank management must concern itself with capital adequacy in order to attract deposits which exceed the insurance maximum. Both for protection of the public and for the promotion of effective bank management, bank-issued debt instruments subordinated to deposits serve the same function as stockholders' equity in the bank.

Whether additional funds subordinated to deposits should be raised and the desirable proportion of subordinated debt to equity are matters for bank management to determine in the light of circumstances, subject to approval by bank supervisors. The flexibility of being able to sell subordinated debt issues in the open market in various denominations and maturities would permit banks to raise funds in the most advantageous manner for given market conditions, and it would offer the public additional forms of assets in which to hold savings. Elemental safeguards for the public are necessary, but these too should be matters for supervisory approval (Recommendation 17).

Bank trust departments now manage nearly $300 billion of assets. The commercial banking industry has developed a high level of skill in financial management and investing funds for the account of customers. At the present time, however, because of restrictions on commingling of funds, only customers with large estates or substantial funds are usually accepted as customers. Thus the inability of banks to service the needs of persons with only moderate amounts to invest discriminates against most of the public.

The Commission recommends that banks, their subsidiaries, and holding company affiliates be permitted to organize and operate mutual funds. This would enable them to improve their service to persons of moderate and low incomes. In the sale and management of mutual funds, commercial banks should be subject to the same regulations, both those of the individual states and of the Securities and Exchange Commission, as others selling and managing mutual funds.

Mutual funds salesmen can sell a variety of funds and be directly employed by an organization other than the mutual fund management company. Commercial banks should be allowed similar latitude. This provision would have salutory competitive effects, especially in small communities where no mutual funds salesmen presently operate or where only a narrow range of funds is available from present vendors. The Commission also recommends that banks, their subsidiaries, and holding company affiliates be permitted to use commingled agency accounts. This would allow them to serve smaller investment accounts at lower costs with corresponding public benefits (Recommendation 18).

The Banking Act of 1933 separated commercial banking from investment banking. This separation was prompted by the conflicts of interest that developed when the same organization handled the two functions. The possibility of conflict of interest would still exist if banks were again permitted to underwrite new issues of corporate securities. The Commission, therefore, strongly recommends the continued prohibition against bank underwriting of private security issues.

The Banking Act of 1933 allowed commercial banks to continue to underwrite securities that were the general obligation of state and local governments. These securities do not raise the problems of conflict of interest inherent in private securities. The issues are sold by a large number of governmental units, many of which are relatively small and which issue securities in small dollar amounts. Bank underwriting of tax exempt securities is especially important to small communities. Since the 1933 Act, banks have been major underwriters of general obligations, and they have provided a major part of the distribution system for securities bearing the full faith and credit of state and local governments.

In the past several years revenue bonds have accounted for approximately one third of the total of tax exempt bonds issued. Revenue bonds can be classified into eight major categories:

1. indirect obligations of states or cities involving lease contracts or some similar arrangments

2. obligations secured by the pledge of special tax revenues
3. college and university dormitory and other facility revenue bonds
4. water and sewer revenue bonds
5. electric revenue bonds
6. toll revenue bonds to finance highways and bridges
7. airport revenue bonds
8. industrial revenue bonds

Most of the bonds in the first category are classed as general obligations by the Comptroller and other bank regulatory authorities. A section of the Housing Act of 1968 authorized commercial bank underwriting in the third category. Admittedly rough data on proportions in these eight categories of revenue bonds suggest that (1) and (3) accounted for approximately 30 percent of the total sold in 1970.

Some types of tax exempt securities are closely linked to private corporations. Some are issued to construct a facility to be used by a private enterprise and service and redemption depend on the payments of the private concern using the facility. The Commission favors the continued exclusion of banks from underwriting such Industrial Development Bonds, for the same reasons it opposes bank underwriting of private corporate issues. Moreover, some lower quality tax exempt securities that do not bear the full faith and credit of the issuer and are to be repaid only from the revenue generated by the project financed have a generally higher default risk than do full faith and credit obligations of the same issuer. The Commission does not favor bank underwriting of these issues, for the inferred attribution of bank prestige could mislead investors.

The Commission recommends, however, a broadening of the types of securities which banks can underwrite. Specifically, with approval of the appropriate regulatory agency, banks should be allowed to underwrite bonds secured by revenues from essential public services with (1) an established record of annual earnings sufficient to cover prospective annual principal and interest charges with a satisfactory margin, or (2) rated "A" or better by established rating services. The Commission realizes that such expansion produces additional supervisory burdens with regard to which securities should be approved. Experience will be needed to determine whether expanded power in this area would justify the additional administrative burden (Recommendation 19).

The Bank Holding Company Act permits holding company affiliates of banks to provide a variety of approved

services. The Board of Governors of the Federal Reserve System is charged with the responsibility for determining that the services are of a financial, fiduciary or insurance nature and, after hearings, for determining that the services are a proper incident to the business of banking. Provision is also made for tests based on competitive factors, including the prohibition of ties between the offering of banking and non-banking services.

The Commission believes that bank holding companies should not be the only vehicle through which services may be extended. The Commission would extend to banks and subsidiaries of banks, with the same procedural requirements, including the requirement for individual applications to the appropriate regulatory agencies, powers of the type, but not more extensive than those approved for bank holding companies by the Board of Governors under the Bank Holding Company Act. The Commission urges the Board to be as liberal as possible in approving new classes of service (Recommendation 20).

CREDIT UNIONS

The Commission recommends that:

21 a Central Discount Fund for credit unions be established. The equity funds would be provided through purchases of stocks by all federally insured credit unions, and the operating costs should be covered by earnings on the fund's loans and investments. The Central Discount Fund would acquire additional loanable funds through issues of debt obligations and deposits of credit unions. The Central Discount Fund should have authority to provide temporary advances, for liquidity purposes only, to federally insured credit unions, to sell debt obligations, to accept interest-bearing deposits from credit unions and, on an emergency basis only, to borrow at prevailing market rates from the United States Treasury

22 the loan powers of credit unions include a full array of secured and unsecured consumer instalment loans, educational loans, residential and agricultural mortgage loans to members and loans to other credit unions and the Central Discount Fund

23 credit unions be permitted to invest in a full range of investment grade private and governmental debt instruments of all maturities, including obligations of the Central Discount Fund

24 credit unions be permitted to offer members a wide variety of share accounts and instruments parallel to certificates of deposit, varying with respect to interest rate and withdrawal option

25 credit unions be permitted to offer third party, negotiable order system services to members, provided that the system requires an interest-bearing loan or line of credit agreement at regular rates and repayment through instalment payments, provided such lines of credit do not exceed 10 percent of total share accounts, and further provided that all credit unions with assets in excess of $1,000,000 be required to hold reserve balances against the lines of credit with the National Credit Union Administration, at the same rate required against demand deposits by the Federal Reserve System, such reserves to be non-interest bearing

26 credit unions be permitted to sell or to act as agent or broker in the sale of travelers' checks, registered checks, cashier's or treasurer's checks and mortgage life insurance, to members only

27 credit unions and associations of credit unions be permitted to sell bookkeeping and data processing services and to lease computer and data processing equipment or time on such equipment to and among credit unions and associations of credit unions only

Credit unions are a vigorous, rapidly growing class of financial institution offering unique services to the public. During the 1960's the total assets of credit unions increased from $5.7 billion to $18 billion (Appendix Table 1), while membership increased from 12 million to 22.8 million.

Credit unions are chartered both by individual states and a federal agency. By Act of Congress, the National Credit Union Administration was established to insure savings in credit unions and to assume the federal responsibility for supervising and examining their operations. This program is fashioned like the two other federal depositor insurance programs and, like them, it presently insures accounts to $20,000. The availability of deposit insurance will certainly have a positive influence on the future growth of credit unions.

Members of credit unions must have a bond of association with the organization or areas in which the credit union operates. The occupational and associational bond, as shown in Table 1 accounts for more than 96 percent of all chartered credit unions. The common bond based on residential considerations accounts for less than 4 percent of the credit unions.

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TABLE 1

PERCENT DISTRIBUTION OF CREDIT UNIONS BY COMMON BOND, DECEMBER 31, 1970

Associational: Church, Co-op, Labor Union, Fraternal, Professional and Trade Association	17.84
Occupational	55.93
Educational Services	7.50
Federal, State, County and Local Government	15.15
Residential	3.58
TOTAL	100.00

Source: Credit Union Year Book 1971.

Occupational and associational common bond confers substantial advantages. These credit unions usually operate in quarters provided by the host enterprise, which often view the credit union as a fringe benefit for its employees or members. The majority of workers in the smaller credit unions are volunteers and record keeping and credit analysis are simplified by the privilege of direct salary deduction for savings allotments and loan repayments. The latter privileges endow these credit unions with substantial cost and marketing advantages vis-a-vis other deposit institutions.

A large proportion of members have accounts at other institutions. But for some, regular payroll deductions into their credit union accounts are their only form of institutionalized savings. There is little doubt that credit unions have increased aggregate savings flows. Moreover, largely because of their low operating costs, they have also tended to produce credit for their members at low cost and have therefore been a significant element in the consumer credit markets.

At the end of 1970 there were almost 24,000 credit unions in the United States. These institutions are substantially smaller than the other deposit intermediaries, with a mean asset size of approximately $750,000. More than half of the credit unions have assets of less than $200,000. The bond of association, which is the hallmark of the credit union movement, dictates a non-diversified liability structure. On occasion, plant closings or slow-downs cause liquidity problems for industrial credit unions.

The existence of a lending facility to provide temporary advances if a liquidity strain develops would guard against the possibility of losses to members of credit unions. Such a facility should be managed by the Administrator of the National Credit Union Administration, with the advice and guidance of a three-member Board of Directors chaired by the Administrator. The other members should be appointed by the President, with the advice and consent of the Senate. The fund should accept deposits from credit unions, have authority to sell debt obligations, and have emergency authority to borrow from the U.S. Treasury in the event of severe disintermediation. To avoid potential conflict, however, deposits from the fund or loans by the fund should be made only to meet legitimate liquidity drains (Recommendation 21).

Under existing operating powers most credit unions acquire funds only from their members and extend credit only to their members. Members may save in share accounts and may be granted a wide range of consumer loans, personal loans, consolidation loans, loans to purchase consumer durables and, especially in recent years, residential mortgage loans.

Credit unions should be permitted wide lending powers for service to members and also should be permitted to acquire and hold the full range of private and public money and capital market instruments (Recommendations 22 and 23).

Credit unions should also be permitted to offer members a variety of share accounts, varying with respect to interest rate and withdrawal power and without the present limits on maximum rates. The Federal Reserve Board should, however, be empowered to set rate maximums until interest rate ceilings on the other deposit intermediaries are phased out (Recommendation 24).*

The Commission regards parity of treatment with respect to taxation, reserve requirements and regulation among institutions offering third party payment and other banking services to the general public as essential.

It follows that an expansion of the bonds of association concept, which would move credit unions in the direction of offering service to the general public, should require assumption by credit unions of the same responsibilities and burdens with respect to taxation, reserves and supervision as other institutions. Moreover, credit unions should not be allowed to offer unrestricted third party payment services, even within the present bonds of association concept, on terms distinctly advantageous relative to those of other institutions providing the same services (Recommendation 25).

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* See also Recommendation 2 in Section A.

In subsequent sections, the Commission recommends that credit unions desiring a broad, public clientele and the right to offer full third party payment services be required to convert their charters to other institutional forms. This would enable them to open their memberships and offer all the services allowed similarly regulated and taxed institutions. Without conversions, additional but less than full powers are suggested (Recommendations 26 and 27).

C. Chartering and Branching of Depository Financial Institutions[1]

SAVINGS AND LOAN ASSOCIATIONS AND MUTUAL SAVINGS BANKS

The Commission recommends that:

1 **federal charters be made available to stock savings and loan associations**

2 **federal charters be made available to mutual savings banks**

3 **the states enact enabling legislation implementing the intent of Recommendations 1 and 2 by authorizing state chartered savings and loan associations and state chartered mutual savings banks voluntarily to convert to a federal form**

4 **by state laws, the power of savings and loan associations and mutual savings banks to branch, both *de novo* and by merger, be extended to a statewide basis, and that all statutory restrictions on branch or home office locations based on geographic or population factors or on proximity to other associations or banks or branches thereof be eliminated**

5 **the chartering authorities, with guidelines set by Congress and the state legislatures, develop regulations to be followed by mutual savings and loan associations and mutual savings banks for converting their charters to stock companies**

Under current law, all 50 states, the District of Columbia and the territories of Guam and Puerto Rico have provisions for chartering mutual savings and loan associations. Twenty-one states charter stock savings and loan associations.

1 See also Recommendation 12, Section H.

Only eighteen states and Puerto Rico provide for the chartering of mutual savings banks. Among the deposit thrift institutions, only mutual savings and loan associations may be federally chartered.

The Commission believes that the widest feasible options among chartering and supervisory agencies should be created and maintained. When a particular type of financial institution can be chartered by only one agency—whether state or federal—a twofold danger emerges. First, the agency may become over-zealous in protecting existing firms, with the result that entry by new firms is effectively foreclosed. Second, the agency may not be as innovative and imaginative as it should be in exercising its authority. Opportunities for dual chartering and supervision mitigate these dangers and improve service to the public (Recommendations 1, 2 and 3).

Under provisions of the McFadden Act, federally chartered commercial banks have their powers to branch, either *de novo* or by merger, determined solely by the laws of the state in which they operate. Interstate branching is prohibited. State laws also determine branching for state chartered savings and loan associations and for mutual savings banks. There is no equivalent of the McFadden Act for federally chartered savings and loan associations. Policy with respect to them is set by the Federal Home Loan Bank Board, which usually, but not always, follows the guidelines of state law.

The Commission urges changes in branching laws at the state level. Current laws sometimes limit charters and branches on the basis of population density, geographic area or proximity to other institutions or branches. In many states, savings and loan associations and mutual savings banks have more restrictive branching privileges than commercial banks. In a few states, savings and loan associations have more liberal branching authority.

Three issues are involved. One is related to competition. Restricting branching by statute to an arbitrary number or restricting branches geographically prevents firms from entering the markets of others.

The second issue is parity among different types of institutions. The Commission sees no reason to extend different branching rules to different institutions, especially when these institutions are otherwise competing. Because the Commission has proposed the enlargement of the powers of thrift institutions and made them more directly competitive with commercial banks, it is essential that Recommendations 4 and 6 be considered together to achieve uniformity.

The third issue is alternatives to branching. Holding companies tend to flourish where branching is prohibited or otherwise restricted. Holding companies may or may not be the preferred organizational form of multi-unit financial firms. The Commission believes that firms should be free to make the choice. The public should benefit from the option granted financial institutions to branch statewide (Recommendation 4).

Chartering authorities, with standards and guidelines set by Congress and state legislatures should develop regulations for mutual savings banks and mutual savings and loan associations which elect to convert their charters to stock companies. The proper disposition of reserve and surplus accounts is the major—and an extremely important—problem with conversions. There was a total of more than $15 billion in mutual reserve accounts at the end of 1970, and "going concern" values are much larger.

There are several schools of thought on the disposition of reserve and surplus accounts at the time of a conversion:

(a) The net worth of a mutual institution belongs to the depositors and should be distributed to the depositors in some combination of stock dividends or cash at the time of conversion.

(b) Depositors in a mutual institution have taken no risk because their capital has been protected by the insuring agency and, therefore, the net worth at the time of conversion should be given to the insuring agency.

(c) The net worth should not be distributed to anyone at time of conversion, but should be frozen as a part of permanent capital, with stock options being given to all existing depositors.

(d) No one has clear moral or legal right to the net worth at the time of conversion and, therefore, the reserves should be dedicated to beneficial public purposes.

It is important that a proper formula be established to solve the question of distributing accumulated reserves equitably. Since there are several possible methods for resolving the question, where no alternatives are clearly correct, the Commission urges that more explicit legislative direction be established (Recommendation 5).

COMMERCIAL BANKS

The Commission recommends that:

6 by state laws, the power of commercial banks to branch, both *de novo* and by merger, be extended to a statewide

basis, and that all statutory restrictions on branch or home office locations based on geographic or population factors or on proximity to other banks or branches thereof be eliminated

7 federal chartering be made available for mutual commercial banks

The major reasons for recommending changes in state branching laws are discussed in connection with the thrift institutions on pages 41-54. There are additional considerations affecting commercial banks. Under current law, interstate banking through the holding company device is not permitted except for those formed prior to the Bank Holding Company Act of 1956. Nonetheless, non-bank subsidiaries of bank holding companies may provide a degree of interstate banking that could ultimately change market structures despite state laws aimed at their preservation.

Although the Commission rejected proposals to permit interstate branching or metropolitan area banking by federal legislation, it urges states to be progressive in changing their laws. Failure to act could encourage the use of inferior organizational and technological means for extending markets (Recommendation 6).

Unless it is made possible to operate a commercial bank on a mutual basis, the other recommendations in this report would require mutual savings banks to convert to the stock form in order to obtain business loan and business third party payment powers. There is no reason to suppose that one form of organization is necessarily linked to one set of powers and responsibilities. Indeed, mutual and stock institutions have long operated side by side with the same powers in the insurance and savings and loan industries. Furthermore, by recommending federal charters for stock savings and loan associations, the Commission has emphasized that both stock and mutual institutions should be permitted on the same footing in the savings and loan business. Parallel treatment would require that mutual institutions be permitted in the commercial bank industry.

At the same time, conversion to a mutual commercial bank charter would avoid the problems of equity involved in mutual-to-stock conversions. No distribution of the reserves of a mutual savings bank or mutual savings and loan association would be required. The institution would be acquiring new powers and restrictions, rather than changing its form of organization. Reserves would continue to perform their present protective function. Unlike the case of mutual-to-stock conver-

sions, there would be no shift of ownership of the reserves, no prospect that these reserves would accrue to the private gain of some favored group, and no perplexing questions to be solved of how to weigh the rights of various possible claimants (Recommendation 7).

CREDIT UNIONS

The Commission recommends that:

8 **as a concomitant of their special tax status and other special characteristics, the bond of association for the chartering of credit unions be available to active and retired members of religious groups, cooperatives, labor unions, fraternal groups, professional, educational and trade associations, the armed forces of the United States, local or regional farmers' associations, and to present and former employees of a common employer, regardless of the number or location of the employer's plants and the occupation or industry, and including employees of federal, state, county, and local governments or sub-divisions thereof, and to wives and children of such employees, and that, other than the bonds of association statutorily permissible under programs of the Office of Economic Opportunity for low income areas, no new charters with bonds of association based solely on geographic or residential characteristics be issued**

9 **by state and federal laws, provisions be made for converting the charters of credit unions to mutual savings banks, mutual savings and loan associations, and mutual commercial banks** [1]

Chartering of credit unions presents problems different from those of deposit thrift institutions and commercial banks. Credit unions are unique in a number of ways. They are exempt from federal income tax, have special reserve requirements and often have operating costs subsidized by the companies under whose auspices they operate. If there were liberalization of the required bonds of association, credit unions would become much like a savings bank, a commercial bank or a savings and loan association. Rather than serving a special group for their common advantage, credit union services would be available on a general basis.

The Commission does not object to such a change *per se*. Indeed, charters of other types of institutions should be

1 See also Recommendation 12, Section H.

available to credit unions that wish to convert. The Commission objects to a credit union's offering to the public at large the services of another type of institution without having the same tax, reserve and supervisory obligations (Recommendations 8 and 9).

D. Deposit Reserve Requirements

SAVINGS AND LOAN ASSOCIATIONS, MUTUAL SAVINGS BANKS, COMMERCIAL BANKS AND CREDIT UNIONS

The Commission recommends that:

1 membership in the Federal Reserve System, as defined in this report, be made mandatory for all state chartered commercial banks and for all savings and loan associations and mutual savings banks that offer third party payments services[1]

2 the legally required deposit reserves for any existing commercial bank and any mutual savings bank required to join the Federal Reserve System, and any existing credit union required to hold reserves with the National Credit Union Administration, be set at a preferentially low initial rate, with gradual increases so that at the end of five years these rates are the same as those for all other members of the system

3 except for the provisions of Recommendation 2, the legally required deposit reserves of all members of the system be the same, with no differences based on classification of city or size of institution

4 the Board of Governors of the Federal Reserve System have authority to set the level of legally required reserves on demand deposits between a maximum of 22 percent and a minimum of 7 percent, with gradual reductions in the level over time

5 legally required deposit reserves on time and savings deposits, share accounts and certificates of deposit be abolished

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1 Because of recommendations made in Section H, the recommendation for mandatory membership in the Federal Reserve System entails only two burdens: satisfying the reserve requirements and the purchase of the required amount of stock in the Federal Reserve.

Required reserves against deposit liabilities were originally intended to assure liquidity. Where the required level of reserves is a fixed fraction of deposits, however, they provide little liquidity. The released reserves are only a fraction of the drain from the decline of deposits. When reserves are required only against an average level of deposits over a period of time, or when their level is not rigidly fixed by law, regulation or custom, they provide somewhat more liquidity. Nonetheless, the liquidity aspect of reserves against deposits is unimportant to the Commission's recommendations.

More recently, the importance of required reserves has been seen in their role in implementing monetary policy. Given the aggregate of reserves in the system, increases in the level of required reserves restrict bank lending and the amount of deposits banks can create. Reductions in reserve requirements produce less restrictive monetary conditions. The Federal Reserve, at its discretion, can have the same effects on bank reserves by purchases and sales of government obligations. Purchases permit monetary expansion; sales (or run-offs of maturing issues held by the central bank) force contraction of the money supply. Even without required reserves, these effects would occur from sales and purchases by the central bank. So long as a reasonably stable proportion of deposits are held by banks for clearing and transactions purposes, reserve requirements are unnecessary for open market operations to control the monetary base effectively.

Reserves for member commercial banks are set by the Board of Governors of the Federal Reserve System within limits established by law. The statutory maximums on demand deposits are 22 percent for reserve city banks and 14 percent for country banks. The statutory minimums are 10 percent and 7 percent, respectively. On time and savings deposits, the maximum requirement is 10 percent and the minimum is 3 percent for all member banks. As of December, 1971, requirements at reserve city banks were 17 percent of net demand deposits up to $5 million, plus 17½ percent of such deposits in excess of $5 million. For country banks, the reserve requirements were 12½ percent and 13 percent for these demand deposits. For all member banks, the reserve requirement was 3 percent for savings deposits and time deposits up to $5 million, and 5 percent for time deposits over $5 million. Reserves must be held as vault cash or deposits with the Federal Reserve Banks.

State laws governing required reserves of state chartered, non-member banks vary greatly. Most allow vault cash and interbank deposits to qualify for the reserve requirement; some

allow holdings of government securities as partial fulfillment of the requirements.

At the present time, mutual savings banks are subject only to the laws of the chartering state. A few states require deposit reserves in the form of vault cash, interbank deposits or government securities. Other states require no deposit reserves. Sixteen states have set reserves for the deposits of savings and loan associations but, since the majority of state chartered associations belong to the Federal Home Loan Bank System, the requirements of the latter are typical. The Board permits vault cash, interbank deposits, and government securities to qualify as required reserves. The Board also requires that a varying percent of assets be kept in short maturity securities.

A number of proposals have been made to change the nature of reserve requirements. One is to abolish required deposit reserves entirely. The Commission does not endorse this proposal, partly because it would make monetary management less efficient, but chiefly because of its effects on banks and their owners. Eliminating required reserves would immediately increase the level of profits of all banks that now hold reserves greater than necessary for management purposes and raise the incremental earnings expected from future increments in deposits. Thus, without a compensating tax, the value of bank stocks would rise, providing a windfall gain to their owners.

Another proposal—one advanced by the Board of Governors, among others—is to extend Federal Reserve requirements to all commercial banks, non-members as well as members. This extension would somewhat improve the ability of the Federal Reserve to manage the money supply and provide more reserve equality among commercial banks. The extension would also increase the reserve requirements of most existing non-member banks and mutual savings banks with substantial demand deposits, imposing a tax-like penalty on their earnings. However, a phasing-in of the requirement and immediate access to the Federal Reserve discount window would offset this burden.

The Commission believes that, in the context of the sweeping changes it recommends in the powers of savings and loan associations and mutual savings banks, the proposal to extend reserve requirements to non-member banks does not go far enough. The Commission anticipates that some of the deposit thrift institutions, especially the larger ones located in money market centers, will elect to use to the utmost the liberalization in powers granted and alter their operations in ways that would make them more like commercial banks. The introduction of third party payment services alone makes them

a part of the nation's payments mechanism. Arguments in favor of extending Federal Reserve requirements to non-member commercial banks apply equally to deposit thrift institutions when they provide third party payments. Subject to a five year phasing-in period for existing non-member commercial banks and mutual savings banks required to join the system, the Commission urges mandatory membership in the Federal Reserve System and equal reserve requirements against demand deposits for all commercial banks, mutual savings banks and savings and loan associations that offer third party payment services (Recommendations 1, 2 and 3).

In certain cyclical conditions the Commission believes discretionary powers for the Board of Governors of the Federal Reserve System are useful. But it also agrees that gradual reduction in the level of reserve requirements is the appropriate policy to pursue (Recommendation 4).

The justification of reserves on demand deposits does not apply to reserves against time and savings deposits. Time and savings account reserves do not intimately affect the efficiency of monetary policy instruments. The Commission recommends the abolition of required reserves on time and savings deposits for all institutions (Recommendation 5).

Proposals have also been made to require asset reserves to assure loans and investments by financial institutions in areas of social priority. Asset reserve requirements would undoubtedly encourage investments in whatever areas were stipulated. Two types of proposals have been advanced. The first would substitute earning assets of the desired type for a portion of existing requirements. The second would add the asset reserve to existing reserves.

As an example of the first proposal, the volume of residential mortgages in an institution's assets might be used to determine credits against required reserves. From the view of the institution receiving such credits, the effect is the same as a tax reduction. The benefits, nonetheless, would accrue only to institutions with reserve requirements. It would be difficult to place such requirements on all financial institutions. For this reason, the reserve credit would be discriminatory and would fail to provide many institutions with an incentive to hold mortgages.

The second type would require changes in the optimum loan portfolio of the institutions, and it is akin to a tax increase. To the extent earnings of these institutions are adversely affected, both savers and borrowers can avoid the tax by placing and borrowing funds elsewhere. Small savers and small borrowers with few alternatives other than institutions with

reserve requirements would, in effect, be subsidizing an inequitable proportion of the priority items. Commission recommendations in Section G favor subsidies that go directly to the consumers of housing and tax credits to mortgage lenders.

E. Taxation of Financial Institutions

SAVINGS AND LOAN ASSOCIATIONS, MUTUAL SAVINGS BANKS AND COMMERCIAL BANKS

The Commission recommends that:

1 Congress enact, as part of the legislation authorizing third party payments for mutual savings banks and savings and loan associations, a single tax formula applicable to all depository institutions offering third party payment services, with the provision that institutions inaugurating third party payment services and mutual savings banks currently offering third party payment services have a five year transition period to adjust to and to conform with that single formula

2 in light of recommended expanded powers leading to changes in the mix of assets and liabilities, Congress develop and enact as promptly as possible tax legislation which would result in a uniform tax formula for all depository financial institutions

The Commission, as noted elsewhere in this report, aims to place competing institutions on an equal footing. To achieve this, Congress is asked to develop and enact a tax system providing uniform tax treatment for deposit institutions offering third party payment services and to move as expeditiously as possible to create a single, uniform tax system for all deposit institutions (Recommendations 1 and 2).

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F. Deposit Insurance

DEPOSIT PAYOFF AND THE RIGHT OF OFFSET

The Commission recommends that:

1 **the Federal Deposit Insurance Act be amended to require the Federal Deposit Guarantee Administration[1] to develop uniform standards among its subsidiary insuring agencies for meeting claims arising from failed and failing depository institutions. Uniformity is especially desirable with respect to the "deposit assumption" and "deposit payoff" settlement methods and to the "right of offset." The dominant criteria used by the Federal Deposit Guarantee Administration in meeting claims should be public needs and the welfare of the community involved, not the minimization of payouts from the insurance funds**

The primary purposes of Federal deposit insurance, established by the Banking Act of 1933, were to protect depositors and eliminate or mitigate recurrent "money panics" and bank failures. During panics, banks called or failed to renew commercial loans. As the aggregate volume of loans, demand deposits and circulating currency declined, the panic intensified. At such times, stronger banks often absorbed those which were failing and, where permissible, operated the acquired institutions as branches. Proponents of the legislation argued that deposit insurance would reduce the pressures for banking concentration. Thus a secondary motive underlying the passage of deposit insurance in 1933 was to stem the rising pressures for extensions of branching laws caused by the high rate of bank failures.

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1 See Section H for recommended changes in the organization and functions of federal regulatory and supervisory agencies.

On January 1, 1934, the Federal Deposit Insurance Corporation began with temporary coverage of $2,500 per depositor. The limit was soon raised to $5,000, then to $10,000 in 1950, $15,000 in 1966 and to $20,000 in 1969. The coverage provided by the Federal Savings and Loan Insurance Corporation has developed in the same way over the past thirty years. It is estimated that 99 percent of depositors at commercial banks are fully insured under the current $20,000 limit. By dollar volume, insured deposits amounted to 64 percent of total commercial bank deposits in 1970.

The Commission considered four familiar proposals for changes in deposit insurance. One is for variable insurance rates, with different rates depending on the character of the risk relative to capital of the insured bank. The second is to extend insurance coverage to 100 percent of deposits. The third deals with the "deposit assumption" and "deposit payoff" methods of handling failing banks.[1] A fourth proposal is that the "right of offset" be abolished.[2] In addition to these, the Commission considered changes that might be desirable because of its own recommendations for changes in financial structure and regulation.

The Commission rejected the variable rate proposal. It recognizes that differences in risk of failure exist and that its recommendation for liberalizing the regulations relating to the asset, liability and capital structures of financial institutions would probably increase these differences. The problem is a practical one. The Commission does not see how differences in risks can be evaluated with sufficient precision to be adequately reflected in insurance assessments. Further, the Commission believes that assessments might be used, albeit unintentionally, to penalize innovative institutions. New and different functions might be regarded as high risk functions. Finally, knowledge that some institutions were paying higher assessments than others could weaken public confidence in those institutions, which would defeat the purpose insurance was designed to achieve.

The proposal for 100 percent coverage of deposits was also rejected. In general, larger depositors are able to distinguish between institutions that are well managed and soundly capitalized and those that are less well run and less soundly

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1 The "deposit assumption" technique involves FDIC action to facilitate the transfer of deposits in a failed or failing bank to a sound insured bank, so that all depositors are fully protected. The "deposit payoff" technique involves FDIC action to liquidate a failed bank under formulas which result in the sharing of losses incurred in the liquidation by FDIC and by depositors with balances in excess of the insured maximum.

2 When the "deposit payoff" technique is used, the FDIC may assert the "right of offset": any debts owed by the depositor to the closed bank are deducted and the net amount is paid to the depositor up to the insured maximum.

capitalized. As long as large deposits are essentially uninsured, institutions have an incentive for good management. Since the Commission is recommending more freedom from regulation and more risk-taking by financial institutions, it is all the more important to retain this incentive.

The Commission recommends that the Federal Deposit Insurance Act be amended to require that uniform standards apply with respect to failing and failed financial institutions. Present law permits the Federal Deposit Insurance Corporation to have the deposits of a failed bank assumed by a sound insured bank and, if conditions warrant, to lend to, deposit in, or purchase the assets of a failed bank pending assumption or reorganization. The Corporation, unlike the Federal Savings and Loan Insurance Corporation, has limited power, however, with respect to a failing bank. The Commission believes the public interest will be served by changing the powers of the FDIC to conform with those of the FSLIC.

The Commission also recommends uniformity among the insuring agencies in the "deposit assumption" and "deposit payoff" settlement methods. Use of the deposit assumption technique is recommended when the welfare of the community served by the institution requires it, even though it may be more costly to the insurance fund than "deposit payoff." The recommendations in Section H for changing the framework of federal regulatory agencies will help to achieve a proper and uniform policy (Recommendation 1).

G. Housing and Mortgage Markets

The Commission recommends that:

1 interest rates on FHA and VA mortgages be determined in the market place, without regard to administrative or statutory ceilings, and with the mortgage originator or lender prohibited from collecting any discounts from any party in connection with the transaction

2 the Secretary of Housing and Urban Development and the Administrator of Veterans Affairs authorize variable rate options on FHA-insured and VA-guaranteed mortgage loans

3 a number of consumer safeguards be established for variable rate mortgages, including full explanation of the terms to borrowers, the offer of an alternative fixed rate mortgage, limits on the permissible rate change, a publicly announced index on which rate changes are based, and, after an initial period, opportunities for "no penalty" refinancing

4 Congress consider the adoption of an insurance program against interest rate risk to mitigate the problems faced by institutions holding long-term debt instruments during periods of rising and high interest rates

5 the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation be encouraged to continue to foster and develop the secondary market for mortgages, and that variable rate mortgages be included in their operations in the secondary market

6 the Government National Mortgage Association continue to guarantee marketable, mortgage-backed securities of the "pass through" and "non-pass through" types, with due regard for the effect of these activities

on private financial intermediaries and requirements for complementary municipal services

7 **states remove statutory ceilings on allowable interest rates on residential mortgages, unreasonable restrictions on loan-to-value ratios for all lenders and, as required, remove legal impediments to the use of variable rate mortgages**

8 **states simplify and modernize the legal work in mortgage origination and foreclosure, including the standardization of terms and conditions of conventional mortgages through the development of a Uniform Land Transaction Code**

9 **states abolish "doing business" barriers to out-of-state financial institutions providing mortgage loans or holding or selling properties in given states**

10 **a special tax credit based on gross interest income from residential mortgages be granted to all investors in such loans**

11 **in the event that mortgage financing is not adequate to achieve national housing goals, Congress should provide direct subsidies to consumers**

Congress and the President repeatedly have affirmed the nation's commitment to expanding and improving the housing stock. The Commission's consideration of mortgage markets and residential construction reflects its support of this goal. Much attention has been devoted to the problems of the housing market and the key institutions operating in it. Questions of tax incentives, increased flexibility of mortgage interest rates, and broader federal support for the market have all been given careful consideration.

The Commission's study of housing and mortgage markets has been limited in several ways. First, although the Commission was concerned with the adequacy and variability of aggregate flows of savings into mortgage markets, it has not attempted to recommend monetary and fiscal policies—even though past failure to meet national housing goals was largely a result of the effects of these policies on housing demand and the supply of mortgage funds. The Commission recognizes the importance of a stable, non-inflationary environment to achieve an adequate and constant flow of funds into mortgage markets, but it regards policy recommendations on ways to achieve these conditions as beyond its scope.

Second, although the Commission accepts the high priority accorded to housing goals, it has not critically examined specific goals nor attempted to define alternative goals. The Commission regards such judgments as the function of Congress and the Executive. The Commission's primary task is to recommend a financial system capable of achieving accepted ends.

Third, the Commission has not considered several obvious, but essentially non-financial, aspects of housing: problems of construction practices, wage costs, the pace of technological progress, zoning and efficient land use.

Finally, the Commission has not attempted to devise new means for subsidizing low-income housing. The Commission realizes public policies for providing housing for low-income groups, along with other policies influencing income distribution, will be used. The problem is one of inadequate income levels, not the improper functioning of mortgage markets.

The recommendations in this section are considerably fewer than might have been the case a few years ago. Fundamental changes in the operations of private and public organizations during the past three years and changes recommended in Section B concerning the deposit thrift institutions should go a long way toward providing the amount of mortgage credit required to finance housing.

Over the past decade, the volume of home building has fluctuated substantially. As shown in Appendix Chart 1, tight money conditions during 1966 caused drastic reductions in private housing starts. By the third quarter of 1966, near the end of a tight money period, the seasonally adjusted annual rate of new private housing starts fell below one million units. After the third quarter of 1966, with the easing of monetary conditions, housing starts rose rapidly and continued a generally upward movement through 1968. When monetary constraints were reimposed during 1969, housing starts declined again. Although the decline during 1969 was large, it was not as sharp as that of 1966. New starts rose substantially during the first half of 1970, despite the fact that interest rates were higher than in 1966 in both long-term and short-term markets.

The improved performance of the housing construction sector of the economy from 1968 to 1970 was due in part to mortgage lending institutions being better prepared for tight money conditions after the experience in 1966. Changes in the policies and organization of government agencies operating in the mortgage markets also had a cushioning effect.

There are two basic reasons for the cyclical variability of the housing industry. One is the reliance of residential mortgage markets on institutions that lend for longer periods than they borrow. The second is the reluctance of home buyers to enter long-term contracts and the reluctance of real estate investors to develop rental units when market and mortgage interest rates are relatively high.

Long-term rates are often below short-term rates in the months or quarters preceding peaks in economic activity. At such times, institutions specializing in mortgage lending find it difficult to maintain their growth rate, or even the level of their liabilities. Other lenders bid funds away from mortgage loans by offering higher yields.

The problems faced by mortgage lending institutions during periods of rising interest rates are caused mainly by regulatory restrictions on their portfolios. The Commission believes that giving broader powers to savings and loan associations, mutual savings banks and other mortgage lenders will permit them to compete for funds more actively and effectively during periods of changing market interest rates. These broader powers will not entirely change the cyclical character of the housing industry.

During 1966 the Federal Home Loan Bank Board followed policies that contracted the new funds which savings and loan associations had available for mortgage commitments. Associations that raised rates on savings faced restrictions on advances from the FHLBB. This policy was due both to administration pressure to follow a restrictive program and to the fact that the FHLBB had insufficient power to police the use of advances requested during the period of high mortgage loan demands.

The Supervisory Act of 1968 permits better policing of advances. After 1968, the Federal Home Loan Bank Board took actions designed to maintain the flow of funds to the mortgage markets. Bank board securities were sold in the money market to acquire funds which were then advanced to savings and loan associations. In addition, the Board lowered the level of liquidity reserves that savings and loan associations were required to maintain against deposits and eliminated the special requirement of additional reserves on new funds imposed during 1966.

The Federal Housing Administration and the Veterans Administration raised maximum rates allowed on insured mortgages very belatedly during 1966. In 1968, 1969 and 1970, the maximums were moved in line with market developments more promptly.

The 1968 Housing and Urban Development Act established programs that increased the demand for housing by subsidizing rent and interest payments. The supply of funds going to subsidized housing was increased by insuring the assisted mortgages.

The effectiveness of the Federal National Mortgage Association in maintaining an active and continuous secondary market in mortgages was enhanced in May, 1968, with the introduction of a "free market" system for purchasing and selling mortgages. Until that time, FNMA announced prices at which it would buy and sell mortgages, accepted all mortgages offered at these prices and supplied the quantity of mortgages requested. With the "free market" system, FNMA announces the volume of mortgages it will purchase and accepts the mortgages offered at the lowest prices up to the quantity specified in advance. In addition, the maximum size of FNMA's portfolio was increased in 1969, thus allowing greater participation in the market.

Under the Housing Act of 1968 the Government National Mortgage Association was authorized to issue "pass through" and "non-pass through" securities backed by FHA and VA insured mortgages. This authorization allows financial institutions and mortgage bankers to dispose easily of the financial commitment to the insured mortgages they originate.

New housing starts in 1970 never fell below an annual rate of one million units. Despite substantially higher interest rates and wider swings in credit market conditions, there were 230,000 more housing starts in 1970 than in 1966. The difference in government assisted housing starts is considerably larger: approximately 380,000 more houses were produced under government assisted programs in 1970 than in 1966.

The array of new government programs has had important effects on mortgage markets and private, subsidized, and non-subsidized housing. Nevertheless, even with these programs—and with the recommendations in Section B concerning thrift institutions—additional recommendations are in order.

The elimination of mortgage interest rate ceilings will help to assure the availability of funds for housing in various money market conditions (Recommendation 1).

Variable rate mortgages have been used in several countries that experienced rapid inflation. These contracts are legal on conventional mortgages in some states in the United States, but they have found limited market acceptance. Variable rate mortgages would, if more generally used, relieve financial institutions with large volumes of mortgages from the risks accompanying rising interest rates. Expanded use of variable

rates on both conventional and guaranteed mortgages should help assure the flow of private mortgage funds.

The Commission recognizes that the variable rate mortgage shifts interest rate risk from the lender to the borrower. In the case of mortgages on single family and small multi-unit dwellings, the borrower is the party least able to analyze the risk entailed in changing rates. The borrower usually has few alternatives and therefore he is unlikely to bargain for a lower anticipated average rate in return for his assumption of the interest rate risk.

If a large number of borrowers were to assume this risk it could prove unacceptable after the fact. Even with full explanation of the terms of the loan at the time of placement, borrowers might resent and react adversely to upward revisions in payment, whether by extensions of the term or by increases in monthly payments, after the loan was placed. Full explanation to borrowers cannot substitute for the experience and expertness of lenders in this respect. In general, they alone are capable of analyzing and assessing interest-rate risks.

Borrowers may more readily accept extensions of the term of their mortgages than additions to their monthly payments. Sometimes, however, the term of a mortgage cannot be lengthened because of statutory, regulatory, or economic restraints. There are other circumstances where extensions of the term—even to perpetuity—will not provide the required rate adjustment. Moreover, unscrupulous lenders could use extensions of term rather than payment increases in a deceptive manner.

In light of these concerns, the Commission recommends that the regulatory agencies issue directives to supervised institutions governing their use of variable rates on guaranteed mortgages. Conventional variable rate mortgages, it is hoped, would also be influenced by these directives. To assure fair treatment of the borrower, the orders would include the following safeguards:

1. The borrower must be offered a fixed rate mortgage alternative.

2. Full explanation of the terms of the variable rate should be given to the mortgagor, including the rate, the maximum movement in the rate, how rate changes are determined, and the conditions under which the borrower can repay the mortgage.

3. The maximum movement allowed for any five year period should be three percentage points, with no increase greater than one percentage point in a single year.

4. The index that determines rate changes on FHA and VA mortgages should be agreed upon in consultation with federal regulatory authorities. It should be announced and changes should be widely publicized so that conventional mortgages with variable rates will tend to conform with these terms.

5. At the end of some interval, say five years, the mortgagor should be allowed the option, with no penalty, of continuing the arrangement for another period or arranging new financing (Recommendations 2 and 3).

Insurance against interest rate risk might be achieved through a contract or policy guaranteeing a lender a rate of return above the contract rate whenever market rates of interest rose to some agreed upon level. For example, a home mortgage might be insured on a basis that whenever the Treasury bill rate exceeds the contract rate, the insuring agency would pay the difference. The lender thus would be assured of receiving at least the Treasury bill rate on his mortgage.

Other bases for insurance are worth consideration. The insurer might offer to buy an insured mortgage at par whenever some agreed upon market rate of interest reached or exceeded a level stated in the agreement. For example, the insurance could give the lender the right to sell the mortgage at par whenever the Treasury bill rate exceeded the contract rate, or some other agreed upon rate.

This type of insurance would keep institutions that are important mortgage lenders competitive during all phases of the monetary cycle, and hence it would allow mortgage markets to function normally in different economic conditions. In a tight money situation, savings inflows might shrink, and some disintermediation might occur, but the institution would still be able to make new mortgage loans and commitments. This would be true whether the insurance reimbursed the lender for the amount of the mortgage or merely brought its interest income up to a current market yield. If the latter, there would be a minimum need for the insuring agency to raise new funds. This type of insurance would result in less disruption of money and capital markets than occurs through sales of obligations by FHLBB, FNMA and other housing agencies.

Since the principal causes of wide interest rate movements are changes in the mix of monetary and fiscal policies, the only appropriate insurer against interest rate risks would appear to be a federal government agency. The issue is extremely complex and the Commission recommends further Congressional study to determine the feasibility of alternative approaches (Recommendation 4).

For a time during 1970, FNMA became the major mortgage lender. Without FNMA purchases and the expanded role of the Federal Home Loan Banks, the performance of the mortgage market in 1970 almost certainly would have been worse than in 1966.

Until 1970 FNMA's secondary market activities were restricted to government guaranteed and insured mortgages. The Emergency Home Finance Act of 1970 empowered FNMA to develop a secondary market in conventional mortgages. Virtually every student of home finance has, at one time or another, recommended this approach as a means of broadening the mortgage market. The Commission urges FNMA further to develop a free secondary market in conventional mortgages and to include in its programs variable rate mortgages.

The Federal Home Loan Mortgage Corporation is also expected to have an important impact on the market. This organization, initiated by the Federal Home Loan Bank Board with original financing by regional Home Loan Banks; has begun to make a secondary market in conventional mortgages. FHLMC currently purchases conventional mortgages only from savings and loan associations. The secondary market for conventional mortgages would be improved if FHLBB were to develop eligibility standards for all originators who wish to sell conventional mortgages to FHLMC (Recommendation 5).

The mortgage-backed security represents an important way in which the government can encourage the housing market without additional guarantee or subsidy. Mortgage-backed securities fill a significant void in mortgage market instruments. These securities encourage intermediaries that currently are limited participants in the mortgage markets voluntarily to increase the size of their mortgage portfolios. The Commission also believes mortgage-backed securities are a more desirable alternative than recent proposals for mandatory participation by pension funds and other lenders (Recommendation 6).

While the programs involving massive borrowing of funds in the markets by FNMA and the Federal Home Loan Banks succeeded in greatly moderating the impact of monetary restraint on mortgage financing in 1969-70, there were perverse effects that cannot be overlooked. The resulting obligations provided additional investment alternatives that stimulated disintermediation. Moreover, it is important to recognize that these borrowings did not add to the total available funds but represented only the ability of the agencies to preempt funds from the total savings available for investment. Since their borrowings are not sensitive to interest rates, they played a part in escalating market interest rates.

A number of actions by the states would also be helpful in improving mortgage markets and flows of funds to residential construction. Ceilings on mortgage interest rates, whether appearing in special legislation or in general usury statutes, impede flows during periods of high interest rates. Variable rate mortgages are prohibited by law in some states. In addition, mortgage origination and foreclosure procedures vary widely. In some states, mortgage closing fees and expenses are high. Uniformity as well as equitable treatment of borrowers could be enhanced through the development and adoption of a Uniform Land Transaction Code. Finally, barriers to "doing business" tend to restrict flows of funds between states (Recommendations 7, 8, and 9).

The Commission has recommended in Part I that social priority investments should be encouraged through direct subsidies, and, where necessary, tax credits. The attempt to achieve the same ends through the special regulation of particular financial institutions has discriminatory effects, encourages avoidance and makes it nearly impossible to estimate the costs in real resources of the social programs.

Tax credits could provide the required incentive to channel funds into socially desirable investments. The Commission has not attempted to define the programs meriting such support or the rates of tax credits to be given. Indeed, it doubts whether there is a set of programs or a pattern of tax credits that would be appropriate over long periods of time. Changes in tax credits should be made over time to alter longer term credit flows according to Congressionally defined objectives.

In general, the Commission believes that tax credits should be used sparingly and not as means to support special industry groups. The objective should be the formation of real capital in areas of social need, and not tax relief for groups or organizations that may, because of changes in supply and demand, find their income levels impaired. An obvious priority that qualifies for tax credits is residential mortgage financing, including the financing of renovation of inner city dwellings as well as new construction.

Because of the long lag between the planning of projects and their initiation and completion, the Commission is pessimistic about the possibility of using tax credits as an anticyclical device. By the time Congress acted to vary the rate and the effects of the change were felt, the intended remedy could itself be cyclically destabilizing.

The Commission endorses the view that tax credits are preferable to income exemptions. Taxpayers will be more aware of the impact of social priority investments on their tax

liabilities when deductions rather than exemptions are used. In addition, the cost of achieving social priority investments in terms of forgone tax revenues can be directly calculated when the tax credit method is used (Recommendation 10).

The direct subsidization of consumers is the preferred means of pursuing social goals that are not otherwise met. Direct subsidies avoid the warping of financial institutions, they are visible, and they are less inflationary than agency borrowings (Recommendation 11).

H. Regulation and Supervision of Financial Institutions

The Commission recommends that:

1 a new agency, the Office of the Administrator of State Banks, be established to examine and supervise state chartered, insured commercial banks and state chartered, insured mutual savings banks. When their deposits subject to third party payment orders aggregate more than 10 percent of total deposit liabilities, state chartered, insured savings and loan associations shall also be examined and supervised by the agency. The Administrator of State Banks shall examine, certify for insurance and assure conformity with all federal legislation for all institutions under its jurisdiction

2 the Office of the Comptroller of the Currency be retitled the Office of the National Bank Administrator and established as an independent agency separate from the Treasury Department. The National Bank Administrator shall retain all existing functions of the Comptroller of the Currency with respect to National banks. The National Bank Administrator shall also have authority to charter, examine and supervise federally chartered mutual commercial banks and federally chartered mutual savings banks. When their deposits subject to third party payment orders aggregate more than 10 percent of total deposit liabilities, federally chartered savings and loan associations shall also be examined and supervised by this agency. The National Bank Administrator shall examine, certify for insurance and assure conformity with all federal legislation for all institutions under its jurisdiction

3 a new agency, the Federal Deposit Guarantee Administration, be established to incorporate the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation and the insurance function

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of the National Credit Union Administration. Three separate funds should be continued

4 the Federal Deposit Guarantee Administration be governed by five Trustees, who shall be the Director of the Federal Deposit Guarantee Administration as Chairman, the Administrator of State Banks, the National Bank Administrator, the Chairman of the Federal Home Loan Bank Board and the Administrator of the National Credit Union Administration

5 the Federal Home Loan Bank Board retain all existing powers, except those relating to deposit insurance and relating to savings and loan associations whose deposits subject to third party payment orders aggregate more than 10 percent of total deposit liabilities. The Federal Home Loan Bank Board shall also have authority to charter, examine and supervise federal stock savings and loan associations. The Board shall examine, certify for insurance and assure conformity with all federal legislation for all institutions under its jurisdiction

6 the positions of Directors of the Federal Deposit Insurance Corporation be abolished and the Corporation be administered by the Federal Deposit Guarantee Administration

7 the regulatory and supervisory functions of the Board of Governors of the Federal Reserve System, except for those pertaining to interest rate ceilings on deposits of commercial banks, savings and loan associations, mutual savings banks, and credit unions, those concerning international banking, those given under the Bank Holding Company Act, the Edge Act, and the Securities Exchange Act, be transferred to the Office of the Administrator of State Banks, but that the Board of Governors have the right to receive examination reports from other federal regulatory and supervisory agencies on any institution that is a member of the System

8 the regulatory and supervisory functions of the Federal Deposit Insurance Corporation, except for those relating to determination and collection of insurance premiums and the payment of insurance claims, be transferred to the Office of the Administrator of State Banks

9 the National Bank Administrator or the Administrator of State Banks, as appropriate, have the right to receive examination reports on any institution under the jurisdiction of the Federal Home Loan Bank Board

which provides third party payment services, and the Federal Home Loan Bank Board have the right to receive examination reports from the National Bank Administrator and the Administrator of State Banks on any institution under their jurisdiction which is a member of the Federal Home Loan Bank System or which is otherwise using Federal Home Loan Bank services

each of the responsible regulatory agencies take due regard for compliance of institutions under its jurisdiction with regulations applicable to them which are promulgated by other agencies

each of the responsible regulatory agencies, as its interests appear, have the right to examine institutions under the jurisdiction of the other agencies and, as a last resort, issue cease and desist orders

any insured depository institution have the right to change its charter to that of another institutional type, subject only to its acceptance of the examination and supervision of the agency responsible for the new institutional type and to acceptance and certification for deposit insurance by the appropriate insuring agency

the independence of the Federal Reserve System be preserved

the Federal Reserve System, the Office of the National Bank Administrator, the Office of the Administrator of State Banks, the Federal Home Loan Bank Board and the National Credit Union Administration be independent of the budgetary controls of the Office of Management and Budget

The Commission's recommendations could be carried out under the existing regulatory framework. Nonetheless, the Commission believes that the performance of the federal agencies that charter, examine, supervise and insure deposit institutions can be improved by a number of organizational changes.

In its proposals for reorganization of the agencies, the Commission developed as criteria: (1) the uniform application of laws and regulations on all competing institutions; (2) the preservation of a dual system of chartering, examination and supervision; (3) efficiency in examination and supervision; (4) regulatory specialization to accompany the specialization of

depository institutions; (5) efficiency in the use and development of monetary policies; (6) improvement in the flow of funds to housing and other high social priority investments; and (7) the interests of consumers and the public.

Under the existing regulatory framework, the Comptroller of the Currency charters, examines and supervises all National banks. It must approve or disapprove of bank mergers where the resulting bank is a National bank. The Comptroller enforces the Truth in Lending Act as it applies to National banks.

The Board of Governors of the Federal Reserve System is responsible for monetary policy and, in addition, it examines and supervises state member banks. Its functions include those given under the Bank Holding Company Act and, for bank mergers where the resulting bank is a state member bank, it approves or disapproves of bank mergers. It enforces the Edge Act and the Truth in Lending Act as it applies to state member banks. It also sets margin requirements on security purchases under provisions of the Securities Exchange Act.

The Federal Deposit Insurance Corporation examines and supervises insured state non-member banks, including insured mutual savings banks, and it has responsibility under the Bank Merger Act and the Truth in Lending Act for insured state non-member banks. The Bank Merger Act also requires advisory opinions from the two agencies not primarily responsible for merger decisions, as well as from the Department of Justice in every case.

The Federal Home Loan Bank Board examines and supervises all insured savings and loan associations. It carries on an independent deposit insuring function through its subsidiary, the Federal Savings and Loan Insurance Corporation. The Board makes advances to savings and loan associations, sets their reserve requirements and buys and sells mortgage instruments depending on its evaluation of mortgage market conditions.

The National Credit Union Administration was established by the Federal Credit Union Act of 1970. It grants federal charters and examines and supervises all insured credit unions. The National Credit Union Administration also operates the office that insures credit union share accounts.

Each of the states has from one to three regulatory agencies that charter and supervise the deposit institutions. There are great differences with respect to chartering, branching regulations, examination and supervisory practices among the institutions and states.

The Commission recommends a consolidation into two agencies—the Office of the Administrator of State Banks

and the Office of the National Bank Administrator—of the federal examining and supervisory functions over commercial banks and mutual savings banks. They would also examine and supervise savings and loan associations with deposits subject to third party payment orders in excess of 10 percent of total deposit liabilities.

The Office of the Administrator of State Banks takes on the examining and supervisory functions currently performed by the Board of Governors and the Federal Deposit Insurance Corporation. The Administrator of State Banks would cooperate to the fullest extent with state banking departments. Through such cooperation, the performance of these state departments can be improved and duplication in bank examination procedures minimized. The Commission believes that steps taken to strengthen the dual banking system serve the public interest.

The Office of the National Bank Administrator is essentially the Office of the Comptroller of the Currency, with independent status (Recommendation 2).

The recommended consolidation should result in more uniformity and efficiency in examination and supervision, and more efficient and uniform enforcement of such statutes as the Bank Merger Act and the Truth in Lending Act. It is intended also to permit the Federal Reserve's Board of Governors to concentrate its attention and resources on monetary management, bank holding companies and problems of international banking and finance. Full consolidation into a single agency for commercial banks is not recommended because of possible adverse effects on the dual system of banking (Recommendations 1 and 7).

Establishment of the Federal Deposit Guarantee Administration is designed to create uniformity in insurance treatment among institutions and, at the same time, to treat effectively insurance problems relating to specialized institutions. Uniformity should come from overall policies set by the Federal Deposit Guarantee Administration; consideration of special problems, from the subsidiary corporations within the Administration. Furthermore, the activities of the Administration and its subsidiary corporations are restricted, for efficiency reasons, to the insurance functions. The basic examining would be performed by the National Bank Administrator, the Administrator of State Banks, the Chairman of the Federal Home Loan Bank Board and the National Credit Union Administrator.

By having the Federal Deposit Guarantee Administration governed by Trustees, four of whom are from the other agencies, an insuring agency is created with little incentive to

maximize the value of the insurance fund. Deposit insurance will operate in a more socially advantageous way than under present arrangements (Recommendations 3, 4, 5, and 6).

The Commission recommends that the Office of the National Bank Administrator and the Office of the Administrator of State Banks should be headed by single administrators rather than boards. The Commission is aware that poor appointments to the positions may occur with adverse results that might be overcome by a multi-member board. On balance, however, the gains in efficiency through having one administrator for each of the examining and supervising agencies outweigh this danger, particularly if the administrator serves at the pleasure of the President, subject to Senate approval. Where broad policy issues are concerned, such as bank mergers or extensions of services, the Commission recommends that advisory opinions between the agencies should be required.

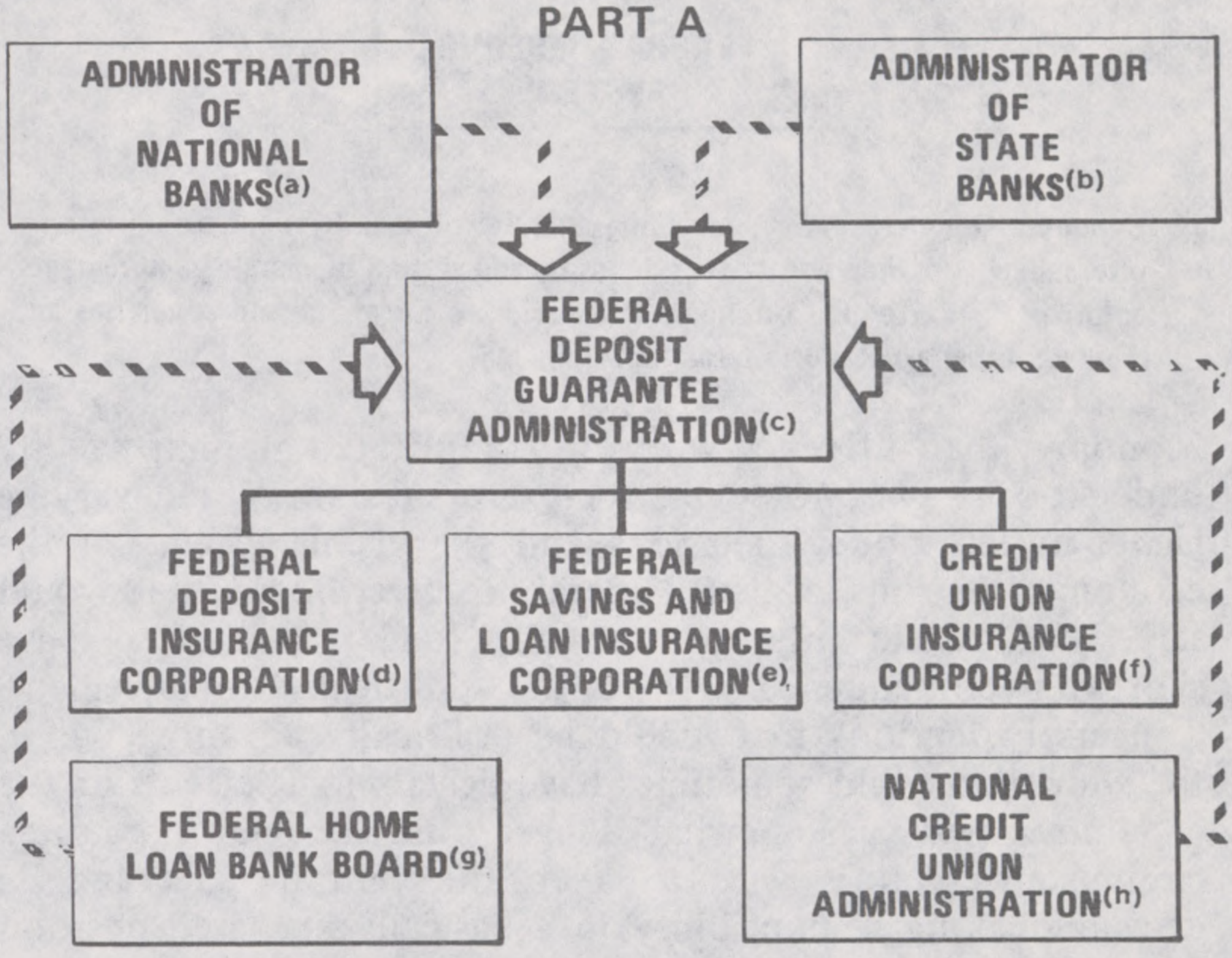
The Commission recommends that the Board of Governors retain its powers under the Bank Holding Company Act. The Commission views bank holding companies as an alternative to branching and the direct extension of services by banks themselves or through their subsidiaries. The advice of the other agencies concerning extensions of services may be presented at hearings conducted by the Board under the Bank Holding Company Act. Under the Commission's recommendations, the advice of the Board and the other agencies could be given at the hearings required of any agency considering extensions of services by any of the depository institutions. The regulatory framework the Commission favors is shown in Table 2.

Public safeguards and communication and coordination among agencies are required under the Commission's recommendations. In particular, each agency would have the right to receive examination reports prepared by other agencies, the right to examine institutions under the jurisdiction of other agencies if a reasonable need appeared and, as a last resort, the power to issue cease and desist orders (Recommendations 9, 10, and 11).

The Commission is particularly concerned that the deposit financial institutions have the ability to alter their assets, liabilities and services without unnecessary constraints arising from regulations pertaining to their type of charter. Ease in transferring from one type of charter to another is urged (Recommendation 12).

The Commission believes it essential that the independence of the Federal Reserve System be maintained. Although money and credit conditions exert a pervasive influence on the

TABLE 2
FEDERAL REGULATORY FRAMEWORK
FOR DEPOSIT INSTITUTIONS
PART A



(a) Charters National banks, federal mutual commercial banks and federal mutual savings banks; examines and supervises National banks, federal mutual commercial banks, federal mutual savings banks and, when their deposits subject to thirdparty payments are in excess of 10 percent of total deposit liabilities, federal savings and loan associations.

(b) Examines and supervises insured, state chartered commercial banks, insured, state chartered mutual savings banks and, when their deposits subject to third party payments are in excess of 10 percent of total deposit liabilities, insured, state chartered savings and loan associations.

(c) Directed by an Administrator and four trustees, the Administrator of National Banks, the Administrator of State Banks, the Chairman of the Federal Home Loan Bank Board and the National Credit Union Administrator.

(d) Insures institutions examined and supervised by the Administrator of National Banks and the Administrator of State Banks.

(e) Insures institutions examined and supervised by the Federal Home Loan Bank Board.

(f) Insures federal and state chartered credit unions.

(g) Charters federal savings and loan associations; examines and supervises federal and insured, state chartered savings and loan associations with deposits subject to third party payments aggregating 10 percent or less of total deposit liabilities.

(h) Examines and supervises federal and insured, state chartered credit unions.

PART B

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM[a]

(a) Conducts monetary policy, including exercise of standby controls on interest rate ceilings on time and savings deposits, and setting of margin requirements; enforces Bank Holding Company Act; enforces Edge Act and supervises and regulates other aspects of international banking.

economy, that influence works in complicated and imperfectly understood ways. Moreover, there are substantial and varying lags between policy decisions and the visible effects in the economy. Actions of the Federal Reserve Board that would serve the public interest over the longer run often have short-run consequences which are politically inconvenient. Conversely, actions that would be politically advantageous in the short run could sometimes have destabilizing effects on the economy over a somewhat longer run. In view of these circumstances, it is wise to keep the central bank and its decision-making responsibility in a basically insulated position within the federal government.

The present position of the Federal Reserve provides for enough communication of ideas and coordination of action with the Executive Branch to serve the purposes of effective government. It also permits thorough and frequent review of central bank performance by the Congress to assure accountability to the public will. These vital safeguards are currently fully respected. The Commission strongly urges that the Federal Reserve System retain its present independence of decision-making to protect monetary policy from partisan political influences (Recommendation 13).

The Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation currently operate outside the budgetary controls of the Office of Management and Budget. This is not true of the Federal Home Loan Bank Board. Yet all of these agencies derive their entire support from fees paid by member institutions, not from tax revenues. To assure their continued freedom of action in serving the public interest, and to avoid the constraints imposed by the budgetary processes of the federal government which are necessary for tax supported institutions, it is important that their funding remain outside the federal budgetary process. The Commission recommends the continued

application of this practice for the three agencies now following it, and further recommends that it also be applied to the operations of the Federal Home Loan Bank Board. Furthermore, upon the creation of the Office of the Administrator of State Banks, the Office of the National Bank Administrator, and the Federal Deposit Guarantee Administration, it is important that their funding also be from members' fees, and outside the federal budgetary process (Recommendation 14).

I. Life Insurance Companies

The Commission recommends that:

1 **state insurance laws be amended to allow life insurance companies to issue policies containing flexible policy loan interest rates, subject to appropriate usury laws establishing interest rate maximums**

2 **the states recognize the heavy tax burden which the current premium tax structure places on life insurance companies as compared with state taxation of other financial institutions**

3 **a reasonable balance be maintained between social insurance and private insurance in providing economic security**

The primary purposes of life insurance are to provide financial protection against the unpredictable contingencies of death and disability and to accumulate savings for retirement and other needs. The level premium method used by the industry in providing these protection and savings objectives creates large reserve funds available for investment in the economy. Another growing source of savings provided by the industry is reserve funds accumulated under pension plans. As a result, the industry is a substantial source of long-term capital. Furthermore, the unique long-term, fixed-dollar nature of insurers' obligations enables the industry to provide long-term debt financing in the form of mortgage loans and corporate bonds.

In recent years, the ability of life insurance companies to serve the nation's capital needs has been impaired. When inflation and restrictive monetary policy caused a sharp rise in interest rates, disintermediation through policy loans substantially increased. This contributed to an overall shortage of institutional credit.

The accumulation of capital through life insurance is also adversely affected by a system of state premium taxes that imposes a relatively heavy tax burden on life insurers and places them at a disadvantage compared with other intermediaries. Another factor that could affect the future role of the insurance industry as a provider of capital funds is the possible expansion of the Social Security System beyond its original purpose—that of providing a minimum floor of economic security. Should the concept be expanded, the accumulation of capital through private insurance and pension plans would be likely to suffer.

Consumers continue to value the protection of fixed-dollar life insurance. The amount per family now averages more than two years of family disposable income compared to one year in 1950. Inflation has eroded the purchasing power of billions of dollars in savings already accumulated through life insurance, and the insuring public has become increasingly aware of inflation's threat to fixed-dollar savings. This awareness has contributed to a change in the life insurance product mix, through a marked shift to term insurance and policies with a relatively small element of savings. Term insurance now accounts for 40 percent of individual sales volume, compared to 30 percent twenty years ago. Growth of group insurance, which is predominantly term insurance, also reflects this trend. Concurrently, the share of insurance with a relatively high element of savings, such as limited-pay life and endowment, has decreased sharply. As a result, there has been a steady decline in the proportionate amount of capital accumulated through the life insurance mechanism.

The inflationary circumstances of the last half of the 1960's caused periodic disintermediation. In the life insurance industry, this took the form of a rapid rise in policy loans. Life insurance policies have a unique contractual right required by state statutes that permits the policyholder to borrow at an interest rate set at the time the policy is issued. In many states this provision is subject to a legal maximum ranging from 5 to 6 percent. Because of the wide spread between the policy loan rate and market rates in recent years, policy loans have more than doubled from $7.7 billion in 1965 to $16.1 billion in 1970. Policy loans now represent 7.9 percent of total life insurance industry assets, an increase from 4.8 percent in 1965. The net increase during 1970, after repayments, was $2.2 billion, which represented 22 percent of the year's increase in the industry's total assets.

These borrowings have had a detrimental effect on the investment experience of life insurers and a discriminatory effect between borrowing and non-borrowing policyholders.

The recent rise in policy loans has been due primarily to borrowings by owners of large policies. Sophisticated borrowers exercise their policy loan privilege when interest rates rise in order to obtain a higher yield on other investments or to avail themselves of credit at lower costs than those obtainable from other sources.

In recent years the spread between average yields on new insurance company investments and the policy loan rate has been as much as four percentage points. Diversion of funds from investments to policy loans has had an adverse effect on investment income. Since interest earned on investment determines both premium and dividend rates, an inequity results. Policyholders who do not borrow in effect subsidize those who do. Most often those policyholders who do not borrow are owners of smaller policies.

A more flexible and market-oriented interest rate on policy loans would alleviate these consequences. Furthermore, such change becomes necessary because of the Commission's recommendation to liberalize rate ceilings on interest payable on deposits in commercial banks, mutual savings banks and savings and loan associations (Section A, Recommendations 1-9).

Policy loan rates are subject to state regulation and therefore are outside direct federal supervision. More flexibility in state laws setting rates would alleviate the adverse effects of rigid ceilings in periods of tight money and allow life insurance companies to respond competitively to the liberalized regulations and expanded powers proposed in this report for other institutions. The states should act promptly to correct these imbalances (Recommendation 1).

Each state imposes taxes on the premiums of life insurance companies. The most common rate is 2 percent of premiums. When a company's premium tax is compared to its net income the result in many instances is an income tax rate substantially higher than that imposed on other savings institutions. Moreover, to the extent that this tax falls on the savings component of premiums, it is a tax on thrift. It is the opinion of the Commission that attention should be called to the disproportionate state tax burden imposed on life insurance companies by the premium tax (Recommendation 2).

Since the enactment of the Social Security Act in 1935, the federal government's role in providing for the public financial security has expanded significantly. In 1945, the total Social Security tax paid by employers and employees was $1.3 billion. By 1970, it had increased to $40 billion. This is an increase from less than one percent of the nation's personal income to more than 5 percent currently. In 1945, the national

average monthly retirement benefit provided by Social Security was $85. In 1971 it is $295. In 1945, a married man at the age of 30 had maximum survivor benefits of approximately $10,500; in 1971, a man of the same age has about $65,000. Individuals' contributions to Social Security now slightly exceed premiums paid for individual private life insurance. Furthermore, pending legislation in Congress would greatly expand contributions and benefits. The current 10.4 percent employer/employee payroll tax would rise to 14.8 percent in 1977, an increase of almost 50 percent. The salary limit to which the tax applies would rise from $7,800 to $10,200.

The Social Security System is designed to provide a floor of economic security for retired and disabled workers and their dependents. Consistent with this broad social intent, it is important that a restructured Social Security System should not impose so heavy a burden of taxation as to hamper the ability of individuals to supplement this protection through various private mechanisms, including life insurance products. Savings through life insurance and pension funds and other private savings media are a major source of capital. The Social Security System, in contrast, generates very little new capital and redistributes each year most of the tax revenues received. Thus, the Commission believes that the flow of savings into the capital markets can be enhanced by strengthening and expanding life insurance and private pensions (Recommendation 3).

J. Trust Departments and Pension Funds

TRUST DEPARTMENTS

The Commission recommends that:

1 **a federal "prudent man investment rule" be enacted providing that, "a fiduciary shall discharge his duties with respect to the fund with the skill, care, prudence, and diligence under the circumstances then prevailing that a prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims"**

2 **the appropriate regulatory agencies examine and monitor bank and other trust departments to assure that:**

a **brokerage commissions are not used to attract or hold deposit balances and loans of brokerage houses with the banking department of the corporate fiduciary**

b **each corporate fiduciary achieves the best execution of buy and sell orders for securities and evaluates the services received by the trust department in payment of which there has been an allocation of brokerage commissions**

c **trust departments in banks with total trust assets greater than $200 million deny trust department investment personnel access to commercial banking department credit information**

d **no director, officer or employee of a corporate fiduciary recommends or initiates any purchase or sale of securities on the basis of insider information**

e each corporate fiduciary establishes procedures to review at frequent intervals the amount of uninvested cash in each trust account and requires the officer responsible to justify the retention of balances

3 each corporate fiduciary be required to file an annual report with the appropriate regulatory agency detailing:

a the twenty largest stock holdings, in terms of market value, except that no holding with a market value less than $10,000,000 that does not constitute at least one percent of total outstanding voting stock need be reported

b in addition to (a) all holdings that constitute 5 percent or more of the outstanding voting stock of any corporation registered with the Securities and Exchange Commission

c dollar values with respect to each listed holding, broken down by sole, shared and no voting responsibility for each security listed

d common directors, officers, or senior employees for securities listed in cases where bank has sole voting responsibility

e cases in which bank voted against management or against a management recommendation

4 bank holding companies be permitted to maintain a single affiliate to carry on trust activites for all banks in the holding company

5 bank holding companies be permitted under state laws to operate system-wide common trust funds among all affiliate banks with trust powers

In 1970 more than 3,400 U.S. banks had trust departments. Banks administered more than one million separate trust accounts having an aggregate market value of approximately $288 billion. These accounts were divided between personal accounts, (comprised of trust and estate), employee benefit trusts, including agents for individual trustees of such trusts, and the other agency accounts for individuals and institutions as shown in Table 3.

As shown in Table 4, nearly three-fourths of bank trust departments hold less than $10 million in assets. These banks

TABLE 3

DISTRIBUTION OF ACCOUNTS BY TYPE, ALL INSURED COMMERCIAL BANKS

TYPE OF ACCOUNT	PERCENT OF ACCOUNTS	PERCENT OF ASSET VALUE OF ACCOUNTS
Personal (Trust & Estates)	76	47
Employee Benefit Trusts	12	35
Agency Accounts	12	18
	100	100

Source: Trust Assets of Insured Commercial Banks, 1970, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency.

TABLE 4

DISTRIBUTION OF TRUST DEPARTMENTS BY SIZE, ALL INSURED COMMERCIAL BANKS

SIZE OF TRUST DEPARTMENT MILLIONS $	NUMBER OF BANKS	TOTAL ASSETS ADMINISTERED BILLIONS $	TOTAL NUMBER OF ACCOUNTS
Under 10	2,455	4.3	110,831
10–25	349	5.6	9,681
25–100	320	15.7	164,956
100–500	192	39.7	257,431
500–1000	38	26.3	114,473
Over 1000	52	196.8	346,660

Source: Trust Assets of Insured Commercial Banks, 1970, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency.

account for less than 1.5 percent of the $288 billion in bank trust departments. On the other hand, 52 banks each administer more than $1 billion in trust assets, representing 68 percent of the total trust assets.

State chartered banks have acted as trustees in the United States since the early 19th century. National banks were allowed to exercise trust powers in 1913. Until recently, trust departments were largely engaged in administering personal trusts that entailed numerous activities in addition to the investment function. During the past two decades a substantial part of the growth of trust department assets has come from the

pension funds administered by banks. The administration of these funds falls almost entirely within the investment function, and a much greater emphasis is placed on the trustee's performance with respect to the overall rate of return on invested funds.

In recent years Congress and several regulatory bodies have shown increasing concern about the operations of bank trust departments. This concern has centered on two major issues: the accumulation of economic power and potential conflicts of interest. It should be noted that, because of the inherent economies of scale in the investment of funds, the question of the accumulation of economic power would arise no matter how trust operations were organized unless there was a regulated maximum size. Conflict of interest would also arise if trust administration were handled outside of banking enterprises, although the particular problems would be different.

The Commission has considered these issues. Because the economies inherent in trust departments are related to their association with banks, it would be costly to split the trust and banking functions. If trust departments were divorced from commercial banks there would be reduction or even elimination of trust service in many locales. Moreover, the Commission's review of the history of bank trust operations suggests they have an exceptionally high degree of responsibility. The vast majority of banks have set up methods of operation to assure proper actions by employees should conflicts of interest arise.

The concern over potential conflicts of interest and the accumulation of economic power is real. The Commission has developed a number of recommendations designed to alleviate concern over these potential problems.

A "prudent man rule" has long pertained to the actions of bank officers with regard to investment of personal trust funds. The rule has developed at the state level through common law and some states have codified it. The statement and applications of the rule continue to vary widely among the states. In any event, the rule applies to personal trust funds rather than pension funds. The Commission believes that such a rule should apply to the selection of securities in pension funds (Recommendation 1).

Trust departments generate large brokerage commissions. Some critics charge that commissions have been used in the past to attract deposit balances of brokerage firms. This practice has been challenged by the Antitrust Division of the Justice Department. Examiners should be required to monitor compliance with this ruling (Recommendation 2a).

Brokerage commissions can still be used to purchase services from brokerage firms. But these allocations should not interfere with the best execution of orders (Recommendation 2b).

The commercial department of a bank receives information from its customers that is not generally available to the public. Such information should not be made available to the trust department. Smaller banks do not have as much potential conflict as larger ones between commercial banking relationships and portfolio management even though the personnel in the smaller banks' trust and commercial departments are often identical. Thus the smaller banks would not be able to comply fully with strict provisions on these points. But since they have little potential for anti-competitive conflicts, they should not be made to comply (Recommendation 2c).

At the present time if bank trust officers have inside information, they are in a dilemma. If they use it in a transaction they may be charged with misconduct. If they have information and do not apply it, they may be charged with not doing the best they can for their clients. A clear rule on correct behavior should be enunciated (Recommendation 2d).

The SEC *Institutional Investors Study* estimated that the indirect value of deposits amounted to 30 percent of bank trust compensation.[1] Trust activities generate deposits in three ways. There is a period between the purchase of a security and the time funds are actually paid out, between the receipt of new funds or money from the sale of securities and the investment of these funds, and between receipt of the dividends and interest income and the disbursement of these funds. It is important that bank trust departments exercise care to keep these deposits to a minimum (Recommendation 2e).

The proper administration of large holdings of equity securities imposes on trust departments the need to vote upon past and proposed actions of the management of the enterprises represented in the portfolios. Where a bank holds a sizable amount of a corporation's equity securities it could have a significant influence on the management of that enterprise. Where its holdings are large enough to be significant, this should be publicly reviewed and monitored by requiring the trust department to report how it voted these security holdings.

Bank trust departments do not have full discretion to vote all of the securities they hold. Securities held without the voting privilege do not confer power over management. Thus, for reporting purposes, holdings should be divided by degree of voting control held by the bank.

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1 Institutional Investor Study Report of the Securities and Exchange Commission (March 10, 1971), vol. 2, pp. 480-483.

An additional potential for control of a corporation's activities exists when there are common officers or high level employees in the bank and a corporation whose securities are held by the trust department (Recommendation 3).

Finally, to permit greater economy in trust department operations, the Commission recommends that bank holding companies be allowed to consolidate their trust department activities in one trust department within the holding company system (Recommendations 4 and 5).

PENSION FUNDS

The Commission recommends that:

6 **the federal "prudent man investment rule" recommended above apply to all pension funds, not only those operated by bank trust departments**

7 **the federal Disclosure Act should be amended to require that the reports recommended in 3 (above) for bank trust departments apply also**

8 **the federal Disclosure Act be amended to require an annual independent audit of pension funds and an annual actuarial report to be submitted to the Department of Labor**

9 **the federal Disclosure Act be amended to strengthen the power of the Secretary of Labor to investigate violations of the law and to seek injunctions where violations are found**

10 **programs for tax-sheltered annuity plans be extended and broadened by revisions in the law permitting each person to establish a personal retirement savings plan which would, under certain conditions, provide essentially the same tax deferment opportunities now provided for employer contributions under qualified plans and for tax-sheltered annuity plans**

Pension funds, both private and public, are an increasingly significant force in the nation's financial and economic structure. They have added billions of dollars annually to the nation's total capital flow. For these reasons, the Commission reviewed the history and present status of this financial intermediary.

Private pension plans, first adopted by industry as early as 1875, began their major growth in the 1940's and 1950's.

Thirty years ago only 9 percent of the work force was covered by private pension plans (insured and non-insured) whereas 50 percent of the work force is covered today. Pension reserves have jumped from $2.4 billion in 1940 to $137 billion today. Since 1940, pension benefit payments have increased from $100 million annually to $6 billion annually.

Paralleling the growth in private plans, state and local governments throughout the country have increased the protection for public employees, and these programs have also become a major factor in the capital markets. Substantially all full-time state and local government employees are covered by public pension plans with reserves amounting to $57 billion.

Meanwhile, the Social Security program has also grown. In 1940, it covered a work force of 26.8 million; in 1970 there were more than 70 million participants. The Social Security retirement benefit payout has also increased. In 1940, about $350 million was paid out in Social Security retirement benefits. By 1960 this increased to $10.7 billion and, by 1970, to $28.8 billion. In contrast to the assets of private pension funds, the Social Security reserve makes a limited contribution to the capital formation process. The system is designed to operate essentially on a pay-as-you-go basis.

The rules and regulations governing pension fund activities are found principally in the Internal Revenue Code and under the federal Welfare and Pension Plan Disclosure Act. The Internal Revenue Service provisions help assure that bona fide, definite and essentially non-discriminatory plans are established.

The federal Disclosure Act, passed in 1958 and amended in 1962, was adopted on the theory of self-enforcement through public disclosure. The Act requires an annual report of a plan's operation and assets to the Department of Labor. The report is available to employees upon request. The 1962 amendments to the Act give the Secretary of Labor enforcement authority, require bonding of administrators, and add criminal provisions against embezzlement, bribery and kick-backs.

It is essential that the plans are operated and their assets invested so as to protect the pension promises to beneficiaries. Employees and pension beneficiaries must be made aware of the nature and limitations of the pension promise.

Positive efforts to expand private plan coverage should be continued. Today 50 percent of the work force is covered. The remainder would benefit from the additional flexibilities and retirement income protection that private plans afford. A primary objective should be the continuation and

further growth of private pension fund savings and corresponding capital formation. Pension funds must be able to fulfill their role as a financial intermediary in the capital process between the individual and corporate saver and the ultimate producer of new goods and services.

A federal fiduciary responsibility provision should be established applying to welfare and pension plan administrators and trustees. Conventional state trust laws were not designed to protect the interests of welfare and pension plan participants. Some existing legal remedies are either inadequate or not well defined (Recommendation 6).

Additional disclosure is needed, but not in such detail that it becomes a burdensome and essentially non-productive effort. The Secretary of Labor should be given the authority to require on an individual basis such additional detailed information as needed to carry out the purposes of the Disclosure Act (Recommendation 7).

The present federal Disclosure Act does not require either an annual independent audit or the filing of an actuarial report. Additional requirements in these areas are needed (Recommendation 8).

Improvements should be made in current government investigatory powers and civil enforcement. The Secretary's power to investigate possible violations of the Act are unduly restricted. Broadened powers to investigate suspicion of wrongdoing would be appropriate. The Secretary also should be given the power to enjoin violations of the Act (Recommendation 9).

Public employee pension plans should have the same degree of accountability to employees as private plans. Affected taxpayers should also have access to reports on the operations and assets of such pension plans. Additionally, managers of such plans should be professionally competent to discharge their responsibilities and should be subject to the same laws and regulations as managers of private pension plans.

The so-called "Keogh Plans" (HR 10) available to self-employed persons and tax-deferred annuity plans available to public school and certain tax-exempt organizations' employees under Section 403(b) of the Internal Revenue Code have contributed to an extension of pension coverage. Nevertheless, a substantial proportion of the nation's working population does not qualify for a private, tax-deferred, pension plan program. Accordingly, the Commission recommends that eligibility of personal retirement plans under Section 403(b) be broadened to provide all individuals with the same tax deferment opportunities now provided for specific classes of employees. Moreover, the funding methods for such plans should be broadened to

include trusts, insurance plans, custodial accounts and special savings accounts. Finally, as a further stimulus to personal savings and an enlargement of private pension retirement benefits, consideration should be given to permitting employees to supplement their retirement benefits under a qualified pension plan with a limited amount of personal, tax-deductible contributions to such plans (Recommendation 10).

A number of recent proposals would affect private pension funds, and some might have a significant impact. These include mandatory vesting, regulation of investments, compulsory funding, and pension guaranty insurance. The Commission is not in a position to formulate detailed recommendations with respect to these proposals, but it does recommend that action on them be aimed at maintaining the viability, flexibility and the growth of these funds as a savings intermediary in the capital formation process.

PART III

PERSPECTIVES ON THE RECOMMENDATIONS

A. Consumers of Financial Services

A basic concern of the Commission on Financial Structure and Regulation has been the welfare of those who use financial services—the consumers, both those who save and those who borrow.

Regulation of interest rate ceilings on time deposits has not operated to the advantage of depositors. The smaller saver has received lower interest on his savings than the saver with a large amount of funds. During periods of disintermediation, the small borrower has found that funds were either unavailable or available only at high rates of interest. Large borrowers fared much better. To aid small savers and small borrowers, the Commission has recommended that these regulations should be used only in times of serious disintermediation, and that they should be phased out entirely in the foreseeable future.

Expanding the permissible functions of the thrift institutions will also improve their service to consumers. Clear gains result from the added convenience of institutions offering a wider range of products and services. In addition, added elements of competition will encourage better service, greater efficiency and possibly lower prices.

Consumers will be indirectly aided by the relaxation of other restrictions. In particular, the lifting of restrictions on mortgage lending on multi-unit income properties will improve the financing and therefore the availability of smaller apartment-type dwellings. Moreover, this will encourage builders to meet local needs through local financial institutions, which should result in the construction of more housing for low and middle income groups.

Consumers will be helped if the states, following Commission recommendations, relax branching and holding company laws to permit greater competition. In many states branching restrictions so limit entry into local markets by firms in the same class as well as other institutional classes that competition is stifled.

The recommendations concerning reserve requirements and taxation also encourage competition. These changes are necessary to ensure that businesses in particular product lines or geographic areas do not have advantages that, for the system as a whole, make competition impossible.

The recommendations improve the ability of credit unions to offer their unique services to employees and other groups brought together by a common bond.

Customers of financial institutions are directly concerned with deposit insurance. In some instances, inadequate aid has been available to failing institutions and the public has suffered. The "deposit payoff" rather than the "deposit assumption" method of settling claims has sometimes been used to the detriment of the affected community. Similarly, the "right of offset" has been exercised on occasion to the detriment of individual customers who have found, through no fault of their own, that their personal or business credit has disappeared through the failure of their bank. The Commission urges more attention to the public interest on all three counts.

Consumer safeguards beyond those currently available are built into the recommendations concerning variable rate mortgages. The implementation of the Commission's recommendations concerning the mortgage market should increase the flow of funds into residential mortgages and make the flow less sensitive to cyclical conditions. This should aid customers.

The recommendations concerning the abolition of interest rate ceilings on FHA and VA mortgages and state usury laws may be regarded by some as contrary to consumer interests. Such is not the case. The effect of ceilings, when operative, is to choke off mortgage funds, not to help the home buyer. If funds are lent during such periods, the home buyer pays a higher rate indirectly through a practice referred to as "paying points"—that is, a percentage of the amount borrowed. This payment adds to the cost of the home, and in general, is more costly than an increase in the contract interest payment.

The Commission recommends the elimination of unnecessarily complicated and costly procedures in mortgage origination and foreclosures and the abolition of artificial barriers segmenting the suppliers of mortgage credit in anticompetitive ways. Again, the borrowing public will benefit.

Clearly the public interest is served by effective examination of financial institutions, and the Commission's proposals for reorganization of the federal supervisory apparatus are designed to enhance this public service. The Commission, in its recommendations for trust departments and pension funds, specifically adds to supervisory and examining functions be-

cause of the large social costs of any lapses in these areas. Potential dangers of concentrated economic power and conflicts of interest exist. Thus additional information concerning the operation of trust and pension funds is desirable.

B. Society's Goals

In Part I, the Commission emphasized that its recommendations are intended to introduce more competition in the financial markets and to improve the ability of financial institutions to adapt to economic and technological change. But this is not the Commission's entire approach. The Commission recognizes that private and social net benefits may differ, and that some of society's avowed goals may remain unfulfilled.

The Commission is not the proper agent for assessing divergences between private and social benefits. It strongly believes, however, that public policies to achieve society's goals should be established where such divergences are found. Elected officials have the responsibility to debate and identify such goals, and to devise means of achieving them. When they seek instruments of public policy, officials naturally turn to existing means, particularly financial institutions.

Government regulation of financial institutions helps serve some public interests—most obviously the interest in having a sound and efficient financial system. But when the goal of public policy is to increase the availability of particular types of goods, regulation of financial institutions is likely to be unsuccessful. Attempts to force inappropriate functions upon financial institutions waste society's resources, cause them to be inefficient, and, most important, often leave goals unmet.

These effects of regulation of financial institutions have been amply demonstrated in the field of housing during the past six years. For that reason, the Commission recommends that, in the event a properly functioning intermediary system leaves housing goals unmet, subsidies should be provided directly to those citizens qualifying for assistance. In addition, a system of tax credits to investors in residential mortgages is urged. The Commission favors the continuation of the intermediary functions of the Federal Home Loan Bank Board and of the Federal National Mortgage Association and the Government National

Mortgage Association, and an expanded role for the Federal Home Loan Mortgage Corporation.

The overriding advantages of the direct subsidy and tax credit methods are that they are efficient and that they make the cost of achieving social goals visible, both in absolute and relative terms. The value of programs can be assessed easily and promptly. Direct subsidy and tax credit programs also avoid the "hidden tax" and inflationary effects of special regulations and special agency financing. Program financing parallels the allocation of real resources and permits better planning, management, and accounting.

The Commission has recommended other means of achieving social goals—for example, authority for financial institutions to participate in community development corporations supplying housing and employment opportunities for low income groups. However, the Commission does not regard mandatory investment requirements for financial institutions as a promising way to solve problems of social policy. To require specific types of institutions to invest percentages of their portfolios in particular types of investments is the equivalent of a special tax. The initial effect would be to move funds in the desired direction, but eventually as other institutions offered savers better terms than the "taxed" institutions could afford, there would be a loss of support for the favored programs.

For similar reasons, the Commission does not favor tax credits against reserve requirements based on holdings of specific assets for those institutions required to hold reserve balances. Again, funds would flow initially to the areas favored by the credits. Eventually, however, since reserve requirements are themselves tax-like in character, the effect would be unfairly to subsidize those institutions required to hold reserves.

The Commission's attitude is the same toward other indirect subsidies to financial institutions. Individuals are the intended beneficiaries of such subsidies; and they should receive these benefits in a direct, visible, and measurable way.

C. The Regulators

The most significant of the Commission's proposed reorganizations is the creation of an Administrator of State Banks. That new agency would consolidate the examining and supervisory functions of the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve System and cooperate with state regulatory agencies. A Federal Deposit Guarantee Administration would be established to perform all federal deposit insurance operations. This consolidation will promote efficiency and assure uniform treatment of depositors in various types of institutions. The Board of Governors, in addition to its monetary responsibilities, would retain regulatory authority over bank holding companies and international banking. Specialized regulators are retained for voluntarily specialized institutions—with an agency for the savings and loan associations, an agency for credit unions and two agencies for commercial banks and mutual savings banks, depending upon whether they hold state or federal charters.

The functions of the Federal National Mortgage Association and the Government National Mortgage Association are essentially unaffected by the Commission's recommendations. Similarly, agencies such as the Farm Credit Administration, the Farmers Home Administration, the Rural Electrification Administration, the Federal Housing Administration, the Export-Import Bank, and the Small Business Administration—all of which have loan or other financial assistance programs—are not directly affected.

The Commission's recommendations for reorganization are designed to allow the Federal Reserve Board to concentrate its resources on its vital function of determining monetary policy. The Board's effectiveness in performing this function is enhanced by requiring all deposit intermediaries that perform third party transfers (except credit unions) to become members of the Federal Reserve System.

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The recommendations will affect regulatory agencies in two other ways. First, the agencies are given considerably more discretionary power to supervise and regulate under flexible rules. This is particularly true of the recommendations concerning banking functions, but it extends as well into the regulation of bank-related functions. Thus, a responsibility is placed on the agencies to maintain high quality staffs under efficient administrators.

Second, the Commission believes that the existence of options will tend to raise supervisory standards of the state as well as the federal regulatory agencies. In effect, the state chartered institutions can take advantage of the options provided by the federal system only when state agencies are themselves well organized and operated.

D. The Regulated

The recommendations provide regulated financial institutions with many more choices than under the present system to adjust their portfolio mixes in the light of market opportunities. Some may choose to continue to specialize; others, to offer a broader array of financial services. But the choice, subject to far fewer regulatory restraints, would be theirs.

The depository institutions also would have greater freedom with respect to finance-related service offerings. The recommendations provide this freedom on a non-discriminatory basis. An institution, regardless of type or location, would be on par with its chosen competitors. Similarly, it is recommended that a number of geographic barriers be eliminated, extending the areas within which institutions may choose to compete.

The institutions would also have new options for organizational and management forms. The stock or mutual form would be open to savings and loan associations and savings banks under a state or federal charter. Differences in operating authorities based on whether or not a holding company form is used would be less pronounced. The principle of duality of banking systems at the state and federal levels is expanded in chartering and regulation.

Increased competition within and among the institutional types is a prime objective of the Commission. Not all those subjected to increased competition will regard it enthusiastically. Bank and bank-related product lines can, under the recommendations, be more easily crossed by several types of financial firms. Geographic areas are less protected. Reserve requirement differentials would disappear. Advantages stemming from regulatory disparities would no longer be possible. Tax treatment would become more nearly identical among competing institutions. Each of these changes would have at least temporarily adverse effects on institutions given special protection under the present system. All of the changes are necessary to make competition work.

SIGNATURES

SIGNATURES

Reed O. Hunt

Atherton Bean

Donald S. MacNaughton

Morris D. Crawford, Jr.

Edward H. Malone

Morgan G. Earnest

Rex J. Morthland

J. Howard Edgerton

William H. Morton

Richard G. Gilbert

Ellmore C. Patterson

William D. Grant

K. A. Randall

Alan Greenspan

Ralph S. Regula

Walter S. Holmes, Jr.

R. J. Saulnier

Lane Kirkland

Robert H. Stewart, III

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DISSENTING STATEMENTS
&
ADDITIONAL VIEWS

DISSENT OF LANE KIRKLAND

I am unable to associate myself with the majority report and recommendations of the President's Commission on Financial Structure and Regulation.

I am persuaded that the basic thrust of these recommendations is designed to promote the interests of private financial institutions without any genuine regard for the most urgent problems and needs of the nation. These problems and needs are vitally affected by the decisions of financial institutions and by the supply and price of funds available to meet them.

I did not conceive that the Commission's primary mandate was to promote the well-being of the financial institutions of this country. I had hoped that this Commission would direct its efforts toward the development of recommendations whose implementation would make our financial institutions more responsive to social needs.

This it did not do.

Treasury Under Secretary Charls Walker, in welcoming the Commission, noted that our financial system has not been working well and "there is great significance in the allocation of funds and quite frankly it has meant that certain areas of high social priority have not received as much financing as the Congress and the people would like to see them receive." He further pointed out: "There is the question of the distribution of those savings among competing uses within an environment where I suspect there is going to be a lot more emphasis on the quality of life and high social priorities as contrasted perhaps with the last 30 or 40 years."

Unfortunately, the Commission, while giving lip service to the broader public interest, washes its hands of the problem and disclaims any responsibility for seeing to it that a fair share of the financial resources are allocated for social priorities.

It recognizes, too, that free competition by itself does not allocate resources properly and that its role is to recom-

mend an institutional framework conducive to achieving whatever social goals the Congress may determine. Then it walks away from the problem. Its recommendation in the area of social need is that the problem be taken care of by Congress through direct subsidies and tax incentives for housing.

This represents an abdication of responsibility on the part of the Commission.

I am in favor of direct subsidies for low and moderate income housing, for water pollution, for medical facilities, urban redevelopment and for a whole host of other socially desirable projects. But let us not be under any illusions about subsidies. Subsidies for social purposes are desirable. They have accomplished much social good. But by themselves they do not fulfil our social needs; nor do they adequately compensate for the tendency of the private financial structure to assign a higher priority to corporate enterprise and other preferred customers at the expense of programs and projects which are essential to meet the requirements of life in this country for the average citizen.

I am opposed to the use of tax incentives and credits, as proposed in the Commission report, to stimulate housing. Tax incentives simply provide another tax loophole, enabling mortgage lenders to get a tax benefit whether or not housing is stimulated. It will increase the profit of the lender without regard to whether there is any increase in housing.

In addition to direct subsidies, I would urge the establishment of a National Development Bank and the mandatory allocation of credit to socially desirable projects.

I would envision the National Development Bank as an instrument of the U.S. government, capitalized by the U.S. Treasury with the authority to issue securities of its own. This bank would be authorized to make direct loans to state and local governments, public agencies, corporations, and individuals for social priority projects. It would also be vested with the authority to guarantee loans made by financial institutions for such projects.

One way of allocating the available credit is through imposition of an asset reserve requirement on the financial assets of all financial institutions. Such a requirement would channel a share of financial resources to social priority investments.

Under this concept, the government would place a 100 percent reserve requirement on a portion of each financial institution's assets unless this portion is invested in housing or other social priority projects. If a financial institution did not invest the required portion of its assets in social priority

projects, the shortfall would be left as a reserve with the government. Thus a financial institution would have the choice of either making interest paying loans in the social priority field or making an interest free loan to the government.

The asset reserve requirement would guarantee that a given percentage of financial resources would be funneled into housing and other priority investments. That percentage would be reviewed periodically and revised as needed. No financial institution would escape making priority loans or suffer a competitive disadvantage thereby. In times of tight money there would be an assurance of an adequate flow of funds into housing and other social priority projects.

Every financial institution would be required to be, in part at least, a social priority lender. However, a financial institution need not necessarily directly engage itself in this type of lending. It could fulfil its obligation by buying bonds of the National Development Bank or of private financial institutions that specialize in social priority loans.

Besides avoiding the social priority area, it would appear that the net effect of the Commission recommendations would be to channel funds out of the housing market as well as to raise the cost of mortgage money—especially during a tight credit market.

The Commission recommendations that would eliminate interest rate ceilings on deposits, widen the functions of thrift institutions and allow interest rates on mortgages to escalate would have a harmful effect on the housing market.

Under current regulations, savings and loan institutions are able to pay a higher interest rate on deposits than commercial banks. This gives them an advantage in attracting deposits for use in the mortgage market. The Commission's recommendation would do away with that advantage and standing by itself would operate to reduce the flow of funds into the mortgage market.

At the same time, the Commission does recommend that savings and loan associations and mutual saving banks be granted a wider range of loan and investment powers, and also be permitted to offer a wide variety of deposits, including checking accounts. These recommendations would make the saving and loan associations and mutual savings banks more nearly like the commercial banks. It would probably increase their profitability, but it would not generate any additional funds for the mortgage market. In fact, in periods of tight money, the mortgage market would be hard hit.

The Commission's recommendations for removal of ceilings on FHA and VA mortgages, for variable interest rates

on mortgages, and for interest rate risk insurance are completely unacceptable. Such measures would allow interest rates to escalate and shift the cost to the home buyer. At a time when interest rates are already too high, the need is not for measures that will permit interest rates to go even higher.

I would remind those who object to compelling financial institutions to allocate a portion of their financial resources for social priority purposes that these financial institutions have a privileged and protected position in the economy. In addition, some of these institutions hold billions of dollars of government deposits on which they pay no interest.

Nor can I agree with the Commission's recommendation upholding the independence of the Federal Reserve Board. I do not believe that the Board, whose actions have such profound effect on the economy and the national welfare, should be free to pursue policies at cross-purposes with those of the Congress and the President who were given responsibility by the electorate for the overall welfare of the country. At the very least, terms of the Board members should coincide with the term of the President and the quasi-private status of this system should be ended and the system made a fully public institution.

I would also favor a more searching examination of the activities of banks and other financial institutions in the administration of trust funds with a view toward a tighter regulation of these operations, particularly from the standpoint of conflicts of interests with other banking functions, and relations with other institutions such as brokerage houses. There should be a ban on interlocking relationships of directors, officers and employees of competing financial institutions, equity kickers, and brokered deposits. I would also recommend a federal reinsurance program for pension funds, to protect workers from losing their pension rights, and the regulation of investments so as to enhance the safety of trusts, as well as pension funds.

I cannot subscribe to the Commission's point of view that the Social Security system should not be "expanded so as to impede the ability of individuals to supplement this protection through various private mechanisms." Without question, the Social Security system has proved the most effective method of providing widespread protection for retired and disabled workers. The Commission's recommendation that "programs for tax-sheltered annuity plans be extended and broadened by revision in the law to permit each person to establish a personal retirement savings plan" is simply a vehicle for the benefit of the wealthy while, at the same time, providing a bonanza for banks, insurance companies and mutual funds. It

delivers nothing for today's elderly and nothing in the future for those of low or moderate income.

While the Commission made some recommendations for credit unions with which I would agree, it did impose some undesirable limitations. The recommendation for a central discount fund is good, but the limitation to liquidity purposes is unduly restrictive and limits the usefulness of the fund. The restrictions on third party transfers, including a limitation of 10 percent of share accounts, are so severe that they may in some cases hamstring current credit union activities.

Credit unions prospered because the commercial banks left the small borrower to the mercy of the loan shark and the personal finance company. By their uniqueness, they have filled a useful social need. I want them to retain their basic character. I do not want them to become commercial banks.

Financial institutions cannot be placed in the same category as other private businesses. They occupy a unique and powerful position in our society. They should not be judged like other businesses by whether they make a good profit or not. I cannot believe that a bank charter is solely a license to make money. I cannot believe that a financial institution should be encouraged to lend money for only the most profitable purposes. I believe that every financial institution must in part, at least, adapt its policies and practices to the attainment of broader public goals, in a society in which the need for large-scale public investment is becoming increasingly more pressing.

In the competition for capital and credit, the allocation of priorities as between corporate giants and such urgent needs as low-cost housing, medical and educational facilities, mass transit and state and local government needs, cannot safely or fairly be left to the sole discretion of the banking fraternity. Some more effective and public-spirited system for the allocation of at least a substantial part of the nation's financial resources is necessary.

DISSENT OF
WILLIAM H. MORTON AND EDWARD H. MALONE

We cannot join the recommendation for a tax credit to holders of residential mortgages, since we believe its implementation could seriously distort normal credit flows and relationships among various types of credit instruments. For example, there could be adverse effects on the municipal bond market, which also serves social goals and has also suffered during periods of monetary restraint. Moreover, the proposed credit would provide a substantial windfall to present holders of residential mortgages. Even so, after market readjustment of relative yields there might be only minimal stimulation to new residential mortgage lending. This illustrates why we prefer to adhere to the position that government assistance in meeting national objectives is best accomplished through direct subsidy to the user. We strongly believe that before such a tax credit proposal is approved there should be a thorough study of (1) its potential impact on all other credit markets, (2) the extent of possible tax windfalls and corresponding revenue losses to the Treasury and (3) the resulting probable degree of stimulation to new residential mortgage lending. In the absence of such a study we oppose this recommendation.

ADDITIONAL VIEWS OF MORGAN G. EARNEST

I commend the assiduous and thoughtful discussion and study by the members of the Commission over the past eighteen months, and express my appreciation for the able, intelligent and diligent assistance of the Commission staff. Long hours and attention were given to the discussion of the role of mortgage credit and savings flows in the United States financial system. The courtesy given by the Commission members to my views as a member of the housing industry is appreciated.

For more than a quarter of a century, it has been recognized that the greatest single critical deficiency in the financial structure of the nation has been in the mortgage market. Central to the Commission's study and subsequent recommendations there should have been more effective proposals to remedy the nation's principal financial deficiency. The Commission's recommendations in this area failed to come to grips with the overriding problem of providing a more stable flow of funds into the residential mortgage market. I still believe this was a key purpose in creating the Commission—a purpose voiced on many occasions during the Commission's planning and study.

The final recommendations do not adequately reflect this concern and purpose. The Commission recommendation to turn to the Federal Government to provide direct subsidies to consumers, in the event mortgage financing is not adequate to achieve national housing goals, highlights its failure to recommend means to even the flow of funds in a private enterprise society. Should the residential construction area have to depend on Congress for funds, that would mean the end of the free competitive system under which it now operates.

The Commission's recommendations would permit an overhauled and restructured financial mechanism without standby interest rate ceiling controls. I am convinced this would continue and possibly exacerbate an unstable flow of funds into the mortgage credit market. Therefore, I offer the following additional views:

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1. The Commission's recommendations did not come to grips with the need to integrate the mortgage market into the overall financing and thrift system in such manner as to relieve its particular vulnerability and victimization to tight money and disintermediation periods.

2. The general premise of expansion of mortgage institutions into other related and unrelated lending areas in order to be more profitable undoubtedly has validity. However, if this is carried too far, the mortgage market would become more of a residual claimant for funds than currently. Some expansion of mortgage institutions into "family" oriented activities certainly has merit. This would include third party transfers, loans directly associated with housing and the like, but authority to engage in such broad categories as consumer loans, credit cards, travel, etc. would mean less funds for home loans, a contraction of residential construction and a negation of national housing goals.

3. It is difficult to understand how the recommendation to permit savings and loan associations, mutual savings banks, and commercial banks to make direct investments in real estate, including participation in stock ownership—and the so-called equity investment concept—will benefit either the home buyer or the housing industry. There is a serious question as to whether or not this type of speculative investment does not do a disservice.

4. The Commission, while noting that private and public pension funds are adding billions of dollars to the nation's capital flows, and are an increasingly significant force in the economic and financial structure, did not develop any recommendations as to how portions of these funds could be employed to the benefit of such funds and the mortgage market. Hopes of expanding mortgage money flows are slim unless the mortgage markets get some funds from this growing sector of contractual and voluntary savings.

5. The residential mortgage market depends on many institutions to provide a flow of credit. One of these is the life insurance companies. In latter years, they have been in and out of the mortgage market during varying economic periods, making it exceedingly difficult for the mortgage market to count on an even flow of credit. The Commission in its recommendations on life insurance companies did not deal with this problem. The mortgage market will continue to be subject to cyclical variability unless methods are proposed which would enable life insurance companies to stay in the mortgage market on a reasonable basis.

APPENDIX

APPENDIX TABLE 1
TOTAL ASSETS OF VARIOUS FINANCIAL INSTITUTIONS
1945-70

(in millions of dollars)

Year	Commercial Banks[1]	percent change	Savings and Loan Associations	percent change	Mutual Savings Banks	percent change	Credit Unions	percent change	Life Insurance Companies	percent change	Private Non-insured Pension Funds[2]	percent change
1945	$157,582		$ 8,747		$ 16,962		$ 435		$ 44,797		$ 2,700	
1946	147,365	-6.5	10,202	16.6	18,662	10.0	495	13.9	38,191	7.6	3,000	11.1
1947	152,773	3.7	11,687	14.6	19,724	5.7	591	19.4	51,743	7.4	3,300	10.0
		0.0		11.5		3.8		18.7		7.3		12.1
1948	152,163		13,028		20,482		701		55,512		3,700	
1949	155,319	2.1	14,622	12.2	21,503	5.0	827	17.9	59,630	7.4	4,300	16.2
1950	166,792	7.4	16,893	15.5	22,446	4.4	1,005	21.5	64,020	7.4	5,200	20.9
		6.4		13.8		4.7		19.2		6.7		23.4
1951	177,449		19,222		23,504		1,198		68,278		*7,960	
1952	186,682	5.2	22,660	17.9	25,301	7.6	1,516	26.5	73,375	7.5	9,620	20.9
1953	191,063	2.3	26,773	18.0	27,199	7.5	1,895	25.0	78,533	7.0	11,630	20.9
		5.0		18.3		7.9		19.8		7.6		18.6
1954	200,588		31,633		29,350		2,270		84,486		13,790	
1955	209,145	4.3	37,656	19.0	31,346	6.8	2,743	20.8	90,432	7.0	16,140	17.0
1956	216,145	3.3	42,875	13.9	33,381	6.5	3,271	19.2	96,011	6.2	18,930	17.3
		2.5		12.3		5.5		16.6		5.5		16.4
1957	221,534		48,138		35,215		3,813		101,309		22,030	
1958	237,473	7.2	55,139	14.5	37,784	7.3	4,346	14.0	107,580	6.2	25,280	14.8
1959	243,423	2.5	63,530	15.2	38,945	3.1	5,024	15.6	113,650	5.6	29,850	18.1
		5.3		12.5		4.2		12.5		5.2		11.0

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APPENDIX TABLE 1 (CONT'D)

1960	256,323		71,476		40,571		5,653		119,576		33,140	
1961	277,374	8.2	82135	14.9	42,829	5.6	6,383	12.9	126,816	6.1	37,510	13.2
1962	295,983	6.7	93,605	14.0	46,121	7.7	7,186	12.6	133,291	5.1	41,890	11.7
		5.3		14.9		7.8		13.2		5.9		11.1
1963	311,791		107,559		49,702		8,131		141,121		46,550	
1964	345,130	10.7	119,355	11.0	54,238	9.1	9,361	15.1	149,470	5.9	52,420	12.6
1965	375,394	8.8	129,580	8.6	58,232	7.4	10,552	12.7	158,884	6.3	59,180	12.9
		7.3		3.4		4.7		10.0		5.1		11.8
1966	402,946		133,933		60,932		11,606		167,022		66,170	
1967	450,713	11.9	143,534	7.2	66,365	8.8	12,775	10.1	177,832	6.5	74,240	12.2
1968	500,238	9.9	152,890	6.5	71,152	7.2	14,210	11.2	188,636	6.1	83,070	11.9
		5.0		6.2		4.2		11.7		4.5		9.4
1969	*530,715		*162,299		74,144		15,868		197,208		90,580	
1970	572,682	7.9	176,574	8.8	78,995	6.5	17,950	13.1	206,193	4.6	95,850	5.8
		--		--		--		--		--		--

1 Insured commercial banks only.

2 Figures are book value.

Note: Data for all years are as of yearend. For earlier years, they may not be strictly comparable with later figures. Changes in the definition of a series are indicated by asterisks. Annual percentage changes are based on revised figures, when available.

Source: Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, National Association of Mutual Savings Banks, CUNA International, Inc., Institute of Life Insurance, and Securities and Exchange Commission.

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APPENDIX TABLE 2
TOTAL DEPOSITS OF VARIOUS DEPOSITORY FINANCIAL INSTITUTIONS
1945-70

(in millions of dollars)

Year	Commercial Banks[1]						Savings and Loan Associations[2]		Mutual Savings Banks[2]		Credit Unions[2]	
	Demand Deposits	percent change	Time and Savings Deposits	percent change	Total Deposits	percent change		percent change		percent change		percent change
1945	$117,847		$ 29,964		$147,811		7,365		15,334		369	
1946	103,416	-12.2	33,613	12.2	137,029	-7.3	8,548	16.1	16,813	9.7	429	16.3
1947	106,935	3.4	34,954	4.0	135,981	-0.7	9,753	14.1	17,759	5.6	510	18.9
1948	105,155	-1.7	35,528	1.6	140,683	3.5	10,964	12.4	18,400	3.6	605	18.6
1949	107,146	1.9	36,049	1.5	143,194	1.8	12,471	13.7	19,287	4.8	703	16.2
1950	117,007	9.2	36,491	1.2	153,498	7.2	13,992	12.2	20,025	3.8	850	20.9
1951	124,880	6.7	38,292	4.9	163,172	6.3	16,107	15.1	20,900	4.4	1,040	22.4
1952	129,992	4.1	41,365	8.0	171,357	5.0	19,195	19.2	22,610	8.2	1,356	30.4
1953	130,289	0.3	44,794	8.3	175,083	2.2	22,846	19.0	24,388	7.9	1,688	24.4
1954	134,783	3.4	48,256	8.3	183,309	4.7	27,252	19.3	26,351	8.0	2,039	20.8
1955	141,037	4.6	49,951	2.9	190,989	4.2	32,142	17.9	38,182	6.9	2,447	20.0
1956	144,385	2.4	52,122	4.3	196,507	2.9	37,148	15.6	30,026	6.5	2,914	19.1
1957	142,827	-1.1	57,658	10.6	200,485	2.0	41,912	12.8	31,684	5.5	3,382	16.1
1958	149,488	4.7	65,681	13.9	215,169	7.3	47,926	14.3	34,031	7.4	3,870	14.4
1959	151,538	1.4	67,473	2.7	219,012	1.8	54,583	13.9	34,977	2.8	4,436	14.6
		2.8		8.6		4.6		13.8		3.9		12.2

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APPENDIX TABLE 2 (CONT'D)

1960	155,709		73,284		228,993		62,142		36,343		4,975	
1961	165,093	6.0	82,812	13.0	247,905	8.3	70,885	14.1	38,277	5.3	5,636	13.3
1962	163,217	1.1	98,227	18.6	261,444	5.5	80,236	13.2	41,336	8.0	6,331	12.3
1963	162,952	-0.2	111,694	13.7	274,647	5.0	91,308	13.8	44,605	7.9	7.166	13.2
1964	178,691	9.7	127,539	14.2	306,230	11.5	101,887	11.6	48,849	9.5	8,242	15.0
1965	183,837	2.9	147,676	15.8	331,513	8.3	110,385	8.3	52,443	7.4	9,249	12.2
1966	191,737	4.3	161,103	9.1	352,840	6.4	113,969	3.2	55,006	4.9	10,106	9.3
1967	210,457	9.8	185,339	15.0	395,796	12.2	124,531	9.3	60,121	9.3	11,324	12.1
1968	228,725	8.7	205,926	11.1	434,652	9.8	131,618	5.7	64,507	7.3	12,324	9.0
1969	240,131	5.0	196,859	4.4	436,990	0.5	135,670	3.1	67,086	4.0	13,673	10.9
1970	246,168	2.5	233,006	18.4	479,174	9.7	146,744	8.2	71,580	6.7	15,480	13.2
		--		--		--		--		--		--

1 Insured commercial banks only.

2 Deposit figures for savings and loan associations, mutual savings banks, and credit unions are "Savings capital," "Deposits (including checking accounts)," and "Shares and deposits," respectively.

Note: Data are as of yearend. For earlier years, they may not be strictly comparable with later data.

Source: Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, National Association of Mutual Savings Banks, and CUNA International, Inc.

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APPENDIX TABLE 3 PART A
SELECTED LOANS OF VARIOUS DEPOSITORY FINANCIAL INSTITUTIONS
1945-70

(in millions of dollars)

Year	Commercial Banks[1]								Savings and Loan Associations[2]		Mutual Savings Banks[3]		Credit Unions[2]	
	Commercial and Industrial Loans		Loans to Individuals		Real Estate Loans		Total Loans							
		percent change		percent change		percent change		percent change		percent change		percent change		percent change
1945	$ 9,462		$ 2,361		$ 4,679		$ 25,769		$ 5,376		$ 4,202		$ 128	
1946	14,019	48.2	4,031	70.7	7,106	51.9	30,470	19.3	7,141	32.8	4,451	5.9	190	48.6
1947	18,015	28.5	5,655	40.3	9,271	30.5	37,592	22.2	8,856	24.0	4,856	9.1	284	49.2
1948	18,765	4.2	6,806	20.4	10,671	15.1	42,388	12.8	10,305	16.4	5,583	15.0	399	40.5
1949	16,939	-9.7	8,007	17.6	11,413	7.0	43,047	1.6	11,616	12.7	6,479	16.0	516	29.5
1950	21,808	28.7	10,061	25.7	13,416	17.6	52,481	21.9	13,657	17.6	9,039	24.1	680	31.8
1951	25,788	18.3	10,399	3.4	14,487	8.0	58,184	10.9	15,564	14.0	9,747	21.2	747	9.9
1952	27,815	7.9	12,642	21.6	15,616	7.8	64,728	11.2	18,396	18.2	11,231	15.2	985	31.9
1953	27,158	-2.4	14,412	14.0	16,613	6.4	68,227	5.4	21,962	19.4	12,792	13.9	1,308	32.7
1954	26,823	-1.2	14,720	2.1	18,347	10.4	71,412	4.7	26,108	18.9	14,845	16.0	1,552	18.7
1955	33,210	23.8	17,160	16.6	20,767	13.2	83,628	17.1	31,408	20.3	17,279	16.4	1,934	24.6
1956	38,707	16.6	18,829	9.7	22,484	8.3	91,705	9.7	35,729	13.8	19,559	13.2	2,326	20.3
1957	40,546	4.8	20,200	7.3	23,104	2.8	95,577	4.2	40,007	12.0	20,971	7.2	2,778	19.4
1958	40,457	-0.2	20,680	2.4	25,267	9.4	100,087	4.7	45,627	14.0	23,038	9.9	3,078	10.8
1959	40,195	-0.6	24,134	16.7	28,031	10.9	112,867	12.8	53,141	16.4	24,769	7.5	3,708	20.4
		7.3		9.3		2.4		6.2		13.0		7.8		18.1

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APPENDIX TABLE 3 PART A (CONT'D)

1960	43,132	4.7	26,377	5.5	28,694	5.7	119,878	6.3	60,070	14.6	26,702	8.2	4,377	10.1
1961	45,157	7.8	27,820	9.7	30,330	13.1	127,414	12.0	68,834	14.4	28,902	10.9	4,818	13.7
1962	48,668	8.9	30,524	13.1	34,309	13.9	142,718	11.4	78,770	15.5	32,056	12.3	5,477	13.7
1963	52,984	13.3	34,532	15.3	39,088	11.9	158,928	9.9	90,944	11.4	36,007	12.0	6,171	14.2
1964	60,040	18.6	39,815	14.3	43,733	12.9	174,649	16.3	101,333	8.9	40,328	10.2	7,046	14.9
1965	71,235	12.9	45,497	5.5	49,394	9.5	203,061	8.5	110,306	3.7	44,433	6.2	8,095	12.3
1966	80,408	9.8	47,992	7.6	54,100	8.5	220,332	7.8	114,427	6.4	47,193	6.6	9,093	8.6
1967	88,258	11.2	51,628	13.1	58,678	11.3	237,518	11.4	121,805	7.4	50,311	5.9	9,877	14.2
1968	98,161	10.4	58,415	8.5	65,333	7.6	264,671	8.3	130,802	7.3	53,286	4.8	11,284	14.7
1969	108,394	3.0	63,356	3.4	70,326	2.8	286,752	3.2	140,347	7.3	55,882	3.5	12,942	9.1
1970	111,594	--	65,556	--	72,302	--	296,064	--	150,562	--	57,775	--	14,123	--

1 Insured commercial banks only.

2 "Loans" here for savings and loan associations and mutual savings banks are "Mortgage Loans;" for credit unions, they are "Total loans outstanding."

3 Mortgage loans are net of valuation reserves.

Note: Data are as of yearend. For earlier years, they may not be strictly comparable with later data.

Source: Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, National Association of Mutual Savings Banks, and CUNA International, Inc.

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APPENDIX TABLE 3 PART B

(as a percentage of total assets)

Year	Commercial Banks				Savings and Loan Associations	Mutual Savings Banks	Credit Unions
	Commercial and Industrial Loans	Loans to Individuals	Real Estate Loans	Total Loans			
1945	6.0	1.5	3.0	16.4	61.5	24.8	29.4
1946	9.5	2.7	4.8	20.9	70.0	23.9	38.4
1947	9.5	3.7	6.1	24.6	75.8	24.6	48.0
1948	12.3	4.4	7.0	27.9	79.1	27.3	56.8
1949	10.9	5.2	7.3	27.7	79.4	30.1	62.4
1950	13.1	6.0	8.0	31.4	80.8	35.8	67.7
1951	14.5	5.9	8.2	32.8	81.0	41.5	62.4
1952	14.9	6.8	8.4	34.7	81.2	44.4	65.0
1953	14.2	7.5	8.7	35.7	82.2	47.0	69.0
1954	13.4	7.3	9.1	35.6	82.5	50.6	68.4
1955	15.9	8.2	9.9	40.0	83.4	55.1	70.5
1956	17.9	8.7	10.4	42.4	83.3	58.6	71.1
1957	18.3	9.1	10.4	43.1	83.1	59.6	72.9
1958	17.0	8.7	10.6	42.1	82.7	61.0	70.8
1959	16.5	9.9	11.5	46.4	83.6	63.6	73.8
1960	16.8	10.3	11.2	46.8	84.0	65.8	77.4
1961	16.2	10.0	10.9	45.9	83.8	67.5	75.5
1962	16.4	10.3	11.6	48.2	84.2	69.5	76.2
1963	17.0	11.1	12.5	51.0	84.6	72.4	75.9
1964	17.7	11.5	12.7	50.6	84.9	74.4	75.3
1965	19.0	12.1	13.2	54.1	85.1	76.3	76.7
1966	20.0	11.9	13.4	54.7	85.4	77.4	78.3
1967	19.6	11.5	13.0	52.7	84.9	75.8	77.3
1968	19.6	11.7	13.1	52.4	85.6	74.9	79.4
1969	20.4	11.7	13.3	54.0	86.5	75.3	81.6
1970	19.5	11.4	12.6	51.7	85.3	73.1	78.7

APPENDIX TABLE 3 PART B Continued

(as a percentage of total deposits)

Year	Commercial Banks				Savings and Loan Associations	Mutual Savings Banks	Credit Unions
	Commercial and Industrial Loans	Loans to Individuals	Real Estate Loans	Total Loans			
1945	6.4	1.6	3.2	17.4	73.0	27.4	34.7
1946	10.2	2.9	5.2	22.4	83.5	26.5	44.3
1947	13.2	4.2	6.8	27.6	90.8	27.3	55.7
1948	13.3	4.8	7.6	30.1	94.0	30.3	65.8
1949	11.8	5.6	8.0	30.1	93.1	33.6	73.4
1950	14.2	6.6	8.7	34.2	97.6	40.1	80.0
1951	15.8	6.4	8.9	35.7	96.6	46.6	71.8
1952	16.2	7.4	9.1	37.8	95.8	49.7	72.6
1953	15.5	8.2	9.5	39.0	96.1	52.5	77.5
1954	14.6	8.0	10.0	39.0	95.8	56.3	67.1
1955	17.4	9.0	10.9	43.8	97.7	61.3	79.0
1956	19.7	9.6	11.4	46.7	96.2	65.1	79.8
1957	20.2	10.1	11.5	47.7	95.5	66.2	82.2
1958	18.8	9.6	11.7	46.5	95.2	67.7	79.5
1959	18.4	11.0	12.8	51.5	97.4	70.8	83.6
1960	18.8	11.5	12.5	52.4	96.7	73.5	87.0
1961	18.2	11.2	12.2	51.4	97.1	75.6	85.5
1962	18.5	11.7	13.1	54.6	98.2	77.5	86.5
1963	19.3	12.6	14.2	57.9	99.6	80.7	86.1
1964	19.6	13.0	14.3	47.0	99.5	82.6	85.5
1965	21.5	13.7	14.9	61.3	99.9	84.7	87.5
1966	22.8	13.6	15.3	62.4	100.4	85.8	90.0
1967	22.3	13.0	14.8	60.0	97.8	83.7	87.2
1968	22.6	13.4	15.0	60.9	99.4	82.6	91.6
1969	24.8	14.5	16.1	65.6	103.4	83.2	94.7
1970	23.3	13.7	15.1	61.8	102.6	80.7	91.2

Source: Based on data furnished by Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, National Association of Mutual Savings Banks, and CUNA International, Inc.

APPENDIX TABLE 4
AVERAGE ANNUAL RATES OF INTEREST PAID ON SAVINGS ACCOUNTS BY COMMERCIAL BANKS, SAVINGS AND LOAN ASSOCIATIONS, AND MUTUAL SAVINGS BANKS, 1945-70

(in percent)

Year	Commercial Banks[1]	Savings and Loan Associations[2]	Mutual Savings Banks
1945	0.87	2.46	1.7
1946	0.84	2.36	1.7
1947	0.87	2.38	1.62
1945	0.90	2.43	1.66
1949	0.91	2.51	1.82
1950	0.94	2.52	1.90
1951	1.03	2.58	1.96
1952	1.15	2.69	2.31
1953	1.24	2.81	2.40
1954	1.32	2.87	2.50
1955	1.38	2.94	2.64
1956	1.58	3.03	2.77
1957	2.08	3.26	2.94
1958	2.21	3.38	3.07
1959	2.36	3.53	3.19
1960	2.56	3.86	3.47
1961	2.71	3.90	3.55
1962	3.18	4.08	3.85
1963	3.31	4.17	3.96
1964	3.42	4.18	4.06
1965	3.69	*4.25	4.11
1966	4.04	4.48	4.45
1967	4.24	4.68	4.74
1968	4.48	4.71	4.76
1969	4.87	4.81	4.89
1970	4.95	5.14	5.01

1 Insured commercial banks only.

2 Member associations of the Federal Home Loan Bank System only.

* Data for years prior to 1965, data may not be strictly comparable with those of later years.

Source: Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, and National Association of Mutual Savings Banks.

APPENDIX TABLE 5
TOTAL CAPITAL ACCOUNTS OF VARIOUS DEPOSITORY FINANCIAL INSTITUTIONS
1945-70

(in millions of dollars)

Year	Commercial Banks[1]		Savings and Loan Associations[2]		Mutual Savings Banks[2]		Credit Unions[2]	
		percent change		percent change		percent change		percent change
1945	$ 8,672		$ 1,582		$ 644		$ 24	
1946	9,288	7.1	1,788	13.0	751	16.6	27	12.6
1947	9,736	4.8	1,894	5.9	855	13.8	31	13.8
1948	10,160	4.4	2,002	5.7	969	13.3	35	12.8
1949	10,649	4.8	2,121	5.9	1,106	14.1	43	22.4
1950	11,281	5.9	2,283	7.6	1,280	15.7	52	20.4
1951	11,923	5.7	2,450	7.3	1,453	13.5	59	14.1
1952	12,585	5.6	2,527	3.1	1,658	14.1	67	12.0
1953	13,264	5.4	2,608	3.2	1,901	14.7	75	12.7
1954	14,279	7.7	2,738	5.0	2,187	15.0	91	21.3
1955	15,009	5.1	2,557	4.2	2,854	16.9		20.7
1956	16,020	6.8	2,950	4.6	2,986	15.4	137	24.2
1957	17,086	6.7	3,105	4.0	3,363	14.0	165	21.0
1958	18,191	6.5	3,227	3.9	3,845	14.3	198	19.6
1959	19,232	5.7	3,362	4.2	4,391	14.3	232	17.4
1960	20,658	7.4	4,983	5.6	3,550	13.4	272	10.8
1961	22,123	7.1	5,708	14.5	3,771	6.2	326	19.6
1962	23,752	7.4	6,520	14.2	3,957	4.9	381	17.1
1963	25,322	6.6	7,209	10.6	4,153	5.0	441	15.8
1964	27,438	8.4	7,899	9.6	4,400	5.9	510	15.6
1965	29,305	9.0	8,704	10.2	4,665	6.0	590	15.5
1966	31,693	6.0	9,096	4.5	4,863	4.2	678	15.0
1967	34,006	7.3	9,546	4.9	4,984	2.5	779	14.9
1968	36,628	7.7	10,315	8.1	5,273	5.8	861	10.6
1969	39,576	8.0	11,239	9.0	5,535	5.0	1,001	16.2
1970	42,427	7.2	12,020	6.9	5,726	3.5	1,120	11.9
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1 Insured commercial banks only.

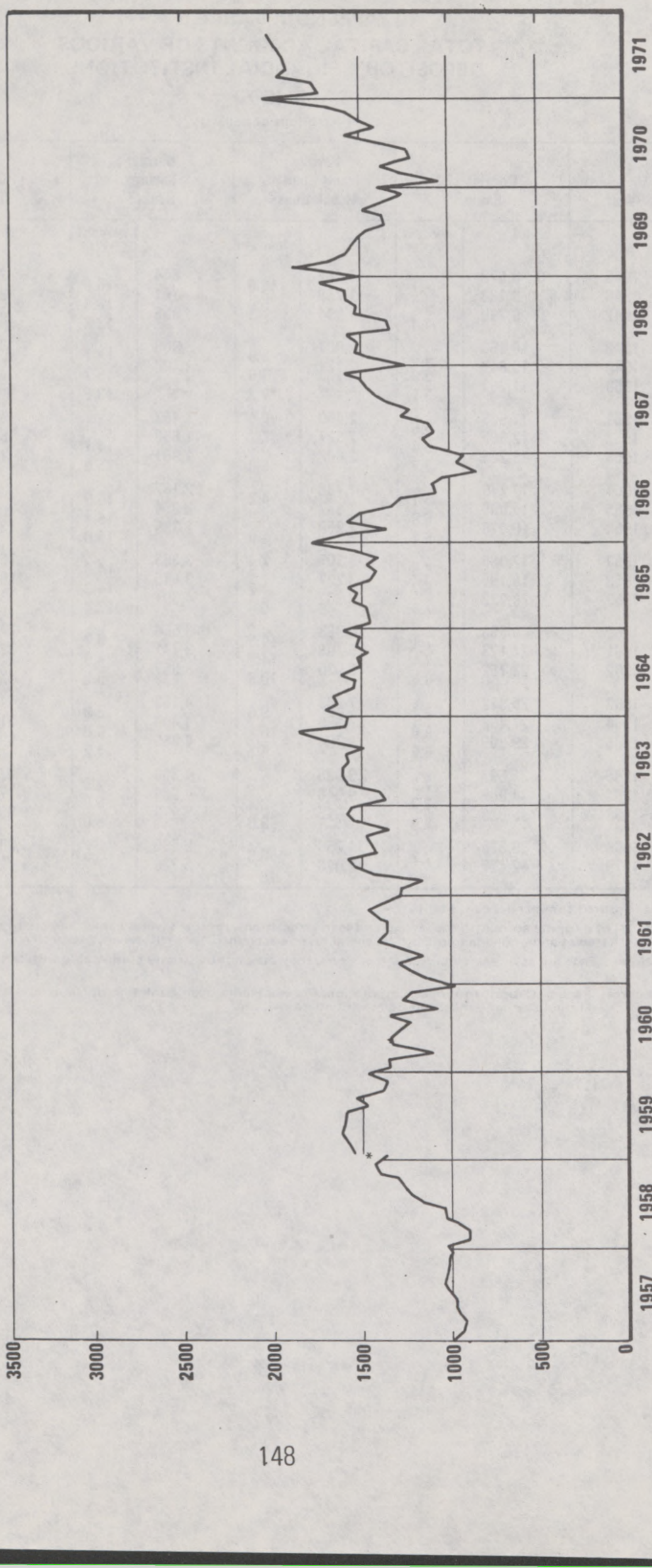
2 "Total capital accounts" for savings and loan associations, mutual savings banks, and credit unions are "Reserves and undivided profits," "General reserve accounts," and "Reserves," respectively.

Note: Data are as of yearend. For earlier years, they may not be strictly comparable with later data.

Source: Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, National Association of Mutual Savings Banks, and CUNA International, Inc.

APPENDIX CHART 1
NEW PRIVATE HOUSING STARTS
1957-71

ANNUAL RATES IN THOUSANDS



* Change in series

Source: Bureau of Census data

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August 3, 1973

Recommendations for Change in the U.S. Financial System

Department of the Treasury

Washington, D.C.
20220

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OFFICE OF THE WHITE HOUSE PRESS SECRETARY

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To the Congress of the United States:

Our country depends on a strong, efficient and flexible financial system to promote sound economic growth, including the provision of adequate funds for housing. Such a system is one which allows financial institutions to adapt to the changing needs of borrowers and lenders, large and small, and is free to make full use of technological innovations.

Events during the last decade, however, have revealed significant defects in the operations of our financial institutions. On two recent occasions when the Federal Reserve System moved to restrain the economy, it was found that the inadequacies of our financial structures created unnecessarily severe burdens for the business community and the consuming public. The consumer-saver was denied a fair market return on his savings, while the consumer and small businessman, as borrowers, often could not obtain adequate funds to meet their requirements.

The inflexibility of our financial system can be directly attributed to the methods used by the Government to direct credit flows—methods designed to meet the depressed economic conditions of the 1930's but poorly suited to cope with the expansionary conditions of the past decade. In recent years, government regulations have limited the efficiency and flexibility of our financial system. Ironically, those regulations that were designed in part to keep a steady flow of funds moving into housing loans actually served to diminish that flow, severely penalizing both the borrower, who could not find funds, and the saver who received an unfairly low return on his savings.

As the Government tries to play its proper role in building a better financial system, we must proceed with one basic assumption: the public interest is generally better served by the free play of competitive forces than by the imposition of rigid and unnecessary regulation.

By law, thrift institutions—a category primarily composed of savings and loan associations but also including mutual savings banks—were created to provide funds for housing by maintaining large holdings of residential mortgages. However, earnings on holdings of previously acquired mortgages do not respond to changes in market interest rates. When market rates rise, the ability of thrift institutions to attract funds is limited and their ability to lend additional mortgage money is diminished.

Attempts to alleviate this problem by restrictive laws and regulations have achieved very little at great cost. The main technique has been to impose ceilings on the interest rates that financial institutions could pay savers for funds. The result, however, has often been a reduction in the flow of deposits to financial institutions. In many cases, in fact, deposits have been withdrawn so that they could be invested in higher yielding securities. Thus interest ceilings that were intended as a protective shield for the housing market turned out instead to be an additional burden.

Interest rate ceilings proved harmful to Americans both as savers and as borrowers in the late 1960's. Because the interest rate ceilings for deposits were often below market interest rates, small savers, who depended on banks and other savings institutions, were denied a fair rate of return on their money. On the borrowing side, smaller increases in savings deposits resulted in a sharp drop in loan funds available to consumers and small business firms.

Since financial institutions were prohibited from paying better interest rates, they were forced to compete for customers in other ways. Much of the public had to settle for so-called "free services" or even offers of consumer goods when in fact they may have preferred to receive higher interest on their deposits. In addition, such competition often led to increases in operating costs which prevented

lending rates from declining when credit conditions later eased.

Finally, because of reduced inflows of savings, thrift institutions cut back on their mortgage lending or borrowed from Federal Home Loan Banks which had to pay market rates for their funds. Although the Federal Government stepped in and picked up some of the slack, mortgage flows were still disrupted.

Recognizing the need for action on all these problems, I appointed a Presidential Commission on Financial Structure and Regulation during my second year as President to study this entire matter and to make recommendations for reforming our financial institutions. The Commission's report identified quite precisely the causes of rigidity and instability in our financial institutions. Its recommendations were of major assistance in our further deliberations concerning the best ways to correct the weaknesses in our financial system.

The time to correct those weaknesses has come. Our current efforts to fight inflation and preserve the value of the dollar at home and abroad require strong financial markets. Without strong markets, the American public will be forced once again to bear excessive burdens.

If we do not act promptly, there is every reason to believe that those burdens will be even greater in the 1970's than they were in the 1960's. Educated by the last two credit crunches and by constant advertisements about interest rates, even the small saver will shift his funds to places offering higher yields. As market rates rise above passbook ceilings and the saver shifts his funds to obtain the higher interest rates, the result may be that little loán money is available from financial institutions.

In keeping with that analysis, I will propose to the Congress legislation designed to strengthen and revitalize our financial institutions. These proposals may be divided into seven major areas:

(1) Interest ceilings on time and savings savings deposits should be removed over a 5½ year period.

(2) Expanded deposit services for consumers by federally chartered thrift institutions and banks should be allowed.

(3) Investment and lending alternatives for federally chartered thrift institutions and banks should be expanded.

(4) Federal charters for stock savings and loan institutions and mutual savings banks should be permitted.

(5) Credit unions should be provided with greater access to funds.

(6) FHA and VA interest ceilings should be removed.

(7) The tax structure of banks and thrift institutions should be modified.

These recommendations would achieve the basic reforms our financial system requires. They represent the best suggestions from many different sources—from the Presidential Commission and from business, Government, consumer and academic communities.

The first five of these recommendations are designed to provide increased competition among banks and thrift institutions. Such competition would help to eliminate the inequities now imposed upon the small saver and borrower. My recommendations, and the increased competition that would follow, should reduce the cost of the entire package of financial services for the consumer. Furthermore, the saver would be assured a fair return on his money. In addition, thrift institutions would be strengthened, so they would no longer need the Government support required in the past.

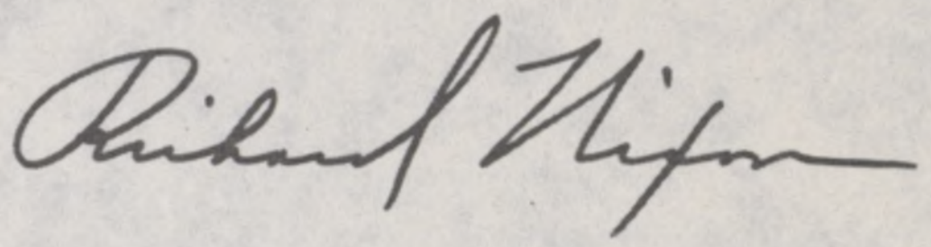
Recommendations 6 and 7, along with the other recommendations, are designed to promote adequate funds for consumer needs, including housing finance. It is clear that interest ceilings on FHA and VA mortgage loans have failed to keep costs down, as evidenced in part by the widespread use of discount "points." At the same time, these ceilings have restricted the flow of private funds into mortgage markets. I will urge that individual states follow our lead and remove similar barriers to housing finance wherever such barriers exist.

The final recommendation would substantially broaden the base of housing finance. Although the final details have yet to be worked out, active consideration is being given to the creation of an income tax credit tied to investments in housing mortgages. Such a credit would be available to all lenders and could vary in direct proportion to the percentage of invested funds held in the form of such mortgages.

These recommendations are not the only steps being taken to strengthen the housing finance market. In my State of the Union Message on Com-

munity Development of March 8, 1973, I pledged that this Administration would undertake a comprehensive evaluation of our housing policies and programs and would recommend new policies to eliminate waste and better serve the needy. An interagency task force, under the leadership of Secretary Lynn, is now completing that task, and my recommendations will be presented to the Congress in the near future.

My recommendations on restructuring financial institutions represent a coordinated approach to this challenge, and I urge that they be considered as a package. For example, removing interest ceilings will not make a positive contribution unless banks and thrift institutions can expand their deposit and lending services. Flexibility and efficiency will be enhanced by placing competing institutions on a roughly equal footing with regard to three essential considerations: deposit powers, lending powers, and tax burdens. Finally, the tax recommendation and the removal of FHA and VA interest ceilings will help ensure more adequate funds for housing. The need for reform of our financial institutions is pressing. I urge the Congress to give these proposals its prompt and favorable consideration.



The WHITE HOUSE, *August 2, 1973.*

SUMMARY OF THE PRESIDENT'S RECOMMENDATIONS

Events during the latter part of the 1960's showed that U.S. financial markets are ill-equipped to deal with periods of credit restraint. As interest rates rose because of inflation, thrift institutions faced a severe profit squeeze which threatened to cut off funds for housing.

Attempts to alleviate the crisis by regulation, mainly the imposition of ceilings on the amounts financial institutions could pay for funds, failed to keep funds flowing into the institutions at previous levels.

Interest ceilings adversely affected the public directly and indirectly. In their role as savers, for whom the thrift institution was a major place at which to save, consumers were denied a market rate of return on their money. Moreover, thrifts reduced in a disproportionate manner the availability of funds to consumers and small business firms.

Less direct, but equally costly to the public, interest ceilings contributed to severe setbacks in efforts to meet our housing objectives, and helped make the Federal Reserve's attempt to combat inflation with monetary policy needlessly costly and complicated.

The time to correct those defects in our financial structure is now. Current efforts to fight inflation and preserve the value of the dollar at home and abroad require strong financial institutions. Without them, there is every reason to believe that the burdens of credit restraint will be even greater than before.

Financial institutions are to be strengthened by phasing out Regulation Q over a 5½ year period; permitting all federally chartered banks and thrift institutions to offer a full range of checking and savings accounts, and permitting federally chartered thrifts to offer consumer and real estate related loans in competition with banks. Housing finance will be strengthened by the elimination of Federal Housing Administration and Veterans Administration interest ceilings and by a tax credit to all taxpayers investing in residential mortgages.

The dual banking system will be preserved and strengthened. Federal Reserve requirements on "checking" accounts will apply only to members of the Federal Reserve and Federal Home Loan Bank systems. Federal charters will be available for stock thrift institutions and for savings banks.

Credit unions are to be strengthened by broadened asset and liability powers and by access to a new source of liquidity administered by the National Credit Union Administration.

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BEFORE AND AFTER STATUS OF FINANCIAL INSTITUTIONS

COMMERCIAL BANKS

BEFORE	AFTER
Deposit Powers	
payments of interest: severe restrictions on all types of deposits.	5½ year phase-out of restrictions, then interest freely determined. However, no interest on demand deposits.
savings accounts: individuals only.	savings accounts: full powers; individual and corporate.
demand accounts: full powers; individual and corporate.	demand accounts: full powers; individual and corporate (no change).
Negotiable Order of Withdrawal (N.O.W.) accounts: not permitted.	N.O.W. accounts: full powers; individual and corporate.
Lending and Investment Powers	
real estate loans: severe restrictions *re* collateral, loan size, maturity and method of repayment.	real estate loans: modest restrictions *re* collateral, loan size, maturity and method of payment; *plus* community rehabilitation loans under a 3 percent leeway authority.
equities: holdings severely restricted.	equities: holdings severely restricted (no change).
Taxes	
tax credits: none.	tax credits: special tax credits for investing in residential mortgages.
Chartering alternatives	
federal: yes state: yes	federal: yes state: yes } no change
Branching	
national banks: } state law governs location state banks: } of branches.	national banks: } state law governs location of state banks: } branches (no change).
Summary	
Consumer interests penalized. Opportunities to compete for funds limited and prohibitions restrict direct participation in housing and real estate finance. Absence of mortgage investment incentives given S&L's.	Consumer interests given high priority. Virtually unlimited opportunities to compete for funds; restriction against housing and real estate finance modified, and positive incentives for such investment, identical to those given S&L's.

THRIFT INSTITUTIONS

BEFORE	AFTER
Deposit Powers	
payment of interest: severe restrictions on all types of deposits.	5½ year phase-out of restrictions, then interest freely determined. However, no interest on demand deposits.
savings accounts: full powers; individual and corporate.	savings accounts: full powers; individual and corporate (no change).
demand accounts: not permitted.	demand accounts: full powers; individual and corporate.
N.O.W. accounts: not permitted.	N.O.W. accounts: full powers; individual and corporate.
Lending and Investment Powers	
loans for housing and closely, related areas.	loans for housing and closely related areas; *plus* (on a limited basis) consumer loans; real estate loans under same conditions as commercial banks; construction loans not tied to permanent financing; community rehabilitation loans under a 3 percent leeway authority.
	commercial loans permitted only to extent they are closely related to housing.
equities: no acquisition of private sector issues.	equities: no acquisition of private sector issues (no change).
securities: no acquisition of private debt securities.	securities: limited acquisition of high-grade private debt securities.
Taxes	
loan loss deductions: preferential treatment compared to banks.	loan loss deductions: will move to experience basis; same treatment as banks.
tax credits: none.	tax credits: special tax credits for investment in residential mortgages; significant incentive to retain high percentage of portfolio in residential mortgages.
Chartering alternatives	
federal: mutual associations only.	federal: mutual and stock associations.
state: mutual and stock associations.	state: mutual and stock associations (no change).
Branching	
federally chartered: governed by FHLBB	federally-chartered: governed by FHLBB (no change).
state-chartered: governed by state law	state chartered: governed by state law (no change).

THRIFT INSTITUTIONS—Continued

	BEFORE	AFTER
Summary	Consumer interests penalized owing to prohibitions against service competition and enforced specialization between thrift institutions and banks.	Consumer interests strengthened by availability of new sources of supply of both deposit services and lending services and the promise of direct price competition between thrift institutions and banks.
	Opportunities to compete for funds limited and little ability to withstand tight-money pressures without substantial government support.	Virtually unlimited opportunities to compete for funds. Ability to withstand tight-money pressures strengthened, minimizing need for government rescue operations.

CREDIT UNIONS

Lending and Investment Powers	severe restrictions.	less severe restrictions.
Chartering alternatives	conversion to Mutual Thrift Institutions not permitted.	conversion to mutual thrift institutions permitted.
Sources of Liquidity	private sector institutions only.	private sector institutions, *plus* NCUA-administered Central Discount Fund for emergency, temporary liquidity purposes only.
Taxes	tax-exempt	tax-exempt (no change).

NARRATIVE EXPLANATION: BACKGROUND OF ISSUES AND RECOMMENDATIONS

Issue 1

PAYMENT OF INTEREST ON DEPOSIT ACCOUNTS

Background

Prohibitions against the payment of interest on demand deposits and interest ceilings on savings accounts were initially a product of the 1930's. The popular notion at that time—since proved incorrect—was that excessive interest rate competition among banks was the cause of bank failures. Thus Congress, with the enactment of the Banking Act of 1933, prohibited banks from paying interest on demand deposits and authorized the Federal Reserve Board to regulate the rate of interest member banks may pay on savings accounts. That era was also characterized by an orientation toward the borrower, in an attempt to bring the nation out of the Depression, rather than toward the consumer/saver.

Studies of the prohibition of payment of interest on demand deposits have shown the reasons for it were ill-founded. Moreover, the prohibition has not kept bank costs from rising during tight-money periods because banks have developed other sources of funds for which they have paid market rates. Unfortunately, misconceptions about the prohibition are so widely and strongly held that removal is not feasible.

However, development of "negotiable order of withdrawal" (N.O.W.) accounts and the development of "electronic funds transfer systems" (EFTS) can be expected to blur the difference between demand and savings accounts to such an extent that the prohibition will become meaningless. N.O.W. accounts provide most of the benefits that would be derived from interest-bearing checking accounts without forcing banks to pay interest on current demand deposits. They also allow banks a means of experimenting before any move to a system where interest is explicitly paid on demand deposits.

Working with the money flow theories of the 1930's, Congress, in September 1966, turned to interest ceilings to protect the deposit holdings of thrift institutions and thus the flow of funds into mortgage markets. It enacted legislation giving the Federal Home Loan Bank Board (FHLBB) and the Federal Deposit Insurance Corporation (FDIC) authority to regulate, in conjunction with the Federal Reserve Board (FRB), interest payments made by the institutions they supervise. The three supervisory authorities then agreed to formalize the historical interest differentials paid by thrift institutions over those paid by commercial banks at about 50 basis points (reduced to 25 basis points on July 5, 1973).

Interest ceilings on savings accounts have failed to achieve their objectives. Contrary to expectations, they did not protect the liquidity of thrift institutions by preventing an outflow of funds during periods of tight money, and thus did not produce funds for the mortgage market. Large savers enjoyed many alternatives for their savings which paid the higher market rates and reacted accordingly. Faced with a loss of funds, thrift institutions cut back on their mortgage lending or borrowed from especially created agencies, which had to pay market rates for their funds, or did both. The result was significant instability in mortgage markets, and accentuated differences between the rate of return to large and small savers.

Ironically, even though the small saver received less than the large saver, the cost of funds to thrift institutions rose appreciably. Ceilings did force those who, due to their unsophistication or small savings, had only limited outlets for their savings to accept less than market rates. However, large savers who withdrew their funds had the option of acquiring debt issues of Federal Home Loan Banks at market rates. Funds raised in that manner were then relent to thrift institutions at rates which were generally above deposit rates.

Interest ceilings also hampered the implementation of restrictive monetary policy. Because depository institutions could not attract funds, large and increasing credit flows were moving outside the banking sector. The base on which the Federal

Reserve operates decreased in relative terms, and its restrictive policies had to be made increasingly stringent at the same time that they became increasingly ineffective.

Formalized interest differentials may have prevented, to some extent, a shift of deposits from thrift institutions to commercial banks. If they did, the interest differential helped to maintain the viability of thrift institutions. That does not necessarily imply, however, that the differentials will be effective in future periods of high and rising interest rates. Educated by the last two "credit crunches" and by constant advertisements about interest rates, even the less sophisticated savers will shift their funds to the highest yield if market rates greatly exceed the passbook ceilings. Such shifts began occurring in the summer of 1973.

Thus it is increasingly unlikely that interest ceilings or differentials will continue to protect thrift institutions. Additionally, large corporations, which are not subject to ceilings, have already successfully experimented with small-denomination capital debentures—e.g., savings bonds. Any corporation or governmental unit is a potential competitor for the savings dollar. Savings institutions therefore must be allowed to compete for these funds if they are to continue to provide their intermediation function.

Should "free-competition" for funds cause some institutions to make imprudent lending and investing decisions, the situation can be remedied effectively through actions of the federal and state supervisory authorities. Blanket regulation of the entire deposit industry, geared to the lowest common denominator of management competence, is neither justified nor desirable.

Recommendation

The payment of interest on demand deposits will remain prohibited for all institutions.

Regulation Q is to be phased out over a period of five and one-half years. Parity of interest ceilings between commercial banks and thrift institutions is to be achieved by raising the rate permitted banks in four annual steps commencing 18 months after enactment of the recommendation. At the same time, preparations can be made for the complete elimination of interest ceilings on time and savings accounts.

N.O.W. accounts are to be subject to ceiling rates so long as the ceiling system remains in force. Such ceilings are to be uniform for banks and thrift institutions and may be no higher than the maximum rate on passbook accounts.

Administrative decisions on the actual levels of ceiling rates will be made by a coordinating committee composed of the FDIC, the FHLBB, the FRB, and the Treasury Department.

Issue 2

EXPANDED DEPOSIT LIABILITY POWERS AND RESERVES

Background

The elimination of preferential interest rate treatment for thrift institutions will necessitate adjustments in the structure of their deposit liabilities and assets so that they will be able to compete with commercial banks and other seekers of the savings dollar. Additionally, the decreasing effectiveness of interest ceiling differentials and technological innovations that blur the traditional lines between savings accounts and demand deposits are actual developments which call for the same remedy.

In the area of deposit powers, federally insured thrift institutions are prohibited by law from offering third-party payment services (i.e. bona fide checking accounts) but they may issue non-negotiable orders of withdrawal.

For their part, commercial banks are prohibited from offering savings accounts to their corporate customers. Such accounts were prohibited by the FRB in 1936 on the theory that they represent the indirect payment of interest on demand deposits. (Section 19 of the Federal Reserve Act prohibits member banks from paying interest directly or indirectly on demand deposits.)

Those constraints upon federally insured thrift institutions and member banks can be effective only in a world where all thrift institutions operate under the same rules and where there are relatively high costs attached to shifting funds from savings accounts to demand deposits. If that ever were the case, it no longer is so. Non-federally chartered thrift institutions in Massachusetts and New Hampshire are offering negotiable order of withdrawal (N.O.W.) accounts which are tantamount to and near-perfect substitutes for interest-

bearing checking accounts. Such a system is made possible by advances in computer technology which enable any institution to offer customers low-cost rapid transfers of funds from checking to savings accounts and the reverse.

It seems imprudent to try to block those innovative changes sought by the consumer. Innovative minds will always find ways around piecemeal restrictions. However, if commercial banks and thrift institutions are permitted to offer the same range of services, some suggest that they should operate subject to the same ground rules. The more important of those rules covers the holding of reserves against accounts subject to third-party payments.

Imposition of comparable deposit reserves on all banks and thrift institutions is controversial. Comparability does not exist now, and differences between the Federal Reserve and the individual states on the issue of reserves is one of the important factors keeping the dual banking system alive. Of the 509 state-chartered banks opened for business in 1970 through 1972, only 30 joined the Federal Reserve System. However, Federal Reserve member banks hold approximately 80 percent of all demand deposits. There are substantive advantages to maintaining the dual system, particularly the advantages and innovations of competitive regulation and the avoidance of overly restrictive chartering policies.

Recommendations

For federal thrift institutions, checking accounts, third party payment powers, credit cards, and N.O.W. accounts will be available to all customers, individual and corporate.

For national banks, saving accounts and N.O.W. accounts will be available to all customers, individual and corporate.

All federally chartered institutions and all state chartered institutions which are members of the Federal Reserve System or the Federal Home Loan Bank System will be required to maintain reserves against deposits in demand and N.O.W. accounts in a form and amount prescribed by the FRB after consultation with the FHLBB. State chartered savings and loan associations insured by the Federal Savings and Loan Insurance Corporation (FSLIC) need not be members of the Federal Home Loan Bank System, just as state chartered banks need not be members of the Federal Reserve System.

N.O.W. deposits will be subject to the same range of reserves as demand deposits. However, the FRB after consultation with the FHLBB may establish a different level of required reserves for N.O.W. accounts.

Required reserves for demand deposits and N.O.W. accounts will range from 1 to 22 percent. Those for savings acounts will range from 1 to 5 percent and those for time accounts will range from 1 to 10 percent.

For state chartered institutions FDIC and FSLIC statutes will be changed to permit competitive equality, if such equality is sanctioned by state law.

Issue 3

EXPANDED LENDING AND INVESTMENT POWERS

Background

The removal of interest ceilings and the granting of a greater range of deposit powers can be expected to alter significantly the maturity structure of thrift institutions deposits. Those changes on the liability side require flexibility for compensating adjustments on the asset side. Such compensations should look to increasing income and enhancing liquidity through portfolio diversification—objectives that can be achieved only through the acquisition of shorter term and more diversified assets, such as consumer loans. Opening up those areas to thrift institutions can be expected to create downward pressures on the cost of credit to consumers and governmental bodies.

It might be argued that such significantly liberalized lending authority may curtail the flow of funds into housing. That issue is not easily resolved, but the Administration's task force concluded that the expansion of powers, coupled with the suggested tax changes, should not adversely affect the supply of mortgage funds. It is impossible to give definitive support to that position because theoretical arguments on both sides abound. The key seems to be the extent to which: (1) thrifts will shift long-term funds into short-term (non-mortgage) assets, and (2) the extent to

which that shortfall would create market inducements encouraging other institutions (e.g. commercial banks and real estate investment trusts) to fill the gap. In its study of the issue, an Administration housing study group, chaired by the Council of Economic Advisers, concluded that the former would likely be small and that the latter would operate, leaving mortgage flows unaffected.

The possibility that commercial banks may fill the gap will be enhanced if current restrictions on their real estate lending are removed, especially in light of the removal of interest ceilings on savings accounts. Furthermore, commercial banks will be confronted by thrift institutions armed with a full range of consumer finance powers and, therefore will need to be more attentive to mortgage credit demands if they are to hold their customers for other consumer business.

However, since housing has a high social priority, it seems advisable to place some restrictions on the acquisition of "non-mortgage" assets and to increase the number of ways thrifts can participate in financing construction activity. In addition, changes are also being recommended in the taxation of banks and thrift institutions to assure a steady flow of funds into housing.

Since the impact of the proposed changes on the availability of mortgage funds is so important, a synopsis of the Administration's task force study on this matter will be found later in this booklet.

Recommendation

Federal savings and loan associations will be authorized to:

(1) make consumer loans not exceeding 10 percent of their total assets;

(2) make real estate loans under the same conditions as commercial banks;

(3) make construction loans not tied to permanent financing (i.e., interim construction financing as offered by banks);

(4) make community rehabilitation and development and mortgage loans on residential and related properties, including a participation in rental income or a share of capital gains on the sale of property, but with this leeway authority not to exceed 3 percent of their total assets;

(5) acquire high quality commercial paper and private investment-grade corporate debt securities in accordance with approved-list and other guideline procedures established by the FHLBB. Such investments are not to exceed 10 percent of total assets, with the maximum limitation to be set at 2 percent in the first year and growing to 10 percent, at the rate of 2 percent per year, over a 5-year period;

(6) utilize for consumer loans the unused portions of authorized investments in private corporate debt (commercial paper and debt securities) and leeway loans; and

(7) continue the acquisition of a full range of U.S. Government, state and municipal securities.

National banks will be granted:

(1) liberalized powers with respect to real estate loans;

(2) a leeway authority, not to exceed 3 percent of total assets, for community rehabilitation and development and mortgage loans on residential and related properties, including a participation in rental income, or a share of capital gains on the sale of property.

The FRB is to be granted more flexible authority to define assets eligible for discount, and the FHLBB is to be given expanded authority to broaden the definition of collateral required for advances to savings and loan associations.

Issue 4

CHARTERS FOR THRIFT INSTITUTIONS

Background

The dual banking system has contributed a great deal to the more efficient operation of financial markets. It has permitted an element of competition among supervisory authorities which has been conducive to innovation and experimentation by financial institutions. In addition, it has restrained supervisory authorities from overzealously protecting existing firms by restricting entry to the field.

The dual banking system is, however, incomplete. Federal charters are not available to mutual savings banks and federal law explicitly prohibits the federal chartering of *stock* savings and loan associations. Both types of institutions have been operating in a more than satisfactory manner at the state level for a number of years. There are no

obvious reasons why federal charters should not be available to them.

Recommendation

The FHLBB is to be empowered to charter stock thrift institutions, granting them powers identical to those enjoyed by mutual savings and loan institutions.

Newly empowered federally chartered thrift institutions may be called either "savings and loan associations" or "savings banks."

State chartered mutual savings banks may convert to a federal charter and be granted all of the asset and liability powers available to all federally chartered thrift institutions. In addition, they may retain their life insurance, equity investments and corporate bond investments. Equity and corporate investments may be no greater than levels determined by their average percent of assets for the 5-year period January 1, 1968 through December 31, 1972.

State chartered mutual thrift institutions which convert to a federal charter will be insured by the FSLIC, even if they had been insured by the FDIC.

Issue 5

CREDIT UNIONS

Background

Credit unions represent a small but rapidly expanding portion of the nation's financial system. At the end of 1972, there were about 23,200 credit unions holding total assets of more than $24.8 billion. That represents only a 4.4 percent increase in the number of firms since 1965, but a 134.6 percent increase in their assets over the same period.

Because of their cooperative form of ownership credit unions enjoy, by law, many advantages not accorded other depository institutions, but must satisfy special conditions to keep those advantages.

Their principal advantage is exemption from income taxes, while the main constraint on their operations is inability to offer services to non-members. Membership is limited to those who share a "common bond of association."

That constraint does not impinge upon the operations of the vast majority of credit unions. Although there are credit unions that would prefer to offer the services of "mutual saving institutions," such an extension of powers would leave them indistinguishable from taxable institutions and their tax-free status could not be justified.

Credit unions deposit in and borrow from commercial banks. However, there is the possibility that in times of severe credit restraint, a credit union may face an emergency, such as a plant closing, and be unable to acquire short-term funds from the banking system. A totally-credit-union-financed "Emergency Fund" might be one method to solve this problem.

Recommendation

A Central Discount Fund will be established for insured (federal or state) credit unions solely to provide funds to meet emergency, temporary liquidity problems. Capital for the fund will be obtained through subscriptions by credit unions wishing to join. The Fund is to be administered by the National Credit Union Administration.

Additionally, there will be some minor liberalization of existing credit union powers. Credit unions will retain their tax-exempt status as long as they remain within the bounds of the existing tax law.

Credit unions that want to expand their services and assume the burdens of full service mutual thrift institutions will be permitted to do so. Procedures to facilitate an exchange of charters will be available.

Issue 6

FHA AND VA INTEREST CEILINGS

Background

One of many federal attempts to keep the cost of housing funds low is the administrative interest ceiling placed upon Federal Housing Administration-insured and Veterans Administration-guaranteed mortgage loans. Those attempts have by and large failed, as is evidenced by the widespread use of "points," and the move by the Federal National Mortgage Association in 1968 to a "free market system" for buying and selling mortgages. If administrative rates have kept costs down, it has been at the expense of fewer funds available for housing.

Recommendation

The FHA and VA interest ceiling will be removed.

Issue 7

TAXES

Background

In light of the expanded powers to be granted thrift institutions and the overall goal of reducing the degree of functional specialization among financial institutions, the basic objective of the tax proposals is a uniform tax formula for all financial institutions. A "tax neutrality" is sought, by providing that a given investment or activity will be subject to the same income tax provisions regardless of the functional type of financial institution making the investment or engaging in the activity.

However, differences in tax treatment, and thus overall tax burden and effective rates of taxation among financial institutions, will continue to exist. Those differences will result from three factors: (1) the form of the institution, i.e., mutual bank versus capital stock corporation; (2) federal and state regulation which will grant certain types of institutions the power to make certain investments and engage in certain activities that are denied to other institutions; and (3) the extent to which an individual institution uses the powers granted to it.

The principal difference between existing income tax provisions applicable to commercial banks and savings institutions is in the area of deductions for additions to a reserve for losses on loans (Internal Revenue Code sections 593 and 585). Those provisions must be changed if there is to be a uniform tax formula. Furthermore, if changes are made in that area, conforming amendments will have to be made to a number of other provisions of the Internal Revenue Code which currently reflect the differences of existing law. Those other changes are technical in nature and do not involve policy considerations. Therefore, the recommendations which follow deal only with the provisions affecting deductions for additions to a reserve for losses on loans.

If the current subsidy being provided thrift institutions through the special bad debt reserve provisions is eliminated, a continued incentive to insure a flow of capital into the residential mortgage market may be provided through a mortgage interest tax credit. Such a credit would be equal to a percentage of the interest income earned on residential mortgages and would operate as a direct incentive in place of the indirect incentive currently being provided through provisions for loan losses. In addition, the mortgage tax credit could be used to compensate thrift institutions for the loss of tax benefit resulting from elimination of the special bad debt reserve deduction.

Recommendation

The special reserve provisions applicable to thrift institutions will be eliminated and all thrift institutions will compute reserve additions under an experience method similar to the one applicable to commercial banks.

Thrift institutions will be compensated for the tax benefit being eliminated by means of a new tax credit equal to a percentage of the interest earned from residential mortgages and other qualifying loans. The credit will be made available to all taxpayers and will serve as an incentive to attract capital into the residential mortgage market.

The size of the credit has not yet been decided, but it will be calculated so as to give thrift institutions full compensation for the tax benefit they would have received in the aggregate (based on projections for a future year) through deductions for additions to a reserve for losses on loans. To induce thrift institutions to continue their high level of investment in residential mortgages (to be eligible for the special bad debt reserve deduction they currently must invest 60 percent of their assets in qualifying real property loans and must invest 82 percent of their assets in such loans to receive the maximum tax benefit) and provide an incentive to other lenders to increase their level of investment in residential mortgages, the credit will be multi-level. For example, one rate might apply to those lenders who invest more than 70 percent of their assets in residential mortgages, a lower rate might apply to those lenders investing more than 50 percent of their assets in residential mortgages and still lower rates might be set for all other lenders. The specific rates and the investment levels have yet to be determined.

QUESTIONS AND ANSWERS

I

Payment of Interest on Deposit Accounts (Regulation Q, etc.)

Q. What are the current regulations governing the payment of interest on demand deposits?

A. Payment of interest on demand deposits by any insured bank is prohibited by federal statute, 12 U.S.C. 1828g.

Q. When and why was the payment of interest on demand deposits barred?

A. Payment of interest was prohibited in 1933 in the belief that deposit rate competition contributed to bank failures. Subsequent studies have failed to support that belief.

Q. What is the legal basis for the current regulations governing the payment of interest on time and savings accounts?

A. Federal law empowers the FRB, the FDIC, and the FHLBB to limit by regulation the payment of interest on time and savings deposits. Ceiling rates may be varied in accordance with deposit size, maturity, location of institution and any other basis deemed desirable in the public interest.

Q. When was that authority first granted those regulatory bodies?

A. The current broad grant of authority was first enacted in September 1966 at the time of the severe liquidity crisis.

Q. Why was it enacted?

A. It was believed at that time that ceilings on deposit rates would hold down the costs of deposit institutions (primarily S&L's) thereby alleviating the squeeze on their profits and maintaining them as viable suppliers of funds for housing. However, the ceilings failed to provide a protective shield.

Q. What is Regulation Q?

A. Regulation Q is a regulation issued by the FRB, under the authority mentioned above, governing the payment of interest by member banks on time and savings deposits.

Q. Are other regulatory bodies empowered to set interest ceilings for the depository institutions they supervise?

A. Yes. Under the legislation originally passed in 1966, both the FHLBB and the FDIC may set interest ceilings on the time and savings accounts of the institutions they supervise. Extension of that authority until December 31, 1974, is currently before Congress. Under current authority the FDIC has promulgated 12 CFR 7829.6 and the FHLBB 12 CFR 526.

Q. Are the same regulations applicable to commercial banks and thrift institutions?

A. Not entirely. The ceiling rate permitted thrift institutions is now generally 25 basis points higher than that permitted commercial banks. There are no ceiling rates on certificates of deposit of $100,000 or more, or on 4-year deposits of $1,000 or more (up to 5 percent of time and savings deposits).

Q. Has the differential between what commercial banks and thrift institutions can pay for time and savings accounts been due to a law or to administrative action?

A. Administrative action.

Q. Why are thrift institutions given an interest-rate advantage?

A. Because of the prominent role they play in funneling funds into housing markets.

Q. Why is elimination of that differential now being proposed?

A. The total package of recommendations contains other and more efficient means of encouraging financial support for housing, principally through the mortgage tax credit.

Q. What is a "N.O.W." account and how does it differ from a demand deposit?

A. A N.O.W. account is a negotiable order of withdrawal offered by mutual savings banks in Massachusetts and New Hampshire. In essence, they are checks drawn on savings accounts in those institutions. N.O.W. accounts differ from demand deposits in that such accounts bear interest and legally a bank does not have to honor it on demand.

Q. Why are you recommending the payment of interest on accounts that are essentially demand deposits while continuing the ban on interest payments for demand deposits?

A. Given the long period in which banks have not paid such interest they will need time to experiment with interest-bearing transaction accounts. Maintaining a distinction, however small, between N.O.W. accounts and checking accounts gives banks time for experimentation.

If interest could be paid immediately on demand deposits, it is believed that banks with their existing large balances of demand deposits would start paying interest on them and S&L's would never have a chance to attract such deposits. Also, many banks would feel that they were being forced by the government to pay such interest. And finally, by allowing N.O.W. accounts rather than interest on demand deposits we have introduced a degree of gradualism into the new world of paying interest on demand deposits.

Q. Why do you want to phase out Regulation Q?

A. We want consumer/savers to have the full benefit of market interests and thus to receive a fair return on their savings.

Interest ceilings on time and savings accounts have inhibited financial institutions from competing with the rest of the capital market for funds, particularly during periods of credit restraint.

Q. If you eliminate Regulation Q, won't we have the same type of cutthroat interest rate competition that led to numerous bank failures in the 1930's?

A. No. The statement that interest rate competition led to bank failures has not been supported by the evidence. There is little if any evidence that pure interest rate competition led to bank failures. The cause was, instead, poor investments.

If irresponsible deposit rates, inaugurated by isolated banks, should lead them to invest unwisely, this can best be handled on a case-by-case basis by the supervisory agencies. There is no point in penalizing all savers and all institutions for potential abuses by a few.

Interest rate ceilings in the past have proved to be discriminatory to the small unsophisticated saver while not really protecting the individual institutions.

Q. If you allow ceiling rates to increase, won't this mean higher rates on mortgages and bank loans?

A. Not necessarily. A number of interrelated factors have to be taken into account:

1. The interest rate for loans is determined by a market that is separate from the one which determines the interest rate for deposits. Although these two markets are indirectly related, they do not necessarily move in unison.

2. The market for mortgage loans is a long-term market, while the market for deposits is short and medium term.

3. To argue that removing Regulation Q will mean an increase in the average cost of funds for institutions is to assert that the Regulation has been effective in holding down the average cost of funds to the institutions. This has not been the case. What has happened has been a tilt in the yield curve with the average remaining about what it would have been otherwise—i.e., short-term Regulation Q rates have been depressed (savings accounts of small consumers) while the longer maturity deposits (big CD's) have been disproportionately bid up due to the intense competition by institutions for these relatively scarce deposits. We might expect this yield curve to "untilt" and thus not necessarily increase the average cost of funds to institutions.

4. However, the overall Regulation Q rates may go up and loan rates may go up. But if this happens, there will merely have been a redistribution of income from borrowers to savers. Who is to say that the consumer savers should not receive a fair return on their savings?

Q. Why not remove Regulation Q immediately?

A. S&L's, due to their portfolios of substantially all long-term mortgages frozen into fixed rates, do not have the ability to immediately start paying free competitive rates. They must be given a couple of years to adjust their portfolios so as to shorten the maturity of some of their assets (i.e., consumer loans) and improve their overall yield.

II

Expanded Deposit Liability Powers and Reserves

Q. What are the major differences in deposit liability powers between commercial banks and thrift institutions?

A. All thrift institutions, both federal and state chartered, offer a full range of savings account services to all customers, individual and corporate. However, thrift institutions may not offer demand deposit services. A major exception is the N.O.W. account offered by mutual savings banks in Massachusetts and New Hampshire. Among commercial banks only member banks of the Federal Reserve System may not offer a full range of both demand and savings account services to all customers. Member banks may not offer savings account services to their corporate customers. That prohibition is a regulation promulgated by the FRB. State chartered non-member banks are subject to state law on the issue of corporate savings accounts.

Q. Why have differing deposit liability powers for commercial banks and S&L's been established?

A. It has been generally believed that the longer maturity structure of thrift assets, vis-à-vis commercial banks, demands a longer maturity structure of deposit liabilities. Hence the general prohibition against S&L's offering checking accounts.

Q. Why the recommendation that the differences in deposit liability powers between S&L's and commercial banks be eliminated?

A. It will be beneficial for consumers and small businesses to be offered a full range of services by all institutions which wish to do so. The elimination of current differences is part of the overall plan to make thrifts more viable financial institutions. By possessing all the powers needed to compete for deposit funds, thrifts will no longer require the great rescue operations used in the past.

Q. Will changes in their liability powers require changes in their asset powers?

A. Yes. Permitting thrifts to have shorter-term liabilities requires that they possess shorter-term assets. Recommendations put forward by the President include proposals that would permit thrifts to make consumer loans and business loans related to real estate.

Q. Will these changes in liability powers mean changes in their deposit reserve responsibilities?

A. Not necessarily. If thrifts are members of the FHLBB system, and membership will be voluntary for state chartered institutions, reserves on their transaction accounts (demand and N.O.W. accounts, but not time and savings accounts) will be imposed by the FRB, after consultation with FHLBB.

Q. Will that be the same treatment accorded commercial banks?

A. Members of the Federal Reserve system will be subject to the same requirements on their transaction accounts as members of the FHLBB system. Again, membership will be voluntary for state chartered institutions.

Q. Will there be any differences between the reserve requirements for thrifts and commercial banks?

A. Yes. Current reserve (liquidity) requirements on time and savings deposits of thrifts will not be altered. Those on the time and savings accounts of commercial banks will be altered.

Q. Before we get into these changes what are the current limits on reserves?

A. Currently, the FRB is empowered to set reserve requirements on demand deposits from 10 percent to 22 percent for so-called reserve city banks and from 7 percent to 14 percent for all other banks.

Q. What are the requirements in effect today?

A. As of May 31, 1973 reserve requirements on demand deposits were

deposits ($ millions)	reserve requirements (%)
0–2	8
2–10	10
10–100	12
100–400	13
over 400	17½

Q. What will the new reserve requirements be?

A. They will range from 1 to 22 percent on transaction accounts (including demand and

N.O.W. accounts), 1 percent to 5 percent on savings accounts, and 1 percent to 10 percent on time accounts.

Q. In what form will reserves be held?

A. For Federal Reserve and FHLBB members, reserves will be held in a form and amount to be prescribed by the FRB.

Q. Are reserve requirements imposed on savings accounts?

A. Yes. Currently, member banks of the Federal Reserve system are subject to reserve requirements on savings accounts. Such reserves may range from 3 percent to 10 percent. At the moment the requirement for all banks is 3 percent. Nonmember banks are subject to state law.

Q. Are there any reserve requirements on time deposits and certificates of deposit?

A. Members of the Federal Reserve system must hold as reserves 3 percent of such deposits for the first $5 million and 5 percent for deposits over $5 million. Recently, the FRB imposed an 8 percent marginal reserve requirement (the regular 5 percent plus a supplemental 3 percent) on further increases in the total of (a) outstanding certificates of deposit of $100,000 and over issued by member banks, and on (b) outstanding funds obtained by a bank through issuance by an affiliate of obligations subject to the existing reserve requirement on time deposits. The 8 percent marginal reserve does not apply to banks whose obligations of those type aggregate less than $10 million.

Q. What proposals are being made for reserves on time and savings accounts in commercial banks?

A. For member banks reserve requirements on savings accounts will range from 1 percent to 5 percent and those on time accounts will range from 1 percent to 10 percent. State law will prevail for nonmember banks.

Q. What is the difference between savings accounts and time accounts?

A. Generally, the two differ in terms of the amount of time funds must remain on deposit and the rules governing withdrawal of funds.

For savings accounts, the depositor is not required by contract to leave funds on deposit for any specified period of time nor to give notice in writing of an intended withdrawal. However, the depositor may at any time be required by the bank to give at least 30 days notice.

For time accounts, the depositor agrees to leave funds on deposit for a specified minimum period of time and for many types of time deposits must give prior notice of withdrawal.

Q. Will new reserve requirements be imposed on time and savings accounts in thrift institutions?

A. No. The liquidity reserves imposed by the state or the FHLBB, whichever is applicable, will continue.

Q. Although the FRB imposes reserve requirements only on member banks, are you recommending that it set reserve requirements for all federally insured banks?

A. No, not all of them. The FRB will have authority to set, in consultation with the FHLBB, reserve requirements on transaction accounts of members of the FR and FHLBB systems.

Q. Won't that recommendation bring some thrift institutions under the control of the FRB?

A. Only with regard to reserve requirements on transaction accounts. There is no way to estimate at this time how many FHLBB thrifts will offer transaction accounts.

Q. Are there any reasons for preserving the dual banking system?

A. Yes. The dual system creates 52 laboratories for experimentation in bank regulation. Experimentation has taken place in areas of ancillary bank services and capital adequacy to the advantage of the banks and the public. In addition, the availability of alternative chartering agencies has resulted in increased competition and more service for the public.

Q. Why is it that state chartered banks which are not members of the Federal Reserve System do not have to hold the same reserves as the system members?

A. The history of our banking laws has been one of dual regulation of state chartered banks and federally chartered banks. We do not wish to damage this very healthy system of dual banking.

By providing a choice of chartering and supervisory agencies to banks and S&L's, we have fostered an innovative and progressive banking system.

We believe that states have the right to regulate their own banks so long as such regulation does not unduly interfere with the implementation of monetary policy which is, of course, a federal responsibility. From a practical point of view, most state banks hold reserves roughly equivalent to those of FR member banks. However, unlike the member banks, they are frequently able to put such reserve balances to productive use.

Q. Summing up, how will this decision on reserves affect financial institutions?

A. National banks—no change.

State Federal Reserve System member banks—no change.

State non-member banks—no change.

Federal S&L's—must hold reserves against demand deposits and N.O.W. accounts; no change on savings and time deposits.

State S&L's—if member of FHLBB (which almost all will remain), same as above. If not FHLBB member, state banking authorities will set reserve requirements. It is hoped they will be the same as for banks.

Mutual savings banks—same as for Federal and State S&L's.

The new ranges within which the Fed may set the reserve level are:

demand deposits and N.O.W. accounts — 1–22 percent
savings — 1–5 percent
time — 1–10 percent

III

Expanded Lending and Investment Powers

Q. What is the general purpose of expanding the lending and investment powers of thrift institutions and banks?

A. Generally, the expansion is part of the overall plan to make thrifts more viable financial institutions. More specifically, changes on the liability side require compensating adjustments on the asset side aimed at increasing income and enhancing liquidity. Those objectives can be achieved only through the acquisition of shorter term and more diversified assets, such as consumer loans. Opening up those areas to thrift institutions can be expected to create downward pressures on the cost of credit to consumers and governmental bodies.

Q. What are the current limitations on lending and investing by thrift institutions?

A. This can be answered precisely only about federally-chartered S&L's, since there are so many laws covering state-chartered institutions.

Currently, federally-chartered S&L's are generally restricted to making loans related to housing and real estate.

There are two exceptions to that rule. First, they may make passbook loans, that is loans to account holders secured by the deposits in their accounts. The size of loan is limited to the amount of funds in the account. Second, thrifts may make loans to individuals to pay for college, university or vocational expenses. Those loans are limited to 5 percent of assets.

Generally, S&L's are precluded by law and regulation from acquiring private sector debt obligations other than mortgages. They may, however, acquire the stock of so-called service corporations—corporations designed exclusively to provide related services such as data processing.

Q. What expanded lending and investing powers are being recommended for federal savings and loan associations?

A. Federal S&L's will be authorized to make consumer loans; make construction loans not tied to permanent financing; make community rehabilitation and development and mortgage loans on residential and related properties, including a participation in rental income or a share of capital gains on the sale of property; acquire high quality commercial paper and private investment grade corporate debt securities; utilize for consumer loans the unused portions of authorized investments in commercial paper and securities, and in community rehabilitation and development and mortgage loans.

Q. What expanded lending and investing powers are being recommended for national banks?

A. National banks will be granted liberalized powers with respect to real estate loans, and au-

thority to invest in community rehabilitation and development and mortgage loans on residential and related properties, including a participation in rental income or a share of capital gains on the sale of property.

Q. Why should thrift institutions be given expanded lending authority?

A. This will allow them to pay the market rate for deposits by shortening the maturity and diversifying the composition of their assets, and increasing the yield thereon.

Q. Won't this diversification divert money from the home loan mortgage market?

A. The CEA study referred to earlier in the discussion of issue 3 concluded that such curtailment will not be significant in view of the other powers being extended to thrift institutions. Moreover, commercial banks can be expected to take up some of whatever slack does occur if current restrictions on their real estate lending are removed, particularly in light of the elimination of interest ceilings on savings accounts.

Q. Why are strict percentage-of-asset limitations being set on thrift institutions' expanded investment powers?

A. Since housing has a high social priority, it seems advisable to place some restrictions on the acquisition of non-mortgage assets and to increase the number of ways thrifts can participate in financing construction activity.

IV

CHARTERS FOR THRIFT INSTITUTIONS

Q. Why are there no existing provisions for federally-chartered stock thrift institutions?

A. At the time the federal law was enacted savings and loan associations were looked upon simply as self-help cooperatives, and there was thought to be no role for stock savings and loan associations.

Q. Why is it being recommended that Federal charters now be granted to stock thrift institutions?

A. Presently 21 states charter stock savings and loan associations. Experience with stock savings and loan associations has been at least as satisfactory as that with mutuals; therefore there is no good reason for the present statutory ban on federal charters. It is also believed beneficial to have a dual option of chartering and supervisory agencies to avoid two problem areas which emerge when a particular type of financial institution can be chartered by only one agency: first, the agency may become overzealous in protecting existing firms; second, the agency may not be as innovative and imaginative as it should be in exercising its authority.

Q. Under the recommendations will there be any difference in activities permitted stock S&L's, mutual S&L's, mutual savings banks, and the new savings banks?

A. Under the recommendations all federally-chartered thrift institutions will have essentially the same asset and liability powers. "Savings bank" will just be an alternative title available to newly empowered federally-chartered thrift institutions. However, state-chartered MSB's which convert to a federal charter will be able to retain their life insurance, equity investments and corporate bond investments. This will enable them to maintain their customary investments which will not be available to other existing or newly chartered federal thrift institutions.

Q. Won't allowing MSB's to convert and retain their investments undermine a dual banking system?

A. No. Allowing mutual savings banks, which can now be chartered in 18 states and Puerto Rico, the option to convert to a federal charter and maintain their customary investments will enhance the dual banking system. Allowing them to retain their investments upon conversion will give them a real option between either remaining under their present state supervisory agency or coming under a federal supervisory agency.

V

CREDIT UNIONS

Q. What is a credit union, and what special privileges does it enjoy?

A. A credit union is a cooperative nonprofit organization of individuals with a common bond of occupation, association or residence. The credit

union's objectives are to promote thrift among its members and to provide them with a source of credit at reasonable rates of interest. Credit unions enjoy an income tax-free status since they are non-profit organizations.

Q. Are federal and state charters available to credit unions?

A. Yes; credit unions may be incorporated under a federal law or under the laws of 44 states.

Q. What resources are available to federal credit unions now to meet temporary liquidity problems?

A. Credit unions may use their investments or increase their direct borrowing from other credit unions and private sources such as commercial banks. However, to qualify for federal insurance, credit unions are limited by a ceiling on aggregate borrowing from all sources.

Q. What is being recommended to meet emergency problems?

A. The establishment of a Central Discount Fund (CDF) to be administered by the National Credit Union Administration is being recommended. It would provide funds to meet the temporary liquidity problems of its members.

Q. Will non-federally-chartered credit unions have access to the CDF?

A. Yes. All *insured* credit unions, either federal or state, may become members of the Fund.

Q. How will the CDF be funded?

A. The capital for the Fund will be supplied through subscriptions by member credit unions. (Presumably additional funds could be provided through the issue of debt obligations and from the deposits of credit unions as recommended by the Hunt Commission.)

VI

FHA AND VA INTEREST CEILINGS

Q. What are the current Federal Housing Administration and Veterans Administration interest ceilings on mortgages and who imposes them?

A. Interest ceilings on FHA-insured loans are set by the Secretary of Housing and Urban Development; those on loans guaranteed by the VA are set by the Administrator of Veterans Affairs. The ceiling on FHA-insured and VA-guaranteed loans was recently raised from 7 to 7¾ percent.

Q. What was the purpose of having interest ceilings on FHA- and VA-backed loans?

A. FHA insurance is intended to enable persons of modest incomes to more easily obtain residential mortgages. Ceilings on FHA and VA loans were imposed with the assumption that borrowers under these programs would pay reasonable rates of interest.

Q. Why are you recommending the elimination of those ceilings?

A. Experience has shown that the administratively set ceilings lag behind market rates for conventional mortgages. This has meant that either FHA- and VA-backed loans become unavailable during periods of rapidly rising interest rates, or the effective rate of interest on these loans is raised above the ceilings by the practice of charging "points," in effect buying the loan at a discount. Ending the ceilings will eliminate this practice and enable persons who rely on FHA- or VA-backed financing to obtain mortgages during periods of high interest rates.

Q. Won't elimination of the ceilings lead to a rise in mortgage interest rates?

A. At present, the interest rates on FHA- and VA-backed mortgages rise with market rates on conventional mortgages through the use of "points" (or mortgage money becomes unavailable). Elimination of the ceilings is not expected to increase the *effective* rate of interest charged on these mortgages but is expected to provide a steadier supply of funds for mortgages during tight money periods.

Q. Why won't there be a phase-out period for these ceilings, as is planned for the interest ceilings on time and savings deposits?

A. The removal of interest ceilings on FHA- and VA-backed mortgages is not expected to sharply affect interest rates charged on mortgage loans so their removal should not disrupt the mortgage market. Some fear that the removal of ceilings on time and savings deposits may lead to substantially higher interest rates on those deposits. Rather than expose financial institutions to perhaps dam-

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aging and sudden competition for those funds, a period of adjustment will be provided, during which these institutions will be able to learn through experience what rates are needed to attract necessary funds without damaging their viability.

Q. Will removal of FHA and VA interest ceilings eliminate all usury-type barriers to mortgage financing?

A. No. Currently, many states employ usury ceilings in the mortgage area. It is the Administration's hope that states which impose such ceilings will move toward eliminating them as soon as possible. During periods of severe credit stringency, arbitrary ceilings below market rates can keep funds from mortgage markets.

VII

TAXATION

Q. Why are changes being recommended in the taxation of banks and thrift institutions?

A. The purpose is threefold: (1) to assure a steady flow of funds into housing; (2) to achieve a tax neutrality by providing that the income from a given asset will be subject to the same tax provisions, regardless of the functional type of financial institution holding the asset; and (3) to place competing institutions on an equal footing.

Q. What are the current special reserve provisions which apply to thrift institutions and how do they differ from the reserve provisions applying to commercial banks?

A. The principal difference between existing income tax provisions applicable to commercial banks and savings institutions involves deductions for additions to a reserve for losses on loans. Currently, thrift institutions are granted more favorable terms than commercial banks.

Q. Will the recommendations completely eliminate all differences in taxation between thrift institutions and commercial banks?

A. Generally, yes. The special reserve provisions applicable to thrift institutions will be eliminated, and all thrift institutions will compute reserve additions under an experience basis rule of the type currently applicable to commercial banks.

Q. How will thrift institutions be compensated for his tax loss?

A. Thrift institutions will be compensated for loss of the tax benefit by means of a new tax credit equal to a percentage of the interest earned from residential mortgages and other qualifying loans.

Q. Would the proposed mortgage interest tax credit be available to all lenders?

A. Yes.

Q. What are the current provisions of tax law with regard to the treatment of loan losses of thrift institutions?

A. In computing taxable income, all deposit institutions may deduct from gross income an expense item called additions to reserves for bad debts.

Currently, thrift institutions may, in calculating that expense item, use the same methods available to commercial banks or, in the case of qualifying real property loans, a special method designed to increase the after-tax profitability of their mortgage holdings.

Under the second alternative, thrift institutions may deduct, for the year 1973, up to 49 percent of taxable income. Between 1973 and 1979 that maximum figure will be reduced gradually to 40 percent.

To obtain the maximum deduction permitted by law, at least 82 percent of a thrift institution's assets must be in so-called eligible assets. As the amount of eligible assets declines so does the percent of gross income which may be deducted as a business expense. If the percentage of eligible assets falls below 60 percent of total assets, the special method is not available.

With regard to non-qualifying loans, bad debt reserve deductions are made under the same ground rules as are applicable to commercial banks.

Q. What changes in the tax treatment of "additions to reserves" are being recommended?

A. As of the effective date of the legislation, all deposit institutions would operate under the provisions now available to commercial banks.

Q. What are those provisions?

A. Banks may deduct amounts in accordance with an "experience method" or a "percentage of eligible loan method."

Under the "percentage of eligible loan method," the amount to be deducted is the amount necessary to bring the level of the reserve for bad debts up to a specified percentage of eligible loans. That percentage is currently 1.8 percent but will be reduced to 1.2 percent in 1976 and to 0.6 percent in 1982. This method will cease to be available after 1988.

Under the experience method, the amount to be deducted is the amount necessary to bring the level of the reserve up to an amount reflecting the actual loss experience for the current year and preceding 5 years.

Q. When thrifts convert to the provisions available to banks, will the level of their reserves be low enough to permit them to deduct loan losses as a business expense?

A. Generally, no.

Q. Will thrifts be given any special treatment as a result?

A. Yes. Highly technical changes in the tax law will be made so that thrifts will continue to be able to deduct additions to reserves for bad debts as a business expense. However, the amount of the deduction will be substantially lower than that which is available under current law. Thrift institutions will always be able to receive a deduction for actual loan losses.

Q. Are the proposed changes in tax law designed to equalize the effective tax rates or tax burden?

A. No. The object of the recommendations is to create a tax neutrality with regard to the lending and investment activities of deposit institutions. Under the proposal, differences in effective tax rates and burden will continue to exist. Such differences will result from a combination of three factors: (1) the form of the institution (i.e. mutual vs. capital stock corporation); (2) differences in federal and state regulation governing the permissibility of certain investments and ancillary activities; and (3) the extent to which the individual institution utilizes the powers granted to it.

Q. What is the background of the bad debt reserve deduction?

A. Under current law a thrift institution is entitled to the special bad debt reserve deduction with respect to all *qualifying real property loans* (defined to include all loans secured by an interest in improved real property or secured by an interest in real property which will be improved from the proceeds of the loan). Improved real property includes residential property such as a single family home or apartment house as well as office buildings, shopping centers, warehouses, hospitals or other health, welfare, or educational facilities.

Based on 1971 figures, approximately eight percent of loans made by S&L's were not secured by an interest in *residential* property. In the case of MSB's virtually all of their mortgage loans were secured by an interest in residential real property.

The proposed mortgage interest tax credit is *limited to interest income from residential mortgages*, but is designed to compensate thrift institutions for the tax benefit they presently enjoy with respect to all real property loans.

Q. If the credit is limited to residential mortgages, what loans would be excluded?

A. All mortgages secured by an interest in commercial and industrial property, and loans secured by an interest in educational, health or welfare institutions or facilities including facilities used to house students, residents, patients, employees or staff members of such institutions or facilities.

Q. What effect will the proposal regarding bad debt deductions have on student loans?

A. Under current law, student loans are one of the types of investments that a thrift institution may make in order to meet the 82 percent test which will entitle it to the maximum bad debt deduction. However, the percentage of taxable income method is available only with respect to qualifying real property loans and does not include student loans.

Under the proposed change, the bad debt reserve deduction with respect to student loans will be unaffected. However, since thrift institutions will no longer be required to maintain a specified percentage of assets in eligible assets, student loans will be classified as consumer loans, for which there will be ample lending authority.

VIII

MORTGAGE AND HOUSING MARKETS

Q. Is the mortgage lending industry viable with its existing structure and regulations?

A. We take "viability" to mean the ability to withstand the effects of cyclical changes in credit market conditions without the need for massive Federal supportive intervention.

A conclusive case that the industry is not viable cannot be made on the basis of available evidence, but there appears to be a high enough probability to warrant attention. The instructive value of 1966 and 1969–70, the last two complete occasions when mortgage markets were under severe pressure, is not easily assessed, since many structural and regulatory changes have taken place over the last few years.

The chance of severe harm to thrift institutions has to some extent been moderated since 1969 by the improvement of the secondary market for both conventional and insured mortgages and by improvements in government sources of emergency liquidity. Moreover, thrifts and banks are now able to offer a "no-ceiling" deposit (minimum $1000 and 4 years) to the small consumer. On the other hand, there seems to be a general awakening of savers to the various forms of holding wealth alternative to deposits at thrift institutions. In addition, new alternatives to savings accounts have emerged in the last two years.

On balance, it appears that if present institutional arrangements were to continue, there would be good cause for concern about large-scale reductions in deposit inflows when market rates climb appreciably.

Q. How can we make the mortgage lending industry more viable without increased Federal support?

A. By implementing the balanced program of broadened asset and liability powers for financial institutions and restructuring tax support for residential mortgage lending.

Q. What are the present forms of government activities relating to housing and mortgage markets, including taxation?

A. Federal assistance to housing now takes two forms: (1) direct assistance to low-income persons building, buying or occupying dwellings and (2) a number of general tax incentives, some with accompanying restrictions, designed to encourage those same activities. Two major incentives are the deductibility of mortgage interest paid from homeowner's taxable income and the favorable manner in which savings institutions can add to bad debt reserves (beyond the levels warranted by losses) in return for the restriction that a high portion of their assets be held in residential real estate mortgage loans.

Q. How will Federal expenditures and tax preferences change if the President's recommendations are implemented?

A. The President's recommendations would not affect the structure of any direct program, but would substitute a tax credit for the bad debt provision for thrift institutions, and would make the residential mortgage tax credit available to all taxpayers. The amount of existing bad debt preferences for thrift institutions was estimated to be $545 million in fiscal 1971. If the tax credit is set at a level which does not alter the taxes paid by thrift institutions, the overall tax subsidy to housing will be larger since other investors will utilize the tax credit. If the overall subsidy is maintained at the current level, thrift institutions would receive less of the tax subsidy, with other holders of residential mortgages receiving the remainder.

Since the outlays in some Federal direct programs are positively related to mortgage rate levels, these would rise if rates increased and decline if rates decreased. If a mortgage tax credit is established in such a way as to compensate for the loss of subsidy through the bad debt reserve treatment, residential mortgage interest rates should not be higher as a result of this package. Indeed if anything they should be lower, as the tax credit would benefit all holders of mortgages. This would reduce direct Federal outlays on housing support programs.

Q. How would adoption of the President's recommendations on expanded powers affect mortgage markets both in the long run and cyclically?

A. The overall impact of the proposed changes on the mortgage market depends upon the relative magnitudes of two opposing effects.

First, expanded asset powers for thrifts, in and of themselves, might reduce the supply of mortgage funds from those institutions. However, the reduction would be small.

Elimination of interest rate ceilings for commercial banks would increase competition for savings and loan associations and mutual savings banks and thus contribute to the negative effect.

On the other hand since thrift institutions will be able to provide a broad range of consumer services, they would be in a stronger position to attract savings deposits. Since a good portion of these deposits would go into mortgages, the mortgage market would benefit.

Finally, the rate of personal savings in the economy might well increase, providing more funds for all financial intermediaries.

It is believed that the *net* effect on mortgage flows of all these nontax factors is approximately neutral. With an appropriate tax credit, the effect will be positive.

Additionally, an element of cyclical stability will be introduced. The new powers to be granted to thrift institutions would improve their ability to compete for funds, strengthen their cash flows, and thereby alleviate tendencies toward disintermediation (loss of deposits) during periods of financial restraint.

Q. Ignoring for the moment the mortgage tax credit, if the recommendations reduce the supply of mortgage funds, won't there be a corresponding decline in the supply of housing?

A. Not necessarily. Mortgage credit and housing finance are not identical. The former is only one constituent of the latter. Other constituents include personal wealth (e.g. savings accounts; funds from sale of current house) for home buyers and equity markets for the development and construction of housing projects and apartment houses.

The popular view is, however, that the rate of housing production is a captive of the amount of mortgage funds in both the short and long run. Those who believe this point to the data which show mortgage funds and housing moving together in the short run. However, that relationship is open to another interpretation: both housing and mortgages are simultaneously influenced by other factors. According to this view, high interest rates reduce housing production by reducing demand for housing and high interest rates channel funds away from thrifts (because of interest ceilings) which are legally required to invest in mortgages. Choosing between the two explanations is not easy. However, the most recent studies tend to support the second idea; credit conditions in general, not the availability of mortgage funds, influence housing over the long run. Over the short run the availability of credit is, however, a significant factor.

Under a contract to the Department of Housing and Urban Development, two Princeton University economists, Professors Ray C. Fair and Dwight M. Jaffee, prepared a report which attacks the problem directly. Using the Federal Reserve-MIT-Penn Model of the economy, the authors ran a number of tests simulating the impact of the Hunt Commission's recommendations during the 1960's. On the expanded powers, the President's recommendations are similar to those in the Hunt Report. The authors summarized the results of their tests as follows:

> "Our results indicate that the housing market would probably, on net, gain under the Hunt Report, while the mortgage stock may gain or lose depending on the specific assumptions. In any case, the magnitudes involved are small relative to the current outstanding stocks of these assets." *

Q. What implications would the recommended changes have for the conduct and effect of monetary policy?

A. The expanded deposit and asset powers for thrift institutions and banks, the abolition of interest ceilings, and the tax credit should make mortgage and housing markets less sensitive to changes in credit conditions.

Removing restrictions on interest paid on deposits would greatly moderate the shifts between deposits and other assets as market rates fluctuate. This would reduce the disorder in financial markets which has accompanied restrictive fiscal and monetary policies.

Q. What are "points."

A. A point is one percentage point of the total value of a mortgage loan. One or more points may be added to the homebuyer's closing costs to com-

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* Ray Fair and Dwight Jaffee, "An Empirical Study of the Implications of the Hunt Commission Report for the Mortgage and Housing Markets," HUD Contract H1781, April 1972, second page of Abstract.

pensate lenders when market rates on loans are above usury ceilings.

Q. What are Government National Mortgage Association tandem plans?

A. Tandem plans were employed by GNMA to add support to housing markets. Under those plans GNMA would buy mortgages typically at above market prices and sell them later at market prices to private buyers (often pension funds). GNMA would absorb any losses that might result.

Tandem plans were suspended June 28, 1973.

Q. What is the Federal National Mortgage Association's role in mortgage markets?

A. FNMA, a private corporation since 1968, has as its primary responsibility providing secondary market services by buying and selling FHA-insured, VA-guaranteed, and conventional mortgages. The great bulk of current holdings is composed of FHA-insured and VA-guaranteed mortgages.

FNMA was permitted to begin secondary market operations by the Emergency Home Finance Act of 1970. However, it did not begin actual operations until February 14, 1972. At the end of April 1973, FNMA held $133 million of conventional mortgages and its rate of activity has increased substantially in 1973 over 1972.

IX

UNIFORM RESERVES

Q. Is it true that the President's recommendations do not call for uniform reserves on all third-party or transaction accounts such as checking accounts or N.O.W. accounts?

A. Yes. Under the President's recommendations only members of the Federal Reserve and FHLBB systems will be subject to federally-set reserves on their transaction accounts. Membership in those two systems will remain optional for state chartered institutions. State non-member institutions will continue to have their reserves set by the individual states.

Q. Why do the President's recommendations exclude the request for uniform reserves?

A. The question of uniform reserves has been discussed at great length over the years, by formal commissions and congressional committees. Although not critical at this point, should the lack of uniform reserves impede the implementation of monetary policy, the question must rightfully be opened.

Q. What has been the practical effect of voluntary FR system membership for state chartered banks?

A. Voluntary Federal affiliation has been healthy for the system and spurred creative regulations. At the moment, about 40 percent of all commercial banks holding about 80 percent of all commercial bank demand deposits belong to the Federal Reserve system. Most newly chartered banks obtain state charters but few of them elect to become members of the Federal Reserve system. Of the 509 state chartered banks opened for business between end-1969 and end-1972, only 30 joined the Federal Reserve system. Small banks used the correspondent banking services of large banks and most large banks belong to the Federal Reserve system.

Q. Why is it important to have uniform reserves?

A. The FRB maintains that uniform reserves are essential for the efficient conduct of monetary policy.

The reasoning underlying that argument seems to fall into two parts. First, the fact that all banks are not subject to uniform reserves limits the effectiveness of changes in required reserves as an instrument of monetary management. Second, there is the fact that demand deposits in non-member banks do not respond directly to other techniques such as open market operations.

As a result of those two factors some contend that member banks bear a heavier burden during periods of credit restraint than do non-member banks.

Q. What has been the practical effect of the existence of non-member banks on the conduct of monetary policy?

A. There is no easy way to answer that question. However, as of June 1973 non-member banks held about 22 percent of all commercial bank de-

posits and about the same amount of demand deposits of individuals, partnerships, and corporations (IPC deposits).

Some argue that under existing conditions nonmember bank deposits need not affect the efficiency of monetary management. So long as the demand for deposit reserves by those banks is stable and predictable and so long as the FRB can control the supply of those reserves the efficiency of monetary management should not suffer.

However, over the longer run, changing circumstances may warrant a reexamination of this issue.

Q. Since the absence of uniform reserves has preserved the dual banking system, what advantages have accrued to the American public?

A. Generally, it has permitted an element of competition among supervisory authorities which has been conducive to innovation and experimentation by financial institutions. It has restrained supervisory authorities from over-zealously protecting existing firms by restricting entry.

Non-member bank deposits need not affect the type experiments on such issues as capital adequacy, capital debentures, and the extension of ancillary services such as data processing services, insurance services, messenger services and the like.

State law and federal law are not the same on those issues and thus some banks have more freedom on the issues than others. They have used that freedom to experiment. And supervisors have learned from those experiments. In some cases the freedoms have been extended to those who had not previously enjoyed them.

If preserved, the dual banking system can continue to serve the public interest and keep the federal system alert.

EFFECTS ON HOUSING OF CHANGES IN FINANCIAL STRUCTURE

The effect on housing of the recommended changes in financial structure can usefully be examined in two parts. First, the overall effect of all the changes except the tax changes can be estimated. Then the tax recommendations can be evaluated. Since the mortgage interest tax credit can in principle be set at any level, it can be established in such a way as to ensure that the overall impact on housing is not adverse.

However, the overall impact of the nontax recommendations together is not likely to be adverse. For that reason, the mortgage tax credit can be established on the basis of subsidies lost when existing tax treatments are changed.

Important to the issue concerning the effects of the Administration recommendations on housing is what effect, if any, the specialized system of mortgage finance has had on housing in the United States. Yet, as the Interagency Task Force Study on Housing chaired by the Council of Economic Advisers makes clear, it is important to realize that this is not the only consideration. There are two important central issues here. The first is what effect, if any, the recommendations will have on the supply of mortgage credit. The second is what effect a change in mortgage credit will have on housing. Even if the recommendations would decrease the supply of mortgage credit, as seems unlikely, it does not follow that anything like a corresponding effect must be transmitted to housing. The last point is not widely understood and merits elaboration.

As a matter of definition, a mortgage is secured by an existing (or potentially existing) house, but the creation of a new mortgage does not imply that new construction will necessarily take place. Nor does the construction of a new house in all cases require a mortgage.

First of all, "mortgage money" is widely used to finance existing housing in addition to newly constructed housing. Indeed, a homeowner may mortgage his house in order to pay for his children's college expenses, or to finance the expansion of his business. A larger mortgage may be sought to enable the home buyer to purchase furniture.* A family may choose a larger or a smaller mortgage, depending on its savings and other sources of potential borrowing. In general, mortgage credit (like any other kind of credit) is "fungible." That is, it can be used for any purpose the borrower chooses.**

Moreover, a mortgage is only one among a variety of sources of funds available to the borrower, whether he seeks money to acquire a house or for any other purpose.*** A family which owns its home outright may finance a new house simply by selling the old one. When outside financing is chosen, it can come either from a mortgage or from several other sources.

Furthermore, the financing of new housing involves not only homeowners but many other categories of investors. The following is a partial list of the types of financing which play a role in the production of housing:

(i) equity investment
—the accumulated savings of homeowners;
—equity for the development and construction of large housing projects, and
—equity investments in apartment houses.

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* In 1971, 35.1 percent of new S&L mortgage loans were classified as for purposes other than housing. Only 17.3 percent were classified as for the purpose of home construction.

** A typical household has a variety of outstanding liabilities (a mortgage, an auto loan, unsecured borrowing, credit card debt, and so on) which have been used to finance its assets. Fundamentally, there is no way to tell which specific asset is financed by which specific liability even though (in certain cases) one can specify which asset is used as collateral to back a specific loan.

*** The technical question is the size of the cross-elasticity of demand between mortgage borrowing and other forms of financing (such as the use of accumulated savings) for the purpose of residential construction. If this elasticity is very high, then, at the margin, funds from other sources are close substitutes for mortgage funds, and the demand for housing is determined independently of the supply of funds.

(ii) construction financing

—short-term debt money for developers and builders during the development and construction phases of housing.

(iii) other debt financing

—long-term mortgage funds for consumers;

—long-term mortgage funds for investors for the purpose of buying and renting housing units, and

—short-term loans for consumers and investors for repair and rehabilitation of housing.

These other sources of financing can (and sometimes do) act as substitutes for mortgage credit. In sum, mortgage credit and housing finance are not identical: the former is only one constituent of the latter.

Frequently, however, the distinction between them has been blurred. The popular view, which is held by many mortgage practitioners and home builders, as well as by some economists, regards the rate of housing production to be a captive of the *amount* of mortgage funds available—in both the short and long run. This view, which may be called the "bottleneck" hypothesis, is held so widely and firmly that few writers, at least until recently, have felt that it is open to question.*

Proponents of this view believe that specialized financial institutions provide additional funds for some borrowers to which they would not otherwise have access. They argue that savings and loan associations and mutual savings banks have produced higher mortgage flows and lower mortgage rates than would otherwise occur because they are forced to invest in mortgages. Thus, they contend that if the financial institutions which funnel funds to the mortgage markets are allowed to reduce their specialization because of the administration's recommendations, the flow of money for mortgages will be reduced and mortgage interest rates will rise.**

If this "long-run bottleneck" view is correct, then policy measures which subsidize or support the mortgage market (holding general credit conditions constant) will also increase the rate of housing production in the long run. Measures which support the mortgage as such will be effective without subsidizing housing directly.

Proponents of this view have supported their case by noting that mortgage flows and housing move together in the short run. Actually, several different interpretations of this numerical relationship are possible, including:

(a) the rate of housing construction is influenced by the supply of mortgage credit;

(b) the demand for mortgage credit is influenced by the rate of housing construction;

(c) mortgage credit flows and the rate of housing construction are influenced simultaneously by outside variables.

Although the first of these views is the popular one, it is the third which follows most naturally from received economic theory. According to this view, the mortgage and housing markets are stimulated or contracted simultaneously by outside influences—in the short run notably by fluctuations in general credit conditions.

The reasons are straightforward and combine two effects. First, when market interest rates rise, households defer long-term borrowing and purchases of long-lived assets, such as housing. Second, higher open market rates induce the public to move out of deposits at thrift institutions into marketable securities since these institutions cannot increase their interest rates on deposits by as much as the rise in open market rates. When the latter fall, funds shift back to institutions.

Thus, high interest rates (i) reduce housing production by decreasing the demand, and (ii) reduce mortgage flows by channeling savings away from the financial institutions that are legally required to invest heavily in mortgages. Such a mechanism would explain why the mortgage and housing markets have often moved closely together in the past. This view places little stress on the *structure* of financial institutions as a determinant of long-run mortgage flows, housing production and mortgage interest rates.

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*A paper by Arcelus and Meltzer contains a critique of the "bottleneck" hypothesis and some empirical evidence against it. See Francisco Arcelus and Allan Meltzer, "The Markets for Housing and for Housing Services," forthcoming in *Journal of Money, Credit and Banking*. Criticisms of the popular view began to appear in the literature many years ago, but have been largely ignored by the dominant school of thought. Other critics include Brunner, Hester, Jacobs, Mayer, and more recently Geisel and Jaffee.

**This argument would, of course, apply to only one part of the recommendations, i.e., that part pertaining to the investment powers of savings institutions. As described subsequently other changes proposed for the savings institutions would provide them with the potential to attract more funds.

Credit can and does flow to ultimate users via a number of routes. A dollar flows to where it can earn the best return, given risk, term to maturity, tax status, and so on. Thus, no one type of borrowing group can enjoy special rates, independent of such attributes, that arise from institutional constraints. Similarly, specialized institutions do not provide increased access to capital for special purposes such as housing.

This view says that a savings and loan association, for example, must be able to compete with other investment opportunities if it is to attract savings from the consumer. If the operation of S&Ls increased the aggregate flow of mortgage funds and lowered mortgage rates below rates of return in the other sectors of the financial markets, S&Ls would be in a weak position to compete for deposits and capital. At the same time, there are other types of financial institutions which provide funds to mortgage borrowers. If S&Ls increased their investment in mortgages, mortgage yields would fall, inducing other suppliers of credit to reduce their mortgage investments.

This approach implies that changes in the supply of mortgage funds, holding general credit conditions constant, will not materially affect housing construction. In this case, indirect policy measures such as the government purchase of mortgages will not succeed in stimulating housing in the long run because government lending simply displaces other lenders. In the short run (up to a year), a stronger case can be made that government purchases of mortgages will have a positive impact on the mortgage and housing markets, and this fact should not be lost sight of.

It is difficult to design and conduct a definitive empirical test of whether housing demand is more responsive to mortgage flows or interest rates. The best available work found by the housing study group supports the interest rate hypothesis. It is also very significant that a number of European countries have experienced the same type of behavior of mortgage flows, housing production and interest rates. This has occurred despite wide variety in the institutional structure by which housing is financed. Accordingly, the Task Force leaned toward the view that the financial effects on housing production operate primarily through general credit conditions and not through the specific characteristics of the mortgage market. Housing production is also presumably affected by economic variables specific to the housing industry itself. The Task Force accepted that credit rationing may occur in the very short run, but was persuaded that over any significant period of time it is the general level of interest rates, rather than the flow of mortgage credit, which acts as the rationing instrument for housing and other durable assets.

There remains the question of how the Administration's recommendations will affect the flow of funds into the mortgage market. This is still a relevant question for two reasons. First, nearly all economists agree that in the short run (about a year or less) changes in the availability and flows of mortgage credit importantly influence housing production. Second, it is of interest to note how the housing stock will be financed in the future. The impacts can be separated into cyclical and long-range.

It is hard to imagine how these recommendations could increase the cyclical variability of housing compared with recent years. The Task Force believes they will decrease it substantially by decreasing short-run disruptions of mortgage flows. This will result from two important sets of changes. First, traditional mortgage lenders will have their cyclical viability strengthened by broadened powers to hold assets and issue liabilities. Second, mortgages themselves will be made more attractive to nontraditional lenders as a result of the mortgage interest tax credit and improvements in the secondary market for mortgages.

Asset restrictions on thrift institutions and the poor development of a secondary market have made it very difficult for thrifts to weather periods of credit restraint for these reasons:

1. The absence of a secondary market in mortgages means that the institutions may not be able to sell their mortgages even with the appropriate capital loss, in order to meet the outflow of deposits.

2. The long-term maturity of mortgages and the resulting low rate of repayment and turnover implies that considerable time may be required before savings institutions can adapt to higher or rising interest rates.

3. The legal prohibitions on investment alternatives and portfolio composition that are placed on savings institutions limit the pool of alternative

assets that they could otherwise sell as an aid in their adjustment problem.

For all of those reasons, the ability of institutions to withstand loss of deposits is hampered by enforced specialization of investments. If their assets were diversified, savings institutions would be able to retain deposits more easily, and thus would not have to restrict new lending so severely. Consequently, the relaxation of portfolio restrictions is expected to help stabilize the short-run cycles in mortgage financing of residential building.

Liability restrictions have similarly made it hard for thrift institutions to maintain their mortgage lending when rates rise:

1. Interest rate ceilings limit their ability to compete with securities markets for funds.

2. Savings institutions are not entirely free to offer new types of deposits and other obligations that may increase their flow of funds.

3. They cannot issue demand deposits, which

(a) May have the advantage of being less interest sensitive than savings deposits; and

(b) Will allow them to provide to the customer services which he formerly had to obtain from a commercial bank.

Again, relaxation of these restrictions will help stabilize the capacity of institutions to provide housing finance in times of tight money. However, while deposit rate freedom should assist thrift institutions to maintain mortgage flows, it will not necessarily reduce the cyclical instability of housing construction. Given relatively elastic housing demand, a significant increase in the interest rates would still imply a significant contraction of residential construction.

Removal of state usury laws and Federal ceilings on insured mortgages should help mortgages attract funds. Use of variable rate mortgages may also do this and may help institutions raise their deposit rates to retain funds when market rates rise. The Task Force is not convinced that variable rate mortgages will be as beneficial as their proponents assert, but sees no reason to impede their use in the private market.

All these changes will stabilize the flow of funds into the mortgage market during periods of high interest rates. Accordingly, they will help eliminate pressures on the housing market caused in the past by the virtual withdrawal of thrift institutions from mortgage lending at these times due to their own precarious positions. Housing production will not be made constant over the cycle, nor should it be, since the demand of housing is highly sensitive to interest costs.

The long-run prospects for funds flowing into mortgages are harder to evaluate. The relevant changes recommended are: (1) relaxed restrictions in investment powers, (2) broadened powers to offer financial services, (3) relaxed restrictions on borrowing powers, (4) equal tax treatment, and (5) removal of obstacles to mortgage lending. Changes (2), (3), (4), and (5) should help mortgage and housing markets, while (1) tends to remove funds from the mortgage market.

Relaxed Restrictions on Investment Powers

The potential mortgage market impact of the proposals expanding lending powers is not simple to analyze.* At first blush, the ability of thrift institutions to invest in assets other than mortgages implies that mortgage flows would be lower. There are important qualifications to this view, however. By investing some of their money in nonmortgage assets, savings institutions will earn a higher rate of return and thus be able to offer higher deposit rates. As a consequence, savings flows could be higher. In addition, allowing savings institutions the opportunity to provide consumer loans will enable them to compete more effectively for consumer savings. When other factors are equal, convenience and familiarity lead people to borrow and to lend with the same institution. Thus, while competitive responses from commercial banks should not be excluded, one effect of allowing savings institutions to offer consumer loans could be larger savings flows to these institutions in the long run. To the extent that there is a greater flow of savings arising from both of these effects, the mortgage and housing markets will benefit.

Broadened Powers To Offer Financial Services

It is proposed that savings institutions be allowed to extend their service functions to consumers. The most important function would be the third-party payment services (primarily the issue of demand deposits). If savings institutions

*See Dwight Jaffee, "The Entry of Savings Institutions into the Consumer Loan Market," Princeton University, February 1972.

could do so, their competitive position vis-a-vis other financial institutions, primarily banks, would be improved substantially. Savings institutions would be better able to compete for the funds of those savers who prefer one-stop banking. As a consequence of this recommendation, savings institutions will thus be in a better position to provide more funds to housing. At the same time, when commercial banks are faced with demand deposit competition, they will need to be more responsive in meeting consumer mortgage demands. In the past, a bank could send a consumer to a savings bank when a mortgage was needed and be relatively confident that that consumer's other business would remain with the bank.

Relaxed Restrictions on Borrowing Powers

Insofar as deposit rate ceilings faced by commercial banks are more severely constraining than those of savings institutions, their elimination would enable commercial banks to compete more vigorously for deposits. If deposits were drawn away from savings institutions, the net effect on aggregate mortgage flows would be negative. This effect could be blunted, however, by higher overall deposit flows to depository institutions induced by higher deposit rates. This would mean that funds were being bid away from other segments of the financial markets or that aggregate saving in the economy was increasing.

Equal Tax Treatment

The Task Force recommends two basic tax principles which, if jointly put into law, could have a positive impact on mortgage flows. First, Congress should enact a uniform tax formula for all depository institutions. Second, a mortgage interest tax credit should be allowed on mortgage investments. This credit would be based on gross interest income from residential mortgages. The credit would be allowed to all investors in such loans, and not solely financial institutions. Such a credit could completely replace the hidden tax subsidy implicit in the tax laws which allow savings and loan associations tax advantages. Of course, the impact of these tax proposals on the mortgage market will depend on how the tax laws are written and the size of the mortgage investment tax credit.

Mutual savings banks and savings and loan associations currently enjoy a tax advantage because their bad debt reserve deduction on qualifying real property loans exceeds actual default experience. The deduction allowed is dependent on an organization having a stipulated percentage of its total assets invested in a prescribed list of assets, the most important of which is mortgages. Thus, current tax laws for these savings institutions provide an incentive for investments in mortgages and supposedly an incentive for investment in housing. The mortgage investment incentive is limited, however, since it is not available to other types of institutions.

One approach in implementing a uniform tax structure for all depository financial institutions would be to base the bad debt reserve on actual default experience. This is currently the direction in which commercial bank taxation is moving. If this route were followed, and there were no offsetting tax credit on mortgage investments, mortgage flows from these institutions could decline. However, any such decline could be offset by implementing the mortgage tax credit proposal, which would act as a subsidy to mortgage flows.

Removal of Obstacles to Mortgage Lending

The Hunt Commission also proposed a number of ways in which the mortgage market could be made a more flexible instrument for financing housing. Since some of these require state action, while others simply exhort existing institutions to continue and expand what they are already doing, these recommendations were not included in the Task Force's overall judgment about the impact of the recommendations on mortgage flows.

The question here is how all these effects add up. The answer to this question will come primarily from judgment, but there is some empirical evidence which can contribute to judgment. Under a contract to the Department of Housing and Urban Development, two Princeton University economists, Professors Ray C. Fair and Dwight M. Jaffee, have prepared a report which attacks the problem directly. Using the Federal Reserve-MIT-Penn Model of the economy, the authors ran a number of tests simulating the impact of the recommendations during the 1960s. The authors summarized the results of their tests as follows:

> "Our results indicate that the housing market would probably, on net, gain under the

Hunt Report, while the mortgage stock may gain or lose depending on the specific assumptions. In any case, the magnitudes involved are small relative to the current outstanding stocks of these assets."*

*Ray Fair and Dwight Jaffee, "An Empirical Study of the Implications of the Hunt Commission Report for the Mortgage and Housing Markets," HUD contract H1781, April 1972, second page of Abstract.

To date, the Jaffee-Fair study has been the only direct empirical analysis of the recommendations, although there is a large empirical literature on the mortgage and housing markets. Other studies, using different econometric techniques, would be desirable. The interagency study group finds that the impact of the Hunt Commission proposals on the long-range flow of mortgage credit cannot be determined with any degree of precision, but may well be approximately neutral.

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