

# The Hunt Commission Report – An Economic View\*

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*The views and interpretations stated below are those of the author and do not necessarily reflect the opinions or policies of the Board of Governors of the Federal Reserve System or of the Federal Reserve Bank of St. Louis.*

**T**HE HUNT COMMISSION, appointed by President Nixon to study the structure and regulations of the nation's financial institutions, was composed of ten executives of financial agencies, six executives of other firms, two academic economists, one labor union leader, and an attorney-politician. The professional staff which apparently exercised a major influence in formulating both the objectives and final recommendations of the report consisted largely of economists. Chief staff roles were played by the Co-Directors Donald Jacobs of Northwestern University and Almarin Phillips of the University of Pennsylvania.

The President issued the Commission a 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."<sup>1</sup>

The Commission's intermediate objective in carrying out this mandate was "to move as far as possible toward freedom of financial markets and equip all institutions with the powers necessary to compete in such markets."<sup>2</sup>

The Commission recognized that most of the problems of our financial system are the result of legislation enacted in response to financial crises, such as

that of the early 1930s. The Commission recognized that the resulting overly-protected financial system is not suited to efficiently meet the nation's current demands for financial services and outlined a series of proposals to make it more competitive and flexible. From an economic view the proposals generally elicit favorable comment.

In consequence, my discussion consists largely of providing theoretical background for some of the recommendations which lacked such a foundation and offering some criticism of minor features of the proposals which appear to be the result of compromises between the occupational interests of some Commission members and the Commission's overall objectives.

## *Competition in the Private Enterprise System*

An economist views a competitive private enterprise system as an elaborate mechanism that unconsciously coordinates the production of goods and services through competitive prices and markets. Each good and service, including the different kinds of human labor, has a price. Although the true price of a commodity is the amount of all other goods and services foregone, it is convenient to express prices in money units. Everyone receives money for what he sells and uses the money to purchase what he desires. If people want more automobiles they will bid up the price and the higher priced automobiles will provide incentive for increased automobile production.

The competitive price mechanism thus brings into equality production and consumption of each good and service. Such a mechanism assures that producers will produce at the lowest possible cost since, if they

\*This presentation was given before a group who had some prior knowledge of the contents of *The Report of the President's Commission on Financial Structure & Regulation*, commonly known as the Hunt Commission Report. Interested readers may find it helpful to consult the *Report* for more complete information on the points discussed.

<sup>1</sup>*The Report of the President's Commission on Financial Structure & Regulation* (December 1971), p. 1.

<sup>2</sup>*Ibid.*, p. 9.

fail to economize on labor or other resources, competitors can undersell them and attract their customers. Higher profits are awarded to the most efficient producers and reduced profits or losses are incurred by the less efficient. In the absence of external effects of production, such as pollution, the free competitive system works most efficiently with a minimum of legal interference.

Financial institutions, which constitute a major sector of our private enterprise system, are subject to the same competitive forces as other firms. Commercial banks purchase time and savings deposits, attract demand deposits, make loans, sell investment funds and trust services, and perform numerous other services incidental to banking. Other financial firms also purchase and sell financial claims and services.

Those firms that can buy, service, and sell most efficiently will tend to grow the fastest and make the greatest profits. They will tend to innovate more readily, have greater flexibility, and contribute more to community prosperity and growth than the less efficient firms. With these objectives in view, the Hunt Commission proposed that the legal restrictions on financial institutions be loosened somewhat to permit greater competition among firms. It believed that the present excessive legal restraints have both retarded the growth of the more efficient financial firms and slowed general economic development.

During the course of my discussion, I do not take the recommendations one by one, but group them into broad classes having common characteristics relative to the functioning of financial markets.

### *Proposals for Relaxing Interest Rate Restrictions*

First, I shall comment on the Commission's proposals for removing restrictions with respect to interest rates. These recommendations call for phasing out interest rate ceilings on time and savings deposits and dividend restrictions on savings and loan association shares, providing for market rates on FHA and VA loans, and removing statutory rate ceilings on mortgage loans.

Interest rate ceilings were authorized at the Federal level during the early 1930s to prevent so-called "cut-throat" competition. The large number of bank failures at that time were believed by some observers to be the result of "excessively risky loans" which banks were forced to make in order to maintain competitive interest rates on deposits. Thus, a mass of New Deal legislation was enacted to reduce such competition. Banks

were prohibited from paying interest on demand deposits, and regulatory authorities were given a responsibility to set ceiling rates on time and savings deposits. A cursory examination of banking since then gives the appearance that the program has been highly successful. Bank failures have indeed declined to a very low rate.

The reduced rate of bank failures, however, cannot be traced to the interest rate ceilings. The rate of failures since the Great Depression of the 1930s has been no greater in those years when market rates were paid on time and savings deposits than when Regulation Q restrictions prevented the payment of market rates. For example, since 1945 there have been seven years when Treasury bill rates were generally above the maximum ceiling rates on savings deposits, thus preventing banks from paying the market rate for savings. During these years an average of 5.29 banks failed per year. Almost the same rate, 5.17, failed per year during the eighteen years when Treasury bills were well below the ceiling rates on time and savings deposits.<sup>3</sup>

The modest proposals of the Commission for reducing such restrictions were certainly in the right direction, but they were made with the apparent fear of treading on quicksand when in fact the foundation was solid. As indicated earlier, during most of the period since the Great Depression the ceilings on time and savings deposit rates have been sufficiently high to be ineffective. Nevertheless, few failures have occurred.

Hazardous situations for bank survival have occurred only in periods following sharp variations in money growth from the trend rate, as in the years since 1965. During this period of rapid money growth, spending and prices rose sharply and inflationary expectations were reflected in higher interest rates. The market rates rose above the ceilings and financial intermediaries were prohibited from paying competitive rates. The inflow of savings declined as savers found other types of investments that yielded higher returns. The restrictions were thus probably more damaging than helpful to the survival of financial intermediaries.

The Commission wisely recommended that the rate restrictions on FHA and VA loans be removed. Prior to limiting the points that could legally be charged borrowers under the FHA and VA programs, the point

<sup>3</sup>For a comprehensive analysis of the impact of interest rate regulation see Albert H. Cox, Jr., *Regulation of Interest Rates on Bank Deposits* (Ann Arbor: University of Michigan, 1966), and George J. Benston, "Interest Payments on Demand Deposits and Bank Investment Behavior," *Journal of Political Economy* (October 1964), pp. 431-449.

spread between the face amount of the mortgage and the amount of funds actually disbursed accounted for the difference between the legal and market rates. Once the points that could be paid by purchasers were limited by law, sellers were forced to make up the difference between legal and market rates by raising their selling price on homes, thus creating an additional problem in real estate sales. The proposal that such mortgages be made at market rates would involve fewer calculations and less effort in shopping for and transacting real estate business.

Although the recommendation that states remove the statutory ceilings on mortgage loan rates is another move toward market determined rates, I see no reason why the recommendation was limited to mortgage loan rates. All loan rate limitations channel funds into less risky loans and deny borrowers who have limited assets the right to pay higher rates to cover such risks. Since lenders make only the less risky loans when rates are actually restricted, the restrictions in effect deny higher risk borrowers access to credit markets. Competition among lenders will assure a market rate to borrowers in the same manner that commodity and other prices are determined in competitive markets.

The Commission pointed out the problems involved in enforcing the prohibition of interest payments on demand deposits. Among the numerous substitutes and subterfuges used to escape the regulation are provisions for "free" services, lower loan rates to those having large deposits, and third party payments by savings and loan associations. A firm or business selects the bank that will provide the package of banking services with the greatest return at the least cost. Thus, if legal restrictions prohibit the payment of the market price for one type of service, the impact of such restrictions will likely be offset by price or service concessions elsewhere.

Despite the use of numerous substitute payments, money is the more efficient means of payment. Other forms of payment lead to poor allocation of resources, since money is the only means whereby all can maximize their returns on deposits at the margin. Nevertheless, the Commission concluded that the undesirable effects of the immediate abolition of the prohibition of interest payments on demand deposits would be greater than the costs imposed by its continuation.

### *Relaxing Operational Restrictions on Financial Institutions*

The proposals that structural and operational restrictions on financial institutions be relaxed should

lead to lower cost financial services. The removal of restrictions, such as limitations on branch banking, and the relaxation of loan and investment restrictions on savings and loan associations (S&Ls) and mutual savings banks should increase the ability of these firms to compete in all markets. Permitting S&Ls and mutual savings banks to accept checking accounts and all the depository institutions to sell and manage mutual funds should likewise lead to greater competition in both banking and the mutual fund business.

The proposals would permit S&Ls and mutual savings banks to compete with commercial banks in servicing checking accounts and convert to commercial banks if they so desire. If they want to become commercial banks, I see no reason why their access to the banking field should be prohibited. Furthermore, I see no reason for the continuation of limited entry into banking as long as the participants can provide assurance of reliability.

It has been argued that banking is a special type of industry into which entry should be limited to protect vital public interests. For example, it is argued that medicine, steamfitting, plumbing, law, and the clergy require special licensing by the state or some association to assure the safety of the public. To such arguments I would reply that the restrictions to entry have always been passed with a grandfather clause; that is, those who were then in the occupation could remain.

If public safety were the major factor, the unqualified should be removed at the time entry is restricted. In addition, if public safety were foremost in view, regular examinations would be required to see that those in the occupation remained qualified. New techniques often result in old methods becoming obsolete. Instead of such assurance that current practitioners remain qualified once a license is obtained, license holders generally have a right to a lifetime practice without further qualification. I thus conclude that most licensing and chartering restrictions are used primarily to restrict entry and provide an element of monopoly power to those already in the business and are in fact not in the public interest.

The conversion proposals, along with others which provide for additional chartering powers, tend to loosen the restrictions on entry into banking. With more agencies having power to charter banks or depository institutions which have free conversion privileges among themselves, we may again approach free entry into the finance business. With free entry we can remove most bank holding company and merger restrictions. Such restrictions will then be obsolete since monopoly is almost impossible given the

relatively small efficiencies of scale among financial institutions, except for the very small firms.

The Commission recognized the fact that branching can increase competition in many bank markets.<sup>4</sup> Nevertheless, it failed to recommend Federal legislation on this subject. For example, it could have proposed that the National Banking Act be amended to permit statewide branching by national banks. Instead, it recommended that state laws be changed to permit statewide branching. This recommendation provides for little optimism that changes in bank structure will be forthcoming, given the deliberation with which most states move, when they move at all, to improve banking services. One can only conclude that a significant amount of compromising among the Commission members led to such a recommendation.

### *Public Welfare Goals*

Throughout the report there is considerable discussion about housing goals. The Commission, however, logically refused to make recommendations for special financial agency regulations designed to increase credit flows into the housing market.<sup>5</sup> It apparently could not resist completely the pressure for so-called socially desirable credit, however, since it did recommend special tax credits to investors in residential mortgages. However, as pointed out by two dissenters, such credits would mean heavier taxes elsewhere and fewer financial resources in the nonhousing sector of the economy.

### *Insurance on Bank Deposits and S&L Shares*

In view of the proposal that savings and loan associations and mutual savings banks be permitted to function more like commercial banks, the Commission's recommendation that all depository insurance corporations be combined into the Federal Deposit Guarantee Administration is appropriate. Nevertheless, the Commission rejected any change in the current method of assessing premiums at a fixed percent of deposits, despite substantial variations in portfolio risks among banks. In addition, the proposals, if implemented, may further widen the variation of risks among firms. For example, if S&Ls and mutual savings banks are permitted to invest in equities up to 10 percent of their assets, their portfolios will carry greater risks than under current operating practices. Similarly,

commercial bank risks will increase if some banks invest in the proposed special purpose equities such as community rehabilitation projects.

The increased competition within the financial system provided in the proposals should warrant the establishment of deposit insurance rates in some relationship to risk. Even under current supervisory regulations, deposit insurance assessments could be used instead of moral suasion to achieve desired objectives, such as capital to asset ratios consistent with risks in individual firms and minimum insurance premiums consistent with a reasonably competitive financial system.

There are significant reasons why the deposit insurance assessments should be made on the basis of risks. First, if all financial firms pay the same rate of assessment on deposits, those with higher risk assets are being subsidized to the extent that such banks are a heavier expense to the insuring agency. Thus, there is some incentive to increase risks given the current inflexible system of assessments. With the increased competition in prospect, the incentive to take greater risks may be increased.

More to the point, however, equity capital in any organization is designed to be the chief risk taker. Since the FDIC has assumed much of the banking risks, it has replaced part of the risk bearing function of equity capital. Banks have thus found it profitable to permit their capital to asset ratios to drift downward since there is little incentive for high ratio maintenance. With a higher assessment on banks with low capital ratios, they will have greater incentive for building up capital and reducing deposit insurance costs.

### *Reserve Requirements*

The Commission's recommendations that all institutions holding demand deposits be required to become members of the Federal Reserve System would place them all under similar competitive rules. Likewise, the proposals for eliminating reserves on time and savings deposits, equal reserve requirements for all banks, and the gradual reduction of reserve requirements over time are moves intended to achieve greater equity among financial firms.

### *Chartering, Regulations, and Supervisory Recommendations*

The recommendations for granting federal charters to stock savings and loan companies, mutual savings banks, and mutual commercial banks will tend to in-

<sup>4</sup>*The Report of the President's Commission on Financial Structure & Regulation*, p. 45.

<sup>5</sup>*Ibid.*, pp. 84-85.

crease competition. As pointed out in the report, when a particular type of financial institution can be chartered by only one administrative agency, the agency tends to become over-zealous in protecting existing firms and forecloses entry by new firms. It is much easier to appease existing firms with a charter denial and confuse the public with the comment that the area is becoming "overbanked" than to serve the public interest by granting charters freely.

As pointed out earlier, I can see no reason why free entry will cause overbanking, overfarming, or an excess of participants in any industry. As long as there is sufficient incentive in an occupation to attract new entrants with their labor and capital, any legislative or administrative action to limit entry reduces efficiency in the production of goods and services.

The proposal that any depository institution has the right to change its charter to that of another type of depository institution should help to assure that overly protective chartering will not occur. If any of the numerous chartering agencies will freely grant charters, there should be relatively free entry into each type of financial activity.

Most of the proposals for restructuring the regulatory and supervisory agencies apparently have little economic content. The new office of Administrator of State Banks would be an independent agency taking over most of the bank supervisory functions of the Federal Reserve System and the FDIC. The Comptroller of the Currency's function would be removed from the Treasury Department and made an independent agency. The Commission felt that these moves would tidy up the administrative functions and leave the Federal Reserve System free to concentrate its attention and resources on economic stabilization policy.<sup>6</sup> I have some reservations, however, in concurring with the view that the additional concentration on stabilization objectives will provide much improvement in stabilization actions. Nevertheless, there may be some specialization gains.

### *Single Tax Formula*

The proposals for enactment of a single tax formula for all financial agencies which hold demand deposits and an eventual uniform tax formula for all deposi-

<sup>6</sup>*Ibid.*, p. 91.

tory institutions offering third party payment services are consistent with maximum efficiency. The Commission urged Congress to enact a tax system that would provide for uniform tax treatment for such firms whether organized on a stock or mutual basis. Currently, firms organized on a mutual basis generally receive more favorable tax treatment. There is little justification for different tax rates for firms just because they happen to be organized differently. If one type of financial intermediary pays less tax, it is in effect being subsidized by those paying more. Under such an unequal tax system there is no means of determining whether a firm can operate competitively. If it cannot operate in a competitive market without subsidies, it should not be in existence since it is wasting valuable resources.

### *Summary*

In summation, the Commission's recommendations are generally consistent with the goal of increasing competition in a private enterprise economy. Its proposals for broadening the activities of financial firms and reducing their structural rigidities are all consistent with greater efficiency. The proposals for tax equality and greater uniformity of operating rules, such as reserve requirements and portfolio holdings, tend to provide greater equality of opportunity for profitable operation. The most efficient firms survive and prosper under such conditions and the less efficient tend to drop out and are taken over by the survivors. Relatively free entry and exit are typical of competitive firms. Such a system meets our demands for goods and services at the lowest per unit cost. The Commission's proposals would move our financial system a long step toward greater competition.

My major complaints with the proposals are the timidity shown in certain recommendations, such as the ten-year interval for removing interest rate controls on time and savings deposits, the hesitancy in recommending freedom for banks to purchase demand deposits, the useless recommendation that states permit statewide bank branching, and the lack of analysis with respect to deposit insurance assessments. These failures, however, can probably be attributed to compromises which were necessary to reach the major agreements in the report. Thus, the recommendations were probably the best obtainable given the occupational interests of the Commission members.

