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Statement by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking and Financial Services

House of Representatives

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It is a pleasure to appear before the Committee to present the views of the Federal Reserve on the need to enact legislation to modernize the U.S. financial system. The Federal Reserve continues to support strongly the enactment of such legislation and believes that H.R. 10 contains the fundamental principles that should be included in such legislation. I commend the Committee for taking up this vital matter so promptly.

The Need for Financial Reform

U.S. financial institutions are today among the most innovative and efficient providers of financial services in the world. They compete, however, in a marketplace that is undergoing major and fundamental change driven by a revolution in technology, by dramatic innovations in the capital markets, and by the globalization of the financial markets and the financial services industry.

For these reasons, we support, as we have for many years, major revisions, such as those included in H.R. 10, to the Glass-Steagall Act and the Bank Holding Company Act to remove the legislative barriers against the integration of banking, insurance and securities activities. There is virtual unanimity among all concerned--private and public alike--that these barriers should be removed. The technologically driven proliferation of new financial products that enable risk unbundling have been increasingly combining the characteristics of banking, insurance, and securities products into single financial instruments. These changes, which are occurring all over the world, have also dramatically altered the way financial services providers operate and the way they deliver their products.

In the United States, our financial institutions have been required to take elaborate steps to develop and deliver new financial products and services in a manner that is consistent with our outdated laws. The costs of these efforts are becoming increasingly burdensome and serve no useful public purpose. Unless soon repealed, the archaic statutory barriers to efficiency could undermine the global dominance of American finance, as well as the continued competitiveness of our financial institutions and their ability to innovate and to provide the best and broadest possible services to U.S. consumers.

We believe that it is important that the rules for our financial services industry be set by the Congress rather than, as too often has been the case, by banking regulators dealing with our outdated laws. Only Congress has the ability to fashion rules that are comprehensive and equitable to all participants and that guard the public interest.

The market will continue to force change whether or not Congress acts. Without Congressional action, changes will occur through exploitation of loopholes and marginal interpretations of the law that courts feel obliged to sanction. This type of response to market forces leads to inefficiencies and inconsistencies, expansion of the federal safety net, potentially increased risk exposure to the federal deposit insurance funds, and a system that will undermine the competitiveness and innovative edge of major segments of our financial services industry. Delay in acting on financial modernization legislation limits Congress's options as these developments proliferate and complicate, increases the difficulty of enacting the safeguards included in H.R. 10 to protect safety and soundness and the public interest, and denies to consumers the benefits that immediate changes in our outdated banking laws will surely bring.

H.R. 10 also recognizes another dimension of the changing nature of banking and financial markets: that financial modernization means more than authorizing new powers and affiliations. Not only are we experiencing a revolution in financial products and their delivery, the U.S. is also at a historic crossroads in financial services *regulation*. It is becoming increasingly evident that the dramatic advances in computer and telecommunications technologies of the past decade have so significantly altered the structure of domestic, indeed, global finance as to render our existing modes of supervision and regulation of financial institutions increasingly obsolescent.

The volume, sophistication, and rapidity of financial dealings will inevitably lead to supervisory emphasis on oversight of risk management of financial institutions and a marked scaling back of outmoded loan file and balance sheet surveillance. As we move into the twenty-first century, the remnants of nineteenth century bank examination philosophies will fall by the wayside. Banks, of course, will still need to be supervised and regulated, in no small part because they are subject to the safety net. My point is, however, that the nature and extent of that effort needs to become more consistent with market realities. Moreover, affiliation with banks need not--indeed, should not--create bank-like regulation of affiliates of banks.

This shift in supervisory mode, which is already underway, is market driven. It is not the result of some potentially reversible ideology. Such an approach is captured in H.R. 10 in many of the so-called "Fed-light" provisions, and we at the Fed strongly support this approach.

H.R. 10 also, in our judgment, has chosen the appropriate structure to combine banking, securities and insurance firms using financial service holding companies. While we enthusiastically support the new powers granted to financial service holding companies, we just as strongly believe that they should be financed by the marketplace, not by instruments backed by the sovereign credit of the United States. The requirement that the new powers be conducted through holding company affiliates minimizes the expansion of the use of the subsidies arising from a safety net backed by the U.S. taxpayer and serves to promote the safety and soundness and stability of our banking and financial system.

The rejection of expanded powers for subsidiaries of commercial banks, at least those conducted as principal, is a decision that will inhibit the widespread employment of federal subsidies over a wide range of activities. These activities, if conducted in bank subsidiaries, would accord banking organizations an unfair competitive advantage over comparable insurance and securities firms operating independently or as bank holding company subsidiaries.

Even more important, to inject the substantial new subsidies that would accrue to operating subsidiaries of banks into the currently mushrooming domestic and international financial system could distort capital markets and the efficient allocation of both financial and real resources that has been so central to America's current prosperity. The choice of requiring the new powers to be harbored in affiliates of holding companies, not in the so-called op-subs of their banks, will significantly fashion the underlying structure of twenty-first century finance.

Another twenty-first century issue is whether we should move beyond affiliations among financial service providers and allow the full integration of banking and commerce. As technology increasingly blurs the distinction among various financial products, it is already beginning to blur the distinctions between predominately commercial and banking firms. We cannot rule out whether sometime in our future full integration may occur, potentially with increased efficiencies. But how the underlying subsidies of deposit insurance, discount window access, and guaranteed final settlement through Fedwire, are folded into a commercial firm, should the latter purchase a bank, is crucially important to the systemic stability of our financial system.

It seems to us wise to move first toward the integration of banking, insurance, and securities as envisioned in H.R. 10 and employ the lessons we learn from that important step before we consider whether and under what conditions it would be desirable to move to the second stage of the full integration of commerce and banking. Nothing is lost, in my judgment, by making this a two stage process. Indeed, there is much to be gained. The Asian crisis last year highlighted some of the risks that can arise if relationships between banks and commercial firms are too close, and make caution at this stage prudent in our judgment. In line with these considerations, the Board continues to support elimination of the unitary thrift loophole, which currently allows any type of commercial firm to control a federally insured depository institution.

These principles, which we see as fundamental to financial modernization, are embodied in H.R. 10. As in all such major legislation, there are, and will be, numerous provisions only indirectly associated with the legislation's core principles that often foster disagreements. These surrounding details are doubtless important, but not so important that they should be allowed to defeat the consensus that has developed around the key principles embodied in H.R. 10. It would be a disservice to the public and the nation if, in the fruitless search for a bill that pleases everyone in every detail, the benefits of this vital consensus are lost or further delayed.

The decision to use the holding company structure, and not the universal bank, as the appropriate structure to allow new securities and insurance affiliations is strongly driven by several key principles embodied in H.R. 10. These principles include that new powers and affiliations should be financed by the market and not by the sovereign credit of the United States, and that supervision of nonbank affiliates must not use the exhaustive bank examination method.

Importantly, that decision also prevents the spread of the safety net that would inevitably lead to a weakening of the competitive strength of large segments of our financial services industry because those securities, insurance and other financial services providers that do not operate as subsidiaries of banks would be at a serious disadvantage to similar firms owned by banks. By fostering a level playing field within the financial services industry, we contribute to full, open and fair competition as we enter the next century.

This choice of the holding company structure is also critical to the way in which the financial services industry will develop because it provides better protection for and promotes the safety and soundness of our banking and financial system without damaging the national or state bank charters or limiting in any way the benefits of financial modernization. The other route toward full powered commercial bank operating subsidiaries and universal banking would, in our judgment, lead to greater risk for the deposit insurance funds and the taxpayer. It is for these reasons that the Federal Reserve, Securities and Exchange Commission, many state functional regulators, and many in the affected industries have supported the holding company framework and have opposed the universal bank approach.

In virtually every other industry, Congress would not be asked to address issues such as these, which are associated with technological and market developments; the market would force the necessary institutional adjustments. Arguably, this difference reflects the painful experience that has taught us that developments in our banking system can have profound effects on the stability of our whole economy, rather than the limited impact we perceive from difficulties in most other industries.

Moreover, as a society we have made the choice to create a safety net for depository institutions, not only to protect the public's deposits, but also to minimize the impact of adverse banking developments on our economy. Although we have clearly been successful in doing so, the safety net has predictably shielded bank shareholders from the full consequences of the risks their banks take. Moreover, since the sovereign credit of the United States fosters the stability of the banking system and guarantees the claims of insured depositors, bank creditors do not apply the same self-interest monitoring of banks to protect their own position as they would without discount window access and deposit insurance. As a consequence, to redress the balance of risk-taking, entities with access to the safety net are required to be supervised and regulated. In this way, the U.S. government protects its own--that is the taxpayers'--interest, which is the cost of making good on the guarantee.

Put another way, the safety net requires that the government replace with law, regulation, and supervision much of the disciplinary role that the market plays for other businesses. Our experience in the 1980s with insured thrift institutions illustrates the necessity of avoiding expanding risks to the deposit insurance funds and lax supervisory policies and rules. But this necessity has an obvious downside: these same rules limit innovative responses and the ability to take the risks so necessary for economic growth. The last thing we should want, therefore, is to widen or spread this unintended, but nevertheless corrosive, dimension of the safety net to other financial and business entities and markets. It is clear that to do so would not only spread a subsidy to new forms of risk-taking, but would ultimately require the expansion of bank-like supervision as well.

In our judgment, the holding company approach upon which H.R. 10 is premised avoids this pitfall; the universal bank approach cannot.

While financial modernization represents much needed reform, we should not forget that this modernization will, by itself, introduce dramatic changes in our financial services industry. We feel confident that the risks of this type of reform are manageable within the holding company framework set out in H.R. 10.

There is a final point I want to make since it appears to have driven Treasury's opposition to last year's version of H.R. 10. H.R. 10 would not diminish the ability of the Executive Branch to continue to play its meaningful role in the development of banking or economic policy. Currently, the Executive Branch influences such policy primarily through its supervision of national banks and federal savings associations. H.R. 10 would not alter the Executive Branch's supervisory authority for national banks or federal savings associations, nor would it result in any reduction in the predominant and growing share of this nation's banking assets controlled by national banks and federal savings associations. Indeed, as of September 1998, nearly 58 percent of all banking assets were under the supervision of the Comptroller of the Currency, up from 55.2 percent at the end of 1996. Moreover, after controlling for mergers of like-chartered banks, the number of national banks has increased over the period 1996-98 and the number of state banks has declined.

Furthermore, Congress for sound public policy reasons has purposefully apportioned responsibility for this nation's financial institutions among the elected Executive Branch and independent regulatory agencies. H.R. 10 retains this balance, and the Federal Reserve does not believe it would serve any useful purpose to alter it. Such action would be contrary to the deliberate steps that Congress has taken to ensure a proper balance in the regulation of this nation's dual banking system.

Conclusion

The markets are demanding that we change outdated statutory limitations that stand in the way of more efficiently and effectively delivering financial services to the public. Many of these changes will occur even if Congress does not act, but only Congress can establish the ground rules designed to assure the maximum net public benefits, protect the safety and soundness of our financial system, create a fair and level playing field for all participants, and assure the continued primacy of U.S. financial markets. For these reasons, the Federal Reserve supports and urges prompt enactment of the financial modernization contained in H.R. 10.