For release on delivery
9:30 A.M., E.S.T.
April 17, 1985

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions, Supervision, and Regulation

of the

Committee on Banking, Finance and Urban Affairs

House of Representatives

April 17, 1985

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

I appreciate the opportunity to appear before this Subcommittee to review with you some of the issues involved in proposed banking legislation. You have requested me to focus my remarks particularly on the long- and short-term effects of chartering so-called "nonbank banks" and on the provisions of H.R. 20, the "Bank Definition Act", which addresses the proliferation of nonbank banks.

I have long supported legislation to close avenues for evasion of some of the basic tenets of public policy, incorporated in the Bank Holding Company Act, that have guided the evolution of our banking system for decades. At the same time, I want also to emphasize at the outset that, while action to close the "nonbank bank loophole" is urgently needed, I hope the Committee and the Congress will also deal in this session with other issues, ranging from powers of bank holding companies to interstate banking, that should be promptly resolved in the interest of a competitive, safe,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

and healthy banking system. Some of those points are addressed by H.R. 15, the bill sponsored by Mr. Wylie, which also deals with nonbank banks.

Public policy has long recognized that commercial banks perform a unique and critical role in the economy and the financial system. They are operators of the payments system; they are custodians of the bulk of liquid savings; they are the principal suppliers of short-term credit; and they are the critical link between monetary policy and the economy. Moreover, the fortunes of individual institutions are so intertwined that instability of one may infect another. In recognition of these circumstances, a Federal safety net -- specifically the Federal Reserve discount window and Federal deposit insurance -- has long been provided to help protect the system. Individual banks are subject to a system

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

of regulation and supervision to help assure their safety and soundness.

Integral to that approach, the Bank Holding Company Act allows ownership of a bank by another company only if that company engages in activities that "are closely related to banking and a proper incident thereto." That provision is designed to enforce a basic separation of banking and commerce, and thus limit conflicts of interest and avoid undue concentration of resources. The law also provides for some supervision and inspection of the holding company as a whole, recognizing that, in practice, the fortunes of one enterprise within a holding company cannot be wholly separated from those of its affiliates. The provisions of the Bank Holding Company Act also provide restrictions on interstate banking by a holding company, paralleling the restrictions on interstate branching in the MacFadden Act.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

In our judgment, the basic concerns about the separation of commerce and banking remain valid, and should be your point of departure today in considering the "nonbank bank" issue.

The definition of a bank is critical to a policy that sets out to separate banking and commerce and to enforce restrictions on interstate banking. The Bank Holding Company Act defines a bank as an institution that both accepts demand deposits and makes commercial loans. That definition was designed to exclude savings and industrial banks (which at the time had little or no demand deposits or other transactions accounts or commercial lending authority) and limited-purpose trust companies.

While thrift institutions today increasingly do commercial lending and can accept transactions accounts of individuals, FSLIC-insured institutions remain exempt

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

under the terms of the Garn-St Germain Act passed in 1982. Moreover, as other forms of transactions accounts have developed with the basic characteristic of demand deposits, institutions with a bank charter can also take all kinds of deposits from the public (including under current court rulings NOW accounts) other than demand deposits and make commercial loans without coming under the restrictions of the Bank Holding Company Act. These are the so-called "nonbank banks," for which there have been hundreds of applications.

Specifically, one form of "nonbank bank" may be owned by any company -- a steel company, a retailer, a securities firm, an insurance company, or a real estate developer. The parent company is not subject to any of the limitations of the Bank Holding Company Act designed to limit risk or conflicts of interest and to avoid unfair competition or excessive concentration of economic power. Thus, in its present guise,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

the "nonbank bank" undermines the basic separation of banking and commerce -- a concept with deep roots in both English and American traditions.

That seems to me the fundamental issue at stake in closing the "nonbank bank" loophole. By permitting commercial companies to provide through subsidiaries almost all the same functions as full service banks, and to obtain access to the payments system, the discount window, and deposit insurance, both the principle and the practical reality of the present restrictions of the Bank Holding Company Act will be seriously undermined over time. The competitive position of those banks still subject to the Act will inevitably be damaged, potentially weakening the system as a whole.

The "nonbank bank" is also, and today more commonly, a device by which a bank holding company, or a commercial firm,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

can escape from the restrictions on interstate banking encompassed in the Douglas Amendment to the Bank Holding Company Act. In fact, interstate banking is a reality in many areas through Edge Act subsidiaries, loan production offices, finance company and mortgage banking affiliates, credit card operations, ATM networks, and otherwise. The nonbank bank offers the added avenue of on-site offices for a full range of consumer business or commercial lending combined with deposit taking. I will be testifying with respect to interstate banking next week, and I believe some liberalization of current restrictions is justified. However, in my judgment, that question should be approached on its own merits rather than by permitting interstate banking through an unintended "back door" device, with the inefficiencies and inequities that involves.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

I sense there is a broad consensus that it is important to preserve the basic policies of the Bank Holding Company Act and that, accordingly, it is essential to close the "nonbank bank" loophole as part of any legislative approach toward banking. Basically satisfactory legislative provisions to achieve that were contained in separate bills last year. One was reported by this Committee and another adopted by the full Senate. While detailed differences in approach were not fully resolved, it appeared that it was other provisions of proposed banking legislation, rather than basic disagreements on the "nonbank bank" question, that stymied enactment.

H.R. 20 basically follows the approach of this consensus. It broadly applies the provisions of the Bank Holding Company Act to all FDIC-insured commercial banks whatever their particular mix of business. In addition, those uninsured institutions that offer transaction accounts and make commercial loans would continue to be covered. This

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

approach is broadly satisfactory so far as it goes, as would be the similar provisions of H.R. 15.

Before turning to areas of omission, I would note particularly that these bills would bring so-called consumer banks clearly within the scope of the provisions of the Bank Holding Company Act. The suggestion has been made by others that banks primarily aimed at serving the consumer might be exempted from the general principle of the separation of banking and commerce and from any restrictions applicable to ordinary banks on interstate banking.

However beguilingly presented as a "family bank" proposal, such an initiative seems to me misguided. I would emphasize that the great bulk of the number of existing banks and other depository institutions are already "family" or "small business" oriented. We have in this country almost 20,000 banks and thrifts, nearly all actively competing for

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

consumer business. Many of them do little commercial lending; for instance, almost 20 percent of commercial banks have 5 percent or less of their assets in loans to businesses, and nearly half have less than 20 percent of assets in such loans.

I see no justification for permitting commercial, industrial or securities firms to compete with these institutions for insured deposits and other banking services under different ground rules as to ownership. The effect could only be to undermine the public policy objectives incorporated in the Bank Holding Company Act generally, and there would be the appearance and reality of unfair competition with banks subject to the Act.

Do we really want, for example, a retail business to be able to gather deposits under the protection of Federal insurance and to use those deposits to fund a credit card they sponsor more cheaply than retailing competitors? Do we want to bless interstate consumer banking simply because

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

there is a non-bank owner? Do we want to encourage joint marketing efforts and "tie-ins," implicit or explicit?

If we are not sensitive to these concerns, then what is the justification for the present restrictions in the Bank Holding Company Act?

Some of the "family bank" concepts propose a kind of sugar coating in the form of higher capitalization, "life-line" banking requirements, and rules requiring prompt deposit availability. If these are indeed valid objectives of legislation -- and I make no judgment on that point now -- then it seems to me the legislation should apply to all depository institutions and not to just a special few.

In other respects, I believe the coverage of H.R. 20 must be broadened. As drafted, H.R. 20 has no provision with respect to the treatment of thrift institutions -- savings banks and savings and loans.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

For some federally insured thrifts -- namely, those owned by <u>multiple</u> savings and loan holding companies -- no legislative action appears required since their holding companies would remain subject to the Savings and Loan Holding Company Act, which has restrictions similar to those of the Bank Holding Company Act. However, others--including FDIC-insured savings banks and privately insured thrifts--would be subject to neither act, and unitary S&L's may engage in substantial nonresidential lending activities without any limitations on the commercial or industrial activities of their corporate owners. Left unattended, the effect would plainly be to deflect the energies now reflected in "nonbank banking" into banking in the guise of thrift institutions -- "nonthrift thrifts."

In recent years, powers available to thrifts have become much more like those available to banks, and indeed the range of thrift powers today, particularly those of state-

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

chartered institutions, often exceeds that of banks. Paralleling that development, there has also been increasingly clear recognition of the need to adopt rules to assure reasonably comparable regulatory treatment.

Considerations of competitive equity alone dictate that the privileges of, and restrictions on, banks and thrifts be brought into a more coherent relationship. But it is not just a matter of competitive equity. Restrictions on powers of bank holding companies and on "nonbank banks" will inevitably be undercut, and rapidly, to the extent thrift institutions with banking powers can simply substitute as a vehicle for undertaking a wide range of banking services, violating the basic separation of banking and commerce.

I recognize that there are difficult questions posed by firms that already have operations on both sides of

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

the line between commerce and "thrift banking." A number of industrial or commercial firms own thrifts, and operate those thrifts as separate and distinct entities without significant problems arising. Those combinations might logically be permitted to continue on their present basis. However, in the environment we now face, these questions need to be approached with an eye toward the future, and a firm policy established with respect to which new combinations are acceptable and which are not.

To deal with this problem, we have suggested that only those thrifts that have a high percentage of their assets in home mortgages should be exempt from the same rules as to ownership applicable to banks and multiple S&L holding companies. We have suggested that present law be strengthened to require that such a "qualified" thrift institution have at least 65 percent of its assets in residential mortgages or housing-related investments.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

I do not believe there is a sound rationale for including residential mortgage originations and sales in such a calculation. Commercial banks, mortgage banks, and others are all active mortgage originators. The distinguishing characteristic of an S&L and many savings banks historically -- and the characteristic that historically has justified special Federal support -- was that they devoted relatively large portions of their own resources to support housing. believe that a substantial commitment to investment in housing should continue to be the test for exemption from certain policies embodied in the Bank Holding Company Act and the Savings and Loan Holding Company Act for multiple S&L holding companies. Furthermore, any holdings of liquidity included in a thrift test should be confined to amounts legally required.

A further step is necessary to limit conflicts of interest and tie-ins when a qualified thrift has a commercial owner. Specifically, joint marketing of services and products should be prohibited.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

I am <u>not</u> suggesting that "nonthrift thrifts" need be brought under the Bank Holding Company Act administered by the Federal Reserve. I am suggesting that institutions that have essentially the same characteristics as commercial banks should have broadly parallel restrictions on combinations with commercial firms, and those restrictions be administered by the appropriate regulator -- for savings and loans and Federal Savings Banks, the Federal Home Loan Bank Board. Moreover, we calculate about three-quarters of all savings and loans would meet the thrift test I have proposed today, and thus would not be restricted as to commercial ownership.

H.R. 20 does not prohibit an affiliation of thrift institutions and non-member banks with securities firms. That existing loophole in the Glass-Steagall Act should be closed in the interest of competitive equity and the purposes

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

of the Glass-Steagall Act. Such a provision has been recommended by the Federal Home Loan Bank Board with respect to thrifts.

In all these areas, appropriate transition periods should be provided, and other detailed questions would need to be resolved. We would be glad to work with the Committee in developing such provisions.

Finally, Mr. Chairman, I would like to comment on the provision of the bill which grandfathers certain nonbank banks acquired on or before July 1, 1983. You and the Chairman of the Senate Banking Committee have strongly supported July 1, 1983, as the appropriate date for grandfathering nonbank banks. I would point out that, even before that date, institutions were well aware that the nonbank bank loophole was a matter of policy and Congressional concern.

We have reviewed both the institutions that would be subject to grandfathering and the activities that are

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

conducted by them. As far as we can determine, H.R. 20 would grandfather about 24 FDIC-insured nonbank banks; most of these are small in asset size, with at least 10 essentially engaged in trust activities and six or seven in credit card operations. Given this situation, we believe that grandfathering as of the July 1, 1983 date, subject to appropriate conditions to assure that their grandfather status is not abused by expansion geographically or otherwise, would not be inconsistent with the objectives of the Act.

Should the grandfather date be moved toward the current date, an increasing number of insurance, securities, and retail firms that were fully on notice about the likelihood of Federal legislation would be permitted to retain bank operations. It is our understanding that few of these institutions have yet made substantial investments, and the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

larger number of charter rights that would be involved would increasingly impair the objectives sought by H.R. 20.

In concluding my testimony, I would note that one Federal District Court in Florida has enjoined the Comptroller from issuing final nonbank bank charters because it found, as a matter of law, that the National Banking Act does not permit the Comptroller to issue a charter which does not provide for the exercise of full National banking powers. As a result of that decision, final National bank charters for new nonbank banks are not currently possible, and the Federal Reserve Board has suspended processing such applications by bank holding companies. However, state-chartered nonmember "nonbank banks" can still be created. While final disposition of the legal issues involved for the National banks may take some time, any reversal of the District Court opinion will quickly touch off a flood of new National nonbank banks.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Consequently, the need for clear and effective action to deal with the nonbank bank question continues to rest with the Congress. I urge you to act expeditiously in this area, and then promptly turn your attention to other areas of banking that desperately need legislative resolution and clarification.

* * * * * * * *

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis