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[Review of banking laws and major financial issues]

Statement of

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Comptroller of the Currency

before the

Committee on Banking, Housing, and Urban Affairs
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I. INTRODUCTION

Mr. Chairman and members of the Committee, we appreciate this opportunity to discuss competitive and economic conditions within the financial services industry and to review major banking laws.

We are all aware of the fundamental forces that are reshaping the financial services industry — both in our country and abroad: inflation and economic uncertainty; erosion of geographic barriers to competition; erosion of product market barriers; deregulation of the liability side of the balance sheet; the revolution in technology; demographic shifts; and finally, the role of the government.

In the face of such change it is essential that we step back; analyze what is happening and where things appear to be headed; assess whether existing policies, regulations, and laws are appropriate; and revise policies, regulations, and laws that will guide the financial system through this period of change and at the same time will strengthen the vitality and increase the flexibility of the system and the economy. The condition of the financial system in the coming decade will reflect not only the forces of the marketplace, but of equal importance, decisions made in the public sector — by the Congress and the regulatory authorities. It will also reflect our success in moderating inflation and restoring economic stability.

These hearings, because of their broad approach, are a valuable beginning in shaping the agenda of issues and topics for comprehensive review and, over the longer term, in reshaping the statutory and regulatory framework within which the financial system operates. In our

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view, no part of this framework should be exempt from scrutiny, including the structure of the financial institutions regulatory agencies.

In the past these hearings focused on the commercial banking system and our testimony tended to center around national banks. However, the many changes taking place make it more appropriate now to speak of the entire financial system — that is, the financial services industry, both domestic and international. Therefore, in discussing the agenda for review it is useful to place national banks, the commercial banking system and deposit-taking institutions in the context of the financial services system.

II. THE U.S. FINANCIAL SYSTEM

Our financial system is comprised of a myriad of different types of institutions. The providers of financial services in the U.S. include the traditional depository institutions -- commercial banks, savings and loan associations, mutual savings banks, and credit unions -- as well as mortgage bankers, finance companies, federally-sponsored credit agencies, insurance companies, pension funds, investment bankers, securities brokers, real estate service firms, and even the financial activities of retailers and other nonfinancial businesses.

At the end of 1980, financial institutions held over $4 trillion in domestic financial assets. Over 42,000 depository institutions accounted for $2.4 trillion or 59 percent of the total. Domestically chartered commercial banks, of which there were 14,630 reporting as of year end, held the largest amount with $1.5 trillion or 38 percent. There were 4,425 national banks at year end, or 30 percent of the total number of

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commercial banks, holding approximately 57 percent of total domestic bank assets.

The 4,600 savings and loan associations were second with approximately $630 billion in assets (15 percent). The 463 mutual savings banks and 22,000 credit unions held 4 percent and 2 percent respectively. Life insurance companies, with $456 billion in assets (11 percent), made up the largest segment of the nondepository financial industry, followed by private pension funds with $265 billion in assets (7 percent).

Historically, financial institutions have tended to fill specific roles, each industry offering a different product to its customers. For instance, in terms of credit offered to borrowers, each depository institution has had its speciality, e.g., commercial loans for banks, residential mortgage loans for thrift institutions, and consumer loans for credit unions. Frequently such specialization has been reinforced by legislation narrowly defining permissible product lines. For example, savings and loans are legally barred from making commercial loans.

While the distinctions between banks and thrifts and between depository and nondepository institutions used to be clear, such institutional differences are disappearing. Different types of financial institutions increasingly offer similar products and services and compete in the same markets. In particular, institutions which do not call themselves banks and which are not legally defined as banks are engaging in a variety of activities traditionally associated with banking. While many of the financial institutions may be virtually indistinguishable from the perspective of a customer purchasing financial services, significant differences still remain in terms of regulatory and legal status.

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To take an obvious example, consumers are no longer limited as they once were to commercial banks for their transaction account services -- now they may go to their local thrift institution or credit union, or to an investment banker or insurance company sponsoring a money market mutual fund (MMF). As of mid-April, MMFs held $116 billion in shareholder accounts, yielding over 14 percent. Merrill Lynch alone holds approximately $23.5 billion of assets in its three money market funds. By way of comparison, commercial banks have approximately $42 billion in NOW and ATS accounts, subject to a federally-imposed deposit rate ceiling of 5 1/4 percent.

More importantly, the pace of change in the financial system appears to be accelerating. Last year, RCA, a diversified communications and electronics concern, paid $1.35 billion for C.I.T. Financial Corporation, one of the country's largest financial services companies with activities in insurance and installment financing. The recent acquisition of Bache Group by Prudential Insurance Co. and the proposed acquisition of Shearson Loeb Rhoades by American Express create two more major multifaceted financial institutions capable of providing to their customers a wide range of financial services including insurance, investment, credit cards and other bank-like services.

Clearly, old distinctions among the providers of financial services are blurring and competition is increasing. This is a natural result of changing marketplace realities and is beneficial to consumers, businesses, the economy and the country. Yet, the framework of laws and regulations that define the boundaries within which different types of financial

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institutions are allowed to operate is uneven, giving unintended advantage to some institutions over others. In particular, antiquated, inappropriate and inefficient laws and regulations substantially impede the ability of depository institutions to compete with other providers of financial services. Although it is possible that we can continue to muddle along, we are convinced that failure to address the problems posed by the existing legal and regulatory framework will threaten the long-run strength and vitality of the commercial banking system — indeed, all deposit-taking institutions.

III. PERFORMANCE OF COMMERCIAL BANKS AND THRIFTS

Before discussing the issues and topics that we believe should be included on the agenda for comprehensive review, it is useful to discuss the recent performance of commercial banks and thrift institutions and to comment on the changes which financial institutions will have to adjust to in coming years.

Events during 1980 were unsettling for the country, the economy, financial markets and financial institutions. The prime rate rose from 13.25 percent to 20 percent, fell to 11.0 percent and then rose again to 21.5 percent. Although a program of credit restraint was imposed and a short recession occurred early in the year, inflation continues unabated. In addition, Congress passed legislation providing for significant deregulation of various activities of deposit-taking institutions.

Commercial Bank Performance

Commercial banks weathered these events unexpectedly well as indicated by their performance in terms of asset growth, earnings, asset quality, liquidity, and capital.

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1. Asset Growth

The combined effect of a sluggish economy and the credit restraint program in effect during early 1980 resulted in the slowest growth in assets at insured commercial banks since 1976. The 9.7 percent increase in total domestic and foreign assets to $1,856 billion last year contrasts with growth rates that ranged from 12.2 to 13.3 percent in the three preceding years.

Growth of Insured Commercial Bank Assets and Equity
($ billions)

	Total Assets	Annual Percent Change	Equity Capital	Annual Percent Change	Equity/ Assets (%)
1970	$ 616	10.9%	$ 40.5	7.8%	6.58%
1975	1,095	4.7	64.3	8.8	5.87
1976	1,182	7.9	72.3	N.A.*	6.11
1977	1,339	13.3	79.3	9.7	5.92
1978	1,508	12.6	87.4	10.3	5.80
1979	1,692	12.2	97.2	11.2	5.75
1980	1,856	9.7	107.6	10.6	5.80

*Definition of equity capital altered in 1976; therefore, numbers before 1976 are not strictly comparable with those after 1975.

The relatively slow growth in bank assets was related to a sharp reduction in loan demand. Loans outstanding at insured commercial banks increased only 7.4 percent and more than one third of that increase resulted from loans booked at foreign offices. Foreign office assets at all insured commercial banks increased 10.9 percent to $323 billion as

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compared to the 9.4 percent increase in domestic assets. That was a sharp break from the experience of the prior 4 years, however, when foreign office growth averaged over 19 percent and peaked in 1979 at nearly 22 percent.

2. Earnings

Insured commercial bank earnings continued to increase in 1980, although the rate of growth declined from 1978 and 1979. Despite increasing reliance on market rate funds, particularly 6-month money market certificates, commercial banks generally were able to maintain their interest rate margins and the return on assets for the banking system declined only slightly to 0.79 percent of assets from 0.80 in 1979.

Net Income of Insured Commercial Banks

	Net Income (billions)	Annual Percent Increase	Net Income/ Average* Assets(%)	Net Income/ Average* Equity (%)
1970	$ 4.837	11.6%	0.83%	12.4%
1975	7.255	2.3	0.68	11.8
1976	7.843	8.6	0.69	11.5
1977	8.879	13.2	0.70	11.7
1978	10.760	21.2	0.76	12.9
1979	12.838	19.3	0.80	13.9
1980	14.010	9.1	0.79	13.7

*Averages are of preceding and current Decembers.

While larger commercial banks have had extensive experience in funding a large part of their operations with market rate funds, the rapid growth of money market certificates from $106 billion to $178 billion during 1980

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and the resulting increased sensitivity of the cost of funds to changes in market rates meant that banks of all sizes had to make adjustments in pricing and operating policies.

The ability of smaller banks to adjust their traditional operating and pricing policies rapidly in light of the economic volatility and the increased sensitivity of their cost of funds to market rates provided dramatic evidence of their flexibility and adaptability. The 12,735 insured commercial banks with assets of under $100 million increased their return on assets from 1.09 percent in 1979 to 1.12 percent in 1980. This continued a generally upward trend that has lasted for more than a decade. Their return on equity was 13.28 percent, a slight improvement over 1979.

Earnings performance at the larger banks did not show a clear gain over their very successful performance in 1979. Return on assets declined by 2 basis points, to 0.78 percent for the 1,682 insured commercial banks with assets between $100 million and $10 billion. Similarly, the return on equity dropped from nearly 13 percent to 12 1/2 percent. The pressure on earnings and equity was felt most strongly by the regional banks, generally those with assets between $1 and $10 billion.

The 18 largest banks with assets over $10 billion and with extensive international operations achieved virtually the same return on assets (0.54 percent) and on equity (13.77 percent) as they did in 1979.

3. Asset Quality

Some deterioration in asset quality was apparent in 1980 resulting from both the economic downturn and the difficulties of some businesses

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and individuals in adjusting to higher borrowing costs. Net loan losses for the year rose to $3.6 billion from $2.6 billion the previous year. National banks reported that 4.2 percent of their domestic loans had overdue payments as of the end of the year, the highest ratio reported for December since 1976. Commercial banks increased their reserves for potential loan losses out of earnings to an extent that more than offset the increase in actual losses and raised their reserves to 1.0 percent of outstanding loans.

Insured Commercial Bank Loan Losses and Loan Loss Reserves
($ billions)

	Net Loan Losses	Allowance for Possible Loan Losses	Allowance/Total Loans (percent)
1970	$0.981	N.A.	N.A.
1975	3.243	N.A.	N.A.
1976	3.503	$6.348	1.01%
1977	2.797	6.894	0.95
1978	2.497	7.957	0.96
1979	2.564	9.183	0.98
1980	3.598	10.053	1.00

National Banks
Domestic Office Loans Past Due
($ billion)

	Amount Past Due	Percent Past Due
1975	$14.7	5.0%
1976	13.0	4.2
1977	13.0	3.7
1978	14.7	3.6
1979	18.2	4.0
1980	20.1	4.2

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Traditionally, the loan-to-deposit ratio reflected liquidity. When this ratio was high a bank generally had less cash and marketable securities to meet liquidity needs. This ratio is no longer a very good indicator of liquidity because it does not measure a bank's ability to purchase funds in the marketplace. Dependence on purchased funds can enhance liquidity but it can also lead to rapid loss of liquidity if the market loses confidence in an institution. There are also other indicators of potential liquidity risks such as asset and liability maturities, interest rate margin and loan commitments.

4. Liquidity

Based on the traditional measure of the ratio of loans to deposits, liquidity of commercial banks improved slightly during 198Ø. That resulted from the slow growth in loans relative to deposit growth. For small banks, the loan to deposit ratio dropped to 59.5 percent at year end, compared to 63.Ø percent in 1979. For the largest banks, however, this ratio continued to increase, as it has for most of the last decade, reaching 74.8 percent at the end of 198Ø.

A better measure of risks to liquidity is the ratio of purchased funds to assets, which indicates the dependence of a bank on purchased funds. Growth in money market certificates, large time deposits, foreign office deposits, federal funds transactions and borrowed money resulted in banks holding short-term, high interest bearing liabilities equal to nearly 5Ø percent of their total assets at year end.

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Insured Commercial Bank Liquidity and Purchased Funds
($ billions)

	Loans/ Deposits (%)	Purchased Funds*/ Assets (%)
1970	60.5%	10.6%
1975	64.0	32.4
1976	63.2	32.3
1977	64.7	33.5
1978	67.4	37.9
1979	68.5	43.9
1980	67.7	48.7

*Foreign office deposits, federal funds transactions, borrowed money (including Treasury notes), large CDs, other time deposits over $100M and 6-month money market certificates.

Although the larger banks continued to rely more heavily on purchased funds than the smaller ones, the advent of money market certificates in 1978 has resulted in a tremendous increase in market rate funds at smaller banks. At the end of 1978 insured commercial banks with assets under $100 million held purchased funds equal to 12.5 percent of their assets. By the end of 1980 that ratio had jumped to 31.4 percent, with most of the increase accounted for by money market certificates. At the largest multinational banks, the ratio of purchased funds to total assets rose from 59.8 to 64.2 percent during the same period. Reliance on purchased funds has increased tremendously for all banks over the last decade, reflecting problems created by deposit interest rate ceilings and changes in the economy, especially inflation and high interest rates. This trend seems likely to continue for the foreseeable future.

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5. Capital

The slow growth rate in bank assets in 1980 caused the equity-to-asset ratio for insured commercial banks to increase for the first time since 1976, despite a sharp drop in new capital issues. The ratio was 5.80 percent in 1980 compared to 5.75 percent in 1979 and 6.11 percent in 1976.

The average equity-to-asset ratio for banks with under $100 million in total assets rose to 8.46 percent from 8.21 percent in 1979 and 7.94 percent in 1976, continuing a long term trend of increases. For the banks with assets above $10 billion, the three-year decline in capital ratios halted in 1980 as the equity-to-assets ratio rose to 3.93 percent from the previous year's 3.90 percent. This ratio was not much different from the 4.03 percent level recorded in 1975, although it was substantially less than the 5.09 percent level achieved in 1970.

6. Banks Under Special Supervision and Bank Failures

The number of national banks characterized by the Uniform Financial Institutions Rating System as having "financial, operational or managerial weaknesses so severe as to pose a serious threat to continued financial viability" increased to 51 at year-end 1980, compared to 49 the prior year. These 51 banks accounted for 1.2 percent of all national banks and held only 0.8 percent of the assets of all national banks.

Continued improvement in banks which do not have a strong possibility of failure or insolvency but still warrant some supervisory concern occurred during 1980. The number of these national banks dropped from 217 in 1979 to 206 in 1980. One small national bank failed in 1980. Additionally, one national bank was merged to avert failure.

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These indicators reflect an industry which, on balance, continues to demonstrate a high degree of financial health and stability. Although costs associated with NOW accounts and the pricing of Federal Reserve services and loan losses stemming from the 1980 recession may place downward pressure on commercial bank earnings this year, we believe that commercial banks have the capability to continue adjusting successfully to the changing and more volatile economic environment. However, longer-term prospects are less encouraging unless competitive and other restrictions that now hamstring the flexibility of these institutions are eliminated or modified appropriately.

Thrift Performance

Inflation and high and volatile interest rates have had devastating effects on those financial institutions, predominantly thrift institutions, whose asset portfolios are composed primarily of long-term, fixed-rate mortgages. During most of the post-World War II period the mismatched asset-liability maturity structure of thrifts has worked relatively well. However, given the current volatile interest rate environment with short-term rates frequently exceeding long-term rates and the dramatic upward shift in the cost of funds caused by the increased interest sensitivity of depositors, the profitability of such an asset-liability maturity structure has been seriously impaired. Thus, many have concluded that continued origination and holding of 30-year, fixed-rate mortgages -- even at today's high rates -- is imprudent. These effects have been amplified by deposit rate deregulation, which began with the introduction of the money market certificate of deposit in 1978 and

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which, under the provisions of the Depository Institutions Deregulation Act, will result in total elimination of controls by March 31, 1986. Rate deregulation, of course, became imperative when inflation-induced high interest rates led to outflows of deposits into unregulated market-rate instruments and created concerns about providing small savers with the opportunity to realize market rates.

The net annual after-tax income to asset ratio of savings and loan associations has decreased sharply over the past two years, falling from 0.83 percent in the second half of 1978 to 0.10 percent of assets in the second half of 1980, according to Federal Home Loan Bank Board statistics. The cause of this decline in earnings is evident: the average cost of funds for insured S&Ls in the last two years rose 2.32 percentage points to a record annualized rate of 9.11 percent in the second half of 1980, while the return on mortgage portfolios of insured S&Ls rose less than one percentage point to 9.44 percent. Approximately 50 percent of all S&L deposits are now in the form of certificates not subject to ceilings or with ceilings tied to market rates.

It should be recognized that for many thrift institutions the problem is not primarily of their own making. By law they have been required to provide financing to housing. This has resulted in asset portfolios dominated by long-term mortgages. Moreover, until recently, public and regulatory policy has favored the fixed-rate mortgage and has retarded the development of adjustable-rate and other alternative mortgage instruments.

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Last year thrifts were given new asset powers that will enable them to diversify their portfolios and shorten maturities. Moreover, regulatory policy has been adjusted to permit a variety of alternative mortgage instruments. More may be required, however, such as additional asset powers to assure the viability of thrift institutions over the longer term.

Most thrifts are well-managed and, given time, will once again be profitable, aggressive competitors. But as long as interest rates remain at or near the present high levels, it will require time to make adjustments. For example, at the end of 1980, over two thirds of the S&L's mortgage portfolios still contained long-term, fixed-rate loans with contract interest rates of less than 10 percent. It would be a tragedy for these institutions, the financial system and the country if what amounts to a short-run problem that can be solved over a period of time were permitted to control events. Until the problem of these below market-rate mortgages is solved, however, it will impede progress in deposit deregulation and prevent depository institutions from becoming competitive with other providers of deposit-like services.

IV. THE SHAPING OF THE FINANCIAL SYSTEM IN COMING YEARS

While much of the financial system, with notable exceptions, has already made substantial progress in adjusting to changed circumstances, basic forces are continuing to reshape the societal, economic and business environment within which banks and other financial institutions operate.

One force is economic uncertainty. Inflation, volatility in interest rates, and fluctuations in unemployment and production have heightened uncertainty and made the business of providing financial services much

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more difficult and risky. It is to be hoped that progress will be made in solving these problems, but prudence dictates that we should be prepared for continued economic uncertainty, expecting the unexpected. Given time and regulatory flexibility, most institutions can adjust portfolios and operating policies and procedures to respond to economic volatility and high interest rates in ways that not only maintain their viability but also enable them to thrive.

Over the long run, depository institutions will be able to reduce asset maturities by diversifying into shorter maturity assets or by adopting flexible pricing on longer maturity assets. Another approach is for them to continue to originate and service long-term assets, but to sell them to institutions better able to manage interest rate risk. Brokering of assets is already occurring through mortgage pass-through certificates and similar programs and conceivably could be extended to consumer and commercial loans. Brokering activities by depository institutions have been limited to date, partly because of the difficulty of pooling and selling loans in the capital markets.

A second force reshaping the environment for financial institutions is the increasing use of more sophisticated technology in the delivery of financial services. Indeed, the use of innovative technology in providing financial services may be on the verge of rapid implementation.

Inflation and technology are important catalysts of the erosion of barriers to competition that have traditionally separated banks and thrift institutions from other providers of financial services. Technological developments enhance the potential for both depository and nondepository

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institutions to expand markets, regardless of price controls and statutory limitations on products and the location of offices. The capacity of larger financial organizations to offer financial services on a mass marketing basis over a wide geographic area will expand greatly. And, either directly or through third party vendors, correspondent banks, bankers' banks, or sharing arrangements, smaller institutions will also be able to offer automated services profitably and at competitive prices.

A third factor affecting the financial environment is demographic and labor force changes. In the 1980s, members of the post-war baby boom generation will mature. There will be more workers in the prime age category of 25 to 44 and fewer young people. The work force will be better educated and more stable; it will be more productive. Moreover, many predict continued migration from the North and East to the South and West. Such demographic shifts will have important implications for financial product markets.

A fourth factor is the government. For better or worse, decisions made in the public sector — whether pertaining to geographic restraints on competition, monetary policy, consumer protection, or capital adequacy -- profoundly affect how the private sector conducts business. It seems, ironically, that although we are all committed to the concept of deregulation, law and regulation have become more, not less, pervasive in recent years.

All these factors point toward an obvious conclusion: the business of providing financial services will not only be different in the 1980s, but significantly more difficult and challenging. It will be uncertain; it

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will be more complex; it will be intensely competitive; and it will involve far greater potential for error.

For these reasons, we believe that not only should we review the existing framework of law and regulation governing the financial system, but we should do so seriously and move as expeditiously as possible to design a new framework that is responsive to the world of today and tomorrow. The agenda is large and comprehensive. It includes competitive issues, consumer protection issues and the structure of the regulatory system itself.

V. COMPETITIVE ISSUES

A significant part of the agenda of issues and topics for comprehensive review relates to the laws and rules which define and restrain competition among providers of financial services. There are three issues in this area: deposit deregulation, geographic restrictions, and laws and regulations which limit products and services that commercial banks and other depository institutions can provide.

Each of these three issues stands at a different stage in the public decision-making process and therefore presents a different kind of challenge.

- o Deposit deregulation, debated for a decade or more, apparently was resolved by the 1980 Depository Institutions Deregulation and Monetary Control Act. The challenge is to stick to the mandate of this Act and to implement deregulation.

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- Geographic restrictions have been debated frequently, if not always rationally, and in many respects the effectiveness of such restrictions is diminishing in the marketplace. While the roadmap for deregulation is rather clear, the challenge is to decide to deregulate and move ahead.

- Glass-Steagall and other product segmenting restrictions have not yet been debated as fully as these other issues and evolution in the marketplace is less far along. Moreover, the roadmap for change is not clear. The challenge now is to examine and debate this issue thoroughly.

Because change creates uncertainty and threatens long-established practices, the temptation to resist it is understandable. History has not been kind, however, to those who ignored currents of change or tried to control them. Energies spent on maintaining protections could be devoted more productively to designing ways to adjust to change. Apart from creating delay, attempts to stem the tide of developments that are inexorably eroding the remaining effectiveness of limitations on competition will be futile. Delay will harm the overall competitiveness of the financial system, particularly those segments that are more heavily regulated.

Deposit Deregulation

From the time of the Hunt Commission until the passage last year of the Depository Institutions Deregulation and Monetary Control Act, the

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issue of deposit deregulation stood at center stage of political and public policy debates concerning financial institutions. Enactment of that legislation marked a resolution — at least temporarily — of the fundamental policy question. Now the question is "how," not "whether," to end federal regulation of the prices and types of deposit products and services.

That the choice of a deregulation strategy is not easy is reflected in the actions of the DIDC during the past year. Though one might question the appropriateness or wisdom of some of those actions, they reflect the Committee's sincere attempts to balance the complicated and sometimes inconsistent missions assigned to it by Congress.

Many depository institutions have expressed their concern to the DIDC recently about the competitive threat posed by money market funds. Suggestions and petitions have been advanced to provide depository institutions with deposit tools to compete with the money market funds or, in the alternative, to place restraints on the funds themselves. This matter underscores the difficult task facing the DIDC in the coming months and the relationship of that task to the fundamental questions involving the structure of the financial services industry.

Our preferred answer to the money market fund issue is to grant depository institutions the flexibility necessary to compete with the funds on an equal footing. This solution, however, would not be simple to implement because of the poor earnings posture of some depository institutions, especially thrift institutions.

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What about restraints on money market funds? We would not be happy to see effort in that direction. On a philosophical level, this would represent new government intrusion, precisely the wrong signal at this time. Whatever form new regulation were to take, it would ultimately be ineffective because a lawyer and a marketer would soon figure out a way to avoid the impact of the regulation. Moreover, it is not really clear that money market funds are a major competitive threat.

What is the answer? There is no easy answer. In the short and medium run, if inflation, inflationary expectations, and interest rates remain high, we will be in a difficult situation. We must choose between slowing the pace of deregulation of deposit rate ceilings and restricting all deposit substitutes or letting the market work. Either choice means allowing some depository institutions, including many thrifts, to disappear or requires providing them with temporary support.

Unfortunately, this dilemma foreshadows a longer-run danger. If we resort to the expedients of regulation and restraint in the short and medium-run, then in the longer run there will be a temptation to renege on the fundamental decision to deregulate the deposit side of the balance sheet. Thus, the challenge for the DIDC and more broadly for the government is a serious one if inflation is not brought speedily under control.

In short, we will be forced to face squarely whether we are willing and able to carry through with a major and, in our judgment correct, deregulatory effort, even though this means incurring short-run costs.

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Geographic Restraints

The second competitive issue concerns geographic restraints on banking. We believe that such restraints upon bank expansion are anticompetitive and impede the effectiveness and efficiency of the financial system. In raising this issue, we want to emphasize our concern for the future of commercial banking.

Preservation of the McFadden Act and Douglas Amendment restrictions will continue to provide some banks with some protection from other bank competitors. In the meantime, however, institutions that are not similarly restricted will have ample opportunity to increase their share of the product markets in which banks compete. Even in banking, the interstate activities of loan production offices, Edge Act corporations and nonbank affiliates of bank holding companies are making McFadden Act protection virtually meaningless in every area but deposit competition. Even in this area, advances in communications technology, as well as deposit deregulation, are reducing significantly the importance of such protection.

Moreover, since the beginning of 1980 federal savings and loan associations have been permitted to establish branches on a statewide basis. In addition, they may be permitted, in certain circumstances, to establish branches across state lines. When S&Ls implement their new powers, statewide branching, and potentially interstate branching, will give them a substantial competitive advantage over banks.

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The Congress has quite accurately perceived the confluence of issues surrounding geographic limitations on domestic banks and foreign bank expansion in this country. The International Banking Act of 1978 placed new limits on multistate expansion by foreign institutions and also called for a review by the Administration of the old limits on domestic institutions. The GAO last year recommended a moratorium on foreign acquisitions of large U.S. banks solely because of the "basic unfairness" resulting from some foreign banks' ability, in certain circumstances, to purchase large U.S. banks that are unavailable for acquisition by domestic banking organizations because of antitrust policy and federal and state restrictions on bank expansion. This is an inequitable situation -- an anomalous result of our own laws and policies. In our opinion, however, the unfairness problem should not be resolved by restricting foreign acquisitions.

For all these reasons, we are convinced that geographic restrictions must be dealt with now. Initially, the Douglas Amendment restrictions on interstate bank holding company expansion should be phased out, including the restrictions on the establishment of new banks and the acquisition of existing banks. Such a phase-out might be implemented on an SMSA basis, contiguous state basis or by regional groupings. Certainly, it should be possible for bank holding companies to acquire failing or floundering banks in other states. Moreover, states can and should begin to eliminate competitive barriers on their own initiative. The key point is to create new possibilities for acquisitions or combinations that could offer benefits to the domestic banking system and the people it serves, and to begin to do so as quickly as possible.

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The most troublesome aspect of such an approach is likely to be combinations of larger banks. Such acquisitions raise legitimate concerns about the aggregation of large amounts of financial resources that are not addressed by existing antitrust concepts or laws. One remedy would be to fashion a statutory policy that requires proponents to demonstrate not only that a proposed interstate acquisition would pass muster under traditional antitrust standards but also that substantial public benefits would be derived from the transaction.

We are aware that implementation of these ideas will be difficult. Geographic restraints on competition lie at the very heart of American banking tradition. Nevertheless, it should be clear that interstate banking is already a reality. The power of the marketplace, propelled by technological innovations that reduce costs in an inflationary environment, is too great to stop. This leads inescapably to the conclusion that whatever the merits of the past debate on the McFadden Act and the Douglas Amendment, the competitive vitality of the commercial banking system depends importantly on developing solutions to the problems posed by these laws.

Product Segmentation and the Glass-Steagall Act

The third competitive issue for the agenda is the segmentation of financial products through laws and regulations which attempt to insulate and divide the various providers of financial services. Although the roadmap has been charted for deregulation of price restraints and the roadmap could be charted for deregulation of geographic restraints, no such map exists with respect to the rules which separate markets,

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primarily because the marketplace has only recently begun to focus attention on the issue. For example, although the questions of whether to restrict money market funds or allow commercial banks to underwrite municipal revenue bonds are being discussed, more fundamental questions have yet to be systematically addressed.

In essence, the matter is a simple one: Should households or companies be able to satisfy their need for financial services at one stop or should we continue to require specialization and predefine financial products through government fiat? The need to examine this question is substantial in both the retail and corporate areas.

In the retail area, it appears that in the marketplace of the 1980s, consumers are willing to forego many of the protections offered by highly regulated depository institutions in favor of the convenience and benefits offered by unrestricted financial services supermarkets. The basic public policy issue that must be debated and resolved is whether the risks of removing all safeguards and protections are unacceptable regardless of the benefits obtainable from unregulated competition. The process of debate and resolution of that issue must of necessity include an examination of the appropriateness of the existing rules of the game, which continue to perpetuate competitive inequalities among depository institutions and between the depository industry and other providers of financial services.

Our own preference is for substantial deregulation in the consumer financial services area. If insurance companies or multinational financial firms can own brokerage firms, if brokerage firms can acquire trust companies, if retailers can own savings and loan associations, if

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Merrill Lynch can offer brokerage services (real estate, commodities, securities, insurance), money market mutual funds, cash management accounts, credit cards -- the full panoply of consumer financial services -- then it seems that the marketplace is already far down the road of dismantling product segmentation. The time has come, therefore, to begin the process of redrawing the roadmap.

In the corporate finance area, the need for reexamination is also apparent. The functions of commercial banks and investment banks should be considered in light of the evolution of the various forms of financing by governmental and corporate customers. For instance, since the enactment of the Glass-Steagall prohibitions in 1933, municipal revenue bonds have become an increasingly important method of state and local government financing. Unlike general obligation bonds, however, municipal revenue bonds cannot be underwritten by commercial banks. Similarly, in the corporate finance area, many.of the larger corporations now view short-term borrowing in the commercial paper market as a substitute for short-term loans. Yet, the authority to sell third party commercial paper has been subject to judicial challenge by the securities industry on the theory that such activity is prohibited by the Glass-Steagall Act. Further encounters of this nature seem likely absent authoritative legislative resolution.

We believe the time has come to reexamine the financial intermediary system which has evolved within the confines of the Glass-Steagall Act. This reassessment should focus on the appropriateness of the Glass-Steagall prohibitions and on what lines of demarcation make sense with

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respect to the financial needs and regulatory environment of today. Because the potential for undue concentration of economic power entails legitimate concerns, we believe that proposals to expand bank underwriting and dealing in securities should be subjected to rigorous but dispassionate scrutiny. At the same time, that scrutiny should encompass the clear potential for the formation of huge financial conglomerates outside the bank regulatory system and the competitive disadvantage which overregulation may be imposing on that system.

VI. SUPERVISORY AND OTHER STATUTORY ISSUES

A reexamination of the statutes dealing with the regulation and supervision of depository institutions is also needed. There are things that can and should be done which would accomplish intended regulatory objectives in ways that are more effective and efficient.

Because of the economic and social costs of widespread or frequent bank failures, the traditional mission of bank regulators, both state and federal, has been to maintain the soundness of the banking system: to spot potential problems in banks before they become serious; to take action to correct the ones that do; and to act in ways that limit failures without unduly inhibiting the free play of market forces. System soundness, however, is not our only concern. We are also charged with the oversight of banks' corporate and trust activities, the enforcement of many consumer protection laws, and the regulation of banks' securities offerings and reports to investors.

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The challenge of regulation is to achieve these mandates in the least burdensome way. The regulatory burden manifests itself in many forms: archaic statutes; inflexible laws; paperwork requirements; resources diverted to developing and maintaining compliance systems; time spent responding to examiners during on-site examinations; and loss of flexibility in decision-making.

Accordingly a comprehensive agenda of statutory and supervisory issues should include a reexamination of existing federal laws to determine how they might be revised to enable regulators to achieve their objectives in the least burdensome ways; it should include analysis by regulators to determine in what ways the burden of compliance with the mandate of existing laws can be reduced; and it should involve an evaluation of how to use limited agency resources more efficiently.

There is danger in pursuing this agenda in a piecemeal fashion. For example, arbitrary reduction of paperwork requirements may prevent the development of even less burdensome remote supervisory monitoring techniques that must rely on the submission of detailed data. Moreover, care must be exercised to assure that one goal, such as efficient and effective consumer protection, is not sacrificed at the expense of another, such as paperwork reduction. As the review proceeds, it would be well to keep these considerations in mind and to rely, as much as possible, on market-based approaches and self-policing techniques to achieve regulatory missions.

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Consumer Protection and Fair Lending Laws

The cry of unnecessary paperwork and regulatory burden is frequently heard with respect to the consumer protection statutes. These statutes have introduced disclosure, public notice, recordkeeping and reporting requirements. Enacted over the last 13 years, these laws are intended to ensure that bank customers are both well-informed and protected against bank error and abuse. However, as the range of bank practices covered by such legislation has grown, consumer protection and fair lending requirements have become increasingly burdensome. Moreover, it is not clear that in all cases burdens have been adequately justified by consumer benefits. It is clearly time to examine these laws systematically, to simplify them and to develop more flexible ways of administering them to assure that the costs do not outweigh the benefits. As we proceed, however, we must bear in mind that as banking becomes even more complex and the range of services even more diverse, the need to educate bank customers and to guard against bank error and unfair practices will become more important.

Most of the consumer protection objectives have resulted in disclosure requirements implemented by regulations that attempt to anticipate types of loan transaction and specify the exact information to be contained in the disclosure notice. The most obvious example is the Truth-in-Lending Act. There are other major credit disclosure laws, such as the Fair Credit Billing Act and the Real Estate Settlement Procedures Act, that need attention. Other consumer laws, such as the Equal Credit Opportunity Act, also contain requirements that could be simplified or repealed.

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Some of these disclosure requirements were devised without a great deal of thought to the costs which they might involve for the lending institutions and their customers. They have been developed piecemeal over 13 years. As a consequence, each has its own distinct legislative and regulatory process. The end result is that lenders have had to spend a great deal of money on designing, filling out, and retaining forms. Consumers, on the other hand, receive lengthy, complex, overlapping, and sometimes confusing series of separate disclosures.

Some progress has been made in reducing the burden of these requirements, most notably the Truth in Lending Simplification and Reform Act passed by Congress a year ago. However, that law fell considerably short of comprehensive simplification. Moreover, the Act did little to reduce the overlap of disclosure requirements affecting, for example, real estate transactions.

For these reasons, comprehensive examination of the entire area of consumer disclosures, encompassing both the credit-related disclosures and others, should be undertaken. We recommend that Congress consider appointing a special commission, composed of legislators, industry repesentatives, a cross-section of consumer representatives, state officials, agency officials and academic experts, to conduct such a review. We recognize that appointing a commission to study a problem can sometimes be a formula for delaying, rather than expediting its resolution. Nevertheless, we feel strongly that a piecemeal review of the consumer protection statutes should be avoided. If these laws are reviewed and reformed one by one, the end result will almost inevitably be

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a continuation of the uncoordinated and duplicative type of system we have now, to the detriment of both lenders and consumers. We believe a commission would be preferable to the normal legislative process because it might have the capacity and perspective to study these extraordinarily complex issues in a comprehensive and highly analytical manner that is necessary for practical reform. As complex as these issues are, we believe, a review would be finite and manageable and could be completed within six months.

As the review proceeds, several principles should be kept in mind. First, the more the marketplace is permitted to offer variety in complex areas in which consumers have difficulty understanding the options presented to them, the greater the possibility there is for consumers to be intentionally or inadvertently misled. If the market is to operate efficiently, consumers must be able to play their part by pursuing their interests on the basis of informed judgment and adequate information. Thus, we may expect to see some pressures build in the future for greater disclosure as an alternative to outright regulation of banking services.

Second, more work should be done in the area of permitting deregulation of small institutions. A major step has been taken in this direction through the Regulatory Flexibility Act passed last year requiring the federal agencies to consider the impact of new regulations on small businesses and to exempt them from requirements where feasible and appropriate. There is no question that small banks are often ill-equipped to deal with the complexities of the consumer protection statutes.

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Third, we believe consideration should be given to devising ways to reduce the burden of compliance systems for lending institutions that have good records of self-policing and effective internal procedures for complying with consumer protection statutes. For example, record retention requirements could be eased or removed for lenders with consistently strong examination results. Such an approach would give institutions an incentive to maintain an excellent record in this area, and would permit agencies to focus supervisory resources on the institutions where serious problems exist.

The Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA)

In 1978 the Congress enacted broad financial institution regulatory legislation (FIRA) designed to prevent perceived abuses in banking practices, particularly with regard to borrowings by bank insiders. The law imposes rigorous conflict of interest standards, burdensome recordkeeping, reporting and disclosure requirements, and new federal supervisory controls upon the conduct of federally supervised institutions. Its provisions, however, are frequently duplicative and, in some instances, inconsistent.

The five federal supervisory agencies represented on the Federal Financial Institutions Examination Council forwarded proposed legislation to the Committee which would make technical changes and correct obvious procedural problems encountered by the agencies in implementing and administering the various provisions of FIRA. In addition to this proposal, we recommend that a more extensive review be undertaken to

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provide simpler, yet effective legislation in certain of the areas addressed by FIRA.

The many-layered nature of FIRA is exemplified by the several statutory procedures, prohibitions and sanctions affecting borrowings by bank insiders from correspondent institutions. Under Title VIII of the law, an insured bank is prohibited from making a preferential loan to any insider of another bank for which it maintains a correspondent account. Unlike other provisions of FIRA concerning loans by a bank to its own insiders, however, Title VIII does not prohibit such a loan to the related interests of an insider of a correspondent institution. Nevertheless, the statute requires that each executive officer and principal shareholder of an insured bank make a detailed written report concerning his or her borrowings and those of their related interests from correspondent institutions. Each bank must then file a separate written report to its federal supervisory agency as to the identity of all such executive officers and principal shareholders and the aggregate amount of their borrowings from correspondents.

The usefulness of these recordkeeping and reporting requirements, and similar requirements under Title IX concerning other insider transactions, should be reconsidered. The prohibitions and the arbitrary ceilings on loan amounts of the statute should either be repealed or amended to permit broader flexibility to individual institutions to make credit determinations in light of the specific characteristics of a loan and the creditworthiness of the intended borrower. A simplified recordkeeping or

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reporting mechanism, coupled with supervisory penalties and potential civil liability, may adequately accomplish the purposes of the law.

We would welcome the opportunity to assist the Committee in reviewing FIRA.

The National Bank Act

While it is clear that recent laws passed by the Congress should be evaluated, we also believe that it is time for a comprehensive review of the National Bank Act. Many provisions of the federal banking laws are no longer as appropriate as they might have been when they were enacted as much as 100 years ago. Several provisions should be either repealed or substantially amended to assure the ability of national banks to meet the evolving needs of our changing economy.

We have already begun to study some of the more troublesome provisions, and certainly others deserve serious scrutiny and, perhaps, revision or repeal. For example, the principal terms of Section 84 of Title 12 of the United States Code have remained essentially unchanged since 1906. The intended purpose of the law, which restricts loans to individual borrowers to 10 percent of a bank's capital and surplus, was to promote diversification of risk and to spread the benefits of a bank's lending capacity throughout its community. Because of this limitation, however, banks, particularly smaller ones located in rural communities, frequently are unable to meet the credit needs of their customers. In addition, many states have considerably less restrictive lending limitations for state-chartered banks, resulting in a competitive disadvantage for national banks. There is no evidence that less

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restrictive limits under state law have increased the level of risk. Accordingly, we are considering proposing changes in this law that would enable national banks to compete more effectively and would simplify the current complicated statute.

Similarly, Section 82 of Title 12, an original provision of the 1864 law, generally limits a bank's aggregate nondeposit liabilities to 100 percent of capital and 50 percent of surplus. Since 1913 this provision has been amended several times to prevent it from interfering with certain national goals such as war production, agriculture, housing and foreign trade. Confusion about the application of this statute has resulted in more than 100 interpretive rulings and opinion letters. Given our current supervisory powers, we are studying whether this law is necessary any longer or whether it should be amended in a way that provides greater flexibility to banks to manage nondeposit liabilities.

Existing federal law also imposes arbitrary ceilings upon the ability of banks belonging to the Federal Reserve System to issue bankers' acceptances, one of the principal means used to finance foreign trade. In recent years many banks engaged in trade financing have reached their legal ceiling. We believe that relaxation of this limitation would assist our balance-of-trade position without adversely affecting bank soundness. Therefore, we recommend review of Sections 372 and 373 of Title 12.

We are also considering the effects of the restrictions imposed on national bank real estate lending activity by the provisions of Section 371 of Title 12. These restrictions were intended to put real estate lending on a safe and sound basis. However, they might unduly

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inhibit national bank participation in the evolving residential real estate finance market. In particular, the rigid loan-to-value ratios, the 30-year amortization requirement, and aggregate limitations on total real estate lending, construction lending, and second-lien real estate lending are often at variance with evolving market realities and deter national banks from engaging in transactions that could at once be prudent and profitable and satisfy borrower needs. We have in the past suggested a revision of this provision that would authorize national banks to make real estate loans subject only to any limitations that the Comptroller of the Currency might from time to time impose. We intend to propose similar legislation during this session of the Congress.

Finally, the normal transactions between affiliated banks are, in our opinion, unduly hampered by the statutory ceiling contained in Section 23A of the Federal Reserve Act (12 U.S.C. Section 371c). The Federal Reserve Board has for several years proposed legislation to permit greater flexibility in dealings between affiliates.

Bank Capital Requirements

While some regulatory reform actions must rely on congressional initiative, many others can be pursued by the regulatory agencies themselves. One initiative we are taking is in the area of bank capital requirements.

The pivotal role that larger banks play in the national and international financial community gives them a responsibility to help preserve stability and confidence. Thus, it is of particular importance that these institutions maintain capital positions that are adequate to

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support the volume and variety of activities they undertake as well as to assure continuing public confidence in their operations and in the financial system as a whole. Last year, we indicated our concern about the long-term trend toward increased leverage in these institutions and outlined a supervisory program to address this matter. During 1980, we implemented the initial phase of the program by conducting comprehensive reviews of the capital plans of the largest banks. Similar supervisory programs are being developed to address the capital adequacy of regional banks. While these programs are necessarily long-term endeavors which may be modified periodically, we believe that such an approach is an effective means of assuring adequate capital levels for these companies as a whole. We are prepared to bring regulatory pressure to bear on individual banks to correct capital shortfalls, present and prospective, as needed.

In smaller community banks, the issue of capital is one of disparity of treatment -- smaller banks generally have capital ratios significantly higher than those of the larger banks. In recent years many small community banks have made significant strides in acquiring and developing the depth and quality of management; the level and quality of earnings; the quality of assets; the geographical diversification; the effective internal planning, operating and control systems; the market presence and reputation; the broad risk diversification in both assets and liabilities; exposure to the disciplines of the public markets; as well as other characteristics which generally justify lower capital ratios for larger institutions. We recognize that these factors, collectively, have more to do with the financial strength and health of a bank, and hence its capital adequacy, than the magnitude of its capital ratio.

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As community banks continue to adopt many of the sophisticated management systems techniques, policies, procedures and controls that are generally characteristic of larger banks, a policy of permitting sound and well-managed banks to reduce their traditionally high capital ratios becomes appropriate. Moreover, we have improved our ability to examine and monitor bank activities. We have developed techniques for identifying banking problems in their early stages on an individual bank basis. This has enabled us to initiate corrective action often before a problem gets out of hand.

Although lower capital ratios may pose some additional risk, we are convinced that the majority of smaller banks can operate prudently with lower ratios. We believe the benefits of more aggressive, competitive smaller banking organizations will outweigh the increased risks lower capital ratios might pose.

Examination and Supervisory Approach

We also recognize the continuing need to review and adjust our approach to examination and supervision to the changing environment. In January we established a task force of senior agency officials to examine carefully the environment in which financial institutions will likely be operating in the 1980s and to determine where changes should be made in our supervisory approach. The intent of this strategic planning effort is to anticipate changes in the banking environment and structure and redirect our resources in the most effective and efficient manner.

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We have begun by attempting to understand the ways in which the environment may change over the next decade and how the financial system will be affected. Simultaneously, we are looking at our own organization to determine our strengths and weaknesses. In the next phase, we will review our supervisory philosophy and assess how we can use new and developing technology to conduct the types of examinations that will be needed, both on-site and off-site. In the final phase, we intend to develop and implement plans for responding to those anticipated changes.

Since the 1970s the national banking system has experienced an explosive growth in assets, sophistication and technology. During the same period, Congress has also given the Office significant new responsibilities for implementing a variety of new banking and consumer protection laws. To keep pace, we have had to reallocate our resources toward new programs to accommodate these changes and away from safety and soundness examinations. Thus, the time between on-site examinations has lengthened dramatically.

At the same time, various governmental actions over the past few years, including hiring freezes and employment ceilings, have kept us from adding to our field examination forces. Our ability to continue to supervise the national banking system effectively and to implement the strategic plan in the years ahead, therefore, will depend upon two critical factors: (1) the efficient utilization of scarce human resources; and (2) the continued modernization of off-site monitoring and analytical techniques, particularly through computer technology.

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continue to experience substantial personnel cuts, our ability to supervise the national banking system effectively may be seriously jeopardized in the years ahead.

In addition, we have made substantial progress in reviewing and changing our examination and enforcement procedures with respect to the Community Reinvestment Act, the civil rights laws and the consumer protection laws. We undertook this review for two reasons. First, the number of laws and regulations covered by the consumer examination has been growing far faster than our resources, creating a need to refocus our examination. Second, we recognized that the consumer examination was ready to evolve from its past orientation as an essentially technical compliance review into a subjective, judgmental evaluation of bank performance. With this recognition came a need for new consumer examination procedures and, importantly, a higher level and breadth of experience in the examiners using them. At this point, we are preparing to test an entirely new set of procedures and an examination team concept that relies on senior level examiners. The new system will take a common sense approach, focusing increased supervisory attention on banks with serious deficiencies, while reducing the compliance burden on the well-managed, well-intentioned institution.

International Supervisory Cooperation

We are also concerned with assuring effective supervision of the international activities of banks. The growing internationalization of the banking industry has caused supervisory authorities from the leading industrialized nations to work toward better mutual cooperation and

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communication. Events affecting banking organizations and markets in one country can have ripple effects elsewhere. The expansion of banking organizations from the home country into other locations necessitates working relationships and coordination among parent country and host country supervisors.

Supervisory authorities have benefitted from increasing communications, formal and informal contacts, and efforts to coordinate their activities. The Committee on Bank Regulations and Supervisory Practices, formed in 1974 under the auspices of the Bank for International Settlements, is perhaps the single most important forum for constructive interchange and cooperative efforts among supervisors of different countries. The Committee's main focus has been the development of broad principles and standards upon which bank supervisors can agree, notwithstanding the various differences in banking laws and regulatory practices among the countries represented. For instance, the Committee has supported international standards for bank accounting on a more consolidated basis than now exists in many countries.

The Committee also provides a forum in which bank supervisors can compare supervisory approaches, identify gaps in the regulatory coverage of international banking, develop guidelines that delineate the responsibilities of host and parent authorities, and exchange information of a sensitive nature derived from a variety of sources. The Committee has been instrumental, for example, in promoting legislation abroad to facilitate arrangements among supervisors for confidential exchanges of information. The European Economic Community (EEC), in its first banking

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directive, provided for exchanges of banking information among member banking authorities to strengthen the bank supervisory process within the EEC. On this point, we strongly support the recommendation of the Federal Reserve Board in its Report to the Congress on the International Banking Act that the IBA be amended to provide additional specific statutory authority for confidential treatment of exchanges of information between foreign bank holding companies and U.S. banking agencies as well as between those agencies and their foreign counterparts.

VII. REGULATORY STRUCTURE

Traditionally there have been five federal regulatory agencies charged with supervising the various federally chartered and federally insured domestic depository institutions. Moreover, one or more state regulatory agencies in each of the fifty states are responsible for supervising the state chartered institutions. In the last three years, Congress has added two more federal regulatory bodies, the Federal Financial Institutions Examination Council and the Depository Institutions Deregulation Committee.

The subject of the optimal structure of the agencies responsible for supervision of deposit-taking institutions is hardly new, but the reasons for addressing it carefully have never been more urgent. Indeed, we are convinced that the benefits to be derived from reorganizing the existing system substantially outweigh the costs. The existing framework is increasingly inefficient — inefficiency that should not be tolerated in a world of expanding agency missions and limited government resources. The challenge is to design a framework that is suitable for today and sufficiently flexible to accommodate change.

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There are several reasons for believing that we should get on immediately with the process of shaping a new regulatory and supervisory framework.

One reason -- the need for effective supervision of a bank holding company and its component parts -- is obvious. Over two thirds of the multibank holding companies contain at least one bank which is nationally chartered and at least one bank which is state chartered. Indeed, it is not uncommon for a holding company system to include national banks, state member banks and state nonmember banks, sometimes in several states.

The possibilities for regulatory confusion and duplication are real and present concerns. It is not sensible for a multiplicity of regulators to have safety and soundness jurisdiction over various segments of an integrated business enterprise. Inevitably, this approach will be at times conflicting and uncoordinated. Moreover, the existing framework confronts bank managers with duplicative and sometimes inconsistent regulatory demands.

Some admittedly modest steps are being taken to rationalize the system. Under the auspices of the Examination Council, the federal bank supervisory agencies have begun to coordinate federal examinations of all bank holding companies with consolidated assets exceeding $10 billion, as well as certain other classes of companies requiring special supervisory attention. In addition, the agencies are attempting to coordinate examinations of all other bank holding companies and their bank subsidiaries where resources permit.

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In an effort to improve productivity, the OCC is developing a system for the examination of multibank holding companies and their national bank subsidiaries from the holding company level, using the company's plans, policies and internal monitoring mechanisms as source material. For the largest bank holding companies, a new financial analytical model is being developed which will focus on the fully consolidated entities. This may result in less frequent on-site examinations or significantly reduced time at individual banks.

These modest steps are worthwhile and point in the right direction, but they do not go to the heart of the matter. What is needed is a unified supervisory perspective on, and authority over, the whole corporate entity.

Our second reason for favoring reexamination and modification of the current structure arises from our belief that we simply must make more effective use of the limited supervisory resources at our disposal.

The creation of the Federal Financial Institutions Examination Council reflected a desire for greater uniformity in the training of examiners and in the methods of examination, supervision, and data collection used by the Federal Reserve System, Federal Deposit Insurance Corporation, Federal Home Loan Bank System, National Credit Union Administration, Office of the Comptroller of the Currency and the state supervisors.

We support the Examination Council's goal of achieving greater uniformity in regulation because of our belief in the more basic principle of applying equal regulatory and supervisory standards to similarly situated participants in the financial system. However, defining who is

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similarly situated and achieving agreement among the agencies on the principles of how to proceed in substantive areas of regulation and supervision is difficult. Even when agreement on principles can be achieved, assuring uniform implementation through the management systems of the different agencies is cumbersome at best, and perhaps impossible in some instances. Thus, despite the progress the Examination Council has made, we are convinced that it is an inefficient tool for coordinating the activities of independent regulatory agencies. Therefore, the time has come to move beyond the Examination Council.

Our third reason for advocating modernization of the current structure, and we recognize this reason is most sensitive politically, is the blurring of distinctions among deposit-taking institutions. Thrift institutions, armed with new powers, are in the banking business — transaction accounts, credit cards and other forms of personal credit — and banks are in the thrifts' business, evidenced particularly by their growing participation in the residential mortgage market. We favor a framework which, at all levels, provides for equal regulatory treatment of equally situated players. The new asset and liability powers of the thrifts underscore the need to include them in a restructured regulatory framework.

A regulatory structure which ignores marketplace realities will only serve to perpetuate anachronisms and to delay — or make more expensive and painful — the very adjustments which the financial industry must go through.

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The numerous options which have been suggested over nearly 50 years for modifying the current structure need not be repeated here. Indeed, either of two basic options which have been proposed, a single agency or separate agencies for federally and state chartered depository institutions, could be structured in ways that would resolve the three immediate problems that we have identified. Other options certainly exist. We do strongly suggest, however, that the time has come to proceed with a rationalization of the structure in a way which at least resolves these three problems. In that process, a number of issues should be addressed, including:

- o What is the appropriate role for the states in the evolving multistate financial services system?

- o What is a responsible, practical distribution of supervisory authority over smaller, locally oriented institutions?

- o How should the regulation of the financial activities of nondeposit-taking organizations be coordinated with the regulation of banks and thrifts?

- o How should the regulation of financial institutions be coordinated with the regulation of providers of telecommunications and similar technologies upon which financial institutions increasingly rely and which they are using in a local and multistate environment?

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- o Where should responsibility for the protection of investors in deposit-taking companies be lodged?

From my personal point of view, having acted in the capacity of Superintendent of Banks of the State of New York, as Acting Chairman of the Federal Deposit Insurance Corporation, as well as a member of its board, and from my almost four years of service as Comptroller of the Currency, I believe that the banking regulatory structure ought to be consolidated into an independent banking commission. I further believe that this commission ought to include the present supervisory and regulatory responsibilies of the Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, Federal Reserve System, National Credit Union Administration and the Office of the Comptroller of the Currency.

VIII. CONCLUSION

In conclusion, I would simply highlight the agenda that is before us. It is useful to identify two categories of items.

There are the laws, regulations and policies which segment markets — geographic and product — and regulate price: in short, the rules and boundaries of the game of financial competition. In these areas, we must recognize that, like it or not, technology, inflation and the vitality of the marketplace have assured deregulation. The task before us is to provide deposit-taking institutions the capacity to compete and serve the public effectively while minimizing the potentially disruptive consequences of dramatic change. This task must continue to be pursued with heightened urgency. It has at least three facets.

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First, the process of phasing out interest rate ceilings must continue apace. To waver in the policy commitment set forth in the 1980 Act might severely damage -- perhaps irreparably -- the role of deposit-taking institutions, thrifts and commercial banks alike, as providers of financial services to individuals. In this regard, I would emphasize the immediate need to agree upon a strategy for addressing the earnings problem of thrift institutions in the short run which allows us to provide all deposit-taking institutions the flexibility to compete for funds in the marketplace. From my perspective, we should have tools, to be used in the event that rates remain high, which provide adequate regulatory flexibility both to facilitate the merger of weaker institutions and, where appropriate, to come to the assistance of institutions _in extremis_. I am hopeful that we will resist the temptation to address the thrift problem by imposing new regulation intended to hamstring competition.

Second, the time has come for decision with respect to the elimination of geographic restrictions embodied in the Douglas Amendment and the McFadden Act. I recognize that the politics are not easy. Moreover, there is no plan for deregulation which is perfectly equitable or which eliminates the possibility of some dislocation. Nevertheless, further study and delay will not provide additional illumination. Nor will it make the decision about how to proceed any less difficult. I am hopeful, therefore, that this session of Congress will chart a course for the deregulation of geographic restraints on deposit-taking institutions just as the last session of Congress did so with respect to deposit rate

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controls. As with rate ceilings, each year that these restraints continue the strength of our depository system will be sapped.

In pinpointing this issue for immediate action, I am not suggesting that it should have highest priority. I am fearful that debate with respect to this subject will in the coming years interfere with our addressing other more important fundamental issues. Rather, I mean simply to underscore that the question of geographic restraints is ripe for decision, that the failure to act may take it out of Congress' hands forever as events in the marketplace moot the question and that banking generally will suffer if that is the outcome.

Third, and most importantly, the time has come to reexamine the various laws, regulations and policies that since the Depression have served to separate the various providers of financial services. This implies, of course, a systematic review of the Glass-Steagall Act. The debate should not, however, be limited to a traditional formulation of the issues. The roles of all providers of financial services — insurance companies, retailers, etc. — and the appropriate function of the government in defining these roles should be addressed. I am hopeful that we can in the coming months define a process for study and debate so that the next session of Congress will be able to consider these issues in a systematic and orderly fashion and come to some resolution.

The second category of items on the agenda addresses regulatory reform. It is imperative that we continue and accelerate the process of reform that has already begun. Deposit-taking institutions are the most regulated of financial providers. Laws affecting them have been enacted

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over the course of more than 100 years. In most cases they marked a reasonable response to a legitimate need. However, taken as a whole, they create a bewildering and conflicting maze — much of which is antiquated and much of which is excessive.

The process of regulatory reform is one which Congress and the agencies must share. In some cases statutory change is required and in some it is not. In this process we must ask several questions:

— Is the goal of a particular statute or regulation still a desirable one and one which warrants governmental invervention?

— Is the strategy chosen to achieve a particular goal an effective one?

— What is the cost of achieving the goal?

— Have we chosen the most efficient possible means to achieve the goal?

By advocating, in effect, cost/benefit analysis, I do not mean to suggest that the exercise is scientific or subject to quantification. It is not. For example, how does one place a value on the benefit of strategies designed to assure confidence in our financial system? Nevertheless, I do believe that it is possible to proceed in a systematic, thoughtful and comprehensive fashion. The process of regulatory reform has at least four parts.

First, the time has come to reorder our financial regulatory structure and by that I mean to include the regulatory framework for all providers of financial services. Although there is no significant constituency for this change, our present framework is increasingly out of touch with

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reality. Whatever reform occurs elsewhere, the failure to address this issue will assure increasingly inefficient and costly regulation. In my judgment, this subject demands higher priority than constituent pressure would accord it.

Second, we should reexamine our civil rights, consumer protection and CRA strategies with the object of enhancing both effectiveness and efficiency. As I have indicated, we have undertaken a comprehensive review of our own policies and procedures. Legislative changes may be required. To that end, we have suggested creation of a Congressional commission to undertake a comprehensive review and report back to the Congress within six months.

Third, I would emphasize that while it is popular to focus on these statutes as examples of costly and burdensome regulation, such a singular focus is inappropriate. These statutes are not alone nor are they necessarily the worst offenders in terms of imposing undue and/or unrecognized costs on depository institutions and their customers. Accordingly, the Congress and the agencies should focus on other groups of laws and regulations as well. For example, simpler yet effective legislation in areas designed to prevent perceived abuses in banking practices, particularly with regard to borrowings by bank insiders, is possible. Moreover, many of the provisions of the National Bank Act are no longer appropriate and should be revised or repealed. We look forward to working with the committee on such issues and anticipate making a series of specific proposals in the coming months.

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Fourth, we in the agencies should reexamine our own approach to examination and supervision in light of resource constraints and the changing nature of the financial services industry. We are implementing programs to review the capital plans of larger banks and to assure adequate capital levels. At the same time, we are permitting sound and well-managed smaller banks to reduce their capital ratios. These programs are aimed at strengthening the national banking system and improving the competitiveness of national banks. In addition, as I indicated, we are developing new approaches and analytical techniques for examining and supervising national banks which respond to changing market realities, which focus our efforts on the more significant problems and areas of risk, and which conserve our limited resources.

We recognize that we have outlined a sweeping agenda for the Congress, the agencies and the industry. Our perspective might well be criticized on the grounds that to undertake the changes we suggest is unrealistically ambitious and politically impossible. In retort, I would suggest simply that there is little choice. For the reasons I have outlined, the business of providing financial services to individuals, to companies and to governments will change radically. Law, regulation and public policy can facilitate orderly change, preserving the worthwhile values of our existing institutional framework. Or, it can serve as a source of uncertainty, an arena for gamesmen, and an impediment to deposit-taking institutions. Which occurs is a matter largely in the hands of Congress and the regulatory authorities. In my judgment, nothing less than the long-run health and stability of the financial system is at stake.

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