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PROPOSED LEGISLATION ON FINANCIAL STRUCTURE AND LEGISLATION

An Address By . . .

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at the

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PROPOSED LEGISLATION ON FINANCIAL STRUCTURE AND LEGISLATION

Early in 1970, Mister Nixon in his Economic Report of the President revealed his intention to appoint a commission to study the nation's financial structure. On April 22 of that year he announced the appointment of Reed O. Hunt as chairman of the group then called the Commission on Financial Structure and Regulation. On April 28th, a meeting was held by the Treasury Department to consider the approaches and methodology to be used by the Commission in dealing with issues identified at that meeting. This meeting was led by Henry C. Wallich, Senior Consultant to the Treasury, and was attended by Under Secretary Charls E. Walker, representatives of the Federal Reserve Board, the FDIC, the Federal Home Loan Bank Board, the Office of the Comptroller of the Currency, the Bureau of the Budget, the Council of Economic Advisors, and by leading scholars from universities and financial institutions.

After the meeting Samuel P. Chase, Donald P. Jacobs, and Almarin Phillips refined the suggestions and prepared the agenda for the Commission's first meeting, with Jacobs and Phillips serving as co-directors throughout the study.

On June 16, 1970, President Nixon announced the names of the outstanding citizens who made up the Commission and directed them to "review and study the structure, operation, and regulation of the private financial institutions in the United States for the purpose of formulating recommendations that would improve the functioning of the private financial system."

At its first meeting on June 27, 1970, the Commission determined that it would deal primarily with the problems relating to commercial banks, mutual savings banks, savings and loan associations, credit unions, private pension plans and reserve life insurance companies. It would, as to these institutions, "study in detail their functional specialization, the effects of deposit rate regulations, chartering and branching, problems of deposit insurance, reserves and taxation, the effects of regulations on mortgage markets and residential construction, competitive problems and the framework of the financial regulatory agencies."

And study in detail they did. After 15 meetings in the next 17 months and the benefit of thousands of pages from individuals, trade groups and government agencies, and scholarly writings from journals, books, hearings and reports, and 19 papers prepared specifically by the Commission by outside experts as well as a 157 page volume prepared by a special committee of the American Bankers Association, the Commission was ready to report. On December 22, 1971, the Commission delivered to the President its report consisting of 148 pages with a 25 page index. In his letter of transmittal, the Chairman alluded to the interdependence of the various financial institutions and asked that the Commission's recommendations be considered and implemented as a package. The report contained some 89 recommendations, some requiring Congressional action, some State legislative action, and some requiring action by the regulatory agencies.

After an extended period of study of the report, the President, on August 2, 1973, sent to the Congress a narrative version of proposed legislation approved by the

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Treasury Department, the Council of Economic Advisors and the Office of Management and Budget (often referred to as the Troika). In it the Commission's request that the report be acted on as a package is ignored, which must be regarded as inevitable, given the size of the package. No mention is made of life insurance companies, pension funds, or trust departments. Nor does the proposal include many of the specific recommendations dealing with commercial banks and their regulation.

When, at long last, on October 12, 1973, the Administration's proposed legislation was sent to the Congress, it did contain a substantial portion of the Hunt Commission recommendations. It did not contain anything outside the report except a provision for NOW accounts and one provision dealing with Truth-in-Savings which seems to have been tossed in to sweeten the pot for the consumer. In what we used to refer to as normal times, this legislation would have received front page coverage with banner headlines. However, these are not normal times and our front pages are filled with the accounts of other Administration activites, both financial and electronic.

However, even though the proposed legislation has stirred up little public reaction, it is of great significance to the banking community and though it has little possibility of being enacted into law at this session, it deserves our attention, because the legislation represents the considered thinking of many of the best minds in the financial world and it may eventually become law. After all, the Federal Reserve did not emerge from the proposals of the Aldrich Commission until 6 years after they were made. It was 25 years after Andrew Jackson destroyed the Bank of the United States before we got the National Banking Act. Given the American penchant for working ourselves into crises, it may be that a crisis caused by a lack of capital for some desirable social end such as housing may trigger the enactment of all or part of this package.

Then let us look at the legislative package. I know that many of you have only seen newspaper accounts of this highly complex legislation and have not really had a chance to read it in detail. Therefore, at the risk of boring you with specifics, let me outline the general scope of the Administration's proposal.

The legislation is divided into 7 titles which, in turn, fall into 5 general categories, the first of which probably is now the most controversial. This one deals with new and expanded deposit powers and reserves and the payment of interest on deposit accounts. It contemplates the removal of rate ceilings (Regulation Q) after 5½ years and the gradual phasing out of such ceilings in the interim, and by means of 4 annual increases beginning 18 months after the enactment of the Act, the elimination of differentials between commercial banks and thrift institutions. The response of both industries has been predictable -- the thrifts insist on retaining the differential and commercial bankers favor the abolition of the differential but insist on retaining rate controls.

This might strike an unbiased observer as somewhat odd since the spokesmen of these industries frequently raise hymms of praise to the free interprise system. Maybe we didn't really mean it when we said at the Miami Convention in 1970 that we should "move further toward a freer market for all deposit categories so that the banking system can, in the present and the future, more effectively serve the needs of a dynamic economy." While I can understand that there may be a comfortable feeling in operating in a restricted and undisturbed economy, I cannot put out of my mind the thought that commercial bankers ought to be the strongest supporters for the elimination of interest rate controls and should not support controls just for their own sake. No other segment of the financial community has the know-how, the experience and the training that are necessary for successful operation in a truly free economy. No other industry has suffered

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more from excessive regulation. Henry Wallich has described banking as the most over-regulated industry in the world. Yet we find that thousands of our banks, particularly small ones, have grown comfortable in their strict confinement and prefer to avoid the cold blasts of competition. Perhaps we would feel more comfortable if some standby interest rate controls were retained for the next few years.

The bill provides that Federal thrift institutions shall have third party payment authority, including negotiable order of withdrawal (NOW) accounts with access to the check clearing process, and the authority to engage in credit card operations, as banks are permitted to do now. Both banks and thrifts would be permitted to offer savings and NOW accounts to all customers, individual and corporate. It may be that this provision can be better evaluated by the Congress after a few more months experience with the experiment now being conducted in New Hampshire and Massachusetts. Even though the Hunt Commission recommended that we retain the prohibition against the payment of interest on demand deposits, this may be the first step in the removal of that restriction. Many competent observers are of the opinion that the prohibition was enacted in 1933 after an erroneous conclusion drawn from the facts then known. It is now fairly well established that excesses in the payment of interest on demand deposits did not play a significant role in the bank failures of that era.

In the first title is also included a "truth-in-savings" provision. This obviously is designed to appeal to active consumer groups. I cannot believe that any banker really wants his customers to have less than a clear, understandable, explicit statement of the terms and conditions of his deposit and I hope that these facts can be expressed in simple language.

It is interesting to note that the Administration, in asking for the establishment of reserves on savings and NOW accounts, left both nonmember commercial banks and nonmember savings and loan associations free of Federal Reserve requirements, though it extended the reserve requirements to time and savings accounts in member savings and loan associations. This is the second of the five categories I referred to earlier.

The Administration shies away from the controversial issue of compulsory membership in the Federal Reserve System and in fact leaves State-chartered savings and loan associations free to retain their life insurance, equity investments and corporate bond investments, while withdrawing from the Home Loan Bank System in order to avoid these reserve requirements.

The third category of administration proposals provides for an increase in lending and investment powers both for Federal savings and loan associations and national banks. Savings and loan associations would be authorized to:

(1) make consumer loans not exceeding 10 percent of their total assets;
(2) make real estate loans under the same conditions as national banks;
(3) extend unsecured lines of credit to builders for construction financing;
(4) make community welfare and development investments, including a participation in capital gains or rental income, but with this leeway authority limited to 3 percent of their total assets;

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(5) invest in high grade commercial paper and corporate debt securities in accordance with guidelines established by the Federal Home Loan Bank Board, with such investments being limited to 2 percent of total assets the first year and increasing by 2 percent each year until the maximum of 10 percent is reached after a 5 year period;
(6) utilize for consumer loans the unused portion of authorized investments in private corporate debt and leeway loans; and
(7) continue the acquisition of a full range of U.S. Government, State and municipal securities.

At the same time national banks will be granted:
(1) liberalized powers with respect to real estate loans (on the same basis as other loans);
(2) a leeway authority to invest not more than 3 percent of total assets in community rehabilitation and development and mortgage loans on residential and related properties, including a participation in rental income, or a share of capital gains on the sale of the property.

In addition, the Federal Reserve Board is to be granted more flexible authority to define assets eligible for use as collateral for advances.

It seems to me that in this area the recommendation by the Hunt Commission that its report be acted on as a package deserves close attention. Otherwise we may find the thrift institutions enjoying the new benefits without new responsibilities. Obviously, the right to make consumer loans, construction loans and other investments will increase their gross income and provide much needed liquidity in periods of tight money. But if thrift institutions are to receive these expanded powers to enhance their cyclical stability, they must be prepared to surrender some of the special privileges they now enjoy and operate with uniform tax rates, interest rates on deposits and uniform reserves.

This brings us to the fourth category -- taxation. Perhaps this should be treated as a part of the third category since it is closely related to it. The Administration's aim here is to achieve a uniform tax system for all financial institutions. It proposes that the special bad debt reserve provisions for thrift institutions be eliminated and that their bad debt reserves be computed in a manner similar to that of banks. The most significant proposal is the establishing of a tax credit related to income from residential mortgages. The purpose would be to achieve a tax neutrality so that a given investment or activity will be subject to the same income tax provisions regardless of the functional type of financial institution making the investment or engaging in the activity. There will still be some differences in tax treatemnt, however. These differences will result from a combination of three factors: (1) the form of the institution, i.e., mutual bank versus capital stock corporation; (2) Federal and State regulations which will grant certain types of institutions the power to make certain investments and engage in certain activities that are denied to other institutions; and (3) the extent of utilization by an individual institution of the power granted to it. To this extent true tax neutrality may be difficult to achieve.

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The last category includes several items. It grants somewhat more liberal powers to credit unions, allowing them higher rates on consumer loans and creating the National Credit Union Administration Discount Fund to meet temporary liquidity problems of insured credit unions.

In this category the Administration proposes to eliminate interest rate ceilings on FHA and VA loans which may make more adequate funds available for housing in those areas where State usury laws or an oppressive "point" system have dried up such funds. In addition, the Home Loan Bank Board would be given authority to charter Federal stock thrift institutions having the same powers as Federal mutual savings and loan associations, and conversions from Federally or State-chartered mutual institutions to Federally chartered stock institutions would be permitted. Too, Federally chartered mutual institutions would be permitted to convert to State stock institutions. Thus our dual banking system would have its counterpart in the thrift system, as stock thrifts would have a choice between a State charter and a Federal charter.

This, in essence, is the Administration's Hunt Commission package. In some ways we can say that the credit crunches of 1966, 1969 and 1973 have served a useful purpose. They have been especially helpful in pointing out the inadequacies of our present financial system, the ineptitude of the present functional specialization. This legislation is intended to correct those deficiencies and, if it is enacted, it may succeed to a degree. I think most bankers approve of the Hunt Commission's expressed objective, "... to move as far as possible toward freedom of financial markets and equip all institutions with the powers necessary to compete in such markets. Once these powers and services have been authorized and a suitable time allowed for implementation, each institution will be free to determine its own course. The public will be better served by such competition. Markets will work more efficiently in the allocation of funds and total savings will expand to meet private and public needs."

I have consciously avoided extended discussion of the committee report of the House Banking and Currency Committee. It purports to seek some of the same goals as those expressed in the Administration package, and it recommends some of the same changes, particularly with respect to expanded powers of thrift institutions, going even farther than the Administration in permitting business and industrial loans. It would impose on banks, savings and loan associations, savings banks, life insurance companies, foundations and private pension funds the duty "to make prescribed investments in residential mortgage loans at levels adequate to meet the need." This imposition of additional controls on assets as well as controls on interest rates would seem to me to be most distasteful to bankers and would represent a major step away from a competitive financial system and toward a financial strait-jacket.

Mr. Patman's staff report recommended, among other things, the creation of a National Development Bank "...to help meet the financial needs of small business and industry and state and local governments...", and the establishment of a single regulatory agency at the Federal level to be known as the Federal Banking Commission, as well as an agency called the Federal Trust Management Commission.

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No legislation has yet emerged from the Patman staff report, but it begins to look like we will have another battle between those who would rely on free markets and those who would prefer increased government intervention.

It seems to this observer that change is inevitable, perhaps not immediately, but certainly not in the distant future. I would, therefore, urge that bankers be-stir themselves and help manage that change so that our financial institutions may develop new and more effective approaches to the management of a strong, vital and buoyant economy.

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