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BANKING IN TRANSITION

Address of

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Federal Deposit Insurance Corporation

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The past twelve months have been a time of transition, for the economy, for banking and for bank regulation. In each case, we know the past, we recognize--no doubt imperfectly--a number of the forces presently at work, and we are certain only that the future will not fit our past predictions.

The economy has reacted slowly to the bitter medicine of our national effort to curb inflation. From extremely tight money, high interest rates, a depressed stock market, production cutbacks and persistent increases in the cost of living a year ago, we have moved to a surplus of lendable funds, lower interest rates on short term paper, a stock market recovery, better than normal housing starts and a much flatter trend line for the cost of living index. On the other hand, unemployment remains high, particularly in industries affected by cutbacks in military spending. Wage demands continue to exert an upward push on prices. But it is the consumer who is the big question mark. Perhaps worried about his job, perhaps worried about continued inflation, he is saving, not spending, and the production of most consumer goods continues to suffer. Monetary and fiscal policies now are intended to stimulate the economy, not slow it down, but new inflationary pressures may be released by just such policies. Economic recovery is likely to be uneven and slower than we might wish in the months ahead.

The banking system has been directly affected by these changes in the general economy, and future developments in that sector will no doubt continue to be the most important determinant of day-to-day banking decisions. But these twelve months have also seen new factors which are likely to have major and long-term significance to banks and their regulatory agencies.

The 1970 amendments to the Bank Holding Company Act will be one of these, I am convinced. The passage of these amendments ended a two-year period of uncertainty and inactivity for some 1100 one-bank holding companies with deposit totals that ran the gamut of American banking, from very small banks to the largest in the country. Even in States where multibank holding companies are not permitted by express provisions of State law, one-bank holding companies have been established and more such formations are likely in the future.

The suddenness with which the one-bank holding company movement swept the field of American banking can be explained only by reference to the regulatory climate in which expansion-minded banks found themselves in the mid-1960's. The progressive liberalization of national bank regulation that took place under Mr. Saxon was welcomed by many observers, including those on the State side of the dual banking system. Yet the one-bank holding company movement in 1968 and 1969 was led, by and large, by national banks. Many were concerned--with ample justification as a succession of court cases have since made clear--that the most significant innovations in the powers of national banks, which were based on new interpretations of a vaguely worded reference in the National Bank Act to the incidental powers national banks possessed as "necessary to carry on the business of banking," might not withstand legal attack. That clause, you may recall, had been used by the Comptroller's office to sustain such activities as direct leasing, travel agency services, collective managing agency accounts, operations subsidiaries, loan production offices, certain types of insurance activities and a host of other powers, many of which were subsequently reflected in specific amendments to State law for State-chartered banks or incorporated, somewhat more vulnerably, into

State law by so-called "wild card" statutes.

Coincident in time with these challenges to the Comptroller's rulings were two other developments: one was the progressively harder line being taken by the courts, the Federal Reserve Board and the Antitrust Division, particularly after 1966, with respect to the acquisitions of banks by other banks or by multibank holding companies, a line which culminated in the Phillipsburg case last June. Expansion by the acquisition of other banks in the same market became a clear risk and, therefore, increasingly unattractive to the larger and more aggressive banks in the country regardless of charter. The second event was the apparent refusal by Congress in its 1966 amendments to the Bank Holding Company Act to close the "one bank" loophole despite the urging of the Federal Reserve Board and others. Since the one-bank holding company remained unregulated, it offered the perfect vehicle for expansion into nonbank fields as well as a means to put certain bank operations beyond challenge if they were spun off to separate holding company subsidiaries. And so, the rush was on.

The 1970 Act by which one-bank holding companies were finally brought under regulatory control is important, in this context, for what it did not do, as well as for what it did. It did not enact a statutory "laundry list" of prohibited activities. It chose instead to give the Federal Reserve Board considerable (but not unlimited) discretion to control the expansion of bank holding companies into nonbank activities closely related to banking or managing or controlling banks. Nor did the 1970 amendments limit geographically the area within which these non bank activities could be conducted.

The first steps taken by the Federal Reserve Board to implement this new legislation have been relatively noncontroversial, both as to the types of activities initially to be permitted and as to the short-form procedures to be utilized when de novo affiliates are contemplated. The more dramatic implications of the amendments--geographically, functionally and competitively--are still some months away, but dramatic they will be.

It is too early to say that State control over the structure of banking within its borders is a thing of the past, but I have no doubt that this touchstone of a decentralized banking system will be seriously compromised by the likely developments under the revised Bank Holding Company Act. The result may be, however, a significantly more competitive financial structure in the United States than we have today. Individual Governors of the Federal Reserve System, for example, have made it clear that they view their Congressional mandate as an opportunity to promote both flexibility and competition in the provision of financial services to the American public. To realize on this opportunity will require the Board to utilize the geographic freedom it has been given, and that is where the erosion of State control over structure will occur, in somewhat the same manner that the Federal Home Loan Bank Board has ignored for Federal associations the restrictions in State law which apply to State-chartered savings and loan associations.

To illustrate my point, assume that the mortgage origination and servicing activities of a bank are spun off to a holding company affiliate. That affiliate, so long as it does not receive deposits, may establish offices wherever its business takes it, possibly even nationwide. It will not be bound by State law provisions that prohibit or limit the location of branch offices of a bank. It will not be bound by State lines. De novo entry by the affiliate into areas remote from the bank's own offices and its original market is likely to be considered procompetitive, since it will add to the public's choice of mortgage financing in the new area. In some cases, the acquisition by the affiliate of an existing mortgage concern in a similarly remote area may also be considered by the Board to be procompetitive. In neither situation is the Board likely to see any reason, under the criteria spelled out in the law, to impose any geographical limitations on the affiliate. Multiply this process by even a small number of the functions presently performed by banks, such as data processing services, lease financing, factoring, or consumer loans, and a significant change in the convenience, availability and provision of financial services will have taken place without reference to State restrictions on the location of bank offices. In States which permit stock savings and loan associations, a more striking change in the financial structure contemplated by the State can be suggested. If the Federal Reserve Board finds eventually, as I think it will, that the operations of a savings and loan association are so closely related to banking as to be permissible activities under Section 4(c)(8) of the amended act, bank holding companies may well seek to charter new savings and loan associations or to acquire existing stock associations, particularly if the branching powers of such a savings and loan affiliate are greater than those of an affiliated commercial bank.

I raise these possibilities to make you aware that despite recent court victories upholding the primacy of State law in matters of commercial bank branching and merging, the 1970 amendments to the Bank Holding Company Act look in a different direction, with the basic decisions being made at the Federal level. In the long run, which concept prevails will have a significant bearing on the future of bank activities in this country and the future of bank regulation.

The Presidential Commission on Financial Structure and Regulation has also been appointed within the last year and is now at work with a very broad mandate to make recommendations on many long-standing issues of contention and controversy in the financial field. Its final report is due in December, and there are indications that significant recommendations affecting the operating powers and competitive capabilities of different types of financial institutions will be made. Until conclusions are reached in these areas, the Commission may be understandably reluctant to take up the organizational questions of bank regulation in which both State and Federal supervisors are vitally interested.

The recent report of your Special Committee on Restructuring the Bank Regulatory System is for this reason a timely contribution to the required reading of the Presidential Commission. It is a fine working paper, collecting in one place the applicable laws and history articulating the advantages of a decentralized system, and identifying the many disadvantages which those who regulate State banks, even at the Federal level, see in the present structure. Your comments and recommendations are being reviewed carefully by the FDIC and, I am sure, by the Federal Reserve System. On a subject where individual views are strongly held, your recommendations are not likely to win universal approval, but your Committee's stated desire

> "...to increase regulatory efficiency, preserve the advantages of decentralization, increase the efficacy of monetary policy, provide greater consistency in regulatory decisions, and provide better banking in the public interest."

expresses the goals toward which every regulatory agency should be striving. Your special study is a serious and balanced presentation which deserves a great deal of attention and reaction from individual Supervisors, the regulatory agencies in Washington, the banking industry and concerned members of the Congress and the public.

The past year also has seen rising Congressional interest in protecting bank customers in their dealings with banks, regardless, I might add, of charter or insured status. The 1970 amendments to the Bank Holding Company Act include a general prohibition against requiring a customer to take an unwanted bank service in order to get one he does want or requiring a customer not to do business with a competing bank as a condition for obtaining some requested service. While exceptions to this anti-tying provision can be made by the Federal Reserve Board, the prohibiting language is broad indeed, applicable to national and State banks as well as banks that are holding company subsidiaries, and enact without apparent regard to the provisions of State law that might also be applicable to State banks. H.R. 5700, scheduled for hearings next week, among other things, reintroduced a proposal made last year to ban insured banks, savings and loan associations and insurance companies from accepting equity participations in a customer's business in consideration for making a loan. Stringent prohibitions are included on a wide variety of interlocking relationships at the director level and on insider loans to a bank's own officers, directors and employees, at least in part on the theory that bank customers not having such special relationships are disadvantaged in doing business with a bank, particularly during periods of tight money. Again, no reference is made to State restrictions in the same area that might apply to State-chartered banks.

This pattern of direct Congressional intervention over State banks, disconcerting though it may be to State supervisors, is not new. The Bank Merger Act of 1960 required the Federal Reserve Board or the FDIC, in all cases where a State bank was the resulting bank, to review their proposed mergers on competitive grounds as well as banking factors irrespective of State law or prior State approval. The Financial Institutions Supervisory Act of 1966 gave both agencies cease and desist powers over State banks, and while the power was not expected to be much used at the Federal level, we have been criticized by Congress for not using it more in problem banks, regardless apparently of whether or not the State supervisor is sympathetic to Federal intervention. The Bank Protection Act similarly gave these two agencies direct regulatory power over State banks in a manner once reserved to the States.

It is true, as your Special Study points out, that State regulation must be in part a reflection of the regulatory role played at the Federal level. But I see no reversal of the Congressional trend to which I have alluded without greater information of State efforts in areas of concern to Congress and without greater confidence by Congress in the effectiveness of State regulation. One need only to look at the debate currently raging in Congress over general revenue sharing to know that this question of Congressional confidence in State activities is not limited to matters of bank regulation.

To its credit, your Association through its research programs, its guidelines for effective bank supervision, its evaluation project for measuring the performance of State banking departments and the work of its Special Committee is moving actively to capitalize on much of the progress which has been made at the State level in recent years to restore the vitality of State banking systems. But the future of State-chartered banking rests ultimately with the Congress of the United States, and it is here that respect and confidence in State supervision is needed.

To transform Congressional skepticism about State supervision into understanding and active support, I would repeat today the four suggestions I made at your Closing Banquet last May.

First, your concern for the structure and vigor of financial competition within your individual States should be evident, and evident in Washington as well as at home. Do the laws of your State promote or hinder competition among financial institutions? How frequently are they reexamined? Are you leading the fight for change, if change is needed?

Second, there should be evidence of local innovation, adaptation and experimentation in the provision of financial services to the people of your State based on State law. Your Special Committee has stated eloquently the possible advantages of a decentralized banking system in which decision-making is dispersed and independent judgments are encouraged among a large number of units. Are these advantages being realized in your State?

Third, there should be evidence that your State is actively seeking ways to finance the resolution of urgent community problems, and that State Supervisors are prepared to accept the fact that many investments now being made by concerned banks in these areas involve risks that cannot be accurately measured from past experience. This is only one indication that concepts of effective bank regulation are changing in Congress and among informed people at large.

Fourth, Congress must have accurate information about banking developments at the State level, about State laws that may be affected by a Congressional enactment, and about your State's capabilities in the field of bank supervision.

Changing what seems to be the prevailing view in Congress will not be easy. But decentralization which substitutes State bank supervision for responsibilities now assigned to a variety of Federal agencies is not likely to occur without this change.

To return to my beginning, we now are in a transition period in the economy, in banking and in bank regulation. Conflicting forces are at work in each, and only the hindsight of five years from now will clarify the direction in which we are heading. If times of transition and ferment are an opportunity to revitalize the ways in which we conduct our affairs, let us take that opportunity to make a decentralized banking system work the way it should--effectively, close to the people and responsive to their needs.

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