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Statement by

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Member, Board of Governors of the Federal Reserve System

Before the

Senate Committee on Banking, Housing and Urban Affairs

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I am pleased to present the views of the Board of Governors on Amendment No. 1586 to the A. Phillip Randolph Institute Bill (H.R. 5625). This Amendment would modify Section 4 of the Bank Holding Company Act to prohibit banking organizations from acquiring a savings bank, a savings and loan association, or a savings and loan holding company except where necessary to prevent an insolvency or to restore solvency.

The issue of affiliations between commercial banks and thrift institutions is an important one for the evolution of the financial sector of the economy. The Board has long believed that this issue should be the focus of careful study and Congressional consideration. The need to do so is heightened by the fact that the distinctions between banking organizations and thrifts are narrowing. However, the Board believes that an indefinite moratorium on such affiliations is not desirable. What is needed is timely resolution by the Congress of the broad public policy issues posed in this area, and we doubt that a moratorium would contribute to that development. Moreover, depository institutions, and especially thrifts, have experienced a significant decline in earnings recently, and pressures on earnings may persist as these institutions adapt to changes in the competitive environment created by recent legislative and regulatory actions.

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The Board feels that the public interest would be best served by a flexible regulatory framework capable of responding to special situations that may arise. A moratorium would only introduce additional rigidities into the regulatory system.

Let me begin by reviewing briefly the economic forces that have been operating during recent years to reduce the distinctions among different financial institutions.

Changes in the U.S. financial system have been occurring at a rapid pace over the past two decades. An evolutionary process is underway that is profoundly affecting the structure and performance of the financial industry. It has involved banks, thrift institutions, nonfinancial businesses, individuals, and financial regulatory institutions--all interacting in response to economic forces. A major initiating source of this proce been the dramatic increase in interest rates that has accompanied accelerating inflation. Each rise of interest rates has brought with it new efforts to capitalize on the time value of money. Repeatedly, banks and thrift institutions have faced usury ceilings and other regulatory constraints that limit profit-making opportunities, and deposit rate ceilings that limit their ability to pay market rates of return to business and individuals. As a result, depositors have shifted funds elsewhere in search of higher yields.

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To avoid regulatory and statutory constraints, and protect their sources of funding, financial institutions have responded by creating new instruments--CD's, NOW accounts, money-market certificates, automatic transfers, and others; new technologies--such as EFT; new concepts of funds management--such as remote or controlled disbursement and reliance on short-term liabilities as a source of liquidity; and even new markets and institutional forms.

These developments have had profound effects on the structure and functioning of the U.S. financial system. The expanded array of services has resulted in a blurring of the distinctions between banks and thrifts and even between depository and nondepository institutions. Regulations limiting the ability of institutions to pay market rates of return have become increasingly ineffective. Barriers to the free flow of funds among markets have been reduced, and geographical mobility of funds has increased greatly. The bank holding company form of organization, besides enhancing leverage possibilities, has served as a vehicle enabling intra-state expansion within states with restrictive branching laws, and expansion beyond state boundaries, particularly with respect to the lending activities of non-bank affiliates. This inter-state expansion, together with the growth and multi-state presence of foreign banking organizations, has called attention to the need for a careful review of the present restrictions on inter-state banking.

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These changes in the financial system contributed to passage of the Depository Institutions Deregulation and Monetary Control Act of 1980. By providing for a phase-out of Regulation Q, expanded asset powers for thrifts, and NOW accounts and automatic transfers, the Act will encourage a further homogenization of depository institutions, especially in the field of consumer services. The Act also sought to provide for competitive equality between banks and thrift institutions offering nearly identical services but subject to different regulatory constraints. The Act would not result, however, in complete equality in the regulatory treatment of financial institutions even when fully in effect. Federal savings and loan associations, for example, have broader branching powers within states and are subject only to regulatory, not statutory, restrictions on interstate expansion.

As the distinctions between banks and thrifts diminish further, it will become increasingly difficult to rationalize the maintenance of barriers to consolidation between bank holding companies and thrifts. We are already faced with an anomalous situation. It is permissible for bank holding companies to acquire other companies meeting the statutory criterion of providing services that are "so closely related to banking or managing or controlling banks as to be a proper incident thereto," such as consumer finance and mortgage banking firms. But the Board has not generally permitted bank holding companies to acquire thrifts,

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which are more similar to banks in terms of the types of services they offer than many of the nonbanking companies whose activities are on the permissible list.

The issue of whether or not to include thrift institution activities on the permissible list for bank holding company acquisitions has come up on several occasions since the enactment of the 1970 Amendments to the Bank Holding Company Act. Beginning in May of 1971, with adoption of its initial list of permissible activities, and in each instance thereafter, the Board has consistently ruled in the negative on this general issue. The Board noted that Congress had created a separate statutory and regulatory framework for savings and loan associations, reflecting its intent to maintain savings and loans as specialized lenders to finance housing. Because of that, the Board felt that affiliations between banks and thrifts involved broad public policy matters that the Congress should address.

The most recent case involving the general issue was in 1977, with the application of D. H. Baldwin to retain an S&L acquired before the 1970 Amendments became effective. The Board again concluded that operating an S&L was impermissible for bank holding companies, for several reasons. The Board noted that there were conflicts between the regulatory frameworks for bank holding

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companies and thrifts, especially with respect to the nonbanking activities that thrifts and bank holding companies are permitted to engage in. The Board felt that it could not resolve this conflict nor could it limit the activities of thrifts so as to fit within the standards of the Bank Holding Company Act. The Board also stated that such acquisitions might erode the beneficial institutional rivalry between thrifts and banks. Finally, the Board recognized that as the powers of thrifts were expanded, and they became more like banks, acquisitions of thrifts by out of state bank holding companies would undercut the interstate restrictions of section 3(d) of the Bank Holding Company Act.

The only exceptions to the Board's general policy in this regard have been cases in Rhode Island and New Hampshire, where such affiliations have been permitted because of the unique banking structures in those states. In both states, state law permits mutual associations to own commercial bank stock, and virtually all thrifts, with the exception of credit unions, are affiliated with commercial banks. Moreover, in the most recent case, involving New Hampshire institutions, the Board indicated that the exceptions made for New Hampshire and Rhode Island were not to be viewed as signaling a departure from the principles set forth in the D. H. Baldwin case.

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In light of the changes in the financial system and competitive environment presently underway, the Board would urge the Congress to address the issues in a purposeful way of whether, when, and under what circumstances, thrift institutions and commercial banks should be allowed to merge or join forces under a holding company structure. We feel it is particularly important to investigate fully the legal, supervisory, competitive and other implications of affiliations between banks and thrifts, especially at this crossroads in the evolution of the financial system. We would be pleased to prepare a timely study of the issues so as to facilitate early consideration by Congress. The Board believes it would be appropriate also for the FDIC and the FHLBB to prepare separate studies, since they would bring to bear their unique experiences as regulators of mutual savings banks and savings and loan associations.

As I have already indicated, there are important reasons why the Board does not feel that this legislation is desirable. In addition to these concerns, this legislation would establish a type of negative laundry list. The Board has consistently opposed such attempts because of the limits that would be placed on the ability to adapt the regulatory structure to a changing competitive and economic environment. In any event, the legislation seems to us defective in several ways.

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First, thrift acquisitions in New Hampshire and Rhode Island already approved by the Board would need to be explicitly grandfathered; otherwise, they might have to be divested.

Second, while the amendment would prohibit banks or bank holding companies from acquiring thrifts, it does not prohibit thrifts from acquiring banking organizations.

Third, the language of the Act relating to acquisitions in emergency situations does not provide the flexibility needed for the Board to permit acquisitions before insolvency becomes imminent. Moreover, the proposed legislation does not provide for suspension of the notice requirements in emergency situations, as is the case in emergency bank acquisitions under section 3 of the Bank Holding Company Act. The Board would not be able to act until proper notice and opportunity for a hearing had been given. This might telegraph to the public that a particular thrift institution was in financial difficulty.

Finally, the Board believes that if a moratorium is imposed, it should have a terminal date of no more than one year to encourage the Congress to deal in a timely way with the broad issues involved.

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