ADDRESS

DELIVERED BY

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This is the basic draft of the speech but Governor Gardner departed modestly from the written text.

Good morning. It is a pleasure to be here and be an early speaker on your program. There is always something going on in banking that is controversial, especially where regulators are concerned. I have arranged an early flight back to Washington today as a precaution. But it would be a disservice to you if I did not express my observations and convictions with some candor for a number of reasons. First, my private business experience for 28 odd years was in commercial banking and, second, my more recent Governmental service has involved many regulatory policy matters affecting all types of financial institutions. I want to see a vigorous, sound banking industry, responsive to social and economic change as a part of a larger, more diverse, strong financial institutional structure commensurate with the needs of the world's largest free economy. These are fine broad goals that anyone could agree to. What disturbs me is the complex of impediments that delay change and progress in banking and finance when the rest of the world, and specifically our own economy, are changing at an accelerating pace.

One can easily speculate on the reasons for the difficulties. First, banks are more heavily regulated than other financial institutions because they have a central role in credit expansion and, thus, are vital to economic progress. Banks hold such a large share of the savings and liquid balances of individuals and businesses that society has decided that the economic cost of bank failures is unacceptable. Banks are chartered more carefully with more restrictions than are imposed on other business. Banks can have Federal charters unlike almost any other form of business corporation except S&L's and credit unions, and they are regulated and supervised at both the Federal and State levels. Their services are restricted by statute and regulation. The examination of banks is the most comprehensive such oversight visited on any form of corporation on a regular basis. The Government, and incidentally the public, have more information on the affairs of banks than that available on any other type of industry.

This pervasive public oversight sets banking apart. If the industry was not mature before the banking holiday of the early thirties, after the codification and development of our regulatory structure that occurred then, it surely has been since. Maturity has its good points, but rigidity or resistance to change is not one of them, in my opinion, and banking as an industry has too often resisted change. Understandably, change is more difficult to achieve in banking because of the infrastructure of law and regulation. Key measures must many times await the enactment of new laws.

But that, of course, is not the whole reason for rigidity. Banking associations play a very natural role in constraining innovation. Bankers very naturally join and support a complex of industry associations which are formed to represent their interests, as does most industry. I am not complaining about associations, but I want to talk about them briefly. First, there are an awful lot of them, and they are effective. Second, they have an impossible job. They, the officers of the association and the legislative committees, have to achieve consensus positions representing a broad heterogeneous membership. Logically, then, they will have to find this in a middle ground, a consertive position. And, too often, as you know, a no-change philosophy can prevail. Once set, however, associations' policies are very ably presented. They have heavy impact, and I think you know the historic results as well as I do.

Thus, there are understandable reasons why it is difficult to achieve change in banking that requires any adjustment in regulation or law. But it is impossible to forever maintain a strict status quo in America. Maverick innovators find bypass ways of straining conventions. State legislatures sometimes are easier to convince than the Congress. The courts, from time to time, have rejected the status quo when new developments were protested and litigated. Statutory commissions study change and most of the time, but not always, the real world disregards their advice. All branches of the Federal Government advocate revisions; administrations, legislatures, regulatory agencies, and some ideas see the light. I think it's all very cumbersome, and society would inevitably have suffered if there were not parallel movements going on.

There are, of course, outside the banking industry. The fact that the value of liquid assets has increased so steadily in our capital-short world and country in the period since World War II has assured this result, as well as the fact that individuals and households have become the largest owners of liquid balances in our affluent society. The demand for financial services among an ever widening majority of our society has increased absolutely, and the variety and numbers of nonbank suppliers of these services have increased as well. I'll confine my evidence to just financial institution competitors of banks. Credit unions, you know, are growing most rapidly. Conditions are favorable for this growth to continue at a high rate, and a significant number of them are paying a dividend on share draft balances. The National Credit Union Administrator has proposed by regulation that permission be granted to all Federal credit unions to offer such share draft accounts. Equally significant is the fact that the ceiling on such dividend rates is not related to Q ceilings and not administered in the same fashion. I suppose he'll be sued by bank associations, but I have no ability to judge the outcome of such a suit. The thrift institutions have been very active, as you know. I do not need to recite what your competitors in this area have done in detail; telephonic transfers, the CBCT controversy and preauthorized third-party transfers for any purpose. Money market mutual funds are also in the business. But all of this burgeoning evidence of change only underlines the futility of attempting to checkmate each new innovation.

When the Financial Institutions Act and the Financial Reform Act were debated last year, the charge was often made that someone was trying to make commercial banks out of thrifts. If I had been more alert then, I would have realized that the someone was the consumer. These developments are basically responsive to the marketplace and the marketplace--the American consumer--is persistently seeking ways to not only simplify financial activities but also to earn a share of interest on outstanding liquid balances. The consumer has been intrigued, cajoled and sold by every other industry that offers new services, and the advantages of technological change that provide easier and more economic ways of doing things. We should not be surprised that the same thrust is occurring in financial services.

Because of all the rigidities attending attempts to change banking laws and regulations, we seem to have slipped into a seasonal debate pattern. Last year at this time and the year before at this time, we were dealing with financial institutional structural change in the old FIA and FRA that I referred to earlier. 1977 is no exception. There has been a lot of informal talk about a new legislative proposal, and there is going to be a lot more talk when it is introduced. I happen to think that it's a pretty good idea to get on with the business of conforming Federal banking statutes with the changes that are occurring both in State laws and by other innovations. It is clearly unwise to artificially weaken the competitive position of one type of institution against another. Further, we should not permit the balkanization of the financial system to grow in the 50 States if we intend for commerce to flow freely through the nation. So I am now going to talk for a few minutes about the basic rationale behind a proposal yet to be introduced in the Congress that I believe you should consider carefully. I also think in view of my earlier remarks that your own opinion of these proposals should be expressed, both in and outside of your industry association, particularly when you are not fully satisfied with any one group's position.

To begin, I would argue that we ought to rationalize what has already happened. Every banker is uneasy about the real cost of demand deposits, and the implicit costs have been high. Large customers have exercised this high bargaining power for many years and with the ability to negotiate for extensive services and ready access to the money market for overnight returns on excess cash, there seems to be no question that businesses have been, and are obtaining, a near-maximum return on liquid balances. In the aggregate the consumer has also had bargaining power. You have aggressively pursued the aggregate consumer with new buildings, drive-ins, a wide variety of services, too often priced below cost, and, ultimately, free checking or nearly free checking. The Board staff estimates that banks, as a group, subsidize consumers' checking accounts by an amount equivalent to an interest rate of 4 to 4-1/2 per cent.

Meanwhile, in New England, the consumer has enjoyed explicit interest on accounts similar to checking accounts since 1972--not only at banks but also at savings banks and savings and loan institutions. Other States have permitted State-chartered thrift institutions to offer noninterest bearing transaction accounts. An experimental group of federally chartered credit unions has been authorized to issue transaction instruments on share accounts. These developments are so widespread that the Board's staff study of Interest on Demand Deposits released earlier this year concludes, in one part, that some form of interest bearing checking accounts will come shortly.

One of the first goals, then, of rationalizing the process by which consumers may receive interest on transactions accounts is that it be done fairly to not disadvantage any type of financial institution, and I think the present trends are eroding the competitive position of commercial banks.

A second fundamental reason for a firm national plan is rooted in the economics of change. Price competition in our society should be more efficient than non-price competition. Why should we encourage the continually increasing use of checks, a costly means of payment, when an incentive to limit such forms of transfers would benefit the consumer, the financial institutions and the third party payees? Why should we not use the experience gained in New England to phase in the transition costs of change to minimize disruptions within a financial industry of great economic importance to the public? Should we not recognize that there are monetary policy implications for the economy as the effectiveness of traditional measures of the money stock are blurred by changes in the character of demand and savings deposits?

The last justification for an orderly change of law governing the payment of interest on transaction accounts, the consumer benefits, is believed to be an arguable premise by many observers. I can't accept that. The whole development that we are discussing would not have persisted and expanded in our markets without consumer acceptance. The Board staff study found that consumers have gotten an effective rate of return on their accounts in New England. The return is expected to decline but still be meaningful as banks and thrifts adjust too liberal early pricing techniques. I am also unimpressed by the contention that the small checking account depositor will gain little, if anything, from interest on a small active transaction account. That assumes he has no other liquid assets and that the incentive of interest will have no effect. I've been in banking too long to believe either such assertion.

The legislative proposal that I expect to be introduced in the Congress within days, or just a week or two, will be a comprehensive, national plan to provide an orderly transition to interest payments on transaction balances. It will provide for a special class of accounts for individuals similar to NOW accounts, at banks, thrift institutions and credit unions. It will guide the developments carefully, providing for a year's lead time. It will recognize competitive balance by providing for similar reserves and similar rate ceilings for all depository institutions. It will address transition costs and explicit interest costs by providing that interest be paid on the reserves required to be held against such accounts. It will also provide for the payment of interest on all transaction account reserves held at the Federal Reserve. It will phase in the reserve requirement for non-members of the Federal Reserve System that now offer NOW accounts. I expect it will also restrict the ceiling rate on accounts to something less than the passbook savings rate with temporary grandfathering in New England.

The evolutionary developments of new transaction instruments within and outside of the commercial banking system and the increasing attrition of Federal Reserve membership have similar implications for stability of the monetary system, for competitive balance in the depository financial industry, and for the execution of monetary policy. These concerns are inseparable at the Board and addressing all of them, as I expect the legislation to do, is essential to the Board's support of any bill.

There surely will be other provisions in the proposed bill dealing carefully and fairly with the way reserves may be held and provision giving the Federal Reserve authority to make revisions in its clearing system. But I have talked about the principal purpose and thrust of the proposed legislation today, and those features which address competitive balance, monetary and financial conditions, and benefits and cost of membership in the Federal Reserve System. Those are the key elements that should be considered and debated in the legislature. In my own view we cannot wait too much longer to rationalize the present diverse trends and address the problems they present.

Next week, the Western Chapter of the Bank Marketing Association is holding its annual conference in San Francisco. The subject is <u>THE DEPOSIT REVOLUTION</u>. I hope many of you will attend. Reading the agenda, one would have the impression that there was no other subject for banking than that of how to meet this challenge. Let me quote from the program: "Clearly, the die for change has been cast. Change that will open up entirely new competitive battlegrounds for the deposit dollar. New products...new markets...new competition. That's what this conference is all about. That's the deposit revolution."

It has been a privilege to open your session here before you go on to hear from outstanding speakers on broader topics. I can only hope that I have presented a fair set of arguments which will encourage you to not let an opportunity to manage change slip away again because I am certain of the vaildity of that one line from the San Francisco agenda. The line is, "Clearly, the die for change has been cast."

Thank you.