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Statement by

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before the

Subcommittee on Financial Institutions

of the

Committee on Banking, Housing and Urban Affairs

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Mr. Chairman and members of the Subcommittee, I am pleased to appear again before the Subcommittee to discuss S. 2591 and related proposals for changes in the structure of the nation's financial system. Let me try to summarize the Board's views in rather general terms, and then respond to any specific questions.

When I appeared before the Subcommittee on November 7, 1973, I expressed the Board's belief that there is a need for reform in the structure of financial intermediaries, along the general lines of the proposed Financial Institutions Act. We believe that such reforms should be designed to improve the flexibility of financial institutions to respond to the changing needs of individuals and business. At the same time, reforms must take full account of the need to maintain a base for effective monetary policy. They must also preserve a safe and sound financial system.

Developments since last November have served to underscore the need for such changes. Mr. Chairman, it is clear that you and members of your Subcommittee recognize this need, and the Federal Reserve wishes to be as helpful as it can to you as you pursue your consideration of these matters.

As we contemplate the future of our financial institutions, it is important to recognize that the most substantial contribution that can be made to their long-run health and welfare is to bring our

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present corrosive inflation under control. For all financial intermediaries doing business in fixed-dollar claims, continued inflation raises very serious threats. But inflation is particularly troublesome for the nonbank thrift institutions, which already face increasing problems resulting from the rise in interest rates associated with rapid inflation and its accompaniments. These institutions find themselves burdened with a portfolio of long term, relatively low-rate investments, but needing to offer higher rates on deposits to attract and hold consumer savings.

As the Federal Reserve sees it, for the thrift institutions to respond to this situation effectively, they must be given power to offer more attractive saving rewards and related services to their customers. Governmental action to facilitate such added attractions could include higher interest rate ceilings and permission to offer variable interest rate deposits.

To pay for such increased deposit costs, however, thrift institutions will need both more flexible lending and investing powers, and time to utilize those powers to expand their earnings inflows. The Board favors broadening the earning asset opportunities open to thrift institutions along the lines of S. 2591, as I mentioned last fall.

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Board members feel that an innovation such as the variable rate mortgage deserves consideration in this connection. We recognize that variable rate mortgages pose problems; however, we believe that it might be possible to work out arrangements for such instruments which would be fair to both the lender and the borrower and which would fully inform the borrower about his rights and liabilities.

In expanding institutional powers, however, certain cautions must be kept in mind. First as a simple matter of fairness, the powers of competing institutions should be equitably related. Second, as a matter of good stabilization policy, provision should be made for the application of monetary controls to all relevant monetary claims. Both these concerns prompted the Board to send to Congress earlier this year its proposal for uniform reserve requirements applicable to all Federally insured institutions handling money-type deposits.

There is a third caution that applies to all the changes I have thus far suggested. Changes can trigger transitional difficulties, some foreseen and some unforeseen. Care needs to be taken that transitions unfold in such a manner as to safeguard the soundness and safety of our institutions and minimize disruptions in credit flows, particularly in the mortgage market which is already depressed. Such considerations point to the importance of making changes on a step-by-step basis, and to the wisdom of giving the regulatory agencies authority to slow down developments if necessary to stem adverse results flowing from too-rapid changes. In this spirit, the Federal Reserve Board favors the

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gradual lifting of deposit rate interest ceilings but believes the retention of standby powers to reimpose such ceilings would be prudent.

Fundamental reforms of the type referred to above will clearly take considerable time to be adopted and bear fruit. In the interim, the financial system is being plagued with a number of short-range problems, some of the most painful of which are ironic manifestations of underlying deficiencies which proposed longer run reforms will eventually ameliorate. For this reason, we believe that it is especially important to respond to these short range problems in a manner which is consistent with our longer range goals.

One such short term problem about which all members of the Subcommittee are well aware is the current attraction of savings funds away from depository institutions by offerings of very high-yielding--and sometimes innovatively designed--market securities. Such securities are epitomized by the new variable-rate note issue scheduled to be sold by Citicorp.

The characteristics of the Citicorp issue have been developed with the individual saver-investor in mind.[1/] As it is presently structured, the offering would compete with a variety of alternatives but particularly

1/ The Citicorp note as now modified would include an interest rate that varies over time with the yield on 90-day Treasury bills, would be sold in minimum denomination of $1,000 with an initial subscription minimum of $5,000, and would, after June 1, 1976, provide the holder with the option of presenting the notes for redemption semiannually on 30 days' notice. The new security would be listed on the New York Stock Exchange and would be marketed by brokers all over the country.

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with Treasury bills and with small and medium-size certificates of deposit in banks and thrift institutions. The Board recognizes that the resulting disintermediation from nonbank thrift institutions (and also from commercial bank time deposits) could be significant if the volume of offerings of this type were to become large. Net inflows to the thrifts have already fallen off substantially in recent months, and any significant additional diversion of funds is a matter for public concern.

Nonetheless, it is not clear that the long-run public interest would be served by prohibiting or severely limiting innovative financing efforts of this type. Offerings like the Citicorp issue promise improved investment opportunities for individual savers, reduced pressures on short-term money markets, and strengthened financial positions for the corporations issuing them. While this first such offering is by a bank holding company, there are numerous nonbank firms that may well follow this lead and bring similar issues to market. Any legislative or administrative counteraction aimed at banks or bank holding companies would still leave savings institutions subject to disintermediating pressures from a stream of Citicorp-type offerings from other issuers.

It is impossible to judge at this point how rapidly developments in this area will unfold or how large the drains of funds from the thrift institutions might prove to be. For all these reasons, the Federal Reserve believes it would be wise not to rush in with hasty

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legislation against Citicorp-type issues. At the same time, we do advocate very close monitoring of the situation, and the prudent development of contingency plans--including possible legislative proposals--to deal with seriously adverse results should they emerge.

In such planning, the Board believes that first and strongest emphasis should be placed on positive means of bolstering the flow of funds to savings institutions, rather than on negative devices that try to dam up flows of funds through other channels. The Federal Home Loan Bank System already has a vigorous program of lending to its member associations, and we and the Bank Board have plans for backstopping the Home Loan Banks if required in necessitous cases.

A more enduring remedy which has considerable merit in our mind is to take steps to be certain that depository institutions are authorized to compete with the Citicorp-type offerings by themselves offering some form of variable rate instruments. It is undoubtedly true that such institutions could not afford to issue as many of these instruments now as they could in future years after their asset portfolios have had time to adjust; but surely now is a time for them to press their interest-paying ability to the utmost.

Congress might be able to help the cost-earnings squeeze on savings institutions by standing ready to appropriate larger amounts to subsidize lending to them at below-market rates from the Home Loan

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Banks. Since mutual savings banks may be especially vulnerable, such programs of assistance might be expanded to include them. Other public officials here today are better positioned than I to comment on the details of this and other possible measures by the Congress to improve the fund-raising ability of the savings institutions.

Now let me turn to the other category of possible actions--those that would try to help the thrift institutions by handicapping competing alternatives. As I have intimated earlier, the Board sees many drawbacks and very uncertain chances for much success in this direction. As a legal matter, the Board believes it has no present authority to constrain bank holding companies from offering securities like the Citicorp issue if the proceeds are not transferred to the subsidiary bank.

Nonetheless, if your Committee and the Congress feel that it is desirable to consider restrictive legislation on this subject, I can offer some Board comment on several suggested possibilities.

Legislation to require the Board (or some other one or combination of Federal agencies) to give prior approval to all obligations issued by a bank holding company or any of its bank or nonbank subsidiaries would seem to us far too sweeping. Even if it were accompanied by the power to grant exemptions by regulation, the Board's administrative burden and the uncertainty and interference injected into bank holding company decision-making appear excessive.

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Another approach would be to expand the Board's regulatory authority with respect to the issuance of "cease-and-desist" orders. This could enable the Board, on a case-by-case basis, to determine if a proposed note issue by a bank holding company or its nonbank affiliates would have a sufficiently adverse impact on financial markets or depository institutions to justify imposition of appropriate restrictions by the Board. Such authority would be more limited than the preceding legislative proposal, but it would still suffer from the same disadvantages, albeit in reduced degree.

Another and direct legislative answer might be for the Congress to amend sec. 19(a) of the Federal Reserve Act to specifically give the Board discretionary authority to subject note issues of bank holding companies and their nonbank subsidiaries to deposit-type regulation--regardless of the intended use of the proceeds. To permit comparable interest rate regulation of all holding companies with depository intermediaries, similar authority would have to be given to the Federal Deposit Insurance Corporation and to the Federal Home Loan Bank Board.

The same result might be accomplished by action which spells out the understanding of the Congress that the Board now has such authority under sec. 19(a). This is the approach taken by Senate Concurrent Resolution 103 introduced by Senator Sparkman (for himself, Senators Brooke,

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Cranston, Proxmire and Williams) which was referred to the Committee on Banking, Housing and Urban Affairs. If the Congress should pass this Concurrent Resolution, the Board would accept that statement of Congressional intent and be prepared to act accordingly.

If either sec. 19(a) were amended or if the concurrent resolution were to pass, we would, of course, have to give careful consideration to the implementing actions which should be taken. For example, this authority might be used to apply appropriate interest rate ceilings and reserve requirements to parent bank holding company issues sold to the general public in denominations of less than money market size (say, $100,000), if they also have maturities or holder redemption options in the first few (say, 2 to 5) years after issuance. Such limited restrictions might perhaps be justified on the grounds that issues for larger amounts or longer terms would not offer sufficient competitive threat to savings deposits to warrant special restrictions.

Weighing all these considerations, the Board is inclined to believe that the above described Concurrent Resolution may be the best interim course to follow if and when Congress decides that restrictive action is necessary. I want to conclude, however, with one further qualifying note. If action of this type is to be taken, the Board believes it should be viewed as a temporary remedy--one that should be reconsidered and probably phased out as the reforms visualized

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in the proposed Financial Institutions Act come into being. Stop-gap solutions have their place, but good public policy requires that they be superseded by more enduring reforms if our system of depository institutions is to keep up with the financial needs of our evolving economy.

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