FRAMEWORK FOR EXPANDED POWERS OF BANK HOLDING COMPANIES

Remarks by

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It is a pleasure to be with you this evening. I have long supported the objectives of your national organization and that combined with my fondness for the Pacific Northwest was reason to look forward enthusiastically to being here.

Your invitation to speak this evening was extended, of course, some months before you knew I would soon be leaving the Board of Governors. Thus, I am particularly pleased that, despite my "lame-duck" status, you warmly reaffirmed your desire to have me come.

Now that my views on monetary policy are largely irrelevant or soon will be, I thought you might be interested in a topic that allows room for the expression of a personal philosophy: that is, the scope of powers that should be permissible for bank holding companies or generally those companies affiliated with banks. Clearly, this is a subject on which reasonable people differ. As a member of a bank regulatory body, I approach it from a perspective that is perhaps a little different from many of you, but I hope at least to stimulate your thinking (if not your agreement) on some important current issues.

The conventional wisdom of the day is that changes are occurring so rapidly in the competitive environment of banking that drastic action is necessary to overhaul the underlying

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statutory framework created by Congress over the past 50 years. I share this conventional view insofar as I recognize the need for substantial changes in the framework governing the powers of bank holding companies so that they may become more competitive. Some of the artificial barriers imposed in the Bank Holding Company Act and the Glass-Steagall Act, for example, could be lifted to increase the competitive viability of banking organizations without adding parallel additional risks to the stability of the banking system. Where I part company with the "conventional wisdom" of the day is that I do not believe that all the walls must come tumbling down. I do not believe in deregulation to the point at which the market alone would determine competitive structure and viability without any significant supervisory framework. While the supervisory framework needs to be changed, it does not need to be dismantled. In an era when many espouse a type of "situation standard" of banking behavior - that is any development accepted by the market must be inherently good - I continue to believe that there are certain fundamental principles based upon public policy concerns that must continue to be the basis for a regulatory structure. While I don't have an immutable 10 commandments of banking, I do believe that certain fundamental principles have served this country's economic and financial structure well and that these principles should not be discarded lightly.

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I believe that bank holding company powers can be expanded in a manner consistent with these principles, and I will suggest what those powers might include by discussing four topics with you this evening. First, I will outline some of the significant changes that have affected and continue to affect the banking and financial environment today. Second, I will indicate what I believe to be the results of these developments and what they have meant for the regulatory structure. Third, I will briefly discuss the principles that I feel remain valid for the banking and financial structure of the country. Finally, in that context, I will suggest the sorts of powers that I believe are consistent with those principles.

As individuals in the trenches or the front line of banking, you are no doubt more aware than I of the developments over the past five years that have had an effect on the competitive structure of banking and have necessitated a review and redefinition of the regulatory structure for banks and bank holding companies. From my perspective at the Board, I can identify at least five such developments.

1. Changes in technology - resulting in the capacity to move large volumes of funds and financial data over wide geographic areas (indeed the world) in a very short time, thereby making possible the national and international integration of financial markets.

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2. The greater volatility of interest rates - resulting from the elimination of the restrictions in the Board's Regulation Q and the authorization for additional deposit instruments.

3. A new array of financial products and services, particularly as a result of the accelerating development of security substitutes for traditional bank loan products. Commercial paper, for example, now accounts for over half of all the short term credit in this country. Mortgage backed securities represent a growing share of mortgage finance. Securitization of automobile loans and credit card receivables has begun and presumably will gather momentum.

4. Internationalization of competition. During the past 20 years financial markets in major countries have become increasingly more integrated. Foreign banking organizations have established offices and acquired banking subsidiaries in the U.S. Similarly U.S. banks have developed foreign branch networks and bank holding companies have established foreign subsidiaries to accept deposits from and extend credits to foreign customers. In the same day banking activity by the same institution may go around the world - from London to New York to Tokyo and Hong

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Kong. This clearly complicates decisions by the Board on issues that were formerly considered to be only national in scope.

5. <u>Competition from non-financial institutions</u>. As you know, the Board has viewed with some concern the development of "non-bank banks". It is fundamentally troubling when commercial enterprises, insurance companies, investment houses and other non-bank institutions can acquire an organization that accepts checking deposits that are insured by the federal government and has access to the payments mechanism of the Fed. Moreover, there have been mergers and acquisitions in a variety of areas that present additional competition for banking organizations that are themselves foreclosed from entering similar areas, thus tilting the playing field even more against the banks.

The net result of these and other similar developments has been a justified cry of anguish from commercial banking organizations that are losing customers, market share, and indeed entire types of loan transactions to competitors that are permitted to engage in a much wider range of services than the banks without at the same time being subject to the same restrictions as banks. Unfortunately, the response of the banking organizations has been far from unified. Some banking

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groups have called for elimination of all barriers to the activities in which bank holding companies might engage while others have suggested that the lines be drawn even more stringently than in the past to keep out non-financial competitors. This lack of consensus among the banking organizations and other interested trade groups has resulted in failure by Congress to revamp the current structure. While there is a general feeling that something must be done, the recommendations for precisely what remedies should be applied vary greatly. There is no consensus as there appeared to have been in the 1930's for the passage of the Glass-Steagall Act or in the 1950's for the passage of the Bank Holding Company Act. Indeed perhaps the most troublesome aspect of this lack of consensus is the feeling by some that the principles that motivated those congressional actions should be discarded. There is no agreement even on the most fundamental of principles upon which to build a legislative foundation.

This congressional inaction has permitted individual organizations to exploit loopholes in the existing regulatory structure. Basic public policy principles are being bypassed as market pressures and competitive instincts play against a legal and regulatory structure that is undermined by conduct designed to evade its basic tenets. The result has been haphazard and inequitable developments in the structure of the financial system in which even those who have sought to exploit

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loopholes have recognized that their efforts and decisions are fraught with political and legal uncertainty and are often, even from a business viewpoint, the second or third best strategies to achieve their goals.

The lack of action by Congress and the exploitation of loopholes have forced bank regulatory agencies to deal with changes in the banking environment in the context of an undermined legal and regulatory structure. The challenge to the agencies is to preserve the public policy objectives of the existing structure while at the same time allowing reasoned and measured innovation in the powers and opportunities afforded financial institutions. Needless to say, this has become increasingly difficult.

As we look ahead to expand the powers for banking organizations, I believe that it is important to emphasize that these powers must be consistent with a carefully designed framework for banking organizations. There are certain principles that I believe continue to be valid and should be reaffirmed by the Congress in granting additional powers. Some of these principles have been emphasized by the Board in its decisions over the past five years or so to expand, in a measured fashion, the powers of bank holding companies. Once again, let me indicate what I believe these guiding principles to be.

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First, I believe that it is absolutely essential in the public interest to protect the stability of the banking system and the payments mechanism. We must continue to recognize that banks play a unique role in the economy. Commercial banks, and increasingly thrifts as they have gained banking powers, are operators of the payments system; they are custodians for the bulk of liquid savings in the economy; they are still by far the most important suppliers of credit and they are the link between monetary policy and the economy. All of these functions are involved with the public interest, and in combination account for the explicit public concern over the years with the strength and stability of depository institutions. Take for example, the nation's payments system -- the clearing of checks, wire transfers, automated payment arrangements, and securities transactions clearances -- which collectively processes over a trillion dollars in transactions each day. The role of the banks in ensuring orderly, quick, and assured operation of the payments system is essential to the efficient operation of markets and the economy as a whole. The sudden failure of one institution, particularly of substantial size, can interrupt a long chain of payments and dramatically and unexpectedly affect other unrelated institutions, some of which may not even have a business relationship with the institution in difficulty and which may have themselves been well-managed and sound. While secondary

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and tertiary effects are of course present to some degree in the failure of any business firm, the effects are never so potentially contagious or disruptive as when the stability of the banking system or the payments mechanism is suddenly called into question. Then, serious implications for overall output, employment, and prices - indeed, for the entire fabric of the economy - are present.

My second principle is that the stability of the banking system and the unique role of depository institutions have long been protected and must continue to be protected by official supervision and regulation and by a governmental "safety net". Normal market incentives must be supplemented by this support apparatus. Public confidence in the banking system, an essential element to the stability of that system, can only be maintained through a system of governmental oversight and the use of such tools as federal deposit insurance, the discount window and necessary powers to rescue or assist troubled institutions.

The market alone cannot be relied upon to assure banking stability and the stability of the economy as a whole. Indeed, reliance solely on the market would result in an ebb and flow of performance and in failures that could spread widely through the system with a resultant loss in public confidence. At a minimum, therefore, there must be a system of oversight, a system of protections or preemptive measures

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designed to instill public confidence and an equitable procedure for dealing with troubled institutions.

The third principle, that I believe flows from the previous two, is the need for appropriate limits on the types of risks that banking organizations can assume. Congress must legislatively circumscribe the activities of banking organizations in order to preclude the sorts of activities that present significant risks to individual banking institutions and to the stability of the banking system. Historically Congress has accomplished this objective through the policy of separating banking and commerce. In this manner Congress has limited the types of risks banking organizations can assume and has promoted other public policy objectives of avoiding conflicts of interest and undue concentration of economic power. This traditional separation of banking and commerce in the United States has proven invaluable in maintaining the stability and integrity of the banking system and public confidence in that system.

I take issue with those who argue that the separation of banking and commerce is no longer needed -- that banking organizations should be free to engage in any activity because, on a case-by-case basis, the banking supervisors will be prepared to deal with any problems that may arise in the individual institution. Banking supervisors have neither the resources nor the expertise to monitor and forestall problems

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from arising in a completely unregulated environment. It is not sufficient merely to provide the tools for supervision and to provide certain financial benchmarks such as capital standards, debt levels and measures of asset quality. As a believer in the old time religion, I think that, along with specified powers, there must be rules that specify what may not be done. In short, there must be limits on the types of activities in which a bank or bank holding company may engage.

In my judgement, there are simply some activities that present too great a risk for banking organizations or create too large a potential for conflicts of interest. If, for example, as some estimates have suggested, nearly 90% of those thrifts that are in danger of failing have encountered difficulties precisely because of real estate development activities or direct equity investments, it is hard to believe that there should not be some sort of limitation placed upon such activities by bank holding companies. I believe that the Maryland and Ohio thrift situations are examples of what can occur when the speculative and risky activities of owners and affiliates of depository institutions are not appropriately curtailed by legislation or regulation.

Let me move on to the types of activities in which it appears appropriate for bank holding companies to engage. I believe that the standard contained in Section 4(c)(8) of the Bank Holding Company Act that the activities must be closely

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related to banking and that their performance by bank holding companies must serve the public interest has proven over the years since it was enacted in 1970 to be a workable standard - one which permits bank holding companies to expand their powers in a reasonable and measured way while maintaining some nexus to their underlying expertise in the banking and financial services areas. The standard has proven flexible enough that the Board has been able to add to the so called laundry list of permissible activities a variety of activities that were not ordinarily provided by banks or bank holding companies in 1970. In other words, the standard seems sufficiently flexible to permit the Board to examine new activities and services as they are developed to decide whether they are the type of services that are sufficiently related to banking to be prudently provided by banks or bank holding companies.

As recently as June 25th of this year, for example, the Board voted to add to the laundry list of permissible activities six new financially related activities. Some of these activities had previously been permitted on a case by case basis in various orders of the Board, but all are now available to bank holding companies as ordinary activities that may even be approved on a delegated basis by our regional Reserve Banks. These activities include:

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1. Consumer financial counseling
2. Tax planning and preparation
3. Futures and options advisory services
4. Check guarantee services
5. Operating a collection agency and credit bureau
6. Personal property appraisal

In addition to the 24 activities that have been by regulation on the laundry list of permissible activities, the Board has recently approved additional activities on a case-by-case basis. The Board uses this approach in order to evaluate the performance of the activity by an individual applicant. It is sometimes the type of activity in which a particular applicant may have some expertise or it may be an activity that the Board feels is just not clearly defined or on the fringes so that it should be added to the laundry list for all bank holding companies at that time. On many occasions, the activities that are approved by order are eventually added to the laundry list. The new activities approved by order in 1985 and 1986 include the following:

1. The Board has allowed the provision of securities brokerage services and investment advice on a combined basis to "institutional customers."
2. In a recent case the Board permitted a bank holding company to acquire a firm that engages in employee benefits consulting.

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3. The Board has also allowed a bank holding company to engage in student loan servicing activities including providing advisory services to the state student loan authority.

4. In another case the Board approved the offering of real estate consulting services on a non-fiduciary basis, including appraisals, cash flow projections and cost benefit analysis that resulted in recommendations as to the acquisition and/or disposition of real property.

5. The Board has continued to allow the sale of and dealing in gold and silver bullion and coins for the account of customers.

6. The Board has approved credit card authorization services and lost or stolen credit card reporting services.

7. In another case, the Board approved a holding company's acquisition of a firm that engaged in new types of data processing activities, including providing price quotations on stocks, bonds, options, mutual funds, commodities and other financial instruments.

8. Most recently the Board permitted a bank holding company to engage in the printing of checks.

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I believe that this extensive list of activities permitted by order and regulation during the last two years is an indication that the Board has shown considerable flexibility in interpreting the "closely related to banking" standard in the Bank Holding Company Act. It has shown a willingness to examine new activities on a case-by-case basis to determine if they are financial in nature and have a sufficient nexus to traditional banking services such that they should be permitted to bank holding companies.

The Board has gone a step further in testimony before Congress and supported changes in the closely related to banking standard in the Bank Holding Company Act to a broader "financially related" standard that would permit bank holding companies to engage in a wider range of nonbanking activities. Under a "financially related" standard, the Board would be permitted to approve, for example, a range of broker or agency activities that are more questionable under the present standard. The Board has testified that a broader financial standard could authorize insurance agency, real estate brokerage and perhaps even travel agency activities. These are the sorts of activities that would provide service income to the bank holding company with little accompanying risk.

There are, in my judgement, three specific types of insurance activities in which bank holding companies should be permitted to engage, but which are foreclosed to them under the

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existing law. First, bank holding companies should be permitted to engage in the sale and the underwriting of title insurance. The Board recently decided that, since title insurance was not included as one of the exemptions under the existing statute, bank holding companies were precluded from the sale or underwriting of title insurance. Certainly lending institutions, those engaged in mortgage lending, are or can easily become familiar with the requirements of a clear title. They often conduct the closings at which the title insurance is purchased. In short, I see no reason why bank holding companies should not be permitted to engage in this activity.

Bank holding companies should also be permitted to engage in unlimited insurance agency activities. There is no financial reason or risk factor that I can see that would preclude this type of activity and the sale of general insurance raises far fewer questions than the sale of credit insurance which is already permitted. Finally, I believe that there are limited types of insurance underwriting that could be permitted to bank holding companies. We already allow the underwriting of credit life insurance and home mortgage redemption insurance. It appears that the underwriting of general life insurance, insurance in which the loss ratios are actuarially predictable, would not present an undue risk for bank holding companies. On the other hand, I believe the underwriting of various types of property and casualty

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insurance present serious issues and should be precluded to bank holding companies. I believe the record of the property and casualty underwriters and the insurance crisis that may have resulted in serious difficulties in your own institutions obtaining blanket bond, directors', and officers' liability insurance, and even premises coverage, are indications of the riskiness of these types of activities.

The final statutory prohibition that the Board encounters in attempting to expand the powers of bank holding companies is the Glass-Steagall Act which limits the type of investment banking activities that may be conducted by commercial banking organizations. The Board has attempted but has not been entirely successful in permitting bank holding companies to engage in a wider range of securities activities, including the sale of commercial paper. I am not one to recommend the repeal of the Glass-Steagall Act and the unlimited involvement of commercial banking organizations in securities activities. I do believe, however, that there is merit to proposals that would permit a wider range of such activities by bank holding companies.

The Board has long supported an approach that, within the scope of appropriate rules to limit potential conflicts of interest and to assure safe and sound operation of securities affiliates, would permit subsidiaries of bank holding companies to engage in underwriting and distributing commercial paper.

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The Board has similarly supported authorization for underwriting mortgage backed securities, revenue bonds, and mutual funds. The area of corporate underwriting, in which U.S. banks do participate abroad, is much more difficult. While the international integration of capital markets and the growth of U.S. bank participation in the Euro markets make the present difference of treatment between domestic and foreign markets stand out, I must continue to express my own reservation about permitting bank holding companies to engage in corporate stock or bond underwriting. Nevertheless, I do believe there are substantial additional opportunities that could be made available to bank holding companies in the area of securities activities.

Having outlined the sorts of activities that I believe bank holding companies should be permitted to engage in, I must end on a note of caution. I believe the experience of the savings and loan industry demonstrates that real estate development, the taking of equity positions rather than mere lending, is not an activity that bank holding companies should be permitted to engage in - at least not without very severe limitations in terms of amount of investment, capitalization, and limits to exposure. I believe the issue of real estate development is a risk issue first of all, but that it also begins to blur the distinctions between banking and commerce.

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I hope that my thoughts on these issues, coming as they do from the perspective of a banking regulator -- but a banking regulator with a background as a commercial banker -- will encourage you to probe further into these issues. The one element upon which I think we can all agree is the need for some consensus that will motivate Congress to take action to address the fundamental issues facing the banking industry. There is too much at stake here for us simply to pursue our own parochial interests. We have reached a critical stage when the approach of "what is in it for me" should give way to more thinking along the lines of "we are all in this together." Thank you.

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