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Remarks by

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The persistent inflation and successive rounds of disintermediation over the past decade and a half have spawned economic and competitive incentives driving the process of financial innovation and related changes taking place in our financial system. These innovations include new instruments--such as CDs, NOW accounts, floating rate notes, and money market certificates--new concepts of funds management--such as liability and cash management--and new institutions such as money market mutual funds and our present-day one-and multi-bank holding companies. The critical feature of many of the more significant of these innovations is that they are attempts to avoid binding regulatory constraints such as deposit rate ceilings, reserve requirements, and limits on product and geographic expansion. In this respect then, regulation and regulatory response to change has played, and will continue to play, a central role in shaping the evolution of financial markets. It affects financial structure and the array of services available. Even more important, it also affects the risk factors and stability of our institutions and markets.

It is also true, however, that financial regulation has not always achieved its intended goals. In fact, it has sometimes had significant unintended effects that transcend its original purpose.

For example, Regulation Q ceilings on time and savings deposits have not achieved their intended purpose. They were intended to limit competition between banks and thrifts, to protect thrift institution earnings during periods of rapidly rising interest rates, and to help buffer the housing industry from the effects of financial restraint.

Instead, however, the inflows of small time and savings deposits to both thrifts and banks have become cyclically more unstable. This instability has resulted in sharp contractions in mortgage lending during periods of disintermediation and has imposed serious adjustment costs on the housing industry. In addition, depository institutions have been forced to rely on more interest sensitive sources of funds to finance their growth which has squeezed their profitability and subjected them to greater interest rate risk. Finally, the ceilings have discriminated against small savers and created an unneeded subsidy to higher-income borrowers at the expense of the low-income saver. It is for these reasons that the Board has long advocated the relaxation of deposit rate ceilings and has supported the expansion of NOW accounts. We have consistently urged the passage of the pending legislation that would phase out the Regulation Q ceilings and extend NOW accounts nationwide.

In a similar fashion, our review of the McFadden Act indicates that many banking organizations are devoting significant and costly resources to achieve an interstate presence and to meet increased competition in ways that do not violate the McFadden Act or the Douglas Amendment. The growth of nonbanking activities of major bank holding companies, the spread of loan production offices (until the recent court decision), and the establishment of Edge Act and Agreement Corporations are clear examples. This expansion is the logical response to the evolution of many banking activities that transcend state and local boundaries and of banks' desires to follow their customers. We have concluded that the usefulness of interstate banking restrictions in their present form has passed.

However, relaxation of these constraints requires the balancing of many factors. Our review does not demonstrate the clear superiority of one type of banking organization or structure. The evidence indicates, for example, that the most apparent advantages of multi-office banking lie in greater public convenience, in greater availability of credit--especially to locally limited customers--and in the competitive benefits resulting from reduced barriers to entry into new markets.

The problems lie in the higher market concentration levels that are nearly always found in multi-office banking environments and in the potential for higher prices that seem to be associated with higher concentration. We are also concerned that greater regional and national concentration will result in undue concentration of economic and political power.

Because of the inevitability of continued market innovations to avoid restrictions on interstate banking, my colleagues and I have generally concluded that some relaxation of current restrictions on interstate banking appears warranted. However, because of our concerns about increases in concentration we felt that unrestricted interstate branching and bank holding company expansion is not appropriate at this time. Further consideration should be given to options that lie somewhere in between the *status quo* and unrestricted multi-office banking. For example, restrictions on interstate banking between large SMSAs could be removed, expansion within geographic regions of the nation could be permitted, or *de novo* expansion only into highly concentrated banking markets might be allowed.

As financial innovation proceeds and the distinctions among financial institutions are narrowed, the equity and scope of regulation become increasingly important problems. The several bank holding company bills pending in the Congress represent an interesting collection of responses to these problems. The proposal to permit bond underwriting attempts to clarify and update the traditional separation between banking and the securities business. The property and casualty insurance prohibitions are efforts by the independent insurance agents to protect themselves from prospective inroads into their business by bank holding companies. Proposals to relax regulatory limits on the maturity structure of acquisition debt in bank holding company formations would afford investors greater opportunity for tax advantages and leverage possibilities but could adversely impact our flexibility to ensure the safety and soundness of these institutions.

I don't want to go through a detailed discussion of this legislation. But, generally, I can say that, except for the revenue bond bill and a few other minor technical amendments, this legislation is quite disappointing. Rather than promoting competition and increasing the flexibility of both financial institutions and the regulators, it tends to do just the opposite. As such, the Board went on record opposing much of this legislation.

I'd like now to say a few words about the longer run concerns I see inherent in financial innovation and its interaction with regulation. Two points seem clear. First, the path we are on suggests that more and more financial innovations will be forthcoming as institutions attempt to avoid regulatory constraints and with this will come the need for ever increasing financial regulation. Regulation breeds more regulation.

Second, there are several reasons to believe that this path may have adverse implications for the stability of the banking system. For example, the dependence upon more managed liabilities implies that greater earnings variability is to be expected over the cycle. The greater reliance upon foreign sources of funds and the growth of foreign banks in the United States means that the U.S. system is becoming more intertwined with that of the rest of the world. This suggests greater vulnerability to destabilizing shocks resulting from foreign business cycles, exchange rate risk and political instability. The increased competition for funds with less regulated nonfinancial and nondepository institutions means that banking organizations will have less flexibility, relative to other competitors, in adjusting to changes in economic conditions. To meet this increased competition and to operate profitably during periods of rising rates, banking organizations have increased incentives to conduct their activities in an unregulated or less regulated environment. Hence, they are under constant pressures to spin activities and functions out of subsidiary banks and to operate through bank holding companies and foreign subsidiaries.

In view of the implications of financial innovation and the often risk-inducing nature of regulation, we need to begin to explore ways to increase the flexibility of banking organizations to compete with unregulated firms and to better enable them to adapt to interest rate cycles. While I don't have specific proposals at this time, part of the solution would seem to be to remove those regulations and constraints that are not achieving their intended goals. I believe that deregulation, if properly done, holds the key to the future health and viability of our financial system.