BANKING LEGISLATION— RETROSPECT AND PROSPECTS

REMARKS BY

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New banking legislation does not develop in a vacuum, but rather within the context of the continuing tension between a Depression-era legislative environment and the financial innovations of the past several decades. In his speech, Mr. Balles analyzes recent legislative proposals against this background, emphasizing the need for equality of competitive treatment for all competing financial institutions. This requirement was not met in House Banking Committee proposals, but any future legislation must ensure that thrift institutions, when granted additional powers, will adopt the sort of burdens that commercial banks have to bear as the price of operating within the payments system. Over the long run, many other factors besides new legislation will influence the shape of the nation's financial markets, especially the financial innovations arising from consumer demands, competitive pressures and technological developments.

John J. Balles

I'm delighted to be here in Southern California again to talk to my friends in the Independent Bankers Association on the subject of banking legislation. Although that will be the main theme of my remarks, I should add that your business and mine are affected by many other factors besides the activities of Congress. For ease of remembering, I might classify all of these concerns under the letter C—Congress, of course, plus consumers, competitors and computers. All of these factors are involved in the pressures which impinge on the legislative arena, as I hope to indicate in at least summary fashion in my talk tonight.

From time to time in the last several years, we've heard that the laws of economics were not working very well anymore. But after watching the legislative scene, I'm inclined to think that there is still one useful law—namely, that the fervor for financial reform varies with the level of the discomfort index, that is, the sum of the unemployment rate and the rate of inflation. You'll notice, for example, that the Commission on Money and Credit was called into existence after the economy went through an inflationary period and two recessions in the late 1950s. Then again, the Hunt Commission was set up about the time that inflation and recession both worsened at the end of the 1960s. And finally, the FINE study—the study of Financial Institutions and the National Economy—came into being at the time of the worst inflation and the worst recession of the past generation, as the discomfort index soared to record levels. You'll notice, however, that in each of those three cases, a subsequent improvement in the national economy coincided with significant easing of the pressures for wholesale financial reform.

Shifting Pressures

In a more serious vein, let's take a look at a few of the factors that help explain why pressures arise for financial reform legislation, and yet why the end result so frequently falls short of the sponsors' plans. One very important consideration has been the continuing tension between the legal environment which was set in place as far back as the 1930s, and the innovative spirit which has permeated the financial system throughout the last several decades.

During the 1930s, the financial scene was dominated by fears of "ruinous competition"—a phrase which seemed to dominate much of the writing on the subject during that Depression era. There were new restrictions on price competition, as seen in the ceilings on deposit interest rates which financial institutions could pay—including a zero interest rate on demand deposits. There were new restrictions on product competition, as seen in the limitations on banks' activities in securities underwriting under the Glass-Steagall Act. There were also restrictions on informational competition, with many regulatory authorities attempting to prevent runs on weaker institutions by limiting the amount of publishable information. This concern is understandable when we remember that 9,000 of the nation's 25,000 banks suspended operations in the early 1930's.

Nonetheless, tensions could be expected to arise between the anticompetitive restrictive environment set in place during the 1930s, and the strongly competitive spirit that has taken hold in the past several decades. Today there are increased pressures for price competition, seen in the frequent calls for the removal of all rate ceilings, including the prohibition on demand-deposit interest. There are increased pressures for product competition; in fact, under the Bank Holding Company Act and its 1970 amendments, many banks are already involved in activities that their forefathers would never have dreamed of, and many would like to expand their securities activities into those areas prohibited by the Glass-Steagall Act. There are also increased pressures for competition through greater dissemination of information—witness the SEC's demands for more information from financial institutions floating new issues, or in the extreme case, the Consumer Union's suit to force the release of competitive data on loan rates and similar information.

These new forces help explain the new legislative proposals which came out of the FINE proposals last fall. The end result of the FINE document would have been the creation of a single basic type of depository institution sharing most financial functions. Consequently, the FINE proposals envisioned a single type of money transfer, a single type of treatment of foreign institutions, and also a single type of regulatory authority—all this, plus the usual attempt to "do something for housing". But as we've seen, this single-minded approach was not translated into new legislation. However, many of the FINE proposals were present in the Financial Institutions Act which passed the Senate last fall, but the similar Financial Reform Act met a more uncertain fate in the House—even after being broken down into several smaller pieces of legislation.

Final Shape of Legislation
As you know, some legislation affecting the Federal Reserve System finally got out of the House and was sent to the Senate. The new bill included such items as a shift in the date of appointment of the Federal Reserve chairman, an increase in the number of directors serving on the boards of the twelve Federal Reserve Banks, and a formalization of the reporting mechanism for the System's quarterly reports to Congress on its monetary policy plans. However, this legislation was a far cry from the extensive overhaul of the System which had been proposed in the earlier FINE Discussion Principles.

The House is now considering another piece of legislation covering the activities of foreign institutions in this country, somewhat along the lines of proposals made by the Federal Reserve a year ago. The basic principle underlying this proposed legislation is "non-discrimination"—that is, foreign banks in this country would have all of the powers available to their American competitors but no more than that. The status of this legislation is still uncertain, but it is likely that some legislation will eventually be put on the books to bring foreign banking practices in this country more into line with domestic practices.

From the banking industry's standpoint, by far the most important bill considered by the House Banking Committee was one pertaining to the functions and powers of depository institutions. The bill was based upon the FINE Discussion Principles, but by the time a specific legislative proposal was written, the concept of fair and equitable treatment for competing institutions had been lost. The final bill considered would have granted significant additional powers to thrift institutions, with respect both to the kinds of assets they could acquire and the kinds of liabilities they could issue—including something very similar to checking accounts.

This final bill, however, failed to contain *any* meaningful provisions that would have required thrift institutions to adopt the sort of burdens that commercial banks must bear as the price of operating within the payments system. Specifically, the bill failed to provide for equality of treatment with respect to reserve requirements, interest-rate ceilings and taxation—and in my view, until there is such equality of treatment, it would be inequitable to grant thrift institutions any of the bank-type powers that have been proposed. Unwillingness to consider such provisions was, of course, what generated the banking industry's massive opposition to the legislation. Moreover, if the same proposals surface again in future legislation, I assume the banking industry will continue its opposition until equality of competitive treatment is assured.

All in all, the activity in the House had fairly minor legislative consequences. Despite all the efforts of the proponents of the FINE study, the various types of financial institutions still tend to operate as before within their own boundaries. (Indeed, the walls of Jericho are still standing.) Perhaps the most important lesson of this legislative impasse is that any effort to make major changes in the nation's tightly interwoven financial markets can have widespread effects throughout the entire financial system—in ways that the proponents of such legislation can neither foretell nor control. "Make haste slowly" is perhaps the best legislative prescription to follow in this vastly complicated field.

Long-run Factors

Yet in the long run, it is essential to realize that although Congress has its influence on the shape of the nation's financial markets, there are many other basic factors which have an even greater impact. As I said at the outset, pressures are arising every day from consumers, from competitors, and from computers, in ways that seem destined to revolutionize many of our current banking practices.

Consumers today are more sophisticated than they were in earlier periods; for example, by obtaining higher returns through money-market mutual funds. They are also considerably more aggressive than they were in earlier decades. For example, the bottom 40 percent of all households account for about 25 percent of all savings deposits but for only about 10 percent of all mortgages—and the consumer movement intends to see that those savers obtain higher interest rates on their savings and not continue to subsidize higher-income mortgage borrowers.

Competitive pressures meanwhile are becoming stronger in your industry, as thrift institutions push for expanded powers in lending, investment, and money transfers. This reflects the fact that thrift institutions quadrupled their deposits over the past decade—roughly double the rate of growth of commercial-bank savings-type deposits. Thrift institutions consequently are anxious to put those increased deposits to work, by shifting their efforts into many new fields.

Finally, new developments utilizing computers, particularly in the field of electronic funds transfers, will be a revolutionary force in the market for decades to come. For example, there are about 6,500 banking offices in our Federal Reserve District alone, and most of these might become outmoded if automatic teller machines take over more branch functions over time. And that of course is only one example of the way in which new electronic developments will influence your future.

Concluding Remarks

What conclusions can we draw from this review? Above all, bankers should remember that we live in changing times, affected not only by shifts in legislation but also by shifts in the general banking environment. Technological change is a constantly disturbing element, posing a major challenge to such established practices as bank branching. The demands of a more affluent and more sophisticated consumer are another disturbing force. Thrift institutions and (increasingly) nonfinancial institutions, by their rapid adaptation to this new environment, provide a serious challenge in many aspects of the banking business. But banks themselves have the potential to expand in new areas by proper adaptation to institutional and technological change.

To help cope with changing times, we might consider several principles first suggested several years ago to the Hunt Commission by a Special ABA Committee which I chaired. Basically, our committee argued that 1) maximum reliance should be placed upon free-market forces to assure an innovative financial system; 2) regulatory processes should be reviewed continually to ensure that all regulations are justified and administratively workable; 3) public-policy measures for financing the nation's social priorities should provide incentives to all lenders and not just certain specialized institutions; and 4) the ground rules for competition among financial institutions should be equitable, with no substantial limitations on the ability of these institutions to compete with one another.

I submit that these principles have held up well, and that they provide a basis for developing an industry-wide position on the issues which surface continually in Congressional discussions of financial reform. But it seems essential that bankers join together behind such principles on matters of importance not just to banks, but to the health of the economy as a whole. If they don't, they will only lose their markets, in a piecemeal fashion, to other institutions—and that will damage our nation's financial fabric and the financing of the entire U.S. economy.