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Statement by

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Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

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The Committee has asked that, in addition to my report on the economy, I present today the views of the Federal Reserve on the need for legislation to modernize the U.S. financial system. The Federal Reserve continues to support strongly the enactment of such legislation and I commend the Committee for taking up this vital matter so promptly.

Need for Financial Modernization

U.S. financial institutions are today among the most innovative and efficient providers of financial services in the world. They compete, however, in a marketplace that is undergoing major and fundamental change driven by a revolution in technology, by dramatic innovations in the capital markets, and by the globalization of the financial markets and the financial services industry.

The technologically driven proliferation of new financial products that enable risk unbundling has created new financial instruments that increasingly combine the characteristics of banking, insurance, and securities products. These changes, which are occurring all over the world, have also dramatically altered the way financial services providers operate and the way they market and deliver their products.

In the United States, our financial institutions have been required to take elaborate steps to develop and deliver new financial products and services in a manner that is consistent with our outdated laws. The costs of these efforts are becoming increasingly burdensome and serve no useful public purpose. Unless soon repealed, the archaic statutory barriers to efficiency could undermine the competitiveness of our financial institutions, their ability to innovate and to provide the best and broadest possible services to U.S. consumers, and ultimately, the global dominance of American finance.

Without congressional action to update our laws, the market will force ad hoc administrative responses that lead to inefficiencies and inconsistencies, expansion of the federal safety net, and potentially increased risk exposure to the federal deposit insurance funds. Such developments will undermine the competitiveness and innovative edge of major segments of our financial services industry. We believe that it is important that the rules for our financial services industry be set by the Congress rather than, as too often has been the case, by banking regulators dealing with our outdated laws. Only Congress has the ability to fashion rules that are comprehensive and equitable to all participants and that guard the public interest.

For these reasons, we support removal of the legislative barriers that prohibit the straightforward integration of banking, insurance and securities activities. There is virtual unanimity among all concerned--private and public alike--that these barriers should be removed.

In designing financial modernization legislation, we firmly believe that the Congress should focus on achieving two essential and indivisible objectives: removing outdated, competitively stifling restrictions on financial affiliations, and, most importantly, adopting a framework for this modernization that promotes the safety and soundness of our banking and financial system and prevents the extension of the federal subsidy.

Framework for Financial Modernization

The first objective is achieved by amending the Glass-Steagall Act and the Bank Holding Company Act to permit financial affiliations and broader financial activities.

In our judgment, the other objective of preserving safety and soundness and preventing the spread of the federal subsidy is best achieved by allowing banks, securities firms and insurance companies to combine in the financial service holding company structure. While we

enthusiastically support the new powers granted to financial service holding companies, we just as strongly believe that they should be financed by the marketplace, not by instruments backed by the sovereign credit of the United States. The requirement that the new powers, at least those conducted as principal, be conducted through holding company affiliates minimizes the expansion of the use of the subsidies arising from a safety net backed by the U.S. taxpayer.

The choice of requiring the new powers to be harbored in affiliates of holding companies, not in operating subsidiaries of their banks, will significantly fashion the underlying structure of twenty-first century finance. To inject the substantial new subsidies that would accrue to operating subsidiaries of banks into the currently mushrooming domestic and international financial system could distort capital markets and the efficient allocation of both financial and real resources that has been so central to America's current prosperity.

New affiliations, if allowed through bank subsidiaries, would accord banking organizations an unfair competitive advantage over comparable insurance and securities firms--both those operating independently and those that are bank holding company subsidiaries. By fostering a level playing field within the financial services industry, we contribute to full, open and fair competition.

This choice of the holding company structure is also critical to the way in which the financial services industry will develop because it provides better protection for and promotes the safety, soundness and stability of our banking and financial system. At the same time, it accomplishes much needed financial modernization without damaging the national or state bank charters or limiting in any way the benefits of financial modernization. The other route toward

full powered commercial bank operating subsidiaries and universal banking would, in our judgment, lead to greater risk for the deposit insurance funds and the taxpayer.

In addition, the holding company structure promotes effective supervision and the functional regulation of different activities. The U.S. is at a historic crossroads in financial services regulation. It is becoming increasingly evident that the dramatic advances in computer and telecommunications technologies of the past decade have so significantly altered the structure of domestic, indeed, global finance as to render our existing modes of supervision and regulation of financial institutions increasingly obsolescent.

The volume, sophistication, and rapidity of financial dealings should continue to lead to supervisory emphasis on oversight of risk management of financial institutions and a marked scaling back of outmoded loan file and balance sheet surveillance. For the same reasons, affiliation with banks need not--indeed, should not--create bank-like regulation of affiliates of banks. A constructive approach to supervision for the twenty-first century is captured in the so-called "Fed-light" provisions of various bills, which focus on and enhance the functional regulation of securities firms, insurance companies, insured depository institutions and their affiliates. We at the Fed strongly support this approach.

Banking and Commerce

A twenty-first century issue that has become a part of the financial modernization debate is whether we should move beyond affiliations among financial service providers and allow the full integration of banking and commerce. As technology increasingly blurs the distinction among various financial products, it is already beginning to blur the distinctions between predominately commercial and banking firms. But how the underlying subsidies of deposit

insurance, discount window access, and guaranteed final settlement through Fedwire, are folded into a commercial firm, should the latter affiliate with a bank, is crucially important to the systemic stability of our financial system. It seems to us wise to move first toward the integration of banking, insurance, and securities, and employ the lessons we learn from that important step before we consider whether and under what conditions it would be desirable to move to the second stage of the full integration of commerce and banking.

Nothing is lost, in my judgment, by making this a two stage process. Indeed, there is much to be gained. The Asian crisis highlighted some of the risks that can arise if relationships between banks and commercial firms are too close, and makes caution at this stage prudent in our judgment. In line with these considerations, the Board continues to support elimination of the unitary thrift loophole, which currently allows any type of commercial firm to control a federally insured depository institution.

Preservation of Executive Branch Influence

There is a final point I want to make since it appears to have driven Treasury's opposition to financial modernization legislation considered last year. That legislation would not have altered the executive branch's supervisory authority for national banks or federal savings associations; nor would it have resulted in any reduction in the predominant and growing share of this nation's banking assets controlled by national banks and federal savings associations. Indeed, as of September 1998, nearly 58 percent of all banking assets were under the supervision of the Comptroller of the Currency, up from 55.2 percent at the end of 1996. Moreover, after controlling for mergers of like-chartered banks, the number of national banks has increased over the period 1996-98 and the number of state banks has declined.

Furthermore, Congress for sound public policy reasons has purposefully apportioned responsibility for this nation's financial institutions among the elected executive branch and independent regulatory agencies. Action to alter this balance would be contrary to the deliberate steps that Congress has taken to ensure a proper balance in the regulation of this nation's dual banking system.

Conclusion

In virtually every other industry, Congress would not be asked to address issues such as these, which are associated with technological and market developments; the market would force the necessary institutional adjustments. Arguably, this difference reflects the painful experience that has taught us that developments in our banking system can have profound effects on the stability of our whole economy, rather than the limited impact we perceive from difficulties in most other industries.

Moreover, as in all major legislation, there are, and will be, numerous provisions only indirectly associated with the legislation's core objectives that often foster disagreements. These surrounding issues are doubtless important, but not so important that they should be allowed to defeat the consensus that has developed around these key goals. It would be a disservice to the public and the nation if, in the fruitless search for a bill that pleases everyone in every detail, the benefits of this vital consensus are lost or further delayed.

The markets are demanding that we change outdated statutory limitations that stand in the way of more efficiently and effectively delivering financial services to the public. The Federal Reserve agrees and urges prompt enactment of financial modernization legislation that achieves the two central and indivisible objectives that I have outlined today.