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Testimony by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Telecommunications and Finance

Committee on Energy and Commerce

United States House of Representatives

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Mr. Chairman and members of the Committee, I welcome this opportunity to appear before the Subcommittee on Telecommunications and Finance to explore the structure of the financial services industry with an emphasis on the regulatory framework that applies to banking and securities activities. I want to express my appreciation to you for calling this hearing and focusing the attention of the Congress and this Committee on the important issue of the basic rules that should apply to the financial services industries.

Mr. Chairman, in a speech that you made recently in San Francisco, you expressed increasing unease that the financial system has evolved beyond the terms of our laws and is functioning without effective legislative guidelines. You said that "Congress must be at the center, not the sidelines, of the development of the policy for structuring our financial industry."

I would like to express my strong agreement with that view. It is essential that Congress come to grips with the difficult decisions that must be made to update our laws to the new circumstances of technology and competition. We all feel considerable frustration that Congress has not acted and I very much welcome the pledge made by both the House of Representatives and the Senate in the Competitive Equality Banking Act adopted earlier this year not to extend the moratorium on banking expansion, to review our banking and financial laws and to make

decisions on the need for financial restructuring legislation before the moratorium expires.

Before turning to the questions of financial structure, I believe it is important to reflect on our starting point. We have the strongest, most competitive and innovative capital market in the world. Our job is to preserve its strengths and make improvements to assure its role in a substantially more competitive world marketplace. Banking is a vital part of this capital market structure and despite a difficult economic environment this industry has shown extraordinary resilience and strength. It has carried a special burden in the transition to a less inflationary economic climate as some of the major sectors it has financed -- agriculture, developing countries, energy, and real estate -- have been seriously and adversely affected by the transition, experiencing in some cases not only a relative slow-down in the rate of inflation, but actual sharp declines in prices. The banking industry is coming through this experience wiser and stronger.

While profitability levels for many banks remain depressed, regional banks have been strongly profitable and have strengthened themselves in the last three years through regional interstate banking arrangements. In the future, I anticipate the development of a broad interstate banking system as regional arrangements evolve into a national framework. Already 10 states have adopted full interstate banking, 13 states have provided for it after a transition period and 8 additional states permit

interstate acquisition of troubled banks. This constructive trend, especially when fully developed, will result in better service to customers and a strengthened banking system.

Securities markets also are adjusting to substantial change. The global marketplace involving 24-hour trading in a variety of securities is now a reality. There has been an explosion in complex new products and services posing new risks and putting a new emphasis on capital adequacy. And, here at home attention has focused on a deterioration in ethical standards and the possible need to take corrective action.

All of these concerns have led to a new and searching focus on how our financial structure can be improved. Your San Francisco speech pointed to many of these issues, including international competition, new securitized products, deregulation of interest rates and nonbanking organization expansion into fields traditionally thought of as banking services and vice versa. All of these developments have amounted to a very much more competitive environment for banking, while at the same time banking has been frozen within a regulatory structure fashioned some fifty years ago. Your statement and those of many others reflect what I believe is a widespread feeling that our existing structure is too rigid, limiting efficient service to the users of financial services, hampering competition in a way that produces unfair and anomalous results. Senator Proxmire's consideration of a proposal to repeal the Glass-Steagall Act is another example of this serious reevaluation of our financial laws.

Among all these changes there is one development that I believe is of particular importance and is now a permanent feature of the financial environment. This is the erosion of the role of banks as intermediaries in the credit granting process as a result of major developments in data processing and telecommunications technology. These changes have taken the form of improvements in productivity permitting the efficient processing of large volumes of transactions, the linking of geographically separate markets and a substantial reduction of costs. These, in turn, have had a marked impact on the traditional role of banks -- intermediation whose function it is to substitute bank credit for the credit of the ultimate borrower. This traditional intermediation, the result of careful credit analysis and diversification of risk, has provided lenders more secure investments than would otherwise have been possible through direct loans from a lender to an ultimate borrower. In this process, the value added by the bank and a core element of its comparative advantage, is its superior information about the creditworthiness of the borrower.

Now extensive on-line data bases, powerful computation capacity and telecommunication facilities provide credit and market information almost instantaneously, allowing the lender to make its own analysis of creditworthiness, and to develop and execute complex trading strategies to hedge against risk. The result is that the basic products provided by banks -- credit evaluation and diversification of risk -- are less competitive than they were ten years ago. These fundamental changes will have

a permanent effect on the competitiveness of depository institutions and will expand the competitive advantage of the market for securitized assets.

The impact of these changes in relative competitiveness due to technological innovation has been accelerated by another simultaneous development. The full force of the technological changes has come at a time when market forces have adversely affected many of the sectors to which a large number of banking institutions have made significant financial commitments. Thus, the growing cost advantage of avoiding the depository institution intermediary, already significant in terms of both a reduction in administrative and regulatory costs, widened as a result of the market downgrading of many banks.

As one important example of the consequences of these changes, we have seen a remarkable expansion of the commercial paper market as a substitute for direct short-term lending by banks to the most creditworthy borrowers. Since 1980, this market has more than doubled -- rising from \$31 billion at the end of that year to \$78 billion at mid-year 1987.

The same kind of securitization of many other types of lending has proceeded apace involving everything from home mortgages to automobile loans. Expansion has been most dramatic in the mortgage market where mortgage pass-through securities exceeded \$600 billion at mid-year 1987 or about one-third of all residential mortgage debt. The concept of the pass-through security has more recently been extended to other claims on the

household sector, notably automobile loans and credit card receivables, which stood at about \$15 billion at mid-year. The development of this market which substitutes securities for bank loans is now reaching down below the top industrial and commercial firms to a broader segment of the economy. As you know, banks have not been able to participate fully in servicing this extension of their own natural markets because of regulatory restrictions.

These same technological forces are now prevalent throughout the world. To remain viable in this highly competitive and innovative environment, financial institutions are seeking to have the broadest range of products available to meet the changing needs of their customers. Thus, we have seen investment firms provide traditional banking services, such as short-term bridge financing, and banking firms, including American and Japanese banks that are under regulatory constraints at home, participate broadly in securities markets overseas. As an aside, I would note that the successful and substantial participation of U.S. banking firms in these overseas markets for debt securities certainly raises important questions about the need for the restrictions on lenders doing the same thing at home. It is considerations of the kind I have outlined above that have led the British and Canadian Governments to adopt or propose substantial changes in their previously segmented financial systems to allow banking and other financial service firms to provide integrated services in the single world financial market.

As I have stressed, we do need to make some changes to our segmented financial structure to make it more competitively effective, both domestically and internationally, and I will turn to this in a moment. One thing I do not think we need to do is follow a deliberate policy of allowing our financial institutions to become larger for the specific purpose of meeting international competition.

One argument that is put forward for this proposition is the fact that of the top 25 banks in the world in 1986, sixteen were Japanese and only two were based here, in contrast with 1981 when four were American including the top two, while ten were Japanese. At the same time, we must ask ourselves whether these changes in the relative ranking of Japanese firms can be explained largely by Japan's rather highly concentrated banking system, its appreciated currency, its trade surpluses, and very high domestic savings. It is no surprise that in these circumstances Japanese institutions would be growing rapidly, particularly in terms of dollars.

But there is no evidence that extraordinary size is necessary for successful international competition. Many banks in countries other than our own compete successfully in the international marketplace with assets that are significantly smaller than those of their American counterparts. Clearly, many American financial institutions have reached the size that is necessary for effective participation in international markets.

On the other hand, I would rate capital adequacy as an important ingredient in the international competitive environment which does require a great deal more attention. The Federal Reserve has begun an effort, in cooperation with banking supervisors both at home and overseas, to achieve agreement on a uniform system for measuring capital adequacy focused on a risk-based standard. Considerable progress is being made toward an agreement, which I hope will be completed by the end of this year. An agreement of this kind will both strengthen the banking system worldwide and assure greater equity in the competitive environment.

I would like to turn now to consideration of how we should go about restructuring the financial system to deal with the problems that I think we all agree are hampering its performance. Mr. Chairman, you have suggested the fundamental test for determining the kind and scope of the required changes is what we will need to do to serve better our nation's economic interest. You point out that in the process of considering removal of some or all of the barriers separating banking and securities firms we have to ask ourselves a number of important questions, including: (a) how can we insulate insured deposits from securities activities; (b) how can we ensure the continued safety and soundness of, and public confidence in, banking and securities markets; and (c) how can we prevent conflicts of interest and concentration of resources? To these important considerations I would add the corollary that our basic objective

must be to promote a system which provides efficient services to customers large and small in a environment that promotes competition. As part of this analysis, I would add two other points that are of particular importance to the Federal Reserve but are also of vital concern to the economy as a whole: (a) we must have a system in which monetary policy can function efficiently, and (b) maintains the integrity of the nation's payment system.

There is, I believe, wide agreement on these goals.

We accept as basic to our thinking that any combination of banking and other firms should take place within an organizational structure which separates the bank in such a manner as to assure that only the bank has the benefit of the support of the federal safety net which includes deposit insurance and access to Federal Reserve lending. There are various ways in which this separation could be accomplished. The three main proposals that have been put before the Congress involve the following ideas:

- (1) Require that all nonbanking activities of a banking enterprise take place in the subsidiary of an overall holding company. This holding company could be subject to the same regulatory framework that we have now for holding companies. This proposal, put forward by the President of the Federal Reserve Bank of New York, suggests that the powers of bank holding companies should not extend beyond securities and insurance activities and that traditional holding company regulation is appropriate in this context.

(2) In contrast, others suggest that functional regulation should be applied to each of the different kinds of activities owned by a holding company parent, but there should be little if any regulatory authority over the parent enterprise.

(3) Finally, suggestions have been made, including those recently put forward in an FDIC staff paper, that it would be appropriate to expand nonbanking activities of banking institutions within the subsidiary of banks themselves without any regulation at all at the holding company level.

While we have yet to come to definitive conclusions about these implementation options, our experience thus far suggests that the most effective insulation of a bank from affiliated financial or commercial activities is achieved through a holding company structure, though we welcome debate on other alternatives.

We also agree that attention must be given to the whole range of relationships between a bank and its affiliated entities to assure that confidence in banks is not compromised and that conflicts of interest are avoided. In addition, we are addressing such issues as (a) the need for limitations on loans by a bank to affiliated enterprises or to customers of affiliated enterprises; (b) the need for adequate separation of directors, officers and premises; (c) restrictions on the flow of confidential information, (d) the scope of permissible joint marketing, (e) rules on intercorporate provision of services, and (f) the need for public disclosure of affiliate relationships.

As a result of this review we at the Board hope to be in a position to advise the Congress on how best to implement the changes that we see are so urgently needed to assure that the financial system continues to serve our public policy goals. We expect to have specific recommendations on how best to achieve bank-affiliate insulation, on the maintenance of safety and soundness, on prevention of conflicts of interest, and on avoidance of conferring competitive benefits that are unavailable to all competitors that are similarly situated. We hope that these recommendations will be valuable to the Congress as it proceeds with its consideration of the restructuring of our financial system and that our recommendations will enable the American financial system to remain competitive, serving the needs of customers here and abroad without compromising the strength or stability of our financial markets.

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