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THE FINAN<sup>N</sup>CIAL SYSTEM  
IN AN  
AGE OF CHANGE

Remarks by  
G. William Miller  
Chairman  
Board of Governors  
Federal Reserve System  
before the  
Robert Morris Associates  
Dallas, Texas

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It is a pleasure for me to be able to appear before you today. As you know, we have had some busy days of late in Washington, attempting to put in place policies that can deal effectively with the major economic problems on the domestic and international fronts. We are making progress in the continuing war to defeat inflation and to restore stability and reason to world financial markets. While our battles are by no means won, it is an appropriate time to examine some other, longer-run issues -- issues that have clung to the cloaks of bankers for a long, long time impervious to whether credit conditions have been tight or easy, or whether the economy has been in boom or recession. I am referring, of course, to issues involving the regulation and supervision of commercial banks.

The banking industry has undergone tremendous change in the past two decades. Your excellent program these past days reflects the current magnitude and diversity of the industry. Your sessions have covered a wide variety of contemporary topics ranging from international lending, to marketing techniques for commercial loans, to compliance procedures under Regulation B.

Today, let me touch on a number of the recent changes and on the issues that relate to them. Changes in the nation's financial system arise from the constant changes, of both a cyclical and a secular nature, that occur in the economy itself. At times, this changing financial system has bumped head on into the existing structure of financial regulations -- sometimes causing problems

for us all. My purpose today will not be to offer pat solutions for all the outstanding problems, but to excite your interest and to elicit your help in resolving areas of potential controversy. The Federal Reserve tries to listen, but we cannot hear if you are silent -- if you do not share your reasoned arguments with us.

I will cover only a small sample of the major supervisory and regulatory duties of the Federal Reserve -- duties which are often interrelated with our responsibilities in the arena of domestic and international monetary policies. It seems appropriate to begin with the Board's special responsibilities under the Bank Holding Company Act.

#### The Bank Holding Company Movement

Holding companies have become the dominant organizational form in banking. Today there are more than 2,000 bank holding companies and they control 71 per cent of domestic bank deposits. The Federal Reserve processes about 1,000 cases each year involving holding company applications to purchase existing banks, to form new banks, or to engage in one of the 17 permissible "non-banking" activities approved by the Board. Indeed, much of the time spent by the Board at its regular meetings involves deliberations on holding company applications.

Where has all this taken us? The chief feature of the holding company movement so far, is that it represents a response -- a natural response -- to

the evolving framework of laws and regulations that constrain and constrict bankers' actions. Let me cite several examples. First, during the 1960's, the holding company form of organization allowed banks to tap nondeposit sources of funds -- mainly commercial paper and longer-term debt markets -- at rates not subject to Regulation Q ceilings. During high rate periods, when Q ceilings were binding, these nondeposit sources of funds were important to banks. Second, nondeposit funds raised at the holding company level have been used to finance nonbank activities free of reserve requirements. Third, funds raised by the holding company parent have been transferred downstream to bank subsidiaries in the form of equity. This procedure -- sometimes called "double-leveraging" -- has had the effect of increasing the leverage of the overall organization, while maintaining or increasing the equity of the bank subsidiary.

Holding companies generally appear to have had important effects on the operations of the banks they acquire. Affiliated banks are less liquid than their independent counterparts, holding greater proportions of loans and State and local government securities in their portfolios, and lesser amounts of cash and Treasury securities. Also, holding company banks have lower capital ratios than similar sized independent banks. Whether such added risk-taking is offset by greater geographical and financial diversification is not known.

The Federal Reserve has reacted to these changes -- introduced through the holding company movement -- with different responses at different times.

For example, the Board has taken the view that the holding company is an integrated organization for purposes of determining bank capital adequacy. That is, leveraging by the parent is viewed in a light similar to leveraging by the bank subsidiary. At other times, the Federal Reserve has viewed holding company innovations as an acceptable response to weakness or inconsistency in underlying regulation. For instance, the Board generally has been sympathetic to interstate expansion by holding companies in the consumer finance and mortgage banking areas -- provided that such expansion is conducted by basically sound banking organizations and in a procompetitive manner. After all, many competitors of banks, including retail firms and certain nonbank financial institutions, are not shackled by the branching and chartering restrictions which constrain banks, and the holding company movement provides one means of partially restoring needed competitive equality. The full potential of this aspect of bank holding companies has not been fully realized, however, since nonbanking activities account for less than 4 per cent of holding company assets. In effect, holding company "nonbank" expansion represents a minor chink in the armor of the McFadden Act -- a subject which I will mention a little later.

My emphasis on competitive equality leads me to turn naturally to another area of responsibility for the Federal Reserve which increasingly bears on the competitive structure of U.S. banking -- namely, the U.S. activities of foreign banks.

U.S. Activities of Foreign Banks and the International Banking Act of 1978

As of May this year, about 230 foreign bank branches and agencies were operating in this country. Such foreign branches and agencies have grown much more rapidly domestically than the large money center banks with which they compete. Total assets at foreign branches and agencies have quadrupled from \$18 billion in 1972 to over \$75 billion in 1978, a rate of growth more than five times that of the domestic operations of money center banks. While the foreign bank branches and agencies in the United States were founded principally to finance the foreign trade of their home countries, they have rapidly diversified into the domestic banking business, particularly by making business loans to U.S. corporations. In addition, U.S. branches of foreign banks have experienced a rapid growth in deposits from domestic customers, mostly corporate depositors. Such deposits grew from \$1.4 billion in 1972 to \$7.8 billion in mid-1978.

Foreign banking institutions also have chartered or purchased domestic banks. The assets of American banks owned by foreign institutions now total \$20 billion, a fivefold increase during the past six years. Assets of foreign-owned domestic banks may grow even more rapidly in the near future through the acquisition of existing banks -- you are well aware of the pending applications by foreign institutions to purchase Marine Midland, National Bank of North America, and Union Bank of California. These U.S. banks have combined total assets in excess of \$20 billion.

How has the Federal Reserve viewed this rapid expansion into domestic banking by foreign institutions? Of course, we welcome increased competition from whatever source. Competition is the lifeblood of American industry and its benefits apply no less to banking than to other sectors of the economy. But competition cannot be fair if one side is playing with a stacked deck, nor can the benefits from competition be fully realized if one side is shackled by special laws and regulations.

There are two important ways in which American banks have been operating at a competitive disadvantage compared with U.S. branches and agencies of foreign banks. First, large domestic banks -- those which compete in the United States with foreign branches and agencies -- are almost all members of the Federal Reserve System. They must hold required reserves in the form of non-earning vault cash or deposits with the Fed. Foreign agencies, on the other hand, have not heretofore been subject to reserve requirements. And U.S. branches of foreign banks generally have held only State-required reserves. State reserve requirements often can be met by holding earning assets or "due-from" balances held in the ordinary course of business. Thus, foreign banks operating in the U.S. have not borne the same reserve burden as their domestic competitors.

Second, the multistate offices of foreign banks have given them some added flexibility not available to domestic banks. A U.S. bank cannot branch

outside its "home" state -- and may even be subject to branching restrictions within its home state. Of course, domestic banking organizations may open commercial loan production offices in other states, and through nonbanking subsidiaries may make consumer loans in more than one state, but their ability to raise deposit funds is impaired by the prohibition of interstate branching.

In 1974, with a view toward eliminating such inequities, the Federal Reserve proposed legislation to the Congress dealing with U.S. activities of foreign banks. It is encouraging that such efforts helped lead the way to passage of the International Banking Act of 1978. The Act provides that U.S. units of foreign banks will be subject to reserve requirements -- as determined by the Federal Reserve after consultation with State supervisors -- and, in turn, may have access to Federal Reserve System services. Also, the Federal Reserve is required to write new regulations revamping the powers of Edge corporations. These regulations will be intended to permit Edge subsidiaries of domestic banks to compete more effectively with existing and future units of foreign banks. Foreign institutions would be allowed to open interstate branches with limited service, if expressly permitted by State law, provided that the deposit-taking powers of such branches are similar to those of Edge corporations. In effect, foreign and domestic institutions will now be able to compete nationwide in international trade-related business -- on equal terms -- through Edge corporations or Edge-like branches.

Clearly, the International Banking Act will go a long way toward equalizing competition between domestic and foreign banks. The Act is a prime example of the dramatic ways in which laws and regulations will have to change in order to accommodate the equally dramatic changes that the financial industry itself has undergone. Indeed, one section of the International Banking Act portends such future change and, quite conveniently, leads me to my next topic of discussion. Specifically, the Act requires the President, in consultation with the banking agencies, to review the McFadden Act and report to the Congress, within one year, on the impact of McFadden on the nation's banking structure.

#### Interstate Branching and the McFadden Act

The McFadden Act of 1927 has the effect of prohibiting federally chartered banks from branching across state lines. In addition, banks are often faced with branching restrictions within their home states. Thirty states are unit banking or limited branching states, and 10 of these states prohibit quasi-branching through multi-bank holding company. In contrast, federally chartered thrift institutions have not had their branching powers limited by statute -- although they have been limited somewhat by the Federal Home Loan Bank Board regulation. If thrift institutions were granted expanded asset and liability powers, such as consumer loans and nationwide NOW accounts, there would be a substantial competitive disadvantage for commercial banks.

If state branching restrictions and the policy of the McFadden Act were liberalized, competitive inequities would be much reduced, but competition in the industry would become much more intense. Increased competitive intensity should be welcome, for expanded competition brings with it many public benefits ranging from greater services to increased credit availability for local communities. There is even some evidence that banks with branches are less prone to failure because of their geographical diversification.

The common fear, however, is that relaxing branching restrictions would adversely affect small banks with the concern that many would be driven out of business by aggressive larger banks. But, there is no substantial evidence to support this. In fact, the evidence shows that small banks can be as efficient as larger ones -- and that they can compete effectively with their big brothers. In California with extensive branch networks, for example, 75 banks -- or one-third of the state total -- have no branches at all, and 69 of these unit banks are located in major metropolitan areas.

Interstate branching would have far-reaching ramifications for state lawmakers and for state and federal banking authorities. To avoid being regulated by a large number of state authorities many banks might convert to national charter. As a result, the Comptroller of the Currency, through his federal chartering and supervisory powers, could well become a more significant force in determining the nation's banking structure. Also, the supervisory

and examination duties of state and federal agencies might be more complex because of far-flung branching systems. Inevitably, jurisdictional disputes would arise.

These problems aside, it is likely that lawmakers and regulators may be outdistanced by the pace of events. The industry is moving inexorably toward expanded interstate competition. Bank holding companies currently engage in "nonbanking" activities across state lines. Banks have multistate loan production offices. Electronic fund transfer has increased dramatically the ease with which service facilities can be placed in remote locations. In the end, the rulemakers will have to accommodate these changes, not stand in their way.

#### Liability Management: New Deposit Instruments

Let me turn now to another area of change in the banking industry, an area which, like banking structure, has been shaped by the intensified competitive atmosphere of the 1960's and 1970's and by the regulations of the period. Of all the areas of banking operations it is the liability structure of commercial banks that has undergone the greatest recent changes.

In the "consumer" market, the changes have been dramatic and they seem to have occurred within moments of one another in our very recent past. NOW accounts have been allowed in New Hampshire and Massachusetts since 1974; in 1976 NOW's were extended to all New England states, and, with passage of the Financial Institutions Regulatory Act last month, NOW's have been extended

to New York State. In June of this year, 6-month money market certificates tied to the Treasury bill rate were authorized for banks and thrifts. And last Wednesday, automatic transfers between bank savings and checking accounts came into being. In a very short period of time these new instruments have reached sizeable scale. NOW accounts balances total almost \$4 billion at banks in New England, and 6-month money market certificates total \$10 billion at banks, with another \$24 billion at thrift institutions. Of course, it is still too early to tell how rapidly savings accounts subject to automatic transfer will grow.

These innovations in financial instruments have come about largely because of competitive pressures and general economic conditions, and in some cases, in response to regulatory action. The money market certificates, for example, represent a conscious response to the threat of disintermediation during a period of rising interest rates. In fact, the continued strong showing of mortgage lending at thrifts, when contrasted with the last period of high rates, is due in large measure to their ability to offer 6-month certificates at market rates. Automatic transfers are another example of response to the environment. The pressure of interest-bearing share drafts at credit unions and the possibility of nationwide NOW powers for thrifts should create even more incentive for banks to offer their customers added convenience. Bankers should regard their expanded powers to offer such new services as an opportunity --

the opportunity to learn about effective pricing and marketing techniques in anticipation of the day when more institutions will be able to offer a wider range of deposit services.

Just as new "consumer" liabilities have evolved in response to economic pressures and to regulation, in the "wholesale" market traditional deposit sources of funds have been replaced by large certificates of deposit, Federal funds purchases, and repurchase agreements. Large CD's have grown from \$11 billion in 1970, when Q ceilings on these CD's were raised, to \$88 billion in 1978 at money center banks alone. And Federal funds/RP's now total over \$95 billion at all banks.

The evolution of the Federal funds/RP market is a special example of response to the environment. No longer are Federal funds used solely for the traditional purpose of borrowing needed reserves from another member bank that has excess reserves. Partly in response to more liberal interpretations by the Federal Reserve of what is an "exempt lender," member banks now borrow immediately available funds from all banks, savings and loans, mutual savings banks, and U.S. offices of foreign banks, without being subject to reserve requirements or interest rate ceilings. Also, the bulk of large banks' RP funds now come from corporate business sources.

As the phenomenon of "liability management" has grown and evolved, it has had important implications for the Federal Reserve's supervisory and

monetary responsibilities. For instance, in our supervisory capacity, we examine a bank's liability structure closely when assessing the adequacy of its capital or liquidity positions. And, in our role as monetary authority, we have been studying evidence that the growth in Federal funds/RP's may be linked with a shift in the demand for M<sub>1</sub>. Further development of "liability management" techniques and cash management services may continue to have a major influence on projections of the monetary aggregates.

#### The Changing Role of the Federal Reserve

My aim today has been to review some of the important recent changes that have shaped -- and will shape -- the banking industry. As these changes have occurred, so has the Federal Reserve changed. We are no longer charged only with the responsibility of conducting monetary policy. Through our rule-making responsibility, we have had to write regulations, that are in effect laws that we must administer and, on occasion, enforce. And most recently our role has evolved into that of "public arbitrator". For example, when deliberating on a bank holding company application to engage in a nonbanking activity, we are required by law to determine whether the proposed activity constitutes a net public benefit.

These growing responsibilities of the Federal Reserve have rarely been the Fed's own idea. Often, legislation has mandated that we take on new duties. So it was that legislation in the 1960's greatly expanded our duties in the supervision and regulation of banking organizations. After legislation passed in 1960

and 1966, the Federal Reserve had to consider both the "convenience and needs" of the community as well as possible "adverse competitive effects" of banking activities. In 1968, the Truth-in-Lending legislation ushered in a decade of extensive rule-making responsibility for the Fed in the consumer protection and anti-discrimination areas. The result, so far, has been Regulations B, C, Z, and AA. The latest legislation to add to the Federal Reserve's rule-making responsibilities has been this year's International Banking Act and Financial Institutions Regulatory Act.

We are as concerned as you are over this constantly changing and ever-growing set of federal regulations burdening the financial system. One manifestation of our concern is reflected in our new "Project Augeas" in which we have undertaken to review every Federal Reserve regulation with a view toward simplifying or deleting wherever possible. Cleaning out our stables will be a difficult task, but we have a sense of excitement over the prospect -- and its effect on our, and your, future.

The changes of the past will be replaced by still more changes -- and those changes are likely to be substantial. Adapting to our new environment will be a challenge for all of us -- bankers, bank customers, and perhaps, especially, central bankers. If we comprehend the opportunities available to us through embracing and charting constructive change, rather than resisting it then we will be motivated to meet that challenge. I believe that is exactly what we will do.