

For release on delivery
Expected at 9:30 A.M. EDT
September 13, 1983

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

September 13, 1983

I appreciate the opportunity to appear on behalf of the Federal Reserve Board before this Committee to review with you a wide range of issues affecting the evolution of banks, banking, and the financial services industry. The proposed "Financial Institutions Deregulation Act of 1983," submitted to you by the Treasury on behalf of the Administration provides a focus for these comments.

I testified before this Committee in the course of its general review earlier this spring, and I expressed then my conviction that Congress should now move to reform the existing legislative framework governing banking organizations to provide some assurance that the powerful forces of change be channeled in a manner consistent with the broad public interests at stake -- the need to maintain a safe and stable financial system, to assure equitable and competitive access to financial services by businesses and consumers, and to preserve an effective mechanism for transmitting the influence of monetary, credit, and other policies to the economy.

Nothing that has happened over the summer has reduced the need for early action -- quite the contrary. New combinations of firms in the financial services area, new services, and new combinations of older services are proceeding.

No doubt, much of this change reflects a natural, and potentially constructive, effort to respond to market

incentives, customer needs, and new technology. What is so disturbing is that much of this activity is forced into "unnatural" organizational form by the provisions of existing law and regulation. The consequences are obvious and serious. In some cases, the services are less readily available, at higher cost, than would otherwise be the case. Important competitive inequalities exist, as some institutions are able to take advantage of loopholes or ambiguities in the existing legal fabric and others are not. And in some cases, important objectives of public policy embodied in existing law are threatened or undermined. The pervading atmosphere of unfairness, of constant stretching and testing of the limits of law and regulation and of circumvention of their intent, and of regulatory disarray is inherently troublesome and basically unhealthy.

As I emphasized in April, there can be no doubt that a reexamination of the existing legislative framework has become urgent. We are at a crucial point. We can turn the system toward creative innovation consistent with certain broad and continuing concerns of public policy. Or, left unattended, we can continue to see the financial system evolve in haphazard and potentially dangerous ways -- ways dictated not just by natural responses to market needs but by the often capricious effects of existing and now outmoded provisions of law.

When I was before you in April, I suggested a possible interim step of a temporary limitation on combinations of nonbank banks (and thrifts) with non-depository institutions, as well as a similarly temporary halt to new state authorizations of expanded nonbanking activities for state-chartered banks. This interim step still seems to me required to provide Congress with the minimum time necessary to decide on appropriate policy approaches rather than be faced with a multiplying number of faits accomplis, vastly complicating the job of orderly reform.

Since that time, other proposals have been made to limit acquisitions of banks and thrifts by nondepository institutions. The particular proposals of Chairman St Germain of the House Banking Committee and Chairman Issac of the FDIC are more sweeping, requiring divestiture of existing combinations, and represent permanent prohibitions. These proposals, as I understand them, are not set forth as immediate, practical legislative initiatives, but rather to emphasize the need for more forward-looking, constructive reform by indicating the logical alternatives to absence of such action.

All these proposals have as their fundamental premise that the present situation is untenable. I share that view. We must either move forward, or we must define more precisely, carefully, and equitably the boundaries of existing law dealing

with the separation of banking and commerce and of activities within the financial sector. Simply waiting for the "dust to settle" where it will cannot be a satisfactory alternative. It is all too likely that the "dust" will fall unevenly and unfairly and impair the financial machinery. The moratorium proposal can provide only an imperfect, temporary shield while you work out a more forward-looking approach, but it would nonetheless serve the purpose of preserving your decision-making flexibility and of setting a deadline for more comprehensive Congressional action.

In that sense, I see it as a complement to, and not a substitute for, the initiative taken by the Administration to place before you a specific proposal for reform. We welcome that proposal, for it provides a constructive framework for your deliberations on a suitable approach to guide us over the next generation.

The remainder of my statement first restates the broad considerations and criteria that we feel should underlie any legislation and then, against that background, deals with more particular aspects.

General Considerations

The core objectives of banking and financial reform seem simple to cite. As in other areas, we want a system that encourages competition in the provision of banking and financial services; and consistent with those competitive

processes, consumers and businesses -- small or large -- should be able to purchase financial services at minimal cost. By its nature, a banking system also needs to be responsive to the concerns of public policy, including the need for an effective transmission belt for monetary policy. Finally, throughout history, here and abroad, there has been special concern about the need to maintain confidence in the basic payments system, implying continuing attention to the safety and soundness of banks.

At the heart of the problem, in setting out an appropriate legislative framework, lies the fact that, in some circumstances, these easy-to-state, agreed objectives may be in conflict or point toward different approaches. We normally should and do look toward the marketplace -- free of regulations except those necessary to preserve competition - to promote competition and efficiency. But when soundness, confidence, and continuity in the provision of money and payments services are at stake, deregulation cannot alone achieve the objectives because some degree of government support and regulation is implicit. The creation of the Federal Reserve and the FDIC -- and, more recently, our shared concern about the need for more intensified supervision of international lending -- are obvious cases in point.

In approaching that dilemma -- encouraging the free play of market forces while also recognizing the need to

preserve a "hard core" of safety and soundness in the financial and payments system -- we have emphasized in earlier testimony several points as a basis for legislation:

- 1 We should continue to recognize that banks, and depository institutions generally, perform a unique and critical role in the financial system and the economy -- as operators of the payments system, as custodians of the bulk of liquid savings, as essential suppliers of credit, and as a link between monetary policy and the economy.

This unique role implies continuing governmental concerns -- concerns that may be reflected both in the support provided by lender of last resort and deposit insurance facilities and by regulatory protection against undue risk or bias in the credit-decision process.

A bank or depository institution cannot be wholly insulated from the fortunes of its affiliates -- their success or failure or their business objectives.

In essence, these essential points seem to us to set broad limits on the extent to which market and competitive forces alone can be relied upon to shape the evolution of banking organizations within the financial and economic

system. For instance, they underlie the strong tradition in the United States of a separation between banking and commerce, although the precise line between the two needs to be reexamined in the light of changes in technology and other factors. It is precisely in drawing lines of this kind -- and in achieving an appropriate balance between legitimate and continuing regulatory concerns and the need to respond to competitive forces that difficult and controversial legislative choices must be made.

For our part, we believe the Administration bill, taken as a whole, provides a reasonable balance and we broadly support the proposal. It would make possible a significant even sweeping -- simplification in the supervisory procedures applicable to bank holding companies, and allow them a broadly expanded range of financial activities. But it also maintains the broad distinctions between banking and commerce, and would prohibit or sharply circumscribe participation in certain financial areas - underwriting of corporate securities and real estate development -- characterized by particularly strong elements of risk or potential conflicts of interest.

I must emphasize that our support for the bill is predicated on the retention of the essential safeguards including an adequate supervisory framework -- to protect the safety and stability of banking institutions and the banking system. We have also noted certain problem areas with respect

co the broader powers that I will be discussing in more detail. We also recognize the bill, encompassing as it is, would leave large areas of unfinished business. I will have comments on state-federal regulatory relationships and on the relationship between bank and thrift powers, both areas where further legislative direction is urgently needed.

Important questions have also been raised about the nature and role of deposit insurance in our evolving banking system -- a matter the FDIC and the FSLIC have themselves had under review -- and about the division of supervisory and regulatory responsibilities in the Federal Government -- a matter under study by the Bush Task Force. I do not in any way minimize the importance of these matters. My own sense is that your consideration of them might logically follow, rather than accompany, your consideration of the present Administration bill. Indeed, the sorting out of bank and thrift powers and Federal-State banking relationships would seem to be a prerequisite for intelligent approaches to the latter issues, and, as a practical matter, is added reason for dealing with the Administration bill promptly.

Bank Holding Company Regulation under the Administration Bill

With this background, I would now like to comment on the major provisions of the bill and how they affect new activities, the definition of bank, supervisory procedures, conflicts of interest, and avoidance of excessive risks. The

Board may wish to bring additional details to the attention of the Committee at a later time.

New Activities

The powers provisions of the Administration bill are its centerpiece, not only because they represent a major expansion in the types of activities in which banking organizations may engage, but also because they in combination with the definition of a bank contained in the bill -- will determine the types of nonbank firms that may own banks. Nonbanking activities of bank holding companies would be expanded to include, with the principal exception of corporate underwriting, not only those services "closely related to banking" but also those of a "financial nature". The bill would specifically authorize ownership of thrift institutions, insurance and real estate brokerage, real estate development (with limitations on the amount of capital investment), insurance underwriting, and certain securities activities if performed in a separate securities affiliate. These securities affiliates would be authorized to underwrite municipal revenue and certain types of industrial revenue bonds and to sponsor and underwrite money market and stock and bond mutual funds registered under the Investment Company Act.

The proposal thus draws the circle separating "banking" from commerce more broadly, but -- taking into account the cautionary comments on certain activities that I

will detail below -- still within the bounds of what we believe is necessary to maintain safety and soundness and to avoid potentially harmful conflicts of interest, excessive concentration of resources, and undue risk -- the basic policy objectives which Congress has sought to attain through the Bank Holding Company Act.

Definition of Bank

The definition of the term "bank" is a key element in the bill because it defines the scope of institutions to which Congress wishes to apply these basic policies. The Administration proposal redefines the term "bank" to include: any insured bank, any institution eligible for FDIC insurance, and any institution that accepts transaction accounts and makes commercial loans.

This definition has attracted wide support. It is contained not only in the Administration bill, but also in our own moratorium proposal and the moratorium bills suggested by Chairman St Germain and the FDIC. This and other provisions would close the nonbank loophole and encompass other deposit taking institutions that could become vehicles for evasion of the policies of the Act. While a broadening of the scope of the definition beyond institutions that are federally chartered and insured should be carefully scrutinized to assure that we are not covering more than is necessary, it is our initial judgment that the broader definition is both necessary and

desirable to assure we are not faced, within a short period of time, with the same kind of loophole evasions that are so troubling today

Supervisory Procedures

Suggestions have sometimes been made that confining the conduct of new activities within nonbank subsidiaries of a bank holding company would itself adequately insulate the bank from risks or conflicts of interest involved in such activities, and therefore make feasible and appropriate virtually any activity within a bank holding company. As I have stressed before, the Board does not believe that this concept can achieve its objectives, although legal separation of parts of the holding company may be desirable to assist appropriate functional regulation and to help contain the elements of risk and conflicts of interest. We believe that the bill before you -- while placing operations of nonbanking activities in separate subsidiaries -- also provides adequate criteria for authorizing nonbanking activities and provision for supervision to the extent necessary. At the same time, unnecessary regulation would be eliminated, and there would be a major streamlining of the necessary supervisory procedures.

Present statutory procedures, in effect, require that a bank holding company, unlike other companies planning to enter a new line of business, be able to demonstrate to a public body -- the Board of Governors -- that there are

positive net public benefits stemming from nonbanking acquisition. This procedure affords competitors and other parties opportunities for comment, for hearing, and ultimate judicial review. In effect, the burden of proof is on the applicant and the process affords opportunities for costly and burdensome delay by competitors.

Under the proposed procedure, a bank holding company making an acquisition within the general framework of the permitted powers would still be required to submit a notice of such acquisition, but it could proceed unless disapproval by the Board of Governors was indicated within a limited time period on the basis of certain statutory considerations. Those statutory considerations -- adequacy of financial resources, adequacy of managerial resources, protection of impartiality in the provision of credit, and avoidance of any material adverse effect on affiliated banks' safety and soundness are designed to assure that certain longstanding purposes of the Bank Holding Company Act are maintained.

As a further measure to assure safety and soundness and fair competition with businesses in the same lines of activity, but not associated with banks, the bill also provides criteria be developed to require that nonbanking activities of banking organizations be capitalized at least as well as those of comparable competing business. At the same time, the provision in the present law that requires evaluation of

competitive factors by the Federal Reserve would be deleted. The anti-trust laws would, of course, continue to apply and consequently, primary responsibility for anti-trust enforcement for bank holding companies, as for other companies, would shift to the Justice Department.

The law would permit the Board, by general regulation, to prescribe limitations on any new activities consistent with the four stated criteria and with safe and sound financial practices generally. The bill also provides adequate supervisory authority over the activities of the holding company and its nonbank subsidiaries after they are in operation. While encouraging reliance on reports required by other regulatory agencies to avoid duplication of reporting requirements, the Board is authorized to obtain further data if necessary to assess compliance with the Bank Holding Company Act and to institute procedures to assure compliance with law.

The net result of the new procedures should be to speed greatly the application process and to eliminate the possibility of dilatory tactics by competitors. At the same time, the Board believes that the statutory criteria and the framework for applying them are adequate to protect customers, the bank, and the financial system.

Conflicts of Interest

One of the major continuing concerns of the Congress in the Bank Holding Company Act has been to prevent conflicts of interest in the provision of credit. The objectives are several: the assurance of fair and open competition in the provision of credit; maintenance of the impartiality of banks in credit judgments; and avoidance of practices that could undermine the strength of the bank itself.

Those broad concerns remain real, but we also believe that extension of bank holding companies into new lines of activity -- combined with changing technology -- require reconsideration of the issue with respect to legislation and regulation. A single firm will be able to provide a much broader range of products to its customers -- that, indeed, is the driving force behind the proposal. This ability promises to provide the consumer with increased convenience through "one-stop shopping" for a range of financial services, and should increase his options.

At the same time, the natural tendency will be toward the joint offering of a variety of products, linked together in some significant way. For example, the combination of banking with real estate, insurance, mutual funds, and securities brokerage in one holding company makes it more likely that these products will be purchased in the same place, and inducements to purchase one service packaged with another

10

offered at an attractive price are natural. We are already witnessing this process with the advertising by a major retail and financial firm that it will provide discounts on its household items if a customer purchases a home through that firm's real estate brokerage subsidiary.

There is no doubt that opportunities for tying, formal or informal, will exist if banking organizations are able to offer real estate, mutual funds, insurance and securities brokerage, together with traditional banking products. Because of concern about maintaining impartiality in the provision of credit, Congress enacted a specific prohibition, at the time it expanded bank holding company powers in 1970, on the tying of bank to nonbank services. Under the Administration proposal, these prohibitions would remain intact.

Our experience in administering these rules indicates that they are effective in preventing abuses of the bank that could endanger its financial stability. We assume that they continue essentially unchanged.

The Board, by regulation, has applied these same rules on tying to transactions involving the nonbank subsidiaries of bank holding companies. However, applying and enforcing such a regulation would become increasingly difficult as nonbank activities expand. Moreover, as indicated by the example above, other companies providing financial services are not inhibited by such rules. If the Congress chooses to encourage

the supermarket of financial services concept, there is no reason why nonbank subsidiaries of bank holding companies should not be permitted to participate in this development on the same basis as other providers of financial services.

We would like to have direction from Congress about whether, in the framework provided by the Administration bill, prohibitions against tying should be maintained among nonbank subsidiaries of bank holding companies as well as against the bank itself. If so, it would appear competitively inequitable to have such strict rules apply (beyond services provided by a bank itself) while continuing to allow nonbank financial institutions the ability, through discounts and other means, effectively to tie their financial products.

Another area of potential conflict arises when a lender -- and particularly a bank lender and fiduciary -- has important ownership interests. In the past, any problem has been minimal in banking because of the strong limitations on equity investment by a bank and its affiliates. However, as a result of real estate development, insurance company and sponsored mutual funds activities, equity investments by a bank holding company would become much more significant in the future.

The provisions of the bill before you provide some basic protections against abuse of the bank. The bill does not authorize underwriting of corporate debt or equity securities,

an area where the potential for conflicts of interest and risk may be particularly great. During an underwriting of securities handled by an affiliate, the securities involved could not be purchased by another affiliate, and the securities or other assets of an affiliate could not without authorization be acquired by another affiliate acting in a fiduciary capacity. The current safeguards on inter-affiliate transactions would be broadened beyond the present restrictions on the extension of credit to include complementary restrictions on the purchase of assets, the furnishing of services, and other transactions with a third party in which an affiliate has an interest, essentially requiring that these transactions be on non-preferential market terms.

These are useful provisions, but there are many potential situations, for example in the real estate area, where objective market values and a "market" test are difficult or impossible to measure. For this reason and to lessen the risk of conflicts that could be harmful to the bank or the public, consideration should be given to a prohibition on loans by a bank to any entity in which a bank affiliate has a substantial or controlling ownership interest. This would help assure that a bank's lending judgments would not be clouded by the equity relationship and would help maintain one of the basic public policy objectives of the Act -- the maintenance of impartiality in the credit extension process.

Controlling Excessive Risk

A basic question in appraising the Administration proposal is whether the result would be to increase unduly the risks to the stability of a bank, and to the banking system generally. As indicated earlier, we do not believe that the fortunes of a bank can be insulated effectively from other parts of its holding company subject to common management, notwithstanding adoption of formal rules and regulations to avoid conflicts of interest and to minimize appearance of a common entity. Consequently, we have reviewed the Administration proposal from that point of view, and we are satisfied that sufficient supervisory authority would be provided to deal with most sources of potential difficulty.

We remain concerned with the area of real estate investment and development, which are, by their very nature, subject to high risk. In recognition of those dangers, the proposed bill limits the investment a bank holding company can make in a real estate development subsidiary to not more than five percent of the primary capital of the holding company. We view this limit as a reasonable and necessary restraint on the size of the capital commitment a bank holding company may make in its real estate development subsidiary, but we also believe, at least in the early stages of bank involvement with this activity, that further restraints may be necessary. For example, a high degree of leveraging in relatively speculative

or otherwise risky real estate development could effectively impair the intended effect of the limit. The experience with real estate investment trusts, when banks had no equity involvement but felt their name and reputation were at stake, remains relevant in assessing the nature of bank exposure to large ventures carried out by affiliated companies.

In that light, we believe it appropriate that the Congress clearly provide regulatory authority for the Federal Reserve to define more precisely the nature of permissible real estate development and the amount by which such a subsidiary could leverage its capital. We also raise the question of whether such activity should normally extend to active control and ownership of essentially commercial operations construction companies, building operations, land speculation, and the like. Our understanding is that many bank holding companies are primarily interested in opportunities for equity or equity-like participation in real estate projects under the active management and control of others and in fuller participation in the financing of such ventures. This range of activities is more congruent with the experience and role of financial institutions.

While similar questions have been raised about the risks involved in insurance underwriting, and particularly underwriting of property and casualty insurance, the record suggests that these risks can be effectively managed through

application of prudent underwriting practices. Such subsidiaries would remain under the supervision of relevant state authorities. Thus, we do not suggest statutory limitations on the types of insurance underwriting that should be considered permissible. However, because of the potential risks involved in some kinds of property and casualty insurance, I welcome the flexibility provided by the proposed bill to limit the scope of insurance underwriting by bank holding companies if experience indicates a need to circumscribe the scope of banking organization participation in this activity.

Consideration of risk and potential concentration of financial resources coincide in suggesting another limitation similar to that imposed by the bill on real estate development companies would be appropriate. As a general proposition, bank holding companies could be expected to enter the insurance underwriting business through acquisitions of existing companies with management expertise in place and with seasoned portfolios rather than through de novo expansion. The same is also likely to be the case for insurance companies entering the banking business. The speed or degree to which these major industries, which have historically operated separately, should be permitted to combine within a holding company structure seems to us an important question. We have doubts about whether it would be good public policy to allow the largest

banks to acquire the largest insurance companies, or conversely, the largest insurance companies to acquire the nation's largest banks.

At some point in the future, should experience confirm that combinations of insurance and banking firms have raised no special problems, elimination of all restraints on such amalgamations may be appropriate and desirable. For now, we would suggest that the process proceed at a more deliberate pace, and an effective means of accomplishing that would be to relate bank holding company investment in an insurance company to a limited fraction of its capital. Under such a rule, the largest banks would be able to purchase smaller or medium-sized underwriters; smaller banks would have to combine in joint ventures to accomplish this result -- not an undesirable result to assure spreading of risk and avoidance of relationships that could result in incentives for tying. Reciprocally, a holding company with a dominant large insurance company would be limited in the size of its bank acquisitions. The bill should be amended to provide explicit authority to apply such an approach as we gain experience.

To assure that the objectives I have outlined can be fully achieved it would be advisable to clarify the provisions of the Bank Holding Company Act to assure that the general examination and regulatory authority of the Board extend on the same basis to insurance underwriting subsidiaries of bank

holding companies as to other nonbanking subsidiaries. The provisions of existing federal law delegate insurance regulation entirely to the states.

Competitive Equality Among Depository Institutions

I have reviewed with the Committee before our concern that as thrifts have assumed more and more commercial banking powers, and as they also retain powers that extend well beyond those of banks and bank holding companies, competition among depository institutions is distorted and inequitable. Left unattended, we are drifting into an inconsistent and irrational public policy. To the extent restrictions and regulations on bank holding companies are justified by abiding public concern, those restrictions will be undercut to the extent the same or similar banking powers can be exercised in a more liberal (or in this context "laxer") regulatory environment. To the extent the restrictions are not justified, they should be abolished.

To illustrate the potential in the present situation, firms engaged in any type of commercial or financial activity can potentially own a savings and loan association which, in turn, has powers comparable to banks but may also (1) branch or otherwise expand interstate and intra-state; (2) have insurance and real estate development subsidiaries; (3) receive long-term expansion funding from the Home Loan Banks; and (4) qualify for special bad debt tax treatment by the IRS. In practice, federally chartered thrifts still have limited commercial loan

and demand deposit powers, and the Federal Home Loan Bank Board has not encouraged widespread ownership of thrifts by commercial firms or investment houses. But it is also true that some states have provided, at their own initiative, full banking powers and more to their own thrifts.

Under the Garn-St Germain Act, the exemption for the unitary savings and loan association holding company from the activity restrictions of the S&L Holding Company Act - and therefore from restrictions on interstate activities and commercial ownership -- are lost if an association fails to qualify for the special bad debt deduction for tax purposes. However, it may be relatively easy to meet the required asset test and at the same time engage in a rather diversified range of banking activities. Our data show that the overwhelming majority of thrift institutions do qualify for the special treatment provided by law because they have in fact specialized in home mortgages. However, over time competitive opportunities provided by the existing rule will likely be increasingly utilized.

The Administration bill approaches these imbalances from two directions. The new powers provided to bank holding companies would, in important respects, match the powers currently available to thrift holding companies; at the same time, the special status afforded to unitary thrift holding companies would, prospectively, be eliminated and the scope of

activities of thrift holding companies and service corporations would be the same as those of banking organizations. These provisions of the Treasury bill would not entirely eliminate the differences between thrift and bank organizations; thrifts would continue to have more favorable branching flexibility and tax treatment, and access to Home Loan Bank funds for expansion purposes.

Nonetheless, the proposal will inevitably be controversial, involving as it does a clear step toward more uniform regulatory treatment, however justified that may appear to be in view of the growing banking powers of thrifts. Such concern may be more justified among thrifts that in fact are not substantial competitors in traditional commercial banking markets and who wish to retain their special character in emphasizing residential mortgage lending.

I have on a number of occasions, before this Committee and elsewhere, noted my personal belief that specialized financial institutions have served this country well over time, and the Federal Reserve could be supportive of some differences in regulatory, tax, and other approaches related to institutions that in fact choose to remain specialized home lenders. For example, one could explore an approach that provides that, if a thrift institution or thrift holding company maintains most of its assets in residential mortgages (including mortgage-backed securities), such an institution

would maintain most of the attributes of a unitary S&L holding company, its current tax status, full access to Federal Home Loan Bank financing, branching intra- and inter-state, and most service corporation powers. It might also be owned by a commercial company so long as the thrift operation was fully separated from the commercial interests and not operated in tandem and provided it could exercise no greater powers than presently authorized. We would not recommend interlocks with full scale investment banking houses because of the envisioned exposure to conflicts of interest and risk. As a matter of reference, about three quarters of all savings and loans currently have 65 percent or more of their assets in residential mortgages and mortgage-backed securities, and two-thirds have that percentage in 1-4 family mortgages and related securities. Any test of the requisite degree of "specialization", and related regulatory treatment, would also have to take account of the particular tradition of savings banks.

On the other hand, a thrift organization that of its own volition engaged in more diversified activities, including sizable amounts of commercial lending and other business relationships, should presumably have to forego the special provisions of law that are unavailable, as a matter of public policy, to banking organizations. We would, of course, envision that it would continue to be supervised by the FHLBB, as proposed in the Administration bill.

Such an approach, while needing refinement and closer examination, seems to me in keeping with the basic traditions of the thrift industry.

Federal-State Banking Authorities

The Administration bill does not deal with another difficult question the proper scope of authority of the federal and state governments in regulating the nonbanking activities of banks. The problem arises from some recent state actions authorizing vastly enlarged powers for banks and their subsidiaries that are inconsistent with the comprehensive framework established by Congress for regulating the conduct of nonbank activities by banking organizations.

Conflicting approaches are of recent origin. For a parallel systems federal regulation of nonbanking activities through the Bank Holding Company Act and dual state-federal regulation of banking activities have worked tolerably well together; they afforded an element of useful experimentation and local adaptation so long as basic goals and approaches were commonly shared. In this context, the Board has facilitated the freedom of action for state authorities by adopting a rule that a bank holding company may conduct through a subsidiary any activity that a state bank could perform directly; in practice, state authorized powers for banks did not go far beyond those permitted for nonbank

subsidiaries by federal law. Our recent survey of the nonbank powers of banks under state law indicates that the great majority of states have remained conservative in their authorization of bank powers and have not gone beyond those provided in the Bank Holding Company Act.

Now, however, major inconsistencies have arisen between federal and state law because some -- so far very few -- of the states have authorized bank and thrift powers that are actually or potentially in sharp conflict with the framework of powers for banking organizations established by Congress. The Board is concerned that competition in financial markets, and competition between states for economic development, is in effect producing competition to establish a lax regulatory framework for banking organizations without taking account of the ~~national~~ issues at stake, and at the clear risk of undermining prudential standards.

Although I regret the need to take a step which would limit the freedom of action of states, it seems plain that the safety and soundness of the banking system is, in the end, matter of national interest. The recent tendency of some states to act in a manner out of keeping with national concerns requires a response.

Specifically, institutions, whether federally or state chartered, that are full beneficiaries of the federal banking safety net should be subject to the minimum federal rules

established because of the overriding national interest in safe and sound banks. What appears necessary is a provision in the new legislation setting some limits with respect to the ability of states to provide authority for a state-chartered institution to pursue activities within such an institution beyond the powers permitted to depository institutions and their holding companies under federal law. The moratorium bill that the Board has proposed also includes such a provision.

States, for instance, might experiment, as they have in the past, in areas that do not pose fundamental questions of safety and soundness and that are largely local in character. Moreover, states might be permitted discretion to authorize any banking and nonbanking activities for state-chartered institutions or their subsidiaries that they deem to be desirable, provided that these activities may be performed only for customers resident in the authorizing state. Such arrangements would preserve local initiative, while assuring that interstate commerce was conducted within the framework for a safe and sound banking system that the Congress decides is most appropriate for the country as a whole.

Interstate Banking

The Administration bill does also not address another major question facing the American financial system -- the appropriate geographic limits for banking operations.

Despite the Douglas Amendment and the McFadden Act, we now have, de facto, a large measure of interstate banking in some product areas. Through more than 7,000 interstate offices, some large banking organizations today are conducting interstate operations through a variety of avenues, including Edge Act subsidiaries, loan production offices, credit card operations, grandfathered holding companies, interstate acquisition of failing banks and thrifts, and a number of activities "closely related to banking" allowed under the Bank Holding Company Act -- mortgage banking, personal loan companies, and others. And no counting of offices can illustrate the further penetration of interstate markets for deposits and loans made possible by the speed and economy of modern data processing, communications, and transportation.

But these developments are uneven and haphazard. In prohibiting brick and mortar presence across state lines for an ordinary range of personal banking services, present law forces banking services to be fragmented, even within many metropolitan areas, whether viewed from the perspective of the banking organization or its customers. The end result is that risks may be increased, costs are higher than necessary making competition less effective from the customer's perspective, and particular banking institutions are relatively advantaged or disadvantaged. To take one example of obvious anomalies, deposits can be and are now brokered across the country, with

securities dealers and others acting as intermediaries through a network of local offices. But banks themselves cannot attract those deposits directly from local offices beyond their own state.

It is not surprising that the states themselves have begun to recognize the anomalies and have started to relax some of the restrictions allowed by the McFadden Act and Douglas Amendment. Four states have authorized interstate banking at least on a reciprocal basis; three New England states are authorizing regional, reciprocal entry; four other states have authorized out-of-state entry for some form of limited banking, such as credit card or wholesale banking operations; and four states permit entry by certain grandfathered companies.

These state actions are constructive in breaking down outmoded barriers but they also dramatically illustrate the haphazard and unequal development of interstate activity. A closely integrated economy requires and deserves more uniform rules in this important area. It is reasonable to ask whether rules that prohibit New York or St. Louis banking organizations from establishing offices across a river, but would permit them to sell insurance in Arizona, serves a national purpose. Similar doubts arise about the logic of proposals that a Providence, Rhode Island bank be able to purchase a bank two states and 150 miles away in southern Vermont, but that an Albany, New York bank 30 miles away be prohibited. We also

have the anomaly of states welcoming foreign banks within their borders, while prohibiting entry of U.S. banks from neighboring states.

For want of any better rule to assure gradualism and to take state preferences into account in the evolution of interstate banking, regional compacts have had an appeal to some as a transitional device. We are concerned, however, about the implications for a kind of balkanization of the process that could discriminate against banking organizations in some states and, without serving a legitimate local purpose, limit the ability of banks wishing to sell or merge to find an appropriate partner. These concerns are already reflected in litigation that has been brought by interested parties to challenge the constitutionality of regional arrangements. We also have, for these reasons, reservations about the legislation proposed to provide authority in federal law for such arrangements in New England.

I have another concern about the impact of the rules prohibiting interstate banking. There is a natural tendency by those who are shut off from their natural avenues of expansion to divert entrepreneurial energies into other areas open to them. Undue restrictions on interstate banking in effect create an artificial incentive for banks to enter into nonbanking fields of activity. Over time the tendency would be to diminish the relative importance of the bank, and management

attention given the bank, within a holding company structure ultimately weakening the safety and soundness of the banking system itself.

At the same time, I recognize the traditional and historic concern about local control of banking, the importance of healthy community banks, and the dangers from excessive concentration of resources. Fortunately, we have a good deal of experience within large states about the ability of small banks to survive and prosper alongside relative giants -- and for the good reason that they can operate efficiently and establish solid relations with local consumers and businesses. Over time, interstate banking would inevitably mean fewer banks and larger average size, but properly implemented and controlled I see no danger that the United States would be bereft of large numbers of smaller banks, or that, with appropriate safeguards, excessive concentration would become a problem.

There are a variety of possibilities for transitional and more permanent arrangements to help assure constructive results. For example, interstate banking might, at least initially, be confined to establishing separate legal entities in other states as part of a multi-bank holding company that would have to conform to state branching restrictions and to state law and supervision in other respects.

Similarly, there are a number of steps that can be taken to prevent excessive concentration of banking resources, to limit the ability of the largest banks to join together, to define the share of resources in a state or area that would be controlled by a single organization, as well as by other means.

In sum, a solution that accommodates the forces of technology and competition, while taking account of our public policy objectives of avoiding concentration of resources and maintaining a role for the states in regulating banking in their jurisdictions, is necessary. There have been numerous studies and recommendations over the years with regard to the proper balancing of federal and state interests in the geographic scope for banking operations.

What is necessary now is to find a consensus on a particular approach. We would be glad to assist your deliberations by providing, in more specific terms, a variety of approaches to balance the various considerations, and by working with other banking agencies and other groups to that end.

Interest on Demand Deposits and Reserves

Comments have also been requested on two additional issues of significance for monetary policy and competition among financial institutions. These issues concern the federal prohibition against the payment of interest on demand deposits

and the payment of interest on reserve balances held by depository institutions with the Federal Reserve System.

As you know, the Depository Institutions Deregulation Committee recently recommended that depository institutions be permitted to pay interest on demand deposits. In approaching this question, it should be recognized that developments over a number of years have importantly undermined both the effectiveness and rationale of the prohibitions. These developments include (1) implicit interest payments on demand deposits through the provision of customer services without explicit charge or at fees below cost, (2) legislative and regulatory changes to permit explicit interest-bearing transaction accounts for non-business customers that are legally distinct from demand deposits, although functionally the same, and (3) market development of close demand deposit substitutes that earn interest, such as money market mutual funds.

The cost implications for depository institutions as a result of authorizing the payment of interest on demand deposits should be manageable over time precisely because many transaction balances are already, directly or indirectly, earning a market rate of return. The material submitted to the Committee by Secretary Regan on behalf of the DIDC on this point is consistent with our analysis.

The potential adverse earnings impact of interest-bearing demand deposits could be mitigated by requiring the payment of interest on required reserve balances held with the Federal Reserve Banks. As a general matter, the Board believes that the payment of a market-related interest rate on reserve balances would be desirable in light of both equity and monetary policy considerations.

Reserve requirements, while imposed for monetary policy purposes, also, from the viewpoint of the depository institution, represent a form of tax that falls unevenly across institutions providing comparable services. Interest on required reserves would remove this competitive distortion. In addition, such payments would work to discourage the incentives toward the development of transaction-type accounts outside the depository system, thus protecting the ability of the Federal Reserve to carry out monetary policy efficiently over time and tending to maintain the payments system within the basic framework of regulated depository institutions and the federal "safety net."

At the same time, payment of explicit interest on demand deposits and reserve balances should be consistent with general considerations of efficiency in the allocation of economic resources and effective competition. Consequently, the Board supports action along these lines.

More specifically, bills have been introduced with the intent of requiring interest to be paid on a limited fraction of required reserves -- those held against money market deposit accounts and Super NOW accounts -- accounts upon which depository institutions now pay market rates of interest. (Most MMDA's -- those not held by businesses -- have no reserve requirement.) Paying interest on reserve balances held against Super NOW accounts would remove one cost for depository institutions not borne by money market fund or other providers of a similar service and then tend to further equalize competitive opportunities. For a period of time, interpretation of the monetary aggregates, particularly M1, could be further complicated by causing savings funds now held in MMDA's or other forms to shift into Super NOW accounts, which is a component of M1. With interest paid on reserve balances, depositors would be able to receive as good a yield on Super NOW accounts as on MMDA's (taking into account service charges) and the former would also have the capacity for unlimited transfers by check. (Potential shifts of this kind could, of course, also be large if market interest rates are to be permitted on demand deposits.) However, that adverse effect is not, in our judgment, a compelling reason not to adopt the proposal, particularly in circumstances in which it could be viewed as a transitional step toward payment of interest on demand deposits and related reserve balances.

Other things equal, paying interest on reserve balances generally would involve a drain on Treasury revenues. Thus, while the Board, as a matter of principle, favors payment of interest on all reserve balances, the question remains of an appropriate phase-in. This is, of course, inevitably related to the present budgetary position, but we do not believe that, over time, reserve requirements should be looked upon as a revenue measure. If banks and other depository institutions are to be specially taxed, such a decision should be made explicitly on grounds other than as a by-product of the role of reserve requirements as an instrument of monetary policy. Payment of interest only on reserves against Super NOW accounts and non-personal MMDA's, at present interest rates, is estimated to entail a net revenue loss of \$125 million a year initially, and the figure would rise over time as deregulation proceeds and these deposit forms become more important.

We believe that such a decision should imply a transition toward payment of interest on reserves more generally to avoid distortions among various types of transaction accounts. In that case, the costs would, of course, be substantially larger.

Finally, I would like to address a related point and remind the Committee of the long-standing Board view that authority should be provided to apply reserve requirements to institutions that are not formally depository institutions (and

thus are not covered by the prudential rules applicable to these institutions and their holding companies) but that do offer transaction accounts similar to those offered by banks. As long as these close substitutes for bank deposits are free from reserve requirements, they have a potential competitive advantage relative to bank deposits and, at times, they can complicate the task of conducting monetary policy.

In an environment in which Regulation Q ceilings on deposits have been largely eliminated, such problems may not be as acute as they were in the 1981-82 period. Payment of interest on reserves would, as indicated, remove a remaining source of competitive distortion. At the same time, however, the process of financial innovation could well produce still other instruments which will present new problems.

Thus, the Board believes it would be prudent to incorporate into the bill a provision whereby financial instruments issued by nonbank institutions that have transaction or third-party payment powers would be subject to reserve requirements. The Board would not expect to use this authority unless conditions arose to demonstrate its necessity.