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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

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For a Chairman of the Federal Reserve Board, there is a special pleasure in the opportunity to come to Salt Lake City to participate with the Senate Banking Committee in a discussion of the basic rules to guide the development of our banking system. The senior Senator from this state has been leading the effort to achieve constructive and timely responses to the need to change our banking laws to meet today's conditions. In that respect, Mr. Chairman, you follow in the tradition of another native son, Marriner Eccles. As Chairman of the Federal Reserve Board for more than 13 years during the 1930's and 1940's, he spearheaded the effort to rewrite banking laws to meet the needs of his time -- and for many years thereafter. Your sponsorship, Senator Garn, of legislation to rededicate our office in Washington in his name is an appropriate and welcome recognition of a man to whom we owe a great deal.

Drawing on his experience as a businessman and innovative banker in Utah, Marriner Eccles greatly strengthened the Federal Reserve and did much to repair the financial system after the ravages of the banking crisis of the early 1930's and the depression. He instinctively recognized the crucial importance of a sound banking system to the proper functioning of our economy, and the necessary role of the Federal Government in setting out an appropriate legislative framework, supported by effective supervision and regulation. He was, of course, particularly conscious of the responsibilities of the Federal Reserve, as the Nation's central bank, in protecting the stability of the banking system. He

built well, and in reviewing the problems we face today, I am struck by many parallels between the basic issues that were before the country then and now.

But, as you well know, under the pressure of technological and market change, there is also a pressing need to adapt the legislative framework to today's conditions lest crucial continuing objectives of public policy be eroded or overturned. In earlier testimony before you, I have reviewed the dangers of permitting the situation to evolve in haphazard and potentially dangerous ways, influenced not just by natural responses to market forces, but by often capricious effects of existing and now outmoded provisions of law. The result would be not just unfair competitive distortions but also an unintended unravelling of basic tenets of public policy that the legislative structure has been designed to promote.

To summarize our basic approach toward these matters, our point of departure is the basic proposition that banks, and depository institutions generally, continue to 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 key and impartial suppliers of short-term credit, and as the link between monetary policy and the economy. This unique role implies continuing governmental concerns about the stability and impartiality of these institutions -- concerns that are reflected in the federal "safety net" long provided by the discount window and by deposit insurance, by regulatory protection

against undue risk, and by policies to discourage conflicts of interest and undue concentration of banking resources. We also believe that these concerns must, to a degree, encompass business organizations of which banks are a part -- bank holding companies -- for the basic reason that a bank or depository institution cannot be wholly separated from the fortunes of its affiliates and from the success or failure of their business objectives.

Those fundamental concerns are broadly reflected in the proposed legislation before the Committee.

There are now two major proposals, S. 2181, the Financial Services Competitive Equity Act, which was introduced by the Chairman, and S. 2134, the Depository Institutions Holding Company Act Amendments of 1983, introduced by the ranking Minority member, Senator Proxmire. Both of these bills have S. ~~1069~~ 1609, the Administration's proposed Financial Institutions Deregulation Act, which has been endorsed by the Board, as a common base. These bills differ in the scope of new powers authorized bank holding companies and in some other important areas, and I also recognize that inclusion of certain provisions of S. 2181 for discussion purposes does not necessarily imply endorsement. But I also believe it important to emphasize that these bills have key provisions that are identical or similar, suggesting and reflecting an emerging broad consensus on the core of constructive legislation. Thus, I believe the raw materials for coherent action are now before you, providing a strong base for legislative action in a matter of months.

Points of Growing Consensus

Analysis and discussion of these proposals suggest the framework for legislative action can be built on three essential elements:

(1) New statutory definitions to clarify what is a bank, what is a thrift, and the proper scope of powers for state-chartered banks;

(2) Streamlining of the procedures of the Bank Holding Company Act; and

(3) Expansion of the powers of bank holding companies.

Other issues, including new rules for interstate banking and payment of interest on demand deposits and reserves at the Federal Reserve Banks, also need early resolution. As a practical matter, these areas may not have achieved the same degree of consensus. We would like to see progress in those directions and we welcome the efforts of your Chairman to advance the discussion. However, we do not believe inability to achieve full agreement in all those areas should necessarily delay legislation dealing with the "core" elements of the bills before you.

I do believe that there is a broad agreement that new definitions of the terms "banks" and "thrifts" are urgently necessary to assure an orderly framework for the development of the financial system, to promote competitive equity, and to establish clearly the competitive rules for the various segments of the financial services industry. One significant area of possible disagreement -- the appropriate role for so-called consumer banks -- I will comment upon at a later point.

Similarly, with respect to the definition of thrifts, there has been increasingly clear recognition of the anomalies that arise as thrifts achieve and implement powers much more comparable to commercial banks, but still operate under more liberal provisions of law -- such as the absence of restrictions on ownership, the ability to obtain long-term governmental lending, favorable tax treatment, and the freedom to branch intra-state and inter-state -- denied commercial banks. The growing similarity of powers, combined with differences in regulatory approaches, result in competitive inequalities and thus in tensions that undermine legislative intentions. All that is reflected in the strong interest of a variety of financial or non-financial businesses in the acquisition of thrifts in order to benefit from bank-like powers and to participate in the payments mechanism, but without the restrictions applicable to banks or bank holding companies.

Looked at from another direction, there is recognition of the fact that the public policy rationale for the favorable regulatory, tax, and credit treatment of thrift institutions is fundamentally rooted in their activity as home lenders. Consequently, the essential idea that a thrift should be defined by a test set forth in terms of residential lending activity seems to be increasingly accepted, as well as the corollary that such institutions should not operate in "tandem" with non-depository owners. Again, there are differences on the specifics of the test that need to be resolved and that I will discuss later.

Recent developments strongly point to the need for another provision defining the role of depository institutions -- provisions which provide a framework for the discretion of states in authorizing new powers for state-chartered banking institutions. To the extent Congress, in the national interest, finds it necessary to circumscribe the activities of depository institutions and their holding companies, such limitations could be rendered null and void over time by unrestrained state action.

There are various approaches toward dealing with this anomaly in the dual banking system, reconciling a desirable element of flexibility for the states to experiment with new kinds of banking powers while avoiding developments that undermine the overall policy intent of the Congress with respect to bank and bank holding company powers. What remains is to decide among these approaches. Meanwhile, we at the Board, in view of existing law and expressions of Congressional intent, have indicated that we could not approve the acquisition of state-chartered banks by bank holding companies with the apparent intent of undertaking, under relevant state law, widespread insurance activities, beyond the state in which the bank is chartered. This is one illustration of the urgent need for Congressional direction in setting appropriate guidelines.

The streamlining of the procedures for dealing with bank holding company applications, and eliminating the burden on applicants to demonstrate net public benefits, is broadly supported by affected institutions and also appears ready for action. In

recent amendments to our regulation governing bank holding company activities, the Board has gone as far as it felt it could, consistent with present law, to speed up procedures and lessen regulatory burdens. The approach encompassed in the bills before you would permit further progress in these directions by eliminating the "benefits and burdens" test of present law, limiting bank holding company examinations and reports, providing for expedited notice procedures for approval of new activities, and setting out new and simplified criteria for determining the permissibility of new activities generally.

The third area with which any bill must deal is defining the degree of expanded bank holding company powers. Again, I believe a nascent consensus has developed for a broader test than incorporated in present law. S. 2134 and S. 2181 approach the matter in a somewhat different way; both would have the practical result of permitting and directing the Federal Reserve to permit holding companies to engage in a somewhat broader range of services and the differences between the bills should be reconcilable. Both bills follow the Administration proposal on expansion of securities powers of bank holding companies, including revenue bond underwriting, and mutual investment fund powers. All of this has long been supported by the Federal Reserve Board. In addition, both S. 2181 and S. 2134 would further provide for underwriting of mortgage-backed securities. Finally, the latter bill would promote competitive equity in this area by applying the Glass-Steagall Act to nonmembers as well as Federal Reserve member banks.

Proposals to extend powers of bank holding companies to insurance underwriting and brokerage and to real estate brokerage,

appear, to varying degrees, more controversial. S. 2181 provides one possible approach toward dealing with the concerns about banks acquiring "healthy" thrifts by limiting such acquisitions across state lines. Various limitations have been suggested for the exercise of real estate development powers. While I will touch upon most of these areas more specifically, we hope and anticipate that further agreement could be reached in the weeks ahead on the basis for proceeding.

I look forward to further opportunities to work with the Committee as it reconciles various points of view. But I also want to emphasize as strongly as I can that the basic "core" elements for constructive legislation do seem to be falling into place, and the opportunity for action is here.

Major Issues That Need Resolution

Title I of S. 2181 draws on the base of the Administration FIDA proposals, but with certain significant changes and additions, including some consistent with my earlier testimony. S. 2134 is also built on the Administration proposals, but is more limited. The remaining Titles of S.2181 deal with a variety of other banking issues. These include: authorization for regional interstate banking compacts; interest on demand deposits and on reserves; pre-emption of state interest rate ceilings on business, agricultural, and consumer credit; and federal rules on deposit availability. Finally, the bill also adds provisions on consumer leasing, credit card fraud, expanded powers for credit unions, and an authorization for bankers' banks to invest in export trading companies.

So far as holding company powers are concerned, S. 2181 would make five important changes from the Administration bill: limitations on tying of banking and insurance products; the scope of real estate development; provisions to avoid excessive concentration of resources; the definition of the term bank; and the proposed thrift definition.

I believe there is agreement that tying of the provision of bank credit or other banking services to the sale of products or services by other affiliates of a holding company could impair impartiality in credit decisions and competitive equity. The existing Bank Holding Company Act, Federal Reserve regulations, and anti-trust laws already contain safeguards and prohibitions against conflicts of interest in this area. S. 2181 would add a number of additional limitations and procedural requirements specifically directed toward the linkage of insurance and banking products, to reinforce the prohibition on tying. Similar questions could arise in the real estate brokerage area.

We recognize the concerns that motivate the new provisions. At the same time, cumbersome detailed requirements could impose burdens not encountered by other businesses, including retail, securities and insurance firms, that might provide insurance services in combination with other services and products, including credit, such as personal loans. We note, for instance, that the proposed provision would not be applied to thrift holding companies.

These potential competitive differences would be ameliorated by extending any tougher anti-tying provisions to thrift holding companies and by curtailing the ability of other businesses to acquire non-banks or consumer banks to which these provisions would not apply. Within that framework, I believe fair and reasonable procedural safeguards could be maintained.

The provisions of S. 2181 limit the scope of real estate development activities, while S. 2134 would not authorize such activities. We believe there is a reasonable middle course.

The term "real estate development" is itself an ambiguous and poorly defined activity, ranging in some concepts to including housing and commercial construction; speculative purchase of land; and owning, managing, and maintaining office buildings and other commercial properties. Taken as a whole, real estate development is an activity that experience has taught has large speculative elements; it is marked by cyclical instability, and the risks and large commitments potentially involved could bias lending decisions. As I understand it, however, the main concern of many banks interested in "real estate development" is taking more passive equity positions in projects managed by others, usually in connection with lending commitments, or to help facilitate the sale and exchange of property.

The Administration proposals provided some basic and desirable limitations on risk by confining investment in real estate development subsidiaries to five percent of holding company

capital, and S. 2181 would rule out construction activity as well. We support those provisions, but also believe it might be desirable to adopt certain other limitations on the scope of real estate development activities. After further consultations with interested groups, we will be prepared to suggest more precise legislative language. In any event, we believe the Board should have clear authority to maintain minimum capital and maximum leveraging provisions for real estate subsidiaries in the interest of the stability of the institutions and the banking system.

Another provision of S. 2181 is responsive to the concerns expressed by some, including the Federal Reserve Board, about the possible potential for an excessive concentration of resources from a combination of banks and insurance or other non-banking companies within a holding company. Specifically, the bill provides that a holding company accounting for more than 0.3 percent of domestic deposits could not invest more than 25% of its capital in any one class of permissible nonbanking activities. I appreciate the ingenuity of the proposed approach. But I am both concerned about the arbitrary elements inherent in a double-barreled statistical test, and whether it would in fact effectively accomplish the stated purpose.

Preliminary analysis suggests, for instance, the largest bank holding companies could acquire controlling interests in the largest insurance companies. We are studying this matter further to see if in fact a simpler and more direct test may

adequately achieve your purpose. The complication does not, of course, arise in the context of S. 2134, which would provide for no expansion of insurance powers.

One of the ways in which S. 2181 differs from the Administration proposal is in carving out a major exception to the general definition of a bank. The proposal raises technical and drafting problems, but I would like to focus today on the policy issues. S. 2181 would, in effect, legitimize the idea of a so-called "consumer bank" operating outside the framework of the Bank Holding Company Act. In effect, a class of banks concentrating primarily on consumer business would be established free from the general banking rules against conflicts of interest, concentration of resources, and assumption of undue risk. Moreover, while the proposal formally attempts to limit interstate acquisition of consumer banks, the provisions for exempting industrial banks from the Bank Holding Company Act would open an avenue for substantial undermining of the restrictions on interstate banking.

Thus, under the proposal, a bank holding company would be able to add interstate deposit-taking and other consumer services to the range of interstate business lending and other activities already permitted under the rubric of Edge Act affiliates, loan production offices, and finance companies. While we favor review and liberalization of restrictions on interstate banking, we believe that question should be approached directly on its own merits, and outside the context of the definition

of the term "bank" that has such important implications for the policy objectives of the Bank Holding Company Act.

For nonbanking companies -- insurance companies, investment houses, retailers, and industrial firms -- the practical effect would be to provide direct access to the payments system and to facilities for offering insured deposits to the general public in conjunction with a range of credit services. Moreover, those nonbanking companies would appear to be able to engage in the equivalent of interstate banking, at least through industrial banks, and probably through the ability of their nationwide office networks to act on behalf of consumer banks owned by these companies.

The overall result would be to provide commercial and investment firms major benefits of being a bank, while not subjecting them to rules applicable to banking institutions -- that is, limitations on the range of activities and ownership, and protections against conflicts of interest, concentration of resources, and excessive risk.

It has been suggested that these nonbank banks do not raise these public policy issues because they could not engage in the range of commercial lending that characterizes the activities of a typical commercial bank. I question whether this is a valid conclusion. Virtually the same issue was faced by the Congress in 1970 when it considered an exemption from bank holding company restrictions for small banks. It concluded then that ties between

firms engaged in commercial and industrial activities and banks, even if those banks were to be engaged predominantly in consumer lending, raised serious problems because of potential conflicts, and could encourage increasing cartelization of our economy through the exercise of preferential lending.

Even more immediately, the proposed arrangement appears competitively unfair to established banks, undercutting the public policy objectives sought by the Bank Holding Company Act, by giving essential benefits of being a bank to those that are not subject to these rules. Any system based on this inequality of treatment will inevitably come under strain.

I would strongly suggest adoption of the definition of bank contained in S. 1609 and S. 2134. The definition contained in these bills seems to have a wide measure of support as evidenced by its inclusion not only in these two bills, but also in legislation proposed by Chairman St Germain, the FDIC, and by the Federal Reserve as well.

Earlier in my testimony, I mentioned the importance of an adequate definition of what is a thrift institution eligible for the special benefits provided by law for these institutions. S. 2181 suggests a dual test for thrift eligibility for treatment as a unitary savings and loan holding company -- 60% of assets in residential mortgages and mortgage-backed securities or no more than 25% of assets in certain qualifying commercial loans. The second alternative and independent test leaves open the possibility that institutions not engaged very substantially in

home mortgage lending would retain liberal treatment with respect to activities and banking. For example, 75 percent of commercial banks could be treated as thrifts because they have less than 25 percent of their assets in qualifying commercial loans (only six commercial banks would qualify under the first test alone). If, however, the bill were modified to provide a true dual test -- i.e., both a minimum residential mortgage and a maximum business credit test -- I believe the real intent of this provision would be met. The point is that only firms truly committed to residential mortgages should be provided the existing benefits of unitary holding company treatment, and a single test of residential mortgage lending, as provided in S. 2134, should be adequate, providing the percentage is sufficient, taking account of current federal limitations on commercial lending powers of thrifts.

Plainly, a problem would be posed by this approach for many savings banks which traditionally have had many securities in their portfolios but which wish to maintain a basic thrift orientation. Moreover, institutions with mutual ownership which fail the test would have difficulty in taking advantage of the full range of holding company powers that would be available to stock institutions.

A large part of the answer could be found in transitional arrangements extending over years; those arrangements could set out benchmarks for measuring progress toward the objective. In

addition, the possibility of non-specialized mutual institutions exercising holding company-type powers through subsidiaries could be explored.

I also note that S. 2134 would limit tandem operations of a qualifying S&L with its non-banking owner; that is the joint offering of products and discounting to common customers would be discouraged. Those provisions seem to me important to maintain the separation of banking and commerce. The general prohibitions on bank holding companies underwriting corporate securities should be applicable to thrifts as well. The further question also arises as to the extent to which thrifts not eligible for unitary treatment should be afforded access to FHLBB credit.

Remaining Points

I will not at this time burden you with detailed comments on the remaining nine Titles of S. 2181. So far as two of those are concerned, I indicated our broad support for payment of interest on reserves and interest on demand deposits in my testimony last September.

Title X would authorize regional interstate banking compacts for a 5-year period. I previously expressed my concern about the Balkanization of the banking system implicit in regional compacts along what must inevitably be arbitrary lines. At the same time, some evolutionary easing of present state restrictions appears appropriate. While I believe there are more efficacious

approaches than regional arrangements, we would not oppose Congressional authorization of regional compacts if viewed as a temporary and transitional matter. That, as I understand it, would be the purpose of the provisions of S. 2181.

We will be happy to submit detailed comments on the provisions about bankers' banks, consumer leasing, delayed availability, usury ceilings and credit card fraud at an early date.

Conclusion

I am convinced that the efforts to improve the legislative framework governing the financial system, taking account of the vast changes in the regulatory and technological environment for the conduct of banking, are now ready to bear fruit. The discussion and debate on new powers, new definitions and on competitive equity have been reflected in a "core" area of near consensus, and the remaining issues are ripe for decision. Workable proposals and the necessary information are at hand.

We still have an opportunity to shape the direction of the financial system in a manner that recognizes and accommodates market forces but also recognizes enduring concerns of public policy.

But we don't have unlimited time. Far from it. The present arrangements are in disarray, and events, willy-nilly, are forcing change that may, or may not, be consistent with considered judgments about the public interest.

We want competition, and the benefits to the consumer inherent in competition. We also want a safe and sound banking system, stable in itself, and contributing to a larger economic stability.

If we act -- and act promptly -- we can further both those aims. We want to cooperate with you actively in working toward that end.

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