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Statement by

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before the

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of the

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I appreciate the opportunity to appear before this Subcommittee to review with you a wide range of issues affecting developments in markets for banking and other financial services.

I have repeatedly expressed my conviction that Congress should move with a sense of urgency to reform the existing legislative framework governing banking organizations. We need assurance that the powerful forces of change in the marketplace for financial services are channeled in a manner consistent with the broad public interests at stake -- the need to maintain a safe and sound financial system, to assure equitable and competitive access to financial services and credit by businesses and consumers, and to preserve an effective mechanism for transmitting the influence of monetary, credit and other policies to the economy. The simple fact is that assurance is lacking today. Quite to the contrary, we have a system that is changing, helter skelter, in response to a variety of economic and other forces, but with little sense of the public policy issues at stake.

The process has emerged over a number of years, but it is accelerating. Much of the change is, in fact, a constructive response to technological and market pressures and the opportunities made possible by deregulation. New combinations of firms in the financial area, new services, and new packaging of older services can be vehicles for responding more effectively to consumer needs and new communications technology.

What is so disturbing is not that change is taking place. Rather it is that much of the activity we see is forced into "unnatural" organizational forms by provisions of existing law and regulation, and that some of the fundamental concerns that motivated those laws and regulations are being lost or overlooked without considered judgment about the continued validity of those concerns. The old laws and rules may or may not serve today's purposes; in some instances, they may themselves be a source of distortions, competitive imbalance and weakness. But deregulation by fiat, by exploitation of loopholes, and by diverse actions taken by individual states is hardly an appropriate response, and threatens to undermine and render ineffective federal oversight of banking. For all these reasons, I appreciate the opportunity to review with you some general considerations that we at the Federal Reserve feel are relevant in assessing what legislative steps are necessary and desirable.

The Current Situation

The accelerated pace of change in the structure of our financial system grows out of several developments. New technology has lead to computerization of banking services, and made it easier for institutions to provide those services, or to combine several services. Business and consumer experience with inflation and related high interest rates of the late 1970's and early 1980's has increased the premium on moving money flexibly. Deregulation of interest rates ceilings on

depository institutions' liabilities has spurred efforts by those institutions to attain new asset powers and new sources of income. Nonbanks have sought ways to enter the banking business to gain access to insured deposits and the payments mechanism.

There have been numerous reactions to the forces driving change I have just mentioned. We see new combinations of financial institutions and new services -- the rapid growth of the money market mutual fund and, more recently, an explosion in brokerage of insured deposits, are leading cases in point. There is the phenomena of so-called "non-bank banks," providing a vehicle by which financial and nonfinancial firms can enter the banking business outside the framework of law and regulation surrounding bank holding companies, and actually or potentially violating the policy proscriptions of combinations of banking and commerce. There is a blurring of distinctions among depository institutions themselves, with some thrifts increasingly assuming the characteristics of commercial banks. At the same time, states are enacting banking and thrift legislation much more permissive than federal law; a narrow purpose is often evident -- to attract institutions and new employment opportunities -- rather than broader judgments about sound national policy.

New and sometimes conflicting federal regulatory initiatives seek to facilitate changes or to maintain Congressional intent, but those approaches are circumscribed

and often rendered ineffective by the outmoded character of the basic legislation. As a result, legal challenges through the courts to stop or speed the process, depending upon the particular private interest concerned, are proliferating, and the court rulings themselves are not guided and informed by any fresh indications of Congressional intent.

All of this has naturally been reflected in an unusual sense of uncertainty and uneasiness among the affected institutions themselves. After decades of stability in the relative position of commercial banks in our financial system, owners and managers of those institutions feel their position threatened by a situation in which they remain heavily regulated but in which other financial or nonfinancial firms can perform basic banking functions. That is one reason why banks are driven to exploit "loopholes" in legislation designed to limit their activities or to turn to state legislatures.

Concerns of the thrifts as to how they could survive in the highly competitive environment have also been acute. In part because of the large portfolios of fixed rate mortgages acquired at lower interest rates, they have been under particularly strong earnings pressure and their capital positions have eroded. With their future prospects seeming in jeopardy, the whole orientation of the industry is in a state of flux. Some individual institutions respond to immediate concerns and earnings pressures by taking greater risks, and others are turning away from their traditional role oriented toward

housing finance -- a role that through the years has been the justification for special benefits provided by federal law.

Deposit-like instruments and payments services are springing up in significant volume partially or wholly outside the framework of governmentally protected and supervised depository institutions. Depository institutions themselves have today -- in this highly competitive environment -- a potentially more volatile structure of liabilities and smaller capital cushions than in the past, and there are strong incentives to take advantage of the most liberal (or least binding) legal and regulatory philosophies and frameworks -- between thrifts and banks, between federal and state laws, and potentially even among federal regulatory authorities. Such anomalies in the structure of our regulatory system -- and challenges to long-standing regulatory and legal interpretations -- are quickly eroding traditional constraints intended to separate deposit taking from other activities.

As regulators and legislators concerned with the public interest, our task is not to block responses to real needs in the marketplace. But I do believe we have a responsibility to see that change is channeled along constructive lines and sensitive to abiding and valid concerns of the public interest.

Left unattended, there is no assurance that the process of change now underway will adequately address these concerns. In fact, it is clear that some of these concerns are being violated as market pressures and competitive instincts play

against an outmoded legal and regulatory structure. The longer we postpone difficult decisions about the direction in which change should be encouraged or discouraged by public policy the more difficult those decisions will ultimately become, and the greater the risk that continuing policy concerns -- including the safety and soundness of the banking system -- will be undermined.

General Considerations

The continuing goals of public policy in this area are easy to summarize:

-- We want to encourage competition in the provision of banking and financial services;

-- We want to promote efficiency and minimal cost;

-- We want to protect against discrimination, conflicts of interest, and other potential abuses;

- We want equitable and consistent treatment of competing financial institutions; and

- We want a strong and stable banking system, implying continuing attention to safety and soundness of banks.

These "core" goals in some circumstances may be in conflict or point to different approaches. In normal circumstances -- and in most industries -- it may be enough to look to the marketplace to promote competition and efficiency. But when safety and soundness, broad confidence in banking

institutions, and continuity in the provision of money and payments services are at stake, competition alone cannot be relied upon to achieve the goals. In recognition of that fact, the creation of the Federal Reserve and federal deposit insurance systems -- both the FDIC and the FSLIC -- have long been accepted as important elements in a "safety net" supporting depository institutions. And the existence of that "safety net," and the special privileges it implies, is naturally matched by burdens and responsibilities not shared by other institutions in our society.

The need to protect the integrity of the payments system deserves special attention. In seeking an overall balance between protections and restrictions for banking institutions, we can and should avoid placing depository institutions at a competitive disadvantage relative to others. To do otherwise would be to erode the vitality and strength of the very sector of the financial system deemed of special importance to the economy. To the extent that other institutions -- financial or nonfinancial -- operating outside the protected, regulated framework nonetheless tend to perform the essential function of banks, there are several alternatives. We can encompass those institutions within a basic framework of supervision and regulation designed to assure safety and soundness and competitive equality (such as regulation as bank holding companies or application of reserve requirements on all types of transactions balances). We can, if consistent with other

objectives, relieve the regulatory burden on banks (such as streamlining bank holding company applications procedures and paying interest on reserves). Or, we can confine the performance of essential banking functions (such as third party payments and direct access to the clearing mechanism or the coverage, implicit or explicit, of deposit insurance) to banks alone. In practice, some or all those approaches can be adopted.

Banks and Their Regulation

The regulation of banks, and the related "safety net," has long reflected their critical role as operators of the payments system, as custodians of the bulk of the liquid savings of the country, as essential suppliers of credit, and as the link between monetary policy and the economy. In that connection, I must emphasize that individual components of the banking and payments systems are, to a large extent, dependent on the health of other elements. Adverse developments here or abroad affecting one institution, particularly of substantial size, can dramatically and suddenly affect other institutions, some of whom may not even have a business relationship with the institution in difficulty. While secondary and tertiary effects are, of course, present in some degree in the failure of any business firm, seldom will the effects be so potentially contagious or so disruptive as when the stability of the banking system or the payments mechanism is

at stake. At such times, serious implications for overall output, employment, and prices -- indeed, for the entire fabric of the economy -- are apparent.

The first and most important line of defense is the interest of banking institutions themselves in maintaining the confidence of their customers. But long ago, in establishing the Federal Reserve System, the FDIC, and the FSLIC, the government determined that normal market incentives and protections needed to be supplemented by an official support apparatus. Ironically, the confidence and related competitive advantages engendered in the public by that support apparatus can, over time, induce greater risk-taking by the depository institutions that benefit from it. That is one reason why I believe a comprehensive system of examination, supervision and regulation, limitations on permissible activities, and insurance premiums, will remain necessary.

The practical and ongoing issues in this area, it seems to me, do not involve a wholesale revolution in past approaches, but a reexamination of the appropriate balance -- the balance between desirable risk-taking and safety, and the balance among competing depository and non-depository institutions -- in today's market circumstances.

One important area that is beginning to receive attention is the appropriate structure of deposit insurance. The insurance agencies are rightly concerned about the proliferation of insured brokered deposits, which have been

particularly important in the case of a number of failing institutions and those characterized by aggressive risk-taking, and the unintended effect such activity may have on both the insurance funds and structure of depository institutions. I share the concerns of the FDIC and FSLIC. The Federal Reserve Board has taken the position that legislation to permit regulatory agencies to set a cap on such deposits -- at a low level tied to some ratio of deposits or capital -- would be an appropriate approach. Absent such legislation, I support the action taken recently by the insurance agencies to limit severely insurance protection of brokered deposits. Developments in this area are one example of how the marketplace can respond to one element of government intervention -- in this case deposit insurance -- in a manner that can, despite some immediate benefits, have unintended and undesirable effects on the banking system or the regulatory system generally. More generally, recognizing that deposit insurance has become such an important element in the support apparatus for depository institutions, substantial change requires careful assessment of the possible consequences.

Bank Holding Company Regulation

Concern with the activities of organizations encompassing banks cannot stop with the bank itself. The restrictions long applied to bank holding companies are importantly rooted in prudential considerations; experience strongly suggests the difficulty of insulating a bank from the problems of a company affiliated with a bank through a holding company. To

be sure, the fortunes of the bank and its affiliates can be (and are) separated to a degree by restrictions on the transactions among them. But I doubt the insulation can ever be made so complete -- at least without defeating the business purpose in the affiliation -- as to rely on those rules alone. The holding companies themselves, the securities markets, and the general public tend to look upon affiliates as part of a larger whole.

Other concerns -- potential conflicts of interest and concentration of resources, particularly through extensions of credit by the bank to customers of the nonbanking subsidiaries -- can also be addressed by law or regulation. But again, insulation is not likely to be complete at all times.

At the same time, segregating nonbanking activities of a bank holding company outside the bank itself can provide important advantages. To some degree, the bank may be shielded from the activities of other elements of the holding company. Segregation from the banks should, in any event, make it easier to assure regulatory consistency and competitive equity between nonbanking affiliates of a bank holding company and other businesses providing comparable services.

Regulations specific to nonbanking activities may not always reflect certain important prudential concerns of bank supervision; to that degree, nonbanking activities conducted by banking organizations may appropriately be subject to rules or surveillance by banking regulators. Conversely, when bank holding companies engage in nonbanking activities, we should seek to avoid competitive advantages arising simply

from the association with a banking institution able, implicitly or explicitly, to draw upon government support. One consideration in this regard is the capitalization of the nonbanking activity. The higher degree of leverage common in banking should not automatically extend to nonbanking activities; capitalization of the nonbank subsidiaries should broadly reflect that required of non-governmental protected competitors by market forces and other regulatory agencies, federal and state. Indeed, adequate capitalization of a bank holding company as a whole, taking account of the particular nature of the nonbanking activities, is important to the safety and soundness of the bank.

In the end, the appropriate range of activities for a bank holding company should remain, in my judgment, a matter for determination by a balance of public policy considerations; it should not be solely a matter of market incentives, and some degree of supervisory oversight over the activities of the holding company as a whole will remain important. The traditional presumption has been that there should be some separation of banks from businesses engaged in a general range of commercial and industrial activities, and vice versa. That presumption still seems to me a reasonable starting point in approaching particular questions. At the margin, that separation will be arbitrary, but in a broad way it reflects legitimate and lasting concerns about risk, about potential conflicts of interest between a bank as owner of a

nonfinancial firm and as an impartial provider of credit to the community, and about the dangers of excessive concentration of economic power. Moreover, to the degree that affiliation with a bank implies the need for some regulatory or supervisory oversight, practical and desirable limitations on the reach of such regulation into industrial and commercial activities implies some limitation on the scope of bank holding company affiliations.

Within this general framework, the precise line dividing what ought to be permissible for banking organizations to do and what should be proscribed does need reexamination in the light of current market conditions, changes in technology, consumer needs, and the regulatory and economic environment. Some activities now denied banks would seem natural extensions of what these institutions currently do, involving little additional risk or new conflicts of interest, and potentially yielding significant benefits to consumers in the form of increased convenience and lower costs. For some time, for instance, the Federal Reserve has suggested that banking organizations be allowed to underwrite municipal revenue bonds and establish and distribute mutual funds. Certain brokerage activities have already been approved within existing law, as have a wide range of data processing services.

Other activities seem ripe for and are being given consideration by other Congressional committees. One general category would be further extension of "brokerage" or "agency"

activities, including sales of a variety of real estate, insurance, and travel products. Insurance underwriting, currently limited largely to credit-related insurance, is being considered within a framework that limits concentration of resources and risk to the banking organization taken as a whole.

Some activities that have been discussed raise considerably greater questions in my mind primarily because of risk, but also because possibilities of conflicts of interest or concentration of economic resources might not be contained without the most elaborate and self-defeating kinds of regulation. Corporate securities underwriting, some forms of real estate development, and, more generally, significant equity positions in unrelated nonfinancial activities fall into that category.

In any event, to the extent that regulation is needed, the goal should be to minimize the costs and burdens of regulation, consistent with the public interest. For example, experience has convinced us that some of the present procedural requirements for bank holding company applications under the Bank Holding Company Act can lead to unnecessary delay. The Federal Reserve Board has gone as far as it feels it can, consistent with present law, to speed up procedures and lessen regulatory burden. Specifically, present statutory requirements for approval of nonbanking activities could be modified to permit simpler "notice" procedures, with a presumption of

approval unless there is a judgment that "safety and soundness" and similar considerations are adverse. Such recommendations have been made in legislation supported by the Administration and in bills already introduced in the Senate, and they appear to have broad support.

Consistency in Bank-Thrift Regulations

The observation that thrift institutions have essentially become bank-like institutions is indisputable with respect to the powers they are allowed to exercise and increasingly accurate with respect to the powers they do exercise. Moreover, in important instances powers available to thrift institutions extend well beyond those available to banks and call into question the separation of banking and commerce now applicable to banks. Considerations of competitive equity alone would seem to dictate that the special privileges and restrictions of banks and thrifts be brought into a more coherent relationship.

Anomalies go beyond considerations of competitive equity. The kind of considerations I just reviewed with respect to the powers of banking organizations cannot be valid for commercial banks alone; limitations on bank holding companies could not be effective to the extent thrift institutions could simply substitute as a vehicle for combining various activities. I recognize there are difficult questions posed by the firms that already have operations on both sides of the line between commerce and "thrift banking", but some way needs to be found to

resolve these questions and establish a firmer policy for the future if we are to bring a rational structure in this regard.

The implication is not that all thrifts and their holding companies must be regulated in all ways like commercial banking organizations. There are ways of adequately defining a thrift institution which would allow us to achieve necessary functional consistency and assure the integrity of our policy intent, while still permitting the special benefits provided by law for institutions truly concentrating on residential mortgage lending. Various asset tests have been suggested for eligibility for treatment as a "unitary" savings and loan holding company -- a minimum percentage of assets in residential mortgages and mortgate-backed securities or such a test in combination with a supplemental test of a maximum of assets in commercial loans.

The interest of investment companies, securities firms, and commercial companies in acquiring savings and loans suggests that an asset limitation too broad in nature would not deter substantial non-depository participation in deposit taking and payments services. Specific limitations on such acquisitions -- similar to those limiting their acquisitions of banks -- appear necessary if the basic prohibitions of the Glass-Steagall Act against combining commercial banking and the underwriting of corporate securities are to remain valid.

Federal-State Relations

For over a century this country has maintained a dual system for the regulation and supervision of banking. On the whole, this dual banking system has played a useful and constructive role in encouraging innovation in the financial regulatory environment and in helping to accommodate local differences in the needs of banking organizations and their customers.

The system has worked as well as it has because the goals and techniques of regulation were commonly shared, and the divergences between federal and state systems were kept within tolerable bounds. As I mentioned earlier, this commonality of goals appears to be breaking down, as states consider expansions of powers for banks and thrifts -- to attract institutions and jobs -- that go far beyond standards allowed by federal law. Yet, they would still rely on the federal safety net for their state-chartered institutions.

Recent developments strongly point to the need to provide a new framework for the dual banking system. We need an arrangement for the exercise of the discretion of states in authorizing new powers for state-chartered banking institutions without that discretion being pushed to the point of undercutting vital national policies. Otherwise, to the extent Congress, in the national interest, finds it necessary to circumscribe the activities of depository institutions and their holding

companies, such limitations will be rendered null and void over time by unrestrained state action.

For example, we at the Board, in view of existing law and expressions of Congressional intent, and with the knowledge that the matter is currently under intensive Congressional review, have recently 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 an area in which we need Congressional direction in setting appropriate guidelines.

In the area of securities powers, the Glass-Steagall Act presumably was originally intended to apply to virtually all banks. However, even in this case the statutory framework needs to be examined because, as a result of changes in law in the late 1930's regarding the requirement of Federal Reserve membership for all insured banks, the question has arisen whether certain sections cover state chartered non-member banks. In fact, the FDIC has a proposed rule that would permit holding companies with state non-member banks to engage in securities activities prohibited for banks or bank holding companies generally.

Interstate Banking

The geographic scope of depository institutions has long been a key question of federal-state relations. The proliferation of nonbank affiliates of bank holding companies operating across state lines, loan production and "Edge Act" offices, integrated national markets for money and credit at the wholesale level, the current action of some states themselves to permit entry of out-of-state banking organizations, and the broadened power of thrift institutions able to operate interstate have by now led to interstate banking de facto for many banking services. But, as a general matter, we have still prohibited on an interstate basis the provision of an integrated range of services in a single office, and we force particular activities into "unnatural," and less efficient, channels. Even in the consumer area, restrictions are rapidly breaking down. Recently, we were compelled by existing law to approve the acquisition of a Florida "nonbank bank," designed to engage in a full range of deposit-taking and consumer lending, by an out-of-state bank. We simply, under the provisions of the Bank Holding Company Act, felt we had no alternative.

We sorely need a fresh Congressional review of our entire policy toward interstate banking. While most of the issues in this controversial area will need to be held over to a later Congress, the present movement toward regional interstate banking arrangements does need to be dealt with

now. Just last week the Board approved two bank holding company mergers under the reciprocal arrangements of Massachusetts and Connecticut, even though there are serious questions both about the constitutionality of such arrangements and their implications for public policy. If Congress wishes to support these regional arrangements, appropriately limited to a transitional period, legislation explicitly authorizing that approach should be enacted.

Conclusion

The legislative framework governing the banking system is sorely in need of change -- change that can take account of the vast changes in the environment for the conduct of banking and our future needs. After long discussion and debate, the time is ripe for action. I believe there is a wide area of "conceptual" consensus, and agreement on a critical "core" of legislation -- on the definition of a bank and a qualified thrift and on regulatory simplification -- is clearly within grasp. The remaining issues surrounding the particular powers of a bank holding company are inevitably more controversial, but nonetheless ready for decision. We should not confuse lack of agreement among affected industry interests with absence of necessary information and argumentation. Workable approaches responsive to the various concerns elicited by months of debate and study can be developed in this legislative session.

I know of the potential difficulties in completing legislation this year. But the simple fact is we don't have much time. A failure of Congress to act only means that the decision-making about the evolution of the banking and financial system will fall to others, without Congressional direction. The current framework and intent of banking law cannot hold in the face of technological change, intense market pressures, competition among states, and potentially conflicting decisions of courts attempting to apply old law to today's circumstances. Regulators are being pushed to and beyond the outer boundaries of the legal framework established by the Congress. None of this will stop in the absence of Congressional action. The system will change, but not in ways that fit into a coherent whole, responsive to national policy. The clear risk is that the overriding public interest in a strong, stable, and competitive financial system will be lost.

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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