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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

of the

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I welcome this opportunity to provide the views of the Federal Reserve Board on the legislative issues before the Committee. As you, Mr. Chairman, aptly observed in your letter of invitation to appear at this hearing, these issues, for the most part, have been thoroughly reviewed and debated over a number of years and now cry out for legislative action.

I cannot emphasize strongly enough that a strong, stable, and competitive banking and financial system is an indispensable ingredient of a healthy and growing economy. Plainly, inescapable forces of change -- technological, economic, and competitive -- at work on an international scale require appropriate and effective response if the broader public interests at stake are to be served.

But the simple fact is that today, in the absence of fresh Congressional direction, that objective is in jeopardy. Both thrift and bank regulators need additional tools to deal with pressing problems. More generally, important principles that have long guided our financial system, and that seem to me integral to its lasting health and stability, are being undermined. Particular institutions and segments of the financial industry are responding to the shifting competitive pressures and their perceived self interests by exploiting loopholes and inconsistencies in present law in ways that will ultimately threaten the integrity of the whole.

The point is not, of course, that forces of change can or should be stifled. Rather, those forces should be channeled in a constructive way. There are clearly areas where market competition should be freed and efficiency promoted. At the same time, there are clearly areas where institutional stability and independence need to be protected by maintaining an appropriate legislative and regulatory framework.

As a practical matter, the controversy and complexity surrounding this area mean that really comprehensive review of the legislative structure -- the range of powers of banking and financial holding companies, the role of deposit insurance, changes in the regulatory apparatus -- surrounding this area must take some time. No doubt, it's too much to accomplish in one fell swoop. However, there are areas in which action cannot wait, both because there are particularly pressing needs and because they will signal the broad framework within which more thoroughgoing reform will take place. It is in that context that I strongly welcome the plan quickly to formulate a limited bill on the basis of the present hearings (and those of recent years) and to seek Committee markup and Senate action early in this session.

The immediate issues fall in four general areas, and they all are ripe for action. The "emergency" need for measures to bolster the ability of the insuring agencies to deal with failed or failing banks and thrifts was made convincingly in the last Congress. The time has plainly arrived to clarify and expand certain securities powers of bank holding companies, a matter that simply cannot be dealt with reasonably and rationally without Congressional action. There is widespread interest in improving the process of check collection in a manner that will speed the availability of funds to depositors in financial institutions. And, it is evident that the long-standing national policy of maintaining a basic separation of commerce and banking and a basic unity between state and federal banking authorities is being eroded; that process needs to be halted before irretrievable damage is done.

Action in all those directions seems to me entirely consistent with the desirable longer-run evolution of the financial system, and therefore need not be delayed awaiting more comprehensive legislation. To the contrary, failure to act can now only complicate, and likely thwart, further constructive reform.

The Basic Separation of Banking and Commerce

This Committee has repeatedly considered the so-called "non-bank bank" (and "non-thrift thrift") question over several years without resolution. In one sense, the issue is technical, involving the increasing exploitation of what was considered at the time of enactment a narrow loophole in the Bank Holding Company Act. However, as commercial firms have increasingly moved to exploit that loophole in their individual interests, and as thrift institutions have assumed banking powers, the more basic issues at stake have become apparent.

Essentially, the non-bank bank has become a device for tearing down the separation of commerce and banking by permitting a commercial firm to enter the traditional banking business without abiding by the provisions of the Bank Holding Company Act. That is accomplished by establishing banks that refrain from making commercial loans, or by establishing banks that refrain from accepting demand deposits, or potentially by establishing both types of banking affiliates that, somewhat awkwardly, would together provide the full range of banking services.

At the same time, some established commercial banks have sought to use the "non-bank" device to expand interstate. However, the incentives to do so are being reduced by the rapid liberalization of interstate banking restrictions by the states themselves, and that particular use of the non-bank bank is not a matter of strong policy concern to us. However, the potential of existing banks to split themselves into two non-bank banks as a means of avoiding the provisions of the Bank Holding Company Act entirely, while still more theoretical than real, illustrates the basic nature of the issue before you.

Fundamentally at stake is not a few inhouse consumer banking offices of some retail chains or operational access of some companies to the payments system, services which can be efficiently provided in other ways. Rather, you are presented with the question of deciding upon the nature of the banking system you want to see evolve in this country.

I believe we need and can support a strong banking system with a variety of units large and small, able to compete efficiently, and capable, if they wish, of participating through affiliates in a wide range of financial services to consumers and businesses alike. At the same time, we want to protect against instability, excessive concentrations of power, and undue conflicts of interest, while preserving an institutional framework for the effective conduct of monetary policy. In seeking those goals, the separation of banking and commerce has been a basic part of the American tradition for what seems to me sound reasons.

Handling other people's money, which is what banking is all about, connotes a fiduciary responsibility -- to invest those funds prudently while making loans available competitively, productively, and impartially to all sectors of the economy. To that end, banking systems in virtually all countries are regulated, and in one way or another the depositors are offered a degree of protection by means of a public "safety net." All of that reflects a fundamental recognition -- from the writings of Adam Smith on down -- that banks play a particularly strategic role in the economy that requires some regulation and support. The interdependence between the fortunes of one institution and others, and the dependence of all on maintenance of a basic confidence in the stability of the whole, imply a special sensitivity to risk and the general interest that is no less important today.

The Bank Holding Company Act itself rests on the philosophy that banking cannot be treated as just another business, with its fortunes entirely subject to the vagaries of the marketplace. It permits banking organizations to engage in related financial businesses. A degree of "separation" is required between affiliates and a bank within a holding company, both for prudential and competitive reasons. However, there is also some surveillance of the whole, recognizing insulation cannot be complete.

No doubt, as I will urge later, the legitimate boundaries of activities permitted by banking organizations need to be reviewed and enlarged. But to extend the interrelationships to business and commerce generally would be a change not of degree but of kind. We certainly do not want to undertake new regulation of non-financial businesses or incorporate them within the public safety net. But without that regulation, how would we protect against new dangers of concentration, conflict of interest, and instability?

What is suggested by some is that strong walls can be built to insulate a regulated and supervised bank from its non-banking and commercial affiliates. As I just indicated, a certain "separateness" is already enforced within a bank holding company. But the insulation is far from complete, and attempting to make it so would present very great practical difficulties.

Common ownership of businesses implies common direction -- why else would they want to join together? In particular, the fortunes of one unit rest on the performance of others, especially in an area so sensitive to confidence as banking.

All our experience with the Bank Holding Company Act points to the strong incentives of management to support all parts of the organization when they come under pressure. That is understandable because it is demonstrable that weakness or failure of one part of a holding company can rapidly spread to others. The legal doctrine of corporate separateness of affliates can and has been challenged in the courts when common direction and management is present. And, suppose we succeeded in building full and credible insulation between a bank and its affiliates -- no direct or indirect transactions among them, no common officers, no tandem operations, no possibility of mutual support or greater capital leveraging as part of a banking organization -- then, I would ask, what is the economic incentive for such combinations at all? Certainly, present restrictions on linkages between banks and other parts of a holding company are often resisted by management.

We are asked to look to foreign experience with "universal" banking systems as justifying greater integration of banking and commerce. But frankly, I don't find much comfort there. We have never been admirers of the old Zaibatsu system in Japan, which led to enormous concentration of finance and commerce. German banks have long had a sizable ownership stake in some industrial companies. Even now, that arrangement is under strong attack within Germany itself as anti-competitive and stifling to the development of equity and capital markets.[1/] Italian authorities, reacting to experience, are moving to restrict non-bank ownership of banks more forcibly, arguing that "firms controlling banks . involved large segments of the banking system together with savers in their crises" (that is, in crises of the controlling commercial firm).[2/] Our Canadian neighbors, in proposing sweeping changes in the organization of their financial system including a broader range of financial services for banking organizations, have indicated a special sensitivity to forestalling any sizable combinations of banking and commerce.[3/] And, in fact, whatever the formalities of the law, there are few instances in

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1/ See generally, Academic Advisory Commission to the Ministry of Economics, Federal Republic of Germany, Policies on the Enhancement of Competition, December 5-6, 1986. Monopoly Commission of the Federal Republic of Germany, Main Report, 1980-81.

2/ Inquiry into the Development of the Banking and Financial System and the Relevant Legislation, Statement of Governor Carlo A. Ciampi, Bank of Italy, before the 6th Standing Committee (Finance and Treasury), Chamber of Deputies, Rome, Nov. 28, 1986. pp. 11-12.

3/ Communique, Department of Finance, Canada (86-210), Remarks by The Honorable Thomas Hockin in the House of Commons on tabling the policy paper, "New Directions for Financial Institutions" (December 18, 1986).

industrialized countries of commercial firms owning important banking institutions.

That is, of course, the situation in the United States today. The non-bank bank phenomenon is recent and, as yet, poorly developed. Excluding industrial banks, there are 79 FDIC-insured non-bank banks, not all of which are in operation. Of those, 17 are owned by banks or thrifts, raising only the question of interstate banking which in any case is in a state of flux. Most of the remainder are affiliates of financial firms; while these are inconsistent with the spirit of the Bank Holding Company Act as now written, they do not, except incidentally, violate the basic separation of banking and commerce. Only the remaining 13 with total assets of some $1.7 billion are affiliated directly or indirectly with firms primarily engaged in commerce. Half of those assets involve only one firm.

Many of those relationships were established with fair warning, after grandfather dates proposed in earlier legislative proposals, and are not yet integral to the successful operation of the parent. But that will change. The time has come, it seems to us, for Congress to set out the "rules of the game" clearly and specifically, before a reasonable case can be made that, de facto, the issue is moot.

For that reason, we would welcome early legislation to redefine a bank along the general lines of the bill that passed the Senate as early as 1984 -- essentially to include FDIC-insured banks and non-insured banks that take transactions accounts and make commercial loans. Existing institutions might be grandfathered so long as their operations are not expanded or operated in tandem with their affiliates. Taking a leaf from the Canadian proposals, control might be shifted to public ownership (with full banking powers) as expansion takes place. Whether non-banks owned by financial firms should be permitted to expand or become full service institutions should be governed by the range of powers open to bank holding companies.

Similar restrictions would be appropriate for "thrift" institutions that in fact operate like commercial banks. But exception could be made for savings and loan associations or savings banks that in fact continue to operate primarily as specialized mortgage lenders without their operations integrated with those of affiliates. That would continue, in practical effect, the existing position of a number of thrifts, some of which have long been owned by commercial firms as independently operated businesses through the vehicle of a unitary thrift holding company. Such an approach would incidentally provide a vehicle for commercial firms to purchase troubled thrifts so long as they chose to commit themselves largely to the residential mortgage market.

<u>The South Dakota Loophole</u>

For more than 100 years, the United States has had a "dual" system of banking law and regulation, dividing chartering and supervisory authority between the state and federal authorities. While that approach is bound to give rise to certain tensions, in general it has operated constructively by providing a certain room for difference and experimentation among the states, and between the states and the Federal Government. At the same time, it is evident that the safety and stability of the banking system as a whole is a national concern -- a concern reflected specifically in the existence of the Federal Reserve and the Federal Deposit Insurance systems. The dual system works well when that overriding interest is respected.

Recently, there have been developments that challenge that basic assumption. Some states, zealous to attract jobs and revenues from others, have moved to grant new powers to their banking or thrift institutions far beyond that allowed federally chartered institutions. South Dakota, in doing so, adopted the unusual approach of permitting certain of those powers to be exercised effectively only outside the borders of South Dakota itself.

That form of potentially destructive interstate competition -- the exercise elsewhere of powers deemed unsuitable for the state itself -- should be eliminated. Moreover, it should be clear that new powers, whether or not exercised within the chartering state, that clearly jeopardize the safety and soundness of banks and thrifts, or violate the basic separation of commerce and banking, with adverse consequences for the federal insurance funds and the financial system as a whole, can be curtailed or overridden by the appropriate federal authorities. We believe clarification of existing authority and a fresh Congressional expression of intent along those lines would be desirable and we would be glad to propose language with that effect.

Securities Powers

Resolution of the non-bank bank issue and clarification of the legitimate role of states in banking regulation does not dispose of the practical issue of resolving the proper scope of powers of banking holding companies in the general area of financial activity. We have long urged that the Congress recognize the competitive, technological, and international forces at work in the banking and financial marketplace and expand the authorized role for bank holding companies.

These issues are inevitably highly controversial for they affect the competitive environment of existing institutions. No doubt, a full redefinition must await more comprehensive legislation. But there are areas in which progress is clearly possible now, and where change is in any event underway. The only question is whether that change will be piecemeal and haphazard as it works its way through the intricacies of present outdated law, with odd and anomalous results, or whether that change will be channeled along more clearly constructive lines.

That is precisely the issue today with respect to the securities powers of banks and bank holding companies. The Glass-Steagall Act, written more than a half century ago, has been commonly interpreted as calling for the "divorce" of investment from commercial banking (with the exception of U.S. Government securities and the general obligations of state and local governments). But it is also true that the literal language of the law, with respect to bank affiliates, indicates vaguely that such affiliates may not be "engaged principally" in prohibited securities activities.

The Federal Reserve Board recently interpreted that language to permit, with strict limitations on volume, sale of commercial paper by a commercial lending affiliate of a bank holding company. We have under consideration applications to permit underwriting of mortgage-backed securities and municipal revenue bonds as well as commercial paper in affiliates largely engaged in trading government securities, which present additional legal and practical issues.

We have long felt, as a matter of good public policy, that all these activities are appropriate for bank holding companies without artificial limitations on the volume of operations. But the issue before us is whether that result can be achieved, legally and reasonably, under existing law.

One thing is evident. Existing law provides a strong incentive for certain large banking organizations to transfer assets and activities out of the bank itself into a non-bank affiliate so that affiliate's otherwise prohibited securities activity will be small relative to the whole. Moreover, only the largest bank holding companies will be able to muster a sufficiently large asset base to make the otherwise prohibited securities activity commercially economic and attractive.

That cannot be a sensible result from the standpoint of either public policy or private interests. The effect is both to artificially encourage the reduction of assets in the regulated and protected banking system and to impose unnecessary restraints on competition. Yet it is the situation in which we find ourselves. And, we cannot defer a decision on this matter much longer. We have scheduled public hearings for early February and a decision in April.

But only Congress can provide a really sensible approach consistent with safety and soundness of the banking system, effective competition, and the interests of borrowers and lenders alike. To that end, we strongly support the suggestion of the Chairman that straightforward authority be provided, as part of an early legislative package, for affiliates of bank holding companies to underwrite private securities backed by 1-4 family residential mortgages, municipal revenue bonds, commercial paper, and mutual funds. Because these are active, growing markets and potentially important sources of revenue, action in this area would go some distance toward meeting the legitimate concerns of banking organizations that they cannot keep abreast of growing sectors of the financial markets even when safety and soundness or conflict of interest considerations are not persuasive deterrents.

Opposition to these powers is almost entirely limited to investment houses now with the field to themselves. We have long been convinced that with appropriate prudential safeguards and protections against self-dealing, these powers can be exercised consistent with the safety and soundness of the banking system and the interest of the public at large in effective competition.

While urging action on these powers now, we would also encourage the Committee to consider other financial areas appropriate for bank holding companies. I recognize these areas -- including insurance and real estate brokerage, insurance underwriting, and corporate security underwriting -- are more controversial and will take more time to resolve. They, together with other important issues (including simplification of the procedures required by the Bank Holding Company Act) can await more comprehensive legislation later in this year or next year. But to that end, I hope the Committee will not act to foreclose further any of existing opportunities of bank holding companies to provide financial services.

I would particularly urge the Committee to undertake hearings or other studies in the area of corporate underwriting -- a process that we would be pleased to support. Clearly the issues in this area are more complicated because of the greater potential for conflicts of interest. However, they cannot be evaded much longer. A very substantial amount of such activity is already conducted by bank holding companies abroad and the increased securitization of financial assets by banks and others, requires fresh consideration of how banks participate in that process. Moreover, the issue could well arise as a matter of interpreting the present provisions of Glass-Steagall.

Emergency Provisions

The need for additional liquidity for the FSLIC is plainly urgent. I know that you have in the past, and will again, be receiving detailed testimony on the Treasury-FSLIC proposal for recapitalization of the insurance fund by leveraging the existing surplus of the Federal Home Loan Banks and providing for special assessments on insured institutions. I know of no practical alternative at this time to that approach, nor is the time available to delay action while considering other possibilities that would require more sweeping reorganization. Moreover, the proposed approach conceptually is correct in looking to the insured industry itself to provide the financial support needed now.

At the same time, we share the views of many in the industry that self help must be accompanied by effective supervisory and regulatory discipline to forestall aggravation of the underlying problem. Clearly, some thrift institutions have not used their existing authorities wisely or well. Perverse incentives have arisen, with deposit liabilities fully insured, to undertake high risk activities inappropriate for any depository institution.

I am aware of the strong efforts made by the Federal Home Loan Bank Board in recent years under the leadership of Chairman Gray to curtail abuses, to sharply upgrade the size and effectiveness of its supervisory effort, to work toward higher capital standards, and to regulate effectively. I believe those approaches deserve your strong support.

As part of more comprehensive legislation in the future, means of obtaining more consistency in accounting, supervisory, and capital standards among depository institutions deserve your thoughtful attention. To my mind, special consideration should be given to the role of thrift institutions that in fact want to remain largely concentrated in the traditional area of residential mortgage lending. Meanwhile, I hope you act promptly on the FSLIC recapitalization proposal.

Fortunately, constructive action by Texas, Oklahoma, and a few other states in recent months to permit the acquisition of failed or failing banks by out-of-state institutions, or to liberalize interstate banking generally, have eased the difficult job of finding buyers for actually or potentially insolvent banks. Welcome as those actions are, however, they do not address the problems that could arise in certain states. Consequently, we continue to urge that you adopt legislation along the lines proposed to you by all the bank supervisory agencies last year,[4/] thus providing greater assurance that we can collectively act, with dispatch and at minimum cost, to deal with acute problems that might emerge.

As things now stand, with the lapse of the authorities provided earlier by the Garn-St Germain Act, we are without any federal authority to arrange inter-state acquisitions in emergency situations.

Funds Availability

The final question raised by the Chairman in considering legislation for prompt Congressional action deals with check holding practices of financial institutions. We believe such legislation has two essential elements. First, there is a

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4/ The federal regulators proposed legislation to (a) reduce the threshold amount for interstate emergency acquisitions from $500 million to $250 million; (b) permit interstate acquisition of banks in danger of closing (with or without FDIC assistance) as well as closed banks; (c) allow for acquisition of a holding company and its affiliated banks if the holding company has a bank or banks in danger of closing with total assets of $250 million or more and which represent at least 33 percent of its banking assets; and (d) permit the out-of-state acquiring bank holding company to expand in the three largest cities or metropolitan areas in the state of the acquired banking institution.

strong and straightforward case that depository institutions clearly disclose to customers their policies with respect to the availability of deposited funds at the time an account is opened and when such policies are changed. Secondly, certain authorities to override individual state statutes are necessary if the process of collection and return of checks is to be speeded (or if truncation is to be introduced), thus reducing or eliminating the risk to depository institutions of making funds available more promptly and uniformly.

In recent years, considerable exploratory work and some pilot projects have been undertaken seeking to speed the return of dishonored checks to the institution of first deposit. Progress is, among other things, dependent upon an ability to enforce expedited procedures by banks not using the Federal Reserve for check clearance. Consequently, federal legislation is necessary.

Mandatory availability schedules imposed by law raise difficult problems. Given existing technology, very tight schedules would pose measurable risks to the depository institutions, with the potential result of curtailing the availability of checking accounts to marginally profitable (or unprofitable) customers. Liberal schedules might unduly ease pressures for more rapid availability. In any event, the nature and extent of the problem varies locally.

In these circumstances, the Board has felt primary emphasis should be placed on efforts to alleviate the problem through disclosure and improvements to the check collection process and by targeting progress toward speedier returns as in the bill before this Committee last year. However, we are aware that some states have enacted mandatory schedules that appear to be operating reasonably effectively. We believe that mandatory schedules would be workable provided the Federal Reserve is given authority to determine those schedules in the light of practical progress in speeding return item times.

We strongly believe that such schedules be established based on the times in which the great bulk of checks can, in fact, reasonably be expected to be collected and returned to the depository institution in which they were first deposited in the event of dishonor. After a relatively short transition period, we believe that schedules of from two to six business days or even less are feasible depending on where the check is drawn. The Board also believes mandatory schedules should contain exceptions to permit depository institutions to place holds on deposits or accounts presenting unusually high risks.

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