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AN OVERVIEW OF THE GRAMM-LEACH-BLILEY ACT AND BRIEF REMARKS ON THE ECONOMY

Remarks by

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It has been a while since I had the pleasure of speaking to this group, and I've been looking forward to this dinner. I have to tell you I think I have become the designated RMA speaker. I've already spoken to the Richmond and Raleigh chapters this year, and later this spring I'll speak to the chapter in Northern Virginia. And I'm honored by this, because RMA is a great organization that provides fine service and support to the banking and financial industries.

Typically when I speak to RMA groups I give a pretty standard talk on the economic outlook. I want to do things a little differently tonight. Late last year Congress passed – finally – and the President signed comprehensive banking legislation that obviously has important implications for the banking industry and indeed the whole financial sector going forward. So I'd like to start off with a few remarks about this legislation. But then I'll revert to my more usual form and conclude with some comments on the economy and monetary policy that I hope you will find useful in thinking about where we may be headed in the year 2000.

But let me start off with a few comments about the new banking law. Again, it has significant implications for the banking and financial industries, and also for regulators like the Fed. The law has been named for the chairmen of the congressional committees primarily responsible for it: Senator Gramm, Congressman Leach and our own Congressman Bliley. So it's called the Gramm-Leach-Bliley Act – GLBA for short – and, if you'll allow me, I'm going to add another vowel and call it "Gilba" so that I can pronounce it in two syllables.

Gilba has been called “historic” financial legislation, and that’s probably fair given its complexity and scope. Frankly, though, it doesn’t so much set a new direction for the financial industry as confirm – one might almost say pronounce a benediction on – trends that are already well established and in train.

Exactly what does Gilba do? At the risk of repeating some things you may already know, let me just summarize its most important elements. As I see it, the law does three things, mainly. First, it establishes – more accurately, confirms – what the structure of the financial industry will be for the foreseeable future. Second, it establishes how this new structure will be regulated and supervised. And third, it establishes new requirements with respect to community reinvestment – CRA – and the right of customers to protect the privacy of their personal financial information.

Regarding structure, Gilba removes the remaining restrictions on combining banking, securities and insurance activities in a single financial company. Specifically, it repeals provisions of the 1933 Glass-Steagall Act, which separated commercial and investment banking, and it repeals provisions of the Bank Holding Company Act of 1956 that have restricted affiliations of banking and insurance. When the key elements of Gilba take effect next month, banks and other financial companies will be allowed to establish so-called “financial holding companies” that can include commercial banking, securities underwriting, insurance underwriting, and merchant banking. Moreover, the Fed, in consultation with the Treasury, can add additional <u>financial</u> activities to this list going forward. Financial holding companies will be certified as such by the Fed once they meet certain threshold requirements with respect to capitalization and CRA ratings. In addition, banks themselves will be able to conduct a full securities business –

including underwriting securities – in operating subsidiaries without creating a financial holding company; however, insurance underwriting and – for the time being – merchant banking have to be conducted outside the bank in an affiliate. Therefore, to engage in these latter businesses, a company would have to be certified as a financial holding company.

Everything I've mentioned so far refers to consolidation in the financial sector of the economy. Broadly speaking, Gilba leaves the general prohibition against combining banking activities and general commercial activities in place, although existing unitary thrifts are grandfathered, like the one that allows our Ukrop's grocery chain in Richmond to operate a bank.

These are the main structural points. What about regulation and supervision? Essentially, the new regulatory setup amounts to an extension of the existing structure for banks, and I should point out here that the new financial holding companies will be bank holding companies. The applicable summary descriptive term is "functional regulation." Banks within a financial holding company will continue to be regulated by their current primary federal bank regulator and appropriate state bank regulators. Non-bank affiliates will be regulated by the appropriate, so-called "functional regulators" – the SEC for securities activities, state insurance commissioners for insurance activities, and so forth. Finally with respect to the regulatory structure, the Fed, which now oversees bank holding companies at the holding company level, will become the so-called "umbrella" regulator for the new financial holding companies. This will be an important challenge for us, and I'll come back to it a little later.

The final major elements of Gilba I mentioned earlier – the consumer privacy and CRA provisions – were among the most controversial in the legislative debate and maneuvering leading to passage of the Act. As you may know, the CRA provisions require that all banks in the financial holding company have satisfactory CRA ratings before the financial holding company can be certified and engage in the new financial activities allowed by Gilba. Moreover, it must maintain a satisfactory rating to enter additional activities later. Also – and this was a particularly controversial provision – community groups must disclose any agreements with banks that involve payments from a bank to a community group exceeding $10,000, or loans totaling more than $50,000. Regarding privacy, banks and other financial institutions must make it possible for their customers to prevent them from sharing personal financial information with third parties such as telemarketers – the so-called “opt out” privacy provision of the law. But the opt out provision does not apply to sharing information with in-company affiliates, and fairly liberal exemptions from the opt out requirements were granted to smaller banks so that they can continue to outsource their back-office work to service companies.

That’s my executive summary of Gilba, and, as you can see, even boiling it down to what I see as the essentials requires more than a few words. Let me close this part of my remarks with a few comments on the broader implications of the new law and the challenges it will present to the Fed and other regulators. In passing, I might say first that the Fed and other federal regulators are presently hard at work drafting rules and regulations to implement Gilba’s various provisions. Gilba is several hundred pages long single-spaced. So writing these regulations will be a big job, and we will be publishing them throughout the year. Some of these new regulations go into effect as early as March 13.

Regarding the broader implications of the law, first, will banks and other financial institutions take advantage of the new powers Gilba grants them? Certainly they will. Indeed, as you are well aware, the Fed and other regulators already allow banking companies to engage in a variety of securities and insurance activities consistent with existing law. Consequently, as I suggested earlier, essentially Gilba will authorize an extension of already well established trends toward consolidation in the banking and financial industries. This trend – and now its extension – is being driven by basic economic forces. There are substantial economies to be gained, for example, from combining credit evaluation for the banking and securities businesses in a single company. And the technological revolution has greatly reduced the real cost of the information processing and communication capabilities required to manage and control large, diversified financial organizations. Gilba will enable significantly more robust exploitation of these economies and reduced costs. So I think Gilba will stimulate significant further consolidation in the U.S. banking and financial industry. I don't know exactly who will be acquiring whom; we will just have to wait and see how that works out. Fundamentally, though, I think these combinations – precisely because they are being driven by basic potential economies of scale and scope – will increase efficiency in financial services markets, and hence are in the public interest, provided the risks inherent in large complex banking companies are adequately managed by the companies involved and monitored by relevant regulators.

This brings me to the question of regulating and supervising the new structure Gilba will create. I think it's worth noting at the outset that Gilba broadens the opportunities for diversification for large financial companies. Therefore, not all of the Act's fallout will necessarily increase risks. But the potential size and complexity of at least some of the new financial holding companies could well increase risks in some cases, including not only risk to the company and its shareholders, but broader risks to the financial system and the economy. Too-big-to-fail is already a major public policy issue – perhaps the major public policy issue in banking and finance – and Gilba is not likely to change this.

So we will need efficient and effective supervision and regulation, and, candidly, achieving it will be a challenge. Potentially a significant number of federal and state banking regulators, the SEC, state insurance commissioners and others will be jointly overseeing particular financial holding companies. They will need to communicate and cooperate to minimize the regulatory burden while at the same time supervising and regulating effectively. This may seem self-serving, but I think the Fed's role as umbrella supervisor is especially important here. Our umbrella authority under Gilba has been labeled Fedlite – as in Miller Lite, presumably. The idea is to limit the Fed's ability to impose additional regulatory burdens beyond those already imposed by the functional regulators. And, beyond burden, to the extent that we were to regulate non-bank affiliates actively, it might appear we were extending the federal safety net beyond the company's basic banking and depository operations. All this is reasonable and understandable, and obviously we will comply. But the reality is that large financial companies manage risk on a company-wide basis. Hence it will be essential that we cooperate effectively with the functional regulators to get whatever information we may need to oversee these risk-managing operations adequately.

Finally, to this point I've been talking primarily about the implications of Gilba for larger banks. What about the law's prospective impact on community banks? The number of answers you'll get to that question is limited only by the number of people you ask – and maybe not even by that. Let me give you my answer, and it's only that. First, I think Gilba, along with all the recent technological developments affecting banking, will intensify competition in the financial sector, including competitive pressure on community banks, and, of course, the competition already is pretty intense. But I'm confident that well-managed smaller banks with a solid grasp of local market conditions and a deep familiarity with the customers they serve, their businesses and their needs, can not only survive but prosper. Community banks have distinct advantages in serving both consumers and especially small businesses in local market areas. I elaborated on this point in a speech I gave to the Independent Bankers of South Carolina back in 1997. It's on our web site if you're interested. Having said this, however, community banks will have to compete effectively, and, in particular, they will have to master and utilize relevant technology, outsourcing where necessary.

So much for Gilba. Let me close with a few summary comments on the economy. This is an historic moment for the U.S. economy. The current expansion is about to complete its ninth year, and it is about to become the longest expansion in U.S. history, breaking the old record set in the 1960s. Actually, it's even better than that since, with the exception of a relatively brief and mild downturn in 1990 and early 1991, the economy has been expanding ever since the end of 1982, almost two straight decades of growth. Moreover, the economy's performance over the last four calendar years, 1996-1999, has surpassed all but the most optimistic predictions at the beginning of this period. Real GDP growth exceeded 4 percent in each of these years. Very few people thought the economy could sustain a growth performance like this without an increase in inflation. But it has, despite increasingly tight labor markets and – at 4 percent – the lowest unemployment rate in a generation.

Given these extraordinary developments, a lot of people are talking about a "new" economy. And while economists can debate about whether we <u>truly</u> have a new economy in terms of its basic structural relationships, it certainly seems different in terms of its performance, at least by the standards of recent years.

What's going on? Well, several things. Much of the public discussion and debate – quite appropriately – has focused on rising productivity growth due to recent advances in information technology and their absorption throughout the economy. A second crucial factor, though – perhaps not as widely understood and appreciated as the contribution from technology – is the steady progress we've made in reducing inflation. Several things have contributed to this progress. But because inflation, at its core, is a monetary phenomenon reflecting monetary forces, most fundamentally this progress against inflation reflects the emergence over the last 15 years or more of a stronger and more consistent Fed commitment to controlling inflation, and the steadily increasing credibility of this commitment. This increased credibility, in turn, has significantly reduced the overall level of risk in financial markets and the economy and, along with diminished inflation expectations, has reduced interest rates and helped stimulate investment focused on applying the new technology. Other developments have helped contain inflation, like the strength of the dollar in recent years and better containment of health care costs. But, in my view, a stronger Fed commitment to price stability has played the key role. I'll come back to this point at the end of my remarks.

What's the outlook for the future? Most economists think the economy will slow down this year. The current consensus forecast among professional forecasters calls for the economy to decelerate from about 4¼ percent real GDP growth in 1999 to 3¼ percent or so in 2000, due partly to the lagged effect of the Fed's monetary policy tightening in recent months, and partly – in the opinion of the forecasters – a weaker stock market and a corresponding diminution of the so-called "wealth effect" from rising stock prices. Many analysts believe this wealth effect has been fueling the recent robust consumer and business demand for goods and services. With demand softening, inflation is expected to remain low.

This is an optimistic forecast in my view but a reasonable one – as likely as any other scenario I can think of. But, of course, as a policymaker my job is to think about how things might go wrong and what we at the Fed can do to prevent this. Personally, I still believe that the principal risk in the outlook is that demand may not slow down but instead remain exceptionally strong and eventually cause the economy to overheat. Real private domestic demand grew 5½ percent last year. To maintain growth in production – supply – at this rate, productivity growth would have to rise to roughly 4½ percent, not just temporarily but on a sustained basis. That's not impossible, but it's not a "gimmie" either. So while I don't think an overheating is baked in the cake, I do think it's a risk, especially in the context of somewhat stronger growth abroad, which will make it more costly for the U.S. to offset excessive domestic spending with a rising trade deficit going forward. The Fed's recent monetary policy actions are aimed at reducing this risk.

All of my comments to this point have been focused on the near-term outlook for the remainder of this year and the first half or so of 2001. Obviously we want the current good times to continue longer than that, and there's no particular reason they can't. I'm not saying we'll never have another recession. But there is no particular reason to expect one next year or the year after. And if one should unexpectedly occur, there is no reason to expect it to be especially severe.

In any case, we at the Fed want to make the maximum contribution we can make with monetary policy to sustained growth in production income, jobs and prosperity. And the way we can do that – as I'm sure I've told this audience before – is to focus on containing inflation, since that's really the only thing the Fed can do directly and concretely to improve the economy's performance. We can't hold the unemployment rate down directly with monetary policy, but we can help keep it low by fostering a non-inflationary monetary and financial climate that reduces risk and in that way stimulates long-term investment and growth. When I talked to you several years ago, I harped on the need for the Fed to achieve price stability. Well, at this point I think we <u>have</u> achieved price stability, or something very close to it. Now we need to focus on sustaining it. To do that we'll need to sharpen our long-term strategy somewhat, in my view, and we may need to take preemptive anti-inflationary policy actions from time to time. Most importantly, though, I think we need to do a better job of explaining why and how vigilance in containing inflation promotes growth rather than retarding it, as, regrettably, a fair number of Americans seem to believe. But that's another speech for another evening.

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