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Vital Issues of Banking Legislation

Address by

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It is a great pleasure for me to be here today and to have the privilege of addressing this gathering.

I thought I might usefully speak to you about some of the legislation pending in the 95th Congress. This is a busy season for banking legislation. Bills under consideration deal with such diverse subjects as nationwide NOW accounts, the financial burden of Federal Reserve membership, the operation of foreign banks in this country, the restructuring of bank supervisory and regulatory authority, and revision of the Truth in Lending statute. There are, moreover, various proposals in the Congressional hopper that aim in one way or another at circumscribing the Federal Reserve's scope for independent judgment and decision.

I cannot, of course, cover this morning all the banking legislation that is now pending. But I welcome this opportunity to comment on some of the major bills that have been introduced, and also to indicate why we at the Board are so deeply concerned about the character of numerous proposals that keep being advanced under the banner of "reform."

Let me say something first about S. 2055 - the legislative package that combines authority for nationwide NOW accounts with measures to lighten the burden of Federal Reserve membership. As you know, this bill was voted out of the Senate Banking Committee in early August and may soon be debated on the Senate floor.

I am well aware that some of you have serious reservations about this bill. Indeed, I have heard from many bankers around the country who object to some of its key provisions -- particularly the contemplated extension of NOW-account authority -- and who urge the Federal Reserve to withdraw its support of the measure. The impact on earnings of paying interest on transactions balances is obviously of concern -- and properly so -- to commercial banks, especially those for which the checking accounts of individuals make up a large portion of total deposits.

Let me assure you that we at the Federal Reserve Board recognize the importance of good bank earnings. We well know that unless earnings are reasonably satisfactory, commercial banks will not be able to serve their communities or the national economy in an effective manner. We also believe that bank earnings will be adversely affected for a time during the transition to a NOW-account environment. That has certainly been the experience with NOW accounts in New England.

Why, then, it may fairly be asked, does the Federal Reserve support nationwide NOW-account authority?

The reason essentially is that we think it is important to bring a sense of order to a development that has the look of inevitability about it but which to date has proceeded in haphazard fashion. The simple fact is that by one means or another depositors have been increasingly successful in earning interest or its equivalent on their transactions balances. Such interest is implicit in the banking services that are provided bank customers without charge or below cost. Beyond this, and on a growing scale, many customers of financial institutions are already receiving interest in cash on transactions balances -- not only in the New England states where NOW's are authorized, but throughout the country. This is the consequence, as you well know, of recent financial innovations that enable individuals as well as corporations to move funds readily between interest-bearing accounts and checking deposits or between money market instruments and checking deposits. Congressional inaction will not stop the spread of interest payments on what are in effect transactions balances; it would simply mean that the movement will go forward without guidance at the national level, attended by inefficiency and competitive distortion. My colleagues and I thus see S. 2055 as a vehicle for guiding this development in a gradual and orderly fashion while limiting the adverse effects on bank earnings.

I well understand the displeasure that commercial bankers feel over the fact that S. 2055 would in effect confer checking-account authority on thrift institutions while leaving intact their ability to pay savings depositors a higher rate of interest than can commercial banks. To be sure, all depository institutions that decide to offer NOW accounts under the new authority would do so on the same terms, so that the troublesome interest-rate differential would be eliminated for that category of deposits. However, since NOW accounts would expand the powers of thrift institutions to a point where they could offer depositors the attractions of "one stop banking," the extension of parity should not be limited to newly created NOW accounts. Both logic and equity suggest that thrift institutions should enjoy either NOW-account authority or the interest-rate differential -- but hardly both.

The difficulty of overcoming opposition to any modification of the differential must not, however, be underestimated. This was evidenced by the failure of the Senate Banking Committee to accept an amendment by Senator Lugar, which would have restored the power that bank regulatory agencies had until late 1975 to adjust the differential without ratifying action by the Congress. I have indicated to Senator McIntyre, the distinguished sponsor of the NOW-account legislative package, the desirability of removing the ratification requirement because it constitutes an impediment to timely adjustment of deposit interest-rate ceilings as circumstances change. Even though Senator Lugar's amendment failed in Committee, this moderate step toward less rigidity with regard to the differential deserves sympathetic consideration by the Congress at large. Senator McIntyre's support of the amendment was particularly encouraging. I hope that interested parties will continue to press the issue.

In your continuing assessment of S. 2055, I would urge that you weigh carefully the point I have made about the disadvantages inherent in letting interest payments on what are essentially transactions balances continue to spread in haphazard, piecemeal fashion. Neither individual bankers, nor their nonbank competitors, nor State legislatures, nor bank regulators, nor the Congress itself are likely to stand still. On the contrary, actions that serve to expand the payment of interest on transactions balances by all types of depository institutions will continue to multiply. It is my strong conviction that ultimately both the general interests of the Nation and the particular interests of commercial banks will be poorly served if the changes we have been witnessing are not subjected to orderly direction.

The transitional problems faced by financial institutions in adapting to NOW accounts will not be easy, but they ought to be less troublesome in most parts of the country than they have been in New England. I say this in part because the New England experience is available as a guide. It surely should be possible to avoid repeating some of the mistakes -- particularly the mistakes in pricing -- that were made by various institutions in that region. Indeed, it seems clear from the statistical evidence that depository institutions in Connecticut, Maine, Rhode Island, and Vermont have generally been able to profit from the earlier NOW-account experience in Massachusetts and New Hampshire. Banks and thrift institutions in the New England states that were relative latecomers to the NOW experiment have tended to pursue more cautious marketing and pricing strategies, and their earnings have consequently stood up better.

There are also other reasons for thinking that New England's experience is not likely to be repeated in other regions. For one thing, competition between commercial banks and thrift institutions appears to be somewhat more vigorous in New England than in most parts of the country. Then, too, S. 2055 is deliberately structured to minimize transition costs and protect bank earnings. It limits eligibility for NOW accounts to individuals. It gives regulatory agencies discretion to set a lower interest rate ceiling for NOW's than currently prevails in New England. It authorizes the payment of interest on reserve balances held at the Federal Reserve, including reserves against the NOW accounts. It anticipates lower reserve requirements on NOW accounts than on demand deposits. It allows more room for reductions in the reserves required of member banks, especially the smaller banks. And it delays the effective date of nationwide NOW-account authority for one year after the enactment of legislation.

These things in combination make it seem likely that depository institutions across the country will be able to maintain their earnings reasonably well as they move to NOW accounts.

I would note especially that the one-year waiting period will afford banks time for rational planning of their operational systems and marketing strategies for NOW accounts. Without this array of provisions designed to maintain earnings strength, the Federal Reserve Board, I assure you, would not be willing to support the NOW-account proposal.

That there will nevertheless be some net cost to many commercial banks in making the transition to NOW's also seems clear. That is why we at the Board have been at such pains to keep this cost down and that is also why we have been so insistent on combining the NOW-account proposal with action to lighten the financial burden of Federal Reserve membership.

Member banks are already very sensitive to the cost disadvantage they suffer vis-à-vis nonmembers because of the more onerous reserve requirements they have to meet. This has resulted in recent years in a significant erosion of membership -- particularly on the part of smaller banks. There is no question at all in my mind that this membership erosion would accelerate if we were to go forward with nationwide NOW's without taking simultaneous action to lighten the burden of membership. That is the reason, of course, the Board has worked so intensely to obtain authority to pay interest on reserve balances and to be in a position to lower reserve requirements -- particularly for the smaller banks.

A healthy, effective central bank is not a matter of parochial concern -- of importance only to Federal Reserve officials and member banks. The Federal Reserve serves the entire financial community and indeed the Nation at large. It would be in no one's interest to see its vitality sapped. Unless the erosion of membership is arrested, a steadily diminishing portion of commercial bank deposits will be lodged with members and the execution of monetary policy will therefore become less and less precise. Other things trouble me still more. Provision of lender-of-last-resort facilities was a critical reason for establishing the Federal Reserve System. I do not like to contemplate the ultimate consequences for the soundness of our banking structure if fewer and fewer banks enjoy ready access to the System's discount window.

Declining membership could also threaten the insulation of the Federal Reserve System from day-to-day political pressures. The System's independence from such pressures will remain sustainable, I believe, only as long as the System continues to have balanced representation of membership among all sizes of banks across the country. But membership attrition has been most acute among smaller banks -- those with deposits of less than $100 million. If the exodus continues and the remaining members are only the larger banks, the Federal Reserve will then be perceived by the public as a big banker's bank. This would almost certainly generate disenchantment with the System. In time, the Federal Reserve's independence -- which enables it to base monetary policy on long-range considerations as well as those related to the short term -- would diminish if not entirely end.

I hope that these comments on key provisions of S. 2055 may suffice to show why we at the Board view the bill on balance as a constructive and desirable piece of legislation. I said before that I know many of you have reservations about it, and I understand the reasons for those reservations. I nevertheless believe that it would be the better part of wisdom to retain an open mind toward this legislative effort and seek to improve it rather than scuttle it.

Let me now turn to other items in the legislative mill. I noted earlier that the banking bills under consideration this year include the usual array of measures to "reform" the Federal Reserve System. The Federal Reserve Reform Act of 1977 recently cleared the House Banking Committee in a form greatly different from the measure originally proposed. Fortunately, the most troublesome features of the bill were eliminated during the Committee markup and this is an encouraging fact. One of the defeated provisions -- that dealing with so-called lobbying communications -- would have placed very broad restrictions on the right of Federal Reserve officials to communicate with bankers about legislative matters. Indeed, were it ever to become law, there would be a serious question whether I or any of my colleagues would be able to address an assemblage such as this in the manner I am doing. Other rejected provisions would have required the Federal Reserve to publicize at quarterly intervals numerical forecasts of interest rates and other sensitive financial variables. Forecasts of interest rates by the Nation's central bank may seem harmless at first blush, but any such pronouncement by the Federal Reserve would in practice carry implications for debt markets that could generate wide and unsettling swings in security prices.

The wish to have us make such pronouncements is somewhat puzzling. My best guess is that preoccupation with interest rates -- particularly with trying to influence the Federal Reserve to keep interest rates down -- often tends to blur judgment. Populist emphasis on low interest rates appears to be a key reason for the steady stream of proposals that in one way or another would enlarge opportunities for exerting political influence upon monetary policy. A less independent Federal Reserve -- particularly one that would be less concerned about inflation and thus more generously accommodative of credit demands -- clearly remains an objective of many people.

A perennial favorite for the past quarter century of those who would like to see the Federal Reserve enjoy less independence is the proposal to subject the System to audit by the General Accounting Office. Indeed, a bill giving the GAO sweeping authority to audit the Federal Reserve -- as well as the Federal Deposit Insurance Corporation and the Comptroller of the Currency -- was introduced in the House last January. In the course of the recent markup by the House Government Operations Committee, a number of provisions were wisely incorporated in the bill with a view to affording some protection against disclosure of confidential information. Even so, the measure retains major deficiencies and ambiguities, and we thus feel compelled to oppose it. Incidentally, the bill is expected to be on the calendar for floor action very soon, possibly this week or next.

The bill raises serious questions of public policy. The Federal Reserve Banks have never been subject to GAO audit. The exempted status of the Board dates back to the Banking Act of 1933. The complete exemption of the Federal Reserve System from GAO audit since 1933 thus complements the original exemption of the Federal Reserve from the appropriations process. These exemptions have conferred on the Federal Reserve a heavy responsibility to conduct its affairs with the highest standards of probity; they have also enabled the System to determine its internal management free from political pressures. Exemption from GAO audit is one of the main pillars of Federal Reserve independence.

In exempting the Federal Reserve from customary appropriations and auditing procedures, the Congress has recognized the special political vulnerability that a central bank tends to develop if it in fact comports itself as it should in carrying out its monetary function. It is simply a fact of life that whenever a central bank imposes monetary discipline, it almost always generates a good deal of opposition. Those displeased with Federal Reserve performance would surely have greater leverage in their efforts to get monetary policy changed if the System were subject to customary appropriations and auditing procedures. I do not mean to suggest that our stewardship should be beyond examination. Accountability by the Federal Reserve is obviously essential, and we believe that the arrangements Congress has fashioned across the decades achieve thorough accountability within a framework of safeguards that take account of the special vulnerability to which central banks are everywhere subject.

What concerns the Board most about proposals for a GAO audit is that such auditing may become a device through which pressure is brought to bear directly on the formulation of monetary policy. To be sure, the pending GAO audit bill excludes a broad range of monetary policy deliberations and transactions from the proposed audit, but it does not flatly and unambiguously exclude all monetary policy matters. For example, the Committee Report indicates that the GAO would have authority to audit and evaluate discount-window transactions to the extent that such transactions are related to the supervisory function of the System -- as distinct from its monetary policy function. This is an extremely fuzzy distinction, and it could easily become a vehicle for GAO intrusion into monitoring monetary policy -- an area in which that venerable institution has neither experience nor expertise, to say nothing of responsibility.

It is to the credit of the pending bill that it recognizes the need to protect sensitive and confidential information concerning private parties. But I am by no means satisfied that the bill's provisions in this regard are adequate. Except for records pertaining to monetary policy, the GAO would be given access to "all books, accounts, records, reports, files, memorandums, papers, things, and property belonging to or in use by the entities being audited, including reports of examination of banks or bank holding companies . . together with workpapers and correspondence relating to such reports . ' These materials obviously include a great deal of sensitive information. And while the bill prohibits the GAO from identifying individuals and institutions in its public reports to Congress, all such information could still be made available to Congressional committees sitting in executive session. Experience suggests that this limitation is scant guarantee that sensitive and confidential information about banks and their customers would not find its way into the public domain. Great damage could thus be caused to banks, individuals, and business enterprises. In self-protection bankers might soon become less forthcoming to examiners, while their work in turn might become infected either by timidity or by zealotry because of the potential for disclosure. The integrity of the entire bank examination process could therefore be undermined.

Ultimately, as I have tried to suggest, the exemption of the Federal Reserve from GAO audit can be properly understood only in the context of the importance that Congressional shapers of the Federal Reserve System have attached to insulating this Nation's central bank from day-to-day political pressures. That present audit arrangements for both the Board and the Federal Reserve Banks are thorough and effective has, I believe, been demonstrated by Federal Reserve officials in public testimony time and time again. It is a fact, moreover, that besides the auditing reports that go to the Congress each year, a great deal of detailed information about Federal Reserve activities and operations is supplied to Congressional committees in response to a steady stream of inquiries. When one also takes into account the scope of the public oversight hearings conducted by the House and Senate Banking Committees, the need for a GAO oversight role is doubtful at best. If the Congress should nevertheless want to go to the considerable expense of an additional audit by the GAO, I certainly hope that such legislation would not allow the GAO to involve itself in any way with monetary policy procedures or deliberations, and that it would also fully protect sensitive and confidential information concerning banks and their customers.

I am mindful that my remarks have been lengthy, particularly for the opening session of a working convention. Even so, there is much in the field of banking legislation on which I have not commented. For example, the Senate Banking Committee will soon consider a proposal to establish a Federal Bank Commission that would assume responsibility for the supervisory and regulatory work now carried on by the three banking agencies. In the Board's considered judgment, removal of the Federal Reserve's supervisory and regulatory responsibilities would at times seriously lessen the effectiveness with which monetary policy is carried out, and that is one basic reason -- among others -- why we are opposed to it. I regret that I cannot discuss this bill fully today, but I hope that you and other bankers in our country will make the effort to familiarize yourselves with the issues surrounding it.

In closing, I would like to touch on one more matter. In recent weeks, banking practices have become prominent in the general news, and as a result are coming under special Congressional scrutiny. Chairman St Germain's subcommittee, for example, has already embarked on hearings dealing with a range of banking practices -- among them, correspondent bank relations, bank policies relating to loan collateral, and bank policies relating to overdraft facilities. Chairman Proxmire has scheduled hearings on similar topics toward the end of this month. Specific legislation directed at some of the banking practices that have recently received public attention will soon be considered.

I deem it premature to make any kind of judgment as to how sustained the legislative interest in such matters will be or to what specific ends it will be directed. My hope is that a sense of calm deliberation and balance will be maintained -- difficult though this may be at present. We cannot remind ourselves too often that haste can easily make for bad legislation.

For several years, the Federal Reserve has been in the forefront of efforts to obtain added enforcement authority for Federal banking agencies. Our efforts in that direction in no sense imply an unfavorable view of banking. Like other industries, banking is not free of problems, but it is my judgment that generally high standards of behavior prevail in banking. The Federal Reserve's long-standing interest in greater enforcement authority simply reflects our belief that some gaps in supervisory authority exist and that improved enforcement powers are appropriate.

The 94th Congress did not give much attention to our initiative. This year, however, after full and calm deliberation, the Senate passed S. 71 -- a regulatory and supervisory bill that embodies more stringent rules on insider loans, strengthens cease-and-desist as well as officer-removal powers, and provides a range of cash penalties for violations of banking law or regulation. At present, the absence of an effective range of penalties at times causes undue restraint on the enforcement procedures of bank regulators.

Perhaps legislative remedies beyond those contained in S. 71 are needed. I certainly have an open mind on this question. But I would urge full deliberation before wider legislative remedies are enacted. The banking legislation that I have reviewed with you or alluded to this morning is quite enough for the Congress to handle in the remainder of this year.

I have talked a long time and I certainly dare not burden you with anything else. May I just express my appreciation once more for the privilege of visiting with you.

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