FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

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Statement on

Committee Print of "Financial Reform Act of 1976"

Presented to the

Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
Committee on Banking, Currency and Housing
House of Representatives

by

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Mr. Chairman and Members of the Subcommittee:

I appreciate this opportunity to testify on the proposed "Financial Reform Act of 1976," a bill designed to reflect testimony and comments received in connection with your Subcommittee's FINE Study "Discussion Principles." The bill also incorporates a number of provisions from the Senate-passed "Financial Institutions Act" (S. 1267), from legislative proposals by the Federal bank regulatory agencies designed to strengthen their available regulatory procedures to prevent and correct problem bank situations (S. 2304, H.R. 9743 and Title I of H.R. 10183) and from the FDIC's proposed "housekeeping" bill (S. 2233, H.R. 9742 and Title IV of H.R. 10183).

The bill before the Subcommittee is long and complex. Many of its provisions are interrelated, and some, for technical consistency and clarification, may require amendments to Federal law beyond those presently contemplated. Because of the short time which has been available to analyze all the ramifications of the bill and its recently proposed amendments, I respectfully request that the FDIC be allowed to file for the record such additional comments and suggestions of both a technical and a substantive nature as may be appropriate in the light of our continued study of this important legislation.

On the substantive side, I have previously testified for the Corporation in general support of the objectives and provisions of the Senate-passed Financial Institutions Act, particularly those provisions which would enlarge the asset and liability powers of thrift institutions, provide a Federal charter option for mutual savings banks, and schedule a gradual phasing out of the deposit rate ceilings presently found in Regulation Q and its FDIC counterpart. Naturally, the Corporation would favor those same provisions in the House bill, as well as those supervisory and housekeeping provisions which have been previously introduced at the FDIC's request and are now included in the same bill.

This morning I intend to confine my remarks* to five aspects included in or relevant to the proposed House bill:

-- the proposed restructuring of the Federal bank regulatory agencies,

-- the requirement that FDIC and the proposed Federal Banking Commission operate on appropriated funds,

-- the imposition of Federal Reserve reserve requirements on all State banks having third party payment accounts exceeding $15 million,

-- the need for a fresh look at the country's housing goals and incentives, and

-- the desirability of further legislation to mandate additional financial and operating disclosure on insured banks with fewer than 500 shareholders.

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* In fairness to my successor as Chairman of the FDIC and to the Comptroller of the Currency who serves ex officio on the FDIC Board of Directors and will be presenting the views of his office tomorrow, these remarks should be considered personal observations of the present incumbent and not necessarily the present or future views of the FDIC.

I. Agency Restructuring

My December 9 testimony before this Subcommittee contained a specific, intermediate proposal for Federal bank agency restructuring which I think superior to the provisions presently in the bill before you, because it would have consolidated Federal oversight of State-chartered banks in one office, preserved significant play between national and State banking systems and provided for an evolutionary structure (the proposed Federal Banking Board) which would include among its five members the Comptroller of the Currency, the Federal Supervisor of State Banks, and a Governor of the Federal Reserve System.

Title I of the proposed Financial Reform Act, by consolidating the present supervisory powers of the Comptroller of the Currency over national banks and the Federal Reserve System over bank holding companies and State member banks, adopts some aspects of my earlier proposal at the expense of others. It provides for the removal of the Federal Reserve System from day-to-day supervision of bank holding companies and State member banks, a transfer of power I continue to support wholeheartedly. Such a transfer does not require that the Federal Reserve conduct its monetary policy in a vacuum, and no responsible person has suggested that the Federal Reserve System be denied information about banking developments which it needs to conduct the all-important monetary affairs of the country. No convincing argument has yet been advanced, however, to justify the daily diversion of the staff and members of the Board of Governors away from monetary policy issues to such matters as regulation-writing under Truth-in-Lending, Fair Credit Billing, and Equal Credit Opportunity or the thousands of decisions required annually under the Bank Holding Company Act Amendments of 1970. The Financial Reform Act would also consolidate in one place the regulation and supervision of most of the nation's larger banks (no nonmember commercial bank today exceeds $2 billion in size), but it does so at potentially great risk to the major State banking systems of the country if the proposed Commission fails to permit some diversity between the way in which national and State banks operate. The bill before you also divides jurisdiction over State banks between the FDIC and the proposed Commission, depending on whether or not the bank is a member of a holding company system. Apparently, the FDIC would also have jurisdiction over State banks that are "members" of the Federal Reserve System so long as they were not in a holding company. I urge the Subcommittee to review these matters carefully, clarifying them as necessary, and again consider the alternative I proposed in December.

II. Placing the Federal Bank Agencies on Appropriated Funds

It is no accident, in my judgment, that the three Federal bank agencies have remained over the years relatively untouched by political scandal or intimidation. I fear, however, that this track record could be substantially altered if the proposed Federal Banking Commission and the

FDIC were to be placed on an appropriated funds basis, subject in the first stage of the process to the tender mercies of the White House and the Office of Management and Budget and in the second stage to the varied interests of individual Congressmen. The practical effect of the appropriation process would be to give the political operatives of the White House and the Congress substantial control over the personnel, the day-to-day operations, and the legislative positions** taken by the Commission and the FDIC, and I need not remind you how sensitive many of these agency decisions can be.

The Congress and the public must, however, hold every agency of government, and its responsible officials, accountable for their performance of duty. In part, this is accomplished today through the requirement of an annual report to the Congress, through oversight hearings of the responsible Committees and Subcommittees of the two Houses and through the limited GAO audit which is presently conducted each year of FDIC's "financial transactions." In addition, the Freedom of Information Act is opening more and more of the activities and decisions of the Federal bank agencies to public scrutiny. This process of enforcing accountability on the bank regulatory agencies could be further strengthened by (i) requiring periodic

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**In this respect, insofar as OMB is concerned, the imposition of the appropriations procedure on the FDIC could have the practical effect of nullifying recent legislation which expressly exempted the FDIC from obtaining OMB clearance before submitting its positions on legislative matters to the Congress.

reports to the Congress on specific subjects of interest to the responsible Committees or Subcommittees, and (ii) enlarging the GAO audit requirements to include a limited sampling of the agency's examination reports and supervisory processes in specific cases, under strict requirements of confidentiality, in an effort to obtain an independent, outside appraisal of the effectiveness of the agency's supervision. We are currently engaged in an effort to compromise the FDIC's long-standing dispute with GAO over its asserted need to have "unrestricted" access to FDIC examination reports in order to accomplish its required audit, and I am hopeful that the pattern that emerges from these current efforts can be used on a regular basis. In any event, legislative oversight and GAO post-audit hold more promise in my view than the appropriations process of preserving the nonpolitical nature of the bank agencies and the public confidence which has accompanied their performance in the past.

III. <u>Uniform Reserve Requirements for Banks with $15 million or more in Third Party Payment Accounts</u>

Under present law the Federal Reserve is required by Federal law to impose reserve requirements on national banks and on State-chartered banks which choose to become members of the System. Some State-chartered member banks apparently find the advantages of membership overcome the cost thereof, although a substantial number of banks have dropped their membership over the past ten years. The principal cost of membership is the maintenance of required reserves in the form of noninterest earning deposits at a Federal Reserve Bank. State reserve requirements for nonmember banks generally are less onerous than Federal Reserve requirements since nonmember banks may use balances held with a correspondent bank and, in some States, may also use earning assets in calculating their required reserves. The most frequently cited advantages of membership are cost-free check clearing and collection services, rediscounting and borrowing privileges at a Federal Reserve Bank, cost-free wire transfer, and safekeeping privileges. Some banks also consider the "prestige" of membership an intangible benefit.

By contrast, nonmember banks receive a variety of services and assistance from correspondent banks in return for maintaining correspondent balances. As fees for such services replace the maintenance of balances (and there clearly is a trend toward this development), it will be more apparent to nonmember banks what the various services, including check clearing and collection, are costing them. Should the Federal Reserve make its clearing wire and transfer service available on a fee basis to all users, nonmember banks would be able to compare costs in this area with those fees charged by correspondent banks. The net result might well be that State-chartered banks, member as well as nonmember, would have better information than they do today in deciding how to have their checks cleared and whether the benefits of discount window borrowing and safekeeping services are worth the residual cost of maintaining reserves with the Federal Reserve.

Proponents of uniform reserve requirements for banks of similar size argue that uniform requirements are necessary for the Federal Reserve to maintain adequate control over the money supply. It is implied that the absence of uniform reserves allows a significant part of the banking system to escape Federal Reserve control and this makes monetary management more difficult.

I am not aware of any substantive research and analysis that gives credence to these arguments. FDIC staff analyses, as well as those of outside economists, do not support the view that the existence of a large number of nonmember banks has hampered monetary management. Sophisticated observers note that except for the large money-market correspondent banks, Federal Reserve membership may not be particularly important for the conduct of monetary policy. They argue that the reserve positions of smaller banks depend upon the reserve positions of large correspondent banks and thus effective monetary control of correspondent bank reserves gives the Federal Reserve effective control over all banks, regardless of the amount or form of these reserves.

Another argument advanced on behalf of uniform reserve requirements pertains to equity. Insofar as State reserve requirements can be met by correspondent balances which compensate for services provided or by placing funds in earning assets, it is sometimes alleged that such institutions tend to be at a competitive advantage compared with member banks; and, in fact, nonmember banks in States with lower reserve requirements have tended to be more profitable than member banks of comparable size. However, extending reserve requirements to all depository institutions is not the only way to address this issue. Another alternative would be for the Federal Reserve to pay interest on member bank reserves, to allow all or a portion of its required reserves to be held in the form of Treasury securities, or to reduce prevailing reserve requirement levels. (There may be considerable logic in tying the latter to the elimination of restrictions on the payment of interest on demand deposits.) With respect to other Federal Reserve services, principally access to the discount window and check clearing services, these might be made available to nonmember banks on a non-subsidized basis.

To reiterate the position outlined in my previous testimony, I believe that the nation's banks should be permitted to retain a meaningful choice between the regulatory options now available to insured banks. For State-chartered banks, an important part of that choice is optional membership in the Federal Reserve System with its attendant costs and benefits. At present, being unconvinced on the merits of the two principal arguments advanced by proponents of uniform Federal Reserve reserve requirements, I would not favor the imposition of such uniform requirements on State-chartered banks. If considerations of either monetary policy or equity persuade the Subcommittee to adopt such a requirement, I believe that a much higher cutoff figure than the $15 million proposed should be used to determine those banks to which such uniform reserves should apply.

IV. A Fresh Look at the Country's Housing Goals and Incentives

Diversification on the asset and liability side appears to be necessary if the specialized thrift institution is to have the earnings and the competitive tools necessary to attract and retain deposits in periods of high market interest rates. To those in the Congress and elsewhere, however, who seek to keep lendable funds flowing to the housing sector, broadened investment powers for thrifts raises the spectre of a reduced commitment to housing. While it may be true that the percentage of assets devoted to mortgage lending and the housing sector is likely to go down with broadened powers, most experts feel that the dollars devoted to housing will not be adversely affected. Heightened competition for deposits also raises the likelihood of higher rates on home mortgages and related housing credit, and this raises understandable concern over the future attractiveness of such expenditures to the purchasing public. Should we then be moving away from specialized mortgage lending institutions?

I think the answer must be "yes," coupled with a more enlightened housing policy. Tax incentives to keep financial institutions in the housing sector, or incentives like the differential under Regulation Q, are directed to lending institutions not the ultimate user. If the incentives are adequate, so the argument goes, more money will flow to housing and home mortgage rates will be kept low. But will this happen and is it what we need today? Will such incentives increase the flow of funds to housing units that are affordable by lower and middle-income families -- who are, after all, the vast majority of our population? Or will it again be the developers and the relatively affluent who benefit from the many real estate incentives presently embedded in our laws?

The basic problems in housing today runs much deeper than the availability of funds or high interest rates. They are a combination of high and rising energy costs, high building costs and a preoccupation with the detached, single-family home. Surely the time has come for a fresh look at the housing goals we have set for ourselves as a nation. A reexamination of these goals, and agreement on what they should be, may lead us to quite different incentives in the housing sector than are contemplated by either the Senate or House bills now before you. I fear that reliance on the traditional incentives aimed at lending institutions and developers will only lead to more disappointments in the actual improvement, both quantitatively and qualitatively, of our housing stock.

V. Greater Disclosure in Banks with fewer than 500 Shareholders

Recent events have accelerated what has been a persistent trend towards greater disclosure of information related to the operations and financial soundness of the nation's insured banks, a trend which I believe benefits the institutions themselves, their depositors and customers, their shareholders and their regulators.

The Federal bank agencies and the SEC have played a major role in this process. The FDIC has for several years, for example, released to anyone who asks the complete Reports of Condition and Income which insured banks file regularly but which had previously been held confidential. Contrary to the fears of some, there is no evidence that this has resulted in any adverse effects on the nation's banking system. Currently, the Federal bank agencies and the SEC are engaged in a concerted effort to expand the usefulness of the information collected in such Reports.

In addition, bank holding companies with 500 or more shareholders are generally required to disclose data, file periodic reports, use proxy statements and distribute annual reports in accordance with SEC standards. Nonholding company banks with 500 or more shareholders are required to meet similar disclosure requirements set by the Federal bank agencies, in substantial conformance with SEC standards. At the present time 321 nonmember insured banks meet the statutory tests and are subject to these extensive disclosure requirements.

I would recommend two additional steps which would significantly enlarge the public dissemination of banking data, both of which would require legislation to be effective. First, the 500-shareholder test should be reduced to 300 shareholders and subsequently to 100 shareholders. The initial reduction would add approximately 500 nonmember banks to those already subject to these extensive reporting requirements, while the reduction to 100 shareholders would add another 1,700 nonmember banks. A comparable percentage increase in coverage would most likely occur for bank holding companies registered with the SEC, for national banks registered with the Comptroller of the Currency and for State member banks registered with the Federal Reserve. Second, all insured banks should be required to send out to their shareholders the data contained in the year-end Call and Income Reports submitted as of December 31 to the three Federal bank agencies. While such data may be obtained from the agencies upon request, placing the burden of dissemination on the banks themselves would lead to more widespread disclosure on an equal basis to all bank owners.