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Statement by

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Board of Governors of the Federal Reserve System

before the

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Regulation and Insurance

of the

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I am pleased to appear before this Committee on behalf of the Board of Governors of the Federal Reserve System to discuss Title I of the FINE "Discussion Principles" relating to depository institutions.

In discussing the wide-ranging proposals of Title I, I think it might be most helpful to the Committee if I summarize the Board's views pointedly but rather briefly, and then stand prepared to answer any questions you might have. Some of these views are not supported by all Members of the Board, but all are supported by a majority of the Board.

When I appeared before your Committee last December to testify on Title IV relating to the regulatory agencies, I noted that your study wisely recognizes the interrelation of many segments of the Discussion Principles. The Board believes this interrelation is particularly significant in considering Title I relating to "Depositary Institutions," and we support the opening statement of Title I that "A coordinated approach is needed to strengthen our depository institutions."

However, a coordinated approach does not necessarily mean that all such legislation has to be enacted at the same time. In our view there are measures, some of which I will refer to in the course of my testimony, that should be acted on promptly within a longer-run framework of legislative reform.

It has been the view of the Board of Governors that there should be coordinated changes in our financial system designed to serve four objectives: (1) increase competition; (2) improve the flexibility of financial institutions to respond to changing needs of individuals and businesses while (3) maintaining a base for effective monetary policy, and (4) preserving a sound and resilient financial system. Although we may differ in detail, we believe that Title I of the Discussion Principles provides a good framework for the type of comprehensive legislation required.

It must be recognized that powerful forces for change are at work within our financial system. Pressures of competition, technological advance, and customer demand for different and expanded services are bringing about many changes in the structure and operations of bank and nonbank institutions. The most effective role here for the Congress and the regulatory agencies is one of channeling and containing these developments within prudent limits.

For example, institutional changes already under way are blurring the distinction between demand deposits and time and savings accounts, as well as the distinction between commercial banks and other savings institutions. The public is holding an ever larger share of its immediate liquidity in interest bearing deposit accounts. Commercial banks and thrift institutions are in direct competition for such balances.

On the other hand, during each period of relatively high market interest rates, there has been a shift of savings funds out of depository institutions into money market instruments in order to maximize their earnings. Whenever Regulation Q imposes below-market-rate ceilings, this movement will undoubtedly reemerge as individuals become ever more financially sophisticated.

For the sake of simple equity to savers, as well as practicality and efficiency, removal of such ceilings is a desirable goal. To be sure, existing rate ceilings could be rendered both ineffective and unnecessary by a sufficient decline in market interest rates. Absent such a major downward adjustment in market rates, however, deposit rate ceilings should only be removed in stages over a period of time, during which thrift institutions -- and perhaps some small commercial banks as well -- could diversify their investment portfolios appropriately.

Asset and Liability Powers of Thrift Institutions

Proposals 2 (Sources of Funds), and 3 (Uses of Funds) in Title I of the FINE Discussion Principles provide a means for gradually dealing with this problem. We are in general agreement with these proposals for broadening the investment powers of thrift institutions. Such broader powers would allow them to invest in a mix of assets on which the return is more responsive to market interest rates. With more diversified asset holdings, thrifts in time would be in a better position to pay competitive rates to savers at times when market rates were rising, and problems of disintermediation would thereby be diminished. To this extent, there should be greater stability of flows of funds to thrift institutions, more stable flows of funds to housing finance, a more equitable return to the individual saver during periods of high interest rates, more alternative borrowing sources for consumers, and a broader range of instruments and loan terms available to consumers.

Although the Board supports expanded consumer lending powers (including the issuance of credit cards and the establishment of revolving lines of credit) and authority to invest in commercial paper, corporate debt and bankers' acceptances for thrift institutions, we believe that it would be preferable to provide for a gradual implementation of these powers. The Board is concerned that the proposed asset diversification could have an adverse impact on housing finance that might not be offset in timely fashion by other proposals in the Discussion Principles. Gradual transition authority would assure that diversification would not have a sudden impact on housing finances, and would permit adjustments to be made to deal with any stresses that might result from the expanded powers by the same token, of course, it would also prolong the transition period during which the thrifts are gaining competitive vitality.

Such a gradual implementation would be consistent with the proposed step-by-step approach to the removal of deposit interest rate ceilings. The Board supports the gradual phasing out of the authority to regulate time deposit interest rates. Because of the uncertainties of financial conditions in years ahead and because of the difficulties many institutions could experience in making the needed adjustment to competition in interest rates, we believe it would be wise to afford an opportunity for final review prior to the termination of this authority.

We also believe it would be important to retain the authority to reimpose interest rate ceilings should a financial emergency arise.

The Board believes that the statutory prohibition against payment of interest on demand deposits should not be lifted forthwith. That prohibition is so deeply imbedded in the banking structure that the decision to remove it should be preceded by careful study of its possible consequences and suitable preparation for dealing with the resulting adjustments, and in any event such removal should be accomplished gradually.

The Board also agrees with the Discussion Principles' proposal to permit savings and loan associations and mutual savings banks to offer demand deposits and other third party transfer arrangements, so long as careful attention is paid to competitive equality, particularly with reference to monetary reserve requirements and all other regulations applicable to deposit accounts at commercial banks.

The Board believes that a comparable expansion of the asset and liability powers of credit unions is an appropriate long-range goal. In our view, however, this increase in authority for credit unions should be programmed on a step-by-step basis so that there can be some assurance of a reasonably smooth and safe adjustment in their operations and subject to appropriate safeguards.

Relationship to the Federal Reserve System

Proposal 5 sets forth a recommendation for reserve requirements that is similar to one made by the Board to Congress in our letter of June 26 to Chairmen Reuss and St Germain. We wholeheartedly approve of the Discussion Principles' statement that all Federally insured depository institutions should be required to meet reserve requirements on their deposit liabilities and that all reserves should be held at the Federal Reserve.

The Board believes that the enactment of this principle into law would bolster the effectiveness of monetary policy by maintaining, and even tightening the relationship between bank reserves and the nation's deposits. The task of monetary policy is now complicated because shifts in deposits between member banks and nonmember institutions alter the relationship between reserves under the control of the Federal Reserve and total deposits, which constitute the major share of the nation's money supply. More importantly, withdrawals from Federal Reserve membership are gradually reducing the share of the nation's total money supply that is directly linked to monetary reserves. Management of money and credit would be made more effective if required reserves against all deposits were held either in balances at Federal Reserve Banks or in vault cash, since such reserves would be immobilized and their total more readily regulated by Federal Reserve actions.

Equity among competing institutions also requires that all institutions offering similar deposit services be subject to similar reserve requirements, particularly with the deposit functions served by the various institutions being brought closer and closer together.

The Board believes that these changes should be enacted promptly. To cushion resulting adjustment, however, we favor the Discussion Principles' proposed five-year transition for institutions that are not subject to Federal Reserve reserve requirements at the time of introduction of the legislation.

The Board also agrees that all depository institutions required to meet Federal Reserve reserve requirements should have "direct, full and equitable access to Federal Reserve services, including the discount window and wire transfer system." The Board recommends that, in broadening access to the discount window, the Congress also provide for liberalization of the present collateral requirements. The law now precludes the use of some sound assets and collateral at our discounts window except at a penalty interest rate one-half of one per cent above the discount rate.

We believe it would be useful to remove that penalty provision and thus eliminate an indirect restriction on the portfolios of users of the discount window. For analogous reasons the Board is opposed to the proposal in the Discussion Principles that would bar the use of loans to foreign borrowers as collateral at the discount window. All sound assets should be available to help serve this important collateralization role.

Competition

The Board is in general agreement with the philosophy of proposal 1 concerning chartering and proposal 9 concerning branching, namely, that there should be greater opportunity for the formation of new institutions and branches to provide needed financial services and enhance competitive vigor. In carrying out its responsibilities under existing law, particularly the Bank Holding Company Act, the Board has consistently stressed the importance of improving competition and preventing any undue concentration of banking resources which would tend to reduce competition.

We support the proposal which would permit Federal chartering of mutual savings banks. We also concur in the general principle that new depository institutions would be chartered "if capital and other requirements," presumably requirements relating to safety and soundness, are met. The implication of this proposal is that sheltering of existing financial institutions from new competition should not be grounds for denial of a new charter. We are in agreement with this approach, so long as the new competition is fairly based. We believe, however, there should be authority to deny a new charter which might reduce competition, as, for instance, a *de novo* charter to a holding company which already accounts for a major share of the relevant market.

The Board believes there are many instances in which branching across State lines could be procompetitive. However, the suggestion in proposal 9 that interstate branching be authorized if it is not inconsistent with State law would, in itself, probably not produce Federal branching across State lines any time soon. A roughly similar provision in the Bank Holding Company Act has in practice served to confine bank holding companies to acquisition of banks within the State of their home office.

We believe Federal legislation to permit branching across State lines should be confined at present to areas where there is a pressing competitive need or some other overriding public benefit to be gained. Such pressing need exists for the Board's proposal to Chairmen Reuss and St Germain of February 19, 1975, providing for limited bank holding company acquisitions across State lines in order to resolve possible large failing bank cases in a manner consistent with preserving competition.

We strongly urge prompt action on H.R. 4008, which contains this proposal. Also in H.R. 4008 is the Board's requested authority to waive the 30-day waiting period for bank holding company acquisitions in emergencies or failing bank situations. This provision, too, is needed now, and it has the added distinction of having -- so far as we know -- no expressed opposition to its enactment.

The Board supports the objectives of proposal 10 to improve competitive equity and increase competition by extending trust powers to qualified savings and loan associations, mutual savings banks and credit unions. We believe that such trust activities should be authorized, however, only upon a finding of the regulatory authority that the institution is sufficiently large and strong to support a trust department, and we would add the requirement that they also have qualified personnel.

Proposal 4, dealing with disclosure also is directed at improving competition by providing depositors, borrowers, and investors with more information than they now receive. The Board agrees that adequate disclosure by financial institutions should be required in order to assist the public, but it believes such disclosure requirements should take into account the special characteristics of depository institutions. In particular, disclosure should not impose reporting burdens disproportionate to the usefulness of the information, and it should guard against misinterpretation or "scare" effects to which banks and other depository institutions are particularly vulnerable because so many of their liabilities are withdrawable at a moment's notice. Given these considerations, we conclude that the details of additional disclosure requirements are best developed by the appropriate regulatory agencies, in consultation with individuals and organizations affected. Indeed, the SEC and the Federal bank regulatory agencies are presently hard at work on this very task.

Appropriate public disclosure of the general financial condition of depository institutions is desirable not only because it furthers competition but also because of the market discipline it imposes on the management of those institutions. Some reinforcement of existing regulatory discipline on the management of these institutions is also needed, as we see it. Accordingly, the Board urges the Congress to give prompt consideration to the joint recommendations of the Board, the Federal Deposit Insurance Corporation and the Comptroller of the Currency submitted to the Committee on September 5, 1975, all designed to help prevent or correct problem situations. These recommendations include provision of civil penalties for several violations where only criminal penalties now exist, broadening the coverage of insider lending limitations, simplifying and making more effective the officer removal authority, and authorizing, under certain limited circumstances and subject to procedural safeguards, divestiture or termination of a nonbanking activity by a bank holding company.

Other Proposals

The Board supports the principle of proposal 8 (taxation) that as a matter of competitive equity depository institutions with similar asset and liability powers should be subject to the same Federal tax treatment.

Proposal 11 provides that banks be permitted to engage in the underwriting of State and municipal revenue bonds, but that the present prohibitions on underwriting of corporate securities be retained.

Over the past two decades or so there have been a number of bills introduced in the Congress to authorize bank underwriting and dealing in revenue bonds. During this period numerous arguments have been advanced both for and against this proposal.

The favorable arguments generally focus on the benefits expected to accrue to governmental units in the form of lower interest costs and improved market efficiency, while the opposing arguments center on potential conflicts of interest and risks of market concentration. The Board, on a number of occasions, has reviewed the question of extending bank underwriting privileges to municipal revenue bonds of investment-grade quality, and since 1967 has consistently voiced its belief that the public benefits of such action outweigh any potential risks. In view of recent developments in the municipal securities markets, however, the Board would wish to make a fresh study of the situation before reaffirming its previous position on this matter.

Finally, the Board agrees with proposal 12 that the Congress await the report from the National Commission on Electronic Funds Transfers before legislating further in the area of new payment mechanisms.

I wish to thank you, Mr. Chairman, and the members of your Committee for this opportunity to express the Board's views on the proposals of Title I of the Discussion Principles. As always, my colleagues on the Board and I stand ready to be of whatever assistance we can in the important work of this Committee.

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