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Statement by

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Subcommittee on Financial Institutions Supervision,

Regulation and Insurance

of the

Committee on Banking, Finance and Urban Affairs

United States House of Representatives

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I appreciate the opportunity to appear before the Subcommittee today on behalf of the Federal Reserve Board to discuss H.R. 3567, the Depository Institutions Examination Improvement Act and H.R. 2282, the Truth in Savings Act. I will begin by offering the Board's evaluation of H.R. 3567 and then turn to H.R. 2282. The Board's responses to the questions posed in Chairman St Germain's letter of May 27, 1986, are appended to this testimony.

The purpose of the proposed legislation is to improve the quality of depository institutions supervision by assuring that the federal supervisory agencies provide adequate compensation and benefits to attract and retain competent personnel, by improving the efficiency of examiner training programs and by providing for the certification of state supervisory agencies. We are in agreement with the basic objectives of the proposed legislation, and have taken steps to achieve many of them. We do have reservations concerning the arrangements the bill would establish to accomplish certain of the objectives, however, and I will discuss them as I proceed.

With respect to the major provisions of the bill that would exempt the supervisory agencies from federal civil service laws and the federal budgetary process, we would point out that the Federal Reserve is already exempt from these constraints under specific provisions of the Federal Reserve Act. Accordingly, the Board believes that the Federal Reserve should be excluded from this portion of the bill. At the same time, the Board supports the legislation insofar as it applies to the other supervisory agencies. The legislation will provide them with the flexibility necessary to establish their own employee compensation programs and budgets and thereby enable them to maintain a qualified examination and supervisory staff.

The proposed legislation would also require the Examination Council to conduct regional studies of private sector pay scales and employee benefits for jobs comparable to those of federal examiners. The Council would report the results of these studies to the federal regulatory agencies, which would be required to take them into account in setting pay scales for their personnel.

Under existing practice, the Federal Reserve Banks, which employ substantially all of the System's examiners, set their salary levels commensurate with those being offered by banks and other financial institutions in their local areas. In determining what the local salary levels are, the Federal Reserve Banks conduct surveys that are essentially the same as envisioned for the Council. The Federal Reserve would be prepared to share with the Council the information that the Reserve Banks gather. Our survey experience, we would point out, is that, while the federal pay scale is below going compensation levels in certain sections of the country, it is significantly above local levels in other sections.

As important as the issue of examiner compensation is, it cannot be considered without regard for the continuing need to control costs government-wide and to achieve budgetary savings consistent with the Gramm-Rudman-Hollings legislation. Although the Federal Reserve System is not covered by Gramm-Rudman, Chairman Volcker has stated the Federal Reserve System's intention to comply voluntarily with the spirit of that legislation. Accordingly, the Board's 1986 budget was revised to meet the 4.3 percent reduction mandated by Gramm-Rudman for other government agencies and comparable reductions were made by the Reserve Banks. Despite this commitment to budgetary restraint, the Federal Reserve is increasing the number of its on-site examinations and hiring additional examiners to help conduct them. These measures are, in our opinion, necessary to meet growing supervisory concerns regarding banks and bank holding companies that are under the Federal Reserve's regulatory authority. Because of these concerns with supervision, we support the bill's objective to provide the other supervisory agencies with adequate budgetary flexibility to meet increased requirements for bank supervision.

It is, of course, particularly difficult to strengthen our supervisory function at a time when our overall budget is being reduced. Of necessity, we have expanded the supervisory function by less than we had planned and, to meet the added expenses of the expansion that has been accomplished, have had to make cuts in other areas of our budget. Thus, if the Congress were to provide the other agencies with flexible compensation and budgetary authority, we would take guidance from this action in setting our own salary and budgetary policies.

The proposed legislation would also provide for the development of a proposal to consolidate all federal agency examiner training programs under the Examination Council and would require that the Council study the feasibility of establishing a graduate education program for examiners. As I understand it, the Council has the concept of a graduate education program under study and is not, under its current authority, restricted from offering such a program. With respect to consolidating all other examiner training in the Council, we believe that in addition to the present schools the Council conducts for all the agencies, serious consideration should be given to having the Council assume responsibility for conducting certain "core" courses for examiners. We would stop short, however, of having the Council assume all educational responsibilities for the agencies. Each agency has unique activities and responsibilities that require specialized training for its examiners -- for example, in the area of bank holding company inspections and Edge Act corporation examinations. Thus, it is essential that the agencies retain the flexibility to offer their own courses to meet their special training needs.

The proposed legislation would also direct the Council to establish standards for judging the adequacy of state supervisory agencies and to conduct reviews of individual state supervisory departments to determine whether federal agencies should rely on their examinations. It seems more appropriate to have the federal supervisory agencies ultimately charged with the responsibility for ensuring the safety and soundness of state institutions assigned the requisite legal authority for certifying the states. Thus, the Board cannot support this portion of the proposed legislation because it does not establish the necessary interrelationship of authority and responsibility.

I would point out that the federal agencies that have statutory supervisory responsibility over state-chartered institutions already have in place programs to coordinate their supervisory efforts with state authorities. The Federal Reserve, for example, has voluntary arrangements with several qualified states to conduct alternate examinations on an annual or more frequent basis. Furthermore, we have recently undertaken to expand its use of examination reports prepared by state examiners.

I might add that the Federal Reserve System has also taken steps to help supplement the training programs for state examiners. The Board has authorized scholarship funds for the Education Foundation of State Bank Supervisors and instructed the Reserve Banks to provide financial assistance directly to state bank examiners who attend Federal Reserve training schools.

In summary, we support the main thrust of the bill to provide, where needed, adequate compensation and budgetary flexibility -- authority the Federal Reserve already has --to assure a continued high priority for adequate supervision of the nation's depository institutions. We also see certain benefits to be gained from further coordinating the examiner training programs of the agencies. We do not, however, believe it is appropriate to vest in the Council responsibility for certifying the acceptability of a state's examination reports for use by the federal supervisory agencies.

I would now like to direct the balance of my comments to the provisions of H.R. 2282.

H.R. 2282 would address deposit account advertising and disclosures by establishing uniform requirements applicable to all depository institutions. The bill calls for advertisements regarding interest rates to state an annual percentage yield and an annual rate of simple interest as well as other factors. With respect to disclosures, depository institutions would be required to provide schedules of fees and charges for all existing accounts and prior to any changes in the schedules. Rule writing authority to implement these requirements for all institutions is given to the Board of Governors of the Federal Reserve System.

Since 1969, the Board has had comprehensive regulations on advertising in Regulation Q. In January of this year, the Board proposed a series of amendments to update, clarify, and simplify its current advertising requirements. This proposal addresses many of the same advertising issues covered by H.R. 2282, such as requiring an annual percentage yield ("APY") and a statement concerning service charges in advertisements. At the same time the Board directed its staff to explore the need for action on disclosure of detailed account information to bank customers. The Board also supports providing bank customers with clear and complete information when they open their accounts and is planning a Policy Statement encouraging disclosures by member banks.

In considering this Policy Statement, the Board has taken into account that the level of information provided to bank customers has been high. Over the past two years, only approximately 4 percent of the total complaints received by the Board on member banks pertained to advertising and disclosure issues similar to these contained in the bill. Moreover, a January 1986 Survey of Consumer Attitudes conducted for the Board by the University of Michigan indicated that 94 percent of current deposit account owners felt that they had received the information that they needed to know about the terms and conditions of their accounts. Eighty-two percent of the families who opened a checking account and 73 percent of those opening a savings account in the past two years reported they had received a written explanation of the terms and conditions of their new account. Although the survey did not provide information on the nature of the disclosures made in written form, it did indicate that a significant majority of consumers are receiving what they believe to be adequate disclosures on their accounts in written or oral form.

While H.R. 2282 would have the advantage of extending uniform advertising and disclosure requirements to all depository institutions, including member and nonmember banks, thrift institutions and credit unions, it may unduly limit flexibility. In particular, by attempting to establish uniform requirements applicable to all accounts, H.R. 2282 does not allow sufficient latitude to tailor advertising and disclosure requirements to individual account characteristics and individual customers' use of accounts. For example, H.R. 2282 requires advertisements regarding the rate of interest payable on an account to state the annual percentage yield ("APY") and the annual rate of simple interest. Similarly in its January proposal, the Board included three alternatives for advertising interest on deposits: simple interest, or an APY, or both. While the Board's Consumer Advisory Council supports requiring both the APY and the simple interest rate, public commenters were divided as to which alternative was most appropriate. Given this difference of opinion, flexibility may be required in determining if the same requirements should apply to all.

Other provisions of H.R. 2282 may also hamper regulatory flexibility in establishing clear and simple advertising requirements. It may be unnecessary to require advertisements containing annual percentage yields to refer to the method of compounding or to require advertisements to state the method of paying interest. Similarly, the statement concerning account charges required by H.R. 2282 refers to elements characteristic of transaction accounts, such as transaction fees, and elements of time deposits, such as early withdrawal penalties, and might be simplified to avoid confusing bank customers as to the charges applicable to their account.

With respect to disclosures, H.R. 2282 could be read to require depository institutions to provide customers with schedules of fees and charges applicable to all accounts and services and a description of all changes in the previous schedules when account terms are changed, even through such schedules may not be applicable to the customer's account. In order to avoid confusion, disclosure requirements should be limited to changes in information relevant to a customer's deposit relationship with the institution.

Allow me, at this point, to reiterate our basic position. The Board supports clear advertising and full disclosure by depository institutions and has proposed for comment amendments to update and clarify its advertising rules and is working toward a Policy Statement that will address disclosures by member banks. As both of these efforts would be limited to member banks, the Board is consulting with the other regulatory agencies in an effort to obtain a uniform application of these concepts to all depository institutions. While we are not seeking legislation, if Congress believes that legislation is necessary to achieve uniformity among the agencies, the Board believes that the legislation should provide a more flexible statutory mandate. This would permit the Board to structure rules that would enhance customer benefits as new types of deposits evolve while minimizing customer confusion and the burden on depository institutions.

Responses to Questions Posed in May 27, 1986
Letter of Chairman St Germain

1. In your view, are the employees of your agency public sector or private sector employees? Are the examiners in your agency public sector or private sector employees?

The Federal Reserve Board is best characterized as an independent agency of the United States, and as such its employees are public sector employees. While the Federal Reserve Banks, which employ substantially all of the System's examiners, are organized in corporate form and their shares are held by members banks, they act as instrumentalities of the United States and their officers and employees, in this capacity, carry out specific public functions under statutory authority.

2. What specific salary and benefit provisions in present law are lacking in order to retain examiners in your agency? Is it possible to keep financial institutions regulatory agency personnel subject to civil service pay scales, generally, but to provide certain limited exemptions where needed?

As I have noted above, Federal Reserve examiners are employed by the Federal Reserve Banks and thus are not subject to federal civil service laws. However, by policy we have kept the salaries of our Federal Reserve Board personnel consistent with federal pay scales. The same policy has also had some effects on the scale of compensation offered at the Reserve Banks. Thus, should the Congress provide more compensation flexibility to the other agencies than they now possess under laws governing the Federal civil service and the budgetary process, the System would view this action as providing guidance for its own policies.

3. The Gramm-Rudman legislation only applies to the regulatory agencies when a sequestration order takes effect. Every effort is being made by the Congress to meet the FY 1987 budget deficit target of $144 billion. In the present situation, there is unlikely to be a sequestration order until October of 1987.

   In light of these circumstances, where is the immediate necessity for taking examiners out from under Gramm-Rudman until other factors develop that may require such measures?

While it is true that the agencies only come under Gramm-Rudman as sequestration takes place, the agencies cannot ignore the potential for sequestration in setting their hiring and budget policies. The Federal Reserve too must be sensitive to these possibilities, since it is now voluntarily complying with the spirit of the Gramm-Rudman law. Thus, in light of the need to strengthen the supervision of depository institutions, additional compensation and budgetary flexibility, where needed, would promote a more effective set of employment and budget practices.

4. Will raising the pay levels of federal examiners cause state regulators to lose many of their examiners?

Certain states may already have lost some examiners to federal agencies because the current federal civil service pay scale substantially exceeds the pay levels for examiners in a number of states. The broader problem facing these states, however, is that their compensation levels are also not competitive with those offered in the private sector. Moreover, if employees in some states are not adequately compensated (adequate, from the standpoint of employee retention in the face of higher wages offered in the private sector or at other levels of government), this should not be permitted to interfere with the efforts of any federal agency to attract and retain qualified personnel.

5. Is there a problem with turnover rates at your agency with personnel other than examiners? If so, please explain fully.

While the Federal Reserve Banks are able to establish salary levels to meet the competition, we are experiencing increasing difficulties in retaining examiners, particularly in certain areas of the country. We are also losing some key Reserve Bank people to the private sector in other functions of the bank.

In recent years, the Board has also had a problem retaining experienced personnel. In particular, we have encountered difficulties in retaining attorneys, economists, financial analysts and secretaries. Many experienced employees in these job families are leaving the Board because they were offered substantially higher salaries and because they were unwilling to invest their future here when the prospects for salary growth are severely restricted.

6. What would be your alternative to the approach taken in the latest version of the Carper/Lundine bill?

As indicated in my testimony, the Board supports the main thrust of the bill with regard to providing the other federal supervisory agencies appropriate authority to compensate their examiners competitively.

ANALYSIS OF H.R. 2282

Prepared by the Staff of
The Board of Governors of the Federal Reserve System

H.R. 2282 would provide for a single regulatory agency to promulgate regulations on the advertising of interest-bearing deposits and on the disclosure of terms and conditions applicable to deposits and services routinely offered by depository institutions. The bill as written presents a number of significant issues.

Section 3. Section 3 requires the statement of a number of factors in "each advertisement, announcement, or solicitation made by any depository institution regarding the rate of interest which is payable on any account." The legislation appears to require the same mandated statements in all media -- newspaper, billboards, radio and television. The staff believes that such a requirement may inhibit advertising in various media such as radio and television where the time constraints inherent in short advertising spots may limit the information that can be provided. The bill should provide the flexibility to tailor rules to different media. This issue was raised in the Board's January proposals to amend Regulation Q advertising rules and flexibility was supported by the majority of commenters who addressed this issue.

° 3(a) -- This section appears to apply only to interest-bearing deposit accounts. Consequently, advertisements for demand deposit accounts may not be covered. Some advertisements for demand deposit accounts may be misleading. For example, an advertisement for "free checking" may be misleading when there is a minimum balance requirement to avoid service charges. Further, the scope of the disclosure provisions in section 4 of the bill appears to encompass demand deposit accounts. Consideration should therefore be given to also including demand deposit accounts within section 3.

- 3(a)(1) -- This provision would require the statement of an annual percentage yield ("APY") and the method by which interest is compounded. If the APY is required, the reference to the compounding method can be deleted. Compounding methods are reflected in the calculation of the APY.
- 3(a)(3) -- Advertisements would be required to state the frequency with which interest would be payable to a depositor. Inclusion of this information may "clutter" advertisements and is usually of little importance to depositors when viewing advertisements.
- 3(a)(4) -- Minimum balance requirements would be required to be stated. It is unclear whether the "minimum balance" required to be stated is that balance needed to open an account, avoid the imposition of penalties or service charges, or earn interest. The Board currently requires that member banks state in advertisements any minimum balance required to earn the advertised rate of interest.

- 3(a)(6) -- This provision mandates language to be used in advertisements concerning the presence of early withdrawal penalties and service charges. The staff believes the statement is too restrictive and overbroad in scope and would confuse consumers. Early withdrawal penalties are solely a function of time deposits and do not apply to transaction accounts. On the other hand, transaction accounts are subject to service charges which generally are not assessed against time deposits. The mandated statement would cause confusion by blurring these distinctions. Staff believes that a more generic statement such as "this account is subject to service charges" or "service charges on this account may reduce your yield" are more appropriate in an advertising context. Of the 66 commenters addressing this issue in the Board's January proposals, 55 supported use of a statement such as the first one quoted above, although several of these commenters expressed the opinion that the statement was not strong enough or sufficiently detailed. Current Board regulations require a statement concerning the early withdrawal penalty.
- 3(a)(7) -- This section would permit advertisements for accounts with maturities of less than one year to exclude APYs. If APYs are included, then a specified statement concerning the yield would be required. Staff recommends this section be deleted and flexibility provided to structure appropriate regulatory requirements. Exclusion

of an APY for shorter-term time deposits would limit consumers' ability to compare deposits of various types. Further, the statement appears to be overly long and could be simplified.

° 3(c) -- This provision requires that written summaries of the information required by section 3 be provided on request. Staff believes this issue is more appropriately addressed under section 4.

Section 4. This section establishes detailed disclosure requirements as well as procedures for maintaining and disseminating the required information.

° 4(a) -- Under this provision, each depository institution would be required to maintain a written schedule of "all fees, charges, and terms and conditions which apply to each type of account and service routinely offered by such depository institution." A list of charges to be included in the schedule is also in the provision. Although the specified disclosure factors present no major issues, the staff is concerned that the scope of section 4(a) is broader than intended. The purpose of this bill is to provide consumers adequate information concerning their accounts. However, as drafted, section 4(a) appears to require inclusion of all routinely offered services, including those services involved in correspondent banking relationships and large commercial accounts in a single schedule. Even more retail oriented services may not be appropriate for inclusion in a schedule when they are not used by the customer receiving the schedules. The regulator charged with promulgating regulations under the Act should be given sufficient flexibility to make these distinctions, or, in the alternative, the bill should be amended to require separate schedules with information limited to particular types of accounts in each schedule.

° 4(b) -- This provision requires that the written schedule be given to all depositors, each potential customer, and any individual who requests it. Further, section 4(b)(2) would require a new schedule with an explanation of changes to be mailed to account holders not less than 30 days prior to the effective date of any change in the schedule. Written schedules of fees and prior notification of changes in such fees are important pieces of information which should be given affected depositors, however, the bill as written may, in fact, work to the ultimate detriment of consumers.

As in the case of section 4(a), the principles embodied in section 4(b) can be retained by allowing for separate schedules for each type of account. For example, depositors would receive a schedule of fees and terms and conditions that is relevant to their relationship with the bank. A depositor that does not have a transaction account with a depository institution would consequently not receive demand deposit disclosures. If depositors decide to use a service or open an account other than one that they have already received information on, the depository institution need only provide the necessary information at that time. Further, targeted disclosure would mean that only those changes relevant to the depositor would be provided to him. Consideration should also be given to requiring prior notification only of changes to an account relationship that are adverse to a depositor. Prior notice of adverse changes would permit depositors to take whatever steps they deem appropriate, such as changing their account, before the effective date of the change. We do not believe that such a concern is warranted where changes are favorable to a depositor, however. In such instances, a prior notification requirement would appear to only increase costs without any increased consumer benefit. (In a potentially analogous situation, Congress amended the Right to Financial Privacy Act to limit the scope of coverage of the Act due, in part, to an estimate that the cost of notifying <u>all</u> customers of their rights under the Act would be approximately $922 million.)

<u>Section 5</u>. This section authorizes the Board to promulgate regulations to effectuate the bill's provisions. It further requires that any regulations provide that APYs are calculated on the basis of a 365-day period. The staff believes this latter provision is unnecessary because it would not improve a consumer's shopping ability. APYs calculated

through the use of uniform formulas, such as those contained in the current Board proposal, will produce the same rankings among institutions using different compounding methods as would APYs that have been "converted" to a 365-day basis.

- 5(b)(2) -- The grant of authority to make special rules for particular kinds of accounts should be broader than merely prescribing uniform rate calculation methods. Special flexibility may also be needed in determining the proper advertising and disclosure rules. Thus, for example, the Board's current proposal includes a requirement that ads for variable rate accounts state that the rate is variable. Such a provision may also be needed under this law and the Board should have sufficient flexibility to adopt it.
- The bill, as drafted, does not address the relationship between the proposed disclosure provisions and existing state laws. Since the bill would cover institutions already subject to state disclosure laws, it should clarify Congress' intention with regard to those laws.