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Statement by

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Vice Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Administrative Law and Governmental Relations

of the

Committee on the Judiciary

U.S. House of Representatives

July 14, 1983

SUMMARY OF STATEMENT OF PRESTON MARTIN,

VICE CHAIRMAN, BOARD OF GOVERNORS OF THE

FEDERAL RESERVE SYSTEM

The Board has in the past and continues to support the broad objectives behind efforts to improve the regulatory process and enhance public participation in regulatory proceedings. However, the goals and objectives of regulatory reform would be achieved more efficiently by careful analysis and review of individual agency functions rather than by imposition of the additional layer of administrative requirements envisioned by H.R. 2327.

The Board has been in the process of reviewing all of its existing regulations and currently operates under a number of procedures in its rulemaking activities that would be mandated by H.R.2327 such as those specified in Executive Order 12044, the Regulatory Flexibility Act, and the Financial Regulation Simplification Act.

An exemption from the procedures that would be mandated by the bill is provided for rules related to monetary policy. This exemption is necessary to preserve the flexibility required in the execution of monetary policy. The Board strongly supports this exemption and, in addition, believes that the limited exemption for rules related to the viability and stability of depository institutions and the financial activities of their holding companies should be expanded. Many of the same policy considerations relating to the need for flexibility of action and speed of response in the area of monetary policy apply to regulations concerning the safety and soundness of banks and thrift institutions. The Board is concerned that H.R. 2327 would seriously hamper the ability of the financial supervisory agencies to react to rapidly changing situations in the financial industry that may require prompt and effective regulatory actions, including authorizing new powers and activities.

I am pleased to appear before this Subcommittee to present the views of the Federal Reserve Board on H.R. 2327, the Regulatory Reform Act of 1983. My testimony will describe the current regulatory review procedures of the Federal Reserve and the types of activities at the Federal Reserve on which the legislation would have an impact. Furthermore, I will discuss the effect of the procedures in the bill on the Board's regulations with respect to the supervision of banking organizations and review the bill's provisions concerning regulatory oversight and the legislative veto as they affect the Federal Reserve's monetary policy rules.

The Board has supported and continues to support the broad objectives behind efforts to improve the regulatory process and to enhance public participation in regulatory proceedings. We are aware that regulatory actions that are intended to promote the public interest may sometimes fail to achieve their objectives and can result in adverse effects both upon the affected industry and upon the general economy. Regulatory reform addresses the need to ensure that the likely effects of proposed regulations are more carefully considered before they are adopted and that existing regulations are reviewed periodically to assess continued need and effectiveness. To this end, the Board supports the goals of simplifying regulations, reducing the existing regulatory burden, and avoiding unnecessary regulation in the future.

However, I believe that the goals and objectives of regulatory reform would be achieved more efficiently by careful analysis of individual agency functions rather than by imposition of an additional layer of administrative requirements as envisioned by H.R. 2327.

As you are aware, the Federal Reserve has long been committed to regulatory improvement and the reduction of unnecessary burdens. Our current regulatory review procedures are a culmination of the steps we have taken over the last several years to fulfill this commitment. In 1978, we established our Regulatory Improvement Project, shortly before President Carter issued Executive Order No. 12044 requiring executive agencies to follow certain procedures with the objective of reducing regulatory burdens. We wrote to President Carter and later to President Reagan to offer our voluntary compliance as being in the spirit of their executive orders on regulatory improvement. The Board's Project was charged with conducting zero based reviews of each existing Federal Reserve regulation and ensuring that proposed regulations and amendments to existing rules were subject to the same review. Thus far, we have completed or are completing review of 17 of our 27 regulations, including those relating to monetary policy and consumer protection. We have eliminated three regulations and have substantially revised fourteen other regulations.

In conducting our reviews of existing regulatory provisions and of new regulatory proposals, the Regulatory Improvement Project staff initiates the preparation of regulatory analyses by staff at the Reserve Banks and the Board. We follow a flexible approach in these analyses and tailor each to fit the characteristics of the particular regulation and the underlying statutory requirements. For example, where the statutory charge to the Federal Reserve is broad, as in the securities credit area, we devoted a substantial amount of resources to the review and explored many alternatives. In other cases, where statutory provisions are very specific and establish the basic regulatory framework, as in the case of Truth in Lending and the Monetary Control Act, our analyses addressed more technical aspects and focused on designing methods to minimize burden and the difficulties of compliance. As a result of our efforts, considerable progress has been made in reducing the burden of compliance in several areas.

Because we have, thus far, been able to use such a flexible approach in our regulatory analyses, we believe that they have generally been more useful. The regulatory analyses have provided Board members information in a systematic fashion, helped focus attention on critical issues, clarified areas of uncertainty and informational deficiencies and, thus, helped the Board to respond to issues arising from changes in the financial markets as well as public concerns as to information, disclosure and financial structure.

Although the Board has found regulatory analyses beneficial, I have strong reservations about the additional benefits to be gained from provisions, such as those contained in H.R. 2327, that require agencies to conduct specific cost-benefit analyses based on estimated economic costs. The Federal Reserve has conducted such studies in the past. Our most recent efforts concerned a review of three regulations in the consumer credit area, conducted in 1981-1982. We found that a majority of financial institutions did not have data on their compliance costs readily available on a consistent basis. In addition, institutions found it very difficult to identify the likely costs of prospective regulations; it is only as institutions implement their compliance programs that they discover all the implications of the regulation. This is not to say that cost-benefit analyses are not useful on a conceptual level, since analysts attempt to identify all areas where the costs may be incurred and try to articulate clearly the likely benefits. But one should be aware that there are usually indirect and more subtle costs associated with regulation with respect to reduced freedom of choice for the regulated and the consuming public. This suggests to me that specific statutory requirements for cost-benefit analyses may impose unwarranted burdens and costs for consumers and the industry without yielding sufficient information to identify clearly the best regulatory choice.

The Federal Reserve supported the enactment of the Financial Regulation Simplification Act of 1980, which prescribes regulatory improvement procedures for the federal financial regulatory agencies. This Act mandates the coordination of regulatory efforts and the establishment of programs for the periodic review of existing regulations. Agencies must attempt to ensure that compliance costs, paperwork, and other burdens on the public are minimized. Additionally, the Act requires the federal agencies to submit annual reports to Congress on their regulatory simplification efforts.

For example, through its annual report of 1982, the Board reported to Congress that it had made significant strides in simplifying compliance across the spectrum of its regulations. The Board removed barriers to entry into various areas by permitting Edge corporations in the United States to offer certain investment advisory and management services and bank holding companies to offer expanded data processing services, securities discount brokerage, and certain consulting services.

An example of the Board's regulatory simplification efforts over that time period in the consumer area concerns the electronic funds transfer (EFT) rules. The Board adopted amendments to this regulation to grant relief to providers of EFT services by eliminating duplicate periodic statements for certain intra-institutional transfers, exempting small institutions from provisions regulating preauthorized electronic transfers and lifting certain burdens from institutions that are members of debit-credit card networks.

As an additional step in reducing regulatory burden, the Federal Reserve has implemented the provisions of the Regulatory Flexibility Act adopted in 1980. That Act requires all federal agencies to consider the impact of regulations on small entities and to conduct regulatory analyses and periodic reviews of regulations. As examples of our efforts under this Act over the last year, the Board has reduced reporting for reserve requirement purposes for small depository institutions and has exempted institutions with assets of $25 million or less from the requirements of Regulation E governing participation in preauthorized credit and debit programs of the federal and private sectors.

The Regulatory Flexibility and Regulatory Simplification Acts thus represent statutory requirements under which the Federal Reserve and the other financial regulatory agencies now operate that parallel those proposed for regulatory review procedures as part of the current bill for regulatory reform. I respectfully suggest a further review of the success of regulatory reform under the existing statutory requirements would be warranted before adopting a proposal that would add additional administrative requirements. The proposed procedures may not contribute significantly to the procedures the agencies currently employ.

H.R. 2327 establishes complex procedures for adopting rules, authorizes the President to specify certain proposals as "major rules," and provides the Office of Management and Budget with the authority to establish additional procedures for the implementation of "major rules." We are pleased that section 621(a)(5)(B) recognizes the unique role monetary policy plays by specifically exempting from the revised procedures rules "relating to monetary policy proposed or promulgated by the Board."

The proper conduct of monetary policy requires a high degree of discretion and a minimum of complex procedural rules that could delay and frustrate timely and effective action responsive to the changing needs of the economy. The Senate previously recognized the need for flexibility when it passed S. 1080 last year. The Board continues to believe that an exemption for monetary policy actions is essential for the effective implementation of monetary policy.

It is important to note the types of monetary policy actions that have been exempted from the provisions of the bill. Monetary policy is carried out, in part, under rules made in connection with the operation of the Federal Reserve's discount window, through which the Federal Reserve performs its function as lender of last resort, and through which loans are made to banks and thrifts for short-term, seasonal, and extended borrowing needs. Another example of monetary policy actions involve rules such as those establishing reserve requirements, a basic tool for influencing the level and growth of the money supply and the availability of credit. Lastly, monetary policy actions include rules relating to margin credit, and interest on deposits.

The provisions for Executive oversight would compound the problems of procedural delays in the taking and implementing of decisions that must be carried out immediately in order to have their proper market impact, while, at the same time raising the fundamental question of the appropriate division of responsibilities for the execution of monetary policy. This concern would still arise even if the oversight provision were advisory.

The issue of the legislative veto appears to have been rendered moot by a recent decision by the Supreme Court.[1/] However, in the event that a legislative veto is fashioned that passes constitutional muster, the Board would continue to caution that such an authority could seriously hamper the speed and flexibility that is needed for the effective conduct of monetary policy. The conduct of monetary policy by the Federal Reserve already is subject to continuing close scrutiny by the Congress. In this regard, the Board reports twice each year before the Banking Committees concerning the System's objectives for monetary policy and appears before committees on

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1/ In Immigration and Naturalization Service v. Jagdish Rai Chadha (51 U.S.L.W. 4907 (U.S. June 21, 1983), affirming 634 F. 2d 408 (9th Cir. 1980)), the Court held that a legislative veto violated the principle of separation of powers of the executive and legislative branch and was unconstitutional.

numerous occasions to discuss monetary policy goals. Accordingly, we urge that the Federal Reserve's monetary policy functions continue to be excluded from the scope of H.R. 2327.

Many of the same policy considerations relating to flexibility of action and speed of response in the area of monetary policy apply to regulations concerning the safety and soundness of banks and thrift institutions. Therefore, we urge Congress to consider applying the same exemptions covering oversight and veto to these rules. There is an inherent link between the central bank's responsibility for the stability of the financial system and the conduct of monetary policy. The Board is concerned that H.R. 2327 as it is currently structured would seriously hamper the ability of the agencies to react promptly and effectively to individual problem situations. Moreover, the need for flexibility in the regulation of financial institutions is particularly acute at the present time when those institutions are engaged in historically unprecedented innovative activities in response to the rapidly evolving competitive environment.

The procedures prescribed by the bill could undermine the ability of the financial institution regulators to maintain an appropriate foundation of safety and soundness upon which the financial system in the United States can continue to evolve and develop. For these reasons, we urge adoption of the provision that excludes rules of the agencies relating to depository institution viability and stability or safety and soundness from designation as major rules. (As a technical point, we recommend that the bill be clarified to assure that the exemption also applies to the financial activities of depository institution holding companies.)

The existing exemption, which would be almost identical to one contained in S. 1080, provides that a rule will not be regarded as a major rule, subject to the new procedural requirements, if it relates to the viability or stability of federally insured depository institutions. This provision is intended to give the federal financial regulatory agencies flexibility in determining what constitutes a rule subject to the additional major rule procedural requirements of the Act. It may be that this provision should be broadened further in that it does not exempt such rules from Executive oversight. Specifically, the President could still determine that such a rule is a "major rule," thus subjecting it to additional requirements that could adversely affect the ability of the agencies to react promptly and flexibly.

The authority to implement rules related to the viability or safety and soundness of depository institutions, including bank holding companies, has been entrusted to the federal financial regulatory agencies in order to assure that public confidence in the nation's depository institutions is upheld. The presence of public policy vehicles ensuring the well being of these institutions such as Federal agency supervision and examination, federal deposit insurance and

Federal Reserve "discount window" facilities reflects Congress' view as to the importance of financial stability. The loss of public confidence in depository institutions can have wide-ranging and adverse consequences, as has been demonstrated in the early 1930s and before. This potential requires the capability of prompt and effective corrective actions on the part of regulators. In this regard, the need for financial regulators to have the ability to act quickly was underlined again over the last two years by the serious problems encountered by the nation's thrift industry, and the unusual demands this placed on the FSLIC and FDIC.

Some examples of rules falling within the viability or stability category would be those covering such subjects as required or permissible levels of liquid assets, borrowings, reserves, or net worth; appropriate accounting, appraisal or underwriting practices; and prudent involvement in the futures or forwards markets. The thrust of such rulemaking is toward observance by a financial institution management of safe and sound practices that do not involve abnormal or undue risk of loss, or that do not tend to undermine public trust and confidence in such institutions. Rules that would be covered under asset powers would involve matters such as implementation of statutory authority to change lending limits or to engage in new investment activities. Rules relating to the various rates of interest payable on deposits would also be covered, although it should be recognized that many of these would expire when the Depository Institutions Deregulation Committee completes its labors and goes out of existence by March 31, 1986.

The current financial environment, characterized by persistent uncertainties about price stability, constantly changing technology and increased competition from largely non-regulated industries, demands that regulators continue to be authorized to provide regulated institutions with an appropriate regulatory framework, within prescribed statutory limits, on an expeditious basis. This will ensure that the deregulation and expansion of powers that is currently taking place in the financial industry is not thwarted by rigid procedural burdens.

While the limited exemption relating to rules concerning viability and stability would cover a significant range of activities, other regulations of the agencies would continue to be covered by the requirements of the Act. Most prominent would be regulations issued by the financial regulators under such laws as the Home Mortgage Disclosure Act, the Truth in Lending Act, the Fair Housing Act, and the Community Reinvestment Act. These regulations are among those that do not involve financial viability or affect safety and soundness. We believe it appropriate to subject those types of regulations to the requirements of the Act, particularly since regulated institutions believe them to be the most burdensome with which to comply.

In closing, I believe the Board has demonstrated its support for efforts to improve the regulatory process. It is our judgment that the objectives of regulatory simplification and reform would not be best achieved by imposition of an additional layer of administrative requirements. We continue to be concerned with any new requirements that could reduce our ability to react promptly and effectively during this period of rapid change in our financial system. Given the specific regulatory reform measures enacted and implemented by the federal financial regulatory agencies within the past three years, and our experience with those provisions, the Board believes that the existing review procedures are serving the public well and that further requirements applicable to these agencies are not needed at this time.