The Federal Reserve Board

# Testimony of Governor Laurence H. Meyer

***S. 1405, the Financial Regulatory Relief and Economic Efficiency Act of 1997***
**Before the Committee on Banking, Housing and Urban Affairs, U.S. Senate**
**March 10, 1998**

The Board of Governors appreciates this opportunity to comment further on S. 1405, the Financial Regulatory Relief and Economic Efficiency Act of 1997. The members of this Committee, and in particular Senators Shelby and Mack, are to be commended for the leadership role you have taken over the past several years in reducing unnecessary burdens on our nation's banking system. This Committee has recognized that unnecessary regulatory burdens hinder the ability of banking organizations to compete effectively in the broader financial services marketplace and, ultimately, adversely affect the availability and prices to consumers of banking services and credit products.

This bill represents a further effort by this Committee to eliminate unnecessary regulatory burdens. The Board believes that a number of sections of this bill accomplish that purpose and recommends their adoption. Several other provisions, however, appear inadvertently to have gone beyond the goal of regulatory relief and may result in changes to the law that were neither intended nor desired. In this testimony, I would like to highlight some of the provisions that the Board supports and some of the areas with which the Board has concerns. (Attached to this statement is an appendix containing several technical suggestions and comments on other provisions of the bill that are not discussed directly in my testimony.)

**The Committee's Past Successes**
This Committee has twice approved comprehensive legislation to ease regulatory burdens for financial institutions. As the Board stated at the time the Committee was considering these prior legislative initiatives, the banking industry badly needed the type of regulatory burden relief embodied in the Community Development and Regulatory Improvement Act of 1994 ("1994 Act") and in the Economic Growth and Paperwork Reduction Act of 1996 ("1996 Act").

Prior to the passage of these two Acts, the aggregate regulatory burden on our nation's banking organizations had become substantial. The Board supported the efforts of the Committee and voiced its concern that obsolete and dysfunctional regulations were handicapping the ability of U.S. banking institutions to operate in increasingly competitive financial markets, both domestic and global. Taking heed of the calls for regulatory reform from the Board and others, this Committee fashioned important legislation to revise anachronistic banking statutes that were imposing costs without providing commensurate benefits to the safety and soundness of financial institutions, consumer protection, or credit availability.

In the 1994 Act, the Committee alleviated the paperwork burden for banking organizations seeking to gain federal approval to engage in certain transactions, enhanced the efficiency of the regulatory process by eliminating applications and other filing requirements, and streamlined examination and audit procedures. Two years later, with the support of the Board, the Committee passed the 1996 Act, which, among other steps, permitted well-capitalized and well-managed institutions to commence previously approved nonbanking activities without filing an application. In the 1996 Act, the Committee also passed important reforms to consumer protection statutes that alleviated the burdens imposed by these statutory provisions on financial institutions without undercutting the goals of the consumer protection laws.

**Our Efforts at the Board**

The Board has long recognized that regulatory burdens on our nation's financial institutions must be reduced. Consistent with the mandate of Congress and this Committee, the Board has sought to ensure that regulatory requirements are imposed only when they are needed to accomplish the statutory responsibilities of the Board. For example, within the past two years, the Board has substantially revised its Regulation Y (which primarily governs bank holding companies) and has proposed comprehensive revisions to its Regulation H (which governs membership of state banks in the Federal Reserve System) and its Regulation K (which governs international banking operations). These changes will make the Board's regulations simpler, less burdensome, and more transparent while still providing banking organizations with powerful incentives to maintain strong capital positions, preserve solid management, and serve the needs of their communities.

The efforts of the Board, coupled with the mandates of this Committee, have had a bottom-line, practical effect: fewer applications need to be filed with the Board, and banking organizations have saved substantial regulatory, legal, compliance, and other costs. In short, these changes have enhanced the competitiveness of banking organizations that are regulated by the Board and have benefited the customers of these financial institutions.

**The Provisions of this Bill**

S. 1405 contains some important additional reform provisions. As I stated before the Committee last week, the Board strongly supports the provision in section 101 of this bill that would permit the Federal Reserve to pay interest on reserve balances that depository institutions are required to maintain at Federal Reserve Banks. Because required reserve balances do not earn interest, banks and other depository institutions employ sweeps and other costly procedures to reduce such balances to a minimum. These reserve avoidance techniques represent a waste of resources for the economy and could also potentially complicate the implementation of monetary policy. Allowing the Board to pay interest on required reserve balances would not only eliminate economic inefficiencies, but also alleviate risks that could affect the future implementation of monetary policy. In addition, as I mentioned last week, the Board would support allowing the Federal Reserve the option to make payment of interest on "excess" reserves, which could be a useful tool for monetary policy.

The Board also strongly endorses the provision in section 102 that would permit all depository institutions to pay interest on demand deposits, including deposits made by businesses. As I explained more fully last week, the prohibition of interest on the demand accounts of businesses is an anachronism that no longer serves any public policy purpose. On the other hand, this prohibition imposes a burden both on banks and on those holding demand deposits, especially small businesses, which frequently do not have the resources to implement sophisticated cash management programs. Repeal of the prohibition would remove an unnecessary regulatory burden, enhance the competitiveness of depository institutions, and benefit bank depositors.

There are other parts of this bill, as well, that would relieve regulatory burden without giving rise to safety and soundness, supervisory, consumer protection, or other policy concerns. For example, section 203 would eliminate the outdated and largely redundant requirement in section 11(m) of the Federal Reserve Act, which currently sets a rigid ceiling on the percentage of bank capital and surplus that may be represented by loans collateralized by securities. Current national and state bank lending limits address concerns regarding concentrations of credit more comprehensively than section 11(m), but do so without the unnecessary constraining effects of this section of the Federal Reserve Act.

In another area, the alternative consumer credit disclosure mechanisms permitted by sections 401 and 402 will be less burdensome to creditors and just as helpful to consumers as the disclosure requirements embodied in current law. Congress has already eliminated the requirement that creditors disclose a historical-table for closed-end variable rate loans. Taking similar action with respect to open-end variable rate home-secured loans, and permitting creditors to make alternative disclosures to meet their obligations with regard to credit advertising under the Truth in Lending Act, would reduce regulatory burdens without sacrificing consumer protections.

The Board supports other sections of the bill as well. Section 304, which would eliminate the banking agency report on differences in capital and accounting standards, is a provision that would terminate a reporting requirement that is no longer necessary in light of the considerable progress the agencies have made (at this Committee's direction in the 1994 Act) in conforming their capital and accounting standards. Section 109 would provide a uniform limit on loans by banks to their executive officers, thereby diminishing confusion among regulated institutions and reducing regulatory burden across institutions with different regulators. Section 306, which would eliminate the Thrift Depositor Protection Oversight Board, would save the government money by terminating an administrative board whose primary function, oversight of the Resolution Trust Corporation ("RTC"), ceased when the RTC closed in 1995. Moreover, as discussed in the appendix, section 502 would make an important change in the health benefits available to FDIC and Board retirees.

A few other provisions of this bill, however, appear to go beyond the Committee's goal of regulatory relief or represent such fundamental changes in the federal regulatory system as to warrant a fuller debate in the context of broad financial modernization legislation. The Board is concerned that these provisions, as currently drafted, may result in changes to the law that the Committee did not intend and will have effects that the Committee may not desire. Some of these changes may give certain entities unfair competitive advantages; other provisions appear to extend taxpayer subsidies in a manner that would not seem warranted.

**Nonbank Banks**

Several provisions of S. 1405 would eliminate a number of important limitations that have been applied to nonbank banks. For example, section 208 would greatly enhance the ability of nonbank banks to expand their banking operations by allowing them to acquire any undercapitalized bank. Section 116 would allow nonbank banks to permit their affiliates to incur overdrafts at the nonbank bank and would allow nonbank banks to incur overdrafts at the Federal Reserve on behalf of affiliates. This section also would remove restrictions in current law on the cross-marketing of products by nonbank banks and their commercial affiliates. Section 205 would allow nonbank banks to offer business credit cards even where these business loans are funded by insured demand deposits. Finally, section 117 would liberalize the divestiture requirements that apply when companies violate the nonbank bank operating limitations.

Eliminating restrictions on nonbank banks, at first glance, may have intuitive appeal. However, there are important reasons why the Board is concerned about these provisions. Nonbank banks -- which, despite their popular name, are federally insured, national or state-chartered banks -- came into existence by exploiting a loophole in the law. By means of this loophole, industrial, commercial, and other companies were able to acquire insured banks and to mix banking and commerce in a manner that was then, and remains today, statutorily prohibited for banking organizations. These companies also have avoided the comprehensive framework of prudential standards and supervisory examination and review under the Bank Holding Company Act that governs all other corporate owners of insured banks.

In 1987, in the Competitive Equality Banking Act ("CEBA"), Congress closed the nonbank-bank loophole. At that time, Congress chose not to require the 57 companies operating nonbank banks to divest these institutions. Instead, Congress permitted the companies owning these banks to retain their ownership so long as they complied with a carefully crafted set of limitations on the activities of nonbank banks and their parents. In a unique statutory explanation of legislative purpose, Congress stated in CEBA that these limitations were necessary to prevent the owners of nonbank banks from competing unfairly with bank holding companies and independent banks. In addition, Congress found that the restrictions were needed to address potential adverse effects, including conflicts of interest, that could result from the ownership of these insured banks by companies that, unlike bank holding companies, are not subject to federal supervision or regulation or to the federal proscription against mixing banking and commerce.

Fewer than 25 nonbank banks currently claim the grandfather rights accorded in CEBA. The Board is concerned that removal of the limitations and restrictions that apply to nonbank banks would enhance advantages that this relative handful of organizations already possess over other owners of banks and would give rise to the potential adverse effects about which Congress has in the past expressed concern. In addition, removal of these limitations would permit the increased combination of banking and commerce for a select group of commercial companies, creating potential disadvantages and inequities for all other companies, including banks and bank holding companies.

As this Committee is aware, there is significant debate in the context of broader efforts to modernize our financial laws regarding whether it is prudent to remove the existing separations between banking and commerce. Because reform of the nonbank bank provisions raises fundamental questions regarding the mixing of banking and commerce, the Board believes that reform of the provisions governing nonbank banks should be considered within the framework of broad financial modernization rather than in the context of efforts to reduce regulatory burden.

**Thrift Powers**

S. 1405, as drafted, also would appear to expand the mixing of commerce and banking by owners of savings associations. In particular, section 107, which appears to have been intended to allow a savings and loan holding company ("SLHC") to acquire a noncontrolling interest in a savings association, would also permit multiple-SLHCs, with the approval of the Office of Thrift Supervision, to acquire more than 5 percent of the shares of any company, including any commercial firm. This would seem to expand the ability of multiple-SLHCs to mix banking and commerce to an unlimited degree, a result that the sponsors of this bill may not have intended. The Board supports clarifying the language in the bill to ensure that the powers of multiple-SLHCs are not unintentionally broadened, and advocates retaining the current proscription against allowing multiple-SLHCs to acquire a significant interest in a commercial company.

**Daylight Overdrafts**
Section 118 would require the Federal Reserve to make intraday credit, in the form of daylight overdrafts, available to the Federal Home Loan Banks. As it did in the last Congress, the Board strongly opposes this proposal, which would provide special treatment to the Federal Home Loan Banks over other GSEs and other lending institutions as well as over all depository institutions with access to central bank credit.

Section 118 would represent the first time that Congress has mandated the availability and price of central bank credit. As such, this bill would serve as precedent for other GSEs to meet intraday liquidity needs with Federal Reserve credit at an administered interest rate instead of with the proceeds of obligations issued in the markets at competitive rates as contemplated by their statutory funding schemes.

In addition, section 118 would serve as a precedent for regularly extending Federal Reserve credit to institutions that are not subject to reserve requirements and, therefore would grant the Federal Home Loan Banks access to that credit on terms more attractive than those available to depository institutions. For these reasons, the Board opposes extending the availability of routine daylight overdrafts to the Federal Home Loan Banks.

**Price Discounts**
Section 204 is intended to allow banks to discount the price of products and services that are offered in bundles to consumers. Current law prohibits banks from offering price discounts in most situations, even though this is a common practice in other industries and even though consumers benefit from receiving a price discount on the purchase of a combination of products and services.

In the past several years, the Board has utilized authority granted to it by Congress to craft a number of exceptions to current law that allow banks to offer price discounts on bundled products. For example, the Board has allowed banks to offer discounts to customers that maintain a certain level of deposits at the bank so long as both the deposit accounts and the other bundled products are also separately available to the public. This type of price discounting both saves money for consumers who desire the bundled products and allows consumers who are not interested in purchasing the entire bundle of discounted services to purchase individual products or services separately at competitive prices.

Section 204, as currently drafted, would appear to go further than is necessary to allow this type of price discounting. The Board would support efforts to allow banks to offer price discounts to customers that choose to acquire multiple products or services from banks and their affiliates where the bundled products and services are also made available separately to customers at competitive prices.

**Affiliations with Government-Sponsored Enterprises**
A provision in section 113 would remove the current restriction on bank affiliations with GSEs. As worded, the section would appear to permit a bank or bank holding company to acquire control of any GSE and to permit any GSE to acquire an insured bank. This broad change, involving all GSEs, raises significant policy issues that the Board believes go beyond the scope of regulatory burden relief. For example, this change raises the questions: Is it desirable to allow a banking organization to exercise control over a GSE? Would a banking organization that affiliates with a GSE gain competitive advantages over its peers from the special tax and quasi-governmental status of the GSE? Would the secondary markets that rely on GSEs be affected if a single banking organization acquires control of a GSE? Conversely, is it appropriate to allow any GSE to acquire control of an insured bank?

These and other questions are raised by a statutory change that would affect all GSEs, but the Board understands that the provision in section 113 is intended to address an existing relationship involving a banking organization's ownership of shares of a single GSE. This situation may be better addressed with a narrower provision that does not raise concerns regarding control of GSEs more broadly.

**Closing Thoughts**
The Board applauds the efforts of the Committee to continue to eliminate unnecessary government-imposed burdens. The Committee's past successes in regulatory reform and relieving regulatory burdens on banking organizations, coupled with the efforts of the bank regulatory agencies, necessarily make the Committee's task today a difficult one. The Committee's substantial previous efforts have left fewer areas in banking law that require reexamination outside the context of comprehensive financial modernization. As a consequence, in some areas, S. 1405 attempts to resolve issues that are better addressed in broader legislation that would reform the financial services industry.

The Board has long endorsed financial modernization strategies that ensure regulatory equity for all participants in the financial services industry, that minimize the chances that federal safety net subsidies will be expanded into new activities and beyond the confines of insured depository institutions, and that guarantee adequate federal supervision of financial organizations. The Board would be pleased to work with the Committee and its able staff to reach these goals.

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**Appendix: Additional Views of the Federal Reserve Board**

*Sec. 105: Regulation and Examination of Service Providers*

This section would, among other things, permit the OTS to regulate and examine a third party that contracts with a savings association (or a subsidiary or affiliate of a savings association) to provide services that the savings association (or its subsidiary or affiliate) is authorized to perform.

The section also appears mistakenly to eliminate the existing enforcement authority of the OTS over service corporations. The section should not strike the enforcement authority of the OTS that is found in section 8 of the Federal Deposit Insurance Act, 12 U.S.C. § 1818(b)(9).

*Sec. 110: Expedited Procedures for Certain Reorganizations*

This section would allow national banks to reorganize to become bank holding companies. The Board has no objection to this provision, but believes that the language should be clarified to state that the Bank Holding Company Act ("BHC Act") would still apply to the formation of a bank holding company. The absence of such language could result in different interpretations and cause confusion regarding the applicability of the BHC Act to such reorganizations.

*Sec. 115: Purchased Mortgage Servicing Rights*

Current law requires banks and thrifts to value purchased mortgage servicing rights ("PMSRs") at no more than 90 percent of fair value. As a result, current law effectively imposes a 10 percent capital haircut on PMSRs. This section would eliminate that haircut requirement by allowing banks and thrifts to value PMSRs at no more than 100 percent of fair market value when computing Tier I capital. This section also would update the terminology used in current law to reflect current accounting rules. The Board recommends that the federal banking agencies be granted authority to modify or eliminate the 10 percent haircut, if the agencies make a finding that doing so would not have an adverse effect on the depository insurance funds or the safety and soundness of the institution or institutions involved.

*Sec. 210: Call Report Simplification*

This section restates section 307 of the Riegle Community Development and Regulatory Improvement Act. The Board and the other banking agencies, working through the Federal Financial Institutions Examination Council, have made substantial progress in implementing the mandate of section 307. Thus far, the agencies have eliminated approximately 80 Call Report data items; placed revised Call Report instructions and forms on the Internet; adopted Generally Accepted Accounting Principles ("GAAP") as the reporting basis for all Call Reports; produced a draft core report; condensed four sets of Call Report instructions into one; provided an index for Call Report instructions; reported to Congress on recommendations to enhance efficiency for filers and users; implemented an electronic filing requirement for all institutions submitting Call Reports; and placed much of the Call Report data on the FDIC's public website. The agencies are currently surveying end-users to identify additional Call Report items that could be eliminated, while retaining items that are essential for safety and soundness and other public policy purposes. This progress made by the agencies to date suggests that this section of S. 1405 is not necessary.

*Sec. 302: Elimination of Duplicative Disclosure of Fair Market Value of Assets and Liabilities*

This section would eliminate a requirement found in current law that the federal banking agencies develop a method for insured depository institutions to provide supplemental disclosures of estimated fair market values of assets and liabilities in reports required to be filed with the agencies. The agencies have relied on requirements in GAAP for institutions to disclose fair market values and, thus, the agencies have not needed to develop a separate methodology. As these GAAP requirements remain in place, the current law's requirement is duplicative and unnecessary. Accordingly, the Board supports the provision in section 302.

*Sec. 305: Agency Review of Competitive Factors in Bank Merger Act Filings*

This section would amend current law to eliminate the requirement that three competitive reviews, one by each of the federal banking agencies, be conducted for each bank merger. The Board supports this change.

This section also would amend current law to provide a list of factors that the Board and other banking agencies must consider in determining whether a proposed banking acquisition or merger would substantially lessen competition. The Board currently considers many of these factors in its competitive analysis to the extent that data are available.

However, section 305 does not take account of the fact that data may not be available to address some factors in individual markets. Moreover, consideration of a newly listed factor may require collection of significant currently unreported data from banking and nonbanking competitors that are not involved in the merger, thereby resulting in a substantial increase in reporting burden. To assure that consideration of the new factors does not result in an increase in burdensome regulatory reporting requirements, the Board suggests that section 305 by amended to provide that the newly added factors be considered "insofar as data are readily available."

*Sec. 401: Alternative Compliance Method for APR Disclosure*

The Truth in Lending Act ("TILA") and its implementing Regulation Z, 12 C.F.R. Part 226, require creditors to give consumers, generally at the time of an application for credit, detailed information about certain home-secured loans. Under current law, creditors offering consumers an *open-end* variable-rate, home-secured loan must provide, among other things, a detailed table showing a fifteen-year history of the changes in the index or formula used to compute interest rates that would have affected the rate and payment on a $10,000 sample loan. Section 401 would amend TILA to permit certain alternative disclosures for creditors offering *open-end,* home-secured *lines of credit.* Under this provision, creditors would be able to provide either the table mandated in current law *or* a statement that periodic payments may increase or decrease substantially.

The Board supports the proposed change. The primary purpose of the table, which is to demonstrate to consumers that fluctuating rates may affect their payments, would be adequately addressed by a less burdensome and more straightforward disclosure that periodic payments may vary substantially. In 1996, Congress provided a similar alternative disclosure in lieu of the historical table for *closed-end,* variable-rate, home-secured loans.

*Sec. 402: Alternative Compliance Method for Advertising Credit Terms*

TILA requires the uniform disclosure of cost information in advertisements. Generally, if certain information is included in an advertisement (a "triggering" term), other information also must be disclosed ("triggered" terms). For example, the reference in a credit advertisement to the number of payments in a loan would obligate the creditor to make additional disclosures. Section 402 would amend current law to eliminate "the number of installments or the period of repayment" as a triggering term in advertisements for closed-end credit products. The Board supports this change. The amendment would reduce burden for creditors without adversely affecting consumer protections.

Section 402 also would allow alternative disclosures for radio and television advertisements concerning various types of credit transactions, including home-secured loans, installment loans, and lines of credit. Under this provision, creditors would be able to provide basic rate information and then provide a toll-free number that consumers can call to request further information. This amendment would avoid the potential laundry-list of credit disclosures in radio or television credit advertisements that often get quickly recited at the end of advertisements while still providing consumers with the disclosures both through a toll-free number and at the time the consumer applies for credit.

The Board generally supports the proposed changes, but we suggest a minor correction. The Board suggests that the proposed section 148(b)(1) of TILA be revised to make clear that, with respect to closed-end credit, creditors provide the simple interest rate and, with respect to open-end credit, creditors provide the periodic rate.

*Sec. 502: Consistent Coverage for Individuals Enrolled in a Health Plan Administered by the Federal Banking Agencies*

The Board supports this provision, which would permit retirees and near-retirees of the Federal Reserve and the FDIC to enroll in the Federal Employee Health Benefit Program ("FEHBP") and to maintain health insurance coverage under FEHBP in retirement. The change would provide affected Board and FDIC retirees and near-retirees with benefits already enjoyed by most Board and FDIC employees, and by all OCC and OTS employees.

Nearly 300 active and retired Board employees and approximately 2,000 active and retired FDIC employees would benefit from this change. The change also would result in substantial savings of health insurance costs to the government, simplify benefits administration, and provide affected individuals with a wider choice of health plans.

Because time has passed since the proposal was first introduced, however, some technical changes will be needed to section 502. In each place it appears, the reference to "January 3, 1998" should be changed to "or before January 2, 1999." In addition, the reference in subsection (b)(5) to "January 4, 1998" should be changed to "January 3, 1999, or such earlier date as established by the Office of Personnel Management after consultation with the Federal Deposit Insurance Corporation or the Board of Governors of the Federal Reserve System, as appropriate."