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Statement by

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before the

Committee on Banking, Housing, and Urban Affairs

and the Committee on Governmental Affairs

United States Senate

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I appreciate the opportunity to appear before the Committees today to present the views of the Federal Reserve Board on S.332. This bill would consolidate the bank supervisory functions of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the bank and bank holding company supervisory functions of the Federal Reserve into a newly created Federal Bank Commission.

In September, 1977 I testified for the Board in opposition to a similar bill, S.684, before the Senate Banking Committee. The Board opposed that bill because it saw no persuasive reasons for consolidating the three regulatory agencies. Moreover, the Board believed that consolidation would involve a number of distinct disadvantages that would outweigh any likely benefits. Today we continue to oppose agency consolidation, as proposed in S.332, for essentially the same reasons.

The primary objective of bank regulation is to maintain a safe and sound banking system. Therefore, the best measure of the performance of the present agency structure is the record of banking stability in this nation over the years. In my judgment, the record is very good. During the last several decades there has been only one brief period--during and immediately following the deep recession of the mid 1970s--when the banking system encountered any significant problems. Even then, the efforts of the three banking agencies helped to contain emerging problems so that the economy was not significantly affected. Since then, the condition of the banking system has strengthened and the problems of the mid 1970s are now largely behind us.

This excellent record of banking stability is certainly due in large part to good management of American banks. But it also indicates that the present agency structure has been effective. Indeed, it is hard to argue that this nation could have compiled this enviable record of banking stability if the present agency structure had serious flaws.

Proponents of agency consolidation have argued that the present statutory division of responsibilities among the three Federal banking agencies is complex and often overlapping. There is, of course, some truth to this charge. But the three agencies have worked out numerous arrangements over the years that have eliminated most of these potential overlaps. For example, while all three agencies have the statutory authority to examine national banks, only the Comptroller of the Currency actually does so.

Proponents of agency consolidation also have criticized the three agencies for having inconsistent policies and procedures and have argued that agency consolidation would end this problem. Historically, there have been differences in agency practices. However, in the last several years the agencies have made a concerted effort to increase the consistency of agency policies and procedures. This effort has been spearheaded by the Interagency Coordinating Committee, which is composed of principals of the agencies, and the Interagency Supervisory Committee, which is made up of top supervisory staff of the agencies. Recent actions of these interagency groups have included the development of a uniform system for rating banks, a uniform approach for reviewing and commenting on the country risk element in bank lending abroad, a uniform set of regulations and examination procedures for ensuring compliance with the Community Reinvestment Act, and an interagency system for evaluating large shared national credits.

In testimony beginning in the mid 1970s, the Board recommended that Congress establish a Bank Examination Council. This Council would formalize existing cooperative arrangements among the Federal banking agencies and assure progress toward greater uniformity in examination principles, procedure and training. Last year the Congress accepted the Board's recommendation and established the Federal Financial Institutions Examination Council. The Council, which also includes representatives from the Federal Home Loan Bank Board and the National Credit Union Administration, will come into existence this March 10. Council members already are working on the group's initial organization and administrative procedures, and the Council will begin to tackle a variety of substantive issues promptly after it is established.

The Board believes that Congress was well advised last year to create the Council and avoid agency consolidation. Now that the Council is about to become operational, we urge that Congress give the Council a chance to perform.

In the Board's judgment, creation of the Federal Bank Commission at the present time would entail some particularly unfortunate consequences. Within the last year or so, Congress has passed massive banking legislation, including the Financial Institutions Regulatory Act, the International Banking Act and the Community Reinvestment Act. In total, the banking legislation enacted by the 95th Congress represents the largest amount of such legislation passed by any Congress since the 1930s. At present, both the banking community and the banking agencies have the sizable task of digesting and implementing all of this complex legislation. The banking agencies, for example, must write new regulations, design new report forms and establish new enforcement procedures. In this hectic environment, the Board believes that the creation of the Federal Bank Commission--with all of the temporary dislocations that this would inevitably involve--would be extremely disruptive. Such a reorganization could impair agency operations and adversely affect the implementation and enforcement of the new legislation.

In testimony during the last several years, the Board has cited other problems with agency consolidation of the sort proposed in S.332. Probably the greatest problem is that these bills would break the present link between bank supervision and monetary policy by removing the Federal Reserve from bank supervision. In the Board's judgment, breaking this link could at times impair the Federal Reserve's ability to carry out monetary policy effectively.

A primary objective of bank supervision is to maintain a safe and sound banking system. Supervisors normally seek to accomplish this objective by restraining excessive risk-taking by banks. The primary objective of monetary policy is to foster financial conditions that promote economic growth, full employment and stable prices. The Federal Reserve seeks to accomplish this objective through measures that influence the pace of expansion in money and credit and impact on the cost and availability of funds. While the objectives of supervisory policy and monetary policy are different, they are clearly interrelated. For example, supervisory actions that require banks to augment their capital positions may impact monetary policy by slowing the rate of growth of bank credit or reducing the availability of bank funds to particular borrowers. Moreover, decisions affecting the structure of bank holding companies or international banking organizations will impact on the performance of credit markets and the international flow of funds. These results, in turn, can influence how financial markets and the balance of payments respond to monetary policy actions.

While supervisory policy can affect monetary policy, monetary policy can also have consequences for supervisory policy by altering the financial environment in which banks operate. For example, a restrictive monetary policy tends to raise interest rates, producing what may be substantial declines in the market value of certain bank assets. Monetary policy, by restricting the growth in money and credit, can also place banks under liquidity pressure and adversely affect the financial flexibility and prospects of certain bank borrowers. Conversely, during periods of monetary ease, interest rates will tend to decline--putting pressure on bank earnings--while banking resources may grow so rapidly that bank capital ratios deteriorate. The conduct of monetary policy thus must always be carried out with the implications for bank performance clearly in mind.

On the basis of its experience, the Board is convinced that bank supervision and monetary policy are closely and inevitably linked, and that supervisory policy and monetary policy should not be determined in isolation. One of the virtues in the existing agency structure is that the Federal

Reserve is involved in bank supervision. As a result, there is assurance that economic stabilization considerations enter into the formulation of bank supervisory policy and that bank soundness is taken into account in the formulation of monetary policy.

The Board is aware that S.332 contains certain provisions designed to bring about a degree of coordination between supervisory policy and monetary policy. This would be accomplished by permitting the Chairman of the Federal Reserve Board to initiate procedures for rulemaking or the issuance of a policy statement whenever he determines that an action or activity of the Federal Bank Commission may have an impact on monetary policy. The proposed statute would also allow the Chairman to participate in an interpretation or the commencement of an adjudication by the Commission. While these provisions in S.332 give recognition to the close link between bank supervision and monetary policy, the Board seriously doubts that they would prove to be effective.

First, S.332 does not provide for any mechanism assuring that the Federal Reserve is adequately and promptly informed of bank supervisory policy actions about to be taken by the Federal Bank Commission, nor of the banking practices--or changes in banking practices--with which they are intended to deal. Without such a mechanism, the Chairman of the Federal

Reserve may not become aware of the monetary policy implications of certain Commission actions.

Second, even if the Chairman were to call for a rule-making or policy statement proceeding, there is no assurance that the Commission would give monetary policy considerations sufficient weight. The Commission would be responsible solely for maintaining a sound banking system and would be prone to overemphasize this public policy objective. The tendency to downgrade monetary policy considerations would be particularly likely if there were no Federal Reserve Board representation on the Commission. Such representation was provided for in the 1977 bill, but not in S.332. Once the link between bank supervision and monetary policy is broken at the policy-making level, we believe there will be serious risk that monetary policy could be impaired.

The major effect of S.332, of course, is intended to improve the overall character and quality of bank supervision. But it is by no means clear to the Board that agency consolidation, as proposed in S.332, would be entirely favorable. In fact, there are a number of reasons for believing that consolidation could have perverse consequences.

First, a single agency would be more inclined to abrupt shifts in supervisory policy--shifts that could destabilize the banking system. This is particularly true where, as in S.332, the chairman is given broad independent power over the activities of the Commission's staff and, at the same time, serves at the pleasure of the President. One of the advantages of the present tripartite system is that it contains certain checks and balances that tend to guard against such extreme shifts.

Second, there has been considerable concern expressed by Congress and others in recent years about regulators becoming captives of the industries that they regulate. While one should not assume that a single bank regulatory agency would necessarily be unduly influenced by the banking industry, agency consolidation would surely tend to increase that risk.

Third, agency consolidation could result in suppressing innovation in the banking industry. One of the prime concerns in many regulated industries is that the sole regulator may, by its behavior, serve to stultify progress in the industry. In contrast, one of the advantages of the tripartite agency structure in banking is the opportunity for experimentation. Under the present system, one regulatory agency can allow a certain degree of experimentation in the offering of new services. When and if it becomes clear that such services are of real benefit to the public and do not involve undue risks, the new practices will inevitably spread throughout the banking system.

Fourth, I believe that the removal of the Federal Reserve from bank supervision, as proposed in S.332, would adversely affect the quality of bank supervision. As the nation's central bank, the Federal Reserve brings to bank supervision a broad prerspective and an in-depth knowledge of the workings of the economy that should not be lost in the development and conduct of supervisory policy.

Proponents of the Federal Bank Commission seem to imply that agency consolidation would produce substantial operating efficiencies. The Board doubts that this would occur because almost all current agency operations will still have to be performed by the new Commission in order to maintain the present quality of bank supervision. It should be noted that the Comptroller General, after reviewing the existing structure of Federal bank regulation, indicated in his report to the Congress that a single agency would not be likely to provide any substantial cost savings.

As indicated earlier, the Board believes the banking agencies have made excellent progress in coordinating their policies and procedures over the last several years. But we also recognize that there is still room for further improvement in some areas, such as in the integration of holding company and international examinations. We are confident that this additional coordination can be accomplished through the new Examination Council and other existing organizational arrangements.

In conclusion, I would like to reiterate the Board's view that passage of S.332 would not be in the public interest. First, the proposal would replace the present agency structure that has worked well for over four decades with a single agency that would be an unknown. Second, S.332, by removing the Federal Reserve from bank supervision, would break the link between bank supervision and monetary policy--to the detriment of both. Third, the creation of the Federal Bank Commision at the present time could seriously disrupt the implementation of the major banking legislation passed by the previous Congress. And fourth, though it might create the appearance of more order on a table of organization, the proposed Federal Banking Commission would not save any substantial amount of expenditure, while it would pose all of the risks that an industry-encompassing super agency entails. In sum, the Board believes that the better course is to retain the present agency structure and to give the newly created Examination Council a chance to promote the greater uniformity in examination procedures and supervisory policy that is the principal aim of S.332.

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