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Statement by

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before the

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 am pleased to appear today on behalf of the Federal Reserve Board to discuss the numerous financial reform measures contained in the Senate-amended H.R. 4986, the related topics contained in H.R. 6198 and H.R. 6216, and recent proposals by Chairman St. Germain regarding deposit interest rate ceilings.

Most of the proposed financial reform measures being considered this morning address a range of problems that have as their root cause our escalating rate of inflation. Today's record-high interest rates are a direct product of that inflation, and these have put great pressure on our depositary institutions, with their heritage of loans and investments yielding the lower interest rates of the past. Moreover, the high current yields available in the market have reinforced the efforts of the public to seek interest-bearing substitutes for traditional money balances. Thus, changes in the operating policies of the institutions--and in underlying law and regulation--are being made necessary by the force of events. But the basic problem of the depositary institutions is unlikely to be solved until we begin to make significant progress in reducing the inflation that plagues our nation.

The Federal Reserve Board supports the essential thrust common to the major financial reform proposals before this subcommittee today. We endorse measures that mandate the phasing out of deposit interest rate controls and we favor the authorization of nationwide NOW accounts. But such actions, in an environment of inflation-induced high interest rates, will work also to intensify the pressures on depositary institutions to find additional ways to reduce their costs and sustain their earnings. For member commercial banks, this is likely to induce accelerated withdrawals from the Federal Reserve System, thereby undermining the ability of the central bank to administer an effective monetary policy.

The enactment of these legislative proposals would thus exacerbate the monetary control problem, adding to the already urgent need for a system of universal mandatory reserve requirements. Since this is a matter of absolute top priority, the Board's views presented today have been framed in the expectation that monetary improvement legislation will be enacted soon, and certainly before any of the cost-raising proposals considered here are scheduled to take effect.

In keeping with the Chairman's request, I will focus my comments on those sections of the proposed legislation that deal with maximum rates payable on deposits and the payment of interest on transactions accounts. However, the Senate-amended H.R. 4986 addresses many other topics of importance for the financial system. For your information, I have attached as an appendix a summary of the Board's views on the many provisions of H.R. 4986 of relevance to us, that cannot be fully covered in my prepared remarks. I would like to discuss briefly three of these provisions before turning to the main subject of these hearings.

Senate-amended H.R. 4986 would override existing Board policy by lengthening the permissible maturity of acquisition debt in one bank holding company formations. The Board opposes this provision because we believe that the proposed 25-year debt retirement period would lead to substantial increases in one bank holding company leverage and debt burdens, and could adversely affect the financial soundness of many of our country's smaller banks. However, the Board has recently requested public comment on proposals that would introduce greater flexibility into our existing policies on acquisition debt, but not jeopardize the safety and soundness of bank holding companies. These proposals

would shift the Board's focus to the attainment of a reasonable, specified debt to equity ratio withing a 12-year period, while maintaining adequate capital throughout in the underlying bank. I might note that industry reaction to date on the proposed new procedure has generally been quite favorable.

Another provision of H.R. 4986 calls for a moratorium of indefinite duration on takeovers of U.S. financial institutions by foreign interests. The Board has been reviewing the operations of foreign-owned banks in this country in the course of implementing the International Banking Act. This review has included issues concerned with the acquisition of U.S. banks by foreign bank holding companies, and supervisory problems that may be associated with such acquisitions. The Board has found no evidence that foreign ownership has produced harmful consequences for our banking system or for bank customers, and we believe that U.S. bank supervisors have adequate powers to deal with any abuses that might develop.

We are continuing to review the operations of foreign banks, in cooperation with other supervisory agencies. In addition, the General Accounting Office is studying these issues at the request of the Chairman of this subcommittee. A moratorium on foreign takeovers of U.S. banks is not needed to provide time to study the issues and would not help in the continuing process of review and evaluation of foreign-owned banks. Meanwhile, it would restrict the ability of some U.S. banks to strengthen their capital base through sales of stock to foreigners--a restriction that would be most burdensome on those banks that may be in the greatest need of capital. More generally, a moratorium could be regarded as a reversal of this country's longstanding policy of neutrality on foreign investment and the free international flow of capital.

And it could lead to retaliation by some foreign countries that would adversely impact on U.S. banks abroad.

In sum, a moratorium is a step that should be taken only if there is clear evidence of harmful effects that cannot be dealt with under existing authority. In the absence of such evidence--and none has yet been found--we see no justification for a moratorium.

Senate-amended H.R. 4986 also calls for the federal preemption of existing state usury ceilings on mortgage interest rates, unless overridden by state legislative action. The Board endorses this provision--although we would have preferred the States to act themselves because usury ceilings can at times distort the impact of monetary policy. When market rates exceed such ceilings, credit flows are dramatically reduced in the affected markets. If there were no usury ceilings, restrictive monetary policy could still be expected to impact on housing markets, but the threat of sudden and severe disruptions would be much reduced. It is in the best interests of public policy to avoid these excessive pressure points. The Federal Reserve would then rely on general credit restraint, in this market as in others, to accomplish its policy objectives.

Moreover, the elimination of mortgage interest rate ceilings would allow thrift institutions and others to lend at a market rate of return in local mortgage markets. The Board has long supported actions, such as the recent authorization of variable rate mortgages by the Home Loan Bank Board, that would help thrift institutions to earn returns on their overall portfolio of investments that would respond more flexibly to market conditions, since this must necessarily accompany the ultimate freeing of these institutions from deposit rate ceiling control. Most thrift institutions and many commercial banks are constrained in their capacity to pay competitive yields on all deposit liabilities

because a substantial share of their assets, being long-term in character, carry the lower interest rate returns of the past. The competitive position of depositary institutions has eroded further in each succeeding period of credit stringency, as depositors have become more aware of the growing number of alternative higher-yielding investment outlets available to small savers. Indeed, the increased attractiveness of market instruments to depositors has led banks and thrifts to promote aggressively the money market certificate--their one short-term deposit instrument whose ceiling rate rises in tandem with market rates. This has increased markedly the average cost of deposits, so that thrift institutions have been experiencing substantial downward pressure on their earnings margins.

In light of these considerations, the Board also favors the widening of thrift institution asset powers so that their portfolio returns may move more closely with market rates of interest. We support those provisions of the legislative proposals that authorize federally chartered thrift institutions to hold up to 20 per cent of their assets in consumer loans, commercial paper and a broader list of market securities. By shortening the average maturity of thrift assets, these investment powers should increase the flexibility of average portfolio returns. Such a limited widening in thrift institution asset possibilities would not likely have a significant adverse impact on overall mortgage credit flows, given the growing variety of alternative sources of mortgage credit.

Along with the liberalization of thrift institution asset powers, the Board strongly endorses the gradual elimination of deposit interest rate controls. We believe that such controls are anti-competitive, inequitable to small savers, and can be disruptive to financial and housing markets. By

restricting competition among commercial banks and thrifts, deposit rate ceilings have retarded the adjustment of many of these institutions to a changing market environment. Moreover, when market rates of interest move well above deposit rate ceilings, a substantial volume of savings tends to shift to nondeposit investment alternatives. In consequence, during such periods the housing market--the very market these ceilings were meant to protect and assist--experiences disproportionate declines in credit availability.

Allowing the thrift institutions to earn more market-oriented rates of return on their portfolios by widening their asset powers will help provide the additional earnings flexibility needed to allow them to pay market rates of return on an increasing portion of their deposit liabilities. But the Board believes that the phase-out of deposit rate ceilings must be gradual so as not to threaten unduly the viability of the institutions. The 5-year horizon provided in H.R. 6198 and Chairman St. Germain's proposal seems an appropriate goal. Market developments are proceeding too rapidly for the 10-year phase-out contained in Senate-amended H.R. 4986 to provide effective relief for depositary institutions and their customers. A 5-year phase-out of deposit interest rate ceilings--beginning toward the end of this year--should provide the regulatory agencies sufficient flexibility in managing the transition so as to balance the sometimes conflicting needs for consumer equity, thrift institution viability, and a stable flow of funds to local housing markets.

In this connection, I want to emphasize the importance of maintaining maximum flexibility in the phase-out schedule. The prudent speed of the ceiling rate phase-out is largely dependent upon prevailing market conditions. The

regulatory agencies should be authorized--as stipulated in Senate-amended H.R. 4986 and H.R. 6198--to postpone, adjust or accelerate the decontrol process as economic conditions warrant or permit. And, as also stipulated in both these bills, the regulators should be empowered to reinstate deposit rate ceilings after the end of the phase-out period in emergency situations.

In addition, the Board believes that money market certificates and the longer-term variable-ceiling certificates should be exempt from mandatory ceiling rate increases until the end of the phase-out period. These deposit instruments already are designed to provide returns that will vary with market conditions, and that yield very close to what can be obtained on market securities of comparable quality. Increasing these ceilings on any fixed schedule would quickly eliminate binding restrictions on such deposit rates and could lead to earnings problems arising from competition between types of depositary institutions during the transition period. Similar exemptions should, of course, apply to any other varible-ceiling instruments that float with the market introduced during the phase-out period.

With respect to H.R. 6198, introduced by Congressman Barnard, the Board cautions that the "maturity ratchet" phase-out, whereby rate controls are progressively eliminated beginning with the longest-term instruments on July 1, 1980, would have several undesirable aspects. This proposal effectively eliminates a true transition period, for the longest-term account ceiling would be eliminated almost immediately and such accounts might well be marketed at the highest institutional rates offered. Thus, a maturity phase-out could encourage institutions to accept large flows of funds into the longer-term deposit categories during a period when interest rates might in retrospect prove to have been unusually high.

Indeed, the maturity ratchet would act to lengthen the average maturity of thrift institution liabilities at the very time that expanded asset powers, such as those included in this bill, would be shortening the average maturity of thrift asset portfolios, making their return more responsive to movements in market rates. This could render thrift earnings particularly vulnerable if interest rates should begin to decline for any extended period. The Board would recommend that the phase-out procedure permit the institutions, to the extent possible, to choose the maturity structure of their liabilities best fitting their own interest rate expectations and portfolio structure. Raising all ceilings simultaneously best achieves this goal, even though it may delay the time that any one deposit category becomes free of rate control.

The Board also has a problem with the maturity structure incentives implicit in H.R. 6216, introduced by Congressman Patterson. This billspecifically mandates an increase only in the passbook savings account rate as soon as possible after 5 years. A sudden sharp rate increase in this account category, which would apply to both existing as well as new deposits, would be extremely costly and might well threaten the viability of some institutions--especially those, like savings banks, with a large proportion of their total deposits in passbook form. Moreover, any passbook ceiling rate consistent with the safety and soundness of the institutions probably would be well below market yields and therefore lead to little if any additional deposit inflow. Determining the relevant market rate for passbook accounts would be difficult, moreover, since there is no market instrument that has equivalent liquidity, convenience and safety. The Board looks forward to the day when market forces determine the rate paid on all deposits, and is opposed to those provisions of H.R. 6216 which would require

the regulatory agencies to administer interest rate controls for the indefinite future.

With respect to the proposals made by Chairman St. Germain at the beginning of these hearings, the Board is concerned that there would be no mandated phase-out schedule, but still a complete elimination of all deposit rate ceilings would take place in 1985. Unless there is movement toward this goal in the interim, a sudden removal of ceilings could be very disruptive to thrift institutions. Although Chairman St. Germain calls on the regulatory agencies to raise deposit rate ceilings gradually over the 5-year period, it is important to recognize that present law gives any one regulatory agency the authority to prevent any increase in ceiling rates since the existing ceiling rate differential cannot be eliminated without Congressional approval. The Board believes that a specific phase-out schedule, with a limited ability for regulatory agency modification, would be preferable. This approach would allow for more certain planning by both financial institutions and their customers.

As is true of a phase-out of deposit rate ceilings, the Board for some time has supported the principle of interest payments on transactions accounts at all depositary institutions. Our support of this principle is based on considerations of consumer equity and economic efficiency. I want to emphasize, however, that we believe that it is important to ensure an orderly transition to this new environment. This might best be achieved by extending an activity with which the institutions already have some experience. Authorizing NOW accounts nationwide would be a logical extension of existing programs in New England, New York, and most recently New Jersey. Moreover, our concern with transitional problems in the move to interest on transactions accounts suggests

that NOW's be subject for a time to a deposit rate ceiling. As with the earnings effect of a phase-out of deposit rate ceilings, the earnings impact of NOW accounts could be especially marked for thrift institutions; thrifts are expected to compete vigorously with banks for the new interest-bearing transactions account business. The Board therefore supports an interest rate ceiling on NOW's--a ceiling that would be phased out in concert with all deposit rate ceilings.

While the Board endorses nationwide extension of NOW account authority, it also urges that these accounts--and indeed all transactions balances at all depositary institutions--be subject to Federal Reserve reserve requirements. Nationwide NOW accounts would make legislative enactment of this authority even more imperative, since there is ample evidence from our experience in New England and New York that NOW accounts encourage consumers to shift funds out of traditional checking acounts at commercial banks into NOW accounts at banks and thrifts. The expansion of the asset powers of thrifts, the phase-out of deposit rate ceilings and the introduction of nationwide NOW accounts all will serve to increase competition in the financial sector. The resulting downward pressure on institutional earnings is certain to make banks more acutely aware of the costs of sterile Federal reserves and could sharply accelerate the rate of membership attrition, eroding our ability to conduct an effective anti-inflationary monetary policy. I would note that the rate of withdrawal from Federal Reserve membership has already increased dramatically in recent months, and has included the two largest banks ever to leave the System. Thus, as I stated at the outset, the Board strongly reiterates its sense of urgency that there be prompt action by the Congress on monetary improvement legislation.

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Appendix to Board Testimony Before the House Subcommittee on Financial Institutions, Supervision, Regulation and Insurance of the Committee on Banking, Finance and Urban Affairs, February 20, 1980
Board Position on Selected Portions of Senate-Amended H.R. 4986
"Depository Institutions Deregulation Act of 1979"

Summary of Proposed Legislative Provisions	Board Position
Title II - Miscellaneous	
--Authorizes S&Ls upon enactment of legislation to phase-out deposit rate controls to invest up to 20 percent of assets in consumer loans, commercial paper, corporate debt securities and bankers acceptances.	Board has long favored the liberalization of thrift asset powers in conjunction with the phase-out of deposit rate controls.
--Authorizes S&Ls upon enactment of legislation to phase-out deposit rate controls to make residential real estate loans to the same extent as national banks under section 24 of the Federal Reserve Act. (Thus, for example, restrictions on loan value ratios and maximum terms would be eased from present standards.)	These provisions are consistent with the limited widening of thrift asset powers that has been supported by the Board.
--Authorizes S&Ls to offer trust services under individual state laws upon enactment of legislation to phase-out deposit rate controls.	
--Authorizes S&Ls to issue credit cards, extend credit in connection with credit cards and engage in credit card operations. This provision would not become effective unless thrifts are given consumer loan authority and a phase-out of deposit rate controls is enacted.	
Overrides state-imposed ceilings on mortgage interest rates and discount points. Covers, for unlimited duration, rates on residential first-mortgage loans made by depositary institutions (or any lender approved for HUD programs). State may reinstate if it acts within 2 years.	Board has consistently endorsed the objective of relaxing usury law restrictions, preferably through outright elimination of ceilings for all lender groups. Has expressed preference for state-level solution, but has supported federal remedy where state action lacking. Majority has regarded provision for states to reimpose ceilings as an adequate protection of state prerogatives.

Summary of Proposed Legislative Provisions	Board position
--Eliminates any state restrictions on the rate or amount of interest that may be paid on accounts at depositary institutions.	This provision is consistent with the phase-out of all deposit rate controls long supported by the Board.
--Increases federal deposit insurance for banks, S&Ls and credit unions from $40,000 per account to $50,000.	The Board agrees that the proposed increase would be in the public interest, but is inclined to favor an increase to $100,000 as contained H.R. 6216.
--Requires the President to convene an interagency task force consisting of Treasury, HUD, the FHLBB, the FRB, the FDIC, the Comptroller of the Currency and the NCUAB to conduct a study of the difficulties faced by depositary institutions which have sizable portfolios of low-yield mortgages. The task force would transmit its findings and recommendations to the President and Congress within three months.	The Board would be pleased to participate in such a study.
--Authorizes federal mutual savings banks to invest up to 20 percent of assets without regard to federal or state law limitations (thereby permitting commercial and industrial loans) provided that 65 percent of such loans and investments must be made within 50 miles of the state. The authority would be phased-in over 8 years and would take effect only upon the enactment of a phase-out of deposit interest rate ceilings.	Consistent with the Board's support of limited liberalization of thrift asset powers.
--Authorizes federal mutual savings banks to accept demand deposits from any source including businesses and corporations upon enactment of a phase-out of deposit interest rate ceilings. The FHLBB might provide for a phase-in of demand deposits or may delay implementation of the authority if necessary to assure the stability and soundness of depositary institutions, but the phase-in or implementation must be completed by January 1, 1990 or whenever deposit interest rate ceilings have been effectively eliminated.	The proposal is a positive step toward greater equality of powers among financial institutions.

Summary of Proposed Legislative Provision	Board Position
Title III--Comptroller of the Currency House-Keeping Amendments	
--Authorizes the Comptroller to permit national banks to hold real estate up to an additional 5 years beyond the current 5-year allowable period, if the bank has made a good faith effort to dispose of the property during the first 5 years and disposal would be detrimental to the bank.	The Board has no objection to this proposal.
--Amends the Bank Holding Company Act to permit the Federal Reserve to extend the deadline for the divestiture of real estate or real estate interests from December 31, 1980, to December 31, 1982. Before granting an extension, the Board must consider whether the company has made a good faith effort to divest and whether the extension is necessary to avert substantial loss.	The Board does not oppose this provision. It might be helpful in those few cases where the 1980 divestiture could pose substantial safety and soundness concerns. To permit adequate time for the Board to consider any request for an extension and for the company to divest in an orderly fashion if denied, the Board would expect the request to be filed at the earliest possible date.
--Authorizes the Comptroller to proclaim a legal holiday for national banks in a state or part of a state when there is a national calamity, riot or emergency condition. When a state designates a day as a legal holiday for state banks, it will be a legal holiday for national banks unless the Comptroller by written order permits national banks to remain open.	The Board supports this provision.

Summary of Proposed Legislative Provisions	Board Position
--Grants the Comptroller rulewriting authority to carry out his responsibilities under the Financial Institutions Supervisory Act of 1966.	The Board does not object to the proposed provision provided appropriate consideration is given to potential regulatory conflicts that might arise, for example, with respect to bank holding companies. Board suggests that it be extended to include all organizations with responsibilities under the FISA Act of 1966 as a clarifying amendment.
--Deletes the requirement that the Comptroller examine national banks three times every two years and allows the Comptroller to examine national banks as often as he deems necessary.	The Board has no objection to this proposed provision.
--Authorizes the Comptroller, upon the request of the Federal Reserve, to assign examiners to examine foreign operations of state member banks.	The Board has no objection to this proposal.
--Amends the requirement that a director of a national bank own stock in the bank by allowing the director the alternative of owning stock in the bank holding company controlling the bank.	The Board supports this proposed amendment.
--Permits a national bank to purchase shares of bank stock for its own account if the bank is owned exclusively by other banks, is engaged exclusively in providing bank services for other banks and has FDIC insurance. The amount of such stock held by a national bank may not exceed 10 percent of its capital and surplus, and a national bank may not acquire more than 5 percent of any class of voting stock of such bank.	The Board has no objection to this amendment, subject to a review of the possible competitive effects of such affiliation.
--Amends the Bank Holding Company Act so that an out-of-state bank holding company could not acquire a federal or state chartered trust company, unless state law specifically permits acquisitions by out-of-state holding companies. This restriction would not apply if the Federal Reserve approved the application on or before November 1, 1979,	The Board opposes the proposed prohibition because it is anticompetitive and because similar prohibitions could be applied to other types of non-bank subsidiaries of holding companies with resulting anticompetitive effects.

Summary of Proposed Legislative Provisions	Board Position
--Prohibits the Federal Reserve from rejecting the application for the formation of a one bank holding company solely because the transaction involves a bank stock loan with a repayment period of not more than 25 years.	The Board opposes this proposal because it believes that the 25-year debt retirement period would lead to substantial increases in one bank holding company leverage and debt burdens, adversely affecting the financial soundness of many of our country's smaller banks. The Board has recently requested public comment on proposals to introduce increased flexibility into our existing policies on acquisition debt, which would require that the acquired bank's ratio of gross capital to assets not fall below 8 percent and that the holding company's debt to equity ratio decline to 30 percent within 12 years.
Title IV--Truth in Lending Simplification	The "Truth in Lending Simplification and Reform Act" is in large part based upon recommendations of the Board. It will improve the delivery of information to consumers while at the same time reducing the cost of compliance for creditors. The Board has consistently supported this legislation and continues to do so.
Titles V, VI, and VII	Already enacted.
Title VIII--Financial Regulation Simplification Act --Finds that many regulations issued by the Federal Reserve, the FDIC, the Comptroller of the Currency, the FHLBB and the NCUAB often impose costly, duplicative and unnecessary burdens on both financial institutions and consumers. Regulations should be simple, clearly written and not impose unnecessary costs and paperwork burdens. --Specifies that regulations issued by the agencies shall insure that: 1) the need and purpose are clearly established; 2) meaningful alternatives are considered; 3) compliance costs, paperwork and other burdens are minimized; 4) conflicts, duplication and inconsistencies between regulations issued by different agencies are to be avoided where possible.	The Board supports the policy and goals of the proposed title. In its view, however, certain exceptions seem to be necessary. Specifically, monetary policy regulations often do not fit into the proposed general procedural framework because the public interest sometimes requires such actions to be taken swiftly and without prior public knowledge. In addition, the Board has concluded that general procedures for an extended comment period and an extensive consideration of alternatives should not be applied to regulations where compliance with these procedures would be impracticable, unnecessary or contrary to the public interest.

Summary of Proposed Legislative Provisions	Board Position
5) timely participation and comment by other agencies, financial institutions and consumers are available; and 6) regulations shall be as simple and clearly written as possible	Board concerns about the particular provisions of Title VIII could probably be handled by making it clear that section 803 is not a mandatory requirement for all regulations but a statement of policy goals. This would also eliminate the danger of legal challenge being made as to the adequacy of agency compliance with each standard. To satisfy these concerns the Board suggests that the caption be changed from "Policy" to "Policy Goals" and that the introductory statement be amended as follows: "Sec. 803. In issuing regulations the Federal financial regulatory agencies shall adopt the following policy goals...."
--Requires the agencies to establish a program which assures periodic review and revision of existing regulations.	The Board supports this provision.
--Requires progress reports to the House and Senate Banking Committees six months after the effective date and then annually.	The Board supports this provision.
--Terminates the Act five years after its effective date.	The Board supports this provision.
Title IX--Alaska USA Federal Credit Union --Permits continuation of an exception to the common bond requirement by allowing Alaska Native Corporations to continue membership in the Alaska USA Federal Credit Union.	No comment.
Title X--Foreign Control of United States Financial Institutions --Requires Federal Reserve and other supervisory agencies to prepare a report analyzing the impact of foreign acquisitions on the U.S. economy and recommending regulations that would be needed if Congress wished to limit or prevent acquisitions.	The Board would be pleased to participate in the preparation of report on foreign acquisitions.

Summary of Proposed Legislative Provisions	Board Position
--Prohibits the regulatory agencies from approving any application relating to the takeover of a U.S. financial institution by foreign interests in order to permit Congress to receive, consider and act upon the report. (Note: the prohibition on approving applications extends indefinitely with no specified termination date.) There are two exceptions to the prohibition. (1) where such takeover is necessary to prevent the bankruptcy or insolvency of the U.S. institution, or (2) if the application has been filed on or before June 1, 1979.	The Board opposes the proposed moratorium on acquisitions because: It would restrict the ability of U.S. investors to strengthen their capital base through sales of stock to foreign banks. It could be construed as reversal of country's longstanding policy of neutrality regarding foreign investment. It might provoke retaliatory action by foreign authorities.