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Statement by

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before the

Committee on Banking, Housing and Urban Affairs

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It is a pleasure to appear before this committee to briefly discuss the condition of the banking system, to make some general remarks about the regulation of banking, and to present the Federal Reserve Board's views concerning recently enacted statutes affecting the banking industry.

As you know, quite a number of major pieces of banking legislation have been enacted into law over the past several years. Some of these new laws are already having a far-reaching effect on financial institutions, and will cause even greater changes in the years ahead. Others will have less dramatic impact on the structure of our financial system, but will affect on an on-going basis the day-to-day conduct of business. It is, of course, not possible to assess fully the impact of these laws at this early date. However, we can provide some general thoughts on our experience, and can identify some areas where adjustments may be needed. This discussion appears in the appendix to my statement. I will confine my remarks to the condition of the banking system and the general -- and very difficult -- issue of the appropriate extent of government regulation of banking.

Condition of the Banking System

During the past year or so, commercial banks have had to operate in a particularly difficult economic and financial environment. In the spring of last year, the economy was subjected to an unusually sharp recession and a rapid rise in unemployment. While this economic downturn fortunately proved to be short-lived, it still left banks with some problem credits. This past year banks also have had to contend with unusually volatile interest rates. These volatile rates have severely tested the ability of bank management to maintain interest margins through a careful balancing of rate-sensitive assets and rate-sensitive liabilities. Banks also have had to cope with the nationwide introduction of interest-bearing NOW accounts, as well as a continuing shift

from low-cost savings deposits to much higher-cost money market certificates. Finally, banks have encountered sharply increased competition from money market mutual funds, foreign banks, thrift institutions and the commercial paper market. This increased competition has tended to put downward pressure on bank profit margins.

Overall, commercial banks appear to have come through these difficult times quite well. The number of bank failures last year was below the level experienced in the mid 1970's, and continues to be well within the acceptable range. Moreover, our examinations of state member banks last year revealed that these banks were in generally good financial condition, with only 2 percent being given an unsatisfactory overall examination rating. Also, even in the face of the considerable adversity that banks experienced this past year, bank earnings in 1980 reached an all-time high of $14 billion, up 9 percent over 1979.

Amid these generally favorable results, however, there have been several recent unfavorable developments that should not be ignored. First, there is evidence of some deterioration in the quality of bank loan portfolios. This deterioration was reflected in a 40 percent increase in banks' net loan charge-offs last year. Major factors contributing to higher charge-offs were sizable write-downs of several large corporate credits and a sharp rise in consumer loan defaults. Problems in the consumer credit area are due partly to higher unemployment and heavier debt service burdens, and partly to the recently liberalized personal bankruptcy laws. There also has been concern expressed about the continuing large balance of payments deficits and financing needs of some countries which are already heavily indebted to U.S. or other banks. Over the near term, it is possible that loans to several of these countries may have

to be rescheduled. However, it should be noted that U.S. bank loan losses in the international area have been relatively low in recent years, and that the exposure of U.S. banks to non-OPEC developing countries, relative to their capital, has not increased significantly in the last several years. All in all, given the continuing high level of consumer bankruptcies and the financial problems experienced by some relatively large as well as small businesses, it seems possible that loan losses this year may well equal or exceed the 1980 experience.

A second area of concern is the continuing attrition in the capital ratios of many of our largest banks. This downtrend, while apparently slowing, has continued with little interruption for the last decade or so. Though earnings capacity provides the first line of defense against unexpected asset problems, shrinking capital ratios also mean that there is a smaller cushion to absorb large losses and protect those who have supplied funds -- many in amounts well above FDIC insurance protection -- to these large banks. Given the difficult economic and financial environment, the Board believes that further declines in the already low capital ratios of large banks generally must be resisted as a matter of regulatory policy. Indeed, we should strive for some improvement over the next few years.

It is, of course, difficult for many banking organizations to go to the equity capital markets in view of the depressed stock prices relative to book value. However, these banks have a number of ways to improve their capital ratios -- including slowing down their rate of growth. This deceleration would not only improve capital ratios, but would also tend to dissuade banks from extending credit to more marginal borrowers at questionable spreads. I might also add that a deceleration in asset expansion by the large banks would be consistent with the national goal of getting our inflation under control.

Thrift Industry Problems

Your letter of invitation also requested information on the problems currently faced by thrift institutions. The Federal Reserve's primary supervisory responsibility, of course, is with commercial banks, and I am sure that the other regulators here today will provide much information on the current and prospective state of the thrift institutions. I would note only that the inflation-induced high level of interest rates in combination with large amounts of low-rate long-term assets on the books of many of these institutions has brought deteriorating earnings for thrifts in 1980 and so far in 1981. As market interest rates have risen, virtually all of the deposit growth at these institutions has been in the form of instruments whose rates are tied to market rates. Deposit costs have consequently risen sharply, leading first to reduced earnings and, most recently, to outright operating losses for a good many institutions. In the meantime, thrifts, in the aggregate, have maintained relatively strong liquid asset holdings, in part to minimize operating losses given downward sloping yield curves, and in particular to bolster liquidity in the event that deposit outflows were to occur.

Thus, although deposit inflows to the thrift institutions have slowed in recent months, the basic problem facing the industry is still earnings rather than liquidity. This earnings pressure primarily reflects the mismatch in the asset liability structure of thrifts, and the pressure will be lessened only by slowing inflation or a basic restructuring of thrift institution asset portfolios, both of which will take some time. The Federal Reserve, the other regulatory agencies, and the Administration have been discussing ways of dealing with any particular problems which may arise during the period ahead, including legislative changes that may be necessary to assure that the appropriate regulatory agencies have fully adequate power.

The Problem of Banking Regulation

There is a general perception, which I share to a considerable degree, that the regulation of financial institutions has become too pervasive, and that the cumulative effect of the numerous specific laws and regulations -- each well-intentioned -- has become so burdensome as to raise questions as to whether the effects on competition and efficiency are not counter-productive. Some danger exists that worst case effects may be cited from time to time as justification for elimination of regulation that truly fulfills a legitimate purpose. Nevertheless, I am concerned that we may have gone too far in certain areas, and have not adequately focused on the full extent of the government regulations which apply to an individual institution. We also may well need to appraise realistically the new competitive forces arising in the marketplace, and consider whether some of the historic restrictions on banking activity are still justified.

Even a small bank, for example, is covered not only by rules of the banking agencies, but it would also be subject to regulations issued by the Treasury Department, the Labor Department, HUD, the Department of Health and Human Services, the SEC and at least 10 other federal agencies. It may also be subject to various state and local ordinances.

It is true, of course, that the bank is only theoretically subject to some of these rules, since it may not be engaging in all the particular practices that they address. But even if a particular rule has little relevance to the bank's operations, someone must determine this, and in some cases must monitor the bank to insure that some change in its operations does not subject it to the rule. Even if the bank's operations don't change, it is very likely that the federal rules will. Most federal regulations are amended from time to time -- and some quite frequently. By our count, a small national bank

received over 100 pieces of proposed or final regulatory material last year from the banking agencies alone. In summary, we have probably placed burdens on some institutions -- particularly small ones -- which they cannot adequately shoulder.

The source of the regulatory problem probably begins with our fundamental approach to considering new rules. In general, we tend to focus on each one in isolation. When new laws are considered, the burden of each statute is evaluated -- often quite thoroughly, but nearly always separately -- rather than in the total context of existing governmental requirements. Each of these laws, taken on its own, has seemed reasonable, responsive to a general problem, and not overly costly. But the effects have been cumulative, and adding one seemingly manageable burden on top of another has created a regulatory burden that may, in the aggregate, not be manageable, particularly for smaller and medium-sized institutions.

The problem is the same one that for years plagued the budget process when each appropriation was considered separately. In calling for individual appropriations of business resources to government regulations, we have not been mindful enough of the limits on the total available resource budget. In the future, we will need to make sure that we examine new proposals in the total context of the aggregate regulatory burden now being carried -- and we must be certain that in attacking one admitted problem, or in responding to the concerns of one constituency, we aren't imposing across-the-board burdens at a cost which outweighs the benefits of the rule.

Possible New Approaches

We will also need to search more diligently for new ideas for the administration of regulations, and be prepared to rely on alternatives -- most fundamentally the competition which often can provide the needed discipline

now provided by government rules. Without necessarily endorsing them, let me mention a few ideas that the committee might wish to explore as a legislative response to the problem.

The fact that no orderly process exists to periodically review and evaluate the current body of the banking law surely contributes to the regulatory problem. One possible approach would be to set a firm schedule for reviewing -- statute by statute -- the entire body of banking law. Specific expiration dates might even be attached to some, but certainly not all, provisions. Although the Board has serious reservations about any across-the-board sunset provisions that would create uncertainty in the implementation of monetary policy, oversight of the Federal Reserve Banks, or supervision of member banks or bank holding companies, even these laws could benefit from being subject to a reexamination according to a set schedule.

The designated review might be coupled with the call for a regulatory impact study prior to the review date -- a time, in fact, more appropriate than the current timing of such studies which is generally prior to enactment of the implementing regulation, and therefore usually prior to the availability of any real data on operational costs.

Another technique that might be considered would be for Congress to attach a specific authorization to certain provisions of law giving the rule-writing agency the power to suspend the provision on an experimental basis. The agency could act if it believed that the Congressional purpose behind the statute was likely to be generally met without continuing a particular governmental requirement. Such an authorization might be attached to existing legislation where the Congress thought that it would be premature, and perhaps unwise, to totally repeal legislation, but where there were some doubts about its necessity. Acting under such authority, the agency might suspend particular

provisions long enough to see whether the "right" behavior would continue without the cost and rigidity of the governmental mandate. Should this not be the case, the provision could then be reimposed.

Since the burden of regulation falls most heavily on small institutions, special attention needs to be given this area. The Congress probably should consider more frequently authorizing special treatment -- or even exemptions -- for small institutions in connection with new legislation. Existing statutes should also be reviewed to explore the possibility of adding such provisions. Not all legislation, by any means, will lend itself to such an approach, but certainly there are possibilities. We have identified one with regard to the Monetary Control Act -- a small institution exemption -- which is referred to in the appendix to my statement. We have also previously suggested to this committee that a small business exemption be provided in the Home Mortgage Disclosure Act by refocusing the current $10 million exemption from a total asset test to a mortgage portfolio test (coupled with provisions to require reporting by large institutions -- say above $100 million in assets -- regardless of the size of the portfolio).

Finally, one of the continuing problems -- particularly in consumer legislation -- is the overlap of state and federal law which covers the same subject. The Board is well aware that a bolder approach to federal preemption in the consumer credit field runs counter to some of the current sentiment for less federal involvement in local matters. One response, of course, would be for federal authorities to refrain from legislating in, or to withdraw from some areas where it has legislated, leaving consumer regulation solely to the states. The defect to this approach is the damage it would do to the nationwide comparability of credit terms, and the increased compliance burdens this might place, in some cases, on interstate business. While the issue is certainly a complex

one, and would require careful study, the Board believes that it may be time to consider a more sweeping preemption of state consumer laws in the areas where Congress has chosen to regulate.

Any rethinking of the proper approach to regulation must take account of the increased competition we now see developing between banks, between banks and other financial institutions, and between banks and nonbanks which are offering expanded financial services. The Depository Institutions Deregulation and Monetary Control Act has radically changed the possibility for "regulation" through the pressures of a competitive marketplace, rather than governmental action. It allows both banks and thrift institutions to offer checkable interest-bearing accounts to consumers; it broadens the range of permissible lending activities for thrift institutions; and it provides for the dismantling of interest-rate ceilings. The number of institutions offering bank-like services to consumers has been increased by the legislation from about 14,000 to about 40,000. In doing so it has raised new questions about whether all the historic limits on bank and thrift branching, the chartering of new depository institutions, and mergers and acquisitions, are appropriate, and whether they too shouldn't be reexamined with an eye to further increasing the competitive environment.

Competition to attract deposits, to make loans, and to provide other financial products will encourage the provision of services and information that many bank customers need and are willing to pay for. Competition will not insure perfect results, as measured relative to some ideal, but neither does regulation. Competition, itself, may offer results that are acceptable when measured against the cost and imperfect success of governmentally regulated behavior, particularly when the benefits from freedom-induced innovation over time are taken into account. If enough customers of all types are willing to

pay for a service, or disclosure, some institution will probably try to enhance its competitive position by offering it. This has been the case, for example, with the provision of credit documents in "plain English," which in several localities preceded the mandatory introduction of the requirement.

The Proper Role of Regulation

Although we have reached a point where we must be rigorous in examining the need for all the various regulations -- and must explore the possibility of less costly alternatives -- we must not lose sight of the important objectives that prompted many of the rules under which financial institutions operate. Many regulations serve legitimate -- even vital -- functions that the Congress has decided could not be served in any other way. These laws and regulations create rights and provide protections that we can not otherwise be assured of having. Our banking regulations, like all regulations, set a minimum standard of conduct that we expect of our depository institutions. It may be that good business practice, or a sense of fairness, would induce the same behavior on the part of the vast majority of institutions, without the burdensome costs of some of these rules. Much of the debate about deregulation will undoubtedly be spent speculating about whether government rules are truly needed. But none of us can say for sure that "fairness" or "common sense" or "good business" -- or even more vigorous competition -- will give us the benefits that regulation, for all its burdens, now insures for us. There is no question that financial institutions are carrying a heavy load of regulations, but we must not be too quick to assume that because the burden at times is heavy, it is necessarily all uncalled for.

Banking has been a highly regulated industry because of the unique role banks play in the economy. The structure of that regulation has been evolving for over 100 years. Because they have been directed to quite different

objectives, the statutory and regulatory constraints have taken a variety of forms. They can be broken down into roughly four categories.

First are the limits on market entry, and product and geographic diversification, which have long been a part of the banking landscape. These restrictions were designed to implement the historic separation of banking and commerce (and between banking and investment banking) which has been the cornerstone of our approach to banking in this country. In addition, these restrictions have sought to protect local markets, and local institutions, from competition which was perceived to be adverse. They are found in the National Bank, Glass Steagall, and Bank Holding Company Acts -- most recently in the International Banking Act -- and in other bedrock pieces of banking legislation. Regulation Q restraints which were extended to protect thrift institutions and to promote the flow of funds to housing at low rates in the mid 1960's, might also be considered to be in this category. The Depository Institutions Deregulation Act has, of course, set in motion a gradual phaseout of this latter deposit regulation.

Although the Board does not foresee any need to question the underlying premise that banking and true commerce should be separated, certain events -- like the phenomenal growth of money market funds and the recent large hybrid financial marriages -- compel a reexamination of some of our traditional notions of what constraints should be placed on the banking industry's ability to offer a broad array of financial services. In addition, it is time to give serious consideration to whether all the geographic restrictions on the banking industry, which were enacted in a far different economic environment, are still suitable today -- particularly given the nationwide presence of some nonbank competitors.

The second general category of banking regulation might be termed the "prudential" regulations. These laws are designed to insure the safety and soundness of financial institutions. They include many of the restrictions found in the National Bank Act, the Federal Reserve Act and Federal Deposit Insurance Act. The provisions in the Financial Institutions Regulatory and Interest Rate Control Act (FIRA) dealing with such matters as insider loans, overdrafts, and the misuse of correspondent relationships also fall within this category. In general, we do not foresee the need for a major overhaul of the safety and soundness requirements, although we have identified some more technical changes which could improve some titles of FIRA.

The third category of regulation includes the legislation imposing reserve requirements and related restrictions to facilitate the conduct of monetary policy. Our most recent embodiment of this is, of course, the Monetary Control Act, which has considerably expanded the relationship between the Federal Reserve and the nation's financial institutions. In the rapidly changing environment we are in we will need to observe developments very closely to determine if any changes should be made to this legislation, other than possibly an exemption for small institutions from reserve requirements.

Fourth is the large body of consumer protection legislation of the last decade which was passed to insure important consumer rights, and to deal with the perceived inequities in the provision of financial services to women, minorities and low and moderate income individuals. We have recently concluded a major revision of the Truth in Lending regulations, pursuant to the Truth in Lending Simplification and Reform Act, which we believe will improve substantially one of the major categories of consumer regulations. Some other possibilities for change may also be fruitful for exploration -- for example, in the Electronic Funds Transfer Act.

This has been, of course, the briefest overview. All of the possible changes I have touched on would need to be examined in some detail, and we would, of course, be pleased to participate in that effort. In the attached appendix we have focused more specifically on our experience with recent legislation. In some cases, we have made specific suggestions for improvement. We would welcome the committee's guidance on its priorities for legislative review, and I can assure you of our full cooperation in that process.

Attachment

RECENT BANKING LEGISLATION

MONETARY CONTROL ACT

The fundamental purpose of the Monetary Control Act is to enhance the ability of the Federal Reserve to conduct monetary policy by applying the discipline of reserve requirements to certain deposit accounts at all depository institutions. Implementation of the Act has already had significant effects upon our relationship with the nation's financial institutions.

The lower reserve requirement ratios of the Act are providing benefits to member banks, which are now receiving one-fourth of the reserve reductions provided by the Act. Nonmember depository institutions, on the other hand, are presently subject to only one-eighth of their scheduled reserve requirements ratio. The application of reserve requirements to nonmember institutions is being phased in according to the law very slowly, which has resulted in some feeling of inequity by member banks. So long as large reserves must be maintained on transaction accounts at no interest, there will be a strong incentive for other institutions which do not bear that burden to get into the transaction account business.

In order to facilitate the smooth implementation of reserve requirements the Board has temporarily deferred requirements for institutions with deposits of less than $2 million. These institutions represent 44 percent of the total number of institutions covered by the Act, but account for only .5 percent of total deposits, and even a smaller fraction of transaction accounts.

Recommendation:

We believe that monetary control would not be appreciably improved by subjecting these very small institutions to the reporting and reserve requirements of the Act, and therefore would recommend that serious consideration be given to the enactment of a permanent exemption for such smaller institutions.

In order to minimize the burden on other smaller institutions, we have also implemented a procedure of quarterly (rather than weekly) reporting and reserve maintenance for institutions with deposits of between $2 million to $15 million. This has considerably reduced the reporting and reserve management burden for another 22 percent of the nation's financial institutions. We plan to continue this procedure, and perhaps expand it to include somewhat larger institutions, as we gain more experience with this process.

The requirements of the Act already have proved of significant value by enhancing our ability to measure accurately changes in the monetary aggregates. Most of the start-up difficulties of reporting by new institutions are now behind us, considerably improving the necessary data base for the conduct of monetary policy. When the reserve requirement structure is fully implemented, we believe that the Monetary Control Act will contribute to improving the Federal Reserve's ability to implement monetary policy.

The Act also provides access to the Federal Reserve's discount window to institutions required to maintain reserves. An increasing number of nonmember banks are turning to the discount window to satisfy their credit needs for short-term adjustment purposes, and we anticipate that this trend will continue as reserve requirements become binding on additional institutions.

There is considerable misunderstanding about the Federal Reserve's use of the discount window. We have always regarded the discount window principally as a source of liquidity to satisfy the short-term needs of depository institutions when funds were unavailable from normal sources. We have never viewed the discount window as a source of long-term lending for purposes of credit expansion, or as a mechanism that permits institutions to make money on the interest rate spread. Consequently, we have been called on so far to provide assistance to only a very few thrift institutions, which were able to demonstrate that they had a short-term need for credit that could not readily be obtained from alternate sources. However, the Federal Reserve is prepared to lend to thrifts if their regular sources of credit should prove unable to meet their liquidity needs, and we fully recognize our responsibility to tailor the terms of any such credit on a case-by-case basis to the nature of the liquidity problem at hand.

The pricing and access provisions of the Act are proceeding on a schedule that accords with the requirements of the Act. Last January we began pricing for our wire transfer service and at the same time granted access to nonmembers to that service. We have already granted nonmembers access to our Regional Check Processing Centers, and a full access and pricing system for our check collection facilities is scheduled to commence on August 1 of this year. We intend to provide access to nonmembers and begin pricing for our other services by early 1982. We are continuing and intensifying our efforts to reduce Federal Reserve float. Our plans for an electronic check collection procedure should result in a further substantial reduction in float. When these operational improvements are completed, additional steps will be taken to eliminate or price float, as the Act requires.

The Monetary Control Act was a most significant piece of legislation, one that affects virtually all of the depository institutions in the country. Its contribution to the nation's financial health is already being felt and we anticipate that the Act will have profound and lasting beneficial effects.

DEPOSITORY INSTITUTIONS DEREGULATION ACT

The Depository Institutions Deregulation Act created a Committee (the DIDC) to oversee the orderly phase-out of deposit rate controls by 1986. The Act requires the Committee to balance the objective of providing consumers with a market rate of return on their savings as quickly as possible, against the adverse impacts such action may have on the financial and competitive position of depository institutions and the flow of funds to housing.

The first year of the Committee's operation has been difficult. The inflation-induced high levels of market interest rates have considerably reduced the attractiveness to savers of fixed-ceiling time deposits. Indeed, growth in small-denomination time deposits has occurred only among those instruments whose ceilings are tied to market rates. Consequently, the average cost of deposits at banks and thrift institutions has escalated. At the same time, those institutions whose portfolios are dominated by long-term fixed-rate assets have experienced increasing pressure on their earnings and capital position.

Thus, the Committee has faced a dilemma. On the one hand, the growing attractiveness of market instruments -- especially, but not solely, the money market mutual funds -- has increased the need to permit depository institutions to pay competitive rates in order to maintain and attract deposits. On the other hand, the Committee's flexibility to do so has been severely limited by the asset-liability mismatch of most thrift institutions and some commercial banks.

The Committee, over the first year of its life, has increased somewhat the rates that can be paid on certificates linked to market rates, but it appears that this action is not sufficient to preserve competitive balance between the instruments issued by depository institutions and market instruments. The need for increased deposit rate flexibility, along with the prospect that renegotiable rate mortgages and other changes will lead gradually to more flexible interest returns on asset portfolios, suggested to the Committee the desirability of either a scheduled phase-out of deposit rate ceilings, or an indexing of such ceilings, beginning with the longer-term deposit accounts. This approach, which is currently out for public comment, would, if adopted, enable institutions to begin to pay market rates on longer maturity deposits, give them greater flexibility in selecting their liability structure, provide the possibility for matching profitability of new deposit inflows with mortgage assets, and make possible an orderly transition to a free market environment in the competition for lendable funds.

However, as long as inflation keeps interest rates at historically high levels, thrift institutions and some commercial banks will continue to face considerable difficulties. The Depository Institutions Deregulation Act charges the DIDC to consider this and other kinds of problems as it moves to deregulate deposit rate ceilings. The Board believes that the Committee created by the Act has behaved in a prudent fashion in carrying out Congressional intent, and that this Act is working well for the benefit of the public and for the long-run strengthening of the nation's depository system.

FINANCIAL INSTITUTIONS REGULATORY AND INTEREST RATE CONTROL ACT

The Financial Institutions Regulatory and Interest Rate Control Act (FIRA) is a major piece of banking legislation dealing with a broad array of subjects ranging from restrictions on the dealings of insiders with their

financial institutions to the creation of a financial institutions examination council. The various provisions of FIRA have been in effect for only about two years and thus the Board's experience with them is somewhat limited. It is probably not possible, therefore, to assess fully the impact or merits of all of the various provisions of FIRA at this early date; however, we do do have some views concerning various aspects of FIRA as well as some suggestions for areas that may need to be changed or that could be eliminated.

Federal Financial Institutions Examination Council. One of the most farreaching portions of this legislation was the establishment of the Federal Financial Institutions Examination Council whose purpose is to prescribe uniform principles and standards for the federal examination of financial institutions by the three federal bank regulatory agencies and by the FHLBB and NCUA. It is also charged with making recommendations to promote uniformity in the supervision of those institutions. During the two years in which the Council has been in operation, it has made good progress toward accomplishing its statutory mandate and has improved significantly the communications among the regulatory agencies. The Council has addressed a number of supervisory issues and has put forward in its annual reports a rather impressive list of accomplishments.

This is not to say, however, that there are not problems with the Council. There clearly are. It has not made as much progress in dealing with the more fundamental issues of bank supervision, such as the harmonization of examination procedures or the delineation of capital adequacy standards, as one might have hoped. Moreover, the Council is, at times, an inefficient and time-consuming vehicle for addressing and reaching consensus on current supervisory issues. The perceived inefficiencies, however, often stem

from the difficult process of tailoring policies to accommodate to all types and sizes of financial institutions. This process was often missing from individual agency deliberations and was one of the principal reasons for the creation of the Council.

In short, we believe that, although there are some problems being encountered by the Council, it is working reasonably well and continues to offer promise as a far preferable alternative to a major reorganization of the Federal regulatory structure.

Change in Bank Control Act. This Act gave federal bank supervisory agencies the authority to disapprove changes in control of insured banks and bank holding companies.

The Board's experience thus far under the Change in Bank Control Act indicates that the Act has probably achieved to a considerable degree the purposes for which it was enacted. The Board notes, however, that the Act has created at least two unforeseen problems that Congress should consider when weighing its success. First, the Act can aid an incumbent management in frustrating the takeover of a bank -- for example, an incumbent management may make derogatory allegations about a proposed purchaser. Investigation of these allegations can greatly lengthen the processing period which, along with adverse publicity, may cause eventual cancellation of a transaction, even though the allegations are subsequently found to be without merit. Second, when the intention to acquire stock of a particular bank becomes public knowledge, this knowledge can lead to a bidding competition for the stock. It could drive the price of the stock substantially higher than the original tender offer (which, of course, would not be seen as necessarily detrimental by the institution's shareholders).

It should be noted that the Board originally opposed the adoption of the Change in Bank Control Act. The Act's notice requirement clearly imposes a burden on both sellers and purchasers. The Board continues to have some reservations about the desirability of this legislation, but we have not had sufficient experience with the Act to form an opinion as to whether the additional burdens it creates are justified by benefits to the public.

Expanded Cease and Desist Authority. The principal supervisory sanction provided by FIRA was to authorize civil money penalties for violations of the Bank Holding Company Act, provisions of an existing cease and desist order, and various provisions of the Federal Reserve Act, including restrictions on loans to insiders and loans to affiliates, and the provisions establishing reserve requirements and interest rate ceilings. In addition, the Office of the Comptroller of the Currency was authorized to levy civil money penalties for any violation of the National Bank Act.

Under the sponsorship of the Examination Council, the agencies adopted general guidelines as to when they would seek to utilize this sanction. Briefly, these guidelines provide that civil money penalties may be assessed where the bank or any of its officers or directors are guilty of serious, willful or repetitive conduct evidencing a disregard of the law, or the safety and soundness of the institution.

Although the Board has had only a limited involvement in assessing civil money penalties, our experience to date indicates it is a useful supervisory tool.

Right to Financial Privacy. The right to financial privacy provisions significantly increased the confidentiality of an individual's records in a financial institution. These provisions have not caused any significant

impediment to the discharge of the Board's supervisory functions, except in one respect. We believe it was the congressional intent to leave unchanged the financial supervisory agencies' practice of exchanging examination reports and other information. However, the literal language of the statute could be interpreted to limit such information exchange to agencies having authority to examine the same institutions.

Recommendation:

We would suggest that the statute be amended to clarify that a broad exchange of examination reports and other information between federal financial institution regulatory agencies continues to be permissible.

Loans to Insiders. Several titles of FIRA all deal, in various ways, with the potential for abuses in loans to insiders -- that is, officers, directors and principal stockholders -- from either the bank or one of its correspondents. The basic thrust of the legislation is to assure that loans to insiders should be on no more favorable terms than are available to others and that insiders should not monopolize the resources of the bank to the exclusion of its customers. The Board is in complete agreement with these objectives; however, we believe that certain prohibitions and disclosure requirements prescribed in the statute are unduly burdensome and are not necessary to accomplish these goals.

Recommendations:

Under the sponsorship of the Examination Council, certain technical amendments were recently submitted to this Committee. We urge prompt Congressional consideration of these recommendations. In addition, we believe that much of the detailed reporting requirements of Title VIII (Correspondent Accounts)

and all of the reports required by Title IX (dealing with reports of loans to insiders) of FIRA have little or no value to either the supervisory process or the public. Accordingly, the Board would suggest consideration of modification of the reporting requirements of Title VIII and deletion of Title IX of FIRA in its entirety.

INTERNATIONAL BANKING ACT

During the decade preceding the passage of the International Banking Act, foreign bank activities in the United States underwent dramatic growth. A good deal of this growth was in the form of direct branch and agency operations, and escaped the federal regulatory and supervisory constraints applicable to domestic institutions. The IBA was a response to the widely held view that foreign banks operating in the United States should be subject to generally the same statutory and regulatory constraints as domestic institutions. The same period that witnessed rapid growth of foreign bank activity in the United States also saw United States banks expanding their international operations. Thus, a second major thrust of the IBA was in the form of a directive to the Board to critically reexamine its regulations governing international banking operations with a view toward making United States banks more competitive at home and abroad.

In June of 1979, the Board completed a major revision of its international banking regulations. The revision enhanced the organizational and operational flexibility with which United States banks can conduct international activities. Particular emphasis was given to upgrading the competitive capabilities of Edge Corporations. The IBA directed the Board to stimulate competition in this area by making Edge Corporation services available at locations throughout the United States.

One Board response was to permit Edge Corporations to establish branches in the United States. These branches take the place of separately chartered and capitalized corporations. The ability to branch added no substantive power not previously possessed by Edge Corporations. It did, however, result in more efficient operations and in the establishment of facilities in cities not previously served by Edge Corporations.

Notwithstanding the improvements in Edge Corporation operations that resulted from the 1979 revision of the Board's regulation, Edge Corporations fall far short of fulfilling the stated congressional objective of being able to compete effectively with foreign banks operating in the United States. The reason for this is that while the Edge Act sets forth the general objective that Edge Corporations are to be competitive, their powers are narrowly circumscribed by statute to activities related to international banking. The activities of foreign bank branches and agencies are not subject to this limitation. In the Board's view, those restrictions, at least so far as they relate to the lending authority of Edge Corporations, fail to recognize the changed banking environment since 1919.

For example, while Edge Corporations are prohibited from making domestic loans, the bank holding company parent of the Edge Corporation may, with the approval of the Board, engage in domestic commercial lending activities under the Bank Holding Company Act outside the state where the bank holding company's subsidiary bank is located. There does not appear to be any sound policy basis for prohibiting Edge Corporations from engaging in lending activities that are permissible for their affiliates.

Recommendation:

The Board recommends that Congress consider eliminating the requirement that Edge Corporations' lending activities be internationally related. On September 17, 1980, the Board submitted a report to Congress on its implementation of the IBA, which included other specific legislative recommendations that we also recommend receive Congressional consideration.

CONSUMER PROTECTION LEGISLATION

During the last decade a host of new laws have been enacted which provide important protections to customers of financial institutions and other businesses. They cover very fundamental areas -- for example, they establish rules for electronic fund transfers that parallel some of the payments mechanism rules for paper checks in the Uniform Commercial Code, and provide protections against unfair credit discrimination based upon race, age, sex and marital status. They also include more technical procedural rules, for example, on how credit terms must be described, what may be in a credit advertisement, and how billing errors must be resolved. Taken as a whole, this area of law, and the efforts we have taken to assure compliance, represent a substantial regulatory burden, and have been the source of considerable complaint by the banking community. Conversely, consumer and community groups view these provisions as hard won and important concessions, and at times assert that such laws still are not responsive enough to perceived abuses.

We have most recently been engaged in a major effort to simplify the Truth in Lending regulations pursuant to Congress' enactment of the

Truth in Lending Simplification and Reform Act. The revised regulation is not a simple document, but given the breadth of the statute that it implements (still some 15,000 words long) and the complexity of the credit transactions it covers, the Board believes the revised regulation -- which is about 40 percent shorter -- is a substantial improvement.

One of the lessons we have learned in this process is that simplification itself can produce regulatory burdens. Although the changes made will indeed be welcomed, they have already used up a considerable amount of resources in the public's preparation of nearly 10,000 pages of comments during the revision process. Even more formidable costs will be incurred in the year ahead as procedures are revised, personnel are retrained and revisions are made to the Truth in Lending forms used in the roughly 150 million credit transactions that take place each year. And this, of course, does not take into account the intangible effects -- like the disruption and uncertainty -- that are inevitably produced by any proposals for change in legislation. Unless Congress is prepared to undertake very radical statutory surgery on Truth in Lending -- for example, by returning to the original concept of just the "finance charge" and the "annual percentage rate" -- further changes in the credit disclosure provisions are probably not worth making.

As mentioned in the body of the testimony there is a considerable problem in consumer legislation because of the overlap of state and federal laws that cover the same subject. States have Truth in Lending laws, Equal Credit Opportunity laws, Fair Credit Billing laws, and other parallel local statutes. When the federal government entered these areas, rather than preempting the field, it sought to accommodate the possibility of concurrent state laws. Most of the federal statutes contain a provision that specifies

that state law is not preempted, except to the extent it is "inconsistent" with federal law. In some cases, the statute specifically provides that state law which is "more protective" is not preempted.

Maintenance of the two sets of requirements has adverse consequences. First, of course, it makes compliance difficult. Not only must federal law be mastered by creditors, but the complex provisions of state law must be examined to determine if some variant on the federal scheme is also required -- a task which is particularly difficult for small and medium-sized creditors. Even large creditors which are aided by sophisticated counsel will at times have difficulty determining with precision which state law provisions are "inconsistent," and how the "more protective" standard may be applied. Under the Truth in Lending Simplification Act, the Board is charged with making these determinations -- but this will be a long and complex regulatory process for the industry.

In some cases the duality of law may well even frustrate the federal objectives. The most striking example is provided by the recent simplification of the federal Truth in Lending Act. Numerous state laws currently on the books were modeled on the original lengthy disclosure scheme, which has now been reduced at the federal level. These state laws are, by and large, unaffected by the shift in the federal disclosure to a simpler format. The effect will be that the new segregated federal disclosures will have to be <u>added</u> on top of the existing state disclosures which are modeled on the earlier Truth in Lending format. The irony is that in many states Truth in Lending disclosures will be longer, rather than shorter, as a result of the simplification effort -- at least until state laws can be changed.

Recommendation:

The Board believes that it is time to reexamine whether continued attempts to integrate state and federal consumer laws are appropriate, given the added burden this imposes, and whether a more sweeping federal preemption may not be more desirable -- perhaps with provision for a state override along the lines of the recent federal usury limits.

There has been an increasing tendency for consumer legislation to include civil liability provisions, which particularly lend themselves to class actions. In some cases actual damages need not be shown. These provisions are often a major contributor to regulatory complexity. Creditors (especially large ones) demand extensive detail and rules to protect them from exposure to liability for actions taken under broadly worded regulations which sometimes may be ambiguous. Although financial institutions should be expected to follow the law scrupulously, the problem with disproportionately severe penalties is that they compel the Board to articulate extremely detailed rules governing every facet of regulated conduct. In giving the requested protection, compliance for everyone is made more complex.

Recommendation:

One possible solution would be to restrict civil liability to cases in which the consumer has suffered actual damages, and the Board believes this approach is worthy of congressional review.

One of the most important pieces of recent consumer legislation is the Electronic Fund Transfers Act which sets forth comprehensive rules governing

such transfers. The EFT legislation followed a pattern that was somewhat different from other consumer protection laws. It was anticipatory, in the sense that much of it was designed to establish, in advance, the rules that would govern any new and developing EFT service. Congress intended that it would provide the basic framework of rights and responsibilities for institutions that offer electronic transfer services and for the consumers who used those services. In creating this framework, the act sets out very detailed requirements -- which sometimes have caused problems with developing systems.

The impact of the act's detailed requirements has not been limited, moreover, to institutions that offer the newer types of EFT services. In many instances, that impact also has been felt by institutions that provide only the most traditional, longstanding services -- in areas where there is little or no evidence of need for special consumer protections.

The Board will shortly be submitting its first annual report on implementation of the EFT Act, and we are currently conducting a survey of the costs and benefits of various EFT Act provisions. When these efforts are completed, we will be in a position to make specific legislative recommendations.

Finally, the Truth in Lending Simplification Act concentrated on simplifying the disclosure requirements in consumer credit transactions. Although consumer leasing provisions are part of the act, they were largely untouched by the simplification effort. The Board could have simplified the leasing regulations somewhat under its regulatory authority, but the breadth of the current statutory provisions was an impediment to real reform.

Recommendation:

We would encourage Congress to study whether amendments which parallel those made for credit transactions under the Truth in Lending Simplification Act should be made to the statutory leasing provisions.