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Statement by

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Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

S. 2298

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I am pleased to appear before this Committee on behalf of the Board of Governors of the Federal Reserve System to discuss S. 2298, and the broad range of important bank regulatory, supervisory and monetary policy considerations which are affected by this proposal.

In the interest of both clarity and brevity, my prepared statement is addressed to the key reasons underlying the Board's positions on the provisions of this bill and on certain alternative proposals. Thereafter, I shall be glad to try to answer any questions you may have.

When you introduced S. 2298, Mr. Chairman, you referred to the speech Chairman Burns made to the American Bankers Association, in October 1974, concerning the banking system. During the past year the Federal Reserve has made detailed studies of the problems highlighted in that speech and what might be done to help correct them. As a part of those efforts, we have given careful thought to the structure of bank supervision and regulation in the Federal bank regulatory agencies. Our views have been evolving during the course of these studies, and they are continuing to develop.

One of the Board's major conclusions from this detailed review is that some reform of the bank regulatory structure is desirable, but that consolidation of all bank supervisory and regulatory authority in a separate agency as proposed in S. 2298 would be unwise. (We also have comments on several details of S. 2298, which are presented in the attached Appendix A.)

A number of considerations have led the Board to this major conclusion. First and foremost, this bill mandates a decisive separation between the Federal Reserve, the nation's central bank, and banking regulation and supervision. That, we are convinced, would be a serious mistake. Now, more than ever, the Federal Reserve's role as monetary policymaker and as lender of last resort interacts with the effects of prevailing bank supervisory and regulatory policies. Each of these areas of public policy increasingly influences the effectiveness of the other. To divorce them is to weaken both.

Because of the importance we attach to this particular issue, let me give you some concrete examples of our concern. Fundamentally, monetary policy works by affecting the liquidity position of banks and the financial system. Good bank supervision should, and will, examine the liquidity of individual banks and urge the correction of inappropriately thin or exposed liquidity positions. But if bank supervisory policy is set without full understanding of broad economic developments or the trend of monetary policy, the supervisor can be impelling ill-timed banking actions. The enforced write-downs of bank assets to the unrealistically depressed market values reached during the Great Depression were among the most unfortunate examples of such too-narrow supervisory vision.

On the other hand, if the bank supervisor sets too-low liquidity standards, or none at all, or changes them at an inopportune moment, he can dilute or frustrate for a time the thrust of monetary policy. For example, the bulge of the past few years in loan commitments -- that is, in bank promises to lend money upon request, made chiefly to businesses -- both slowed and skewed the restraining effects of monetary policy, and thereby helped worsen our inflation. Those adverse effects could have been considerably worse, were it not for the fact that the Federal Reserve, drawing upon its supervisory as well as monetary responsibilities, took the initiative in expressing concern to bankers regarding the large build-ups in their commitments. With the benefit of hindsight, however, I wish that our countermeasures could have been even more vigorous.

Bank capital standards set by supervisors also interact with both national economic and monetary policy. Supervisory rules that require banks to raise their capital ratios or that make it more difficult for banks to raise capital can reduce the availability of bank funds to prospective borrowers and thus slow the rate of growth of bank credit and money. These are matters of significance to monetary policy. For example, right now, in the wake of several years of strong bank credit expansion and some recent loan reverses, a strengthening of capital positions of many banks is most desirable. But supervisory pressure for improving capital ratios should not be overdone in this environment, as it could deter bank willingness to lend to the extent of interfering with the financing of recovery. Nor, for the same reason, should supervisory pressure be such as to inhibit the ability and willingness of banks to go to the market to raise needed capital.

There are two other important aspects of interaction between supervisory and monetary considerations that should be accented.

Bank supervisory activities provide a flow of information concerning detailed developments inside the banking system that can be of inestimable value to monetary policymakers. Examiner asset evaluations supply first-hand knowledge of the changing quality of credit, and of the quality of bank management that is administering that credit. Important insights are gained also into bank policies regarding liability management and participation in various types of credit markets. This kind of information provides valuable supplements to the meaning of the quantitative statistics on monetary and credit aggregates.

When one turns to the regulation and supervision of international banking activities, more monetary implications ensue. Changes in bank rules or examiner standards can generate flows of funds into or out of this country that markedly alter the international balance of payments and the foreign exchange value of the dollar. Similarly, such changes can create financial problems for other countries and adversely affect the relations between our country and others.

In all these supervisory and regulatory matters, the standards of objective examiner professionalism need to be respected, but such standards need to take account of their broader domestic and international consequences. To our mind, this reasoning argues decisively for a close relation between monetary policy and supervisory and regulatory considerations.

The Board's deliberations have led to the conclusion that an optimum system of bank regulation and supervision is one that would achieve three main objectives: (1) to keep banks safe and sound, (2) to protect the legitimate interests of present and would-be bank customers, and (3) to be attentive to overall monetary considerations.

It might seem logical to pursue these various objectives by consolidating all the public agencies concerned with them under one roof. That would amount to centralizing all banking and monetary powers in one agency.

However, experience with regulation in industries other than banking suggests that placing all regulatory authority in a single agency does not necessarily result in sound regulatory policy. Too much centralization entails substantial risks. To the extent that the possibilities of criticism and constructive differences of view from within the regulatory structure are eliminated, the benefits of knowledgeable checks and balances are diminished. The stimuli to initiative and innovation are reduced. A sole bank supervisory agency, not subject to challenge from sister agencies, could tend to become inflexible, or even ossified.

In addition, any supervisory agency design needs to take careful account of the danger of the development of an unhealthy relation between the supervised and the supervisors. I believe Federal government agencies generally make a sincere effort to avoid becoming captives of the industries they regulate. However, the necessary closeness of the relationship creates opportunities for undue influence which must be guarded against.

As we have weighed these risks against the improvements upon recent performance that could realistically be expected to flow from complete centralization of Federal bank regulatory authority, we have concluded that the gains are not worth the risks, at least at the present stage of experience. Likewise, we have concluded that there are not such critical shortcomings in our present bank regulatory system as to call for the kind of drastic overhaul proposed in S. 2298. Too often, we believe, advocates of this kind of radical change are comparing the real with an untested ideal. Any existing arrangement will show up with some blemishes in such a comparison.

Our analysis of the banking problems that have surfaced in recent years indicates that many of them would probably have occurred regardless of what structure of Federal supervisory agencies was in place, and that most of them can be dealt with without a drastic restructuring of the banking agencies.

In the light of recent experience, many necessary or desirable corrective measures have already been introduced by both banks and bank supervisors. Banks in general have been sobered by the problems they have faced and are taking a more prudent posture both in pursuing new activities and in monitoring possible excesses. The agencies, on their part, have launched a number of important remedial measures to improve bank examination, supervision, and regulation. Without taking the time to identify all the improvements that have been undertaken, I will simply attach as Appendix B to this testimony a list of some of the significant changes and proposals that the Federal Reserve itself has made.

Surveying all these and similar changes, we believe they promise a substantial and responsible improvement in the banking environment. But I am not here to try to lull this Committee into inaction with a claim that "Everything is fine." On the contrary, we believe there are certain problem areas where current progress is not good enough, or fast enough, or uniform enough to be satisfactory. Accordingly, the Board believes that some change in the Federal bank supervisory structure, designed to improve performance in those particular areas, would be worthwhile. To be specific, the objectives that we have in mind are: (1) to more efficiently and uniformly modernize bank examination and surveillance procedures, (2) to provide for more vigorous and consistent follow-up procedures when bank examinations reveal weaknesses, (3) to attain greater consistency in some regulations, and (4) to improve the coordination of bank supervision with monetary policy.

What agency changes would do most to foster these objectives while avoiding the pitfalls cited earlier in this testimony? The answer to that question is, in the end, a matter of personal judgment. On balance, no one proposal for agency reform has gained the support of a strong majority of the Board at this time. Two different reform proposals, however, have developed strong support within the Board.

The first, and perhaps the simplest, is to consolidate the functions of the Office of the Comptroller of the Currency within the Federal Reserve System. This change would accomplish a good deal of what is claimed would be accomplished by a complete consolidation of Federal bank supervisory functions, without some of the dangers of complete unification.

There is logic in this proposal, because all national banks are required to be members of the Federal Reserve System and thus subject to its regulations, but their primary examination and supervision lies with the Comptroller; the Board has supervisory responsibility for all bank holding companies, and yet many of the major bank subsidiaries of such holding companies are national banks; the Board must approve the opening of foreign branches of national banks consistent with its international monetary responsibilities, but the supervision and regulation of those branches rests with the Comptroller; the Board authorizes Edge Act corporations, but many of the banks with whom those corporations are associated are supervised by the Comptroller.

The examination and supervision of national and State member banks could be integrated efficiently. At the same time, the continued existence of the FDIC would provide another Federal banking agency to check or stimulate the supervisory and regulatory actions of the Federal Reserve.

If the Congress should make such a change in bank regulatory structure, it would then seem appropriate to have the incumbent of the Office of the Comptroller of the Currency added as an eighth member of the Federal Reserve Board until the next Board vacancy occurred, at which time he would be appointed to fill that vacancy.

The second reform proposal which has developed strong support within the Board is the creation of a Federal Bank Examination Council. Such a Council would be focused on the areas that we believe are most in need of improvement -- i.e., efficient and uniform modernization of bank examination and vigorous and consistent follow-up procedures when bank weaknesses are revealed. Such a Council could be established administratively, or by statute. Its statutory authorization would undoubtedly give more impetus to the establishment of such a Council, and would also provide it with more clear-cut authority to take definitive action within its statutorily defined areas of administration.

The Federal Bank Examination Council should have authority to establish standards and procedures for bank surveillance, examination and follow-up, applicable to all the Federal banking agencies, and it should review significant problem cases when and as they develop. All three Federal banking agencies should be represented on the Council. Because of the importance of close coordination between bank supervision and monetary policy, we would favor appointing a member of the Board as our Council representative and making him Chairman of the Council.

Establishment of a Federal Bank Examination Council of this kind would be consistent with an experimental and evolutionary course. Experience with the Council would conceivably lead in time to the conclusion that some further consolidation of banking regulatory and related authorities would be desirable. If so, that decision would be based upon actual experience and a greater practical awareness of the difficulties to be overcome than we now have. This step-by-step approach to reform in bank regulatory structure could, we believe, bring about significant improvements in bank supervision.

The adoption of either of the two reform proposals that I have sketched should help to reduce instances of "competition in laxity" such as were noted by Chairman Burns in his October 1974 address. They would, at the same time, continue a system of checks and balances which, as Chairman Burns also observed, "is the traditional way of guarding against arbitrary or capricious exercise of authority."

The Board recognizes that reasonable men differ on the scope and desirability of revisions, if any, in bank regulatory structure. As I have tried to indicate, we are not wedded to the *status quo*. We look forward to continued work with your Committee in developing the most workable and desirable revisions in bank regulation and supervision.

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The Board offers the following comments on substantive changes in various statutes that would be made by the passage of S. 2298.

Section 199:

Sec. 199 would amend 12 U.S.C. 301 by adding:

"In no event shall any discount, advance, or accommodation be extended to any member bank for the purpose of ameliorating the consequence of any unsafe or unsound condition unless the Federal Bank Commission certifies to the Board that such advance, discount, or accommodation is necessary in the public interest and the Board shall find affirmatively that such advance, discount, or accommodation may alleviate a significantly adverse impact upon the economy of the Nation or any section of the country."

Under present law and regulations Federal Reserve credit may be made available to a member bank in difficulty because of financial strains arising from particular circumstances affecting the individual bank, including sustained deposit drains, impaired access to money market funds, or sudden deterioration in loan repayments. As long as the member bank is solvent (based upon the bank's primary supervisor's determination), Federal

Reserve credit assistance can play a role in providing the time needed to develop a longer-run solution to the bank's problems. All loans to member banks must be secured and a Federal Reserve Bank will not lend if it cannot reasonably expect to be fully repaid. In cases where borrowing is expected to continue for an extended period of time, the bank must provide a plan outlining the steps it will take to resolve its problems and eliminate the need for credit assistance. In determining whether to make advances in exigent cases, the Federal Reserve Bank evaluates the role of the bank in its community, as well as the impact of its possible failure. The Reserve Bank has the authority to require a special, higher discount rate when a bank borrows for an extended period. Such a rate is intended to reduce or eliminate any undesirable margin below prevailing market rates and to encourage prompt repayment.

The Board thus believes that the additional restrictions on borrowing by member banks proposed by section 199 would be both unnecessary and undesirable. Such added restrictions might delay or otherwise hamper timely credit assistance to individual member banks. These possible delays and the uncertainties associated with the Federal Bank Commission's certification deliberations could give rise to concern by market participants that Federal Reserve loans will not be forthcoming with sufficient speed, in sufficient volume, and for sufficient duration. This would be the case particularly if the market perceives Congressional intent as being to minimize the use of Federal Reserve credit to mismanaged banks, regardless of the implications of a large bank failure. As a result, depositors and lenders to banks would be likely to withdraw more rapidly from any bank or banks that are suspect.

In short, market fears of impairment in the Federal Reserve's ability to use its "lender of last resort" powers promptly and in the degree needed could produce expectations that would adversely affect the stability of the financial system. Moreover, such concerns would limit the time available to policymakers to restructure distressed banks and rebuild confidence in the banking system.

In addition, it should be pointed out that access to the discount window is one of the most important advantages of membership in the Federal Reserve System.

By becoming members of the System banks now suffer a marked competitive disadvantage, because they are required to maintain a significant share of their assets as nonearning reserves. One reason for banks leaving the Federal Reserve System is this loss of revenues from nonearning assets. For the same reason, nonmember banks and newly chartered State banks may choose not to join the Federal Reserve System.

We believe that any further impediment to access to Federal Reserve loans by member banks, at least until such time as all banks are subject to the same reserve requirements, could be damaging to the maintenance of Federal Reserve membership and could lead to a serious erosion in the base for Federal Reserve monetary policy.

Sections 205 and 234:

Sec. 234 proposes to amend 12 U.S.C. 1814 by striking out the sections of the law which provide that every national bank and every State bank which becomes a member of the Federal Reserve System shall be an insured bank from the time it is authorized to commence business or become a member of the Federal Reserve System.

Sec. 205 amends 12 U.S.C. 329 to provide that "no bank shall be admitted to membership (in the Federal Reserve System) unless it is approved for deposit insurance under the Federal Deposit Insurance Act by the Federal Bank Commission."

The combination of these two provisions would require a newly organized State bank to obtain three supervisory approvals, from the State chartering authority, the Federal Bank Commission, and the Federal Reserve before it could become a member of the Federal Reserve System. Again, because of the possible further erosion in the Federal monetary policy base through an added deterrent to membership, the Board objects to these provisions. It is suggested that Sec. 234 amend 12 U.S.C. 1814 so that a State nonmember bank which becomes a member of the Federal Reserve System would continue to obtain Federal deposit insurance coverage as a result of that membership.

Section 258:

Sec. 258 provides for audit of the Federal Bank Commission by the Comptroller General of the United States, and specifically states that representatives of the General Accounting Office shall have access to "reports of bank examinations and related papers, from whatever source."

The Board has serious reservations about making bank examination reports available to the General Accounting Office. There is a strong public policy favoring confidentiality of bank examination reports. That policy has been confirmed by the Congress in 18 U.S.C. 1906, which makes it a crime for any bank examiner, without the Board's authority, to disclose information regarding individual loans.

In the course of making an examination report, an examiner will carefully review and appraise three major factors -- quality of assets, adequacy of bank capital, and quality of management -- to reach a judgment as to the overall condition of a bank. Consequently, bank examination is an expression of the examiner's judgment as much as it is a fact-finding procedure. The possibility of disclosure might curb examiners' willingness to make frank judgments.

Bank examination reports contain much information that is sensitive and potentially damaging both to the bank and to the bank's customers. The confidential affairs of every debtor whose loan is classified are revealed in such reports. Disclosure of this type of information could have a serious impact on bank-customer relations generally.

The Board believes that access to reports of examination made by the proposed Federal Bank Commission should be limited to the traditional Federal law enforcement agencies and, in the case of a State-chartered bank, to its State supervisory agency. The Board is concerned that access to these reports by the General Accounting Office or other Federal agencies would increase the dangers of disclosure and therefore should not be permitted.

Section 5(b):

This section transfers all functions of the Federal Reserve System under certain specified laws, including the Banking Act of 1933, to the Federal Bank Commission. The basic authority to regulate the payment of interest on time and savings deposits of member banks (12 U.S.C. 371b) was conferred by the Banking Act of 1933. It is noted that in the conforming amendments no change is made in 12 U.S.C. 371b, however, and therefore the Board assumes that it is the intention under the bill to leave this authority with the Board.

It is the Board's view that interest rate ceilings should be phased out, as provided in the proposed Financial Institutions Act. As long as interest rate ceilings are imposed, however, they are regarded as such an important adjunct of monetary policy that there should be no possible question about the Board's continuing authority to set such ceilings for member banks.

Accordingly, even though at the present time the Board's interest rate regulations are promulgated under the temporary authority of the Act of September 21, 1966 (P.L. 89-597, 80 Stat. 824), as amended, it is suggested that, to remove any possible ambiguity, section 5(b) be amended by inserting, after "the Banking Act of 1933" the phrase "(except those provisions dealing with the payment of interest)".

APPENDIX B

Recent Activities by the Federal Reserve in the Area of Banking Supervision and Regulation, Including Legislative Proposals and Regulatory and Administrative Actions

A. Legislative Proposals

1. Bill relating to the supervision of foreign banks in the United States (S. 958, H.R. 5617).

2. Bill to permit more expeditious handling of problem bank and bank holding company situations and to permit acquisition of a problem bank by an out-of-State bank holding company (H.R. 4008).

3. Bill to: (a) strengthen penalties for violation of cease and desist orders; (b) place aggregate limits on loans to insiders and their interests; (c) permit easier removal of officers or directors of a banking institution; and (d) permit divestiture of a bank holding company subsidiary (S. 2304).

4. Bill extending application of reserve requirements to all depository institutions (S. 2050, S. 1961).

B. Regulatory Actions

1. Changes in Regulation A relating to member banks' access to longer-term emergency credit.

2. Amendments to Regulations H and F requiring State member banks to treat standby letters of credit and ineligible acceptances in the same manner as loans.

3. Proposed guidelines for evaluation of requests, and regulatory changes to increase flexibility in the issuance of notes and debentures by State member banks. (Comments under review)

C. <u>Administrative Actions</u>

1. Increased efforts to examiners to identify potential problem State member banks.

2. Increased efforts to identify potential liquidity problems of all banks.

3. Intensified and more uniform follow-up procedures when a problem bank is identified, including progress reports, meetings with directors, and special-purpose examinations.

4. Uniform procedures relating to identification of bank holding company liquidity problems and on-site examinations.

5. Introduction of interagency early warning system regarding subsidiaries of bank holding companies.

6. Initiation of an expanded computerized surveillance system for bank holding companies.

7. Expanded efforts to identify risks associated with banks' foreign exchange trading and to improve banks' audit and control procedures.

8. Clarification of limitations on bank extensions of credit to their holding company affiliates. (Being transmitted to banks)