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Statement by

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Board of Governors of the Federal Reserve System

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Regulation and Insurance

of the

Committee on Banking, Currency and Housing

House of Representatives

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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 Title IV of the FINE "Discussion Principles" relating to the regulatory agencies.

We at the Board are impressed, Mr. Chairman, with the thoughtful approach which your Committee is employing in its study of Financial Institutions in the Nation's Economy. Your study wisely recognizes the interrelation of efforts to restructure financial institutions with questions relating to housing, holding company operations, international banking activities, and the role of the regulatory agencies. The Board hopes that it will be able to contribute to your comprehensive efforts in a meaningful way.

Turning to the Discussion Principles relating to the regulatory agencies, I note that Title IV starts with a reference to Chairman Burns' speech before the American Bankers Association in October 1974.

You will recall that I also used that speech as a starting point in my testimony before this Committee last July. As I indicated at that time, the Federal Reserve, for more than a year, has been making 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 Federal bank supervision and regulation.

In my testimony last July, I offered certain tentative conclusions reached by the Board. Since that time our studies have continued, our views have been evolving, and they are continuing to develop. In the course of these deliberations our positions on two of the tentative conclusions offered last July have solidified.

Our first and foremost conclusion is that the Federal Reserve, as the nation's central bank, needs to be closely involved in the process of bank regulation and supervision. Our second conclusion is that some improvement in the present structure of the Federal bank regulatory agencies is desirable. Let me explain how we have reached each of these conclusions, and relate our thinking to the distinctive features of the proposals put forth in the FINE Discision Principles.

The place to begin, as we see it, is with the relationship between monetary policy and regulatory policy. 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 counter-measures 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 interest 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 either dominating or 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.

For similar reasons, we have concluded that there are not such critical shortcomings in our present regulatory system as to call for the kind of drastic overhaul proposed in the FINE Discussion Principles. Certain special features of the FINE proposal, however, call for some added comment.

First, the regulatory commission proposed in the Discussion Principles would include as a member of the five-man commission the Vice Chairman of the Federal Reserve Board. We are pleased with this recognition of the need for the Board's representation on a commission regulating depository institutions. However, for the reasons I set forth in the first part of my statement, the Board believes that the relation between monetary policy and bank supervision and regulation should be strengthened rather than weakened as it would be under the FINE proposal.

Second, the FINE proposal would include under the jurisdiction of the new Federal Depository Institutions Commission not just commercial banks but also all Federally insured savings and loan associations, mutual savings banks and credit unions. We agree that there is some logic in this proposal. As the activities of other depository institutions are permitted to take on more of the attributes of banking, the distinctions between the different types of institutions become increasingly blurred, and the need to coordinate their regulation and supervision grows correspondingly stronger. At this time, however, the Board believes that, logical as it may appear, combining the regulation of all depository institutions in one supervisory authority at one stroke would be too potentially disruptive a step to take.

Third, your Discussion Principles implicitly recognize that there is a problem in consolidating five Federal supervisory authorities into one by suggesting a three-year transition period. The Board agrees that any change of the character proposed would have to be made gradually.

In our view, however, it is preferable to start with less sweeping substantive changes in the structure of depository regulation, and then to introduce further reforms as necessary, building on the experience gained from the actions previously taken. I shall be making more explicit comments in this vein later on in my statement.

We are led to recommend this more moderate, step-at-a-time approach by our analyses of the banking problems that have surfaced in recent years. Our studies indicate that many of such banking problems 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. Some of those measures I mentioned in my testimony here last summer. Without taking the time to repeat and expand upon them, I will simply attach as an appendix 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 has concluded 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 eliminate some of the anomalies pointed out in the Discussion Principles. Indeed, it could 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 one I outlined to you in July, namely, 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 of action. 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 without risking the potential disruption that could accompany more sweeping changes.

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 the 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 practicable and desirable revisions in the regulation and supervision of depository institutions.

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APPENDIX

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. Administrative Actions

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)