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Statement by

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before the

Subcommittee on Intergovernmental Relations

of the

Committee on Governmental Affairs

U. S. Senate

May 25, 1977

It is a pleasure to appear before this distinguished Committee today to present the views of the Board of Governors of the Federal Reserve System on S. 600. This bill sets out specific procedures for the periodic review of the myriad of regulations issued by our many Federal agencies, with consequent revision and restructuring where appropriate. In testimony before the full Committee on a similar bill one year ago, Vice Chairman Gardner indicated the Board's strong sympathy and support for the basic objectives of the proposed legislation. I am happy to note that the Board's suggestions with respect to the need to consider the interrelated nature of separate industry regulations and the greater time required for a truly comprehensive review process have been addressed in S. 600.

The Board continues to support the broad goals expressed in the Regulatory Reform Act. By virtue of our continuing evaluation of economic developments in connection with the formulation and conduct of monetary policy, the Board is acutely aware that government regulation of various aspects of economic activity may introduce distortions and inequities into the economy. Despite laudable objectives, there is little doubt that both Federal legislation and the regulations implementing that legislation have often had the unintended effects of introducing rigidities and imperfections into the functioning and evolution of industries and their related markets. All too frequently the results have been a lessening in competition, a reduced resilience to deal with economic change, and a higher and more rigid structure of costs and prices which the consuming public must inevitably bear.

It is clear also that regulation has contributed to the inefficient use of real resources in the economy. When regulated businesses are precluded from competing directly on a price basis, for example, they are likely to spend more on advertising, or elaborate office furnishings, or an unnecessary proliferation of facilities. Also, banks and other depository institutions, which are not unknown for resorting to such devices, frequently offer free services and give away free merchandise in their efforts to attract new funds when price competition is limited by interest rate ceilings on deposits.

In addition, the costs of compliance with regulation can be quite high. In banking, numerous reports must be filed with Federal bank regulatory agencies or filled out and kept accessible for enforcement purposes. The cost of this paper work to the institution constitutes a hidden tax imposed by the regulators on the regulated that must ultimately be passed on to the bank's customers. The Board has been quite aware of these costs and has embarked upon a System-wide effort to cut back on the reporting burden. I am happy to say that, in the last year and a half, we have been able to reduce the overall volume of reports received by around 7 per cent.

Worst of all, Federal law and regulation have sometimes had the effect of fostering monopolistic and cartel-like behavior on the part of ostensibly competing firms by insulating these firms from the discipline of effective competition. On other occasions, regulatory action may preserve the inefficient marginal firm, or divert resources to less than the most productive uses through the

offering of special advantages to certain industries. Moreover, promotion of the special interests of individual industries via the legislative and regulatory process, in the name of the public interest, may have the effect of advancing those special interests at the expense of consumers. The danger that such regulation can be anti-consumer in nature has been enhanced because, until recently, the economic impact on consumers often was omitted from the factors considered in evaluating net public benefits.

In fairness, it needs to be recognized that some Federal regulation does promote the public interest and contribute to the performance of the economy. For example, regulation designed to maintain the safety and soundness of individual banks is critical to the strength of the financial system and the efficient functioning of the economy as a whole. Another example appears in the area of securities regulation where the SEC disclosure requirements help make needed information available to aid investor decision-making and increase the efficiency of securities markets. But there is a critical need to review and evaluate outstanding regulations on a periodic basis to see whether they are still justified, can be simplified or need to be modernized in light of recent developments.

It is important to recognize, I believe, that regulation per se is never costless. As noted, there are always certain compliance and administrative costs incurred by both the regulator and the regulated. Moreover, there are usually indirect and more subtle costs associated with reduced freedom of choice for the regulated and the consuming public. The goal of the regulator in implementing regulations should

be to minimize both these costs and their distributional effects, and to assure that there are always public benefits that outweigh these costs. As I understand it, the principal purpose of the proposed legislation is to assure that there will be such a thorough and detailed review of these effects of the regulatory process, agency by agency and industry by industry.

While the Board agrees with the general thrust and objectives of S. 600, there are certain key features with respect both to its coverage and method of implementation that need to be clarified. We are especially concerned with the so-called "sunset" provisions that require the termination of, first, regulatory enforcement authority and, second, the entire agency in the event that no reform plans are enacted within the prescribed time period. There are several reasons for questioning the advisability of using such a strong forcing mechanism in order to assure that the necessary regulatory reform will take place.

First, many Federal agencies, pursuant to their legislative mandates, perform a variety of functions that are not basically regulatory in nature, but that may still depend in part for their implementation on enabling rules, orders, and regulations. In the case of the Federal Reserve Board, for example, such responsibilities include: (1) its central banking function with regard to international finance; (2) the formulation and implementation of monetary policy; (3) oversight activities with respect to the Federal Reserve Banks, which in turn play a pivotal role in the operation of the nation's

payments system; (4) its rules for the administration of the discount window, through which the Federal Reserve System serves as the lender of last resort to the banking system and, in exigent circumstances, to the economy as a whole; and (5) the supervision of member banks and bank holding companies. In comparison with these functions, the Board's strictly regulatory responsibilities for banking and finance, including its role in consumer credit protection, account for a relatively small portion of the agency's efforts or for the impact of its actions on the economy.

The coverage of the Regulatory Reform Act, in the case of the banking agencies, specifically refers to their "regulation of banking and finance." It would appear, therefore, that the intent is not to discontinue all nonregulatory functions, or to dismantle an entire agency, for want of reform plans to cover the agency's regulatory functions. We believe that the Congress would not want to risk the abolishment or suspension, even temporarily, of the conduct of monetary policy or the supervision of banks. Similarly, we would be deeply concerned if there were no central oversight of the operation of the Reserve Banks and the payments mechanism, or of the discount window function. Such potential problems are by no means unique to the Federal Reserve Board. For example, what would become of the deposit insurance function of the FDIC or of its role with respect to the banks requiring liquidation? I should also point out that the Comptroller of the Currency is the chartering and supervisory authority for national banks, and these

activities, too, would be suspended in the event of termination of that agency. Surely these functions should continue.

Nevertheless, there are no explicit provisions within the bill to provide for the continuance of these functions. Even if they were construed to be covered by the provisions for regulations "essential for preserving public health and safety," we would have grave reservations that the Department of Justice could assemble the necessary resources to perform these functions which are essential to the nation's economic well-being. For these reasons, we must presume that the bill is directed to the purely regulatory activities of the agencies and would not, in the case of the Federal Reserve Board, encompass central banking, monetary policy, oversight of the Reserve Banks, operation of the discount mechanism, bank supervision and the incidental regulations of the Federal Reserve necessary to carry out these functions.

In view of the problems associated with the "sunset" provisions, the Board would urge a narrower and more specific delineation of the aspects of regulation of banking and finance to be covered by the bill, to which the application of these provisions would then be directed.

The Board has a second concern about the "sunset" mechanism. Instead of easing the regulatory climate, the abrupt termination of even the regulatory functions of Federal agencies might present obstacles to the efficient functioning of the economy simply because of the language of many of our laws. Federal statutes are generally implemented by way of agency regulations, and in many cases agency

approval pursuant to those regulations is necessary before individuals or firms can participate in certain activities or markets.

In the event the "sunset" provisions of S. 600 were triggered by lack of action on bank regulatory reform, under one possible interpretation this would mean that institutions seeking Board approval would be hampered--not freed--for lack of a regulatory process. Thus, for example, as the Bank Holding Company Act is written, it is unlawful for a bank holding company to be formed without the express approval of the Board of Governors. Similarly, existing bank holding companies wishing to expand or to engage in new activities would be denied the opportunity to have their applications for Board approval reviewed and acted upon. The same situation would exist with respect to applications to the Board for new branch offices, to establish Edge corporations, to engage in foreign banking activities requiring Board approval, or for permission to issue new debt or equity securities--to name a few. The result could be severe inequities for firms who could not obtain Board approval to engage in activities that may have already been authorized for their competitors.

This brings me to the final point I wish to make about the proposed legislation. As I have noted, most regulatory agency rules and regulations are issued pursuant to the mandates of specific laws. As such they represent the efforts of the agencies to implement Congressional intent. It may therefore be that many of the economic problems and inequities caused by regulation are rooted in the enabling legislation itself, rather than in the specific form the regulations have taken.

I would suggest, therefore, that consideration be given to broadening the scope of the review contemplated in the Regulatory Reform Act to encompass, where necessary, review and reform of the enabling legislation as well as existing regulation. Real progress in improving and simplifying our Federal regulatory apparatus, I would imagine, would often require rather fundamental amendments to underlying statutes.

In conclusion, I wish to reiterate that the Board supports the basic concepts of the Regulatory Reform Act but believes that further attention should be given to problems of its scope and implementation.

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