THE FINANCIAL REGULATORY ENVIRONMENT

Remarks by

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This opportunity to discuss with you some of the changes occurring within the financial regulatory environment is timely. The regulatory environment is an important part of the overall economic environment, in which the Federal Reserve System has a major role. At present, our role is to fight the pervasive and pernicious inflation with which our economy has been afflicted in recent years.

The long standing nature of the problem of inflation makes our task more difficult. As measures are taken to combat inflation, consumers and businesses act in ways which render these measures less effective. Even with the package of actions last week, it is still too early to judge whether they will be effective. We arrived at our present state of escalating inflation over a period of years. It will require time to reduce inflation to an acceptable level.

CHANGES IN THE BOARD OF GOVERNORS

The Federal Reserve "cast of characters' has changed considerably during the current year, beginning in February with the resignation of former Governor David Lilly. In March of this year, Chairman Miller replaced former Chairman Burns. Mr. Miller brings with him the same commitment to fight inflation that Dr. Burns possessed but his style presents quite a contrast. Mr. Miller brought with him experience as head of a major corporation for several years, while Dr. Burns was an economist in government and in academia. Changes in administration of the System are already evident.

This fall, Nancy Teeters, the first woman governor, took office. Governor Teeters is a former staff economist at the Board of Governors but most recently was with the House Budget Committee. Her knowledge of fiscal policy should be valuable to the Board. Effective November 17, Governor Phillip Jackson has resigned from the Board. Obviously, we are interested to learn who will replace him. Whoever it is, you may be sure that we will continue the fight against inflation.

CONSUMER CREDIT REGULATION

A not inconsiderable cause of inflation is the increasing burden of regulation which, ultimately, the consumer must bear. Banking, probably the most regulated of industries, takes on a new regulatory burden today--the Community Reinvestment Act, or CRA, which is implemented by the new Federal Reserve Regulation BB. The CRA requires Federal bank and thrift regulatory agencies to encourage regulated institutions to help meet the credit needs of their communities, including low and moderate income neighborhoods, consistent with safe and sound operations. Within 90 days, each regulated lender is required to adopt a CRA statement, which will delineate the "entire community" the lender serves, and will specify the types of credit the lender is prepared to extend to the community. The CRA statement must be available for public inspection in public areas of lenders' offices, and lenders must retain public comments for supervisory review for two years.

Supervisory agencies are required to assess the record of institutions in meeting the credit needs of their communities when considering applications for branches, mergers, charters, deposit insurance, holding company acquisitions and office relocations. In addition to reviewing public comments, examiners will review records of loans accepted and rejected to assess the lender's record. It is rather obvious that Congress expects regulatory agencies to deny applications for expansion from those who fail to meet the test imposed by the CRA.

The CRA is only the latest in a series of Federal consumer credit statutes, which began with the Truth in Lending Act in 1968, and continued with the Equal Credit Opportunity Act, the Home Mortgage Disclosure Act, the Truth in Leasing Act, and, more recently, the Fair Debt Collection Practices Act. The Federal Reserve has rule-writing and supervisory responsibilities with respect to several such statutes; we and the other bank regulatory agencies now conduct separate consumer compliance examinations in addition to our regular examination procedures. Also, in order to assist member banks in avoiding the substantial civil penalties which can result from noncompliance with consumer statutes, we have conducted Consumer Affairs Advisory Services for well over 100 member banks in the Sixth District alone.

THE OMNIBUS BANKING BILL

In addition to the CRA, the 95th Congress enacted legislation which will affect significantly the way in which banks and other financial institutions do business. This, of course, includes the Omnibus Banking Bill, a part of which is also known as the Financial Institutions Regulatory Act. The basic thrust of this legislation is to address those matters generally referred to as "insider practices" and to set limits upon them. During the past year, there have been a number of proposed versions of the so-called "Safe Banking Act," a nomenclature which was offensive to the banking community and was abandoned in favor of FIRA. Until just before adjournment, it was widely believed that no bill would be passed this year. Nevertheless, a last-minute burst of legislative maneuvering resulted in passage in both Houses of Congress during the early morning hours of Sunday, October 15. The bill places limitations on abusive insider practices, including insider loans and overdrafts, and loans from correspondent banks, and requires banks to file annual reports of insider loans with supervisory agencies. Management interlocks between competing financial institutions are prohibited, and supervisory agencies are now able to forbid changes of control detrimental to banks. Supervisory agencies are given increased cease and desist powers to deal with abusive practices.

In addition to these provisions directed at abusive insider practices, the bill contains several other provisions of importance. It creates a "Federal Financial Institutions Examination Council," consisting of officials of the three banking agencies, the Federal Home Loan Bank Board, and the National Credit Union Administration; the Council will establish uniform examination procedures and report forms, and conduct examiner schools. The bill also authorizes NOW accounts for New York State; authorizes FDIC insurance up to $100,000 for IRA and Keough accounts; extends Regulation Q interest rate control authority for two more years; eliminates the Q differential for NOW accounts and automatic transfer accounts; and enacts EFT legislation limiting customer liability for unauthorized electronic transfers to $50 if certain conditions are met, and to $500 in any case. The Federal Reserve Board is given rule-writing authority in several sections of the bill, including those dealing with interlock provisions, changes in control, and electronic funds transfer.

THE INTERNATIONAL BANKING ACT OF 1978

The International Banking Act of 1978, passed in the 95th Congress, should be of special interest to Georgia bankers. The principal focus of this legislation is to bring foreign banks operating in the U. S. into competitive equality with U. S. banks. This is particularly true with respect to their operations across state lines, and with respect to reserve requirements, FDIC insurance, and, to an extent, Federal supervision. This Act also permits foreign banks to own Edge Act Corporations, while liberalizing restrictions on Edge Acts. In addition, it requires the Administration to report in one year as to whether the restrictions of the McFadden Act, passed in 1927, should be retained. This provision could eventually mean liberalization of the McFadden Act's prohibition against interstate banking.

THE MEMBERSHIP PROBLEM

Legislation Congress did not pass includes the proposed bill which would have addressed the Federal Reserve System's long standing membership problems. The decline in System membership has accelerated markedly in the last decade. While member banks held 83 percent of bank deposits in 1965, by the end of 1977 this percentage had declined a full 10 percent to 73 percent.

The problem of membership attrition has been more severe in New England, where NOW accounts have been permitted during the last few years. The reduction in earnings associated with NOW accounts has induced banks to seek ways of lowering their costs, and as a result, they have assessed more carefully the costs and benefits of membership.

This trend in New England, in tandem with the move in Congress to extend NOW accounts nationwide, coupled with the erosion of the prohibition against payment of interest on demand deposits, has emphasized the need for finding a solution to the membership problem. Until recently, the preferred solution included the payment of interest by the Federal Reserve on reserve accounts, together with other changes such as explicit pricing of services. Originally, the Federal Reserve preferred that these changes be embodied in the NOW account bill. However, NOW account legislation appears to have been pretty much placed on the back burner by Congress, despite the extension of NOWs to New York, and we have had to consider other avenues of approach to the problem. Earlier this year, after Chairman Miller took office, the idea was advanced that the Federal Reserve could pay interest on reserves without specific legislative authorization--there is, in fact, no specific statutory prohibition against such payment. Nevertheless, the idea of paying interest on reserves unilaterally was received quite negatively by key figures in Congress, and as a consequence, this line of thinking has been throttled considerably.

In July, legislation was proposed which was designed to address the membership problem. This bill would have imposed universal reserve requirements on transactions accounts in all depository institutions in excess of $5 million, and required the pricing of Federal Reserve services for all institutions that use them. This bill drew opposition from a number of quarters, a major contention being that universal reserves would undermine the dual banking system. Subsequently, Chairman Reuss of the House Banking Committee proposed a substitute bill which would impose reserve requirements on all deposits over $100 million, with reserves reduced below present levels; pricing would be left to the discretion of the Federal Reserve, but would be expected. In turn, we proposed $50 million as the cutoff, and this was generally accepted by the House and Senate Banking Committees. This would mean that 74 percent of bank deposits in the country would be subject to reserves, virtually the same as now.

There have been some adverse reactions to the Reuss Bill and to the proposed modifications. The ABA opposes more favorable treatment for small banks than for medium-sized and larger banks and feels that reduction of reserve requirements, in the absence of mandatory reserves, would be a preferable approach. Interestingly, Senator Proxmire, Chairman of the Senate Banking Committee, favors the Federal Reserve approach, and suggests that it is time for the Federal Reserve System to resemble more closely a central bank rather than a "members-only" club.

In the next Congress, some legislation embodying a solution to the membership problem should gain favor, most probably resembling the Reuss Bill with some of our proposed modifications. Hopefully the result will be an overall improvement in the structure of banking, together with a significant improvement in tools available to the Federal Reserve with which to fight inflation through more effective monetary policy.

THE AUTOMATIC TRANSFER SERVICE

Effective November 1, 1978, banks, upon agreement with their depositors, may automatically transfer funds from their savings accounts to their checking accounts. The automatic transfer service is designed to permit the automatic coverage of checks drawn or to maintain a minimum balance in a checking account. It will provide depositors with an alternative arrangement to the present automatic overdraft loans and should be beneficial to check clearing by reducing the number of items returned. The ATS met with a legal challenge from the United States League of Savings Associations, but at this time it appears that the System's position in favor of the ATS has prevailed. Congress appeared to have recognized the legitimacy of the ATS by eliminating the Regulation Q differential with respect to it.

A number of banks are promoting this new service aggressively, but it appears that most are assessing substantial account charges or requiring sizeable minimum balances and are not using the ATS as a loss leader. The ATS represents a fundamental change in the way banks will be doing business in this country.

PROJECT AUGEUS*

In March, 1978, President Carter issued a directive that required executive agencies to adopt procedures to simplify Federal regulations. Among other things, it required that each regulation be written in "plain English" and be understandable to those who must comply with it.

While the directive did not apply to "independent Federal agencies" such as the Federal Reserve System, the Board of Governors felt this to be a worthy goal, and has approved a program for a zero-based review of all our regulations. It has been dubbed "Project Augeus"--you may recall from Greek mythology that one of the labors of Hercules was to clean the Augean stables, which had been left untended for 30 years. Hercules cleaned the stables by redirecting the River Alpheus through them--I doubt that the Environmental Protection Agency would allow that now.

Project Augeus is intended to produce a simplified set of regulations by the end of 1979. It will focus not only on simplification of language, but also will entail a substantive review to determine whether the regulations meet current policy goals, whether they continue to be in the public interest, and whether legislation permitting necessary revisions should be recommended.

Under Project Augeus, each Federal Reserve Bank has been assigned one or more regulations to review. Atlanta has been assigned Regulation Z--Truth in Lending--admittedly complex and not an easy regulation with which to comply. Any suggestions or comments you care to submit would be welcome.

*Pronounced "ahGEEus"

During the past year, an increased degree of cooperation among the bank supervisory agencies has been accomplished. The Interagency Supervisory Committee has been formed and is meeting monthly. Specific achievements include a uniform interagency bank rating system, which facilitates interagency communication and reporting to Congress on the condition of the banking system; uniform interagency trust and EDP rating systems; and an interagency agreement for joint supervision of banks' EDP servicers. As the ISC's work is continued within the framework of the Federal Financial Institutions Examination Council, we look for further achievements.

BANK HOLDING COMPANY SUPERVISION

Supervisory efforts in the bank holding company area have intensified during the current year. Recognizing the difficulty of separating the affairs of a bank holding company from those of the banks it owns, a new, much more comprehensive report of inspection for bank holding companies has been designed. At the same time, a formal requirement for frequency of inspections has been established. Beginning in 1978, all holding companies with $300 million or more in consolidated assets will be inspected yearly, except for a relatively few which are in satisfactory financial condition and which do not have significant credit-extending nonbank subsidiaries. Most smaller holding companies which are in satisfactory financial condition will be inspected every three years.

In addition to our traditional concerns such as capital, asset quality, liquidity and leverage, the intensified holding company inspection program is directed to a number of specialized concerns. These include inappropriate tax accounting transactions such as upstreaming of deferred tax liabilities, and inappropriate methods of assessing bank subsidiaries for management and service fees. Such fees should be reasonably related to services rendered, and should not be merely the vehicle for providing funds for debt service.

COMMERCIAL BANK SUPERVISION

Supervisory efforts with respect to commercial banks have also intensified. The System is placing increased emphasis on the use of the additional authority provided under the Financial Institutions Supervisory Act. These supervisory tools will be used to emphasize the corrective actions needed to return problem banks to a satisfactory condition and to impress upon directors their important responsibility for directing the affairs of the bank in a prudent manner. Hopefully, the use of these tools will support an improvement in the financial health of the banking system.