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Federal Reserve Notes

FEDERAL RESERVE BANK OF SAN FRANCISCO • AUGUST 1977

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FED IMPROVES REVIEW OF BANK APPLICATIONS

The Federal Reserve System has taken steps to speed up its review of bank and bank holding-company applications, following procedures outlined by Governor J. Charles Partee in a letter to Reserve Bank Presidents. Henceforth, Reserve Banks must act on an application within 12 business days, either by accepting the application for processing or notifying the applicant that additional information is needed. This action helps alleviate confusion as to when actual processing of an application would begin.

Partee emphasized, however, that about 80 percent of the acquisition and merger applications filed by banks and bank holding companies already are processed in less than 90 days. "I believe that much criticism is the result of lack of understanding on the part of applicants as to the reasons for delays," he contended.

As a rule, applications are first sent to the appropriate Reserve Bank for review. Before the applications can be acted on, the documents must be complete in all respects. Delays can occur because of such things as insufficient current financial data. Objections from various sources—other banking institutions, supervisory authorities, Federal agencies and the public—as well as court proceedings can delay final action.

When applications involve the expansion of the list of permissible bank holding-company activities, the Board is required to make extensive staff studies. Public comments may be called for, and sometimes formal

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Displaying currency residue for visitors from the Bank of Canada is Assistant Vice President M. C. Petersen of the Bank's Portland Branch. The guests are (from left) M. Morin, Auditor; R. H. Osborne, Chief of Administrative Operations; and S. V. Suggett, Assistant Chief of Operations.

PORTLAND DESTRUCTION PROCESS WINS PRAISE

Representatives from the Bank of Canada—Canada's central bank—recently inspected the model currency-destruction equipment at the Federal Reserve Bank of San Francisco's Portland Branch. The visitors included R. H. Osborne, Chief of the Department of Administrative Operations, S. V. Suggett, Assistant Chief, and M. A. Morin, the Bank's Auditor. Osborne is responsible for currency destruction throughout Canada.

"We were especially impressed by the efficiency and environmental improvements incorporated in the Portland system," Osborne said. "It is good to see success first hand."

The Portland disintegrator, which became operational in mid-1976, destroys millions of dollars in unfit currency each month. The branch had previously relied on an incinerator, but found that process to be too costly in terms of rising fuel prices, and undesirable also from an environmental standpoint.

With the disintegrator system, currency is mechanically shredded into a residue resembling confetti, and automatically compressed into a receptacle for disposal with normal waste paper. This process sharply reduces fuel costs. Maintenance expenses are also slashed, since the disintegrator features a self-feeder, which permits currency to be destroyed without continual monitoring.

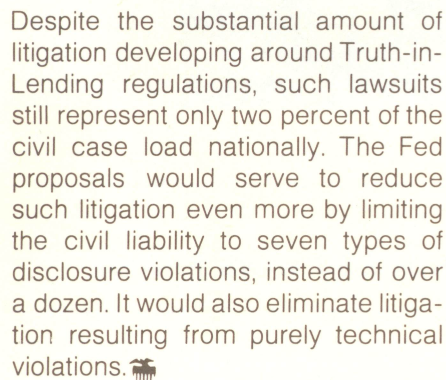
FED WORKS TO SIMPLIFY TRUTH-IN-LENDING

Both consumers and creditors stand to benefit from proposed revisions which would make Truth-in-Lending disclosure forms less complex and easier to understand, Federal Reserve Governor Philip C. Jackson, Jr., told a Congressional subcommittee last month.

The Fed official outlined a draft bill, phrased in simple English, that would cut nearly in half the number of disclosures required of creditors in credit statements. "We believe that clarity is better served if only the most important terms are emphasized on the disclosure statement," Jackson commented. "The rest will be in the contract, just as now."

According to the draft bill, the form would be written in plain English, so that consumers could immediately recognize such basic items as the amount being financed, the finance charge and the total and monthly payments.

Despite the substantial amount of litigation developing around Truth-in-Lending regulations, such lawsuits still represent only two percent of the civil case load nationally. The Fed proposals would serve to reduce such litigation even more by limiting the civil liability to seven types of disclosure violations, instead of over a dozen. It would also eliminate litigation resulting from purely technical violations.



FED IMPROVES REVIEW

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hearings are necessary. Staff investigation is required when there may be possible violations of the Bank Holding Company Act, when commitments have been made in past applications, or when conditions have been imposed by the Board.

Partee said that the application process goes relatively smoothly despite these unavoidable complicating factors, and that changes now being implemented will further streamline the process. He added that the System is paying special attention to the way applications are processed and supplemental information is obtained.

WALLICH VIEWS BANK CAPITAL ADEQUACY IN LIGHT OF INCREASED INFLATION

New ways to insure the soundness of banks should be studied in light of the impact of inflation on bank earnings and capital, Federal Reserve Governor Henry C. Wallich recently told the Twelfth Annual Banking Law Institute.

The Fed official said that adequate capital remains the first line of defense in protecting the financial system, but he argued that inflation has severely reduced the true income of banks. He said that this situation raises fundamental questions about the ability of the banking system to generate sufficient earnings in order to maintain capital ratios, or to sell enough new stock to achieve that purpose.

He noted that the substantial increases reported in bank capital practically had disappeared after adjustments were made for this decade's inflationary upsurge. Inflation-adjusted capital, stated in constant dollars, increased only from $75.4 billion in 1972 to $80.5 billion in 1975.

"It should not be surprising to find that bank capital tends to shrink during inflation," Wallich said. "Bank capital is essentially money, and money loses value through inflation. To maintain the real value of their capital during inflation, and its normal growth from retentions, banks would have to earn a rate that, after taxes, would cover the rate of inflation in addition to providing a normal return."

The Fed official stated that the norm for long-term earnings growth for banks has been about 10 percent. With recent rates of inflation, however, banks' rate of return (after taxes) would have to be half again as great as that norm to maintain capital in real terms and keep it growing through retentions.

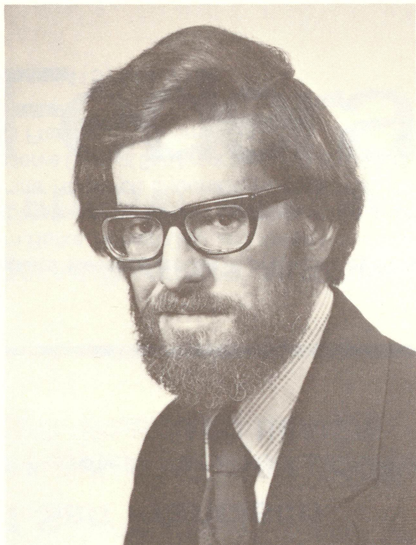
"I very much doubt that either bankers, or the public, or legislators would regard such a rate of return on bank capital as at all appropriate," he commented. "The area of bank earnings and capital seems to be one of the last bastions of money illusion."

Wallich said this situation makes it very difficult to maintain an adequate level of bank capital. The obvious answer is to stop inflation, but until that happens the maintenance of adequate capital ratios becomes very difficult. He said that it would not be appropriate to limit the growth of bank credit and the money supply through more stringent capital requirements for banks. Such a course of action might cause a larger proportion of the total flow of credit to move outside the banking system.

Because of these conditions, he said regulators should look for alternative means of ensuring the soundness and safety of the banking system. One alternative might be the extension of the principle of pooled insurance, as first implemented by the Federal Deposit Insurance Corporation. He admitted that banking authorities have been cautious in moving in this direction, because this form of insurance tends to reduce the discipline imposed by the market upon the banking system. Nevertheless, he said that the further extension of this principle could provide depositors with greater safety while still leaving some degree of risk.

Another alternative he cited was graduated insurance premiums for those banks with high-risk portfolios. This approach could help impose a form of discipline over bank risk-taking.

"There exist several routes toward the achievement of safety and soundness of the banking system," Wallich concluded. "Adequate capital has been the traditional major safeguard. But if inflation makes it difficult for banks to maintain adequate capital ratios out of earnings, and simultaneously makes it very costly (if not impossible) to raise capital through new issues, there are alternatives. These would require very careful study before anything decisive can be said. But that study should be undertaken before we either accept a resumption of the trend toward lower capital ratios or seek to maintain these ratios by uneconomic means."



W. Poole

POOLE NAMED VISITING SCHOLAR

William Poole, Professor of Economics at Brown University, has been appointed to serve the summer term as a Visiting Scholar at the Federal Reserve Bank of San Francisco.

The Visiting Scholar position was inaugurated at the San Francisco Fed to encourage creative research and the interchange of ideas by practicing economists. Scholars from Stanford, Ohio State, the University of Oregon, the University of Washington, and the University of Chicago have held such appointments with the bank. One of the most recent Visiting Scholars was Milton Friedman, the 1976 Nobel Laureate in Economics.

After receiving his B.A. degree from Swarthmore College, Dr. Poole earned an M.B.A. and Ph.D. from the University of Chicago. He has taught at the Johns Hopkins University, American University, George Washington University, Georgetown University, Harvard University, and also at the Massachusetts Institute of Technology.

Dr. Poole has served as a Senior Economist at the Board of Governors of the Federal Reserve System in Washington, D.C., and in addition, as an Advisor at the Federal Reserve Bank of Boston.

He is a member of the American Economic Association, the American Finance Association, and the Western Economics Association. In addition, he is an Associate Editor of the *Journal of Money, Credit and Banking* and a Senior Advisor to the Brookings Panel on Economic Activity.

FED REVIEWS MERRILL LYNCH PLAN FOR CREDIT AND INVESTMENT

A new credit and investment plan known as a Cash Management Account (CMA)—which combines elements of credit cards, margin loans and money-market funds—does not violate any Federal Reserve regulations or statutes, according to a recent communication from the Board of Governors. However, the Board is still studying CMAs to determine any possible adverse effect on monetary policy and banking operations.

Under the plan developed by Merrill Lynch, Pierce, Fenner and Smith, Inc., qualified customers could open a CMA account by leaving securities in a margin account. Idle funds in the account would be invested automatically once a week in a money-market fund, and dividends would be earned daily at prevailing money-market rates. CMA customers would also receive bank checks and a bank credit card issued by City National Bank of Columbus, Ohio. Card holders could use the credit card to obtain goods and services from merchants as well as cash advances from participating banks.

A customer's checking and card transactions also would be backed by a direct line of credit based on the margin value of the securities in his account. By borrowing on such an account, he could obtain a substantially lower interest rate—about 6½ to 8 percent—than the 12-to-18 percent rate available with credit cards or instalment-loan plans.

Theodore E. Allison, Secretary to the Fed's Board of Governors, said in a letter to Merrill Lynch, "The Board is concerned that the CMA plan and other similar programs could have adverse effects on the quality of stock-market margin credit, could lead to unregulated banking, and could reduce effective monetary control over the growth of transaction balances in the economy. The Board will be studying these issues further, and perhaps may want to consider legislation or regulatory action to deal with such issues."

The Board did not express any view as to the legality of the CMA program under Section 21 of the Glass-Steagall Act, which deals with the separation of commercial banking from the brokerage business. The Department of Justice is responsible for enforcing Glass-Steagall, and Allison suggested that Merrill Lynch should take up this issue with Justice. In addition, the Board did not comment on the possible implications of CMA regarding Truth-in-Lending provisions.

Merrill Lynch plans to implement CMA plans on a pilot basis next month in Atlanta, Columbus and Denver, if no objections are raised by the Justice Department or bank regulatory authorities.

FED STAFF STUDIES PRIVATE PLACEMENT

A staff study by the Federal Reserve Board of Governors concluded recently that private placements of securities for corporate clients are "within the scope of permissible activities for commercial banks." However, the study added that this area is "not free from doubt."

Chairman Henry S. Reuss of the House Banking Committee requested the study in order to evaluate attacks on the practice by securities-industry spokesmen. Some charge that commercial bankers have an unfair advantage over investment bankers in arranging private placements, and others contend that this activity may pose a conflict of interest for commercial banks.

The Fed staff study found that the legal aspects governing this activity were subject to differing interpretation under the Glass-Steagall Act. (Glass-Steagall provides for the separation of commercial banking and investment banking.) "The stronger case would support a conclusion that assistance

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Federal Reserve Notes is produced by William Burke, Ronald Getz and Karen Rusk. The publication is distributed to commercial banks by the Research Information Center, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco, California, 94120.
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BOOK-ENTRY PLAN CONTINUES TO GROW

Millions of potential paper certificates became computer entries instead, as the second phase of the book-entry plan for Treasury securities was implemented this summer by the Treasury Department and the Federal Reserve System.

Under the book-entry system, Treasury securities are recorded in the accounts of banks or other financial institutions acting as custodians for investors. Instead of an engraved certificate, the purchaser is given a receipt as evidence of purchase.

The program was begun last December with the offering of 52-week T-bills in book-entry form, and was continued in the second phase with 26-week bills. The final phase will occur next month as 13-week bills are converted, marking the final transition of bill issues to the new book-entry system.

When fully implemented, the program promises to save the government and taxpayers millions of dollars from reduced handling of paper certificates. Investors too can save money because the program eliminates the possibility of lost securities, which have amounted recently to about $1 million a month.

A limited number of Treasury bills still are offered to institutional investors required by law or regulation to hold securities in "definitive" (paper) form. Definitive issues in denominations of $100,000 will be available to such investors for all issues through December 1978.

As a public service to bankers and investors, the Federal Reserve Bank of San Francisco has designated a book-entry phone line to answer questions about the new program. Calls can be made to the Fiscal Department at any of the Bank's branches, or to (415) 544-2477 in San Francisco.

More information is available through films and slides that explain the operation of the book-entry program. A 12-minute film provides a general description of the program and the procedures involved, and a lengthier two-part slide show (with audio cassette) provides more detailed information. Films and slides can be obtained from the Bank Relations unit at the nearest Fed office.

PRIVATE PLACEMENT

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of private placements is not prohibited by the act, and is within the scope of permissible activities for commercial banks." Following completion of the staff study, Federal Reserve Chairman Arthur F. Burns wrote Congressman Reuss that the Fed would be willing to work with the House committee to develop legislative proposals in this field, although it has nothing specific in mind at the present time.

In its study, the Fed staff surveyed six large New York and Chicago banks and separately analyzed the findings of a Securities and Exchange Commission (SEC) survey of 256 banks. It found that commercial banks were involved in 94 private placements in 1976, amounting to $1.3 billion. The great majority of these were made by the large money-center banks. However, no bank ranked in the top ten firms in terms of value of placements.

In a separate report, the SEC disclosed that 26 banks formally offer private-placement advisory services. This compares with 272 registered broker-dealers active in this particular field.

Banks have informally provided private-placement services for years. Yet because of the small number of banks involved, the Fed staff concluded that significant economic or financial concentration was unlikely in the foreseeable future. Moreover, Fed examiners found no evidence of alleged abuses during their examinations of commercial banks' private-placement activities.