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FEDERAL RESERVE POSITION ON RESTRUCTURING OF
FINANCIAL REGULATION RESPONSIBILITIES

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One fundamental premise of the Federal Reserve's interpretation of, and response to, any proposed restructuring of arrangements for the regulation and supervision of banking and related markets and institutions is that such responsibilities cannot be insulated from -- or thought of as something separate from -- the basic responsibilities of a central bank. Central banking responsibilities by law and custom, in the United States as well as most other industrialized countries, plainly encompass concerns about the stability of the financial system in general, and the banking system in particular.

Crucial points of concern include:

- a) the operation of the domestic and international payments system -- that is the reliability and safety of arrangements by which hundreds of billions of funds are transferred among banks and others day-by-day.
- b) The capital and liquidity of the banking system so that it can (1) absorb shocks originating inside or outside the banking system, and (2) respond effectively to monetary policy decisions.
- c) The general risk profile of banks, and the consistency of regulatory and supervisory approaches toward risk with objectives of monetary policy.

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- d) The structure of the banking system and the powers of banking or other financial organizations as they bear upon these concerns.

The clear implication is that the Federal Reserve as the nation's central bank must remain substantively involved in the regulation and supervision of the financial and banking system because those functions impinge upon its general responsibilities.

These responsibilities are broader than those implied by any particular operational mode for monetary policy; they go back to the founding of the Federal Reserve System as an institution for forestalling and dealing with financial crises. But it is also true that, taking monetary policy as the point of departure, that policy will be either complemented or compromised by regulation and supervision of the banking and financial system.

In sum, "central banking" concerns about regulation and supervision need to be considered together with other valid concerns of regulatory policy -- competition, simplicity, adaptability, fairness, and Federal-State relationships -- in any "reform" of the regulatory system.

This memorandum first develops these basic points about the interrelationships between central banking and supervisory and regulatory responsibilities, including the possibility of conflicts among them. It then emphasizes that proposals for administrative reform of supervisory authority need to be viewed in the light

of proposed changes in substantive legislation governing powers of banks and bank holding companies.

THE FEDERAL RESERVE AND BANKING REGULATION

A basic continuing responsibility of any central bank -- and the principal reason for the founding the Federal Reserve -- is to assure stable and smoothly functioning financial and payments systems. These are prerequisites for, and complementary to, the central bank's responsibility for conducting monetary policy as it is more narrowly conceived. Indeed, conceptions of the appropriate focus for "monetary policy" have changed historically, variously focusing on control of the money supply, "defending" a fixed price of gold, or more passively providing a flow of money and credit responsive to the needs of business. What has not changed, and is not likely to change, is the idea that a central bank must, to the extent possible, head off and deal with financial disturbances and crises.

To these ends, the Congress has over the last 70 years authorized the Federal Reserve (1) to be a major participant in the nation's payments mechanism, (2) to lend at the discount window as the ultimate source of liquidity for the economy, and (3) to regulate and supervise key sectors of the financial markets, both domestic and international. These functions are in addition to, and largely predate, the more purely "monetary" functions of engaging in open market and foreign exchange operations and setting reserve requirements; historically,

in fact, the "monetary" functions were largely grafted on to the "supervisory" functions, not the reverse.

In a real sense, the Federal Reserve was founded out of an instinct that monetary and banking disturbances were inter-related. The concept is still plainly relevant. At times of strain, the Federal Reserve is looked to as central to efforts to contain the crisis and maintain confidence -- to maintain "stability" and "continuity" -- even if the involvement of the banking system is only derivative. Examples can be found in the Federal Reserve's participation in efforts to deal with the threat to the commercial paper market in the early 1970's from the bankruptcy of Penn Central, or with the pressures on securities firms (and potentially banks) from the collapse of silver speculation in early 1980. These crises had the seeds, and more, of requiring a response in terms of monetary policy itself -- that is, the need to provide more liquidity to the economy. The point is that monetary policy can potentially be thrown off course by disturbances or fragilities arising in the internal structure or performance of financial markets, and those disturbances may, in some instances, require a monetary policy response. The public interest requires not only a continuing effort to foresee and deal with such weaknesses before they erupt into crisis, but also effective "crisis management" fully aware of monetary implications.

Central banking responsibilities for financial stability are supported by discount window facilities -- historically a

key function of a central bank -- through which the banking system, and in a crisis, the economy more generally, can be supported. But effective use of that critically important tool of crisis management is itself dependent on intimate familiarity with the operations of banks, and to a degree other financial institutions, of the kind that can only be derived from continuing the operational supervisory responsibilities. We need to be aware of the ways in which financial markets and institutions are intertwined, recognizing that problems in one area typically affect others. In particular, a "crisis" in one limited part of the banking system can quickly affect the strength and well-being of others and the system as a whole, both because of direct links through the payments system and because the system, in the end, rests on intangibles of confidence.

It is our view that it would not be workable or reasonable -- it would indeed be dangerous -- to look to the Federal Reserve to "pick up the pieces" in a financial crisis, without also providing the Federal Reserve with the tools to do the job and with adequate "leverage" in shaping the system so as to reduce the likelihood of a crisis actually arising. However imperfect the foresight of any institution in the best of circumstances, these continuing concerns and responsibilities demand a strong place for the central bank among the institutions shaping financial regulations.

These concerns have continuing operational implications. Year in and year out, supervisory and regulatory decisions will influence the manner in which depository institutions respond to monetary policy decisions. On those occasions when the economic environment may require particularly forceful monetary policy action, the failure of supervisors and regulators adequately to have foreseen potential strains on depository institutions could either constrain the ability of the central bank to act vigorously to meet monetary policy objectives or create a situation in which needed monetary restraint pushes the stability of the system to and beyond a breaking point. The administration of the discount window from day-to-day and operations in the open market, domestically and internationally, presume a capacity to evaluate the circumstances and soundness of the institutions with which the Federal Reserve is dealing or providing credit.

Some have argued these needs of the central bank can be met by adequate exchange of information. We respectfully, but strongly, disagree. Clearly, close working arrangements among all agencies with supervisory responsibilities are helpful and important. But no one familiar with bureaucratic processes over the years, in fair weather and foul, and with the realities of changing personalities and consequent possibilities for friction, can count on access to examination reports or other information prepared elsewhere, or on opportunities to express views formally or informally, to substitute adequately for at

least a share of "hands on" operational and policy responsibility. Otherwise, the voice of the central bank in regulatory and supervisory matters can and sometimes will be ignored, the analysis it performs or is performed for it in these areas will be superficial, and the able and forceful staff it needs will be dissipated. Almost inevitably, the tendency would be to retreat into a kind of ivory tower, adversely affecting both monetary and supervisory policy.

Possibility of Conflicts

Some have argued that conflicts between regulation of banks and the conduct of monetary policy can arise, and that when, in specific instances, the conflict becomes acute the Federal Reserve will in effect tend to override the supervisory or regulatory concerns, presumably to the detriment either of safety or soundness or the competitive strength of banking. Others may argue the reverse, that at times of financial crisis those concerns may lead to the provision of significant additional liquidity to the detriment of monetary targets.

We do not dispute the obvious -- that in particular instances, different responsibilities may lead to legitimate differences in points of view. The real question is how best to resolve such differences so that any "trade-offs" are carefully weighed and decisions made with a balanced view of the public interest.

The nature of the Federal Reserve's responsibilities for the overall financial health of the economy force it to weigh

various trade-offs among various goals. Specifically, conflicts between measures taken to achieve objectives of monetary policy and those of supervision and regulation have to be reconciled; more positively, those objectives need to be pursued in a mutually reinforcing manner. Indeed, regulatory and monetary policy will both be improved by taking advantage of information obtained in the execution of each.

Conversely, the public interest will not necessarily be served by the single-minded pursuit of different -- and possibly competing -- policy objectives. To take an extreme case, imposing highly conservative supervision standards at a time of strain in pursuit of the safety and soundness of individual institutions -- one legitimate and continuing objective of supervision and regulation -- could unwittingly place the stability of the entire system at risk; such an approach may not take account of "trade-offs" that have implications for the ability of the financial system as a whole to withstand and manage the strains. Conversely, our supervisory arrangements should encourage continuing concern with the ability of the banking system to withstand potential pressure even during long periods of fair weather, when temptations may develop to cater to the instincts of the most aggressive banking entrepreneurs.

There can be no absolute protection from these dangers. But experience here and abroad suggests a strong central bank, by the very nature of its broad responsibilities and its relative independence, is in a unique strategic position to

take a balanced and long view. The design of any regulatory and supervisory system needs to take account of that broad perspective -- a perspective essentially shared only with the Treasury or finance ministry.

Some historical perspective on the point is useful. A major concern of the Federal Reserve Board and others during and after the Great Depression was that bank supervisors enforcing unduly conservative lending standards were undercutting the effects of expansionary fiscal and monetary objectives. At other times, the opposite concern may develop. The fact is such general regulatory policies as capital and liquidity standards, reserving policies, interest rate ceilings (when they were in effect), and disclosure of financial information have very great significance for monetary policy and the stability of the entire financial system. In specific instances, they can even be a dominating influence on actual policy results.

A current example is the situation with respect to loans to under-developed countries, in which we face complex and interrelated questions about financial and economic stability, bank soundness and public confidence, and appropriate disclosure. The various regulators of depository institutions inevitably have somewhat different emphases in carrying out their responsibilities, and there is considerable merit in bringing these disparate views to bear on supervisory and regulatory problems. But in the end, resolution of the issue will have the broadest implications for monetary policy and our economy, and the

economies of other major countries. The Federal Reserve cannot help but be deeply concerned and involved in the decision making.

It is possible -- indeed probable -- that any "reform" to eliminate or greatly reduce the Federal Reserve's formal regulatory and supervisory involvement would eventually be overwhelmed by the need to achieve coordination, and the regulatory structure would in practice provide significant weight to the views of this nation's central bank. But this clearly is not the intent of certain proposals, and it would obviously be totally unsatisfactory to have recognition of the central bank's legitimate and necessary interests reasserted only after lurching from crisis to crisis.

Foreign Experience

Although specific arrangements differ, the concerns expressed in this memorandum are widely recognized in the practices of other industrialized countries. Among 22 OECD countries,* fully half (including England, Italy, the Netherlands) place both the monetary policy and the main supervisory functions directly in the central bank. In several major countries, including France, Germany, Japan, and Switzerland, supervisory responsibilities are shared in varying degrees between the central bank and either a banking commission or the Ministry of Finance. In one country -- Canada -- the formal responsibility lies basically with the finance ministry. The remaining six small countries

*Excluding Luxemburg, which as part of a monetary union has no central bank, and the U. S.

have separate (and typically very small) banking commissions; those commissions usually have formal links with the central bank, and may rely on the central bank for operational surveillance as well as for policy input.

THE LOCUS OF REGULATORY AUTHORITY AND SUBSTANTIVE BANKING LEGISLATION

In our view, much of the discussion involving the organization of financial supervision -- including various schemes to curtail or practically eliminate the Federal Reserve's regulatory or supervisory role -- is out of focus. The present sense of disarray among regulatory agencies and their approaches grows in substantial part out of questions of substance and policy inherent in applying a framework of law developed many years ago to markets and institutions transformed by economic and technological change. These are not, at bottom, questions of procedure or bureaucratic jurisdiction -- they urgently need to be sorted out by the review of substantive law underway in the Congress.

For instance, one key concern revolves around the question of what nonbanking business banks and other depositories should be permitted to engage in and the types of organizations that should be permitted to own banks. Uncertainty in the industry is rife, and conflicts in regulatory approach in interpreting current law are obvious.

The problem has become acute as banks and bank holding companies have attempted to expand into new businesses such

as securities and insurance brokerage, while nonbank entities such as insurance companies, securities firms, and retail firms have made inroads on the banks' traditional franchise in deposit taking and the payments system. A glaring illustration of this process was the success of the money market funds in competing with the banks' core business of collecting deposits. The problem has accelerated with various deregulatory steps, the vast improvements in communications and data processing technology and, until recently, with rising inflation and interest rates.

Exploitation of loopholes in existing law -- law which for many years protected the core of the banking business from outside competition -- has recently favored "non-bank" competitors, while generally restraining banks from diversifying their business lines. The problem has been compounded by provisions of the Bank Holding Company Act in which the Congress placed on banking organizations a differential burden of demonstrating net public benefits from proposed new activities and which gives procedural advantages to banks' competitors when banks seek to undertake new activities through the holding company vehicle. These problems are rightly of concern to the banks. But the concerns fundamentally arise from the law, not from the particular administrators of the law -- although, as a common phenomenon of human nature, the "messenger" can be blamed for the message.

Some parts of the banking community have argued that the Bank Holding Company Act is too restrictive in terms of the powers permitted to banking organizations. The Federal Reserve shares that view, and we have endorsed and supported the Administration's proposed Financial Institutions Deregulation Act. That bill provides for expanded powers for banking organizations and firmly defines the banking powers of nondepository institutions. It carefully defines "a bank" and thus the scope of institutions that are subject to the Bank Holding Company Act. Moreover, as a natural complement, the proposals would greatly simplify the regulatory procedures for holding company initiation of the new activities that are provided for in the bill.

Passage of the "FIDA" legislation would, in and of itself, settle many of the substantive issues, provide direct and fresh indications of Congressional intent as to how the law should be administered, and bring about great improvement and simplification in the regulatory process. Concomitantly, it could be expected to clear the atmosphere and eliminate, or greatly alleviate, many of the pressures by banking trade associations to seek change through a different regulatory structure conceived as more sympathetic to their substantive or procedural concerns. Indeed, in the absence of fundamental legislation dealing with both powers and procedures, it is doubtful that any reshuffling of governmental responsibilities

for bank regulation would relieve the legitimate concerns of commercial banks about their competitive position and hence their discomfort with the regulatory regime.

POSSIBLE APPROACHES TO CHANGE

The Federal Reserve does not need nor seek sole responsibility for regulation and supervision of depository institutions, but it must have a continuing substantial involvement in this process. It must be able to bring to bear effectively its concerns about the direction of regulation as the financial system evolves, and needs significant supervisory authority as well. Such authority will keep the Federal Reserve in touch with developments at financial institutions and will give weight to its views in the formation of supervisory policy, which is at the foundation of a sound financial system.

Consequently, proposals that would simply remove the most important element for Federal Reserve regulatory and supervisory influence -- its responsibility for bank holding companies -- cannot meet the minimum requirements unless "leverage" is restored in other ways. One vote on a five-member council and the right to accompany the examiners of other agencies as a kind of junior partner as they supervise a limited number of the nation's largest banks--without regulatory authority

or the power to require corrective measures--is not an adequate substitute. And, to the extent concurrent regulatory or supervisory authority is provided for a small group of institutions, problems of a clash in policy and confusion for the supervised banks would be magnified.

We also recognize that the current regulatory system has a number of problems of overlapping or divided authority, and these problems have been aggravated by differences toward substantive questions. In our view, the fresh Congressional direction on these questions implied by the adoption of FIDA would eliminate much of the difficulty, and present the remaining problems in a different, and more manageable, context.

Modifying the Present Framework

In approaching change, the strengths of the present regulatory system should not be overlooked. Most broadly, it has provided some balance among various interests and concerns within the government in the process of supervision and regulation. For example, through the Office of the Comptroller of the Currency there is a link to the broad policy concerns of the Secretary of the Treasury. At the same time, the supervision and regulation function as a whole, and particularly the portions concerned with "case work," are insulated from political pressures and administrative arrangements encourage a degree of continuity that would be lost if tied directly to the Executive Branch.

The current system also incorporates an important role and influence for the Federal Reserve in domestic and international banking regulation without concentrating all power and "case work" in that agency.

There is a significant role for the deposit insurance agency, while offering some balance to its inherently conservative mandate to protect the insurance fund. The existing system also fits reasonably comfortably within the context of the dual banking system; a more centralized system, impelled to treat banks with a high degree of uniformity, might inherently tend to erode a meaningful role for states in regulation and supervision.

These are matters that must be dealt with in any reform, and it remains to be seen whether it can be done as effectively in another framework.

The point was made earlier that enactment of FIDA would, in itself, deal with some of the most important concerns of the regulated banks and achieve substantial simplicity in bank holding company regulation. A number of other steps could be taken to improve the present supervisory and regulatory structure independent of FIDA.

Those steps include consolidating the responsibility for anti-trust analysis of cases involving domestic banking organizations in the Justice Department. Another step would be to consolidate the responsibility for administration of the securities laws as they affect deposit-taking companies in the Securities and Exchange Commission. Authority for margin requirements could

be realigned, if retained at all. (It might be noted that, when these steps have been considered in the past, the banking industry itself usually has urged that the basic authorities be kept with the bank regulatory agencies.)

Regulatory responsibility for much of the consumer credit protection legislation (and for relations with the Consumer Advisory Council, which, in any event, should be preserved) might also be shifted from the Federal Reserve to an agency with responsibility for other consumer-related legislation. However, the current arrangement appears to be working satisfactorily, and this, in itself, is probably not a priority matter.

Improvements toward simplicity and consistency can be made in other areas, potentially more closely related to the essence of the Federal Reserve's concerns for regulation and supervision. These steps could be taken whether or not FIDA is passed, but would make a greater contribution if FIDA were the operative law.

One possibility would be to shift responsibility for one-bank holding companies where no significant non-bank activities are in fact conducted to the primary banking regulator; while a heavy case load is present in this area, the holding companies are essentially nothing more than financing vehicles for the bank.

Another possibility would be to shift responsibility for regulation of the banks that are part of holding companies with

significant non-banking activities to the Federal Reserve. This would create a situation where both the bank and the bank holding company would be regulated by the same agency, further reducing the overlapping jurisdiction now in place.

Regulation of non-banking activities of bank holding companies and multibank holding companies raises questions of uniform treatment for activities that extend over state and national boundaries, and the logic points strongly toward maintaining regulation and supervision in a single agency. From the standpoint of the Federal Reserve, this provides a critical vantage point for maintaining oversight and surveillance over the evolution and risk characteristics of the system as a whole.

Under current practice, the Federal Reserve routinely solicits the recommendation of the OCC, FDIC, and state supervisory authorities, as relevant, on applications that come before it under the Bank Holding Company Act. With rare exceptions, the final determination by the Federal Reserve is consistent with those recommendations. Nonetheless, the supervisory system could be better integrated if the law were amended to provide the presumption that the Federal Reserve accepts the findings of the primary banking supervisor with respect to the financial and managerial factors bearing on the lead bank of the holding company.

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