

For release on delivery  
Expected at 11:00 A.M., E.S.T.  
March 27, 1985

Statement By

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Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Commerce, Consumer and Monetary Affairs

of the

Committee on Government Operations

United States House of Representatives

March 27, 1985

I appreciate the opportunity to appear before this Subcommittee to review with you recommendations to reform the Federal regulatory structure for financial institutions contained in the Report of the Task Group on Regulation of Financial Services, chaired by Vice President Bush.

I want to state clearly at the outset that we at the Federal Reserve Board support the Task Group recommendations when viewed as a comprehensive and interrelated package.

Obviously, other approaches could have been taken, and a number were considered. The Report, as you explicitly recognized, Mr. Chairman, in your letter to me requesting this testimony, involves "trade offs" among competing objectives and valid concerns of regulatory policy. Some of those concerns, perhaps inevitably, were weighed differently by different members of the Task Group. Reaching an agreed approach was a difficult process, and necessarily involved a degree of complexity in the specific proposals. But I am satisfied the net result would be both greater simplification and in some areas greater coherence in the regulatory and supervisory processes. Other approaches reviewed by the Task Group could not achieve as much.

Within the general framework of the present proposal, Congressional debate and consideration may point to the need for modification. But certain basic elements of the proposed approach, in my judgment, should not be undermined.

You have requested that I be explicit about those areas that are of critical importance to the Federal Reserve or otherwise, where even seemingly small changes would alter the desired balance and be "fatal" to our continuing endorsement. I will address those points, as well as noting some areas where we perceive possible problems in implementation that need to be explored more fully in the legislative process.

#### The Regulatory Environment

Reform of the Federal regulatory structure for banking institutions is, as you are aware, not a new issue. Through the years, there have been many proposals for change, yet the current structure has been in place essentially unchanged for a long time. That history suggests the present system has responded fairly effectively to continuing and diverse needs. But I share the widening perception that the time has come for change. The overlapping responsibilities among the banking, thrift, and other agencies at a time of rapid technological and institutional change in the financial world has been reflected in increased uncertainties both among those regulated and the regulators. There have been inconsistencies in regulatory rulings or approaches by different agencies, flowing from differing responsibilities under existing law or differing views of

how the financial system should evolve. In some instances, a clear locus of responsibility for newly emerging institutions or practices is not clear.

At the same time, I must emphasize as strongly as I can that the present sense of disarray does not arise primarily as a result of jurisdictional questions. Rather, in my judgment, it grows mainly out of the difficulties for any agency in interpreting and carrying out policies set out in existing substantive law. That body of law was developed in a quite different setting many years ago, and markets and institutions have meanwhile been transformed by economic and technological change.

The financial system is adapting, as it must. But those adaptations have often not been guided by clear expressions of public policy enunciated by the Congress in the light of changing circumstances. As things now stand, the pressures for change are reflected in, and potentially distorted by, exploitation of perceived loopholes, reinterpretation of existing laws by regulators and the courts, and actions taken by States with little or no consideration of the implications for the financial system generally. These questions about banking law and Congressional intent need urgently to be resolved by fresh expressions of substantive law. They will not be resolved

by changing regulatory structure, procedures, or bureaucratic jurisdiction. Instead, it is those substantive questions that breed the appearance of regulatory conflict and inconsistency. Consequently, I would again urge the Congress to proceed as expeditiously as possible to deal with needed changes in substantive law, and to consider administrative structure in that light, rather than the reverse.

The problem becomes steadily more acute with the passage of time. Banks and bank holding companies, and thrifts and their service corporations and holding companies, are expanding interstate and into new product lines -- including investment banking, real estate development, and insurance activities -- whenever and wherever they can find room through new interpretations of Federal law or new state law. Nonbank entities -- securities firms, insurance companies, and commercial and retail organizations -- are making inroads where they can into the banks' traditional franchise in deposit taking and payments system. In the process, long established policies set by the Congress are breaking down -- the separation of banking and commerce and commercial banking and investment banking, as well as statutory limitations on interstate branching. Confusion abounds. Equity is lost.

My point is not that all change in these directions is necessarily bad. To the contrary, in some areas the process of change should be facilitated rather than forced into unnatural channels, with full consideration of the implications for safety and soundness, competition, conflicts of interest, and other fundamental continuing considerations of public policy.

It would make little sense to move ahead on the question of regulatory structure without first resolving these underlying substantive issues. The entire complex of issues -- summed up in "nonbank banks," "nonthrift thrifts," the relationship between state and Federal banking powers, expanded powers for bank holding companies, and interstate banking -- should be considered and decided as quickly as possible. I know that many of these issues still are controversial within the affected industries. But I also know that no administrative structure can be expected to work well without a fresh sense of direction from the Congress as to these basic issues.

#### The Goals of Financial Regulation

Governmental regulation of the financial system in general, and of depository institutions in particular -- both commercial banks and thrifts -- has been intended to serve a variety of objectives. The most prominent among

these is commonly referred to as "safety and soundness." That goal is directly related to protecting individual depositors but also has profound implications for the operation of the financial system and the economy as a whole.

Commercial banks, in particular, are custodians of the largest share of the money supply, liquid assets and the payments system. The stability of one part of the banking system rests increasingly on the soundness of the whole as the interrelationships among institutions become even more complex. In the last analysis, prospects for growth and stability in the economy as a whole must be premised on a strong and stable financial system.

In recognition of that fact, the Federal government has long provided a strong "safety net" for depository institutions, reflected primarily in the assistance available at times of need from the Federal Reserve, the Federal Home Loan Bank Board, the FDIC, and the FSLIC. And that "safety net" is logically paralleled by a system of supervision and regulation designed to keep risks manageable.

At the same time, the regulatory and supervisory apparatus is designed to achieve other continuing objectives. These objectives include protection from conflicts of interest, fraud, and other abuses, encouragement of competition and avoidance of excessive concentrations of

financial power, and promotion of certain social objectives, such as consumer protection and, traditionally, access to mortgage credit.

These objectives have spawned a variety of Federal agencies and approaches, and the responsibilities are shared between the Federal and State governments. Legislation at the federal and state levels can set out in relatively broad terms the boundaries between acceptable and unacceptable behavior, and the responsibilities of different agencies. But substantial elements of discretion by those administering the laws are inherent in the process.

Regulations issued by those agencies elaborate the general principles enunciated by law in more detailed form, and, in effect, amplify and clarify the public policies set out by the Congress. Supervision and examination is a process by which government agencies seek to assure, on a case-by-case basis, appropriate compliance with relevant laws and regulation, involving the application of professional expertise, judgment, and discretion. One technique of supervision and regulation may be to encourage or require financial disclosures, seeking by that method to protect the public and encourage natural market disciplines on financial institutions and other participants in financial markets.



As with any complex set of objectives, specific situations often arise in which the goals of financial regulation are in conflict, and there is a need to choose or balance between the attainment of one and the others in greater or lesser degree. Moreover, the weights society places on these goals may change over time. Finally, the specific techniques used to attain these goals may need to be modified over time because of changes in financial conditions or practices.

All of this is the backdrop to any consideration of reform of the administrative apparatus. None of it suggests that any simple formula provides an all-encompassing answer. What we need is a workable balance, adequately reflecting the public priorities involved.

#### Some General Considerations in Modifying the Regulatory Structure

In approaching the particular issues of administrative structure, several potentially conflicting considerations need to be taken into account.

First, the regulatory and supervisory structure should encourage a high degree of continuity, consistency, independence, and professionalism. That points toward an "arms-length" relationship to the regulated industries and to a high degree of insulation from narrow political

pressures, particularly in the quasi-judicial "case work" of examinations and supervision. But it is also true that regulation and supervision must be alert and responsive to the legitimate needs of the affected industries -- we need a strong and competitive banking and financial system -- and to the basic policies enunciated by our elected representatives in the Congress.

Second, the regulatory and supervisory process should be as simple and cohesive as possible -- an objective emphasized by the Bush Task Group in the light of the sheer mass of regulation and the layers of overlapping and sometimes conflicting authority that have developed over time. But simplicity pursued singlemindedly implies a degree of consolidation that may conflict with a desirable element of checks and balances and experimentation. One issue in this respect is the appropriate role for the state regulatory authorities within the context of the "dual banking system." Another is the extent to which conditions still justify separate regulatory and supervisory treatment for thrift institutions that have come to closely resemble banks in their powers and functions.

Third, the question of the appropriate degree of coordination with related areas of public policy can arise in several guises. For instance, any Secretary of the

Treasury, in the light of his broad responsibilities as the chief financial officer of an Administration, will have a continuing interest in the functioning of financial markets and institutions, in the soundness of the insurance funds, and in the general direction of regulatory policy. That interest can be and is expressed through the Administration's role in the legislative process. In the present system, it also has a tangible reflection in the location of the Comptroller of the Currency within the Treasury, in the Secretary's participation in the Depository Institutions Deregulation Committee, and in more informal consultative arrangements.

Fourth, even more immediate are the concerns of a central bank. By law and custom, here and in other industrialized countries, the central bank is and must be concerned about the stability and functioning of the financial system as a whole and the banking system in particular. Indeed, this was the primary concern in establishing the Federal Reserve, and the Federal Reserve has always had a substantial presence in both the regulation and the supervision of banking institutions. In fact, Congress has substantially increased the Federal Reserve's regulatory and supervisory responsibilities over the years.

Beyond the specifics of legislation, I also believe it apparent that the Congress and the public at large have looked to the Federal Reserve to take a lead role in anticipating and dealing with financial problems that impact the financial system as a whole. In the light of our responsibilities for monetary policy and as lender of last resort, it is hard for me to see how it could be otherwise. The obvious and essential corollary is that the Federal Reserve must have enough involvement in the ongoing regulatory and supervisory effort to provide it with the knowledge, the expertise, and the tools necessary to discharge those responsibilities.

We believe the Task Group proposals adequately recognize those fundamental concerns. Conceptually, those concerns could be met by other arrangements, some of them potentially more desirable from our perspective. At the same time, a basically different approach would raise concerns from other perspectives. So long as the provisions bearing on our ability to discharge our responsibilities remain as outlined in the Task Group proposals, we are satisfied that the Federal Reserve will be able to meet its responsibilities effectively.

The Federal Reserve and Financial Regulation\*

In light of the critical importance of the point, it may be worth amplifying the interconnection of responsibilities for monetary policy and financial regulation and supervision. Both, at their roots, are concerned with a stable, smoothly functioning financial system. More specifically, the banking system and other depository institutions provide the critical mechanism for transmitting monetary policy impulses to the economy, and those impulses work through financial markets more broadly. Ideally, that system will have the strength, resiliency, and competitiveness to adapt to changes in economic conditions and monetary policy while maintaining continuity in services and the confidence of the public. If there are weak spots or fragilities in the system, they could well bear upon monetary policy decisions. The Federal Reserve must be in a position to sense emerging vulnerabilities.

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\*Attachment I develops these points in greater detail. It is a slightly modified and updated version of a memorandum I distributed to members of the Task Group during its deliberations. Attachment II presents a summary of Central Bank responsibilities for bank supervision in selected countries.

Conversely, the Federal Reserve has inherent powers to deal with dislocations in the banking system, through the discount window and otherwise. Effective exercise of those powers implies ongoing knowledge of the condition of the financial system, and requires expertise, manpower, and experience to deal with points of trouble. The actions taken -- for instance, through the discount window -- in turn may have market and monetary effects, which need to be taken into account in the conduct of monetary policy.

The points are not theoretical. Within the past year the Federal Reserve has necessarily had to consider appropriate responses -- including the provision of needed liquidity -- to counter threats to systemic stability and confidence implicit in the problems of the Continental Illinois bank, of the agricultural sector, and of the state-chartered, privately insured savings and loans in the state of Ohio. More broadly, management of the international debt problem has had clear systemic implications. Each of these problems had different causes and different implications for the financial markets and the economy. Each required a response from the central bank. And, unless contained, each could have had implications for monetary policy.

While the need for a close familiarity with the operations of banking institutions and for adequate authority is

dramatically important during times of financial distress, the need is on-going. We have a natural interest in encouraging a strong banking structure and payments system on a continuing basis to minimize the possibility of crises and to maintain the effectiveness of monetary policy. While that general goal can be and is shared by others, I doubt that, without a strong ongoing Federal Reserve voice in the evolution of the system, these concerns will be appropriately balanced with other objectives.

Policies such as those affecting capital and liquidity standards, the "toughness" of examinations, loan-loss provisioning, and information disclosure can have great significance for the effectiveness of monetary policy as well as for the stability of the entire financial system. Conflicts will inevitably arise in these areas as they are approached from different perspectives. Those conflicts need to be resolved, and I believe the perspective of the central bank is one essential part of a satisfactory resolution.

In sum, to be effective in carrying out its interrelated responsibilities for monetary policy and the stability of the banking and financial system, the Federal Reserve needs to maintain a strong position as "hands-on" regulator and supervisor, not just as an advisor or bystander. Specifically, we must have a sufficient level of supervisory and regulatory authority so that we can (1) retain a well-informed, able, and motivated staff in these areas, able to understand markets and institutions, (2) act forcefully to deal with emerging problems, and (3) play an active role in shaping public policy toward banking and financial regulation.

#### Current Role of the Federal Reserve

Congress has long recognized the need for the Federal Reserve to maintain an active role in bank supervision and regulation. These criteria are broadly satisfied by present arrangements.

Our specific jurisdictions are as the primary federal regulator of state member banks, bank holding companies, and certain activities of foreign banks operating in the United States and of U. S. banks operating abroad. While the Comptroller is the primary regulator and supervisor of National Banks, the Board has residual supervisory jurisdiction by virtue of their membership in the Federal Reserve System.



With the growing numbers and activities of holding companies, regulatory authority in this area has assumed increased importance. Centralization of the authority has helped assure a substantial core of consistency in regulation of banking institutions and their affiliates throughout the country, especially with respect to the involvement of banks in nonbanking activities and in activities involving interstate locations. Many bank holding companies already engage in nonbanking activities nationwide, and as more and more states join regional interstate banking compacts or otherwise engage in interstate deposit taking, the regulation of bank holding companies will take on even greater significance.

The Congress has also entrusted the Board with broad rule-making authority in a variety of other areas affecting both state and national banks. Some of these, such as reserve requirements, are an integral part of monetary policy. Other areas include margin requirements, enforcement of some Glass-Steagall Act provisions, limits on loans to insiders, limits on loans to affiliates, Truth in Lending, and certain other consumer statutes. Some of the responsibilities peripheral to our "core" functions as a central bank could reasonably be lodged elsewhere.

In general, present arrangements permit us to maintain a capability with respect to relevant facets of the banking business essential to the performance of our central banking responsibilities. Through the regional Reserve Banks, that presence is maintained in all parts of the country.

#### The Task Group Recommendations

The Task Group recommendations for regulation of banking institutions would, as I will describe in a moment, change some of the supervisory and regulatory responsibilities of the Federal Reserve, decreasing them in some areas while strengthening them in others. Taken as a whole, the recommendations, at least at a conceptual level, would continue to satisfy our needs as a central bank, and on balance should lead to an effective and somewhat simpler supervisory structure as a whole.

The recommendations would centralize in the Federal Reserve, for the first time, all federal supervision and regulation of federally insured, state-chartered banks. At present, the Board's direct responsibilities for state-chartered banks is limited to the minority that choose to be members of the Federal Reserve System. In assuming responsibility for other state-chartered banks, we would also have primary responsibility for establishing and monitoring a

program under which qualifying states could be certified to assume much of the federal supervision of state banking organizations.

The Board would continue to regulate and supervise the largest bank holding companies -- so-called "international class bank holding companies" -- regardless of the charter class of their lead bank. Authority over holding companies in which the "lead bank" is state chartered would also continue. Our residual authority over national banks, by virtue of their membership in the Federal Reserve System, would remain unchanged. The Board also would retain its current jurisdiction over foreign bank holding companies operating in the United States as well as over U.S. banks operating foreign branches.

At the same time, the Office of the Comptroller of the Currency would assume the title of "Federal Banking Agency" (FBA) and, as an Executive Branch agency, would remain attached to the Treasury Department.\* The Agency would remain the primary supervisor of national banks. Apart from "international class" organizations, the Agency would also supervise and regulate bank holding companies where a national bank is the lead bank. It would become the initiating agency in deciding upon nonbanking activities appropriate for all bank holding companies.

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\*The term Executive Branch Agency, in Task Group terminology, implies that the agency director would report to the Secretary of the Treasury on broad policy issues and on overall budget and staffing in order to maintain conformity with Administration programs in these areas.

The recommendations reflect several concerns of the Task Group. The concept of more than one federal bank regulator is retained, despite the complications, partly in order to maintain checks and balances as a safeguard against undue concentration of regulatory power. Insofar as possible, consistent with other objectives, the Task Group wished to provide a single supervisor for a bank and its holding company, sacrificing assured uniformity among all bank holding companies to achieve that objective. Also, incentives would be provided for a greater role for state supervisory authorities.

As indicated earlier, the essential needs of the central bank are respected. In retaining the basic institutional structure for the regulation of national banks, the Secretary of the Treasury is afforded a direct avenue for continuing input and influence on regulatory policies and direct access to expertise.

The role of the FDIC under the Report's recommendations would be limited essentially to administering the federal deposit insurance system. The composition of the FDIC Board would consist of three Presidential appointees, with the Director of the FRA and the Chairman of the Federal Reserve serving as non-voting members.

The extent to which the insurer of banks needs to remain involved in the active continuing supervision of banks was a matter of considerable discussion, and was resolved by providing the FDIC expanded powers to monitor all troubled insured banks that pose a direct threat to the FDIC insurance fund, as well as a sample of non-troubled banks, in cooperation with the primary supervisor. However, the FDIC's current day-to-day supervision, examination, and regulation of state nonmember banks would be transferred to the Federal Reserve Board or state agencies that have been certified by the Board to assume such responsibilities.

The recommendations regarding state banks provide a substantial opportunity for simplification, both by reducing the number of federal agencies involved and by working toward less overlap with the states. The structure of the Federal Reserve, which through twelve district Federal Reserve Banks has strong regional roots and contact with local banking institutions, should enhance prospects for fruitful cooperation with state authorities.

(1) Bank Holding Company Regulation

One of the most significant changes in the structure of bank regulation recommended by the Report is the division of supervisory and regulatory authority over bank holding companies, as opposed to the present centralization in the Federal Reserve Board.

(a) Division of BHC Regulation. The Report's goal of reducing the number of regulators overseeing particular banking organizations is straightforward. The advantages are strongest in the case of those bank holding companies with only one subsidiary bank, and where the parent company is essentially a shell with no significant nonbanking operations of its own. That is true of the vast number of bank holding companies -- more than 5,000 out of the total of about 6,100.

The merits are more ambiguous in the case of multi-bank holding companies (of which there are over 600) with a combination of state and national bank subsidiaries that would be regulated by the Comptroller, the Federal Reserve, and one or more state supervisors. In these cases, the goal of a single regulator of bank and holding company cannot be achieved, although the bulk of the banking assets would ordinarily be under the same supervision as the parent holding company.

At a practical level, friction could arise as the asset size of banks within a holding company varies over time, calling for a different federal supervisor of the holding company. Indeed, some bank holding companies may find it advantageous to shift the charters or assets of their subsidiary banks in order to switch from one regulator

to another. The recommendations thus introduce into holding company supervision at least the theoretical possibility of "forum shopping" or "competition in laxity" not present in the existing bank holding company regulatory structure.

These jurisdictional questions could become more difficult given the trend toward interstate banking and the regional banking compacts being enacted by many states. As an increasing number of bank holding companies have subsidiary state banks in a number of states, delegation of authority over the holding company could become complicated and contentious.

(b) International Class Bank Holding Companies. The Report recommends that the Federal Reserve Board retain its jurisdiction over the so-called "international class" bank holding companies -- those holding companies owning or controlling U. S. banks with foreign branches or material foreign banking subsidiaries, or companies with total assets in excess of one-half of one percent of aggregate bank holding company assets (approximately \$12.5 billion at present). (As more banking institutions establish international operations or cross the threshold of relative size, they would be added to the "international class" grouping).

This recommendation, while retaining a situation in which the holding company supervisor may be different from

the lead bank supervisor, recognizes that the supervision and regulation of large banking institutions inherently carries important implications for the stability of the domestic and international financial system as a whole. Those implications are directly related to the broader responsibilities of the Federal Reserve and treatment should be uniform.

(c) Nonbank Activities. The recommendations in the Report contemplate that the Federal Banking Agency (rather than the Federal Reserves, as at present) take the initiative in determining the scope of nonbanking activities for all bank holding companies. The main ground for that proposal appears to be a sense that these decisions affecting the structure of the banking system might better be made by an Executive Branch agency more assuredly responsive to Administration policy and philosophy. These decisions once made are not practically reversible and can profoundly affect the structure of financial markets. Our concern is that the decisions do not undercut the stability of the banking system and its safety and soundness, given the inherent interdependence and interconnection among parts of a holding company organization.

In recognition of those concerns, the Report proposes that the Federal Reserve Board retain a right to veto any



activity determined to be permissible for bank holding companies by the Director of the Federal Banking Agency if, by a two-thirds vote, the Board determines that the activity would "undermine the stability of the banking system or have a serious adverse effect on safe and sound financial practices." Clearly, exercise of that veto would require, and is intended to require, a strong sense of conviction on the part of the Board, and would likely be exercised only rarely. Differences of opinion between the Federal Banking Agency and the Board about the suitability of specific non-bank activities should normally be resolved by informal consultation. Clearly, the specificity of substantive legislation delineating the appropriate range of activities for bank holding companies would be important. In any event, the Congress will have to decide the degree to which it is appropriate to provide latitude for these decisions by an Executive Branch agency headed by an individual.

(2) State Certification Program

The Report recommends operational examination and supervisory responsibilities for state-chartered banks be transferred to the extent practicable to state agencies as those agencies are "certified" as having the capability to assume such responsibilities. The Federal Reserve Board would be charged with administering such certification pro-

cedures and with monitoring their performance. However, the basic criteria for certification would be determined by a majority of the Federal Reserve Board, the Federal Banking Agency, and the FDIC. While cumbersome, that procedure would help assure the interests of each Federal agency are taken into account. We believe that the concept that state regulators could potentially play a larger role in the detailed supervision and examination of state institutions, where the resources are adequate to perform that function, is valid. For many banking institutions, particularly of smaller size, duplicative examinations would be avoided. Moreover, the States would have stronger incentives to provide needed professional resources.

State banks would, in any event, continue to be subject to the substantive provisions of federal law, where applicable, and state regulatory agencies would be required, as a prerequisite for certification, to demonstrate their ability and willingness to ensure compliance by state banks with federal law.

States that desire their regulatory agencies also be certified to supervise bank holding companies, where a state bank is the lead bank, would be required to adopt a law no less restrictive than the Federal Bank Holding Company Act. The Federal Reserve, as the Federal regulator of those banks

and bank holding companies, would maintain sufficient oversight to insure that state banking departments were fulfilling all their commitments.

We envisage that the certification process would proceed with some flexibility, probably envisaging different levels of certification (and Federal Reserve participation in examinations) depending on the size and activities of the banking organization. In many states, for instance, the most rapid progress toward full reliance on state examinations would likely be with smaller and medium-sized institutions. However, states with demonstrably strong banking departments would be expected in time to assume a primary role in all but the "international class" institutions.

Effective administration would depend heavily on close working relationships between the regional Reserve Banks and the state authorities. The Federal Reserve Board will strongly encourage close cooperation, and is prepared to work with states in training programs for examiners and in developing common supervisory approaches.

(3) Simplified BHC Regulation

The Report calls for streamlined reporting requirements and elimination of restrictions on the opening or relocation of bank holding company nonbanking offices. The Report also would substitute a notice procedure for the

current application procedures for bank holding company acquisitions and activities. These recommendations would in part simply codify some changes that the Federal Reserve Board has already implemented, and would facilitate further simplification.

(4) Antitrust, Securities, and Margin Responsibilities

The Task Group recommends that the competitive effects of mergers and acquisitions be reviewed exclusively by the Justice Department under normal antitrust standards, rather than, in the first instance, by the banking agencies as at present.\* Similarly, the Securities and Exchange Commission would assume the current responsibilities of the banking agencies to administer and enforce the disclosure and other requirements of the Securities Exchange Act of 1934 for bank securities -- matters that already conform to SEC policy direction. While present procedures do not appear to have posed serious problems for the industry or the agencies, these steps toward "functional regulation" could result in some limited but useful simplification.

The Report also makes certain recommendations with respect to margin requirements on stocks and options. The Board's regulations are now consistent with some of the technical recommendations.

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\*Financial and managerial criteria would continue to be developed and administered by the banking agencies, and competitive criteria could be overridden in the case of failing banks.

More importantly, the Board recently sent to the Congress a comprehensive study of federal regulation of margin requirements. We have proposed that the Congress establish a general regulatory framework for setting margins on securities, on options, and on futures based on securities, possibly through a self-regulatory body with Federal oversight. We would recommend that the appropriate Congressional Committees consider that study, and we would be glad to work with the SEC and with the Congress to prepare implementing legislation.

(5) Deposit Insurance Reform

The Task Group recommendations include several proposals to reform the Federal deposit insurance system. These include the adoption of common minimum capital standards for insurance purposes and common accounting rules by the FDIC and FHLBB by a fixed date (such as within 7 years). It also calls for authority for risk-sharing for uninsured depositors and risk-related insurance premiums.

Equity alone would suggest that banks and thrifts should have common capital and accounting standards, especially as thrifts become more like banks in the types of activities they can and do participate in. Recently the FHLBB adopted new capital requirements designed to tighten and strengthen the net worth positions of thrift institu-

tions in recognition of greater risk-taking by them. This would narrow somewhat the gap between capital required for banks and thrifts, but that gap is very large and should, as suggested by the Report, be closed over time.

The proposals for authorizing risk-sharing and risk-related insurance premiums have been made in legislation previously proposed by the FDIC. The broader issues involved in deposit insurance reform have recently been reviewed by the Working Group of the Cabinet Council on Economic Affairs. The Federal Reserve was not a direct part of that effort and the Board has not taken a position on their recommendations.

The Board does believe, however, that a variety of issues that have arisen with respect to deposit insurance do deserve active study, and that some change would be appropriate. We also believe that the prospect of change should be approached with great care and deliberation given their sensitivity in terms of the confidence of depositors and the stability of the banking system. We would urge that these issues be approached on their merits, separate and apart from administrative reform of the regulatory framework.

### Conclusion

The Bush Task Group Report is the most comprehensive review of the Federal regulatory structure pertaining to

financial markets and institutions that has been made for many years. It's main thrust and purpose is to achieve simplification by reducing overlapping jurisdiction and avoiding unnecessary regulation. As the discussion proceeded, it also became evident that certain fundamental and lasting objectives of the regulatory process, and the legitimate needs of different agencies charged with policy responsibility, inevitably posed complications for any reform plan.

In our judgment in the Federal Reserve, the Report outlines a reasonable and practical approach toward reconciling these conflicting objectives, building on experience and the strengths of the current structure. Specifically, the particular needs that we perceive as crucial to the effective conduct of monetary policy and our responsibilities for helping to ensure the stability of the financial system are respected. While other approaches are clearly conceptually possible consistent with our needs, we commend the Report to you as the base for a practical legislative program.

As I emphasized at the start, however, the sense of confusion in banking and financial regulation stems largely from basic economic and technological change that has outmoded much of the substantive law that the various agencies

must interpret and administer. No reshuffling of regulatory authorities will be satisfactory without resolving those substantive matters.

I believe that there is a wide area of conceptual consensus and agreement on several fronts -- on what a "bank" is and should be; on the desirability of retaining a broad separation of banking and commerce; on the need to redefine a "thrift;" and on simplification of procedures under the Bank Holding Company Act. While more contentious, the time has come to reach a new consensus on such matters as the appropriate range of discretion by states in authorizing new activities for banks or bank holding companies that may conflict with safety and soundness or other basic aspects of Federal policy, on the appropriate range of additional nonbanking activities for bank holding companies, and on a rational approach to interstate banking. These issues have been before the Congress for some time. They urgently need to be settled.

The Federal Reserve Board clearly has a great and continuing interest in all these issues. We stand ready to work with your Subcommittee as you proceed with your examination and deliberations.

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## Attachment I

### FEDERAL RESERVE POSITION ON RESTRUCTURING OF FINANCIAL REGULATION RESPONSIBILITIES\*

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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\*This is a slightly modified and updated version of a memorandum presented to the Bush Task Group on December 15, 1983.

- 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 provide 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 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 a central part of 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, with the pressures on securities firms (and potentially banks) from the collapse of silver speculation in early 1980, or with the implications of the international debt situation for the stability of the financial system. More recently the Federal Reserve has had to actively respond to threats to stability and confidence -- through the provision of liquidity and otherwise -- implicit in the problems at the Continental National Bank, in the agriculture sector, and at the state-chartered, privately insured savings and loans in the state of Ohio. Some of these disturbances 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. Indeed, the problems surrounding the temporary closing of privately insured savings and loans in Ohio unless contained, would have created such a situation.

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 influence 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 a major 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 continuing monetary objectives.

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.

The public interest will not 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 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. The recent problems in the agricultural sector is a case in point, where adherence to strict supervisory standards, rather than exercising forbearance in a manner consistent with safety and soundness, could have resulted in



significantly greater strains on many banks and their customers. Similarly, when the international debt problem surfaced in 1982, an excessive reaction by supervisory agencies at the time would have intensified the systemic risks. Conversely, during long periods of fair weather, when temptations may develop to cater to the instincts of the most aggressive banking entrepreneurs, our supervisory arrangements should encourage continuing concern with the ability of the banking system to withstand potential pressures.

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 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 emphasis 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 for central bank involvement, through the provision of liquidity, and the regulatory structure would in practice seek, and then provide significant weight to, the views of this nation's central bank. 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 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

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 regulatory structure, 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

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\*Excluding Luxembourg, which as part of a monetary union has no central bank, and the United States.

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 gave 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 legislative proposals for expanding powers for banking organizations and placing limitations on the banking powers of nondepository institutions. Such proposals carefully define "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 legislation that addresses the underlying substantive issues would, in and of itself, 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.

## ATTACHMENT II

### CENTRAL BANK RESPONSIBILITY FOR BANK SUPERVISION IN SELECTED COUNTRIES

Central banks in many industrial countries, as well as those in most developing countries, have major responsibility for bank supervision and regulation. In the United Kingdom, Italy, and the Netherlands, the central bank has sole responsibility for bank supervision.<sup>1</sup>

In a number of other countries of the Organisation for Economic Co-operation and Development responsibility for supervision both in form and in practice is divided between the central bank and a bank supervisory office or commission. Legislation recently enacted in France placed the banking commission more directly under the Bank of France. On-site inspections of banks in France are conducted by inspectors of the Bank of France. Luxembourg has recently created a new institution with most of the powers of a central bank, including responsibility for prudential supervision of financial institutions.

In Germany and in Japan, responsibility for bank supervision is shared by the central bank with a banking commission and with the Ministry of Finance respectively. In Germany, the Bundesbank is consulted on all major supervisory decisions, concurs in the establishment of liquidity ratios and guidelines, conducts on-site examinations (through the state central banks), and collects reports on large credits.

Responsibility for Bank Supervision in OECD Countries

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Primary central bank responsible	Joint responsibility	Little direct central bank responsibility
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G-10 countries		
France	Belgium	Canada
Italy	Germany	Sweden
Luxembourg	Japan	
Netherlands	Switzerland	
United Kingdom	United States	

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Other OECD countries		
Australia		Austria
Greece		Denmark
Iceland		Finland
New Zealand		Norway
Portugal		
Spain		
Turkey		

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In Japan, the Ministry of Finance has statutory responsibility and authority for licensing, but operational supervision is closely coordinated with the Bank of Japan, which has its own inspectors who examine loan quality and management.

In Belgium and Switzerland the central bank is somewhat less involved in bank supervision. In Belgium, the Deputy Governor of the Central Bank has a seat on the banking commission, and the commission consults with the central bank before establishing solvency and liquidity ratios; the commission relies on external auditors to ensure compliance with banking laws. In Switzerland, the central bank in supervision has taken a role only recently, and at times it has had a seat on the banking commission.

In Austria, Canada, and the Scandinavian countries the central bank has a limited role in bank supervision.

In all OECD countries, the central bank and the banking supervisory institution consult on problem cases, particularly in view of the role of the central bank as lender to the banking system. Moreover, central banks have responsibility for monitoring developments in foreign exchange and domestic financial markets, for identifying trading and other market practices that may signal prudential problems, and for overseeing the smooth functioning of the payments system.

The accompanying box summarizes ways in which the central banks in the OECD countries participate in supervising banks.

#### United Kingdom

The Banking Act of 1979 is the statutory basis for banking supervision and regulation in the United Kingdom. It defines two categories of institutions: recognized banks and licensed deposit-takers. The Bank of England supervises recognized banks through its direct and continuing contacts with management, while the licensed deposit-taking institutions are regulated through more formal procedures.<sup>2</sup> As of February 1984 there were 290 recognized banks and 308 licensed deposit-taking institutions in the United Kingdom.

The Bank of England does not conduct regular on-site examinations of banks. The supervisory process is initiated through its analysis of statistical reports filed by the banks. These reports are utilized in quarterly or semiannual discussions with banks' senior management. These discussions are intended to analyze the ability of management to control the business objectives of the banks.

#### Italy

The Bank of Italy is responsible for supervision and regulation of the domestic banking system, subject to directives from the Interministerial Committee for Credit and Savings. The Banking Law of 1936 granted the Bank of Italy broad powers to license banks, to establish supervisory requirements, and to conduct on-site examinations. The Bank of Italy has an inspection department that regularly conducts such examinations.

### The Netherlands

The Netherlands Bank has broad responsibility for supervision of the credit system, including licensing authority, monitoring responsibilities, and the ability to impose sanctions on credit institutions. Its supervisory responsibilities cover the universal banks, cooperative banks, savings banks, and mortgage institutions. The supervisory system is highly formal, with detailed regulations on solvency and liquidity. The central bank also attaches considerable importance to its informal contacts with banks. On-site inspections by the central bank form an important part of the supervisory process.

### France

The Banking Law of January 24, 1984, brought all credit institutions in France under a single supervisory structure, with considerable authority and responsibility for supervisory policy and for on-site inspection vested in the Bank of France. That new law created three separate bodies with bank supervisory responsibility:

1. The Bank Commission, chaired by the Governor of the Bank of France, is responsible for ensuring the safety and soundness of the credit institutions and monitoring compliance with banking laws and regulations. On-site banking examinations are conducted by inspectors of the Bank of France.

2. The Committee on Bank Regulation, chaired by the Minister of Finance with the Governor of the Bank of France as Vice Chairman, establishes prudential regulations and accounting standards, and determines what activities are permissible for commercial banks.

3. The Committee on Credit Institutions, co-chaired by the Governor of the Bank of France and the Director of the Treasury, is responsible for approving licenses to establish new banks and for making technical decisions regarding application of regulations to individual banks.

#### Luxembourg

The Institut Monetaire Luxembourgeois (IML) was established in June 1983. The IML performs many of the functions of a central bank, including issuing coins and notes, holding and management of official reserves, regulation of domestic credit, serving as a depository for government funds, and supervising financial institutions. The legislation establishing the IML transferred the exercise of all supervisory and regulatory powers of the previous Banking Control Commission to that institution.

#### Germany

The Federal Banking Supervisory Office (FBSO) is responsible for the supervision of banks and other credit institutions in

Germany, although it exercises its functions in close cooperation with the Bundesbank, which maintains its own bank supervision department. Financial reports are collected by the Bundesbank, but the FBSO has the responsibility for taking appropriate steps in the light of such reports. Similarly, the FBSO has responsibility for issuing detailed regulations on liquidity and capital adequacy; however, the Bundesbank is consulted in the determination of applicable ratios that may have implications for monetary policy. The FBSO is empowered to conduct on-site inspections of banks, but does not generally do so. These inspections are conducted by external auditors or by the 11 state central banks (Landeszentralbanken), which are analogous to District Federal Reserve banks. Presidents of the Landeszentralbanken sit on the Central Bank Council, which determines monetary and credit policy.

Present supervisory arrangements reflect reforms introduced in 1976 after the failure of the Herstatt bank, including rules on risk spreading and foreign exchange exposure, the establishment of a "lifeboat fund" for banks experiencing liquidity difficulties, and an extended deposit protection scheme. These arrangements have been supplemented by a series of "gentlemen's agreements" aimed at extending the supervisory function to the foreign operations of German banks.

Following the Herstatt episode, the Bundesbank, in conjunction with the domestic banking industry, established

the Liquidity Consortium Bank (Liko-Bank) to assist banks that run into temporary liquidity difficulties but are otherwise sound.

In early 1984 the German cabinet approved draft changes to the Banking Law that would limit outstanding credits of the consolidated bank (including majority-owned subsidiaries) to 18 times capital, would reduce the limit on single credits from 75 percent to 50 percent of a bank's capital, and would improve the statistical coverage of foreign subsidiaries.

#### Japan

The Ministry of Finance (MOF) has broad responsibility for licensing, regulating, and supervising banks and other financial institutions in Japan, although the Bank of Japan (BOJ) also has a role in bank supervision, which it fulfills in close consultation with the MOF. Since 1981 the emphasis in bank supervision has shifted from the traditional approach of administrative guidance toward a more formal regulatory structure, although the MOF retains considerable discretionary authority.

The BOJ also conducts on-site inspections of banks because of its substantial extensions of credit to banks, with the aim of ensuring a stable financial environment as well as the smooth implementation of monetary policy. In addition to the MOF, the BOJ has its own inspectors who focus

primarily on an assessment of the banks' loan quality and management. Copies of examination reports submitted to the MOF are provided to the BOJ.

#### Belgium

The Banking Commission, established in 1935, is responsible for supervising the Belgian banking system. A member of the Management Committee of the National Bank, often the Deputy Governor, is usually a member of the Banking Commission. The Banking Commission's functions are confined largely to preventive supervision and to regulation. Deposit protection is provided mostly through the Institut de Reescompte et de Garantie.

The National Bank has a limited statutory role in supervision. Regulations on balance sheet ratios, reserve requirements, and other matters of economic policy are the responsibility of the National Bank, although in practice it consults regularly with the Banking Commission before issuing monetary policy guidelines affecting banks. On-site inspections are generally conducted by auditors appointed by the Banking Commission, which also uses its own inspectors in special situations.

#### Switzerland

The Federal Banking Commission is the chief supervisor for institutions that accept deposits from the public in Switzerland.

The members of the commission are appointed by the Swiss government and must be experts in banking. At times since 1975 a vice president of the Swiss National Bank (SNB) has been a member of the commission, facilitating cooperation between the two institutions, but there is no legal requirement that a member of the commission be from the SNB. In practice, the cooperation and coordination between the commission and the SNB is quite close. The SNB receives copies of licenses issued by the commission (but not audits), and provides the commission with certain statistical reports. The staff of the commission is quite small. On-site inspections are typically performed by private auditing firms, which are appointed and paid for by the banks but are licensed by the commission. The outside auditor's report is in a format and content designed by the commission, and it must give an accurate assessment of the financial condition of the bank and its compliance with banking law and licensing criteria.

#### Canada

In Canada, the Inspector General of Banks is responsible to the Minister of Finance for the administration of the Bank Act, including supervision of the country's banking system. The Inspector General must report to the Minister of Finance at least once a year on the financial soundness of each bank.



The focus of the examination procedures is a management audit, with emphasis on capital, asset quality, management, earnings, and liquidity. There is heavy reliance on outside auditors, who must rotate every two years.

Because the Bank of Canada is the lender of last resort, it cooperates closely with the Inspector General in the supervision of problem banks. The Governor of the Bank and the Inspector General both sit on the Board of the Canadian Deposit Insurance Corporation. The Bank of Canada collects, processes, and analyzes financial returns submitted by banks, and is in daily contact with banks through trading of foreign exchange and government securities.

The Governor of the Bank of Canada also serves as Chairman of the Board of Directors of the Canadian Payments Association, a group that oversees clearing and settlement of Canadian payments.

#### Sweden

Bank supervision in Sweden is conducted by the Bank Inspection Board (Bankinspektionen), which reports to the Minister of Economics. Its principal functions are ensuring safety and soundness of banks, compliance with banking laws and regulations, and conducting on-site examinations. The Swedish Central Bank (Riksbank) regulates the credit markets, serves as a source of liquidity, and acts as the lender of last resort.

The Riksbank has some role in supervising banks' foreign exchange positions, and the reports by banks on foreign lending exposure are provided to both the Bank Inspection Board and the Riksbank, which discuss them at regular joint meetings.

## Footnotes

1. The material for this appendix was derived from Richard Dale, Bank Supervision Around the World (New York: Group of Thirty, 1982); and Board of Governors of the Federal Reserve System, Report to Congress on Bank Supervision in the Group of Ten Nations and Switzerland (The Board, 1984).

2. The statutory requirements for recognition as a bank by the Bank of England are more stringent than those for obtaining a deposit-taking license. The main criteria are (1) adequacy of financial resources (including a minimum capital requirement); (2) high reputation and standing in the financial community; (3) provision of a specified range of financial services; and (4) a management of integrity and prudence commanding appropriate professional skills.