Congressional
August 1979

CM
#14

August 31, 1979

The Honorable William Proxmire
Chairman
Committee on Banking, Housing and
Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

I am responding to your letter of August 20 requesting information concerning bank credit utilization by Chrysler Corporation, Chrysler Financial and Chrysler Canada Ltd. The information is summarized in the enclosed table.

The table distinguishes between the bank credit facilities of Chrysler Corporation and Chrysler Financial and between bank credit facilities of U.S. banks as distinct from foreign banks. The first distinction is relevant not because the absolute size of the bank credits to Chrysler Financial are larger than to Chrysler itself, but because the assets associated with these bank credits are almost exclusively wholesale and retail receivables. In this sense the assets of Chrysler Financial are to a sizable degree, of a different nature than those of Chrysler the parent.

The data indicate that Chrysler Financial has total bank credit facilities of about $3.2 billion of which somewhat more than $2 billion are being used. About two-thirds of these facilities are with U.S. banks. Chrysler Corporation (including Chrysler Canada) has total bank credit facilities somewhat in excess of $1.1 billion, all but $200 million of which are in use. About $600 million of these facilities are with domestic banks. Most of the foreign bank credits to Chrysler and Chrysler Financial are with Canadian banks and with a cross section of the larger British and European commercial banks.

As the table further indicates, United States banking organizations had aggregate credit facilities to Chrysler and Chrysler Financial in an amount of about $2.9 billion as of July 31, 1979. Almost $2.0 billion of the domestic bank credit facilities, or 64 per cent of the total, were being used by Chrysler and Chrysler Financial. While we do not have complete data, we know that the rate of usage of these credit facilities has risen further during August. For example, due to Chrysler Financial's inability to roll-over commercial paper in any appreciable amount, the amount of loans under commercial paper back-up lines has risen to $1.1 billion as of August 13, 1979. This would place the rate of credit facility utilization for domestic banks at around 73 per cent.

As the table indicates, there are a large number of U.S. banks that have at least some exposure to Chrysler and Chrysler Financial. To give you some insight into the distribution of the credits, the 25 largest banks that are creditors to Chrysler account for about $1.3 billion and 66 per cent of the almost $2 billion in bank credits outstanding to Chrysler and Chrysler Financial.

Your questions about bank lending limits involve some difficult issues of measurement. For one thing, the agreements to purchase receivables represent third-party paper to the acquiring banks and, as such, are not subject to legal lending limits. In addition, the computation of lending limits for state-chartered banks differs from state to state. Finally, in some instances, individual banks have "house" lending limits which are more restrictive than legal lending limits. With these factors in mind, we estimate that the direct credit agreements between the group of creditor banks and Chrysler and Chrysler Financial amount to about 50 per cent of legal lending limits in the aggregate. For individual banks, however, the picture can be quite different in part because of the presence of "house" lending limits, and in part because of the uneven distribution among the group of banks.

If I can be of any further assistance to you, please let me know.

Sincerely,

S/Paul A. Volcker

Paul A. Volcker

Enclosure

EGC:mhw

I. Bank Credit Facilities of Chrysler Financial as of July 31, 1979

	Facilities	Usage	(%)
	(Millions)		
A. Facilities Involving U.S. Banks			
Comm. Paper Bank-up Lines (247 banks)	$1,407	$ 860	(61)1/
Whlse Standby Purchase Agreements	610	432	(71)
Retail Standby Purchase Agreements	150	0	--
Term Loans (70 Banks)	136	136	(100)
Euro-dollar (4 Banks)	16	16	(100)
Subtotal	2,219	1,444	(62)
B. Facilities Involving Other Banks			
Syndicated Euro-dollar Loans	478	469	(98)
Canadian Bank Loans to Chrysler Credit Canada LTD	232	62	(27)
Commercial Paper Back-up	206	98	(48)
Subtotal	916	630	(69)
Total Chrysler Financial	3,235	2,074	(64)

II. Bank Credit Facilities of Chrysler Corporation (parent)

	Facilities	Usage	(%)
A. Facilities Involving U.S. Banks			
Revolving Credit (95 Banks)	543	387	(71)
Short-term Credit Lines (38 Banks)	50	27	(54)
Subtotal	593	414	(70)
B. Facilities Involving Other Banks			
Syndicated Euro-dollar Loans	305	300	(98)
Canadian Bank Loans to Chrysler Leasing LTD	30	30	(100)
Canadian Bank Loans to Chrysler Canada LTD	172	172	(100)
Revolving Credit	24	17	(71)
Short-term Credit Lines	30	16	(53)
Subtotal	561	535	(95)
Total Chrysler Corporation	1,154	949	(82)
GRAND TOTAL	$4,389	$3,023	(69)1/

1/ As of August 13, commercial paper back-up line utilization increased to approximately $1,109 million or 80 per cent of the facility. Primarily due to the draw down on the back-up lines for commercial paper, the total U.S. bank and total facilities utilization percentages increased to 73 per cent and 76 per cent, respectively.

United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, D.C. 20510

August 20, 1979

#14

The Honorable Paul A. Volcker
Chairman, Board of Governors of
the Federal Reserve System
Washington, D.C. 20551

Dear Mr. Chairman:

The Committee on Banking, Housing and Urban Affairs may be considering legislation to provide a loan guarantee or similar financial assistance to the Chrysler Corporation, in the event that the Administration requests such legislation. In this connection, it is essential that the Committee have before it accurate data on the involvement of U. S. banks in Chrysler's financing arrangements and the potential for additional bank financing of Chrysler under any financial plan that may be proposed.

The Committee has been told that the Chrysler Corporation (including both the parent company in the U. S. and Canada and Chrysler Financial) has $4.4 billion in lines of credit outstanding with about 300 U. S. banks and that most of these banks are at either their house or legal lending limits. It was also stated that about $3.9 billion of those lines of credit had been taken down.

I would appreciate your examining the situation and reporting back to the Committee as soon as possible with regard to the actual amount of U. S. bank financing of both the parent company in the U. S. and Canada and Chrysler Financial and the relation to banking lending limits. Any additional information which you may consider relevant to the Chrysler situation will, of course, be welcome as well.

Best regards.

Sincerely,

Bill Proxmire

William Proxmire
Chairman

WP:ebl

We are, however, working on the problem with the Bank Administration Institute. In addition, a task force of the ABA is working to develop a procedure for clearing checks of people who are relocating. I am told that the problem arises because of the time required to <u>return</u> checks for which there are insufficient funds. Apparently, checks are cleared forward very rapidly, but returned checks are sent back by mail. Although we don't know the volume of returned checks yet, we expect it is relatively small. We are planning to obtain this information in the near future.

Under existing instructions, banks are supposed to clear all consumer checks over $2,500 by wire. However, only about 50 percent of checks of that size or larger are cleared that way. We are also looking into the possibility of encouraging the banks to use the "bank wire" to notify the receiving banks of checks that won't clear. Another possibility is changing the Uniform Commercial Code to require banks "to return checks as expeditiously as possible."

The Taskforce of the Bank Administration Institute is due to report this fall. We will be back to you with their report and with a more definitive view of the size of the problem and, hopefully, some solutions to the problem.

Sincerely,

S/ Paul

Paul A. Volcker

Enclosure

TL:PAV:jrg (#V.5)
bcc: Tom Luck
Catherine Mallardi (2)

August 28, 1979

The Honorable Henry S. Reuss
Chairman
Committee on Banking, Finance
and Urban Affairs
House of Representatives
Washington, D. C. 20515

Dear Chairman Reuss:

In connection with your letter of August 21 about delays in crediting checks, we do have a good deal of information at hand. Practices in this area were surveyed during 1978 and a report summarizing the results of that survey is enclosed.

We plan to meet with other banking regulatory agencies to exchange thinking and review possible approaches toward the problem shortly.

I should perhaps indicate my own, very preliminary, thinking in this connection. I know from personal experience that delays can be irritating. But is this an area in which we should resort to detailed Federal control--control that almost inevitably would be highly complex in the light of the wide variety of circumstances and practices involved--or should we rather rely primarily on competitive forces and consumer common sense? I am not enamored with a regulatory approach that may impose costs on the banks and indirectly on the public, generally far out of proportion to actual abuse. As in other areas, the appropriate focus may be straight-forward disclosure rather than regulatory prohibitions. I know that disclosure is not a solvent for every problem, but I am certain that the temptation to reach all problems by setting out detailed regulatory standards also needs to be resisted.

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-SIXTH CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, D.C. 20515

225-4247

August 6, 1979

V-5

The Honorable Paul A. Volcker
Chairman
Board of Governors
Federal Reserve System
Washington, D. C.

Dear Chairman Volcker:

I am concerned about the delay in crediting deposited checks to customers' accounts in our country's depository institutions. The enclosed two articles recently appeared in the press describing inordinate delays which appear to be completely out of line with the time it takes for normal check clearing.

Please provide us with any information that the Federal Reserve has collected on these practices, together with any recommendations for remedying this problem.

Sincerely,

Henry

Henry S. Reuss
Chairman

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Gold, Bill. "The District Line: Electronic Banking Revisited." *Washington Post*, July 20, 1979.

August 9, 1979

Dear Mr. Chairman:

I much appreciate your letter on my appointment, and hasten to say that I could not agree more with the importance of maintaining those excellent relations with your Subcommittee that characterized the terms of my predecessors.

I would be delighted to meet informally with the Subcommittee after the recess, and I am sure Bob can work out a convenient time with my staff.

I look forward to seeing you soon. There are no shortages of problems.

With best regards.

Sincerely,

Paul A. Volcker

The Honorable Parren J. Mitchell
Chairman, Subcommittee on Domestic
Monetary Policy of the Committee on
Banking, Finance and Urban Affairs
U.S. House of Representatives
Washington, D.C. 20515

PAV:smk

cc: Don Winn
Jerry Corrigan

PARREN J. MITCHELL, MD., CHAIRMAN

STEPHEN L. NEAL, N.C.
NORMAN E. D'AMOURS, N.H.
DOUG BARNARD, GA.
JIM MATTOX, TEX.
JOHN J. CAVANAUGH, NEBR.

225-7315

GEORGE HANSEN IDAHO
RON PAUL, TEX.
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U.S. HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-SIXTH CONGRESS
WASHINGTON, D.C. 20515

August 2, 1979

The Honorable Paul A. Volcker
Chairman, Board of Governors
Federal Reserve System
20th and Constitution Avenue N.W.
Washington, D.C. 20551

Dear Chairman Volcker:

I welcome and warmly endorse your appointment to the Board of Governors of the Federal Reserve System and designation as its chairman -- congratulations! The responsibilities you are assuming are awesome. I wish you well in carrying them out.

The Subcommittee on Domestic Monetary Policy has had excellent relations with the Federal Reserve since I became Chairman of the Subcommittee in 1977. We worked closely and constructively with both Chairman Burns and Chairman Miller in carrying out our oversight and legislative responsibilities in regard to the Federal Reserve and the conduct of monetary policy. I look forward to having the same close and constructive relationship with you.

I am hopeful that we can arrange for the members of the Subcommittee to meet with you on an informal basis shortly after the House reconvenes in September. I have asked Bob Weintraub to call your legislative liaison about this.

With best wishes and warmest regards I am,

Sincerely,

Parren

Parren J. Mitchell
Chairman

PJM/rw:jlt

95th Members Caucus

of the U.S. House of Representatives

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
1979 OCT -2 AM 11: 15
RECEIVED
OFFICE OF THE CHAIRMAN

September 28, 1979

Mr. Paul A. Volcker
Chairman, Federal Reserve Board
Federal Reserve Building
Constitution Avenue
Washington, D.C. 20551

Dear Mr. Volcker:

On behalf of the Members of the 94th and 95th Caucuses, I would like to thank you for your presentation on Thursday.

The analysis and implementation of fiscal and monetary policy can be an elusive and imprecise task. We appreciate the perspective you gave us and shall bear those points in mind as we try to apply some legislative sense to our economic problems.

Thank you again for meeting with us.

Sincerely,

Dick

Richard A. Gephardt, M.C.
Chairman

1041 Longworth House Office Building • Washington, D.C. 20515 • (202) 225-4996

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date August 31, 1979

To Board of Governors

From Jack Ryan

Subject: Letter to Board Members from Congressman Wes Watkins

Congressman Wes Watkins sent the attached letter to Chairman Volcker -- and apparently to all other Board Members -- regarding the Board's policy on the retirement of acquisition debt incurred in the formation of one bank holding companies.

Attached for your information is a package of material relating to this matter. We are in the process of preparing a response to Congressman Watkins for Chairman Volcker's signature.

Attachment

#21

WES WATKINS
3RD DISTRICT, OKLAHOMA
(202) 225-4565

MAJORITY ZONE WHIP

CHAIRMAN
CONGRESSIONAL RURAL
CAUCUS

CONGRESS OF THE UNITED STATES
HOUSE OF REPRESENTATIVES
WASHINGTON, D.C. 20515

COMMITTEES:
BANKING, FINANCE AND URBAN AFFAIRS
SCIENCE AND TECHNOLOGY
SELECT COMMITTEE ON AGING

August 30, 1979

Mr. Paul Volcker
Chairman
Board of Governors
Federal Reserve System
Washington, D.C. 20551

Dear Mr. Chairman:

Recently I received a copy of a letter from Mr. John E. Ryan to Mr. Forrest Jones of Oklahoma City, Oklahoma, concerning the Board's Committee on Bank Supervision and Regulation decision regarding the policy on the retirement of acquisition debt incurred in the formation of one-bank holding companies. I was disappointed to learn the Committee felt this policy did not need to be changed.

Title VIII of FIRA alone necessitates a re-examination of the repayment schedules for bank stock loans. Since preferential rates are no longer allowable, higher interest rates are having to be incurred. These increased debt servicing costs have been creating burdens on banks that need to have their repayments stretched out over a longer period of time.

Mr. Ryan's letter also states that, "... the earnings of small banks generally grow at a faster pace in a rising interest rate environment than when rates are stable or declining." The term "generally" does not take into account the position of those banks whose earnings are not growing as fast as some and who need a longer repayment schedule. It would appear that you are not trying to help these banks improve their situations. You are placing these banks in jeopardy and the Fed will have to take full responsibility when these banks run into difficulties.

Your action continues to weaken the Federal Reserve's position in the eyes of this country's banks by your lack of responsiveness to their needs and problems. It is no wonder so many are withdrawing from the System.

OKLAHOMA DISTRICT OFFICES:

203 POST OFFICE BUILDING
DUNCAN, OKLAHOMA 73533
(405) 252-1434

232 POST OFFICE BUILDING
ADA, OKLAHOMA 74820
(405) 436-1980

118 FEDERAL BUILDING
MCALESTER, OKLAHOMA 74501
(918) 423-5951

Hopefully, we can work together to improve this situation. I hope you will reconsider the Committee's decision and try to be helpful to this group of people in the banking industry.

Thank you for your time and attention to this matter.

Sincerely,

Wes Watkins

WES WATKINS
Member of Congress

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FIDELITY BANK N.A.

January 29, 1979

FORREST D. JONES
PRESIDENT

Mr. John E. Ryan, Director
Division of Banking Supervision & Regulation
Board of Governors of the Federal Reserve System
Washington, D. C. 20551

Dear Mr. Ryan:

I sincerely appreciate the time spent with us this last Thursday morning to discuss the maximum permitted repayment program by a one bank holding company on bank stock indebtedness.

The group that met with you was composed of several Oklahoma bankers that are senior officers in small to large size banks. It was our common purpose to request consideration of a longer repayment period than the present twelve year maximum.

Although the present program has flexibility in that the Federal Reserve System has approved the formation of one bank holding companies wherein the structured twelve year debt contained an escalation of payments, it is believed an extended period is needed under current conditions.

To retain sufficient earnings in a well managed bank that will provide capital for growth, there is insufficient dividend paying capability to retire bank stock debt by the holding company within a twelve year period.

We respectfully request that the Federal Reserve Board of Governors consider granting a longer repayment period and suggest twenty years. In your consideration of making such a recommendation to your Board, I submit the following comments.

1. Banks are presently selling for prices that range from 1½ times book to 2½ times book. In unusual situations, they are selling for a higher multiple. The multiple being primarily determined by the future growth and earning opportunity of the banking facility. We have found that the Comptroller of the Currency will not allow us to extend bank stock credit in excess of book value and believe you will find that most, if not all, lending banks are national banks.

ROBINSON AT ROBERT S. KERR AVENUE P. O. BOX 24128 OKLAHOMA CITY 73124 (405) 272-2000

It is not our desire to recommend any change that would enhance the market price of a bank, to increase loans beyond a book value maximum, or to do anything that would permit additional borrowing leverage by a one bank holding company. Each borrower, under present requirements, must have supportive collateral and/or cash to provide equity necessary to bring the debt on bank stock to a book value transaction or less.

2. Interest rates are changing. As rates have generally cycled over the last three or four decades, the peaks and valleys have grown higher and while it's difficult to accept this, it's very possible that this gradual change in interest structures will continue to escalate to higher levels.

In any event, we could probably agree that it's unlikely that we will see prime rates reduce in the near future to the more comfortable 3% or 4% range that we enjoyed some ten or fifteen years ago. Even with the tax benefits gained through the creation of debt in a one bank holding company rather than by a partnership or individual debt, higher interest rates do diminish the ability of the borrower to repay debt. Recognition of this is evidenced by the extremely long repayment programs being granted under government guarantee on farm properties and on residential housing, as well as on non-guaranteed real estate loans.

In applying for one bank holding company status, the application to the Federal Reserve Bank includes a pro forma based upon an average interest rate over the life of the loan. Most recently the applications that we have observed have included guesstimates that the interest rate would be 7% or 8%. We are beginning to question whether the interest can be forecast for a twelve year period and if it can, whether 8% if high enough to use an an average figure. It probably is not.

Under the Federal Institutions Regulatory Act, bank stock loans as well as all other loans are to be made on comparable commercial rates. Although we are not entirely sure that we understand what compliance will mean, we assume that this would cause bank stock loan rates to at least equal New York prime. Recognizing the need for capital retention, we believe that it is to the benefit of the holding company and/or its subsidiary bank to have a longer repayment period if repayment is to come solely from the payment of dividends. High interest costs are difficult to pay, but they must be paid before principal reductions.

3. Inflation is a problem. If inflation is in the 9% range as it has been this past year, we would expect each bank to grow at least 9% purely from inflationary causes. Any actual growth adds to the capital problem.

Using the statistics provided by the most recent F.D.I.C. Annual Report (1977), banks in the size category of $10MM to $25MM earned an average of 11.34% on capital and banks in the $25MM to $50MM size range earned 12.5%. Recognizing that a dividend payout would not normally equal even 50% of the net income, it's obvious that the net dividend flow even on a tax free basis through a holding company would have difficulty paying interest in today's market.

The need for retained earnings in a heavy inflationary period further diminishes the ability to pay holding company debt through a reasonable dividend program.

Once again - a stretched out repayment program needs consideration.

4. In the discussion that we had, someone mentioned that it would be undesirable to permit further leveraging of holding company debt. We submit that this will not, and cannot occur because of the restraints on bank stock lending in effect by virtue of the regulatory action of the examiners from either the F.D.I.C., Comptroller's Office, or state bank commissioners. For many years, the maximum loan acceptable to these regulators has been 100% of book value.

Bank stock debt created by borrowers other than a one bank holding company now enjoy longer repayment periods than twelve years and we respectfully request consideration by the Board of Governors of the Federal Reserve Bank to increase the maximum allowable period of repayment to twenty years. To extend the limit only two or three years provides modest relief.

Cordially,

Forrest D. Jones
President & Chief Administrative Officer

jer

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

July 25, 1979

Mr. Forrest D. Jones
President and Chief Administrative Officer
Fidelity Bank, N.A.
P. O. Box 24128
Oklahoma City, Oklahoma 73124

Dear Mr. Jones:

This is in response to the request made at a meeting in Congressman Watkins' office by several representatives from the Oklahoma Bankers Association and contained in your letter to me that the Board reconsider its present policy on the retirement of acquisition debt incurred in the formation of one bank holding companies.

The Board's staff has completed its review of the amortization policy in connection with your observations relating to the impact of current levels of interest rates and inflation on the ability of small one bank holding companies to retire acquisition debt. The staff's findings, summarized below, may be of interest.

First, there is no question that rising interest rates have increased the debt servicing burden of small one bank holding companies in instances where acquisition debt is priced on a floating rate basis. However, the staff found that the earnings of small banks generally grow at a faster pace in a rising interest rate environment than when rates are stable or declining. This is largely attributable to the fact that small banks tend to have more interest-sensitive assets than interest-sensitive liabilities. Typically, small banks have a large base of stable demand, time and savings deposits, the cost of which is insulated from rising interest rates by rate ceilings. Moreover, vis-a-vis their larger counterparts, small banks do not rely on volatile interest-sensitive liabilities to any great extent. Thus, during periods of rising interest rates, their yield on earning assets tends to increase faster than their cost of funds.

More importantly, the available evidence suggests that the increase in bank earnings resulting from escalating interest rates typically more than offsets the increased interest costs experienced by the parent company. Consequently, the ability of small one bank holding companies to service their acquisition debt generally does not appear to be adversely affected by rising interest rates.

Second, it is recognized that inflation has made it difficult for some small one bank holding companies to retire their acquisition debt on schedule while simultaneously maintaining the capital ratios of their banks at acceptable levels. Inflation usually leads to strong loan demand and to higher rates of growth of bank assets. A bank that is called upon to meet parent company debt servicing requirements will normally have to increase its dividend payout. As a result, its rate of equity growth is likely to fall below its rate of asset expansion, causing some slippage in the capital ratios of the bank subsidiary.

An examination of what has actually happened to the capital ratios of bank subsidiaries of small one bank holding companies revealed that while capital ratios declined, the decline was for the most part short-lived, lasting only several years subsequent to acquisition. On average, the capital ratios did not fall to unacceptable levels.

There have been occasions when one bank holding companies have had to modify their debt retirement schedules in order to maintain adequate levels of bank capital. The Board has never criticized a holding company for retiring acquisition debt over a longer period than originally stated in an application where the decision to modify the retirement schedule was necessary to avoid undue strain being placed on the bank's capital position. This flexibility in the administration of the amortization policy has enabled the Board to accommodate unanticipated needs of bank holding companies such as those caused by high levels of inflation.

Third, although the staff found that the transfer of ownership in small banks would be facilitated by liberalizing the present policy on debt retirement, it is not clear that any improvement in the transferability of small banks is needed. As you noted in your letter, most small banks are being sold for substantial premiums over book value. This suggests that the demand for small banks is strong, particularly when bank stocks in general are selling at a discount from book value in today's market.

In addition, the number of one bank holding company applications has risen dramatically in the past two years. In 1978, 259 3(a)(1) applications were approved by the Board, the highest number since the 1970 amendments to the Bank Holding Company Act were passed. This also suggests that the transfer of ownership in small banks has not been a serious problem.

Finally, the staff concluded that the liberalization of the debt retirement policy would encourage prospective one bank holding companies to incur more indebtedness than would otherwise be the case. Although it was contended that this cannot occur because "the Comptroller of the Currency will not allow us to extend bank stock credit in excess of book value" there have been numerous 3(a)(1) applications submitted to the Federal Reserve System where the acquisition debt exceeded the book value of the bank to be acquired.

The staff presented its findings, along with your letter of petition, to the Board's Committee on Bank Supervision and Regulation, which is composed of two governors. The Committee agreed with staff's analysis and was concerned that a liberalization of the debt retirement policy would lead to higher premiums and higher levels of leverage. The Committee concluded that the present policy is sufficiently flexible to accommodate the reasonable needs of applicants seeking to form one bank holding companies under current economic conditions.

As you know, several bills have been introduced in Congress which, if passed, would alter the Board's present policy on debt retirement. It appears likely that the Board will be asked to testify on these bills in the near future. In view of your interest in this matter, I will be happy to send you a copy of the testimony as soon as it is available.

Sincerely,

John E. Ryan

John E. Ryan
Director

FIDELITY BANK N.A.

FORREST D. JONES
PRESIDENT

July 30, 1979

Mr. John E. Ryan, Director
Board of Governors of the
Federal Reserve System
Washington, D. C. 20551

Dear Mr. Ryan:

As you can imagine, I was disappointed in the decision of the Federal Reserve Bank to leave the present repayment restrictions on bank stock loans through holding companies at twelve years.

Similarly, I disagree with some of the logic that has led you and the governors to this decision.

I agree that there has been an amazing increase in applications for one bank holding companies in the past two years. There are two reasons for this - one is that an obvious tax advantage does exist for the repayment of debt through a holding company rather than to take dividends personally and then repay a personal obligation.

Second, there has been much more activity from the Federal Reserve Bank encouraging an application for one bank holding companies these past two years at least in our area.

While we construe this as being an unusually cooperative attitude by the Fed, at the same time there has been a far more aggressive stance by the Kansas City Federal Reserve Branch and we assume this revised attitude is nationwide.

It's difficult to understand why the Fed feels so strongly about a twelve year maximum repayment period when by policy, it is indicated that there is no need to restrict yourself to the twelve years that any reasonable request will provide for an extended repayment period during the lifetime of the loan.

As commercial lenders, we normally ask for a repayment period that is within the customers ability and expect the customer to adhere to the repayment period without an extension of time.

Page Two
Mr. John E. Ryan
July 30, 1979

As a matter of fact, if we allow an instalment customer to have any more than a modest extension during the course of a contract, the Comptroller will charge off the loan or severely classify it.

I was unaware that several bills were introduced in Congress which would alter the Board's present policy on debt retirement. The only bill that I am aware of is the legislation introduced by Representative Wes Watkins of Oklahoma.

While I assume that the matter has been concluded on the part of the Fed, I sincerely wish that you would reconsider the request and allow a greater percentage of judgment to be exercised by the lending banks, rather than retaining a maximum timeframe for the repayment of what is typically a large debt.

Cordially,

Forrest D. Jones
President & Chief Administrative Officer

jer

cc: The Honorable Wes Watkins
Member of Congress

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

August 9, 1979

Mr. Forrest D. Jones
President and Chief Administrative Officer
Fidelity Bank, N. A.
P. O. Box 24128
Oklahoma City, Oklahoma 73124

Dear Mr. Jones:

This refers to your letter of July 30 concerning the Federal Reserve's policy on the retirement of acquisition debt incurred in the formation of one bank holding companies.

In my earlier response to you, I did not intend to convey the impression that the Board had made a final decision on this matter. Although the staff completed its analysis of the present policy and presented its findings to the Committee on Bank Supervision and Regulation, the matter has not yet been presented to the Board.

It is expected that the Board will review the present policy on debt retirement in connection with its upcoming testimony on H.R. 2747 (see pages 3 and 4), H.R. 3548, and H.R. 4004. In connection with such review, we intend to present to the Board the request of the Oklahoma Bankers together with material submitted by you.

I have enclosed a copy of each of the bills and will send you a copy of the Board's testimony as soon as it is available.

Sincerely,

John Ryan

John E. Ryan
Director

Enclosures

96TH CONGRESS
1ST SESSION

H. R. 2747

To amend the Bank Holding Company Act and the Bank Merger Act to restrict the activities in which registered bank holding companies may engage and to control the acquisition of banks by bank holding companies.

IN THE HOUSE OF REPRESENTATIVES

MARCH 8, 1979

Mr. HANLEY (for himself and Mr. ST GERMAIN) introduced the following bill; which was referred to the Committee on Banking, Finance and Urban Affairs

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A BILL

To amend the Bank Holding Company Act and the Bank Merger Act to restrict the activities in which registered bank holding companies may engage and to control the acquisition of banks by bank holding companies.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Bank Holding Company Amendments of 1979".

I—E

I

96TH CONGRESS
1ST SESSION

H. R. 3548

To amend the Bank Holding Company Act of 1956 to provide that the Board of Governors of the Federal Reserve System shall not deny any application for the formation of a one-bank holding company because the transaction to form such one-bank holding company involves a bank stock loan which is for a period of not more than twenty-five years.

IN THE HOUSE OF REPRESENTATIVES

APRIL 9, 1979

Mr. WATKINS introduced the following bill; which was referred to the Committee on Banking, Finance and Urban Affairs

---

A BILL

To amend the Bank Holding Company Act of 1956 to provide that the Board of Governors of the Federal Reserve System shall not deny any application for the formation of a one-bank holding company because the transaction to form such one-bank holding company involves a bank stock loan which is for a period of not more than twenty-five years.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 3(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1842(c)) is amended by adding at the end thereof the following: "Notwithstanding any other provision of this

I

96TH CONGRESS
1ST SESSION

H. R. 4004

To amend the Bank Holding Company Act of 1956 to provide that the Board of Governors of the Federal Reserve System shall not deny any application for the formation of a one-bank holding company because the transaction to form such one-bank holding company involves a bank stock loan which is for a period of not more than twenty-five years, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

MAY 8, 1979

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Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 3(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1842(c)) is amended by adding at the end thereof

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date May 30, 1979

To Board Committee on Bank Regulation and Supervision

From Division of Banking Supervision and Regulation (Messrs. Cornyn and Talley)

Subject: Petition to Liberalize the Board's Policy on the Retirement of One-Bank Holding Company Acquisition Debt

I. Introduction

Recently, a group of bankers from Oklahoma requested that the Board reconsider its present policy on the retirement of acquisition debt incurred in the formation of one bank holding companies. It is the Board's policy that acquisition debt should be retired over a reasonable period of time, generally not exceeding 12 years. The bankers argued (see attached letter) that this policy is inconsistent with current levels of inflation and interest rates and recommended that the retirement period be extended to 20 years.1/

Summary

As argued by the Oklahoma bankers, high interest rates do increase the debt servicing burden of the parent of small one-bank holding companies. However, high interest rates also tend to increase the earnings of the holding company's bank subsidiary, because most small banks have more interest sensitive assets than liabilities. Available evidence suggests that the increase in bank earnings resulting from high interest rates typically more than offsets the increased interest costs experienced by the parent company. Consequently, the ability of small one-bank holding companies to service their acquisition debt does not appear to be adversely affected by high interest rates.

There is evidence, however, that rising inflation has made it difficult for some small one-bank holding companies to retire their acquisition debt on schedule while simultaneously maintaining the capital ratios of their banks at an acceptable level. Data for a sample of 73 holding companies formed during the early 1970s show that, in aggregate, the capital ratios of their banks declined significantly for several years following formation, but

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1/ On April 9, Congressman Watkins of Oklahoma introduced a bill (H.R. 3548) in the House of Representatives that would "amend the Bank Holding Company Act of 1956 to provide that the Board of Governors of the Federal Reserve System shall not deny any application for the formation of a one-bank holding company because the transaction to form such one-bank holding company involves a bank stock loan which is for a period of not more than twenty-five years." Passage of this bill would presumably nullify the existing policy.

then bottomed out due to a sharp rise in bank retained earnings. In aggregate, the capital ratios of these holding company banks did not fall materially below their peer group. In some cases, holding companies advisedly have not stuck to their acquisition debt retirement schedule so that their banks could retain more earnings and build up their capital. Also, some holding companies probably have had to constrain the growth of their banks in order to maintain reasonably acceptable capital ratios.

The Board's present policy is that acquisition debt should be retired over a reasonable period of time, generally not to exceed 12 years. However, in practice, the Federal Reserve has not insisted that existing holding companies adhere to a 12 year retirement schedule if, due to unanticipated events, retirement would place an undue strain on the bank's capital position.

Lengthening the debt retirement period for newly forming holding companies would further facilitate the ownership transfer of small banks. However, it would also tend to result in holding companies incurring even more debt since they would have more years to pay it off. Incurring more debt would place a greater strain on their banks to service this debt. In our judgment, this adverse factor outweighs any likely benefits from increasing the transferability of small banks.

II. Discussion of Arguments Advanced by Oklahoma Bankers

Impact of Rising Interest Rates

The Oklahoma bankers contend that the escalation in interest rates has made it difficult to comply with the Board's debt retirement policy. This is because interest rates on bank stock loans are generally tied to money market rates. As interest rates rise, they argue, a parent company's debt serving capacity declines.

The validity of this argument rests upon the capacity of relatively small one bank holding companies to control their exposure to interest rate risk. Generally speaking, a banking organization can minimize interest rate risk by funding interest-sensitive assets with interest-sensitive liabilities and by matching the maturities of assets and liabilities. As long as the rate-mix characteristics of assets and liabilities are in balance, the institution is "protected" against interest rate fluctuations. Because acquisition debt is usually priced on a floating rate basis, the key issue is whether the impact of rising interest rates on acquisition debt is, or can be, offset by the underlying subsidiary bank. On the basis of information presented below, it appears that the adverse impact of rising interest rates on the variable rate acquisition debt of the parent company is, or can be, minimized and in most cases totally offset by the asset sensitivity of the underlying subsidiary bank. In short, we suspect that most small one bank holding companies perform better in a rising interest rate environment than when rates are stable or declining.

We have attempted to measure the interest rate sensitivity of various size groups of banks with less than $100 million in total assets by examining recent Call Report data. Although the sensitivity of a bank's assets and liabilities cannot be measured precisely with the Call Report due to certain data limitations, we believe that it can provide some reasonably accurate measures of rate sensitivity. Interest-sensitive balance sheet items were defined to include the following:

Interest-sensitive Assets	Interest-sensitive Liabilities
Interest bearing balances with other banks	Domestic time deposits in denominations of $100,000 or more
Trading Account Securities	Deposits in foreign offices
Securities with a remaining maturity of one year or less	Federal funds purchased and securities sold under agreements to repurchase
Federal funds sold and securities purchased under agreements to resell	Other liabilities for borrowed money

It should be emphasized that the definition of interest-sensitive assets understates the actual volume of assets that are highly sensitive to fluctuations in money market rates as it excludes loans that are priced on a floating-rate basis and other loans with a maturity of less than one year. (These items are not reported on the Report of Condition by banks with less than $300 million in assets.) In contrast, the definition for interest-sensitive liabilities probably overstates the actual level of rate sensitive funds because the Call Report line item, "Other liabilities for borrowed money," although predominately short-term, often includes fixed rate, intermediate and long-term borrowings.

The following ratios were used to measure interest-rate sensitivity:

(1) $\frac{\text{Interest-sensitive assets}}{\text{Total Assets}}$

(2) $\frac{\text{Interest-sensitive liabilities}}{\text{Total Assets}}$

(3) $\frac{\text{Interest-sensitive assets less interest-sensitive liabilities}}{\text{Total Assets}}$

Table 1 shows the distributions of each of the ratios for various size categories of banks with less than $100 million in total assets for December 1976, December 1977, and June 1978. As shown in Table 1, banks with total assets under $40 million tend to be asset sensitive, with the degree of asset sensitivity greater the smaller the bank. Banks with total assets between $40 and $100 million were slightly asset sensitive in December 1976 and December 1977, but were modestly liability sensitive in June 1978. Again, it should be stressed that the data in the table understate the degree of asset sensitivity because floating rate loans and short-term fixed rate loans are not included as interest sensitive assets.[1/] Allowing for this factor, it is likely that a sizable portion of banks under $100 million (and particularly those under $40 million) are sufficiently asset

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1/ Data on floating rate loans are available on banks with $300 million or more in total assets. These data reveal that floating rate loans represent a significant proportion of the total loans made by larger banks. For example, as of June 30, 1978, floating rate loans averaged 43.33 percent of all loans (except consumer loans) for banks with $300 million or more in assets.

Table 1

NATIONAL BANKS

Total Assets (millions)	Interest Sensitive Assets/1/ Total Assets	Interest Sensitive Liabilities/ Total Assets	Interest Sensitive Assets Less Interest Sensitive Liabilities/ Total Assets
December 31, 1976			
0 - 10	15.86%	5.03%	10.83%
10 - 25	13.11	6.61	6.49
25 - 40	11.89	8.07	3.81
40 - 100	11.88	10.08	1.80
December 31, 1977			
0 - 10	15.41%	4.80%	10.61%
10 - 25	12.59	6.62	5.98
25 - 40	11.21	8.17	3.04
40 - 100	10.48	10.15	.33
June 30, 1978			
0 - 10	13.34%	4.87%	8.47%
10 - 25	10.14	7.11	3.03
25 - 40	9.00	8.64	.35
40 - 100	8.15	11.26	(3.11)

1/ Excludes variable rate loans.

Source: Comptroller of the Currency.

sensitive to offset much, and in some instances all, of the interest rate risk associated with variable rate acquisition debt issued by the parent company.

Moreover, it should be noted that the level of interest-sensitive assets as a percentage of total assets has varied considerably from one period to the next. Looking at banks in the $25-40 million category, for example, interest-sensitive assets have ranged from 11.89 percent of assets to 9.00 percent of assets between December 31, 1976, and June 30, 1978. This suggests that some banks have the capacity to alter the rate sensitivity of the asset side of their balance sheets.

In terms of earnings performance, we can expect small banks to perform better when interest rates are rising and worse when they are falling.

The key issue, however, is whether the asset sensitivity of small banks is great enough to offset the adverse impact of rising interest rates on floating rate acquisition debt. To answer this question, it may be helpful to examine a hypothetical transaction involving the formation of a one bank holding company. For purposes of illustration, let us assume that the bank to be acquired is structured so that rate-sensitive assets represent 12 percent of total assets and rate sensitive liabilities represent 8.0 percent of total assets. If the bank has an equity/asset ratio of 8.0 percent, its balance sheet would appear as follows:

Bank Prior to Acquisition

Interest-sensitive assets	$12	Interest sensitive liabilities	$ 8
Fixed-rate assets	88	Fixed-rate liabilities	84
		Equity	8
Total Assets	$100	Liabilities & Equity	$100

Assume further that an applicant purchases the bank at its net asset value of $8 (i.e., no premium is paid) and borrows 75 percent of the purchase price, or $6. The resulting parent company and consolidated balance sheets would look like this:

Parent Company

Investment in Bank	$8	Debt (interest-sensitive)	$6
		Equity	2
Total Assets	$8	Debt & Equity	$8

Consolidated

Interest-sensitive assets	$12	Interest-sensitive liabilities	$14
Fixed rate assets	88	Fixed-rate liabilities	84
		Equity	2
Total Assets	$100	Liability & Equity	$100

Looking at the consolidated balance sheet, it can be seen that rate-sensitive liabilities now exceed rate-sensitive assets by $2, or by 2.0 percent of total assets. In order to eliminate this mismatch, the subsidiary bank would have to realign its balance sheet by increasing the volume of interest-sensitive assets (and/or by decreasing the volume of interest-sensitive liabilities) such that the excess of rate-sensitive assets over rate-sensitive liabilities represents 6.0 percent of total bank assets, an increase of only 2.0 percentage points from the pre-acquisition level of 4.0 percent.

In the above example, it was assumed that 12 percent of the bank's assets and 8 percent of its liabilities were rate sensitive. While these figures are consistent with those shown in Table 1, the data in that table greatly understate the level of asset sensitivity. Therefore, in the typical one bank holding company, the asset sensitivity of the underlying subsidiary bank would probably more than offset the liability sensitivity of the parent company's acquisition debt. If this is true, then contrary to the position taken by the Oklahoma bankers, we would expect small one bank holding companies to perform better in a rising interest rate environment than they would if rates were stable or declining.

Impact of Inflation

The Oklahoma bankers contend that the present debt amortization policy is inconsistent with current rates of inflation. The substance of their argument is that it is difficult for a bank to hold asset growth below the prevailing rate of inflation and that banks which are called upon to service parent company debt cannot retain enough earnings to keep their equity growth rate from falling below the rate of asset expansion. To illustrate this point, it can be seen that if a bank earns a 12 percent return on equity and distributes 50 percent of its earnings in dividends, then its rate of internal capital generation is only 6.0 percent. Unless asset growth is held to 6.0 percent, the bank's equity to asset relationship will deteriorate.

To determine if subsidiary banks of one bank holding companies that have employed acquisition debt have had problems maintaining their capital ratios subsequent to acquisition, we have looked at 73 banks which were acquired during the 1971-73 period. Acquisition debt was employed in each of these cases. Since formation, 46 of the 73 banks have been retiring their debt on schedule, while 27 have not.

The trend in the average capital position, as measured by the ratio of equity to assets of the 73 banks, is shown in the second column of Table 2. As can be seen from the data, there was a noticeable decline

Table 2

Equity Capital as a Percent of Total Assets
For Selected Groups of Insured Commercial Banks

Year-end	Category		
	All banks with less than $100 million in Assets	Subsidiary banks of one bank holding companies formed in 1971-1973[1/]	Subsidiary banks of one bank holding companies, formed in 1971-73, that have been retiring acquisition debt on schedule[2/]
1970	7.63	8.84	8.99
1971	7.41	8.61	8.96
1972	7.21	8.68	8.27
1973	7.33	7.92	7.69
1974	7.64	7.56	7.42
1975	7.65	7.28	7.22
1976	7.93	7.57	7.52
1977	7.85	7.57	7.59

1/ Includes 73 banks.

2/ Includes 46 banks.

Source: Consolidated Reports of Condition.

in capital ratios during and immediately following the years in which debt financed acquisitions occurred. This downward trend bottomed out in 1975 and from there capital ratios rose through 1977. By year-end 1977, the capital ratios of 36 of the 73 banks were below their pre-acquisition levels.

Looking at the average level of capital for the 73 banks, it can be seen that the ratio of equity to assets for the group had declined to 7.57 percent by 1977, a drop of 1.27 percentage points, from the 8.84 percent level of 1970. In contrast, the capital ratio for all insured commercial banks with less than $100 million in assets rose from 7.63 percent to 7.85 percent over the same period. Nevertheless, it is comforting to note that by the end of 1977, the average capital position of the 73 banks was not dangerously low, and, in fact, was only slightly below the average for all banks with less than $100 million in assets.

Table 3 provides a comparison of the average returns on equity, dividend payout ratios, and rates of internal capital generation of the 73 banks with those of banks in the $100 million and under size category. As might be expected, parent company debt servicing requirements led to a pronounced increase in the dividend payout ratios of the 73 banks in 1971 and 1972. The payouts were relatively stable from 1972 through 1975 and then declined in 1976 and 1977. On average, the payouts of the 73 banks remained well above the norm for banks in the less than $100 million category from 1972 through 1977. Another noteworthy observation is that the average return on equity for the 73 banks rose sharply in 1973 and 1974 and remained significantly above the average of all banks with less than $100 million in total assets. This dramatic increase in profitability has enabled the group to maintain respectable rates of internal capital

Table 3

PROFITABILITY, DIVIDEND PAYOUT, AND INTERNAL CAPITAL GENERATION RATES, 1970-1977

Year-end	All banks with less than $100 million in Assets			Subsidiary banks of one bank holding companies formed in 1971-73[1]		
	Net Income/ Average Equity	Dividends/ Net Income	Rate of Internal Capital Generation	Net Income/ Average Equity	Dividends/ Net Income	Rate of Internal Capital Generation
1970	12.7	28.4%	9.1	10.2%	22.4%	7.6
1971	12.2	28.4	8.7	10.3	30.6	6.8
1972	12.1	27.2	8.8	10.7	46.4	6.6
1973	13.3	25.2	10.0	13.1	47.4	7.2
1974	12.7	27.4	9.3	15.4	47.8	8.0
1975	11.3	29.5	7.9	14.4	48.5	7.0
1976	11.7	27.7	8.4	15.3	44.2[2]	8.7
1977	12.0	26.3	8.9	15.7	36.1	9.9

1/ Includes 73 banks.

2/ Excludes data on one bank that had a dividend payout ratio of 512 percent.

generation, despite higher than average dividend payout ratios. The increase in profitability does, however, suggest that these banks may be taking greater risks in order to generate the earnings needed to meet debt servicing requirements while simultaneously trying to maintain capital ratios.

In conclusion, while these results gloss over wide variations in the performance of individual banks, they nevertheless show that the need to service acquisition debt tended to lead to some deterioration in the capital ratios of banks during the years following acquisition. This deterioration tended to be short-lived, and, on average, did not cause bank capital ratios to fall to unacceptable levels.

However, it is also clear that subsequent to acquisition, the rate of internal capital generation experienced by these banks has been in the 7 to 10 percent range, which is below recent rates of growth in nominal GNP. Consequently, some banks are undoubtedly having to constrain their growth in order to maintain reasonably acceptable capital ratios.

III. Policy Considerations

The Board's present policy is to allow small one bank holding companies to issue relatively large amounts of acquisition debt compared to their equity, but to require these companies to demonstrate the capacity to retire the debt within a reasonable period, generally not to exceed 12 years. The reason for allowing small holding companies to issue sizable amounts of acquisition debt is to facilitate the transfer of ownership of small banks. The reason for requiring the debt to be retired is to bring both parent and consolidated holding company leverage down to a lower and safer level over the longer run. The choice of 12 years as the normal retirement period was deemed to be a reasonable tradeoff between facilitating the transfer of ownership of small banks and keeping holding company leverage within safe limits.[1/]

It is important to recognize that the Federal Reserve has not insisted that small one-bank holding companies adhere to the 12 year debt retirement schedule irrespective of subsequent developments. In the last few years, some banks in these holding companies (due largely to stepped-up inflation) have grown much faster than originally anticipated by either the holding companies or the Federal Reserve. In some cases, the capital ratios of these banks have come under pressure, and the holding companies have decided not to extract sizable dividends from the banks in order to retire the parents' debt on schedule. Typically, the Federal Reserve has not criticized this practice because it contributed to the maintenance of adequate capital ratios in the banks.

As a matter of policy, the Board continues to require newly forming small one-bank holding companies to demonstrate the capacity to retire their acquisition debt within 12 years. If this retirement period were extended to 20 years, as proposed by the Oklahoma bankers, it would tend to further facilitate the ownership transfer of small banks since it would probably increase the number of potential buyers. However, it is not clear that improving the transferability of small banks is greatly needed. First, most small banks are now being sold for approximately 1 1/2 to 2 times book value; and there does not appear to have been any marked deterioration in this premium in

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1/ Setting a specific retirement period for acquisition debt (such as 12 years) tends to establish an effective ceiling on the amount of such debt, given projected holding company cash inflows and outflows.

recent years, as one would expect if ownership transfer problems were increasing. Secondly, the number of one-bank holding company applications filed and approved during 1977 and 1978 was substantially above the level for 1971 through 1976--additional evidence that ownership transfer is not becoming considerably more difficult.

3(a)1 Applications

Year	Number of Applications	Number Approved	Percent Approved
1971	67	65	97.0%
1972	123	112	91.0%
1973	147	146	99.3%
1974	154	138	89.6%
1975	156	141	90.4%
1976	155	143	92.2%
1977	236	220	93.2%
1978	273	259	94.9%
Total	1,311	1,224	93.3%

The major disadvantage of extending the normal 12 year retirement period is that it would probably result in some newly forming holding companies taking on significantly more acquisition debt. At present, the Board does not have a policy that sets a specific debt/equity ceiling on parent company leverage. In the absence of such a ceiling, the extension of the acquisition debt retirement period would increase the effective leveraging capacity of newly forming holding companies (just as an individual can take on more mortgage debt if he has 30 years to repay rather than 10 years). An increase in leverage would raise holding company risk.

Conclusion

In our judgment, the Board's present acquisition debt retirement policy is working reasonably well and should not be changed. The policy is designed to put a cap on holding company indebtedness and to encourage holding companies to reduce their initial parent company and consolidated leverage in a systematic fashion. At the same time, the Federal Reserve permits existing holding companies to extend the repayment period in individual cases in order to avoid undue strain being placed on the bank's financial resources. Finally, we see no compelling reason to lengthen the 12 year retirement period in order to alter the current tradeoff between facilitating the transfer of small bank ownership and protecting banks from excessive holding company leverage.

Board staff discussed the acquisition debt retirement question with Reserve Bank personnel at a System conference in early June. The Reserve Bank staff reported that there did not appear to be significant banker agitation for liberalizing the Federal Reserve's current policy. Likewise, it did not appear that the Reserve Banks would favor any liberalization.

August 28, 1979

The Honorable John M. Murphy
House of Representatives
Washington, D.C. 20515

Dear Mr. Murphy:

Thank you for your letter of August 10 on the Monetary Control Act of 1979 which overwhelmingly passed the House of Representatives shortly before the August recess. This legislation does address a very serious problem facing the Federal Reserve and looks towards a legislative solution in the near future.

I join the other members of the Board of Governors in expressing my appreciation for the priority attention this legislation has been accorded by Chairman Reuss, the House Banking Committee, and the House leadership. In the near future I plan to consult with the Senate Banking Committee looking towards expediting the consideration of legislation in the Senate.

I am concerned about some aspects of the bill as it passed the House and am hopeful that the bill can be strengthened in the Senate. I will be pleased to keep you informed as my views on this important legislation evolve.

Sincerely,

S/Paul A. Volcker

Paul A. Volcker

KAG:pjt (#V-18)
bcc: Mrs. Mallardi (2)

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Congress of the United States
House of Representatives
Washington, D.C. 20515

JOHN M. MURPHY
17TH NEW YORK

CHAIRMAN:
MERCHANT MARINE AND
FISHERIES COMMITTEE

CHAIRMAN:
AD HOC SELECT COMMITTEE
ON OUTER CONTINENTAL SHELF

INTERSTATE AND FOREIGN
COMMERCE COMMITTEE

August 10, 1979

#18

Mr. Paul Volcker, Chairman
Board of Governors of the Federal Reserve System
Washington, D.C. 20551

Dear Mr. Volcker:

This letter is in response to correspondence sent by Mr. G. William Miller in which he expressed his support for H.R. 7, the Monetary Control Act of 1979.

This bill was introduced on January 15, 1979 by Representative Henry Reuss, and is designed to facilitate the implementation of monetary policy and to promote competitive equality among depository institutions. This measure, as amended, passed the House by a vote of 340 yeas to 20 nays. I am happy to report the I was among those who voted in favor of this measure.

A compromise was reached regarding the freedom of choice amendment, an aspect of the bill that was of particular concern to Mr. Miller. Introduced by Representative Stanton, this amendment would require the mandatory participation of banks only if the total percentage of deposits in the nation's reserve banking system covered by reserve requirements falls below 67.5%. It is believed that this "trigger" mechanism will serve to stabilize the amount in reserve and improve the Federal Reserve's ability to conduct monetary policy.

I greatly appreciated Mr. Miller's advising me of his views on this matter. It is my hope that you will continue this practice.

With kind regards, I remain,

Sincerely,

John M Murphy

JOHN M. MURPHY
Member of Congress

August 28, 1979

Mr. William B. Cherkasky
Co-chairman
Chairmen's Representatives Group
c/o Select Committee on Small Business
United States Senate
Washington, D.C. 20510

Dear Mr. Cherkasky:

I would be pleased to meet with the Chairmen's Representatives Group at a mutually convenient time.

Please call Mrs. Catherine Mallardi on 452-3201 to work out the necessary arrangements.

Sincerely,

S/ Paul

Paul A. Volcker

KAG:pjt (#V-19)
bcc: Mrs. Mallardi (2)

United States Senate
SELECT COMMITTEE ON SMALL BUSINESS
WASHINGTON, D.C. 20510

August 23, 1979

#19

Honorable Paul A. Volker
Chairman
Federal Reserve Board
Federal Reserve Building
Washington, DC 20551

Dear Mr. Chairman:

On behalf of the Chairmen's Representatives Group, I would like to extend an invitation to you to be our guest breakfast speaker at one of our regularly scheduled meetings on the first and third Fridays of each month.

The Chairmen's Representative Group is comprised of administrative assistants, committee staff directors and other top majority staff to the chairmen of the Senate committees. This is an informal group which meets twice a month for breakfast to discuss national and international issues in S-120 of the Capitol Building. Breakfast is held from 8:30 to 9:00 followed by the guest speakers remarks of ten to fifteen minutes. A question-and-answer period follows and adjournment occurs no later than 9:30. Since this group began over five years ago, we have had as speakers:

Walter Mondale - Vice President of the United States
Robert Strauss - Special Trade Representative
Stuart Eisenstat - Domestic Policy Staff Chief
Harold Brown - Secretary of Defense
Michael Blumenthal - Former Secretary of Treasury
Simcha Dimitz - Former Ambassador from Israel
H.E. Alejandro Orfila - Secretary General, OAS
Joseph Califano - Former Secretary of HEW
Robert Byrd - The Senate Majority Leader
Juanita Kreps - Secretary of Commerce
Zbigniew Brzezinski - National Security Advisor to the President

We hope your schedule will permit you to join us as a speaker on a Friday between now and mid-November. We are in the process of trying to firm up the speakers schedule for the fall and would very much appreciate your advising us whether and when you would prefer to address the group. Should you be interested in meeting with us but find it impossible to do so this fall, please let me know if you can be with us during the period of January to September, 1980.

Your early response would be most helpful.

Sincerely,

Wm B Cherkasky

William B. Cherkasky
Co-chairman
Chairmen's Representatives Group

WB:c

✓ need to return at appropriate time in early Sep re HR7

Harrison A. Williams, Jr.
New Jersey

United States Senate

WASHINGTON, D.C.

August 27, 1979

Dear Paul:

Your note caught up to me upon my return from Europe.

I hope very much that we can spend some time together soon.

With warmest regards,

Sincerely,

Pete

Mr. Paul A. Volcker
Chairman of the
Board of Governors
Federal Reserve System
Washington, D.C. 20551

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
1979 AUG 28 AM 11:23
RECEIVED
OFFICE OF THE CHAIRMAN

August 27, 1979

The Honorable J. William Stanton
House of Representatives
Washington, D.C. 20515

Dear Bill:

In your letter of July 31, you expressed the concern that a major problem in assessing the hearings that have been held on H.R. 2255 and related bills to amend the Bank Holding Company Act was the absence, in many instances, of hard data to support the positions of eigher those in favor of or opposed to the bills. We would agree that this lack of data is a significant problem. However, I am faced with the simple fact that most of the data you request are at present simply not available to us. In many cases these data would be extremely costly to collect, and even in instances where parts of the relevant data may be in our files, or those of other agencies, they are not available in conveniently retrievable form. Specifically,

1) "Number of banks (both national and state-chartered) and bank holding companies (through their nonbanking subsidiaries) that are engaging in each of the activities that would be prohibited by Section 3 of H.R. 2747."

The only portion of these data that can be easily supplied is a listing of bank holding companies authorized to engage in each of the activities through either the parent holding company or one of its nonbanking subsidiaries. We are preparing such a listing and will send it to you promptly. We cannot ascertain from our computerized data which of the authorized companies are actually engaging in the activity. Further, we would note that of the activities to be prohibited in H.R. 2747 only REIT advising, credit related insurance sales and auto leasing, within strict constraints, have been generally approved by the Board. The others were either never authorized by regulation, were denied by the Board or Courts, or are carried out only under various exemptions and grandfather provisions of the Bank Holding Company Act. We have no information in our files on these exemptions. The Federal Reserve Board has no readily available information on the activities of either state chartered or national banks (as distinct from a holding company), since authorization of these activities is the responsibility of the Comptroller of the Currency or the state chartering authority and not the Federal Reserve. Presumably, this information could be obtained by reviewing each individual bank examination report, but this would be very costly and labor intensive because the examination reports are not computerized. Moreover, most of these reports are maintained by the Comptroller of the Currency and the FDIC and not the Federal Reserve.

2) "The dollar volume of business of banks (both national and state-chartered) and bank holding companies (through their nonbank subsidiaries) that are engaged in each of the activities that would be prohibited by Section 3 of H.R. 2747."

Similar problems to those noted above also exist for the dollar volume information requested. In addition, "dollar volumes" of business for individual activities are, for the most part, not collected from nonbanking subsidiaries or in the consolidated holding company reports.

3) "The penetration rates achieved by (in terms of percent of total market share) and banks (both national and state-chartered) and bank holding companies (through their nonbank subsidiaries) that are engaged in each of the activities that would be prohibited in Section 3 of H.R. 2747."

Again, market share information for specific bank holding company activities are not routinely collected, except in the context of particular applications. Even more importantly, the bulk of the business done in the activities listed in H.R. 2255 is largely by non-regulated businesses. The Board does not collect data routinely from nonbanking firms in these industries except as the data may be available from outside sources. These data would need to be collected if meaningful measures of market shares were to be constructed.

As a result, it is unfortunately not possible to provide anything like the scope of information you would like within the time frame you require. It would require a very substantial research project to approximate the data in a longer time period.

Sincerely,

S/ Paul

Paul A. Volcker

RAE:PAV:pjt (#V-6)
bcc: Bob Eisenbeis
Mrs. Mallardi (2)

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-SIXTH CONGRESS
2129 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515

July 31, 1979

V.6

Honorable Paul A. Volcker
Chairman Designate
Federal Reserve Board
Washington, D.C.

Dear Mr. Chairman:

The Subcommittee on Financial Institutions Supervision, Regulation and Insurance has been conducting a series of hearings on several bills (H.R. 2255, H.R. 2747, and H.R. 2856) pertaining to the activities of bank holding companies. Section 3 of H.R. 2747 would amend Section 4(c)(8) of the Bank Holding Company Act to prohibit bank holding companies from engaging in a number of specified activities.

Throughout these hearings it has been my opinion that there has been an absence of hard data regarding precisely how bank holding companies in particular are affecting each of the industries that is seeking legislative redress in Section 3 of H.R. 2747. As far as the insurance industry is concerned, for example, former Chairman Miller stated in a letter to me, dated June 16, 1978: "there is...no empirical evidence supporting the need for a limitation on the insurance activities of bank holding companies at this time."

The problem as I see it is a lack of data or evidence to support either side. For the record, will you please provide me with the following data:

(1) the number of banks (both national and state-chartered) and bank holding companies (through their nonbank subsidiaries) that are engaged in each of the activities that would be prohibited by Section 3 of H.R. 2747.

(2) the dollar volume of business of banks (both national and state-chartered) and bank holding companies (through their nonbank subsidiaries) that are engaged in each of the activities that would be prohibited by Section 3 of H.R. 2747.

(3) the penetration rates achieved by (in terms of per cent of total market share) banks (both national and state-chartered) and bank holding companies (through their nonbank subsidiaries) that are engaged in each of the activities that would be prohibited in Section 3 of H.R. 2747.

I would greatly appreciate receiving this information before the full Committee marks up these bills.

Sincerely,

Bill

J. William Stanton

JWS/gw/a

August 27, 1979

The Honorable William Proxmire
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Chairman Proxmire:

Thank you for forwarding a copy of your Committee's Second Monetary Policy Report for 1979. Copies are being distributed to the other Members of the Board and to the Reserve Bank Presidents so that they will be cognizant of the views and recommendations set forth in the Report.

Sincerely,

S/ Paul

Paul A. Volcker

DJW:vcd (#V-12)

bcc: Mrs. Mallardi (2)

United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

WASHINGTON, D.C. 20510

V-12

September 15, 1979

The Honorable Paul A. Volcker
Chairman, Board of Governors
Federal Reserve System
Washington, D.C. 20551

Dear Mr. Chairman:

Transmitted herewith for your review is the Second Monetary Policy Report for 1979. The report was submitted by this committee pursuant to Public Law 95-523, the Full Employment and Balanced Growth Act of 1978.

Sincerely,

William Proxmire
Chairman

WP: kml

Enclosure

96th Congress 1st Session | SENATE | Report No. 96–310

SECOND MONETARY POLICY REPORT FOR 1979

FROM THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

NINETY-SIXTH CONGRESS

FIRST SESSION

A REPORT

together with

ADDITIONAL VIEWS

SUBMITTED PURSUANT TO PUBLIC LAW 95–523

AUGUST 9, 1979.—Ordered to be printed

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

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LETTER OF TRANSMITTAL

U.S. Senate,
Committee on Banking, Housing,
and Urban Affairs,
Washington, D.C., August 9, 1979.

Hon. Walter F. Mondale,
President of the U.S. Senate,
Washington, D.C.

Dear Mr. President: Transmitted herewith is the Second Monetary Policy Report for 1979 on the Conduct on Monetary Policy, pursuant to Public Law 95–523 and oversight hearings held on July 23 and 24, 1979.

Sincerely yours,

William Proxmire, *Chairman.*

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SECOND MONETARY POLICY REPORT FOR 1979

I. INTRODUCTION

The Senate Committee on Banking, Housing, and Urban Affairs held its second hearing on the conduct of monetary policy for 1979 on July 23 and 24, 1979, pursuant to the requirements of the Full Employment and Balanced Growth Act of 1978 (Public Law 95–523). The committee received the "Midyear Monetary Policy Report to the Congress" from the Board of Governors of the Federal Reserve System on July 17, 1979.

The committee heard testimony on the Federal Reserve's proposed plans and objectives for monetary policy from four private sector economists on July 23, 1979: Prof. Benjamin Friedman, Department of Economics, Harvard University; Mr. Henry Kaufman, partner and member of the Executive Committee, Salomon Bros.; Prof. Lawrence Klein, Department of Economics, University of Pennsylvania; and Prof. Allan Meltzer, Graduate School of Industrial Administration, Carnegie-Mellon University.

The committee received the testimony of Hon. Henry C. Wallich, a member of the Board of Governors of the Federal Reserve System, on July 24, 1979. Governor Wallich testified in place of Chairman G. William Miller because Mr. Miller had been designated to become Secretary of the Treasury by President Carter on July 19, 1979.

The process of congressional review of monetary policy is based on the following major provisions of section 2A of the Federal Reserve Act, as amended by Public Law 95–523:

Statement of long-term goals to be pursued

The Federal Reserve is required to pursue monetary policies—growth of money and credit—consistent with the economic potential to increase production, and to promote the goals of maximum employment, stable prices, and moderate long-term interest rates.

Monetary policy oversight procedures

The Board of Governors of the Federal Reserve System is required to submit written reports to the Congress by February 20 and July 20 of each year. These reports are to consist of four parts:

(1) a review and analysis of recent developments affecting economic trends in the Nation;

(2) the monetary policy objectives and plans of the Federal Reserve Board and the Federal Open Market Committee in terms of the ranges of growth of the monetary and credit aggregates for the calendar year during which the report is transmitted (and in the July 20 report for the next calendar year.) Those plans and objectives are to take into account past and prospective developments in employment, unemployment, production, investment, real income, productivity, international trade and payments, and prices;

(3) the relationship of the Federal Reserve's monetary policy plans and objectives to the numerical goals for the current and the next calendar year as set forth by the President in the Economic Report for employment, unemployment, production, real income, productivity, and prices or to any revisions to those of the Board's objectives and plans to the goals established by the President and any subsequent goals established by the Congress, it is expected that the Board will provide the Congress with a full discussion concerning the extent to which the Federal Reserve's intended policies will help to achieve those goals; and

(4) if any changes in monetary objectives or plans are made by the Federal Reserve between reports to the Congress, the Board is required to include in the next report an explanation of the reasons for those revisions to or deviations from the previously announced objectives and plans.

II. MONETARY POLICY PLANS AND OBJECTIVES

In its report to the Congress on its monetary policy plans and objectives the Federal Reserve indicated that the Federal Open Market Committee had decided to retain the growth rate ranges for the monetary and credit aggregates for 1979 that had been selected last February. Those ranges, measured from the fourth quarter 1978 to the fourth quarter 1979, are: M_1, 1.5 to 4.5 percent; M_2, 5.0 to 8.0 percent; M_3, 6.0 to 9.0 percent; and bank credit, 7.5 to 10.5 percent.

The Open Market Committee also decided to initially establish the same target ranges for growth in these aggregates for the period fourth quarter 1979 to fourth quarter 1980. The report indicated that these ranges are consistent with a policy of gradual reduction in rates of increase of the monetary aggregates in order to curb inflation. It also said; "Since satisfactory economic performance remains the basic economic objective of the Federal Reserve, monetary policy, from time to time, may have to permit growth rates in the aggregates that temporarily interrupt the downward trend."

In its report the Board noted that growth of Automatic Transfer Services (ATS) and NOW Accounts had been expected to reduce the growth of M_1 by 3 percentage points. But, during the first 6 months of 1979, actual experience indicated that the impact of ATS and NOWs on M_1 growth had been only 2¼ percent, at an annual rate.

The report indicated that the growth rate ranges for M_2 and M_3 imply that depository institutions will receive adequate inflows of lendable funds during the remainder of 1979 and into 1980. The range for bank credit reflects the Board's expectations that loan demand at commercial banks will begin to moderate in the months ahead.

TABLE I.—FEDERAL RESERVE SYSTEM TARGET RANGES AND ACTUAL GROWTH RATES

[Percent]

Change from 4th quarter to 4th quarter (ending in period shown)	M_1		M_2		M_3		Bank credit	
	Target	Actual	Target	Actual	Target	Actual	Target	Actual
1976, 4th quarter	4.5–7.5	5.8	7.5–10.5	10.9	9.0–12.0	12.7	*6.0–9.0	*8.0
1977, 4th quarter	4.5–6.5	7.9	7.0–10.0	9.8	8.5–11.5	11.7	7.0–10.0	11.3
1978, 4th quarter	4.0–6.5	7.2	6.5–9.0	8.4	7.5–10.0	9.4	7.0–10.0	11.4
1979, 4th quarter	1.5–4.5	†2.7	5.0–8.0	†5.3	6.0–9.0	†6.4	7.5–10.5	†12.9
1980, 4th quarter	1.5–4.5	NA	5.0–8.0	NA	6.0–9.0	NA	7.5–10.5	NA

*The credit aggregate used by the FOMC as a target for monetary policy was the bank credit proxy in 1976. After November the credit aggregate targeted by the FOMC became total bank credit.
†Actual growth rate 1978 4th quarter to 1979 2d quarter annualized.
NA—Not applicable.

Definitions: M_1—Private demand deposits plus currency in circulation. M_2—M_1 plus time and savings deposits at commercial banks other than large negotiable CD's at weekly reporting banks. M_3—M_2 plus deposits at mutual savings banks, savings and loan associations, and credit unions. Bank credit: Total loan and investments at commercial banks.

In order to improve the understanding of its monetary objectives the Board provided an economic projection representing the consensus of the Board members at the present time and given present information on the economy. That forecast is summarized in Table II, along with the midyear forecasts of the Administration and the Congressional Budget Office.

The committee would like to take special note of the fact that this is the first time that the Board of Governors has provided a consensus economic forecast in its discussion of monetary policy objectives. Previously, the Chairman (both G. William Miller and Arthur Burns) has offered his personal forecast, but not a consensus forecast of the Board. The committee believes that such forecasts are an aid to the understanding of the Board's policy objectives. The committee looks forward to a continuation of this practice by the Board of Governors.

TABLE II.—MIDYEAR FORECASTS FOR THE ECONOMY

	Actual 1978	Administration		C.B.O.		Federal Reserve Board	
		1979	1980	1979	1980	1979	1980
Change from 4th quarter to 4th quarter percent:							
Nominal GNP	13.1	9.2	10.3	6.2–10.3	9.9–14.1	8–10.0	8.5–11.5
Real GNP	4.4	–.5	2.0	–2.0–0	1.9–3.9	–2––.5	–.5–2.0
Implicit price deflator	8.3	9.8	8.1	8.4–10.4	7.9–9.9	9.5–11.0	8.5–10.5
Average level in 4th quarter percent:							
Unemployment rate	5.8	6.6	6.9	6.4–7.4	6.7–7.7	6.25–7.0	6.75–8.25

Pursuant to the reporting requirements of Public Law 95-523, the Federal Reserve's report to the Congress explained the relationship between the administration's goals and the Federal Reserve's plans for monetary growth, as follows:

"The monetary ranges set by the Federal Reserve should be adequate to finance the amount of spending in current dollars projected by the administration. However, the administration's forecast does seem to envision a somewhat more favorable combination of real output and inflation than that suggested by the Board's consensus projection. The actual price-output mix will be determined primarily by supply conditions and by other structural or behavioral characteristics of the economy. These relationships are not known with certainty, of course, and thus many different price-output combinations must be viewed as possible for given rates of monetary growth.

"Monetary growth rates are much more closely related in the short run to nominal GNP than they are to the division of nominal GNP between output and prices. The tradeoff between output and price might be improved, however, through the use of other policy tools. Governmental action to eliminate regulatory or market impediments to price competition could be helpful in tempering inflationary pressures. So, too, could a continuing program of voluntary wage-price guidelines, which may help in restraining the anticipatory actions that have made the wage-price spiral so intractable. The nation's ability to avoid an escalation over the next year or so—without serious recession—will depend in considerable degree on whether a means is found to overcome the tendency for workers and businesses to seek higher wages and prices in an effort to offset the effects of the income transfer associated with the rise in oil prices. Over the longer run, the ability of the nation to achieve sustained growth of real income will depend importantly on whether it can solve its energy problem."

III. VIEWS AND RECOMMENDATIONS

1. *Our limited ability to fine-tune the economy must be recognized*

Our economy is in a period of significant uncertainty because of long-term energy shortages and deep rooted inflation. The enormous and unexpected increases in the price of imported oil and the recent shortages of refined oil products pose problems of fundamental importance to the future well-being of our Nation. Increases in energy costs have exacerbated our already serious inflationary problems. Energy shortages have disrupted the economy's productive and distributive processes. They have also resulted in some postponement or curtailment of consumer purchases that has depressed aggregate demand. The result has been a pause in economic activity during the second quarter. While this pause is reason for concern about the economic outlook, there is not as yet conclusive evidence that the economy has actually entered into a recession.

The committee recognizes the possibility that the economy may be entering a period of continuing inflation combined with reduced real economic activity and rising unemployment. The Administration's latest unofficial forecast predicts a higher rate of unemployment through 1980 compared to earlier projections. However, such a scenario is still uncertain. Thus, it is important to recognize the limits to our ability to fine-tune the economy in the formulation of both monetary and fiscal policies. Most forecasts of recession expect only moderate declines in real output lasting two to three calendar quarters. At this late date policies designed to forestall or dampen a mild recession could prove to be too much too late, with the resulting stimulus manifesting itself in additional inflationary pressures. The lag between implementation and maximum effect of stimulative monetary policy has been estimated to be three to four calendar quarters. Personal income tax cuts or increases in transfer payments have relatively small effects the first year and then only moderate effects the second year. Business tax cuts, either accelerated depreciation or investment tax credits, have small initial effects, but sizeable effects on GNP in 3 to 4 years. Thus, the maximum effects of macro-economic stabilization policies designed to provide stimulus to the economy now, either monetary or fiscal in nature, could very well occur at a time when the economy has already turned around by virtue of its own underlying strength and resiliency, or because of new programs to increase energy supplies and capital formation.

The committee recommends, therefore, that the Federal Reserve continue to restrict the growth of monetary aggregates in a firm and stable manner until significant progress has been made in reducing inflation. The Fed should also restrain the growth of bank credit, and credit availability generally, so as to meet the targets set by the FOMC.

2. The slowing of inflation is still our number one economic problem

The committee continues to believe that the slowing of inflation is still our number one economic priority. The pursuit of price stability is of fundamental importance to the long-run social well-being of our Nation. In the committee's view, therefore, it is proper for the Federal Reserve to pursue policies that foster financial conditions which will both tend to moderate inflationary pressures and facilitate the implementation of other national policies to control inflation. The Federal Reserve's task of gradually reducing the growth rates of the monetary and credit aggregates will be made more easily achievable if Federal spending is restrained and the Federal deficit reduced or eliminated. The Committee recognizes, of course, that should the economy experience a recession the deficit may rise because of declining tax receipts and rising outlays for built-in countercyclical programs. Smaller Federal deficits would reduce Federal financing requirements and thus permit credit flows to be distributed among private sector needs.

The committee recognizes that aggregate monetary and fiscal policies alone have been unable to achieve price stability and full employment and production. This point is fully recognized in the Humphrey-Hawkins Act approved by the Congress last year. Coordinated fiscal and monetary policies to deal with the problems of stagflation must be complemented by a structural approach to policy formulation which can take into account demographic and institutional changes that have been going on in the economy and our special need for additional energy supplies and technology. Overall tax cuts, expenditure increase, and accelerated monetary growth are seriously inadequate. Structural policies are needed to deal with inflation, productivity growth, age-sex inequities in the unemployment situation, changing financial arrangements, and shortfalls in energy supplies.

Structural programs to help reduce inflation should take several forms. First, it is critical that we devise improved policies relating to our needs for adequate supplies of food and energy. Exogenous shock to supplies of food and energy have had an important contributing role in our inflation. It is not sufficient to say year after year that we can do nothing about price increases generated by shortages of food and energy: those shortages must be remedied if we are to attain price stability. Second, the process of examining the inflationary effects of federal regulations must be continued, and those inflationary regulations that are not necessary revised or eliminated. Third, productivity growth must be revived. Capital investment should be stimulated in order to bring into the production stream new technologies. It must be recognized that business investments generally take several years to generate increases in productivity. Thus, the return from such programs will not be immediate, but rather 3 to 5 years away. Those long-term rewards are worthwhile, because capital investment will tend to raise productivity and attack inflation at the same time. Finally, ways must be sought to cut through the wage-price spiral which continues to feed the underlying rate of inflation. The public must be convinced that widespread moderation in wage and price increases is necessary if inflation is to be stopped.

3. The role of the dollar in the international finance should be re-examined

The U.S. dollar has played a key role in international transactions for many years. In view of the historically sizable position of the United States in international trade and finance, this role as the key international currency is certainly understandable.

In a world of flexible exchange rates and large deficits, due largely from our dependence on foreign oil, the role of the dollar should be reexamined.

International events of the past year have brought into clear focus the serious problems for domestic monetary policy that the Federal Reserve faces because of the instability of the dollar on international exchange markets. The fact that the dollar is fundamentally sound has not stopped speculative pressures on the dollar.

Maintaining a strong dollar is important to our economy. A decline in the value of the dollar will, in the short-run, create additional inflationary pressure domestically. But, increases in interest rates to attract dollars into this country in order to prop up the value of the dollar may come at a time when the domestic economy is heading into a recession. Monetary policy, the most flexible macroeconomic tool we have, has been partially immobilized by the role of the dollar internationally.

It is the committee's recommendation that the Federal Reserve and the Treasury not hesitate in reviewing the current role of the dollar as the key currency in international finance. Perhaps that role should be shared with the stronger currencies of our major trading partners, especially the West German mark and the Japanese yen. Perhaps, special drawing rights (SDR's) should play a wider role. Other alternatives certainly exist and should be explored. The problem is not likely to be self-correcting because national interests are involved. But that is the precise reason why the committee believes this problem can no longer be ignored by our central bank and our Treasury.

4. The meaning of growth in the monetary aggregates is unclear because of financial innovations

The committee recognizes the uncertainties concerning the meaning of growth in the monetary aggregates—M_1, M_2, and M_3—as those variables are currently defined. Such growth is difficult to interpret because of recent regulatory changes and financial innovations. M_1 growth is difficult to predict because of ATS, NOW accounts, and repurchase agreements. Growth of M_2 and M_3 depends on developments relating to the issuance of money market certificates issued by banks and thrift institutions. Several developments have increased the uncertainty surrounding the behavior of M_1 according to the Federal Reserve's report to the Congress. The estimated effect of transfers of funds to ATS and NOW accounts on M_1 growth has been somewhat smaller than expected. Future growth of these money substitutes cannot be known with certainty because of the April Appeals Court decision barring ATS and certain other payment services as of January 1, 1980.

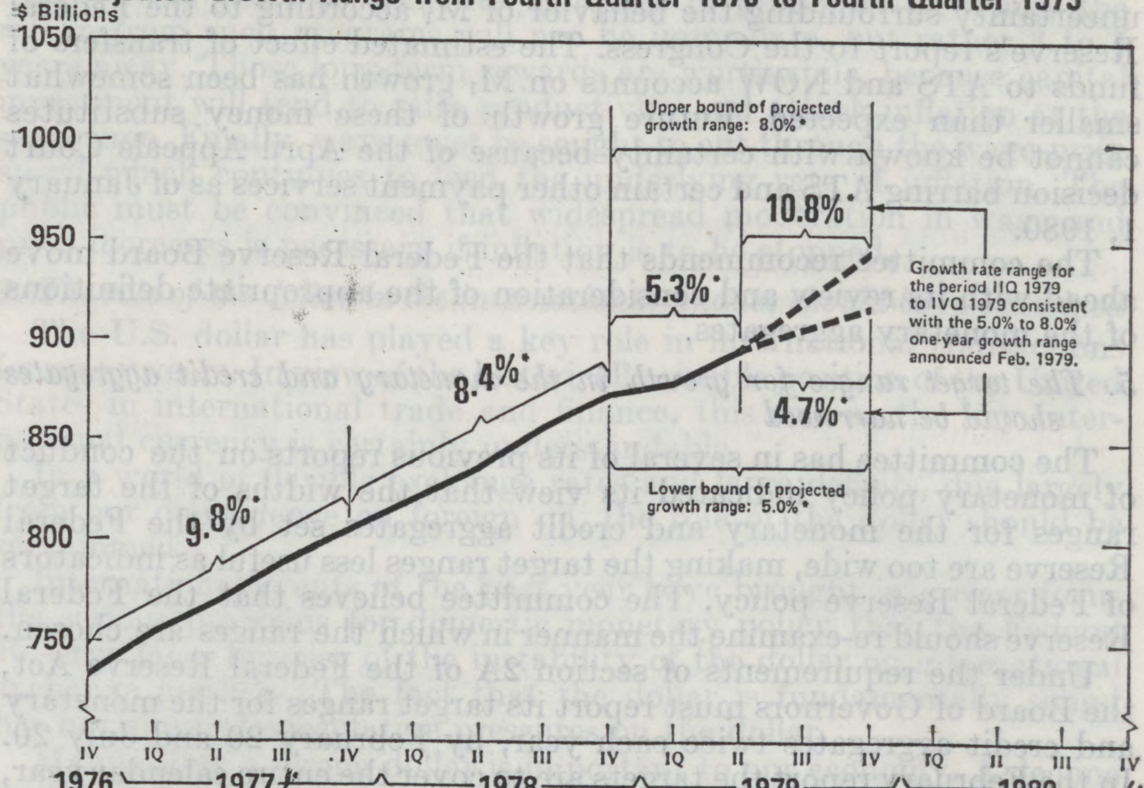
The committee recommends that the Federal Reserve Board move ahead with its review and consideration of the appropriate definitions of the monetary aggregates.

5. The target ranges for growth in the monetary and credit aggregates should be narrowed

The committee has in several of its previous reports on the conduct of monetary policy indicated its view that the widths of the target ranges for the monetary and credit aggregates set by the Federal Reserve are too wide, making the target ranges less useful as indicators of Federal Reserve policy. The committee believes that the Federal Reserve should re-examine the manner in which the ranges are chosen.

Under the requirements of section 2A of the Federal Reserve Act, the Board of Governors must report its target ranges for the monetary and credit aggregates twice each year, by February 20 and July 20. In the February report the targets are to cover the entire calendar year, that is, a one year horizon. In the July report the targets cover the current calendar year and the next calendar year, that is, two sets of targets with horizons on 6 months and 18 months, respectively. In its July 17, 1979 report to the Congress the Federal Reserve has stated its target ranges for 1979 without indicating that they imply very considerable latitude over the next 6 months by virtue of the fact that one-half of the policy period has elapsed. This is demonstrated clearly in the chart showing the M_2 target range. Such wide flexibility imposes little or no discipline on the Federal Reserve's conduct of monetary policy.

MONEY SUPPLY (M2)
Actual Levels from Fourth Quarter 1976 and Federal Reserve Projected Growth Range from Fourth Quarter 1978 to Fourth Quarter 1979



* Growth rates are seasonally adjusted compound annual rates.

Data Source: Quarterly observations and growth rates are calculated from seasonally adjusted data series of the Board of Governors of the Federal Reserve System as revised in May 1979.

The committee recommends that the Federal Reserve narrow the target ranges for growth in the monetary and credit aggregates. This will make those target ranges more meaningful indicators of the direction which the Federal Reserve intended policy will take in the future. The committee also recommends that the Federal Reserve carefully explain the reasons for the width of the target ranges in explicit terms, including such factors as the probability of attaining the desired growth in each aggregates, and the time horizon covered by the target ranges.

6. The Federal Reserve should devote more attention to the growth of the credit aggregates

The Federal Reserve has provided the Congress with its target ranges for growth in bank credit, the credit aggregate it has selected in accordance with the requirements of section 2A of the Federal Reserve Act. During each of the last two years growth in bank credit has exceeded its target range by a wide margin. Over the first half of this year bank credit was again above the target range by a significant amount, as compared with the monetary aggregates which are within the specified ranges. Even with our relatively high interest rates, credit remains readily available in the economy, which may contribute to inflationary pressures. Three of the four economists testifying before the committee indicated that the Federal Reserve should pay more attention to credit availability. Governor Wallich indicated that he found himself looking more at credit than in the past. It would, therefore, be appropriate for the Federal Reserve to examine the relationship between credit bank economic activity, to take a critical look at the various credit aggregates that might be used as policy targets—bank credit, total liquid assets, M_7, and the debt proxy—and report back to the committee. This would provide the committee with a greater understanding of the usefulness of bank credit aggregates in evaluating monetary policy.

ADDITIONAL VIEWS OF SENATORS GARN, TOWER, LUGAR, HEINZ AND KASSEBAUM

We agree with the committee report that inflation is still our Nation's No. 1 economic problem, and we agree with the recommendation that the Federal Reserve should continue to restrict the growth of money in a firm and stable manner until significant progress has been made in reducing the rate of inflation. We also agree that restraint on Federal spending and the reduction or elimination of the Federal deficit is important because it would make it easier for the Federal Reserve to achieve that goal. Finally, we agree that the target ranges for growth in the monetary and credit aggregates should be narrowed. All of these steps are essential if the Nation is to reduce the rate of inflation and achieve stable economic growth over the period ahead.

However, we believe that the committee report failed to emphasize the crucial role which fiscal and monetary policies have played in creating inflation and causing a recession. We believe that the presently high rate of inflation and the unfolding recession are due to more fundamental factors than fuel and food shortages. In our opinion, inflation has been caused by massive Federal deficits and excessive monetary growth. Deficit spending by the Federal Government persisted far too long in the expansion to be considered fiscally prudent, and the excessive rate of growth in money and credit has often proceeded at a pace that is totally inconsistent with price stability. The economy has been overly stimulated in the process, and the Federal Reserve has been required to take a number of steps toward increased monetary restraint, highlighted last fall by the rather severe and almost desperate measures to prop up the dollar abroad. The excesses of monetary and fiscal policies created the inflation, and the reversals in monetary policy to compensate for those earlier excesses have laid the groundwork for recession.

We do not believe that inflation can be dealt with until the fundamental sources of it have been rooted out. We recognize that supply shortfalls in certain sectors of the economy have complicated efforts to achieve inflation-free economic growth. But, monetary policy should not attempt to compensate for those shortfalls by expanding the money supply at a rate that is clearly inappropriate under existing economic conditions. We view with particular concern the rapid rate of growth in the monetary aggregates which has occurred since last February or March. If allowed to continue, this growth in money will underwrite and accommodate the price increases associated with sectoral shortfalls, with more inflation occurring in the process.

Unwinding the presently high rate of inflation will be a long and trying process that cannot be achieved in the face of a rapidly expanding money supply. There are limits to the output of real goods and services both within certain sectors of the economy or across the board, and the hopes of reducing inflation cannot be hinged on unreasonable expectations of what is possible on the supply side. Nor do we believe that inflation can be solved through a system of wage-price guidelines or controls, no matter how elaborate they may be. The prospect for reducing inflaton lies elsewhere in prudent and reasonable monetary and fiscal policies.

In our opinion, the Federal Reserve should pursue a monetary policy that is consistent with noninflationary economic growth. It should avoid excessive monetary growth and the severe reversals which such growth in the money stock necessities at a later date. Economic forecasting has not yet reached the stage where it can predict every bend and twist in the economy, particularly those associated with the oil-pricing decisions of the OPEC nations or the weather. We believe the Federal Reserve should pursue a policy of gradually reducing its monetary targets over time to noninflatonary rates and maintaining the growth of the monetary aggregates within those targets.

In our opinion, the Federal Reserve should not pursue a policy of chasing interest rates downward by an accommodative and expansionary monetary policy, particularly at a time when inflation is accelerating. Such a policy will only produce more inflation and higher interest rates in the long run. High interest rates are a reflection of the rapid rate of inflation, and interest rates can only be expected to decline when the rate of inflation has been reduced and inflationary expectations dissipated. A reduction in interest rates is an important economic goal because high interest rates are not only disruptive to our Nation's financial system but discouraging to increased fixed investment, which is needed if productivity is to increase in the future. Productivity growth has lagged considerably in recent years. Larger increases in production are needed in the future to offset higher production costs, moderate upward pressure on prices and provide meaningful employment opportunities.

In all of this, it is important to recognize the role of the dollar. A declining dollar in foreign exchange markets is not in the long run best interest of the United States or its major trading partners. It feeds inflation at home by increasing the prices of imported goods, and it encourages restrictive economic policies that do not serve any useful purpose. But, the future of the U.S. dollar abroad is unavoidably intertwined with our economy and the perception which dollar holders abroad have of our Nation's ability or resolve to put its own house in order. An overly expansionary monetary policy at this point in time would, unfortunately, be perceived as a clear lack of resolve in reducing inflation. The end result will be downward pressure on the dollar abroad and heightened uncertainty over the future course of the economy at home.

The economic outlook for the United States is highly uncertain. The depth and extent of a recession are unknown. But, it is clear that the recession which appears to be emerging is one that is starting with an unacceptably high rate of inflationary steam behind it. That unfortunate turn of events is the product of the mismanaged fiscal and monetary policies of the past which were based on the mistaken belief that such events could be fine tuned out of existence. Under these conditions, we believe it is still prudent to recognize the inflationary and disruptive effects which rapid expansions in the money supply can have on the economy. A recession may not be avoidable at this point in time, but the opportunity to put the economy back on the path to inflation-free and sustainable economic growth is still within the Nation's grasp, providing that prudent and responsible economic policies are adopted and pursued.

JAKE GARN,
JOHN TOWER,
DICK LUGAR,
JOHN HEINZ,
NANCY LANDON KASSEBAUM.

○

August 22, 1979

The Honorable Benjamin S. Rosenthal
Chairman
Subcommittee on Commerce, Consumer,
and Monetary Affairs
Committee on Government Operations
House of Representatives
Washington, D.C. 20515

Dear Chairman Rosenthal:

Thank you for your letter of August 14 inviting the Board to testify at your Subcommittee's hearings on supervision of bank advertising practices.

Governor Emmett J. Rice will be pleased to appear on behalf of the Board on September 12.

Sincerely,

/S/

Paul A. Volcker

CO:pjt (#V-7)
bcc: Gov. Rice
Janet Hart
Mrs. Mallardi (2)

C 11

August 17, 1979

The Honorable Benjamin S. Rosenthal
Chairman
Subcommittee on Commerce, Consumer
and Monetary Affairs
Committee on Government Operations
House of Representatives
Washington, D.C. 20515

Dear Chairman Rosenthal:

Many thanks for your letter of August 13 regarding the materials provided by the Board staff in connection with your Subcommittee's hearings on foreign acquisitions of U.S. banks. It is gratifying to know that this input was useful to the Subcommittee, and the staff members involved have been notified of your compliments.

You may be assured that your Subcommittee will be kept apprised of any further analysis conducted by the Federal Reserve on this subject.

Sincerely yours,

/s/

Paul A. Volcker

JPB:jmr (#V-9)

bcc: Governor Schultz
Governor Wallich
Jack Ryan
Fredh Dahl
Bud Talley
Jim Houpt
Sue Wasilewski

August 17, 1979

The Honorable Fortney H. Stark, Jr.
House of Representatives
Washington, D.C. 20515

Dear Mr. Stark:

Thank you for your letter of August 2, concerning pooling of funds to obtain higher interest rates. As former Chairman Miller indicated in his letter to you of July 9, in adopting the interpretation regarding pooled deposits the Board followed the course that it regarded to be most consistent with maintaining the deposit interest rate ceiling structure that is required under Federal law. In this regard, we continue to believe that the prohibition set forth in the interpretation regarding advertising of pooling by member banks constitutes a reasonable restraint in light of the strong Congressional intent to maintain the ceiling rate structure.

I appreciate the benefit of your views on this matter and I can assure you that the Board will continue to support measures that would result in the eventual elimination of all rate ceilings, so that the markets may operate more efficiently and depositors may receive the maximum competitive return on their savings.

Sincerely,

/S/

Paul A. Volcker

AFC:PSP:jmr (M-283)
G.C. #215

bcc: Mr. Pilecki
Mr. Cole
Legal Files (2)
Mr. Petersen

BENJAMIN S. ROSENTHAL, N.Y., CHAIRMAN
ROBERT T. MATSUI, CALIF.
EUGENE V. ATKINSON, PA.
FERNAND J. ST GERMAIN, R.I.
JOHN CONYERS, JR., MICH.
ELLIOTT H. LEVITAS, GA.

LYLE WILLIAMS, OHIO
JIM JEFFRIES, KANS.
JOEL DECKARD, IND.

MAJORITY—(202) 225-4407

NINETY-SIXTH CONGRESS

Congress of the United States

House of Representatives

COMMERCE, CONSUMER, AND MONETARY AFFAIRS SUBCOMMITTEE
OF THE
COMMITTEE ON GOVERNMENT OPERATIONS

RAYBURN HOUSE OFFICE BUILDING, ROOM B-377
WASHINGTON, D.C. 20515

August 13, 1979

#7

Hon. Paul A. Volcker
Chairman
Federal Reserve Board
Washington, D. C. 20551

Dear Mr. Chairman:

I am writing to express my thanks to the Federal Reserve staff, and particularly to Mr. Houpt, for the excellent work that was done in preparing statistical materials in response to my request of July 24. I especially appreciate the promptness with which the materials were assembled for the subcommittee's use. These materials proved very useful and informative.

If the Federal Reserve does any further analysis of this or similar data to study the banks that have been acquired by or merged with foreign interests, please convey a copy of your analysis to the Commerce, Consumer and Monetary Affairs Subcommittee.

Sincerely,

Ben

Benjamin S. Rosenthal
Chairman

BSR:tb

August 17, 1979

The Honorable Abraham Ribicoff
Chairman
Committee on Governmental Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Ribicoff:

Thank you for your letter of July 12 concerning the applicability of Title IV of the Civil Service Reform Act, which establishes a government-wide Senior Executive Service, to the Board of Governors of the Federal Reserve System. It is gratifying to be made aware of your view that Congress, in enacting the Civil Service Reform Act, did not intend to alter the long-standing independence of the Board. This view coincides with the Board's interpretation of that legislation.

With respect to your suggestion that the Board seek a presidential waiver pursuant to 5 U.S.C. § 3132(c), the staff of the Board has considered this option and discussed it with the staff of the Office of Personnel Management. However, in light of recent developments, it appears unnecessary to pursue this alternative. On July 30, 1979, the Comptroller General of the United States, at the request of the Office of Personnel Management, issued a ruling on whether the Senior Executive Service legislation was applicable to the Board. The decision was that Title IV of the Civil Service Reform Act does not apply to employees of the Board, (File No. B-195418). A copy of the decision is enclosed for your convenience. The Comptroller General's conclusion was based on the finding that the Federal Reserve Act, as amended, expressly grants the Board independence with regard to its own personnel system. The specific provisions of the Federal Reserve Act must, according to the decision, be given priority over a subsequently-enacted statute, such as the Civil Service Reform Act, that is applicable generally to all federal agencies, unless there is a clear indication that Congress intended otherwise. The Comptroller General found no such clear intent to supersede the Federal Reserve Act.

On August 8, 1979, the Office of Personnel Management formally acknowledged that, in accordance with the Comptroller General's opinion, the Board is not subject to the provisions of the Senior Executive Service legislation. No further action by the Board in connection with this matter is anticipated.

Your efforts in pursuing our common interest in preserving the independence of the Federal Reserve System are greatly appreciated.

Sincerely,

/S/

Paul A. Volcker

Enclosure (Comptroller General Decision (B-195418) dated 7/30/79)

RA:jmr/vcd (#M-258)

bcc: Mrs. Mallardi (2)
Rich Ashton

CHAIRMAN OF THE BOARD OF GOVERNORS
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

August 16, 1979

The Honorable Henry S. Reuss
Chairman
Committee on Banking, Finance
and Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Chairman Reuss:

I have read with interest the second report of the House Committee on Banking, Finance and Urban Affairs dealing with monetary policy for 1979. In doing so, I also noted at one place in the report, your Committee seemed to suggest the monetary targets for 1980 were not clearly specified, and in any event, further justification of the rationale for the monetary targets would be useful.

Permit me to clarify any possible misunderstanding. The FOMC set the same ranges for M-1, M-2, M-3, and bank credit for 1980 as for 1979. In doing so, it emphasized the ranges for next year are tentative. By law, they will of course need to be reconsidered in February in the light of emerging economic conditions. But beyond that normal caveat, as the Board's mid-year monetary policy report noted, adjustments might be needed in light of legal and legislative developments affecting particularly M-1, including specifically the uncertain status of NOW and ATS accounts. Moreover, the current period, partly because of inflationary distortions and pressures, has seen a proliferation of new payment and investment instruments, such as money market funds. As a consequence, the Board is undertaking a fundamental study of the aggregates, looking toward possible redefinition of money stock measures to make them more consistent with emerging payments practices and to improve their usefulness as guides to monetary policy. I expect that by the time the 1980 targets are reassessed, such new definitions will be available, and the revised aggregates may have some sufficiently different characteristics to affect the precise targets.

While adjustments may be required for these reasons, or because of changing economic conditions, the ranges recently set for 1980 were designed to encourage a reduction in the rate of inflation, without starving the economy of money needed for a resumption of real growth. The projected growth range for M-1 would permit a slowing in monetary expansion in 1980; we are very conscious of the need over time to achieve such a slowing, as expressed by your Committee. As the Board's report indicates, a slowing trend may have to be interrupted from time to time because of institutional developments or because of the need to take account of short-run changes in economic conditions. With regard to the broader aggregates, anticipated growth rates for 1980 allow for a flow of funds into banks and thrift institutions that would appear ample enough to maintain the availability of credit to home buyers, businesses, and consumers consistent with restoration of economic growth, provided inflationary pressures are not exacerbated.

I greatly look forward to continuing the fruitful dialogue on monetary policy, and other topics of mutual interest, that has developed in recent years between your Committee and the Federal Reserve. It has been helpful to all of us. In that spirit, I have sent a copy of this letter to each member of the Banking Committee.

Sincerely,

/S/

Paul A. Volcker

SHA:PAV:pjt

cc: To all members of the House Banking Committee
bcc: Mr. Axilrod
Mrs. Mallardi (2)

August 16, 1979

The Honorable Fernand J. St Germain
Chairman
Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
Committee on Banking, Finance, and Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Chairman St Germain:

Thank you for your letter of June 29 requesting comments on three bills which would amend the Currency and Foreign Transactions Reporting Act ("Act") to permit more effective enforcement of its provisions to impede the flow of funds utilized in illicit activities (H.R. 4071, H.R. 4072, and H.R. 4073). Those bills would amend the Act to allow payment of compensation to informers, to make it illegal to attempt to export or import large amounts of currency without filing the required reports, and to allow United States customs officials to search for currency in the course of their presently authorized search for contraband articles.

The Board assists the Treasury Department in its enforcement of the Act by monitoring the compliance of State Member Banks in connection with its examinations. Board examiners check to see if those institutions are obtaining required currency transaction reports from their customers, and they review each institution's list of persons who are exempt from reporting. The Board's staff has reviewed the bills and has determined that their operation, if enacted, would not alter or affect the Board's role in enforcement of the Act. However, you may be interested to know that Board staff members are currently participating in a task force established by the Financial Institutions Examination Council in co-operation with the Treasury Department to improve examination procedures for detecting violations of the Act.

Please let me know if we can be of further assistance.

Sincerely,

/S/

Paul A. Volcker

bcc: Fred Dahl, Bob Gemmill, Mike Prell, Gil Schwartz
CBB:JB:jmr
#244

August 14, 1979

The Honorable Bob Stump
House of Representatives
Washington, D.C. 20515

Dear Mr. Stump:

Thank you for your letter of August 1 recommending Mr. R. D. Dunham as a member of the Board's Consumer Advisory Council.

You may be assured that Mr. Dunham's qualifications will receive full consideration by the Board when it makes the 1980 appointments to the Council this fall. We will be in touch with you when the selections are made.

The Board appreciates receiving your recommendations and your interest in the Consumer Advisory Council.

Sincerely,

/s/

Paul A. Volcker

CO:pjt (#V-8)
bcc: Anne Geary (w/copy of incoming)
Mrs. Mallardi (2)

BOB STUMP
3D DISTRICT, ARIZONA

211 CANNON HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515
(202) 225-4576

DISTRICT OFFICE:
5001 FEDERAL BUILDING
PHOENIX, ARIZONA 85025
(602) 261-6923

ARMED SERVICES COMMITTEE

SUBCOMMITTEES:
PROCUREMENT AND NUCLEAR SYSTEMS

NATO

Congress of the United States
House of Representatives
Washington, D.C. 20515

August 1, 1979

#8

1979 AUG 14 AM 11:02

G. William Miller
Federal Reserve System
21 Street and Constitution Avenue, NW
Washington, D. C. 20551

Dear Mr. Miller:

It has come to my attention that Mr. R. D. Dunham of Scottsdale, Arizona is interested in an appointment on the Consumer Advisory Council to the Federal Reserve System.

I support Mr. Dunham's nomination, as he has previously been a member of the Board of Directors of Consumer Finance State Association for Louisiana, Georgia and Florida, and is presently on the Board of Directors of Arizona Association. In addition, he has been the immediate past President and current member of Executive committee of Nationa Second Mortgage Association and is presently on the board of the Arizona Mental Retardation agency. I feel that Mr. Dunham's 23 years of business and position of President and Chief Executive Officer of the Wells Fargo Credit Corporation will provide the Consumer Advisory Council a tremendous resource to draw on.

Appreciate your every consideration of Mr. Dunham's application. Thank you.

Sincerely,

Bob Stump

BOB STUMP
MEMBER OF CONGRESS

BS:cj

August 13, 1979

The Honorable Sidney R. Yates
House of Representatives
Washington, D.C. 20515

Dear Mr. Yates:

Thank you for your letter of August 8 recommending Ms. Andrea R. Rozran as a member of the Board's Consumer Advisory Council.

You may be assured that Ms. Rozran's qualifications will receive full consideration by the Board when it makes the 1980 appointments to the Council this fall. We will be in touch with you when the selections are made.

The Board appreciates receiving your recommendations and your interest in the Consumer Advisory Council.

Sincerely,

/S/

Paul A. Volcker

CO:pjt (#V-3)
bcc: Mrs. Mallardi (2)

Anne Geary (w/copy of incoming)

SIDNEY R. YATES
9TH DISTRICT, ILLINOIS
WASHINGTON OFFICE:
2234 RAYBURN HOUSE OFFICE BUILDING
20515
(202) 225-2111
CHICAGO OFFICE:
230 S. DEARBORN STREET
60604
(312) 353-4596

Congress of the United States #V3
House of Representatives
Washington, D.C. 20515

COMMITTEE
APPROPRIATIONS
SUBCOMMITTEES:
CHAIRMAN, INTERIOR
FOREIGN OPERATIONS
LEGISLATIVE

August 8, 1979

1979 AUG -9 AM 11:02

The Honorable Paul A. Volcker
Chairman
Board of Governors of the
Federal Reserve System
Federal Reserve Building
Constitution Avenue, N.W.
Washington, D.C. 20551

Answer unless being prepared.

Dear Mr. Chairman:

I am writing on behalf of my constituent, Ms. Andrea R. Rozran, 4248 North Hazel, Chicago, Illinois 60613.

Ms. Rozran has been nominated as a candidate for the Federal Reserve Board's Consumer Advisory Council. As you can see from the enclosed resume, Ms. Rozran has had a wide range of experience including work with consumer, volunteer, and community organizations. Most recently she has been an Associate of the Woodstock Institute and a member of the Illinois Health Facilities Planning Board and has formed a consulting firm specializing in health regulation. Ms. Rozran is a very bright and warm woman whose membership on the Council would bring much credit to the Federal Reserve Board.

I would be most grateful if you would give Ms. Rozran's nomination your sympathetic consideration.

Sincerely yours,

Sidney R. Yates

SIDNEY R. YATES
Member of Congress

#1522

CHAIRMAN OF THE BOARD OF GOVERNORS
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

August 8, 1979

The Honorable Jack Brooks
Chairman
Committee on Government Operations
House of Representatives
Washington, D.C. 20515

Dear Chairman Brooks:

This letter relates to General Accounting Office Report B-172255 entitled "Are OPEC Financial Holdings a Danger to U.S. Banks or the Economy?" This report contains recommendations concerning the Federal Reserve and therefore requires comment in accordance with Section 236 of the Legislative Reorganization Act of 1970.

The recommendations essentially provide that the Federal Reserve should inform the House Committee on Government Operations why it does not disclose data on assets in U.S. banks, or loans by U.S. banks, for individual members of OPEC.

On July 18, Governor Coldwell, a member of the Board, testified on behalf of the Board before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations on the issue raised by the GAO's recommendations. A copy of Governor Coldwell's statement is enclosed.

The Federal Reserve attaches considerable importance to the principle of maintaining the confidentiality of particular accounts in U.S. banks, whether held by OPEC monetary authorities or others. The GAO assessment of the potential problems involved in large OPEC deposits with U.S. banking institutions is in general in accord with our own concerns. We would not agree, however, that the information on this subject that has been made available is not sufficient to permit appropriate analysis and assessment of any problem related to these assets.

The Federal Reserve has provided several detailed tabulations responding to specific requests by the Subcommittee; however, we do not believe it appropriate to change our current data disclosure policy.

Sincerely,

Paul

Paul A. Volcker

Enclosure

August 8, 1979

Mr. John M. Martin, Jr.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Martin:

Thank you for providing the opportunity to offer comments on H.R. 4646, the "Capital Cost Recovery Act of 1979."

In an effort to assist the Committee in its evaluation of this proposed legislation, I am enclosing a report prepared by our staff at the request of former Chairman Miller which analyses the costs and impacts of a comparable scheme--the "1-5-10" accelerated depreciation plan. While this system also provides for five year equipment write-offs and 10-year structure write-offs, it additionally calls for 1-year expensing of government-mandated investments. However, this latter feature does not affect markedly the cost and impact analyses developed by the staff.

Please let me know if I can be of further assistance.

Sincerely,

/S/

Paul A. Volcker

Enclosure

SR/JSZ/JLK:jmr
Ref. #267

bcc: Mr. Kichline
Mr. Roach

August 6, 1979

The Honorable Mary Rose Oakar
House of Representatives
Washington, D.C. 20515

Dear Ms. Oakar:

Thank you for your letter of July 18 commenting on the Board's proposed amendments to Regulation B. You urge the Board to retain the prohibition against creditors discounting reliable income from part-time employment, alimony, and pensions.

Please be assured that the Board's purpose in issuing its April 19 proposals was to strengthen, not diminish, the protections against unlawful credit discrimination. As the enclosed press release of July 24 indicates, when the Board adopted the present form of Regulation B, it focused primarily on discriminatory practices of judgmental systems of credit analysis used by the vast majority of creditors. At that time, the Board had general knowledge about how scoring systems operated, but only limited information about their potential for discrimination.

Since that time, the Board has learned a great deal more about credit scoring. It has become increasingly apparent that, although Regulation B's specific rules identify certain discriminatory practices of judgmental systems, they may not sufficiently protect the public against discrimination that could result from some practices of scoring systems. In part, this may stem from the lack of clarity about the proper application of the existing rules to particular scoring practices. To achieve the intended objectives of the Equal Credit Opportunity Act, the Board may need to establish additional rules to deal with possible discrimination by scoring systems.

The Board's proposals on each of the issues addressed present the broadest possible range of alternatives in order to obtain maximum information about a highly technical field. The Board hopes that public comment on the entire spectrum of options will result in a full exploration of the ramifications of each option.

Turning to the specific issue that you raise, the Board agrees that reliable income from part-time employment, alimony, and pensions should receive the same treatment as any other reliable income. The proposal raises the narrow technical issue of how to implement best this principle for credit scoring. For example, many systems do not score income at all. Clearly, confusion exists about how such a system should handle part-time employment, alimony, and pension income.

The Board very much appreciates receiving your comments. They will receive careful consideration before the Board takes any final action. I might also note that, because of the degree of public interest in these proposals, the Board recently extended the close of the comment period for another 60 days to August 20, 1979. Please let me know if we can be of further assistance to you.

Sincerely,

/S/

Frederick H. Schultz

Enclosure

DCH:jmr
#M-268

bcc: Paula Rice (for distribution)
David Hsia
Gov. Schultz
Ms. Mallardi

August 6, 1979

The Honorable Stewart McKinney
House of Representatives
Washington, D.C. 20515

Dear Mr. McKinney:

Thank you for your letter of July 18 commenting on the Board's proposed amendments to Regulation B (which implements the Equal Credit Opportunity Act) and enclosing a letter from Audrey Triolo, Executive Director of the Darien YWCA. Both you and Ms. Triolo urge the Board to retain the prohibition against creditors discounting reliable income from part-time employment, alimony, and pensions.

Please be assured that the Board's purpose in issuing its April 19 proposals was to strengthen, not diminish, the protections against unlawful credit discrimination. As the enclosed press release of July 24 indicates, when the Board adopted the present form of Regulation B, it focused primarily on discriminatory practices of judgmental systems of credit analysis used by the vast majority of creditors. At that time, the Board had general knowledge about how scoring systems operated, but only limited information about their potential for discrimination.

Since that time, the Board has learned a great deal more about credit scoring. It has become increasingly apparent that, although Regulation B's specific rules identify certain discriminatory practices of judgmental systems, they may not sufficiently protect the public against discrimination that could result from some practices of scoring systems. In part, this may stem from the lack of clarity about the proper application of the existing rules to particular scoring practices. To achieve the intended objectives of the Equal Credit Opportunity Act, the Board may need to establish additional rules to deal with possible discrimination by scoring systems.

The Board's proposals on each of the issues addressed present the broadest possible range of alternatives in order to obtain maximum information about a highly technical field. The Board hopes that public ploration of the ramifications of each option.

Turning to the specific issue that you and Ms. Triolo raise, the Board agrees that reliable income from part-time employment, alimony, and pensions should receive the same treatment as any other reliable income. The proposal raises the narrow technical issue of how best to implement this principle for credit scoring. For example, many systems do not score income at all. Clearly, confusion exists about how such a system should handle part-time employment, alimony, and pension income.

The Board very much appreciates receiving comments from you and Ms. Triolo. They will receive careful consideration before the Board takes any final action. I might also note that, because of the degree of public interest in these proposals, the Board recently extended the close of the comment period for another 60 days to August 20, 1979. Please let me know if we can be of further assistance to you.

Sincerely,

/S/

Frederich H. Schultz

Enclosure

bcc: Paula Rice (for distribution)
David Hsia
Gov. Schultz
Mrs. Mallardi

DCH:jmr
#M-268

August 6, 1979

The Honorable Phil Gramm
U.S. House of Representatives
Washington, D.C. 20515

Dear Representative Gramm:

Thank you for your recent letter concerning the Joint Notice of Statement of Enforcement Policy for Regulation Z (Guidelines) which became effective on January 4, 1979. The Guidelines provide methods of uniform corrective action that the five federal financial institution regulatory agencies use to enforce the Truth in Lending Act and its implementing Regulation Z; particularly with respect to reimbursing consumers for overcharges on their loans. Your letter specifically questions the necessity for requiring banks to review their loans for overcharges back to October 28, 1974.

To begin, I would like to point out that under the Guidelines, a creditor is not automatically required to review all loans in its portfolio just because a few isolated reimbursable violations of Regulation Z are discovered by an examiner. The creditor is required to conduct its own review only when the examiner has an adequate indication that a pattern of violations resulting in reimbursable overcharges exists.

As part of our consumer affairs examination, examiners determine whether a bank is in compliance with Regulation Z. This determination is made primarily by drawing statistical samples of each type of loan offered by the bank and reviewing the loan documents in the sample for adequacy of disclosure and proper computation of the finance charge and annual percentage rates (APRs). If the examiner finds that an APR or finance charge is understated, as defined by the Guidelines, the creditor will be required to reimburse to the customer the difference between the disclosed APR or finance charge and the actual APR or finance charge, as the case may be.

If a violation of Regulation Z requiring reimbursement is systematically found in all or a significant number of the sampled loan files of a given type, the examiner can reasonably believe that this same violation exists in other loans of the same type that were not in the sample. Only then would an examiner require the creditor to review all files for the type of loan that contains the violation and make reimbursements pursuant to the Guidelines. The creditor's review must include all outstanding loans consummated since October 28, 1974, and all terminated loans consummated within two years of the examination in which the violation was noted. This procedure is designed to insure that all overcharged consumers, not just those whose loans happen to fall in the examiner's sample, receive reimbursement.

The choice of October 28, 1974, was made by the agencies after careful consideration of several alternatives. It was ultimately decided that, on balance, the use of that date would be most equitable to both consumers and creditors. By using this date, a large number of consumers would be protected by the reimbursement policy but the administrative burden on creditors would be less than if they had to review all of their files back to the Act's 1969 effective date. This date was also used in the restitution provisions of the bills to simplify the Truth in Lending Act that passed the Senate during the last Congress and the present Congress.

Please let me know if I can be of further assistance.

Sincerely,

/s/

Frederick H. Schultz

BCC: Tim Burniston
Gov. Schultz
Mrs. Mallardi ✓

TRB:CO:jmr
#M-272

FEDERAL RESERVE BANK OF NEW YORK
NEW YORK, N.Y. 10045
AREA CODE 212 791-6173

PAUL A. VOLCKER
PRESIDENT

July 31, 1979

The Honorable William L. Armstrong
Senate Office Building
Washington, D. C.

Dear Senator Armstrong:

I am attaching answers to the questions you submitted to me in your letter today. I apologize for the lateness of the hour, but I hope you find them responsive.

Sincerely yours,

Paul A. Volcker

Paul A. Volcker

Attachment

RECEIVED
AUG 1 1979
P. A. V.
ANSWERED
ATTENDED TO

(1.a.) Many economists believe that we are now beginning a stagflationary cycle. Inflation is well into the double-digit range while real growth in the economy appears to be grinding to a halt. Under the circumstances, what do you consider to be prudent monetary and fiscal policy?

Under present circumstances, I believe a prudent monetary policy is broadly reflected in the ranges for monetary growth recently adopted by the Federal Open Market Committee and discussed with your Senate Committee last week. Because current problems stem in substantial part from inflation and inflationary expectations, I believe we cannot prudently depart from disciplined monetary growth without jeopardizing in a still more serious way prospects for future gains in employment and productivity. I also believe the budget should be brought into balance as soon as possible, but what is possible and prudent in the short run will depend on business developments. As I suggested yesterday, a broad program of tax reduction at this particular time seems premature. I believe that this is even more true of expanded spending programs, which might add to the difficulty of achieving budgetary balance.

(1.b.) What extent, if any, do you believe the federal budget deficits constrain efforts to reduce inflation?

Federal budget deficits, other things equal, bring pressures on financial markets and in some conditions may inhibit productive investment by the private sector. For both reasons, budget deficits may make it more difficult to reduce inflationary pressures both in the long and short run. However, the speed with which we can move toward budgetary balance will depend on, among other things, shorter-range business trends.

(1.c.) You mentioned in your testimony that it was your personal goal to slow the rate of growth in the money supply to near zero while accommodating real economic growth through increased monetary velocity. How soon do you expect to implement this policy? Over what period of time would you expect to achieve this goal?

You may recall that I noted that a very low rate of monetary growth would be consistent with overall price stability. Under present circumstances, that condition must be considered an objective that can be reached only over a period of years and toward which we should move in prudent steps. The speed with which we can move will depend in considerable part on the strength of price and cost pressures arising from other economic forces. We can begin to move in that direction, but I cannot now reasonably suggest a precise date for reaching the objective of essential stability in the stock of money and the general price level.

(2) While you served at the Treasury Department, you managed the policy of demonetizing gold. At the time, did you foresee that the price of gold would increase from $35 per ounce to more than $300 per ounce? In retrospect, was this policy wise? Do you foresee circumstances under which the United States might return to metallic backing for its currency? Would you favor or oppose such a change?

I should note first that the process of demonetizing gold began before I served at the Treasury Department and continued after that period of service. In any event, I cannot say that I foresaw a price of gold at $300 per ounce. I can say, and have always thought, that the combination of domestic inflation and instability of the dollar internationally could prove unsettling in terms of both expectations and economic performance. In retrospect, I believe a change in the value of the dollar was necessary in the early 1970s. However, insufficient attention was paid to the importance of damping inflationary forces arising during that period from a variety of sources, among which the effects of the changes in the value of the dollar through the devaluations of 1971 and 1973 were relatively minor. I do not foresee circumstances under which the United States would return to backing the dollar by gold, and I would not favor such a change.

(3) Last November, President Carter initiated the dramatic "dollar rescue program." This forced the United States to borrow from the International Monetary Fund for the first time since World War II. As a result, the United States will have to issue bonds denominated in foreign monies. This is a critical benchmark in our economic history. At the time, many thoughtful people predicted the program would ultimately fail. They may be right. The dollar is weak on foreign exchange markets. Inflation continues unabated at double-digit levels at home. In the past three months, monetary aggregates for the Federal Reserve have exploded past its own targets. In light of this evidence, do you believe the President's program is sound?

Does the program reflect that the United States has forsaken its role as the world's economic leader?

As Chairman of the Federal Reserve, what would you recommend to strengthen the dollar abroad and reduce inflation at home?

In light of the sharp monetary expansion, does it indicate that the Federal Reserve has not placed an appropriately tight rein on money supply?

As I indicated yesterday, I was in full sympathy with the program undertaken last November. It was desirable in light of the inflationary situation at home and the instability of the dollar abroad, and it was fully consistent with appropriate domestic economic policies. Obviously, the particular steps taken at that time do not provide in themselves an adequate program for the future. Monetary, fiscal, and other measures need to be kept under continuous review, but I do believe the general direction and tenor of the measures taken were sound. And I do not believe that these actions were in any way contrary to the role of the United States as the world's economic leader. In fact, they supported that role.

In regard to measures to strengthen the dollar abroad and to reduce inflation at home, I have touched upon those concerns in my testimony yesterday and in my answer to question 1 (above). I would emphasize again

(3 Continued);

that a successful attack on inflation and on our external problems will require actions and programs that extend beyond monetary and fiscal policies. Quite clearly an effective energy program must be an important ingredient in any solution, and I am very conscious of the strong cost pressures arising both in the private economy and directly and indirectly from a variety of government programs.

As you noted, there has been a sharp monetary expansion in recent months. I would point out, however, that the period of rapid growth has been rather short. Taking the first and second quarters of this year together, there is evidence of some moderation in monetary growth. I am sure that the Federal Reserve will continue to monitor developments closely and take those actions necessary to keep monetary growth within appropriate ranges.

(4) The press recently reported an economic minister in a major European government saying, "I hope that whoever becomes dominant will pursue a conservative monetary policy, and not delude themselves into thinking they can float the United States off its difficult energy and other economic problems by adopting an inflationary policy." What is your reaction to this advice?

As I have stated, I find myself in broad agreement with the sentiment expressed in the quotation. It would be an illusion to believe that we can resolve our present dilemmas and difficulties by permitting inflation to accelerate or even by maintaining the current rate. I believe that ultimately the only sound foundation for the continuing growth and prosperity of the American economy is much greater price stability.

(5) Although the Federal Reserve has no direct responsibilities for tax policy, the Chairman of the Federal Reserve has influence on all economic decisions. Therefore, I would appreciate knowing whether you 1) favor utilization of the tax code to achieve income redistribution?; 2) favor major tax reductions this year for individuals and corporations?; 3) favor faster depreciation allowances and postponement of Social Security tax increases to spur economic growth?

1) The tax code has over a great number of years been used in part to achieve some income redistribution and I would expect that that objective will remain relevant. But also I believe we have learned that there are limits on the extent to which the tax code can be used for that purpose consistent with the achievement of other objectives.

2) As I indicated yesterday, I believe consideration of tax reductions at this point is premature.

3) Should circumstances arise in which tax reductions appear desirable--and over a period of time I hope such circumstances will arise--I believe attention should be given to both faster depreciation allowances and some method of achieving relief from heavy payroll taxes which tend to contribute to cost and price pressures. Obviously before a decision could be reached, other desirable tax changes would also need to be reviewed, and I recognize the importance of maintaining some relationship between social security taxes and benefits.

(6) To follow up on a question I asked earlier today. I understand, the Federal Reserve is limited by law to the amount of U.S. Securities it can purchase. The Federal Reserve, however, often works in concert with the Treasury to create favorable conditions to enhance the marketability of these securities. If that fails, the Reserve can, up to its statutory limits, purchase either directly or indirectly, those outstanding securities. Is it appropriate for the Federal Reserve to work in concert with the Treasury Department to create a financial climate favorable to enhance purchase of U.S. Securities? To what extent, if any, does this responsibility conflict with your advocacy of slowing the rate of growth of the money supply?

You refer to the Federal Reserve working in concert with the Treasury to create favorable conditions to enhance the marketability of Treasury securities. While that comment may be relevant to some earlier periods of history, particularly in the period of World War II and its aftermath, I do not believe that it is a fair characterization of relationships in recent years. There are very strict limits, recently reinforced, on the ability of the Federal Reserve to purchase securities directly from the Treasury. While the Federal Reserve does purchase Treasury securities in the open market, such purchases (and sales) are arranged in a manner to achieve the objectives of the Federal Reserve with respect to monetary policy rather than to meet the convenience of the Treasury in marketing its securities. The Federal Reserve does of course consult with the Treasury Department about its financing activities, and I would expect such consultation to continue.

As I suggested in my answer to your first question, a heavy supply of Treasury securities on the market can influence adversely the climate in financial markets generally and to some degree would be taken into account by the Federal Reserve in arriving at decisions on monetary policy. That is one important reason why I would like to see the Federal budget deficit eliminated over a period of time.