Banking Supervision and Monetary Policy

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It is a real pleasure to join our Philadelphia colleagues in this traditional luncheon meeting with our many good friends of the New Jersey Bankers Association—and it is especially pleasant to do so in this lovely setting of Bermuda. As Mr. Eastburn has said, this is the last occasion I will have to address you in my capacity as President of the Federal Reserve Bank of New York. I have valued your friendship and your support in our many joint efforts looking toward better banking and better central banking over the years.

Since I saw you a year ago we have all been through a trying and difficult period, as the economy has experienced not only the deepest recession of the postwar years but also a period of virulent inflation coupled with peak interest rate levels. The worst of the inflation now seems to be behind us, and it is my hope and belief that business will be well on the road to recovery before many months have passed. But, while the severity of the recession and its financial ramifications are still very much on our minds, it may be well to reflect briefly on some of the lessons that have been pointed up more sharply than they had been in more stable and prosperous times. And I would like to dwell particularly on the relationships between the commercial banking system and the Federal Reserve in the latter's functions as the nation's monetary authority and as one of its principal bank supervision agencies.

At the outset, let me stress the mutuality of our interest in a healthy growing economy and a healthy growing banking system. As far as the Federal Reserve is concerned, our overall objectives are spelled out in broad terms in the Federal Reserve Act and in the Employment Act of 1946, and they are objectives to which I am confident all of you would subscribe—sustainable economic growth, full employment, stable purchasing power, provision of an elastic currency, provision of the functions of the lender of last resort, and maintenance of a sound banking system. By tradition and widespread agreement, the maintenance of reasonable balance-of-payments equilibrium has also been added to these objectives. Of course it is not always easy to serve all of these objectives at once. There must be a constant weighing of values—and all of us face serious dilemmas from time to time—but this is inevitable, and it underlines the vital importance of judgment, whether one is a commercial banker or a central banker. Judgment can never be satisfactorily replaced by easy automatic formulas, tempting though it may be to seek such simplistic guides.

As you well know, monetary policy operates through the banking and financial systems to ensure that the flow of money and credit is sufficient to foster sustainable growth of economic activity, but not so abundant as to foster excess demand and inflation; and of course the commercial banking system is affected most directly by our policies. It is essential that our banking and financial institutions remain strong and effective, since a weak and inefficient financial system would constrain or blunt the impact of monetary policy and would also impede the nation's economic progress. It follows that the Federal Reserve must take a keen interest in the soundness and efficiency of individual banking institutions and their ability not only to withstand the impact of adverse economic and financial developments but also to continue to meet the credit and deposit needs of the public.

Since ours is essentially a market economy, the channeling of money and credit rests primarily in the hands of bankers and other private lenders, who compete with one another as they determine the relative creditworthiness of

various borrowing needs. Whatever influence the Federal Reserve exercises is focused on overall monetary and credit conditions rather than on the channeling or allocation of funds. In my view, it is hard enough for the central bank to determine and achieve desirable total flows of money and credit without becoming involved in credit allocation. Not only would such allocation complicate enormously an already very demanding assignment, but it would also place the Federal Reserve in a position of deciding social priorities that are better left to political bodies such as the Congress. It also seems to me that credit-allocation devices are seldom effective for very long, in part because the credit markets are so highly interdependent. Attempts to increase the supply of credit for any one sector set in motion market forces, such as interest rate changes, and a search for new financing instruments and techniques, which over time tend to negate allocative efforts. I recognize that voices have been raised in various circles favoring an activist role for the Federal Reserve in this area, but I remain decidedly unconvinced.

Since this credit-channeling function is now performed primarily by private financial markets, you bankers have a heavy responsibility to see that your portion of these credit flows contributes to a vigorous and healthy economy. And now that business recovery is so essential, you have every reason to assist in this recovery by meeting the legitimate credit needs of business firms and other borrowers. In this connection, some of my banker friends have recently indicated some uncertainty as to the relationship between an accommodative overall monetary policy, such as the Federal Reserve has been pursuing for some months, and the earlier admonitions from the central bank urging greater attention to liquidity, asset condition, and capital adequacy. Actually I see no real conflict between these forces. The banking system must play a major part in financing recovery, but there will inevitably be differences in the ability of individual banks to do so in the light of their own financial condition.

Bankers have an obligation to appraise the impact of their credit operations and liability management practices on the financial strength of their organizations and on their ability to withstand the temporary, but often severe, adjustments that can occur in a changing economic environment. Certainly the current recession has carried further, and financial strains have been greater, than most observers would have predicted a year or so ago. But the wiser bankers had provided themselves with a comfortable margin of safety to tide them over the economic and financial strains of the past year.

It is also true, however, that in attempting to satisfy the inflated credit demands of the early seventies some banks allowed their liabilities and assets to expand much more rapidy than their capital. In too many of these banks, I fear that this reflected overemphasis on a "go-go" philosophy, which placed too much emphasis on the "bottom line" and not enough on building basic strength as a bulwark to withstand a deteriorating economic environment. Adequate capitalization is essential to banks in the performance of their function as the nation's principal suppliers of money and credit. And, if capital deficiencies show up, action to remedy them is called for.

I realize that the very conditions that have caused awareness of capital deficiencies have also made it difficult for banks and bank holding companies to acquire new capital. I am also aware that the disclosure requirements of the Securities and Exchange Commission (SEC), as now applied to banking organizations, are making it quite difficult for them to raise funds in the capital markets. While no one questions the need for sufficient disclosure to provide adequate protection for investors in the securities of banking organizations, it also seems clear that the same standards cannot be applied indiscriminately to banking organizations and industrial companies. The banking system has the unique function of creating deposits and money—a function which has long been recognized as so essential to the country's well-being as to require special legislative and regulatory treatment. The principal goal of banking legislation and regulation has been to insure the integrity of the nation's money supply and financial system, with special emphasis in this regard on depositor protection. Thus, I think there is a need for greater cooperation between bank supervisors and the SEC in an effort to develop standards pertaining to the securities issues of banking organizations that are realistic and equitable to all concerned.

I believe that these problems can and will be resolved and that banks and bank holding companies will find opportunities for raising new capital through the sale of debt and equity instruments in periods in which pressures in the nation's capital markets have eased. At the same time, banks should take a hard look at their dividend policies from the point of determining the best balance between internal and external sources of funds to meet their needs. For example, as bank profits have improved, a number of banks have been able to pare payout ratios without reducing dividends. In addition, banking organizations should not be deterred from raising equity capital merely because current market prices are below book values. Perhaps bankers should take a cue from those public utilities which have recently raised new equity capital through successful common stock offerings. Some

dilution of the existing equity interest may be a price well worth paying, for a strong equity base deserves a high priority in the thinking of banks' senior management and is surely in the long-run interest of the shareholders.

The dilution of equity can of course be avoided if banks build equity capital out of earnings. Banks should intensify their efforts toward increasing earnings by trimming operating expenses and curtailing marginally profitable activities, but more especially by pricing their products realistically. I have in mind the fact that banks have for many years been liberal in establishing lines of credit without fees and have charged too little in fees for loan commitments. The banks, like the proverbial grasshopper, found to their regret that fees paid for commitments contracted in the "summer" conditions of 1971 and 1972 represented bargain prices for access to credit in the "winter" conditions of 1973 and 1974. I was pleased to see the trend toward higher commitment fees which began last year. I might also add that there are many in the System—and I include myself among them—who would, over time, favor some easing of the reserve requirement burden borne by Federal Reserve member banks as an aid to improving their capital positions.

Needless to say, a bank's capital needs as viewed by the regulators are importantly affected by the quality of the bank's assets and the nature of its liabilities. Both bankers and regulators share a common interest in seeing that the quality of bank assets is maintained at high levels. Of course there are certain factors bearing on asset quality that are not under the immediate control of individual banking organizations. The percentage of loans involving delinquency by the borrowers typically rises in periods of economic strain and recession, and the present episode is no exception. To the extent that banks' asset quality has suffered as a result of the general softening of the economy, there should be a marked overall improvement once the national economy begins to recover. Meanwhile, bank regulators must "call the shots as they see them" and cannot lower their standards because the recession has spread a certain degree of loan weakness fairly widely throughout the banking community.

I should emphasize that, despite these loan troubles, I believe the nation's banking system is sound and in a good position to meet the changing economic and financial needs of the country. In this regard, the recent substantial increase in deposit insurance has helped to assure the public of the continued strength of the banking system. While some problems still remain, I think the worst is behind us. For example, the latest report of the Federal Deposit Insurance Corporation indicated that 183 banks required "close supervision" at year-end 1974, but these banks represented only 1.3 percent of all insured banks and about 1 percent of total deposits. We expect that the problems of these banks will not result in disruption of banking services to the public, or have any adverse impact on the overall strength of our banking system.

We have all been impressed with the international nature of some banking problems, and banking authorities in other countries are also interested in ensuring the strength of their own banking systems. Since the foreign exchange losses experienced last year, banks all over the world have taken a more cautious view of foreign exchange operations. In this country, authorities are strengthening examination techniques relating to foreign exchange operations, and are monitoring positions for indications of any tendencies toward undue exposure. The Federal Reserve System is also cooperating with other central banks in an attempt to develop an early warning system for banking problems that might have significant international effects. The Federal Reserve Bank of New York's action last summer in purchasing the foreign exchange book of the Franklin National Bank was motivated in part by a desire to prevent the international difficulties that might have stemmed from the Franklin National Bank's inability to deliver the foreign exchange for which it held forward contracts.

Let me say a word about the Federal Reserve's role as "lender of last resort". The System has demonstrated in a number of recent instances, notably in the case of the Franklin National Bank, its ability to cope effectively with severe liquidity problems in troubled banks, and the System's very effectiveness in such efforts has tended to cause a number of nonfinancial corporations and political entities to look to the System for help when they have found themselves in difficulties. However, the Federal Reserve is by its very nature better equipped to handle the problems of financial institutions than those of nonfinancial firms or political bodies. Moreover, it is worth pointing out that Federal Reserve credit is not available on a long-term basis to any institution, financial or nonfinancial. Rather, it serves to provide needed liquidity to creditworthy borrowers in temporary emergencies until more permanent financing can be arranged, and only if the failure of the borrower would have broad financial consequences. There are strict statutory limitations on the Federal Reserve's power to make emergency credit available, not least because Federal Reserve credit serves as the base for the creation of money and bank credit.

The financial difficulties encountered by various organizations in the past few years have led to a good deal of thinking about the possible need for a new Government agency, modeled perhaps along the lines of the Recon-

struction Finance Corporation, to provide intermediate- or long-term credit to important elements of our national economy having financial difficulties and finding themselves unable to obtain needed credit from existing private or public sources. There has been wide disagreement, however, as to the desirability of such an agency, with the opponents citing the danger of political abuse of such credit facilities and possible squandering of public funds on enterprises that might better be left to sink or swim on the basis of their degree of access to normal market funds. I recognize the risk of abuse, but on balance I find that the advantages of having such an emergency lender in the wings probably outweigh the disadvantages. I would emphasize, however, that I am expressing a purely personal view.

One question that has been receiving a great deal of attention recently is whether some change would be appropriate in the structure of the Federal bank regulatory framework in the interest of greater efficiency. Certainly a good case can be made for less dispersion of authority, but it is certainly not easy to find a solution that will meet all needs. The suggestion that the Federal regulatory and supervisory authority be centered in the Federal Reserve has encountered much opposition on the ground that combining all Federal supervisory authority with the responsibility of conducting monetary policy would constitute too great a concentration of power. On the other hand, I have been impressed, especially in the last few years, by the very close relationship between bank regulation and the exercise of monetary policy. The central bank has a direct interest in seeing that supervision is such as to provide a sound and efficient financial environment in which monetary policy can operate effectively. Moreover, the close familiarity with banking problems acquired through our bank supervision certainly permits a more intelligent implementation of monetary policy than would be possible if we were operating in more of an "ivory tower" atmosphere. No matter what solution is found, the Federal Reserve should have a major part to play in any more unified Federal supervisory structure.

As for the general economic outlook, I can see real grounds for optimism. The recession would appear to be following a customary cyclical pattern, with some constructive forces already at work in the form of diminished inflation, some strengthening of consumer buying, progress in achievement of a better inventory balance, and easier credit conditions that should bring gains in many economic sectors, including housing. On the other hand, now that the Congress has passed and the President has signed a bill to provide fiscal stimulus, there remains a serious risk that the Federal deficit may ultimately grow so large as to interfere with the financing of private credit demands and to rekindle inflationary fears. Obviously, this situation calls for a high degree of caution in keeping Federal spending under control.

On the international front, I am heartened by what I take to be an increasing awareness that the dollar's position in exchange markets deserves the close and solicitous attention of United States financial authorities. While the sudden emergence of huge current-account surpluses in oil-producing countries and huge deficits in oil-importing countries is still causing very real economic and financial difficulties for many countries, at least the magnitude of the problem is less than was feared only a few months ago, primarily because the world has learned to economize considerably in its use of petroleum and the oil-producing countries have been able to step up their imports and investments much more rapidly than most observers thought possible. Furthermore, the oil-producing nations have shown a willingness to grant sizable amounts of aid to less developed countries.

I might add that many people have been unduly pessimistic regarding the United States balance-of-payments position. I believe that the weakness of the dollar has been exaggerated in recent months, and the foreign exchange markets have tended to overlook a major improvement in the United States trade balance, reflecting a greater competitiveness of United States exports. In part, the dollar's weakness during the winter months was attributable to a temporary cyclical widening of the spread between interest rates here and abroad, which has tended to mask the underlying improvement in our payments position. I have been confident that a more realistic assessment of the United States balance of payments would soon come to the fore, and I have been gratified by the buoyant trend of the dollar rate in recent weeks.

We still face some danger that disruptive financial events here at home or abroad might interrupt the prospective improvement of the economy. The coming months will call for a prudent balance between policies of expansion and policies of consolidation, and nowhere will this need for balance be more marked than in the banking business. All of us—bankers and central bankers alike—have been through a profoundly sobering experience in the past few years. I trust that we shall make the most of that experience in coping with the economic developments that lie ahead. Indeed, the years ahead will not be easy ones. Taming the inflation which has plagued us for the past decade will require a long period of disciplined and sustained effort. I am confident, however, that my colleagues at the Bank, in the System, and in the banking community will measure up to tomorrow's problems and challenges.