For release upon delivery
(Approx. 8 p.m. EST)
Tuesday, April 20, 1965

Balance in Bank Regulation

Remarks of George W. Mitchell

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at the

Annual Business Meeting

of the

Chicago District, Illinois Bankers Association

Chicago, Illinois

April 20, 1965

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Public servants who have gone off to Washington, whether elected or appointed as I was, often return home with first-hand accounts of "Potomac problems." I am moved to make some such speech tonight. For there is something of a "problem on the Potomac," in a field that affects each one of you here.

I am talking about the structure of Federal banking regulation. The passage of time has revealed more and more of its shortcomings, but never more than in the past few months when instances of conflict and confusion have become more than trade news as they have made the headlines of the daily papers.

We have come to a point where we badly need, I think, a firm and cooperative effort not only by the industry and the regulators, but also by the Congress and the States, to bring into being a better sense of balance in bank regulation.

I am aware that balance is a term used by some to justify retaining several overlapping regulatory agencies in order to set one off against another. This is not the sense in which I use the term. The balance that I think it is imperative to achieve is a balance of prudent restraint and competitive freedom, of conservation of values and innovation of ideas, of comprehensiveness in coverage and efficiency in performance. In a phrase, what we need is a "cost-benefit" appraisal of bank regulation, with both costs and benefits interpreted in their broadest social sense. Such an appraisal should, in turn, provide the basis for considered judgments as to the most appropriate kind of organizational superstructure and the kind of regulatory philosophy to be embodied in statute and administration.

Proposals for organizational reforms of bank supervision are even now the subject of hearings before a subcommittee of the House Banking and

Currency Committee. A week ago one of my colleagues, Governor Robertson, testified before that subcommittee on two proposals to bring into one agency all Federal bank supervisory functions. Recalling the reception that his proposal for unification of banking agencies had received two years earlier, he expressed the view that today "it is fair to say that the focus of inquiry now has shifted from whether federal bank supervision should be unified to How this shall be accomplished."

Both in that testimony and in various earlier statements, Governor Robertson has underscored graphically the inconsistencies and conflicts in interpretation and administration experienced in the present divided responsibility. I could not agree with him more that the record in this respect is a sorry one. Just as an illustration, the delay in dealing firmly with the abuses associated with brokered C.D. sales strikes me as simply the latest instance when the Federal supervisory superstructure has been too entangled to be timely.

But I see another level as well on which I think that the contemporary forms of bank regulation have not served the public interest as well as could be expected.

I believe banking rules and regulations have been conceived and proliferated in a manner that has curtailed the banking system's adaptability to the needs of its customers and, also, the corporate interest of bank shareholders.

A good many banks have been telling us this over recent years. A growing number of academic and institutional critics have been making the same point, both in logical discourses and in down-to-earth factual studies. And, most important of all, bank customers have sent us many such messages, particularly during the years when they demonstrably shifted some of their demands for financial services to other forms of financial institutions, speeding their growth in the process.

I expect it is true that every regulatory restraint in banking, when it was enacted, was aimed at some particular current abuse that people wanted corrected. But not always were those presumed remedies carefully weighed against their costs--namely, their disadvantageous side effects--and still less often have they been subjected to periodic re-evaluation of costs versus benefits in the light of the marked changes that have taken place in the economic and financial environment.

How, then, would one sum up the gains and losses resulting from regulatory constraints on banking services and practices? To be brief, let me be assertive.

There is surely no doubt that, on grounds of public policy looking to the protection of depositors, regulation has cramped initiative and slowed the adaptation of banking services to changing needs of businesses and individuals. It has left many communities with restricted alternatives for services and led many potential customers to turn to other financial intermediaries or to more service-minded banks in other locations.

In the process, the safety of deposits, the major objective of regulatory constraints, has certainly not suffered. True, there are some failures nearly every year and some losses to depositors, but it is important to remember that the amounts lost are insignificant in relationship to the deposit totals of the community at large.

Regulation through the restriction of entry has necessarily lessened competition. When competition is more pervasive, services usually are more conveniently available and charges are lower. Furthermore, banking has demonstrated significant economies of scale for the same complex of services. Yet oftentimes regulatory constraint on branching and mergers and other forms of consolidation has inhibited the expansion of banking units to more nearly optimal size for their areas.

In reaching an ideal balance between banking safety and banking service, safety margins need to be judged in relationship to the likely exposure to four main banking risks: defalcation and embezzlement; mismanagement; environmental shocks; and liquidity crises. Judged in these terms, banking regulations appear to have been greatly over-protective regarding the risks of losses and failures. In current Pentagonese, we have an inordinate "over-kill capacity" where losses and failures are concerned.

The greatest single protection against defalcation and dishonesty is the internal and external accounting and auditing safeguards that bank stockholders must adopt to protect their own investment. These safeguards are operative wherever bank ownership is knowledgeable, and sufficiently separate from management to preclude an identity of interest in wrongdoing. Furthermore, such accounting and auditing safeguards are being continually improved, and can be pushed still further in this direction by appropriate stockholder and supervisory encouragement.

In addition to these accounting and auditing safeguards, banks today are further protected from these types of losses by bonding coverage.

Within the individual institution, capital funds are a cushion against losses from a variety of causes, including mismanagement and some environmental shocks. And those banks that are members of the Federal Reserve

System have in their reserve account an additional kitty of protection to their depositors.

Finally, an important source of internal strength in the banking system does not appear in the balance sheet at all. It is the integrity and competence of management itself. Properly selected, trained, and rewarded, this is a bulwark not to be underrated. And both bank management and directors have their skills repeatedly tested and buttressed by the examination processes of the bank supervisors.

External protection for depositors is afforded by the Federal Deposit Insurance Corporation, which has a broad-based capacity to handle nearly any situation that is beyond the internal resources of an individual bank in trouble. Deposit accounts up to the insured maximum are protected without question, and, in most cases, over-limit deposits are conserved by timely remedial action by the insuring or supervising agency.

The main, if not sole, exposure to loss that is not an isolated case is a nationwide collapse in capital values or a liquidity crisis. Protection against these perils is afforded by a whole range of private and governmental policies, with particular responsibility for countering such financial contraction resting on the Federal Reserve. Of course, should a bank wish to afford its own protection against these latter hazards, it could only do so by confining its assets to cash and very short Treasury bills. In so doing, it obviously would not be performing most of the essential services we associate with banks today. And this, I think, makes the point clear that the banker is more than a conservator--he is also an instrumentality for channeling the funds he has garnered into productive uses--preferably, and other things being equal, in the community where his bank is located. This phase of his function is deserving of more emphasis in the law and in regulatory practice.

As if all this were not enough depositor protection, banks are also hedged about with a great variety of rules as to what kinds of assets they can put depositors' money into, and in what proportions, and even as to what they can spend their gross incomes and capital contributions on, and in what amounts. The end result is a layering of regulation upon regulation, constraint upon constraint, in dimensions that invite ridicule and rebellion.

How does the bank stockholder and management come out in all of this? On the surface these private interests are secondary and in the short run may get short shrift. But that is not wise, for in the longer run--and to the degree capital and entrepreneurship are needed in the industry--it will be found that adequate earnings from banking do serve a public interest.

I would think--and again it is a matter of judgment--that for most responsible bankers and bank owners, regulation and statutory constraints are more of an annoyance than a hardship. There are exceptions, of course. Entry and merger constraints are the greatest handicap. But parts of the banking system are astonishingly resilient. Some, when denied the authority to develop local markets more intensively by prohibitions against branching, have turned their attention to national and international opportunities, competing aggressively for corporate business throughout the United States and over much of the free world. Thus it is not surprising to find that there are many large banks, both in and out of New York, with demand deposit totals heavily dominated by corporate deposits, a substantial portion of which is nonlocal. As for time deposits, the corporate CD reaches from any large bank to any large business in the country, as we know. The assumption that a bank is confined to the markets adjacent to the location of its main office, or its home office city, is becoming less valid every business day.

Thus the regulatory strictures on the right of entry, branching, and merger are overcome in significant degree insofar as larger bank customers and also bank stockholders are concerned, as their opportunities are not as easily confined as the patterns of the past would suggest.

On the other hand, all bank customers are not so fortunate. The great bulk of personal depositors, and most small businesses, do not have the capacity to reach much beyond the confines of their own community to obtain financial services. Thus, they are provided with only that quality and quantity of banking services that regulation has permitted to develop in their locality. Here, I think, is the real economic irony of over-regulation: with the intent of protecting in particular the smaller and less sophisticated depositor, we have created banking constraints that can materially inhibit the overall quality and quantity, and efficiency, of banking services to which he has access.

What is the best technique for extricating ourselves from the regulatory excesses or inadequacies that prevent the banking industry from achieving a greater contribution to economic welfare?

The greater part of my colleague's testimony before the House Banking and Currency Subcommittee was devoted to considering where to place the responsibility for Federal banking regulation: in a newly-created Banking Commission, with the Secretary of the Treasury, or with the Federal Reserve Board.

While I have no quarrel with his conclusion that Federal regulation should be in one agency instead of parceled out among two or three, I am not so sure that this one step is the cure-all for such fettering, or unfettering, of the banking industry as is desirable.

For example, I feel sure the public suffers more inconvenience and economic loss from the differences among the 50 State banking systems in the United States than it does from differences among policies and practices of three Federal regulatory agencies. But I take the inconsistencies and conflicts growing out of divergencies in State laws and their pre-emption over Federal banking law as a basic institutional fact that cannot be changed without a major political effort. And this, in turn, would, in the nature of things, require a stronger case for a single national banking system than I believe we are able to make.

Such facts as I am familiar with seem to indicate that if a given State confines its banking institution in any one of a number of ways, or if it so restrains entry and nurtures merger and concentration as to expose its citizens to monopolistic services and rates, most of the damage done is to local citizens and local business. The banking needs of regional and national business can be supplied from across State lines too readily for any such firm to have to put up with inadequate services or noncompetitive practices in any jurisdiction.

My agreement with Governor Robertson that we should have a single Federal agency is qualified, then, to the extent that I attach less importance to this one reform than I believe he does. In my view, the question of unification of regulation is subordinate to the broader issue of how far regulation needs to go in restraining competitive forces from providing better and broader services.

Regardless of how much or how little is accomplished by the unification of Federal agencies, however, I believe--in contrast to Governor Robertson--that the job could be done better by the Federal Reserve System than by any other agency that has been suggested.

It would do me little good to deny that institutional loyalty has anything to do with this view, though I believe loyalty colors my judgment far less than an understanding of the nature of the Federal Reserve System and its capacity to perform regulatory functions of this sort.

Any single agency, be it the Federal Reserve, a Banking Commission, the Federal Deposit Insurance Corporation, or the Secretary of the Treasury, if Congress provides an adequate directive and financial support, would do a better job than is being done now. My preference for the Federal Reserve System rests basically on grounds of economy and the advantages of decentralization. The Federal Reserve would achieve the same quality standards more economically than anyone else because it already has offices in 36 cities in the nation and transacts day-to-day business directly or indirectly with every bank in the country. The System's many service responsibilities require that these offices continue in operation whether or not any new, or other, agency performs the regulatory function. However, if the System is given the regulatory responsibility as well, its offices, administrative overhead, and regional know-how can serve this enlarged activity as well as existing Federal Reserve activities.

There are, of course, matters on which cost is a secondary consideration, but in this case I see no reason for deliberately creating or perpetuating a needless duplication of an existing nationwide field organization.

Governor Robertson contends that the Federal Reserve Board is too burdened with domestic and international monetary matters to have time for the regulatory functions. We at the Board certainly are burdened with monetary matters, but I doubt that increasing our time for abstract reflection and worry is the solution to the tough problems of monetary policy, particularly when it involves severing the link with the banking system that regulative and examining activities provides. Any one of a score of public officials in Washington has more functions, responsibilities, employees, problems, or whatever measure of work load one prefers, than the Federal Reserve Board.

Their and our work load is made manageable by formulating and adopting policy guidelines under which administrative responsibility can be delegated. Today, many of the System's responsibilities are placed on the Reserve Banks--more should be delegated to them, and I direct your attention to the Board's unanimous recommendation in its latest Annual Report seeking Congressional authority to delegate a variety of administrative matters to staff and the Reserve Banks.

The power to delegate regulatory activities would permit the Board to capitalize further on the advantages of the regional nature of the Federal Reserve System. Each Federal Reserve Bank's services and informational activities keep it in close touch with the economic and financial environment of its area. Its operating staff is in continual contact with each member bank, often on matters that reflect not only the needs and preferences of the bank but also those of the bank's customers. Such a background of intelligence puts Reserve Bank staffs in a position to be sensitive to changing community needs, and to draw on more qualitative as well as quantitative sources of judgment than would ever flow to Washington. Possessing such knowledge, and given administrative authority, the Reserve Banks would be in a position to act far more promptly on all regulatory situations than would be the case if the matter had to be referred to Washington for decision.

Their action, moreover, could be more smoothly coordinated with the regulatory activities of State Banking Supervisors, whose role remains vital as long as the dual banking system is retained.

In Washington responsibility would be focused on what a board is able to do best: the development and articulation of guidelines whose implementation is managed by the men on the spot. Such procedure is not alien to the Board of Governors; we already use such an arrangement in the conduct of open market operations and in lending to member banks through the discount window. If we can work out appropriate delegation of authority (as permitted by law) in the use of these two critical instruments of monetary policy, I have no doubt we can develop workable delegation arrangements with respect to appropriate areas of bank regulation.

In my own judgment, there are many delegable areas of regulatory activity, ranging from such technical matters as the approval of an intended investment in bank premises up to the approval of chartering and branch applications and the conduct of examinations. Applications for merger and holding company acquisitions arise much less often and, for the time being, should be left with the Board. The problem in these particular areas is one of developing a workable set of guidelines for the analysis of the competitive factor.

Another consideration that argues for centralizing all Federal banking regulation in the Federal Reserve System is the more intimate knowledge of banking development thereby revealed to the monetary authority. The supervisory and examination aspects of regulation involve an important by-product in the form of timely insights into banking behavior and motivation. These can be helpful in the evaluation of the effects of monetary action. Particular illustrations are the knowledge in depth that examination can provide of changes in the quality of bank credit, in the liquidity of bank portfolios, and in the terms and conditions of lending and deposit solicitation.

Let me be sure to leave you with a clear distinction between my major and minor themes. I am convinced the major problems of bank regulation are more in the substance of regulatory constraints than in the fragmentation of regulatory authority. The banking system is encompassed by a framework of regulations that I doubt will stand the test of a careful weighing of costs versus benefits in the contemporary environment.

Such a reevaluation is badly needed. It would probably proceed more expeditiously--and would certainly be implemented more efficiently--if all Federal bank regulatory responsibility were consolidated in a single agency. Were that to be done, I believe the organization and functions already vested in the Federal Reserve System make it the most logical place for such regulatory authority to reside.