Federal Reserve System

Speeches Burns

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The Federal Reserve and the Banking System

Remarks of Arthur F. Burns,
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<u>The Federal Reserve and the Banking System</u>

It is a pleasure to be with you here in Boca Raton this morning. I am particularly pleased because this meeting gives me a timely opportunity to discuss with leading representatives of the banking community some of the concerns which have been uppermost in my mind since February when I assumed my present position.

The principal concern of a central banker is, of course, monetary policy. I have already expressed my views on this subject at some length in two recent appearances before committees of the Congress, and I shall not return to it this morning. What I should like to do instead is to discuss with you the Federal Reserve Board's administrative and regulatory policies.

Let me tell you, first, how we have altered our administrative procedures. Almost all of the independent agencies of the Federal Government, acting on the recommendations of the Hoover Commission, now centralize administrative authority in the head of the agency. In keeping with this strong trend, the Board recently delegated the bulk of its administrative responsibilities to me as Chairman. I, in turn, have redelegated some of this authority to Governor Sherrill, who in the past has devoted considerable time and effort to this area. I expect that centralization of administrative control will significantly improve the efficiency of our procedures.

Other delegations of authority have been made to other members of the Board, to Directors of its Divisions and to the Reserve Banks, and still further delegations are contemplated. The result has been that relatively minor issues involving banking structure, foreign banking, and internal personnel procedures no longer consume much of the Board's time. We have been able to reduce our meetings from five days a week to three. And we can now devote these meetings largely to monetary and regulatory policy issues, besides attending to difficult or precedent-setting banking applications.

With regard to Federal Reserve actions affecting banking structure, we are taking steps to arrive at prompter action where this can be done without harm to the integrity of the regulative process. To further this objective, the Board recently created the new post of Program Director for Banking Structure, and named Mr. Brenton Leavitt, Deputy Director of our Division of Supervision and Regulation, to that post. He will be responsible for marshalling staff resources so as to expedite decisions on bank merger and holding company applications.

I should point out that progress in this area is all the more necessary because of the increasing number of banking applications coming to us. For example, during 1969, the Board issued decisions on 91 holding company applications, compared with 44 in 1968 and only 17 in 1965. During the first three months of 1970, we issued decisions in bank holding company cases at a rate in excess of 150 per year. Streamlined procedures have been introduced to process this increasing flow of applications on a timely basis. Our current goal is to handle all but the most difficult cases within 90 days of acceptance. Considerable progress has already been made in this direction, and we aim to reduce processing time below 90 days as our procedures improve. Let me add that you can be of considerable help to us in reaching these goals by submitting applications which give at the outset all the factual information needed to reach a decision.

The Federal Reserve's current emphasis on centralization and delegation of authority has already enabled us to discharge our responsibilities with increased efficiency and speed. Even more important, however, than these present results, is the improved capability these arrangements have given us to deal with new problems flexibly and effectively.

I would like to convey to you now the trend of current thinking at the Federal Reserve on regulatory policies. There are three basic strands in the Board's approach to regulatory issues. First, we always aim to formulate policies that are consistent with the safety and soundness of the banking system. Innovations that significantly threaten either of these elements are clearly undesirable in the long-run, whatever their short-term attraction may be. Second, as far as practicable, we are attempting to develop policies that will be consistent with market principles. Wherever we can, we wish to avoid introducing artificial constraints upon the free play of market forces. In this way the overall efficiency of our economy will be furthered. Third, our efforts are being directed at building a structure of regulatory policies that are consistent with effective monetary policy. Regulatory policies should provide a means for furthering, nor hindering, the execution of monetary policy decisions. This is a basic and inescapable constraint within which the Federal Reserve must work.

These efforts to improve our administrative efficiency and to rethink our approach to regulatory decisions have been the result of a continuing process. This process did not suddenly commence on February 1st. And, I can assure you it is one which will continue.

The changes within the Federal Reserve that I have been describing are fundamentally a response to changes in the financial environment during the past decade, especially the latter half of the decade. I would like to review with you what seem to me to be the major factors which have led to the new emphasis in Federal Reserve policies.

Bankers have had to function under an extremely tight monetary policy twice in the past five years. Though the banking industry has generally supported anti-inflationary policies in those years, the particular means and degree of the credit restraint to which the industry was subjected brought forth a stream of objections. Circumventing maneuvers by banks occurred not infrequently, and some of these elicited an eventual Federal Reserve response in the form of regulatory counteraction. These episodes were not calculated to endear either of our groups to the other. I shall explore with you a bit later what might be done during periods of tight money to prevent a recurrence of such episodes.

Significant changes have also taken place in the competitive environment of banking in the past ten years. Competition among commercial banks has increased sharply. Moreover, savings and loan associations, finance companies, and commercial paper issuers have grown in both size and number; new debt instruments have proven highly successful in drawing savers directly into the financial markets and away from such traditional intermediary instruments as bank deposits. This trend toward increasing competition for funds seems likely to continue. I suspect that in the future you will have to work even harder to acquire the funds you need. But, I am hopeful that your efforts to find new sources of funds will not create the strains our relationship has recently experienced.

The decade of the 1960's has also been one of remarkable change in the structure of banking. We have seen a sharp rise in bank mergers, an expansion of branch systems and of overseas banking activities, and a notable increase in the number of bank-holding companies, especially of the one-bank variety.

These rapid structural changes have been in part a cause and in part a result of the increasing competition of which I have spoken. They have also been both a cause and result of changes in the statutory and regulatory environment. Liberalizations as well as restrictions have occurred. But, where limitations on structural change have been imposed--as by the 1966 amendments to the Bank Merger and Holding Company Acts, the imposition of interest rate ceilings and the expansion of the Reserve Board's regulations, especially D and Q--increased burdens have inevitably been placed on the relationship between banks and the Federal Reserve. I would hope that these strains will in the future be eased, where this can be done without injury to the public interest.

Another factor which has been instrumental in transforming the banking environment has been technology. The new science of computers and of data processing has had, and will continue to have, striking effects upon our entire society. We have yet to experience the full impact of this technological revolution. The past decade contains some hints, however, of the order of change we will be experiencing. The present check collection system, I am told, owes its survival to the advent of automated processing. The new technology has facilitated the growth of banks, but it has also created problems. Corporate treasurers have learned to manage their cash flows better through the use of automated bookkeeping. Demand balances have suffered as a result, placing additional pressure on banks to seek new sources of funds. In a comparatively short time an electronic payments mechanism will be a reality. As we move towards such a payments system, even greater alterations can be expected in the competitive environment and structure of the banking industry.

At the Federal Reserve we are preparing our communications system for the payments mechanism of the future. At this moment, we are in the final stages of installing a highly advanced computer switching apparatus which will link all Federal Reserve Banks and the Reserve Board. This apparatus should be operating by mid-year. It will provide banks and their customers with a means of moving money and securities at a higher speed than ever before. The computerized operation will permit the gradual removal of limitations on the volume of transfers now imposed on the Federal Reserve leased wire network by manual operations and outdated equipment. This nationwide electronic grid will also be of considerable benefit to the Federal Reserve itself. High-speed communications with the Reserve Banks will improve the timeliness and availability of our data. We expect this improvement in the flow of information to aid our assessment of economic and financial developments.

The changes I have been describing in the financial environment and in the Federal Reserve's efforts to meet these changes through improvements in its equipment and its administrative and regulatory policies, must be seen against the broader economic and social setting which encompasses them. Significant changes in the financial environment are usually a reflection of far-reaching economic, technological, and social developments. Thus, the types of economic and social demands society will be making on the financial system will condition the types of activities in which both banks and banking regulators will be engaging. They will, therefore, partially determine the relationship between the regulators and the regulated. Within this setting, I believe ways can be evolved to enable banks and the Federal Reserve to interact more harmoniously in furtherance of the public interest.

Let me tell you then what I think bankers might do to help our relationship in the future. After that, I shall say a few words about what the Federal Reserve Board can do on its part. Please remember that these are not the official views of the Board, but simply my personal observations. I trust that you will treat them as such.

One way to improve our relationship would be for you to pursue policies which are more compatible with overall economic stabilization efforts. As you know, these efforts require that restraints sometimes be brought to bear on credit-financed spending. In this connection, the task of economic stabilization might be easier if bankers considered reforming some of their lending techniques. I am referring in particular to the practice, which appears to have grown of late, of making binding commitments for large amounts of credit tied to a conventional "prime" rate. Such commitments tend to insulate a sizable sector of credit from the effects of monetary policy. If bankers were to limit their commitments to totals they felt sure they could finance in periods of tight money, and if they charged at least as much for commitment take-downs as they themselves were paying for additional funds, I suspect that some of our nation's battles against inflation would be easier to win.

Another matter which I think deserves more attention is the underlying trend in the quality of credit. The period since 1965 has been of the kind which historically has given rise to deterioration in credit quality, sometimes with unhappy consequences. It is hard to tell to what extent the quality of credit has suffered in recent years, for statistics in this area are fragmentary, and oftentimes of dubious significance. We at the Federal Reserve are trying to press ahead with studies in this field. At this stage, however, those of you in the very midst of the lending process are in the best position to perceive the drift of credit quality. I urge you to be watchful, and to share your assessment of the situation with us.

Lastly, I would urge you to be extremely sensitive to the importance of preserving a vigorous competitive environment both within and outside the banking industry. If you keep this caution in mind, you may save yourselves a good deal of grief at the hands of the bank supervisory agencies, the Justice Department, and the courts. There is much yet to be learned about the essential ingredients and prudent limits of vigorous banking competition, and you can help to further understanding by your comment and example. But, progress in this area needs to be conditioned by a deep awareness of the value that is placed upon truly competitive banking alternatives being available to our citizenry.

The increasing demands on banks for new and improved services create considerable pressure for increases in the size and diversity of banking organizations. It is vital, however, for bankers to remember that public fears of undue concentration of economic power in banks are easy to rouse and difficult to lay to rest. Our nation's economic, social, and political philosophies are not congenial to the creation of monolithic centers of power along the lines of Japan's zaibatsu. Bankers have done very little to allay the fears of the American public, and of the Congress, that efforts to expand the scope of banking are leading us in this direction. Part of the problem here has been a seeming unwillingness on your part to have a sharp line drawn between banking and industry. I personally believe that a reasonable distinction can and must be made, difficult though that task may be. The One-Bank Holding Company Bill now before the Congress seems to me, however, to confine banks too narrowly. That it does so is at least partly a result of a gap in communication between the banking industry and the American people.

This communication failure is the greatest we have seen since the '30's. The banking industry has simply failed to win public understanding and acceptance of its lending practices, its charges, and its aspirations. The result has been a rising level of suspicion and even antagonism. I think the time has come, indeed is past due, for making every possible effort to correct this unfortunate state of affairs. I urge you to take positive steps in this direction.

Now I should like to turn briefly to what I believe the Federal Reserve can do to serve the banks and the public interest more effectively. First, we need certainly to press forward with current efforts to improve our administrative efficiency. Next, I can assure you that we shall try to be sensitive to the effects of changes in the financial environment on the competitive position of the commercial banking industry. In that connection, let me remind you that in February of last year, in a statement dealing with the proper scope of banking activities, the Board expressed the view that "banks should be granted greater freedom to innovate new services and procedures..." when these activities are not inconsistent with the purposes of the governing statutes. I look forward to Board action in the spirit of this statement of principle as we consider the bank regulatory issues ahead of us.

I have mentioned before the importance of permitting market forces in banking as much free play as is consistent with the protection of the public interest. This is the kind of generality that is easier to express than to apply, for the pragmatic considerations of the moment often press in an opposite direction. In my view, however, banking is burdened with too many regulatory legacies of past circumstances in which pragmatic concerns overrode market processes. To cite a specific example, I regard interest rate ceilings on deposits as one device that is overdue for serious re-examination. As a matter of personal economic philosophy, I would like to see an evolution away from reliance upon interest rate ceilings as an ancillary device of monetary policy, at least as far as instruments of the money-market type are concerned. When and as circumstances permit, I believe an element of greater economic rationality would be introduced into the financial system if interest rates on such instruments were permitted to find their own level as a result of market forces.

Finally, the Federal Reserve needs to explore means of achieving a more equitable impact of monetary policy on all segments of the economy. The strongly adverse effects of a tight money policy on the housing industry, state and local government financing, and small businesses need hardly be amplified. The public, quite rightly, is especially concerned about housing, which has borne a large portion of the burden of tight monetary policy. Efforts to alleviate this situation must be made.

Among the various proposals now before the Congress, one would require the Federal Reserve to provide up to $3 billion a year to the Federal Home Loan Bank system to support the middle-income housing market. While the underlying intent is commendable, this proposal would undermine the Federal Reserve's ability to stabilize the economy and would eventually lead to our supporting other special segments of the economy. The consequence would be a drastic diversion of the Federal Reserve System from its historic and essential role of protecting the integrity of the dollar and promoting stable prosperity for our nation. I need hardly tell you that I am doing everything I can to promote wiser legislation.

The Federal Reserve has been accused of insensitivity to the nation's housing needs. This is by no means true. We are well aware of the plight of the housing industry and we have underway at this moment a major study of housing finance needs. Its results, I hope, will indicate what steps may dependably be taken to improve the housing situation. A great deal of study will have to be devoted also to other sectors of the economy, particularly municipal finance. Necessary changes are likely to be of a kind that take considerable time to put into effect. Some of them may make the banker's job easier, and some may make it more difficult; but, like all the ideas I have been expressing, they will stand the test of time only if they promote the long-run welfare of the nation as a whole.

Now seems to me a particularly apt time for us at the Federal Reserve to be re-examining our relationship with the commercial banking industry. At this moment financial markets and institutions are under somewhat less pressure than earlier. Money, bank credit, and savings flows are again beginning to expand moderately. There is reason to believe that changes in the financial environment will result in a relaxation of some of the constraints under which banks and their regulators have been operating. The decade before us promises to bring with it even greater changes in banking than the past ten years have brought. I firmly believe that we can learn from the hard-earned lessons of the past--that we can find ways to discharge our responsibilities in a spirit of greater harmony and thus bring out the best in both of our institutions. The ultimate ~~benefactor~~ beneficiary will be not the banks, nor the Federal Reserve, but the public we both serve.

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