# FDIC NEWS RELEASE

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Address by

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It is a pleasure for me to return to Wisconsin and to see so many of my good friends. I want to share with you today a few thoughts on the development of the banking industry over the past quarter century and then turn briefly to some of the issues confronting both banks and bank regulators. Before proceeding further I should state that the views I express today are my own and do not necessarily represent the views of the other members of the FDIC Board.

BANKING YESTERDAY AND TODAY

The banking industry has been closely scrutinized and often criticized during the past few years. Some view it as thriving on tradition and being unwilling to make change, but in my opinion the industry has been constantly evolving to meet the demands of a rapidly changing economic and social environment.

Let's look at the record over the past 25 years. During this period the United States has experienced increased (and increasingly mobile) population; continued economic expansion, particularly in the service industries; major new technological developments; shortages of certain resources, particularly energy producing; and dramatically changed social attitudes. Banks found that in order to grow and to satisfy our Nation's financial needs, both product and geographic markets had to be significantly broadened. This, in turn, required bankers to become better business people with more sophisticated knowledge of basic management techniques including cost controls, asset and liability management, marketing, corporate finance and personnel management.

Let me give you a few statistics to demonstrate my point. From 1952 to 1977 assets of commercial banks increased from $205 billion to $1.3 trillion while deposits grew from $188 billion to $1.1 trillion. More telling is the change in the asset mix. In 1952 cash represented 22 percent of total assets whereas in 1977 it was down to 18 percent. Investments in securities declined from 41 percent to 19.2 percent. Net loans, on the other hand, increased sharply from 35 percent of total assets to approximately 53 percent. Within the loan portfolio, as a percentage of total assets, commercial and industrial loans increased by 50 percent, real estate loans rose by 40 percent, and loans to individuals climbed by 230 percent.

Banks in 1952 were essentially in the business of making short-term, commercial loans and investing in U.S. and municipal securities. Since then banks have added a substantial number of diverse types of loans--particularly in the retail or consumer sector--and have increasingly provided industry with not only a large proportion of its working capital but also with much of its long-term financing needs.

Banks have also strived to provide more convenient services by lengthening banking hours, developing electronic funds transfer systems and expanding their physical presence in their communities. Banking offices more than doubled during the period, going from approximately 19,000 in 1952 to over 48,000 in 1977. Many new services were more extensively developed by banks, including credit-card loans; certificates of deposit; data-processing and cash-management services; commercial and consumer leasing; and commercial and consumer finance services. The larger banks expanded vigorously on an international scale and "liability management" became the name of the game in the scramble to fund the rapid growth in assets. Low cost sources of funds were sharply curtailed as competition for funds intensified, and businesses and then consumers became more aware of the value of their money. Finally, bankers utilized new methods of conducting business, such as bank holding companies, to allow greater operational flexibility. Holding companies now hold approximately 70 percent of the Nation's deposits and operate over 23,000 banking facilities.

While banking has obviously become far more service oriented over the past quarter century, it has also encountered many new challenges and risks. The growth in the financial services industry and a changed regulatory climate have spurred competition for banks from many sources. Banks and bank holding companies have obviously become much more competitive among themselves. Competition has also come from nonbank financial institutions such as savings and loan associations and credit unions. These institutions enjoy certain privileges that banks do not and are now engaging in services and activities that were once the province of the banks. As a result, long-established competitive barriers have been eroded. Most recently, U.S. banks have encountered competition from foreign sources. Foreign banks have increased their presence in the U.S. and now control over $25 billion in domestic deposits. These institutions enjoy a competitive advantage over U.S. banks in that they are able to avoid, depending on the structure of their operations, reserve requirements, deposit insurance premiums, and restrictions on interstate banking.

Moreover, there is an additional $67 billion outstanding in commercial paper--deposit-like funds which are obtained directly by various corporations. Of this amount, approximately $57 billion is issued by nonbank financial firms. In addition, there are large retail trade, insurance, and investment banking firms which offer credit cards, loans, and cash-management and other services in direct competition with commercial banks.

International banking now represents a material part of the operations of many large banks and is filtering down to smaller institutions, some of which may not have the expertise to fully evaluate the various risks involved. Asset growth has outstripped core-deposit growth, necessitating an increased reliance on less stable, borrowed funds. In addition, some banks have committed vast amounts of funds to newly-developed types of lending arrangements, such as REIT loans, before fully understanding and assessing the risks.

Banks are finding themselves much more sensitive to changes in the economic environment as they further leverage their operations. The recent pattern of recession, inflation, and "stagflation" accompanied by wide fluctuations in interest and exchange rates have mandated that banks constantly review their asset and liability mix, liquidity, and credit standards and controls. The industry's 64 percent loan-to-deposit ratio in 1977 compared to 38 percent in 1952 almost by definition involves greater risks for the banking system.

LOOKING AHEAD

Despite the rapid pace of change in banking over the past quarter century, and all of its accompanying turmoil, there remains a full agenda of issues for bankers and their regulators to tackle in the years ahead. Let's look at a few of them.

DEREGULATION

One of the most complex and difficult subjects to deal with is deregulation of the banking industry. There is no question in my mind that the banking industry is over-regulated and that this situation is not in the best interests of either banks or their customers. To the extent that we regulators are responsible for and have control over the regulations, we should act promptly to simplify or eliminate them. We recently established a task force at the FDIC for that very purpose.

Probably the best example of a banking regulation that cries out for simplification is Regulation Z, or "Truth-in-Lending." Before you applaud, let me hasten to state that I have absolutely no quarrel with the objective behind Regulation Z -- debtors are entitled to full and simple disclosure of the basic terms of their credit transactions, and before Truth-in-Lending they were too often not receiving it. But it ought not to require volumes full of regulations, rulings, and interpretations of rulings to achieve that laudable objective.

Creditors ought to be able to comply with the law without having to resort to batteries of lawyers. In my opinion, it is imperative that Congress and the Federal Reserve Board act promptly to simplify Truth-in-Lending. In that process, I believe that serious consideration ought to be given to either exempting entirely the small banks or at least imposing less onerous requirements on them.

Deregulation of banking, to me, involves far more than merely simplifying or even eliminating a few regulations that many people might consider bothersome. Over a period of time we must also consider eliminating some laws which restrain competition among banks and between banks and other financial intermediaries.

Interest rate controls can no longer be justified. They clearly produce disintermediation, leading to a stop-and-go flow of funds to housing. Corporate and upper-income borrowers are benefitted at the expense of small savers who have neither the resources nor the sophistication to obtain a higher rate of return on their money. Variable-rate mortgages, tax subsidies, and other incentives should be put into place as alternatives to rate controls to ensure that funds will be available for housing.

Prompt and serious consideration also should be given to phasing-out restrictive branching laws. The first step might be to allow branching within a certain radius or perhaps within SMSA's without regard to State boundaries. Having just moved to Washington I find it difficult to accept the fact that I must now bank with two different organizations, one in the District, where I work, and one a few miles away in Virginia, where I live. The same situation exists in many other cities and towns throughout the country. The customers of banks are the most obvious losers under this arrangement. But as competitive pressures increase from the larger holding companies and from foreign banks, savings and loan associations, credit unions, investment banking firms, large retailers, insurance companies, and the like, it is becoming more and more clear that the banking industry itself is suffering from these restrictions.

If these restrictions are phased-out, we regulators must take great care to ensure that the smaller, independent banks continue in business and remain viable. One of the great virtues of our Nation's banking system, in my view, is the fact that we have thousands of small, independent banks. We must vigorously enforce existing antitrust laws to control anti-competitive mergers and predatory practices. Indeed, it may even be desirable to adopt more stringent laws in this area, although I totally disagree with proposals to create arbitrary limitations on the percentage of a State's deposits held by a single banking organization.

I believe strongly in the free enterprise system. For it to work we must have fully competitive markets. If banks continue to operate as utilities, in a protected environment, they should expect increased government interference in their business. Deregulation, in the true sense of the word, will never come about until banks shed some of the protective legislation adopted nearly half a century ago in reaction to the Great Depression. It is doubtful that much of this legislation was justified at the time it was adopted; in any event, it has probably outlived its usefulness.

## SOCIAL RESPONSIBILITY

Banking has always been closely associated with the public interest. In the past the public has tended to focus on issues regarding the safety and soundness of the banking industry and on its competitive structure. In recent years Congress has identified a new agenda of social problems and has turned to the financial sector for at least some of the solutions.

We see this current of social responsibility running all through the banking legislation of the past several years. It is evident in many areas--in anti-redlining laws, in truth-in-lending regulations, in credit-evaluation standards, and in privacy protections. At its best, this is a desirable trend. It encourages bankers to take a greater interest in the human side of their services and to help to upgrade the quality of living for everyone in their communities. It can also be profitable. Banks stand to gain more business as the financial health of their communities improves. We must recognize, however, that there is also a more ominous side to this trend. At its worst, it can degenerate into a hostility toward business that can gravely injure the prospects for social and economic gains for everyone in our society.

I believe that bankers can see to it that the positive aspects of social action are the ones that dominate. In the conduct of your business you must do more to create a spirit of cooperation. You must be more sensitive to the needs of all sectors of your communities. You must communicate more effectively with the public and demonstrate that you are conducting your affairs with the best interests of your communities in mind.

The Community Reinvestment Act is a good example of the modern kind of social action legislation. Congress found that many low-income areas did not have an adequate reservoir of credit to finance local development. Congress also found that many banks and thrifts were making a large number of out-of-area loans, the overall effect of which was to draw money out of the communities where the funds had been deposited. The Community Reinvestment Act is designed to help reverse these patterns.

The role of government under the Act is comparatively minor; it emphasizes private initiatives by financial institutions. The Act calls on these intermediaries to invest in their communities wherever possible, consistent with safety and soundness factors, and to make a special effort to meet the needs of low-income customers. The regulators are to determine how well each institution is complying with this goal and to take this record into account when the institution applies for permission to branch, merge, or expand in various other ways. But there are no draconian penalties imposed, and no private right of action has been created. We expect that, with encouragement and leadership from the regulators, bankers will carry out the spirit of the Act. It is important to recognize, however, that the Act is only one possible way--and a comparatively gentle way--of encouraging financial institutions to serve this particular public need. If this plan does not work, Congress could well turn to stronger measures.

In my opinion one of the most pressing needs of our Nation is to bring about full participation in our economic system by those whose participation is presently very limited. Bankers, if they use their resources and ingenuity, can be part of the solution.

Bank regulators must help by providing leadership, guidance, and, where possible and appropriate, incentives. We must work to better understand the financial needs of our society and to cooperate with banks, community leaders, public interest groups, and others to ensure that our economic system is open to everyone. Although one of our primary responsibilities is to insure the safety and soundness of the banking system, we also have an obligation to make sure that bankers know what we expect of them with respect to social legislation. Open and effective lines of communication have to be established and maintained. We have conducted seminars for bankers on a sporadic basis for various compliance matters. In the consumer and civil rights areas, where laws and regulations have proliferated, these types of programs can be particularly helpful. I will be encouraging more extensive FDIC participation and will certainly be receptive to your suggestions as to how this can be best accomplished.

## REGULATORY AND ENFORCEMENT POLICIES

A. Insider Dealings. One of the hottest banking issues involves insider transactions by bankers. There is no question that there have been some serious abuses in recent years by insiders of some banks. Since 1960 we have had 106 bank failures in the United States. In approximately 57 percent of the cases abusive insider transactions played a major part in the failure and in another 25 percent the major factor was fraud or embezzlement. These failures have cost the FDIC well in excess of $100 million and should not be taken lightly.

Yet we should keep them in proper perspective and not react with overly burdensome or punitive legislation or regulations. There are over 14,000 commercial banks in the United States and less than 100 have failed in the past 18 years because of dishonesty. I am not sure that we could have prevented the majority of those failures had we possessed every enforcement tool known to man.

Until recently the bank regulatory agencies were very reticent to use the enforcement powers at their disposal. During the 5-year period from 1971 through 1975, for example, the FDIC issued only 53 cease-and-desist orders. There has since been a dramatic change in attitude. In 1976 we issued 41 orders and in 1977 we issued 45. When we uncover insider abuse we bring it to the attention of the bank's full board and work with the board to remedy the situation. If that fails to produce quick results, formal enforcement proceedings are promptly commenced. Moreover, we have adopted an insider regulation which requires that bank boards review and specifically approve loans to directors and that a record be kept of any dissenting votes. We have taken this approach because it helps to keep down the cost of oversight, and it requires the directors to take full responsibility for these transactions.

I know that nearly all banks fully support a vigorous enforcement effort by the bank regulatory agencies. Abuses are not widespread but to the extent that they exist they create serious problems for every bank in terms of loss of confidence and esteem, not to mention the problems which stem from the resultant legislative and regulatory reaction. We at the FDIC intend to do our part to make this an issue of the past.

B. Capital Adequacy. Another matter of serious concern to us at the FDIC is the continuing decline of equity capital in commercial banks, a trend that has continued almost unabated since the early 1800's. As mentioned earlier, banking has grown considerably more complex and has assumed substantially greater risks during the past quarter century. At the same time, equity capital ratios have decreased, falling from 7 percent of total assets in 1952 to 5 percent in 1977. The decline has been particularly pronounced in the larger banks. The FDIC is concerned about this trend, and we have established a high-level task force to study, among other issues, the common practice of utilizing subordinated debt in place of equity capital.

C. Credit Life Insurance Premiums. A third regulatory issue which I want to touch on today is the practice followed in some banks of allowing officers to collect personally credit life insurance commissions. As you know, some feel that the profits earned from the sale of insurance should inure to the benefit of the bank; indeed, the Comptroller of the Currency has adopted a regulation requiring that National banks receive these profits. Once again, this issue is under active consideration by a task force at the FDIC. I hope that the study group will complete its work in the near future and present its recommendations to the Board of Directors before the end of the summer. If the Board decides to act in this area, I am sure that we will allow plenty of opportunity for public comment and will appreciate any thoughts that you might have.

## CONSOLIDATION OF BANKING AGENCIES

I want to address briefly one more major issue before closing. The subject of consolidation of the Federal banking agencies is once again before the Congress, and the proposal probably has a better chance of being enacted than at any previous time.

My position on this issue is one that I have held for several years. I oppose a complete consolidation of the Agencies, but I favor an alternative reorganization proposal, one that will streamline our present system while preserving the dual banking system of which I am a strong proponent. Essentially I believe that the formulation and implementation of monetary policy should be separated from bank supervision. In other words, the Federal Reserve Board should be removed from bank supervision and regulation, and that authority should be given to the FDIC for all State banks. I do not believe that the Federal Reserve needs to be involved in bank regulation in order to carry out its monetary policy functions; indeed, it seems to me that bank and bank holding company regulation amount to little more than a distraction that the Federal Reserve could do without.

Probably the most serious inadequacy in the present regulatory framework at the Federal level is the separation of bank holding company supervision from bank supervision. Several recent bank failures have been caused in large part by massive unsafe and unsound practices which occurred in the bank's parent holding company or its nonbanking subsidiaries. It seems to me that this problem should be remedied by giving the bank regulator which supervises the lead bank in a holding company system the primary supervisory responsibility for the entire system.

I have tried today to touch briefly on a wide range of issues. I no doubt have raised more questions than I have answered so, if we have some time, I would like to respond to anything that may be on your mind.

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