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GOALS OF A REGULATOR: THE NECESSITY FOR BALANCE

Address by

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before

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Today I will discuss some of the issues facing the banking industry and consider the general direction in which the industry may be heading. There is a full agenda of issues that deserve thoughtful attention and require an open dialogue among bankers, regulators, public interest groups, and legislators. It is important, as we consider these key issues, to keep in mind the need for a balanced approach. Too often we proceed down the agenda, item by item, and fail to capture the total consequences of our recommendations. A theme of balance is not new; in a sense it is age-old, dating back at least to the ancient Greek philosophers. They saw the universe as a harmony of opposites: all things were composed of contraries -- the one and the many, the limited and unlimited, rest and motion, and light and darkness. Aristotle translated this view of universal contradictions into the ethical mean -- what came to be known as the "golden mean" -- where virtue was seen to occupy a middle position between the extremes. Horace put it in more practical terms: "Whoever cultivates the golden mean avoids both the poverty of a hovel and the envy of a palace." The wisdom of these ancient philosophers has significance even today.

As Director of the FDIC, I am committed to four major policy goals:

<u>The first</u> is ensuring a safe and sound banking system;

<u>The second</u> is fostering a competitive, efficient, and innovative banking industry;

<u>The third</u> is encouraging a socially-responsible banking industry; and

<u>The fourth</u> is maintaining an efficient, responsive, and equitable regulatory system.

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Almost all major issues and problems facing the banking industry can be evaluated within the context of these objectives. On the surface there appear to be some potentially serious conflicts among the goals. Encouraging competition can sometimes be at odds with ensuring the safety and soundness of the banking industry. Pursuit of social responsibilities can conflict with a commitment to a sound and profitable banking system. The fact that tensions exist among these goals brings home the point that a balance must be struck -- that positions on particular issues cannot be taken in isolation without regard for how they affect the balance among competing policy objectives.

Let us consider some key issues facing banking within this framework of competing policy goals. The controversial issue of eliminating or phasing out interest rate controls is certainly topical considering the Presidential task force on Regulation Q and the recent experiment with money market certificates of deposit. The arguments for deregulation are compelling. Interest rate controls have generally worked to the disadvantage of small savers. In fact, in this time of high inflation rates, individuals who keep their money in passbook savings accounts must, by law, accept a negative real return. Interest rate controls also have led to disintermediation, inducing a stop-and-go flow of funds to residential mortgages. Perhaps the housing industry would be better served by eliminating Regulation Q and usury ceilings, initiating variable rate mortgages with appropriate safeguards, and legislating direct tax incentives and subsidies.

On the other hand, consider the implications of deregulation, particularly as they reflect on the safety and soundness of the banking industry. As interest rate controls are phased out, many financial institutions will find that their business is more complex and management judgment is at a premium. Experience with the money market certificates has already demonstrated that these new instruments cannot be offered pell-mell -- that management must fit them into its overall liquidity plan, earnings forecast, and strategy for growth.

We must also consider the changes that have taken place in the banking industry. Banking has become increasingly competitive over the past 30 years. Bankers have dramatically restructured their balance sheets since the years when war financing needs dominated. Risk assets grew from 22 percent of total assets in 1945 to approximately 74 percent today. Bankers created the concept of liability management when they introduced the certificate of deposit in the early 1960s. The bank holding company movement further blurred the distinction between banking firms and other financial intermediaries. Our banks went overseas looking for growth opportunities, and foreign banks came to the United States for the very same reason.

Meanwhile, the economic environment has also changed. Perhaps the most significant change has been the gradual rise in the rate of inflation over the past 15 years. Inflation rates, which averaged from 0 to 3 percent in the early 1960s, now run in the 6 to 8 percent range, and sometimes even higher. In a number of complex ways, inflation has probably had the effect of increasing the risk in the economic environment. The incentive for both households and businesses to leverage is accentuated during periods of accelerating inflation. While the post-World War II experience with rising debt levels has probably been beneficial in many respects, at some point the debt service burden becomes too high and the margin for error -- the ability to withstand a surprise event -- becomes too small. Inflation has also acted to increase uncertainty and probably accentuate general instability in the economy.

Whatever cause one chooses to focus on, and there are undoubtedly many causes other than inflation, the symptoms of increased risk are there. In the early sixties, we averaged two bank failures a year; today we are averaging about ten per year, and they are of a significantly larger size. Charge-off ratios for both consumer and business loans are at a secularly higher level today. Loan loss reserves, which used to average as high as 2 percent of loans, are now in the area of 1 percent of loans or below. Capital ratios have continued their secular decline. In 1945, the industry had equity capital equal to 25 percent of risk assets; in 1977, it was less than 10 percent. I will not be surprised if the figures eventually show that this year the equity capital cushion has declined to near the 1974 low of about 8.5 percent. In part due to inflation and in part due to increases in the deposit insurance limit, the deposit insurance fund has substantially declined as a percentage of insured deposits.

All of these facts and figures lead me back to my central theme. As we examine the deregulation issues facing the banking industry, we must recognize the importance of balance between competition and risk-taking on the one hand, and the stability and soundness of the banking system on the other. As we move to eliminate interest rate controls or branching restrictions, we must do so cautiously, one step at a time, carefully measuring the effect of each move and allowing time for adjustments. Moreover, we must move with equal vigor to strengthen the capital position of the banking industry and other risk buffers such as profit margins and loan loss reserves.

We must also monitor the effects of our actions on the competitive structure. This will be particularly true when we undertake to review the McFadden Act as mandated by Congress in the International Banking Act. I generally favor liberalized branching laws. However, if the McFadden Act is repealed or amended, serious thought must be given to the adequacy of existing laws and regulations concerning anticompetitive mergers and predatory practices. The intent of changing existing branching laws presumably is to promote competition within the banking industry and to allow banks to compete more effectively with other financial institutions. We must make sure that is the effect as well -- that we do not end up with a very concentrated industry structure. In my judgment, one of the great strengths of our present economic system is the presence of thousands of small independent banks and small independent businesses. I suspect that they are mutually supportive. We must not take action on one issue, such as branching, and ignore the possible consequences for the structure of the banking industry and, perhaps, the structure of the entire American business system. I am not arguing against change; indeed, change will probably occur with or without modifications in laws or regulations. I am arguing for controlled change -- for a balanced evolution of the banking industry to meet the demands and challenges of the 20th century and beyond.

Consider the third goal -- that of encouraging a socially-responsive and responsible banking system. The Community Reinvestment Act and the attendant new compliance regulations and examinations are currently the central issues in the area of social responsibility. Admittedly there are potential conflicts between this law and the goals of bank safety and soundness and efficiency in banking and bank regulation. Many bankers have told me that they see the potential for credit allocation in CRA -- clearly the ultimate conflict. Yet, I believe that a balanced and reasonable approach is both possible and necessary. Most bankers have long recognized that they serve several constituencies -- stockholders, borrowers, depositors, employees, and the community-at-large. As the community grows and prospers, bank deposits expand, high-quality loans are generated, and the bank benefits. If a bank is aware of its local community, is knowledgeable about the various kinds of credit needs, and is innovative in fashioning its services, it will be well on the way toward meeting CRA's requirements and fulfilling its role as a good corporate citizen. CRA does not dictate that a bank make a certain kind of loan, in a certain neighborhood, to a particular individual. But it does mean that bankers cannot pursue profits with a narrow, single-minded determination. Bankers must recognize social objectives. The alternative is not pleasant: the government might well step in and do it for you -- and probably not as well and at a higher cost. It is in our self-interest as bankers and regulators to take a balanced and constructive approach to CRA, in particular, and to the idea of social responsibility, in general. It is probably the only viable long-term strategy.

The fourth goal calls for maintaining an efficient, responsive, and equitable regulatory system. Again, balance is a necessity. Take, for example, enforcement activities. The FDIC and the other bank regulatory agencies have a legislative mandate to guard against abusive insider transactions, violations of consumer and civil rights laws, and other unsafe and unsound banking practices. Insider abuses and fraud have been responsible for the vast majority of our bank failures over the past 15 years. Consumer and civil rights protection are important to the maintenance of public confidence in the system. However, we must take care that our resources are allocated properly and that we do not overreact with redundant or punitive laws and regulations. Vigorous use of enforcement tools such as our cease and desist powers can be quite effective when voluntary compliance is not readily forthcoming. But we should involve the private sector in the regulatory process to the greatest possible extent. The FDIC has attempted to accomplish this by requiring more involvement and oversight by boards of directors. We have also encouraged greater use of codes of ethics and other techniques for self-regulation. Finally, we have moved toward more public disclosure regarding the practices and condition of banks. The vast majority of banks has everything to gain and nothing to lose from increased disclosure. The public will come to better understand the vital role that these institutions perform in our society and will develop a greater appreciation for their integrity. At the same time, this information will allow the marketplace to regulate to a greater extent those few who fail to conform to acceptable standards. This will enable government to lower its profile.

There are many other issues and conflicts that we could explore. But I have gone on at some length, and, by now, the task of bank regulation must appear hopelessly fraught with conflicts and confusion. I do not see it quite that way. There are conflicts and there is confusion. But the task of resolving the conflicts and bringing order to the confusion is far from hopeless.

In this process, I am guided to a large extent by the principle of free enterprise. To be sure, even the concept of free enterprise must be accepted with a degree of moderation, for history clearly teaches us that there is a legitimate role for the government to play in banking. But, in my opinion, the government's role should be as limited as possible and should be focused squarely on fundamental issues.

Viewed in this context, the balancing act does not appear quite so formidable and the conflicts seem more soluble. Free enterprise cannot exist without competition. Price competition -- i.e., interest rate competition -- is part of the package. Less restricted entry into markets is also important. At the same time, however, we cannot have competition without strong competitors; thus there is a necessity for evolution rather than revolution, for insistence on capital standards, for encouragement of good profit margins, and for vigorous enforcement of antitrust laws.

Free enterprise is not viable without socially-responsible corporate behavior. Our society has made it abundantly clear time and again that it expects its corporations to concern themselves with the social and environmental well being of the nation. Profits are essential; they are the cornerstone of the free enterprise system. Without profits, progress toward social goals is not possible, but the pursuit of profits cannot be single-minded.

Finally, free enterprise is not possible without adequate public information and education. The marketplace cannot regulate corporate behavior unless it has the information necessary to informed decision making. In the absence of effective marketplace regulation, the government normally fills the void, albeit less efficiently.

In sum, there are four major policy goals to which I am committed:

A) Ensuring a safe and sound banking system;

B) Fostering a competitive, efficient and innovative banking industry;

C) Encouraging a socially-responsible banking industry; and

D) Maintaining an efficient, responsive, and equitable regulatory system.

There are often tensions between and among these goals. We must be aware of the necessity for balance in the pursuit of any one of them. This balancing act is made easier for at least one regulator by his faith in the free enterprise system. If we keep these objectives in mind and pursue them within the framework of a strong free enterprise system, I have no doubt that the outlook for banking will be very bright indeed.