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The Goals of Bank Regulation
An Address by
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The world is not born new every morning. It has a character and a direction which determines its near future. We often have the sense that we can make it over, but that sense usually proceeds from a delusion of youth or the arrogance of rationalism.

Nonetheless, if we spend an evening addressing the issue of appropriate goals for bank regulation, it is a harmless waste, intellectual jogging which, if nothing more, will tone up our mental musculature. And if we discover that bank regulation, in fact, is misguided in seeking the goals it seeks or wrongheaded in the methods it uses, one gets a bonus for an evening's effort -- that delicious sense of superiority of sharing with a small elite a truth which, even if given broad public notice, would have precious little effect. It is a cult pleasure to know one is right in a world gone wrong.

Broadly there are two ways to approach the issue, what are the appropriate goals for bank regulation. One is to examine what law has required of banks and why the law has so required as revealed by legislative intent and judicial interpretation. The other is to address the issue frontally as a problem in social philosophy and social engineering.

The first method, the exegesis of legislative intent, is the traditional and highly favored one. The method grows from the research necessities of litigation; that is to win a case it helps to argue that your client's position is four-square with the letter, spirit and intention of the law. But that method is ill suited to the task of establishing what we as a people should be striving to accomplish in any collective political undertaking. The divining of legislative intent is backward-looking; the analysis of appropriate goals looks forward.

The method presupposes that legislatures and courts somehow express social wisdom. Much effort and time is spent incanting over the records of legislative deliberations to distill quintessential motives. Those legislators of yesteryear suddenly grow to the stature of statesmen who collectively are thought to have a rational structure of social values and an articulated theory of social process unerringly expressed in statute law. And it is thought, by means of Talmudic dedication that strucutre of values and that theory of process may be seen as through a glass darkly. In fact, of course, those legislators of yesteryear have no more an orderly social philosophy than legislators today, and the group dynamics of the legislative process typically provides no more than a Delphic statement of intention. The courts, bless them, out of sheer necessity provide sensible dimension and order to statute law. The judges, as medieval doctors before them, lend an intellect to text it would otherwise lack.

No, we are stuck with the second approach, making a frontal attack on issues such as we face tonight, if we are to say anything meaningful about the proper goals and their priority. This approach asks what social benefits are we seeking, what costs do we incur if we use one means rather than another and who gains, who loses and how much from the choice of one method or another. To be sure, 15 minutes will not do justice to that assignment, but I shall attempt a sketch in the spirit of that approach in any case.

The primary forms of regulation of financial institutions are:

(1) control of entry;

(2) Control of mergers and acquisitions; and

(3) regulation of portfolios (lending, investing and borrowing powers and restraints).

The two most important goals of regulation have been "competition" and "safety". The concern for competition has manifested itself most clearly in public policy toward bank mergers and holding company acquisitions. The concern with safety has been the more dominant theme in the regulation of entry--branching and chartering policies--and in the regulation of portfolios of depository institutions. The public support for competition among depository institutions has rarely been positive, to encourage competition, but rather, to discourage monopoly, market power, or excessive concentration of resources. The concern with safety has been motivated primarily by a desire to protect the banking system and other depositories from breakdown in order to contain the severity of economic dislocation and secondarily, to safeguard the liquid capital of depositors of small means.

While both safety and competition considerations have been important in shaping the character of the regulation of depository institutions, it was only after the Great Depression that the two goals were thought to be in irreconcilable conflict. The economic collapse of the 1930s was so severe that considerations of safety became paramount. Indeed, most of the restrictive legislation and regulation governing depository institutions dates from the Depression, perhaps more than is generally realized. The checkered performance of the banking system earlier in our history resulted over time in a slow development of restraining regulation, but the regulation introduced in the 1930s makes all that preceded appear modest by comparison.

Government has also sometimes intervened to encourage or direct institutions to make socially desirable investments or perform socially desirable services. Early in American history, banks were organized to finance major public utilities, such as roads, canals and railroads. More recently residential housing has drawn major support from government programs to induce or require financial institutions to provide an ample flow of funds at less than market rates to finance residential construction. The social priority of housing has assumed such singular importance in recent years that it may prove ultimately to be as important a shaping force as safety and competition have been to date.

Other social motives have also played a role in the regulation of depository institutions. One notable example is market intervention on behalf of buyers or sellers who are weak or disadvantaged. Consumer protection legislation and usury ceilings are cases in point. Another motive is the protection of investors. For sometime it was thought that banks would be exempt from the full force of investor protection safeguards. It is now clear that such is not the case.

Still another motive has been to assure a "fair" distribution of credit. This motive was important early in our history when, in a savings-poor country, credit was in particularly short supply.

Finally, bank regulation also is charged with preventing irresponsible or fraudulent banking. This function, of course, has been a high profile issue for the past year since the Lance hearings. Interest in the issue has been maintained by the introduction and fluctuating vitality of the Safe Banking Act and the report on insider loan and overdraft practices of American bankers. While some argue that the regulation of insider dealing is simply an aspect of regulating for safety, I believe that it is a separate and distinct goal and seeing it as an aspect of regulating for safety is significantly misleading.

This brief review of the goals which have at one time or another in American history determined, and continue to determine, the letter and the spirit of bank regulation appears to make one simple statement. There is a social willingness to regulate banks for whatever reason seems appropriate, and I might add, to fail to regulate in the face of splendidly appropriate reasons for so doing. (Perhaps most notable in that respect was the failure to establish a central bank in face of a century or so of recurrent banking panics.) While safety and competition have been the most important goals, there are, as I have indicated, many others as well.

Only one of these goals, the safety goal, is uniquely related to banking. The rest are goals which are more broadly rooted in American economic and social philosophy which makes them no less legitimate, simply not *sui generis*. Implementing such goals in banking simply represents another manifestation of social purpose. For example, the stimulation of housing credit, primarily through the thrift industry, has analogs in a broad range of financing, subsidy and public housing programs which make up national housing policy.

Protection of bank investors is no more than the application to banking of securities statutes and regulations applicable to business in general. Consumers are protected in their dealings with vendors in other industries in ways different in detail, but not in principle, from the ways they are protected in banking. And the control of abusive dealing by insiders has venerable sources in common law to which all corporations are subject.

Indeed, excluding the implementation of the "safety" goal, to the extent that one can meaningfully compare the substance and character of law and regulation among industries, banking law and regulation is not notably dissimilar from law and regulation applicable to other industries. Where the difference lies is in enforcement. The examination which is in the first instance an instrument of the safety goal is a convenient vehicle for enforcing law and regulation in pursuance of other goals as well. As a result with respect to such other goals banks are subject to much more comprehensive and effective enforcement of law and regulation than other industries. The sense of bankers that they are overregulated with respect to other industries, ignoring their endemic paranoia, is, I would judge, justified to that extent.

In any case, there appears to be no *a priori* arguments for limiting the goals of bank regulation. However, I believe that there are good arguments for examining how we implement those goals because the cost of implementation, I would judge, are high relative to the social benefits which have flowed from our efforts. In the brief time available to me this evening I would like to focus on the goal of bank safety. It is the most important goal and what we understand it to mean has important implications for the extent and character of regulation.

Precisely what is that we are trying to make safe when we say that safety in banking is an important goal? What is it we are trying to secure as a public benefit - the safety of the individual institution, the safety of deposits in any single institution, the safety of the system of financial institutions, with safety of the payment mechanism. Without belaboring the argument the appropriate goal is the safety of the system of financial institutions so as to maintain the economic life of the nation and the limitation of depositor losses. The special place afforded to limiting the losses of individual depositors derives from a concern about the "little man".

The first correlary is that there is no social obligation to prevent a bank failure or for that matter 10, 20, or 30 bank failures. The obligation is to prevent a failure of the banking system and to indemnify "small depositors" as defined by the extent of deposit insurance. Thus, such social concern as we have about individual bank failures should be based on the relation of individual bank failures to systemic stability and to the protection of depositors.

An individual bank failure would have the potential of systemic failure only if such a failure resulted in a liquidity panic among depositors and other bank creditors. Clearly, the small depositor is insured and is largely indifferent to the prospects of an insured bank. Large depositors -- the corporate treasurer, the municipal finance officer, and banks, whether as respondents or as sellers of fed funds -- are the channels through which an individual bank failure might become epidemic. The only defenses against such a liquidity crisis is 100% insurance or the provision of emergency liquidity to keep essentially balance-sheet solvent banks from succumbing to a cash unsolvency. We in fact use both these methods. While we do not insure deposits or other bank liabilities to their full amounts, the FDIC has favored "purchase and assumption" transactions to liquidation, the effect of which is to eliminate losses by depositors and other bank creditors. Moreover, the Federal Reserve stands prepared to float the system in the event of incipient liquidity panic, as it demonstrated when the Penn Central failure threatened to close down credit without which commercial paper issuers could not meet their obligations to frightened holders.

To be sure, a liquidity crisis may conceivably arise from a systemic credit crisis and we have had some intimations of such crises -- REITS loans, tanker loans, and international loans, to name a few. And a crisis may be aggravated by a financially fragile banking system, one in which bank capital is low relative to assets, and short term assets are low relative to long term assets and to short term liabilities. Such a banking system is less able to resist shock irrespective of its source.

Bank regulation attempts to address these factors broadly in two ways: first, with respect to the quality of credit, law and regulation tends to limit the riskiness of some individual contracts by restriction on the maturities, and down payments, or by limiting the amount a bank may hold in portfolio. Also concentrations to individual borrowers are typically limited; finally, there is a broad influence of unknown effect of moral suasion to limit generally the risk-taking propensities of bankers. Moral suasion is also the principal tool for influencing banks to maintain a conservative financial structure.

Indeed, the bulk of regulatory costs are expended on such endeavors, which can be characterized as <u>preventative</u>. The logic as it relates to the objective of maintaining a stable banking system is that if banks in general are held to conservative credit, capital and liquidity practices, the chances of systemic failure will be diminished. To what degree does the massive regulation of loan contracts, asset choice, interest rate restrictions (such as Regulation Q and the prohibition of interest payment as dividend deposits), jawboning about the adequacy of capital, and liquidity and about the appropriate structure of asset and liability, contribute to the safety of the entire system and at what cost. I would judge that the impact on the system is small and may not be positive at all and to the extent that preventative regulation is at all successful in making banks more conservative, it results in some social loss as riskier (read, small and new) businesses and less credit worthy (read, poor) borrowers are closed out of the market, and depositors are deprived of the full return of their deposits.

Why is the impact likely to be small in any case and perhaps perverse? First, bankers do not plan to make bad loans. At the time the first REIT loans were made it is highly unlikely that the even the most astute examiner could foresee inherent default. And if he had, he could not in any event have classified the loan at that time or otherwise deterred the banker from making such loans. With respect to heading off developing fragility in the banking system, much the same can be said. There are no standard ratios that are so honored by the tests of experience that an examiner may use them as clubs to beat a banker back into line. Indeed, the post war rise in loan-deposit ratios and in purchased money ratios was heralded as the "new banking"; it developed a respectable intellectual rationale and ultimately drew on the force of custom. At best, an examiner might slow down the front runner; he could not dictate the pace of run.

Indeed, the evolving fragility of the financial system reflected broad trends in financial practices in general. Banks, it must be remembered, are not exogenous to the system; their assets are someone else's liabilities and their liabilities, someone else's assets. The economic pathology of the seventies affected everyone, directly and indirectly. Real economic shocks and ineffective national economic policies were potent forces which distorted the balance sheets of individuals and businesses and, of course, banks, too. To expect examiners to stand against such forces is simply unrealistic.

Bank supervision, in a word, is a "microeffective" technique and the problems of financial fragility require "macroeffective" techniques. Moreover, bank supervision is most effective with banks whose problems are realized, not with banks whose problems are potential. What effect preventative bank regulation has on maintaining the stability of the banking system is unclear. I think that it is a real question, worthy of much more serious attention. What is clear is that by comparison the "postventative" techniques are relatively effective in providing protection against systemic collapse and are relatively inexpensive. Indeed, the lesson we learned from the time of troubles may have been precisely the wrong one. We might have conlcuded that since we were already expending a great deal in real resources without achieving satisfactory results, we might best have reduced the preventative effort and cut the social cost, instead of redoubling our efforts in that direction.

Let me return to my original point, that the essential safety goal we seek is the stability of the banking system and trace its implications down a different path. While that is the actual goal, the operational goal of regulation is the prevention of bank failure. It is so because (1) there is no accepted operational definition of the stability of the banking system against which regulation might be measured, and (2) legislators and the public tend to get upset when banks fail. In fact, the number of bank failures or the dollar volume of assets in failed banks do not bear a certain relation to the essential social goal. Moreover, the number of bank failures in the country is very low. Even at its recent high point the bank failure rate was only about one-quarter the rate for businesses in general. And finally the depositors and creditors of banks have generally not been injured; generally only shareholders, who put their money at risk, have incurred losses. And so the system protects the innocent, while still providing that sometimes capital punishment which keeps the free enterprise system viable.

We should be quite satisfied, but instead when the failure rate rises, legislators hold hearings and propose changes in legislation to reduce further the incidence of failure. A case in point is the concern over insider abuse and the proposals that we increase our surveillance of all banks, at increased private and public cost, or that we limit credit available to bank insiders. The safety argument is that most banks fail because of insider abuse and controlling such activities will contribute to bank safety. To be sure, most banks do fail because of insider abuse; that is more a reflection of the fact that the natural failure rate of banks is low so that non-economic factors, such as fraud, are likely to be relatively important. In any case reducing the number of failures from 10-15 banks to 5-10 banks per year will not secure for us the goal we seek, but it will certainly cost us a great deal to do. If we are morally outraged by the breach of fiduciary responsibility of bank officers or bank directors, then legislate, for heavens sake, but understand that the motive is not safety and the costs are high.

I have failed to discuss a number of important questions for the lack of time, because I wanted to focus on the safety issue which is the linch-pin of bank regulation. The issue, I believe, has been misunderstood and led us more and more into increasing the public and private costs of regulation with uncertain social benefits. I think it is time for a close appraisal of our position and our direction.