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Remarks By [on problems and issues facing the banking industry]
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Nineteen seventy-four has been a difficult year for the banking industry as well as for the economy. Thus far, however, agency and industry response to the liquidity squeeze of the summer and early fall and the problems of Franklin and American Bank and Trust have produced concrete evidence of resiliency and strength in our banks and the framework of regulation. That evidence is buttressed by the fact that in the face of strains unlike any experienced since the Depression, there has been no rash of failures or the hint of panic. At the same time, the strains of the past year and the uncertainty of the coming one have crystallized the need for bankers, the agencies and Congress to come to grips with certain problems and issues.

First of all, bankers should apply the lessons of the past year. The past fifteen years have perhaps been among the most exciting and innovative periods in banking history as banks have expanded rapidly and creatively to meet the needs of a rapidly expanding economy. Among the vehicles for such growth have been the holding company movement, the development of extensive international operations and liability management. The past year has served to highlight the risks involved in each of these and to underscore the need for discipline.

The liability management area is illustrative. Assuming that they "can buy all the liquidity that they want in the market place if they are willing to pay the price," some institutions have relied far too heavily on purchased funds as a basis for unrestrained growth. This proved unwise for several reasons.

As the Franklin and American Bank and Trust experiences demonstrate, access to the money markets can be lost and, once lost, is difficult if not impossible to regain. A setback which otherwise might not have proven disastrous may lead to a loss of confidence and the outflow of "hot" or purchased funds which is not stemmed by the willingness of the lender of last resort to provide funds or the stabilizing efforts of other agencies.

A number of other effects should be noted. First, there can be little doubt that the rapid decline of capital relative to either assets or deposits is due in part to the availability of money market funds. Second, a number of institutions whose rapid growth has been based in significant part on the use of purchased funds to support medium or long-term assets have experienced a decline in earnings while bank earnings generally have stood at high levels. This phenomenon has been exacerbated by the appearance of a multi-tiered price structure in the money markets--even in the overnight federal funds market. This has tended, by and large, to favor large money center insitutions and penalize the aggressive regional purchase of funds. Third, some critics have attributed a decline in credit quality, as reflected by an increase in loan losses, to laxity induced by the easy availability of funds. While I doubt that most banks have eased standards, there can be little dispute that the assumption of unlimited liquidity caused a relaxation of discipline in some banks. Finally, it is probably also true that the same assumptions led to loan commitments that are now proving embarrassing or inconvenient.

For these reasons, it is now clear that expansion should not be based on the presumed availability of purchased funds at an acceptable cost. Rather, expansion should be a function of the natural level of deposits, addition of capital and the concrete expectation of income. Similarly, banks should not respond to credit needs on a day-to-day basis nor make loan commitments assuming the availability of virtually unlimited liquidity in the money markets.

Moreover, banks should recognize that, in the short-to-medium run at least, capital necessary to support expansion must be generated from earnings. This flows from the fact that the present prices of bank stocks and the cost and unsuitability of debt financing foreclose the capital markets for a great many banks. Accordingly, banks wishing to expand will also have to rely on the basics of sound banking--greater attention must be paid to costs, the pricing of services and the profitability of lines of services and large customer accounts.

Finally, with the unsettled state of our own and the world economy, bankers should no longer expect the luxury of relatively stable conditions and certainly not the sort of boom and expansion which characterized the better part of the sixties and the early seventies. For example, we are in the midst of a recession the severity and depth of which is uncertain. In this climate, it is only reasonable to expect that in many areas of the country, businesses will experience their own liquidity problems and that loan losses and delinquencies will increase. Anticipating those conditions, bankers should focus on credit and investment quality, avoiding the risk associated with high yielding but speculative ventures. At the same time, bankers must be prepared to assist customers and enterprises in their communities through what may be very difficult times.

Many bankers are already moving rapidly and effectively to make the required adjustments. Bankamerica's President A. W. Clausen's announcement of a formal policy of restraint represents a dramatic indication that this is the case. In part he stated:

> Economic growthmanship--without equal concern for quality and staying power--has always been a faulty philosophy. Today, more than ever, it is a philosophy at odds with the economic needs and financial realities of this country.

and:

> Given these difficult financial times of high interest rates and unprecedented loan demand, we are convinced that shareholders, depositors and the public at large all are better served by a policy that gives the quality of assets and the stability of earnings higher priority among corporate goals than size alone.

This approach must be applauded and might well serve as a policy statement for the industry.

With a policy of restraint in the granting of credit goes a large measure of responsibility for the shaping of the face of the community which a bank serves--whether it be a rural community or the worldwide markets of our money center banks. The assumption that virtually unlimited liquidity is available, which pervaded the philosophy of liability management, allowed bankers to avoid difficult choices. The time of that luxury is probably past. In announcing Bankamerica Corporation's policy of restraint, its president, Mr. A. W. Clausen, recognized that a rationing process necessarily flows from such a policy. He stated:

> Clearly we cannot meet all the credit demands we now receive. We shall continue to honor the normal essential credit requirements of established customers. But, as we continue to serve their needs, other borrowers may find it difficult to obtain all the funds desired.

The fact that hard choices must be made in the coming months has also been reflected in the growing debate over the issue of credit allocation. Some members of Congress and respected economists have argued with force that a mandatory system aimed at directing the flow of funds is required to insure the proper allocation of credit. In a recent statement Congressman Henry Reuss indicated that he will press for mandatory credit guidelines in the next Congress. To date, the Fed has rejected the notion that it should implement mandatory credit allocation guidelines, emphasizing instead bank cooperation with voluntary guidelines.

In its press release of September 16, 1974, the Board of Governors summarized the conclusions of the statement of the Federal Advisory

Council to the Board in this respect. The release stated:

> The Board regards restraint in lending policies as essential to the national effort to control inflation. Restraint best serves the public interest when limited credit resources are used in ways that encourage expansion of productive capacity, sustain key sectors of national and local economics, provide liquidity for sound businesses in temporary difficulty and take into account legitimate needs of individuals and small as well as large businesses.

Even within the parameters of the Fed's guidelines difficult choices are posed. A banker must necessarily face hard questions which pertain not merely to an analysis of the yield and credit risk of a given asset but to what is good or bad in the long run for the communities served by their banks. I do not pretend that the answers will be easy or even that there will be a right answer in each case. I do believe, however, that such questions must be faced and answered--either through the voluntary exercise of responsibility of bankers or through credit allocation policies implemented at the federal level.

Moreover, in my judgment, bankers must realize that it is not enough merely to oppose controls arguing that they constitute an unworkable interference with the operation of the market place. Rather, they must demonstrate in concrete fashion that the public interest, and not merely that of banks or their good customers, are best served by a system which relies on individual exercise of responsibility. In the present political and economic environment, the failure to make that case will and should sooner or later lead to further federal intervention in this area.

In calling for greater discipline and self-restraint in the industry, the supervisory agencies must take care to undergo their own process of critical self-examination. Bank supervision must adapt to the present economic environment and to the greatly increased complexity and importance of the business of banking that has resulted from the innovation and expansion of the past fifteen years. It may be true that some bankers were "careless" in their pursuit of growth at any price. However, it would be unfair not to frankly acknowledge that the philosophy and practices which have characterized banking during the past dozen years did take place under the supervision of the regulatory agencies.

In addition to the challenges facing bankers and bank supervisors, events of the past year underscore the need for Congress to give serious attention to certain questions. In conclusion, I would like to touch briefly on three issues which will probably be the subject of Congressional scrutiny in the coming months.

First of all, Congress will undoubtedly examine very closely the actions of each of the banking agencies involved in the Franklin matter and the insolvency of American Bank and Trust in South Carolina. While these cases were resolved expeditiously and with a minimum of ill effects, they provide informative case studies which reflect the options and procedures presently available in dealing with failing and troubled banks.

Among the issues which Congress might address are division of responsibilities and tasks among the agencies, the rigidity of the statutory options available to FDIC under Section 13(c) and 13(e) of its Act, and the disadvantaged position of state non-member banks with respect to emergency access to short-term liquidity.

Secondly, the depression in the housing industry and the substantial disintermediation from the thrifts which occurs in times of high interest rates insures that Congress will once again address the recommendations of the Hunt Commission and in the process the question of interest rate ceilings. Already Senator McIntyre's subcommittee has begun the final markup of the Financial Institutions Act. Predictably, vested interests are already jockeying to lobby for that portion of the package which appears favorable to them and against that which does not. In light of the seriousness of the strains which the system has felt in the past few months, it seems to me that we cannot afford a business-as-usual approach to this piece of legislation.

It has been demonstrated time and again that Regulation Q ceilings are inefficient and cause severe dysfunction in the operation of our money markets. Moreover, and to my mind more importantly, the Q ceilings constitute a subsidy or shelter to the housing and thrift industries which is funded by what consitutes a tax on low and middle-income savers. In times of inflation with interest rates at present levels, this tax is unwarranted and unfair.

I am well aware that abrupt elimination of Regulation Q without significant measures to avoid dislocation would be grossly irresponsible. Yet those measures were defined in the report of the Hunt Commission and are included in the proposed Financial Institutions Act which is before Congress. If other safeguards and transitional measures are required, they deserve our support. The time has come for Congress, the agencies, and the various industry groups to confront and resolve this question.

Finally, there is some indication that Congress will give consideration to the subject of regulatory reform. Unlike the matter of Regulation Q, we are only beginning serious consideration of this subject. The range of solutions is broad, the questions complex and the interests conflicting. The process will require careful thought, compromise and a willingness to forego narrow vested interests. I have not resolved in my own mind all of the most basic questions and certainly have not begun to address the multitude of lesser considerations, but I am convinced that the time has come to address and resolve these questions. I am anxious to hear your thoughts and those of my fellow panelists on this subject.

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