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Carter H. Golembe Associates, Inc.

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We are in the midst of a period in which there lies potential for rapid and fundamental change. As the industry, the agencies and Congress face the future there are two possible courses of action for dealing with the changes that are occurring or will occur. There can be a common and concerted effort to control and shape events with the objective of creating a more sound, flexible financial system better able to meet the credit needs of our economy and more resilient in the face of frequent and varied shocks. Or, there can be a fragmented reaction to each change as has been characteristic of the past.

The past fifteen years have been by far the most exciting and innovative period in banking history. Responding to competition and the needs of customers, banking has burst out of its stodgy and conservative shell. Geographic barriers to competition fell as the holding company mechanism allowed a multistate presence, branching restrictions were modified and banks developed extensive international operations. Innovative techniques in structuring and managing assets and liabilities have allowed banks to respond to both the increased demand for consumer services and the sophisticated requirements of business customers. All this has been facilitated by technological breakthroughs in the processing and transmission of information, with further change promised through implementation of EFT systems. In short, banks have been in tune with and responded aggressively to the needs of a complex, prosperous and expanding economy.

Coming on the heels of many years of optimism and growth, 1974 has been a difficult year for the industry with the outlook for 1975 reflecting a level of pessimism not felt since the thirties. Such factors as the protracted ordeal of Franklin National Bank, interest rates unprecedented in the history of modern American banking, the sudden demise of American Bank and Trust in South Carolina, notoriety given recent bank failures in Europe, instability in the foreign currency markets and the situation in the Middle East could hardly help but create an air of uncertainty. Moreover, it is now clear that our economy is in worse straits than many imagined possible a few months ago. The debate now is not about whether we are in a recession, but whether its shape will be a "V", a "U", or an "L".

Nevertheless, I am confident that the banking system as a whole is capable of sustaining strains significantly more severe than those presently envisioned. Agency and industry response to the liquidity squeeze of the summer and early fall and the resolution of Franklin's and American Bank and Trust's problems 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. Certainly, there is no reason to expect the sort of chaos and shakeout that is occurring in the securities industry.

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This is not to say, however, that the effects of current economic difficulties will be insignificant. Already, the strains of 1974 have underscored risk and shortcomings in certain banking practices, including the holding company movement, international operations and liability management, which may not have been appreciated previously. In coming months loan losses are certain to rise, and, if the recession proves very severe, the incidence of bank failures or consolidations could increase somewhat. Accordingly, it seems clear that our current economic distress will affect banking, as well as other industries, to an extent and in ways not yet determined.

Moreover, it is well to recall the oft-made observation that significant changes in our financial system occur only in times of crisis. Reflecting the mood of the country, the Congress just elected is likely to be one of the most reform-minded and consumer-oriented in the nation's history and may be impatient with old solutions that do not work--even when the alternatives are less than clear.

In the context of what seem to be converging currents of change it is important to note that the level of risk in the banking system has increased significantly as a result of the aggressiveness and innovation that has characterized major segments of the industry in recent years. A review of some of the elements of risk that have grown out of this period of creativity and expansion underscore the need for bankers, the agencies and Congress to respond in disciplined and coordinated ways to the problems and issues at hand.

Recent actions of the Fed with regard to holding companies have served to highlight one such area of increased risk. While the total equity of some holding company systems is significantly greater than that of their banking subsidiaries, that is not always the case. Equity capital may actually be less when computed on a consolidated basis than for the bank alone. As a result, the amount of equity which once supported the risks of a single banking system now supports the bank plus a variety of enterprises. The rapidity with which change has occurred is seen in recent Salomon Brothers statistics which showed that the composite ratio of total capital funds to total assets, less cash and due from banks, of the twenty-five largest bank holding companies declined from 8.8 percent in 1972 to 7.7 percent in 1973. At the same time the ratio of equity capital to non-cash assets declined from 7.2 percent in 1972 to 6.2 percent.

Potentially more troublesome is the fact that the failure or distress of an affiliate in the holding company system may affect the bank itself. The danger is twofold. First of all, there will be great temptation to tap the bank as an answer to the problems or needs of affiliates. Secondly, even where the bank is effectively insulated from direct financial drain, holding company problems are often reflected in market judgments about the bank itself. This is encouraged by the fact that many holding company executives would agree

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with Ronald Terry, President of First Tennessee National Corporation, who stated: "I think we should keep the bank's prestige behind the capital market issues of affiliates." The dark side of this approach was graphically illustrated in the Beverly Hills Bancorp case--undoubtedly a source of Fed concern in this area. An affiliate of the Beverly Hills Bancorp, the Beverly Hills National Bank, had been selling some of its parent company's commercial paper. When the troubled parent was unable to meet interest payments on the paper, a run on the otherwise sound bank was triggered. As a result, the holding company was forced to liquidate the bank's assets through sale to Wells Fargo.

The great expansion of international banking operations is a second source of increased risk. Foreign assets range between 42.8 and 30.4 percent of the total assets of our five largest banks, and they are, in many cases, responsible for the dramatic drop which has been seen in the capital ratios of some of our larger banks. For example, one money center bank has a ratio of equity plus reserves to total assets of 6.6 percent when computed on domestic basis and 2.9 percent when international operations are included.

In addition to spreading more thinly the system's capital resources, such operations contain their own peril, especially for the aggressive uninitiate. Franklin National Bank's experience in the foreign exchange market is a case in point, but the losses of Lloyd's Swiss branch in the foreign currency area demonstrate that even the most established and prudent of institutions can be burned. Furthermore, the precarious state of the international payments system, the disruptive effects of the flood of petrodollars and the financial problems of countries which are substantial debtors to American banks have each served to greatly increase the risk of international operations.

Paralleling and to a significant degree funding expansion abroad has been an application of the liability management theory of bank liquidity. In essence, liability management meant that banks were no longer substantially limited in their sources of funds. The new view was described by Lehman Brothers economist Leonard Santow when he stated:

> The pragmatic view of banks is that you can't look at the old ratios. They don't apply anymore when people can buy all the liquidity they want in the marketplace if they are willing to pay the price.

The benefits of this approach are substantial. Not constrained by the level of deposits growing out of normal customer relationships, money center and regional banks responded to burgeoning credit demands. It also allowed regional banks to achieve or begin to realize their international ambitions. Smaller banks have benefited as well since many profited handsomely as net lenders of federal funds. The rapidity of change in this area is reflected in

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the fact that the ratio of purchased funds to assets for larger banks grew from 7.8 percent in 1965 to 14.3 percent in 1970, and to 26.5 percent in June 1974. For many institutions, growth was far more dramatic.

Notwithstanding its benefits, resort to the money markets as a source of liquidity was not without its perils and served to add another element of risk to the system. These were dramatized by events in 1974, which included the failures of Franklin and American Bank and Trust and the stresses caused by the liquidity squeeze engendered by tight money and business borrowing from banks, that grew at an annual rate of more than 25 percent through the summer.

Franklin, of course, is the clearest example of an institution which relied far too heavily on purchased funds as a basis for rapid expansion. Anxious to achieve status as a money center institution, the bank purchased funds in increasing proportions to support risky assets. More importantly, as the bank penetrated new markets, growth far outstripped management skill. What was once a relatively sound Long Island institution became a multinational enterprise situated in lavishly appointed Manhattan quarters yet lacking the depth and managerial expertise required to run the suddenly complex operation. Unable to control expenses, management soon faced a serious earnings problem, which was probably the ultimate cause of the bank's downfall. Indeed, one might speculate that Franklin's well-publicized foreign exchange losses were the result of attempts to recoup losses.

The most dramatic element of risk involved in the view of bankers that they "can buy all the liquidity they want in the marketplace if they are willing to pay the price" lies in the fact that access to the money markets can be lost. As the Franklin and American Bank and Trust experiences suggest, once the liquidity provided by the access to such markets is lost, it is difficult if not impossible to regain. In each case a setback which otherwise might not have proven completely disastrous triggered a loss of confidence and the outflow of "hot" funds. There is evidence which suggests that while deposit insurance maintained the confidence of most small depositors in the face of the worst sort of adverse publicity, willingness of the lender of last resort to provide funds and the stabilizing efforts of other agencies did not stimulate the confidence of large individual and institutional depositors.

Another pitfall is reflected in the recent earning performance of a number of institutions whose rapid growth was based on the use of purchased funds to support medium or long-term assets. Even where other operating expenses are controlled, record interest rates have pushed the cost-of-funds to high levels. The problem is particularly acute among banks, such as American Bank and Trust, with a high proportion of real estate-related loans.

That such risks and shortcomings have surfaced in modern banking practice

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does not mean that they should be curtailed nor the clock turned back. That is neither practical nor desirable. Rather, as I have indicated, the presence of such risks signals the need for bankers, the regulatory agencies and Congress to come to grips with certain issues and to do so without delay.

Bankers should move immediately to apply the lessons of the past year. Certainly neither expansion nor credit commitment can any longer be based on the presumed availability of purchased funds at an acceptable cost. Similarly, volatile and potentially high-priced funds ought not to be used to fund risky or long-range assets to achieve market penetration. Rather, expansion should be a function of the natural level of deposits, addition of capital and retention of income, and the commitment of resources based on careful planning balancing present and future credit demands with anticipated resources.

Banks should also 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 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.

Yet the lesson is not that expansion or aggressive banking is bad. Nor should the fact that some institutions have been overzealous mean that it is now appropriate for all to pull in their horns, adopting an ultrarestrictive attitude toward the provision of credit. It is true that many institutions are stretched to their limit and should be restrained; the data, however, which I review indicates other institutions are more than adequately capitalized and have secure and productive portfolios. In the present recessionary environment, these should move aggressively to respond to the needs of creditworthy borrowers. Indeed, for some institutions, the assumption of a higher level of risk would not be at all inappropriate.

What is required of bankers at the present is not necessarily retrenchment. Instead of uniform reaction to the gloomy picture presented by the economy and the cautionary note struck by supervisory authorities, bankers should simply apply in disciplined fashion the tools of modern asset and liability management. The widespread failure of solid institutions to respond in this manner could have the effect of reinforcing the recessionary spiral. This point is particularly worthy of note because it reflects the need for bankers to respond independently to the facts and circumstances of their own market environment in light of the peculiar strengths and weaknesses of their own institution, and not to react to the fad of the moment or regulatory jawboning which is not really applicable to their case.

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Many bankers are already moving rapidly and effectively to make the adjustments required by their bank's circumstances. 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.

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, 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.

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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 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 and 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, the Fed's guidelines and the Joint Economic Committee's concern must be taken seriously. It is not enough merely to oppose controls arguing that they constitute an unworkable interference with the operation of the marketplace. They must demonstrate with concrete results that the public interest, and not merely that of banks or their good customers, is best served by a system which relies on individual exercise of responsibility. Given current economic conditions and the concern that they engender, the failure of bankers to see that funds are available for projects which are productive and necessary for community welfare should and will lead to federal intervention.

In calling for greater discipline and self-restraint in the industry, the supervisory agencies must also take care to undergo their own process of critical self-examination. Bank supervision must adapt to the present economic environment and the greatly increased complexity and importance 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 acknowledge frankly that the philosophy and practices which have characterized banking during the past dozen years did take place under the supervision of the regulatory agencies and was, by and large, not inconsistent with the monetary policies pursued by the Federal Reserve System.

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In addition to the challenges facing bankers and bank supervisors, events o 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, 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 reported to the full Committee the Financial Institutions Act. Legislation of this type and its goal of open competition among financial institutions deserves our full support.

Perhaps the most controversial aspect of this package relates to the ultimate removal of Regulation Q ceilings. Yet it has been demonstrated time and time again that Regulation Q ceilings are inefficient and cause severe dysfunctions in our financial markets. Disintermediation is one example. It has also been argued with force that by virtually eliminating competition for deposits, the Regulation Q ceilings increased the need for bankers to resort to more volatile money market instruments thereby increasing the level of risk in the system. Also, by denying small savers access to inter rates which a freely functioning market would set, Regulation Q ceilings may have actually discouraged savings which might otherwise have been put to productive use as investment.

In addition to the fact that interest rate ceilings have been counterproductive in purely economic terms, there is another side of Regulation Q that has received too little attention--even by the most outspoken advocates on the part of consumers. Regulation Q constitutes a subsidy or shelter to the housing and thrift industries which is funded by what constitutes a tax on low and middle-income savers. Totally apart from the fact that the device has demonstratably failed to provide a stable flow of housing, it is wrong that the burden for providing this subsidy should fall on the group which can least afford it. With inflation at present levels, the inequity is especially severe.

I am well aware that abrupt elimination of Regulation Q without significant measures to avoid dislocation would be irresponsible. Yet such measures have been defined. If other or transitional measures are required, they deserve our support. They should not, however, provide an excuse to delay elimination of an unjust and inefficient interference with the operation of the market mechanism.

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Secondly, 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 statutory options available 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.

Finally, it now seems 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 vested interests.

While I have not resolved in my own mind all of the most basic questions, and certainly have not begun to address the myriad of lesser considerations, it does seem clear to me that efficiency and common sense demand restructuring along functional lines. For example, I find it difficult to justify the tripartite division of either examination and supervisory functions or of those functions which deal with structure such as chartering, mergers, holding company acquisitions and branch and facility approvals. Similarly, it would seem to me that functions dealing with troubled and failing institutions should also be consolidated.

While no formal proposals have been made to Congress, it has been suggested that all these duties be centralized in the Federal Reserve System. I must admit that I would have very grave reservations about a reorganization which vested in one independent federal agency sole authority to regulate both monetary policy and our nation's 14,000 banks. I say this for two reasons. First of all, recent months have made obvious the importance of careful and expert execution of monetary policy as well as the costs that could result from its mismanagement. It seems to me that the agent of this delicate and critical function should not be assigned further duties of almost equal magnitude and complexity without a clearcut demonstration of both the need to do so and the fact that the responsibilities would not conflict. Secondly, while the present system is unsatisfactory in many respects, it does provide certain checks and balances. While others may differ, I would find very disturbing the vesting of such pervasive power over the economy in a single agency.

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In conclusion, I should merely reiterate what I stated at the outset. Char is upon us whether we like it or not. The shape of that change will depend on whether those of us in the industry, the agencies and Congress seek to understand and manage the forces at work or merely react in traditional ways to the problems and issues which confront us in the coming months. During periods of abundance and rapid expansion, it is possible and quite natural to avoid or postpone hard choices, to tolerate waste and inefficiency, and to benefit from the operation of forces only dimly understood. We no longer have that luxury.

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