FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

[Banking, credit and the economic conditions of the 1970's.]

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The coming months hold the potential for rapid and fundamental change in banking and bank regulation. Developments in the economy and in the political process make likely such change. Facing this prospect, the industry, the agencies and Congress have two alternatives. There can be a concerted effort to control and shape events in the interest of a more efficient, flexible and resilient system. Or, there can be the sort of fragmented reaction to problems and crises which has characterized response to economic developments over the past thirty years.

Nineteen seventy-four was a difficult year for the industry. 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, the distress merger of Security National in New York, the expected strains of Petrodollar flows, the notoriety given bank failures and other developments abroad and the year-end prospect of large loan losses resulting from the economy's decline created an air of uncertainty. While the broad base of public confidence remains unshaken, banking's image has been tarnished--a fact reflected by the attention which banking has received in the popular press.

Moreover, the outlook for the remainder of 1975 and 1976 is more gloomy than any since the Thirties. President Ford in his recent Economic Report of the President stated:

> The economy is in a severe recession. Unemployment is too high and will rise higher. The rate of inflation is also too high although some progress has been made in lowering it.

Unemployment jumped to 8.2 percent in January and, according to some, could reach 10 percent or more later this year. Prices of consumer goods and services increased more than 11 percent in 1974 and government forecasts envision a similar increase this year. Industrial production declined 6 percent during 1974, most of this coming in the last quarter; productivity in terms of output per man-hour fell 5 percent; and average weekly earnings dropped more than 5 percent after adjusting for the effects of inflation.

To these factors must be added the disturbing fact that economists are frankly admitting that present reality does not correspond to existing models of how the economy should behave. In his address to the annual convention of the American Economic Association, association president Robert A. Gordon reflected this viewpoint, "I am quite dissatisfied with the state of economics today. I don't think we have a body of economic theory which is of great help to us in today's world." This lack of analytical clarity about the working of our system has been underscored by the unforeseen rapidity of the slide into deep recession. Even more disconcerting than the shortcomings of forecasting techniques is the feeling among both economists and policy makers that traditional remedies do not address our present problems and that the required new approaches are yet to be developed.

Thus, while our economy has a reservoir of basic strengths that insures ultimate recovery, bankers can no longer rely on an ever booming economy, punctuated by moderate swings of the business cycle. Rather, bankers must make decisions assuming a degree of instability not experienced in recent years as the economy makes the required adjustments.

Confronting this situation, many bankers have recognized problems in their own institutions which were highlighted by the events of 1974 and are moving quickly to remedy them. Certain general principles have been accepted. 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, since the present price 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 at the same time, the danger of overreaction does exist. The fact that some institutions have been overzealous does not 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 indicate that other institutions are 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.

Thus, 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. Indeed, there is reason to believe that restrictive lending policies, combined with a loss of consumer and business confidence, are responsible for the 8 percent annual rate of decline in currency and demand deposits which occurred in January. This point underscores that the proper approach of bankers to rapidly changing and troubled economic conditions is 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 the fad of the moment.

In addition to the changes which bankers must expect as a result of a new economic environment, substantial changes are likely to occur in the supervisory and regulatory environment as well. It is well to recall the oft-made observation that significant changes in our financial system occur only in times of crisis. Moreover, reflecting the mood of the country, the Congress just elected is likely to be the most reform-minded and consumer-oriented in the nation's history, impatient with old solutions and politics as usual.

Certainly, the evidence to date bears out these observations. As you know, in both the Senate and the House, new chairmen--Senator Proxmire and Congressman Reuss--head the respective banking committees. Each is a knowledgeable and vigorous legislator and each is known to be less than satisfied with the performance of the industry or the agencies in certain areas. Furthermore, each has already demonstrated his intention to move decisively--Mr. Proxmire in successful efforts to establish a permanent investigating subcommittee which he will chair and Mr. Reuss, first in unseating Mr. Patman, second in the introduction and advocacy of legislation which instructs the Fed to lower long-term interest rates and provides for the allocation of credit. It should also be noted that far greater cooperation might be expected between the two committee chairmen than has occurred in the recent past, thereby enhancing the prospects for the passage of significant legislation.

In addition to changes in the leadership and organization, there has, of course, been considerable turnover in the membership of both houses with the new members on the whole tending to be somewhat younger and more liberal. In the House, for example, there are 91 new members. In the best of times, such circumstances would produce ferment. In the current economic and political climate, significant change in the regulatory environment is likely. I will touch on some of the areas where change might be expected.

Bankers should anticipate a greater emphasis on the various aspects of consumer protection. If for no other reason, the presence of Mr. Proxmire as Chairman of the Senate Committee on Banking, Housing and Urban Affairs would assure it. Moreover, the last Congress passed and the President signed into law a bill aimed at insuring that the agencies do give greater attention to consumer matters. The provisions pertaining to banking were part of a much larger piece of consumer legislation known as the Consumer Product Warranties-Federal Trade Commission Improvements Act. With respect to banking the bill requires the Federal Reserve Board to promulgate regulations for banks which are substantially similar to FTC unfair trade practice regulations unless it finds that such regulation conflicts with monetary policy or is inapplicable to banks and publishes this finding in the Federal Register within sixty days. In addition, the legislation provides that:

> In order to prevent unfair or deceptive acts or practices in or affecting commerce (including acts or practices which are unfair or deceptive to consumers) by banks, each agency . . . shall establish a separate division of consumer affairs which shall receive and take appropriate action upon complaints with respect to such acts or practices by banks subject to its jurisdiction.

We at the FDIC are in the process of structuring a division directly responsible to the Board which will be charged with implementing the provisions of this Act as well as promoting consumer interests. Notwithstanding the FDIC's traditional focus on safety and soundness, bank customers have the right to expect that the FDIC will protect their rights just as vigorously as it pursues the goal of capital adequacy. Recognizing that we bear something of a burden of proof, it is our intention that these expectations be satisfied.

The changed atmosphere in Congress is clearly reflected by legislation introduced by Chairman Reuss which addresses two issues of great importance to the public and to the banking industry: the development and implementation of monetary policy and credit allocation. The legislation was originally introduced as one bill, the "Lower Interest Rate Act of 1975." After hearings before the Subcommittee on Domestic Monetary Policy two weeks ago, a separate bill was reported out of subcommittee on each of the issues.

The revised monetary policy bill would require that the "Federal Reserve shall conduct monetary policy in the first half of 1975 so as to lower long-term interest rates." The bill would also require the Fed to report monthly to both the Senate and House Banking Committees "on its progress toward achieving this goal." The original version of this provision would have requested the Federal Reserve to maintain a growth in "demand deposits and currency outside banks" of no less than 6% during the first half of 1975.

Both the original and revised legislation suggest a troublesome dilemma. The independence of the Fed from political pressure by either Congress or the executive is of utmost importance. Similarly, the delicate task of shaping monetary policy should not be shifted to a 535 member legislative body. At the same time, the Federal Reserve System is a creature of statute. Congress does have a constitutional obligation to understand fully its function and performance and to take action where that performance is clearly not in the public interest. Exercised in a responsible manner, such scrutiny should not be incompatible with the appropriate degree of Board independence. Moreover, it might serve to dispel accusations that the Board has been subjected to undue pressure from the executive branch and is already politicized.

For my own part, I tend to agree with the proposal by the American Bankers Association representative, Beryl Sprinkel, in the hearings on the bill as originally drafted:

> As an alternative to Section 2 of H. R. 212, we suggest that the House and Senate banking committee develop with the Federal Reserve Board an administrative procedure for regular Fed reporting of its monetary plans and actions and the reasoning behind them, preferably in the form of hearings to allow for dialogue. This approach should balance Congress' need for knowledge of the Federal Reserve actions and rationale with the need for the Fed to retain its independence from undue political influence.

The second bill, the Credit Allocation Act of 1975, deals with an even more emotional issue for bankers. The bill requires the President to "allocate credit away from inflationary uses, and toward national priority uses. . . ." The President or his delegate would be given discretion to administer this Act using any procedures provided by law, including (1) supplemental reserve requirements, as determined by the Federal Reserve Board, against non-priority loans and investments minus a credit not to exceed the supplemental reserve for national priority loans and investments and (2) adoptionof a "Voluntary Affirmative Action Program" by all insured banks to shift loans and investments from nonpriority to priority uses in stages over the next three six-month intervals with submission of monthly progress reports to the President detailing progress in meeting affirmative action credit allocation targets.

The objective of the Credit Allocation Act is to encourage commercial banks to stress loans for activities deemed to be in the public interest. National priority uses, as determined by the President for credit allocation purposes, would include: essential and productive capital investment, including technological innovations and investments which increase competition; normal operations of established business customers in order to overcome lack of adequate working capital; low and middle-income housing; new and existing small business and agriculture; and state and local governments. The bill further stipulates that

> The President shall, within thirty days after the enactment of this Act, transmit a report to the Congress which shall include a detailed listing of categories which he has determined constitute inflationary uses of credit and a listing of categories, in addition to those listed above, which he has determined constitute national priority uses.

The President would be able to add or subtract high priority claims from the list if after a sixty-day notice, Congress did not object.

I do not support mandatory credit allocation. As a former banker, I cannot rid myself of the belief that a banker interested in the long-run health of his community is in the best possible position to make the credit rationing choices which affect that health. However, it must be recognized that the bill does address a very real and serious problem.

It is patently obvious that existing financial markets do not necessarily allocate resources in a manner that is either socially useful or economically efficient. Housing is in short supply in many areas, yet the housing industry is devastated, largely as a result of the design of our financial markets. Ironically, new resort condominiums and high-rise offices lie empty and unneeded. Cities and local governments have been forced to forego capital expenditures and public utilities to defer needed expansion. The credit allocation program Congressman Reuss proposes represents an attempt to redirect the flow of funds and resources to those enterprises which are most important to the nation in a manner which leaves great discretion in the hands of the local banker.

Because the problems are real, the question of credit and resource allocation must be faced and answered--either through voluntary exercise of responsibility of bankers or through credit allocation policies implemented at the federal level. It is not enough merely to oppose controls arguing that they constitute an unworkable interference with the operation of the market place. One must demonstrate with concrete results that the public interest, and not merely that of banks or their favored 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 banks to see that funds are available for projects which are productive and necessary for community welfare should and will lead to federal intervention.

I should add that, because banks do business in a restricted and closely supervised environment, no bank has a right to be financially successful unless it is socially useful.

Another issue likely to occupy the attention of Congress is that of regulatory reform. While I have not yet resolved in my own mind precisely how the federal system of bank supervision and regulation should be restructured, it does seem clear to me that efficiency and common sense demand reorganization 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, functions dealing with troubled and failing institutions should also be consolidated.

Consolidation along functional lines could be accomplished in one of two ways. First, all supervisory and regulatory functions might be combined in a single agency. This agency might be the Federal Reserve Board, as some members of the Board have suggested, or it might be another agency either presently existing or newly created, as former Board Governor Robertson suggested some years ago. Alternatively, the existing agencies might be retained with certain functions shifted among the agencies to eliminate overlap and minimize conflict.

For my own part, I have not yet determined which alternative I favor. However as I have indicated elsewhere, I would have very grave reservations about a reorganization which invested in one independent federal agency sole authority both to administer monetary policy and to regulate our nation's 14,000 banks. I say this for two reasons. First of all, the experience of recent months has made obvious the importance of careful and expert execution of monetary policy as well as the cost 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. Former Governor Robertson summed up these problems in an article published in the Autumn 1966 issue of <u>Law and Contemporary Problems</u>. There he stated:

> As a practical matter, I believe it would be seriously detrimental to place in the Board the important additional responsibilities that would accompany unification. There are limits to man's ability effectively to perform his assigned duties. In our complex society,

merely keeping informed of what is going on in the national economy is becoming more and more difficult. Developing and implementing appropriate monetary policy at a given time require consideration and evaluation of the significance of an enormous volume of available data and their interrelationships. The responsibilities are of such magnitude that the Board should not be also burdened with the performance of bank supervisory functions. Supervision is too important a function in itself to be the Federal Reserve's part-time job.

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.

Either as part of its consideration of agency restructuring or separately, Congress will undoubtedly examine very closely the action of each of the banking agencies involved in the Franklin matter and the insolvency of American Bank and Trust in South Carolina, and perhaps the recent merger of Security National in New York, as well. While these cases were each resolved expeditiously and with a minimum of ill effects, they do provide informative case studies which reflect the options and procedures presently available in dealing with failing and troubled banks. We at the FDIC are now engaged in a comprehensive review of the subject area. It is our present intention to make specific recommendations to Congress sometime in late spring or early summer.

Finally, the depression in the housing industry and the substantial disintermediation from the thrifts which occurs in the times of high interest rates insure that Congress will once again address the recommendations of the Hunt Commission and in the process the question of interest rate ceilings. Senator McIntyre's subcommittee reported the Financial Institutions Act to the full committee last fall. Legislation of this type and its goal of open and equal competition among financial institutions deserve our full support.

I was disappointed, however, to learn that among the changes the Administration has made in its package is the extension of authorization to set deposit rate ceilings under Regulation Q for five and a half years. In the original version of the bill, a gradual phase-out of deposit rate ceilings was called for over four years, beginning 18 months after the bill was enacted. According to newspaper reports, this change in the legislative package was designed to make it more politically acceptable to the thrift industry. While one can appreciate the Administration's sensitivity to political considerations in seeking to obtain the passage of an important piece of legislation, its decision to compromise is disappointing.

It has been demonstrated time and time again that Regulation Q ceilings are discriminatory and cause severe dysfunctions in our financial markets. It has also been argued with force that by virtually eliminating competition for deposits, the Regulation Q ceilings increase the need for bankers to resort to more volatile money markets instruments, thereby increasing the level of risk in the system. Also, by denying small savers access to interest rates which a freely functioning market would set, Regulation Q ceilings may have actually discouraged savings which might otherwise have been put in productive use.

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 and to mortgage borrowers which is funded by what constitutes a tax on low and middle income savers. Totally apart from the fact that the device has demonstrably 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, however laudable that goal. With inflation at present levels, the inequity is especially cruel. The Treasury Department's view on this issue is particularly ironic in view of Secretary Simon's testimony with respect to credit allocation. Of Representative Reuss' bill, Secretary Simon stated: "This system would be inequitable, and extremely disruptive. . . . Eventually there would be gross distortions in the economy and economic conditions would sadly deteriorate." Such a statement could far more aptly have been used to describe Regulation Q ceilings which the Treasury would now extend five and a half more years.

I'm well aware that abrupt elimination of Regulation Q, without measures to avoid dislocation, would be irresponsible. Such measures should not, however, provide excuse to delay the elimination of this unjust and inefficient interference with the market mechanism. I sincerely hope that both bankers and Members of Congress will come to appreciate the extent to which the attempt to allocate credit to housing, to protect the thrift industry and to effect monetary policy through Regulation Q is inefficient, ineffective and, most importantly, unjust. It would indeed be ironic if this were ignored in this period of high interest in consumer protection.

In conclusion, I should merely reiterate what I stated at the outset. Change 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 operations of forces only dimly understood. We no longer have that luxury.

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