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"Regulatory reform in the banking context"

Address by

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Large bank failures and economic strains have focused attention on the banking industry and our system of bank supervision and regulation to a degree not seen since the thirties. Beginning with the speech given by Arthur Burns of the Federal Reserve at the American Bankers Association Convention in 1974 in which he decried what he termed a "competition in laxity" and described the existing regulatory framework as a "jurisdictional tangle that boggles the mind", the issue of bank regulatory reform has never been far from the attention of either the banking committees in Congress or the banking agencies themselves. A myriad of proposals has been put forward, untold hours have been consumed in discussion, numerous speakers have pontificated, reams of paper have been produced, and, finally, what should have been a careful analytical exploration degenerated into a personal political vendetta. I do not need to tell you the outcome: after much sound and fury, the issue of bank regulatory reform is dead in the 94th Congress.

Nevertheless, I think it is desirable to reflect on the subject of regulatory reform in the banking context, since, like it or not, governmental and regulatory reform seems to be an idea whose time has come. When I talk with businessmen, bankers, and even consumer advocates around the country, I hear one persistent complaint: profound dissatisfaction with the pervasiveness of governmental intervention in our day-to-day affairs and with the reams and reams of paper that are required to effect even the simplest and least controversial of transactions. The extent of this concern has been one of the dominant themes of the current Presidential election campaign.

The issue posed by this dissatisfaction is not a simple one. Most informed people share the recognition that our economy is too large and complex to function properly without some governmental supervision or regulation. For example, while some might disagree with the direction of monetary policy at a particular time, few would deny the need for a mechanism to control the quantity of money in the system. Similarly, although one may disagree with the specific policies of many environmentalists, the absence of some controls over the disposal of commercial waste and other pollutants would lead to disastrous consequences in a highly industrialized society such as ours. And finally, by way of illustration, there is, I believe, general agreement that some surveillance and supervision of the operation of individual banks is required to avoid an excessive number of failures that would create economic instability.

Accordingly, the problem is not that regulation and supervision of economic and commercial affairs is inappropriate, but rather that regulation often outlives the problem it was intended to address; that we do not always take sufficient care to choose the least costly means to achieve the desired end; and that, often, regulation results in unanticipated consequences which can be more severe than the problem which regulation sought to remedy.

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It is not surprising, however, that these problems are so rarely dealt with effectively. All too often those who are regulated, while screaming loudest about the sanctity of an unfettered free enterprise system, grow comfortable in their regulated environment and resist mightily when any serious effort is made to deregulate. Similarly, regulatory bodies acquire a vested interest in their own existence and the "turf" which they regulate which prevents their objective assessment of the regulatory policies which they pursue. As a result, governmental agencies are often loathe to engage in critical self-examination. And, finally, it must be acknowledged that while it is possible to deal with these issues with some ease in the abstract, real-world solutions are not easy to produce. In part, this is a consequence of practical politics and the fact that any change in the framework of an industry's regulation may lead to significant short-run dislocations or adjustment costs. At least as important, however, is the simple fact that answers to many of these problems are extremely difficult to discover.

These factors provide a partial explanation of why the results of bank regulatory reform efforts were so disappointing in the 94th Congress. Notwithstanding the difficulties, however, I believe that it is important -- and perhaps crucial -- that bankers and bank regulators develop a systematic and reasoned approach to regulatory reform. In my judgment, the failure to develop such a positive approach will have several adverse consequences. A golden opportunity will be lost to deal in a meaningful way with the problems of excessive and inefficient regulation, and to highlight the unintended ill effects and hidden costs of regulation. Similarly, an opportunity will be lost to remedy certain demonstrable inadequacies in the present supervisory framework. And, finally, I think that it is critical that we not opt out of the process of shaping the changes which are both inevitable and bound to affect us deeply.

In the time which remains, I would like to identify some of the elements of such an approach, and to suggest some of the changes which might flow from this analysis. I hasten to emphasize that these remarks are not intended to be a comprehensive or definitive plan but are rather a tentative effort to suggest an orderly way of thinking about regulatory reform -- an effort which I hope to refine substantially in the months ahead.

First of all, remedies should be developed which respond directly to inadequacies and abuses which are demonstrated by careful analysis of the facts, rather than to empty phrases such as "competition in laxity". In my judgment, the failure of recent legislative efforts to focus upon specific, demonstrated shortcomings of the system insures that at least one serious flaw will be with us for at least two more years.

Recent events have illustrated that the existing framework for the regulation and supervision of bank holding company systems is not only unduly costly

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because of the overlapping and conflicting jurisdictions involved, but also in some instances simply has not functioned properly. In three of our largest bank failures in the past eighteen months -- the insolvencies of the $1/2 billion asset Hamilton National Bank of Chattanooga and the $175 million American City Bank of Milwaukee, and the distressed merger of the Palmer National Bank of Sarasota -- the cause of bank failure was not abusive self-dealing, which from 1960 through 1973 was far and away the predominant cause of failure, but rather massive unsafe and unsound lending practices occurring in the essentially unsupervised environment of a non-banking holding company affiliate. The failure of the Hamilton National Bank of Chattanooga -- a venerable, traditionally conservative, well-run institution -- is the most graphic and tragic illustration of this phenomenon. But for $80 million in mortgages initiated by an Atlanta-based mortgage company affiliate over a period of months and dumped on the bank, the bank in Chattanooga would be in existence today.

These cases illustrate two points which should be recognized by both the banking agencies and the Congress. First of all, the notion that one segment of a holding company operation can be insulated from the remainder of the system is quite simply a myth. It is the worst form of self-deception to think that the lead bank in a holding company is in a safe and sound condition because its last examination was satisfactory if other facets of the holding company system are not undergoing equally rigorous scrutiny. (I should emphasize parenthetically that I am not an advocate of more stringent portfolio supervision. Quite the contrary.) Rather, my point is that when holding companies were allowed to proceed in a manner that would be unacceptable in a commercial bank, some of them were encouraged, in effect, to hide enormous risk.

The second point flows from the first. That is, it simply makes no sense for as many as four bank regulatory agencies to have safety and soundness jurisdiction over various segments of an integrated business enterprise. Inevitably, this approach will be at times conflicting and uncoordinated.

Accordingly, as an individual involved with the agency concerned with the administration of the deposit insurance fund, I would rate the fragmented and ineffectual framework of regulating holding company systems and not some vague notion of "competition in laxity" as the most profound cause for concern in our present supervisory structure. As has been suggested by others, including Comptroller of the Currency Jim Smith, this problem could be remedied by charging the supervisor of the lead bank with the primary supervisory responsibility for the entire system, including the holding company itself.

Even if it were not possible to illustrate the adverse consequences of the present framework in concrete cases such as the Hamilton failure, such a framework should be rejected both because of the governmental waste that

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results from the unnecessary duplication of effort and because of the burden imposed upon the banker, who must deal with four bank regulators as well as the SEC, the Justice Department, the FTC and miscellaneous other regulatory bodies.

This brings me to what seems to me to be a second element of any serious attempt to reform a regulatory framework: that is, a concerted effort should be made to eliminate redundancy and overlap within the framework of regulation that applies to an industry. Although many of the regulatory reform proposals which surfaced recently purported to rationalize the bank regulatory structure, some of the most notable instances of duplication and inefficiency were largely ignored.

In my judgment, the existing system of review under the Bank Merger Act represents a classic example of a regulatory process which, although benign, is redundant, time-consuming, and unduly costly. As you know, our present system of review of the competitive aspects of a merger has three elements. Under the statute, the primary federal regulator is charged with the responsibility for considering both anti-trust and banking factors in determining whether a given merger should be approved or denied. Second, each of the remaining two federal banking agencies and the Justice Department is required to file with the primary regulator its own analysis of the competitive implications of the merger in question. Finally, after approval by the banking agency, Justice may, within thirty days, sue to overturn the merger on anti-trust grounds.

This system was designed by Congress ostensibly to obtain uniform application of the Act. Moreover, on paper at least, the system seems a good example of how checks and balances can be built into governmental processes. Yet, in fact, the record as developed and reviewed by the Senate Banking Committee this session reveals that uniformity has not been the result. And I can personally testify to the fact that the advisory opinions contribute little, if anything, in the way of facts or analysis that is not brought to our attention by FDIC staff.

Thus, the net effect of this process is, in my judgment, that the energies of bright competent people are consumed in a meaningless task and that more paper is circulated in a city already choked with it. The redundancy, it seems to me, could be remedied without altering the present application of the law. At the very least, the requirement of the extra competitive factor reports should be eliminated. However, I would go a step further, and recommend simply that the primary bank supervisor and the Justice Department be given notice of the intention of two banks to merge. The bank agency would have the responsibility of reviewing the merger from a safety and soundness point of view and the Justice Department would review the competitive factors. If, in the judgment of the banking agency, the merger was defective in terms of banking factors, then the agency would have the authority to prevent it. The Justice Department could, as it does now, file suit under the anti-trust statutes to stop the merger within the time period.

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Another area of redundancy has been underscored by the recent highly publicized efforts of the SEC with respect to disclosure of financial information by large holding companies about to go to the market with debt issues. Congress made a determination that banks should be exempt from the registration requirements of the Securities Exchange Act of 1933. That decision was undoubtedly based on the belief that the special expertise of the bank supervisors would better protect investors, on the idea that the disclosure of the sort mandated by the securities laws was incompatible with the maintenance of confidence in the banking system and, perhaps, on the political clout of banks at the time.

Whatever the reasons underlying this scheme or its merits, the rapid evolution of the holding company and its dominance of banking have served to nullify it. So long as holding company systems finance through the holding company rather than the bank -- and that has been one of the attractive features of the mechanism -- bank exemption from SEC jurisdiction is meaningless. Accordingly, it seems to me that Congress should face up to this fundamental anomaly in the law and vest jurisdiction for the protection of investors in bank securities in either the SEC or the banking agency or agencies. The failure to do so will, it seems to me, lead to further duplication of time and effort as well as further conflict and confusion.

I have focused upon the administration of the securities laws and the Bank Merger Act not so much because the redundancy involved in each leads to "bad" or ineffective regulation, but because they illustrate so clearly the extent to which we have all come to expect, and live easily with, needless and wasteful government when the same resources could be employed to achieve meaningful and needed results. At best, as in the review of merger cases, the result of duplication and overlap in governmental function is waste and inefficiency within the government. At worst, as in the area of holding company supervision, the result is increased costs and burden upon those regulated and their customers, confusion of responsibilities, and, most importantly, regulation which is far less effective than it might be.

Finally, and most importantly, any serious effort at regulatory reform must be based upon an analysis of the objectives and functions of the entire bank regulatory framework. Congress has assigned to the banking agencies and to other agencies of the government such as the Justice Department, the FTC and the SEC a host of functions, including, among others, the promotion of economic stability through the administration of monetary policy; the protection of the safety and soundness of the banking system and individual banks through bank examinations and supervision; the protection of investors and the securities markets through fair and adequate disclosure under the securities laws; the promotion of competition; the protection of consumers; the enforcement of anti-discrimination laws;

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the regulation of interest rates paid on deposits; and the amelioration of the effects of bank failures when they do occur.

As even the recitation of this partial list suggests, bank regulation is multi-faceted. All too often these several goals conflict, necessitating trade-offs among them in terms of both the allocation of resources and the resolution of disputes. In order to understand, much less intelligently reform, the structure and content of bank supervision and regulation, each of these functions and its relationship to other functions should be fully comprehended and evaluated. Indeed, I think that it is quite likely that much of the recent controversy surrounding bank supervision is the result of misunderstanding, confusion and submerged disagreements as to the relative weights which are to be accorded the different functions involved in bank regulation. While this evaluation of each of these functions is a tedious and difficult process -- and one for which the political crucible of Congress is especially illsuited -- it is in my judgment essential if regulatory reform is to lead to anything but disruption of a system that -- by and large -- works.

In conclusion, I would simply like to reiterate what I suggested earlier. The current Presidential campaign confirms what we should have already known: that reform of our governmental and regulatory processes is an idea whose time has come. Kneejerk opposition to change will not prevent its occurrence, but may serve to exclude the opponents from participation in shaping that change. I sincerely hope that we as bankers and bank regulators will have the foresight to deal with the issues involved in an orderly and analytical way. If we do, I am convinced that the net result will be a regulatory framework that is less burdensome and more effective and an industry which better serves its customers.

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