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THE CHALLENGE OF REGULATION AND BANKING

Address by

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Americans appear to be concerned about increasing governmental regulation generally, but are divided about what to do specifically. There is, on the one hand, a recognition that regulation is costly: it raises prices and contributes to inflation and it sometimes meddles needlessly in private decision-making. On the other hand, there is also a recognition that regulation is necessary in a complex economy -- sometimes to protect weak, disadvantaged, or unaware citizens, or to make economic markets function better.

To be sure, Americans often find reasons for favoring regulations advantageous to themselves, but I perceive a consensus in favor of less regulation. And the consensus goes beyond the business community. For example, in a recent U.S. News and World Report survey of consumer attitudes, 71 percent of the 5,873 persons questioned believed that competition is better than government regulation in ensuring that customers get what they are paying for. Almost two-thirds believed that the more government regulation there is, the less efficiently companies can operate. And, only a little over one-third believed that the cost to taxpayers of regulating business is well worth it.

Consumer advocates, too, understand the effects of regulation in raising prices consumers must pay. Nonetheless, the advocates are wary of accepting too quickly the cry of "high costs" for fear that it is a cry of "wolf" that will be raised against any proposal they may advance no matter how meritorious. In any case, both the desire for less regulation and the conflict over where to draw a line have spurred a reassessment of the ability of competitive markets to provide fair and equitable results and also spurred a search for less costly but more effective forms of regulation.

Banking has been regulated for a far longer time and in more detail than most other industries. And I would judge that bankers have been more tolerant of regulation, in part because they are used to it and in part because they

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recognize that banking is affected by public interest more than other businesses. However, in my recent meetings with bankers they have been testy and aggressive on the issue of regulation. And if there is a general drift toward less regulation, they believe that banking regulation is going against the trend.

Today I would like to provide some perspective on regulation in banking so that we may better understand the confrontation between over-regulation and deregulation in banking. I would also like to discuss what the FDIC has been doing about the problem and how bankers may be constructive in minimizing regulatory burdens.

Depository institutions came under governmental regulation early in the Nation's history. In the early years, the State governments were the regulators. However, the First and Second Banks of the United States, although not through direct regulation, exercised significant discipline at times over the issuance of notes by State chartered banks. Direct financial regulation of banks at the Federal level began in 1863 when the National Banking Act created the Office of the Comptroller of the Currency -- originally hoping to strangle the State system, ultimately to share responsibility with the State system. Today banking and thrift institutions fall under the jurisdiction of at least five Federal financial regulatory agencies. And these supplement, often overlap, the State supervisory systems, not to mention the FTC, SEC, and the Labor Department.

The most important reason for regulating banks is to ensure their safety and soundness, but bank regulators have been assigned other missions as well. The preservation of competition is one of the other important goals. To that end, for example, bank regulators review proposed mergers and holding company acquisitions. Bank regulation also plays a role in encouraging home building. Indeed, the savings and loan industry was dedicated by law and regulation to

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that purpose at the time of its rebirth in the 1930's and some in the industry continue to cling tenaciously -- and too narrowly in some respects -- to that mission. In that regard, savings banks, too, have been a bulwark of housing finance, but they have understood the need to widen their mission to meet the financial needs of consumers. In recent years the protection of investors and of consumers has come to the fore as a goal which society wants bank regulators to help achieve. Finally, one of the oldest responsibilities of bank regulation, newly emphasized, is to control irresponsible and fraudulent banking practices. In any case, the perception of many bankers that bank regulation has until the last few years been dedicated to one and only one goal -- bank safety -- is incorrect. In fact, the goals have been multiple and evolving, and the emphasis changes as the public becomes more concerned about achieving one goal or another.

A primary source of increased regulation in banking is a series of fairly recent consumer credit protection statutes. The first of these -- the Consumer Credit Protection Act -- includes four well known titles: Truth-in-Lending (including Fair Credit Billing and Consumer Leasing), Equal Credit Opportunity, Fair Credit Reporting, and Fair Debt Collection Practices. In addition, there are the following separate acts: Fair Housing, Real Estate Settlement Procedures, and Home Mortgage Disclosure. These laws have loaded a great many new costs on both the regulators and the private sector. The regulators have had to hire and educate personnel, prepare manuals, conduct hearings, design forms, and keep both consumers and bankers advised of changes in the implementing regulations. To meet its extensive responsibilities, the FDIC in 1977 initiated separate compliance examinations. Whether or not bank regulators are conducting separate examinations, the examination costs they incur to meet their consumer protection responsibilities are much higher today than they were only a few years ago.

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Banks also have incurred additional costs. Banks have had to hire and train staff; develop new procedures and print new and ever-changing forms; and provide additional legal services to interpret the laws and regulations and, perhaps, defend against suits. Also, banks have been subjected to heavier recordkeeping requirements.

All this effort has resulted in public benefits. Use of the uniform annual percentage rate (APR) has made shopping for credit much easier than it was prior to the Consumer Credit Protection Act. Indeed, before the Act the many ways in which the price of credit was stated made comparison of credit costs virtually impossible except for highly sophisticated citizens who had more than a passing knowledge of financial arithmetic. The other titles to the Act also effected worthwhile ends -- the outlawing of discrimination in the granting of credit, the maintenance of accurate credit history information, the establishment of fair procedures for the collection of debts, the protection of home buyers in making the largest purchase of their lives, and the recording of performance of depository institutions in making home mortgage loans.

The critical question is whether the benefits issuing from these various Acts have been worth the cost. That is a difficult question which is under study, but I think there is broad agreement that the Truth-in-Lending regulations need to be simplified. These regulations are too difficult for consumers to understand and too complex for bankers to administer. The Senate has been considering revision of the statute to aid simplification and we support that effort. Other consumer protection statutes and regulations should be reviewed, not to emasculate their effectiveness, but rather to find more effective and less costly ways of securing the desired ends.

I think, too, that bankers should appreciate that the underlying philosophy of Truth-in-Lending relies on market forces and not regulatory mandate to

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accomplish the desired goals. Disclosure is the key so that buyers will be better informed and will make better choices in the market by dealing with low cost, efficient creditors and by refusing to deal with high cost, inefficient creditors. As tools of regulation, disclosure and minimum standards of fairness are much to be desired over what might have been -- mandated asset allocation or the setting of loan rates by legislative or regulatory bodies.

Indeed, I cannot resist a comment on the regulation of interest rates which finds bankers deploring loan rate ceilings and supporting deposit rate ceilings. Somehow the dedication to free markets melts too easily in the warm sun of personal advantage. As Lyndon Baines Johnson used to say, "All I want is a fair advantage." As to my own views, you know them well. The elimination of usury ceilings and deposit ceilings would be beneficial. I do not think legislators or regulators should determine how much the banker should pay for money or charge on loans as long as the banker operates in vigorously competitive markets. I have faith in the competitive system to dictate fair prices on both sides of the balance sheet.

The regulatory agencies are now faced with the implementation of the Community Reinvestment Act. The Federal agencies held hearings in seven cities throughout the country. The Act declares that the concept of "convenience and needs" of the "community" embraces meeting the credit needs of the community with particular emphasis on the credit needs of low income and moderate income neighborhoods. The Congress gave us a tough job. How does one define a "community?" And what is a "credit need?" For a statewide branch system, is the bank's community the entire State or is the bank's community the service areas of each of its banking offices? If a large fraction of deposits of a bank originates outside the State in which it is located, is the bank's community interstate as well? Should we rely on defined geographical boundaries such as counties or standard metropolitan statistical areas?

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Loan demand is easy enough to identify: it is a credit-worthy borrower standing at a loan officer's desk. But how does one determine a loan need? If a credit need is an unvoiced desire of borrowers who are otherwise credit worthy, how do we as regulators satisfy the statutory mandate that such needs be met? Are the credit needs to be broadly construed to represent all the credit needs in the community for whatever purpose: business needs, personal needs, mortgage needs; or should credit needs be narrowly construed to be inner-city mortgage needs? What does the regulator do about a wholesaling institution which has little-developed capacity to service personal and mortgage loan markets?

Finally, how does one designate low-to-moderate income neighborhoods and what implications does lending in such neighborhoods have for the safety of institutions? That perhaps is the issue which is of most concern to bankers. However difficult it may be to designate low and moderate income neighborhoods, I assure you that it is not the intent of the law and it will not be the effect of the regulations that will induce financial institutions to make unsound loans. That does not mean that banks and thrift institutions should not review their underwriting standards to make sure they are not overlooking sound credits in less prosperous communities.

Indeed, it is my surmise that if there are sound credits in inner-city neighborhoods that are not being financed, the problem is primarily one of marketing. The economic distance between willing lenders and anxious borrowers must be bridged by intelligent, cooperative, and hardheaded intermediaries who understand the needs of borrowers and the responsibilities of lenders. And governmental authorities -- State, local, and Federal -- cannot stand outside of the process. They are responsible in part for the quality of life in the community that makes it an attractive place for private investment. I would

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hope that the Community Reinvestment Act would stimulate the active cooperation of bankers, community groups, and government. This approach holds the promise of benefits to declining neighborhoods much beyond the benefits that would flow from a grudging acquiescence to the requirements of the law.

We listened to a great deal of testimony in the hearings. Much of the testimony was not constructive. Some witnesses, rankling under the prospect of more regulation often shook their fists at the law instead of offering positive suggestions that might help us do the job to which the statute binds us. Indeed, one of the ways you as bankers can do something constructive about burdensome regulation is to send us thoughtful comments on proposed regulations. We read them. And the files are full of unissued regulations and the binders are full of revised regulations that attest to the effectiveness of bankers' comments.

The agencies are planning to propose regulations implementing the Act by July 1. The agency staffs are diligently considering how the agencies might best effect the intent of Congress. Some agency staffmembers would like to bite the bullet and provide substantive answers to those difficult questions regarding credit needs and community. Others would prefer that each bank provide its own answers for its own markets within the framework of a marketing program. Each bank would submit its plan to its regulator for review and would make the plan available to the public. Examinations would then assess the bank's record of meeting the credit needs of its entire community, and the bank's record would be taken into account in connection with applications to branch, to merge with another institution, and to expand in other ways named in the Act.

As for my own position, I am philosophically inclined more toward the latter approach than the former. During the congressional deliberations it was stated

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that banks would be able to comply with the law without any additional recordkeeping. Although that statement may have been excessively sanguine, I would like to see us make it as close to reality as possible. In any case, final decisions await further work by the staffs of the agencies and policy level consideration by the agency heads.

The FDIC is engaged also in a study of State and Federal regulation of commercial banking. The study's primary focus is the overlap of the two systems of regulation and one of its important purposes is to develop policy options for eliminating duplication, thus reducing regulatory costs to the agencies and to regulated institutions.

Each State chartered bank, has two bank regulators, its State authority and either the Federal Reserve or the FDIC. Every application for a new branch, a merger, a change of capital, and for many other corporate actions must typically be passed on by two authorities -- often with delay, inconvenience, and high cost. Every State bank is subject also to dual examination. The study will address these issues and others with the hope of making regulation more cost effective and less burdensome to banks.

Indeed, the FDIC has been working for some years to improve the efficiency and effectiveness of examinations. Because of the increased responsibilities for consumer protection and the increased complexity and riskiness of the banking environment, the demands on the examination process have increased substantially during the past decade. But, we have economized by re-thinking our mission and our methods. We have, for example, shifted examination time and resources away from the well-run bank in favor of expending greater supervisory efforts on the bank in less satisfactory condition.

The FDIC also has been experimenting with alternative methods of performing the examination function to reduce the amount of time supervisory personnel is in the bank. For years, the FDIC and banking departments in many of the States

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have conducted examinations jointly or concurrently. In the joint examination, the two agencies issue a single report; in the concurrent examination, the work of the examination is shared, but the agencies issue separate reports. Either arrangement saves each agency work hours and eliminates the burden on the bank of a second visit.

An experiment to eliminate State and Federal overlap in the examination function was started in February 1974 with the implementation of the withdrawal program. Under this arrangement, the FDIC withdrew from the examination of half or more of the State nonmember banks in the States of Iowa, Georgia, and Washington and accepted reports of examination completed by State examination personnel. This program was designed to appraise reliance on State banking departments for the performance of the safety and soundness examination.

The experiment evolved into a third arrangement, known as the divided examination. Under this program the State and Federal regulators alternate the conduct of the examination and exchange reports. For well run banks this arrangement will result in fewer examinations. Thus far, three States have been enlisted in the program: Georgia, New Jersey and Missouri. The divided examination program is being monitored to determine how extensively it can be applied.

The study is in the fact-gathering stage so I have no findings or conclusions to report, but preliminary investigations suggest rich possibilities for the more effective dovetailing of State and Federal efforts. It is my view that the dual system has been an effective one, but it has been burdened by a layering of State and Federal supervision which has made it more costly than it should be. I am hopeful that the study will provide approaches for streamlining the system while preserving its strengths, and will set a standard for creative State and Federal cooperation that will serve as a model for others.

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Deregulation will not come easily. Each law, regulation, and supervisory practice had a rationale at its inception and many have developed constituencies which resist repeal or amendment. If we are to make progress, all of us must take a fresh view and be willing to compromise. Bankers must be willing to rely more on markets -- even when it may hurt; bankers must be willing to participate in effecting public policy goals -- whatever those goals may be and whether or not they favor the goals sought. But, be assured there is a way, and there is a better way, to implement goals. Your constructive participation in the process can help us find the better way. Holding yourself aloof from the process leaves the field to others.

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