BANK REGULATION ONE REGULATOR'S VIEW

Address by

GEORGE LeMAISTRE, Chairman
Federal Deposit Insurance Corporation

Before the

Arkansas Bank Management Seminar, Fayetteville, Arkansas
August 15, 1978

Good morning! This will be the last time I will speak as Chairman of the FDIC before a group such as yours. Tomorrow I shall be a former Government official. Reflecting back over my 5 years as a Member of the FDIC's Board of Directors reminds me of one of Aesop's Fables. Those of you who are familiar with Aesop's Fables will remember his account of the fly which lit on the hub of a chariot speeding across a sandy plain and looking back said, "What a dust I do raise."

I would like to take a few minutes to share with you some reflections about bank regulation and about the role the banking industry, the Federal Government, and others have in determining the extent of regulation. Widely expressed concern over the last several months about overregulation on the one hand and abusive and unethical banker conduct on the other hand make this an especially appropriate time to reflect on the nature of bank regulation. To understand why our present bank regulatory system is as it is requires knowledge and appreciation of the development of banking and finance since the inception of the American Republic.

In looking to the history of banking and finance it occurred to me that in our language we use the word "history" to refer to that which has happened as well as to the record of what happened. We speak of the history of a people or a Nation, or of the great events or epochs of history, and we also call a history the book which gives a narrative account of these matters. The word history can refer to a kind of knowledge. It can refer to a type of literature. It can mean an actual sequence of events in time which constitutes a process of irreversible change — a change in the structure of the world or any part of nature, a change in human affairs, or a change in society or civilization.

Whether we try to grasp the various conceptions of the patterns of history as expressed by such philosophers as Plato, Bacon, Darwin, Hegel, or Toynbee or refuse to accept any of their theories as definitive, we still find that there is a problem which is common to all conceptions of the pattern of history. This is the problem concerning the causes that are at work as history unfolds. Whatever the factors, they will operate in the future as they have in the past. From their knowledge of the past and with a dim perception of divine providence, people look forward to the future with confidence or apprehension depending on which part they see as stemming from choices freely made and which part they see as inexorably determined.

Whatever the philosophy of our historians, it seems practical to agree with Thucydides that "An exact knowledge of the past is an aid to the interpretation of the future, which in the course of human things must resemble it if it does not reflect it."

Machiavelli put it in these words: "Wise men say, and not without reason, that whoever wishes to foresee the future must consult the past; for human events ever resemble those of proceding times. This arises from the fact that they are produced by men who have been, and ever will be, animated by the same passions, and thus they must necessarily have the same results." And you are all aware of the warning of Santayana that those who ignore the mistakes of history are doomed to repeat them.

With this as a background, let us look briefly at a bit of history that revolves around the need to create a banking system that would finance the economic needs of a growing nation and at the same time would be resilient enough to withstand the vicissitudes of strong economic setbacks. The Federal Government's role in banking stems from the earliest days of our Nation's history. It originally arose from the Continental Congress' need to finance the Revolutionary War. However, the diffusion of the power to coin money among the States of the Confederation and deficit spending by the Continental Congress through the issuance of paper currency created difficulties. You are all probably familiar with the term, "Not worth a Continental."

At the Constitutional Convention, the need for a strong Federal Government which would have the right to levy taxes and to coin money was evident to most delegates. As a result, these powers were delegated to the Congress by the Constitution. During and immediately following the Constitutional Convention a lively debate took place between Federalists and others about how the monetary affairs of the new central government should be handled. Secretary of the Treasury Alexander Hamilton was an exceedingly strong and persuasive advocate of a government bank. As a result of his efforts, the first Bank of the United States was granted a 20-year charter in 1791. Among other responsibilities, the Bank acted as the Treasury Department's fiscal agent and issued paper currency.

The charter was not renewed in 1811 because of considerable opposition to the centralization of banking fuctions in a single national bank. State Governments were jealous of their own prerogative. Nevertheless, the financial strains induced by the War of 1812 led to the chartering of the second Bank of the United States, again for a period of 20 years. Those who remember their American history will recall that President Jackson vetoed a bill in 1833 that would have extended the charter of this bank. His reasons were essentially the same as those that led to the demise of the first Bank of the United States.

Until 1863, the Federal role in banking was limited to coining money and bank chartering was left exclusively to the States. However, the Civil War placed severe strains on the Treasury Department's ability to raise funds. The National Bank Act of 1863, which was amended in 1864, created a system of national banks which were empowered to issue "greenbacks" secured by bonds of the Federal Government. This monetization of the Federal debt by the national banks was much the same function that the Federal Reserve System performs today. The same Act created the Office of the Comptroller of the Currency as an independently funded agency of the Treasury Department. National banks provided the funds through periodic assessments. Among other responsibilities the Comptroller was vested with the power to issue charters and to examine national banks.

Eventually, most State-chartered banks were also subjected to some form of Federal supervision and regulation of their affairs. The first to be included were State banks that joined the Federal Reserve System after 1913. Then, most other State banks came under the Federal umbrella when they chose to apply for and were granted Federal deposit insurance in 1933 and 1934.

The purpose of this litany has been to demonstrate to you that Federal regulation of banks has deep roots in our Nation's history. The Federal role developed originally in response to the need to fund the Federal Government and to manage the Nation's economy. This role grew over time as the Industrial Revolution progressed and as the interrelationships among various components of the Nation's economy became increasingly complex and more closely linked.

Yet, the Federal role in banking really did not become omnipresent until the Great Depression and the New Deal. The collapse of the banking system and the thousands of bank failures were viewed by all as absolutely intolerable and our political leaders were determined to prevent such an apocalypse from happening ever again. The solution was Federal deposit insurance, Federal control over bank failures and liquidations, Federal examination and supervision of banks, higher standards for obtaining charters, and other Federal means of reducing opportunities for the free market to work such as prohibiting interest on demand deposits and limiting rates on time and savings deposits.

If the success of the Federal controls is measured by the number of bank failures, then they must be judged as having achieved their intended objective. Yet, what has been the cost of this success? Some suggest that inventiveness has been hindered, inefficiency fostered, and adaptability to the changing requirements of our fast moving economy retarded. The most extreme pessimists darkly prognosticate that the sheer enormity, complexity, and cumbersomeness of regulatory controls will inexorably cause a hardening of the arteries of commerce and precipitate a general malaise, if not an outright decline, of our society.

While I am skeptical about the accuracy of this line of argument, I am concerned about 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. I think we are all aware that regulation has gotten out of hand. There is a growing consensus among those of all political persuasions that this is the case. Yet, there is little consensus on what to do about it. No one really favors deregulation or regulatory reform in the abstract. Rather, each person's position seems to depend upon the precise individual governmental action as it affects that person and that person's perception of relative advantage or disadvantage to be realized from it.

To put the foregoing discussion in better perspective, I believe it would be useful to consider what Adam Smith had to say in ***The Wealth of Nations*** 200 years ago. Smith postulated that the self-interested actions of each person would result collectively in the maximum benefits for all. However, for such a result to be realized, no restraints of any kind may be placed on competition and everyone must be informed. Now, one of the basic human drives is for security. This drive is continually manifested in attempts to restrict competition and, by so doing, to lessen the degree of uncertainty. Thus, bankers tend to favor interest rate controls because they are viewed as protecting earnings. They tend to favor high standards for approving branch and charter applications because this lessens competition. Furthermore, people are simply not ever informed about everything. And, in keeping with Smith's arguments that one acts in one's own self-interest, the ignorant and ill-informed frequently are taken advantage of. All of you, at one time or another, have heard the maxim, "caveat emptor" — let the buyer beware.

Thus, regulation springs on the one hand from those who are seeking a special advantage: A freedom from competition. On the other hand, it is a device used to protect the weak and ill-informed. The latter is manifested in the body of statutes bearing the words "truth," "fair," or "equal" in their titles. For example, consider Truth-in-Lending. There is little evidence to document the value of the existing customer disclosure form. Yet, because of inadequacies in price competition and because of the difficulty a customer has in determining the cost of credit, some means of imparting information to the customer is a legitimate objective.

There is yet another reason why regulation comes about. Superimposed on Smith's rational economic model is society's system of values. For the economic model to work effectively in guiding the actions of individuals, the allocation of income and wealth dictated by that system of values must be viewed as fair. There are competing sets of values in our society and the democratic process leads to selection and enforcement of various values. For example, a value that has the blessing of our society is that the weak and the old should be cared for. Hence, the Government has devised the welfare and social security systems. Today, we are confronted with the deterioration of our cities. That deterioration is a direct result of governmental decisions made long ago to promote highway building and suburban living. Now, many would have the Government intervene and design programs to rehabilitate our cities. The Community Reinvestment Act is one illustration of such intervention. Society's values are changing and Government is being used and will be used as an instrument to effect that change.

In the early days of this Nation's history, the economic system was based primarily on relatively self-sufficient agricultural units. There was only limited need for Government at the Federal level to intervene. But as the Nation became increasingly industrialized and urbanized and as the pace of change quickened, self-sufficiency was lost and the interdependence of each one's activities grew. At the same time the family and the community, which in simpler times had provided most of the needed guidance of human affairs, weakened and were no longer capable of dealing with the complexities of modern society. Governments at all levels, especially the Federal Government, stepped in to provide the role formerly supplied by other institutions in our society.

The thrust of this discourse is that a Federal role in our affairs and in banking is unavoidable. And, when I say that regulation has gotten out of hand, I do not mean to convey the impression that the scope of regulation can necessarily be reduced. Rather, my concern is that given legitimate regulatory objectives, we have not always devised the most efficient regulatory mechanisms to achieve those objectives. Regulation seems to sink all too quickly to the lowest common denominator. For example, if one bank denies a credit-worthy woman a loan, a regulation is issued requiring all banks to document that their lending decisions are not discriminatory. Justice Louis Brandeis once wrote: "Experience should teach us to be most on our guard to protect liberty when the Government's purposes are beneficient . . . . The greatest dangers to liberty lurk in insidious encroachment by men of zeal, well-meaning but without understanding."

To complain about paperwork is a way of venting frustration but that alone does not solve the problem. I would suggest that regulators, bankers, consumers, and others focus on working together to improve existing regulatory systems and to eliminate those that having little redeeming value, rather than indulging in unproductive rhetorical debate. The Federal supervisory role could be reduced if effective alternative supervisory mechanisms could be devised to accomplish those regulatory objectives that are considered both necessary and legitimate.

For example, the FDIC's focus upon two existing institutional mechanisms in its insider transactions regulation — the bank's board of directors and the examination process — represents a regulatory strategy preferable to others that have been suggested to meet the problems associated with conflicts of interest in banks. This strategy was selected in lieu of prohibition, disclosure, or extensive reporting requirements.

In particular, the FDIC's emphasis on strengthening the bank's board of directors represents an effort to strengthen a system of self-regulation which is inherent in the structure of American corporate law. When existing institutional mechanisms for self-discipline can be made to function properly and effectively, the need for governmental intervention is minimized, if not totally eliminated. Such regulation is not only less costly to the regulated institution and the regulator but, in my judgment, is far more effective.

Bankers can do their part to minimize the need for supervisory oversight. For example, each bank should consider adopting a statement of policy elucidating a code of conduct and ethical principles to which it expects its employees to adhere. Although this would be an important first step in setting a tone, it would be insufficient by itself. Special efforts should be made to convince employees that the intent is sincere and serious. In addition, control mechanisms for monitoring and enforcing such a code are essential. The internal auditors could play such a role and management and members of the board of directors should also play such a role.

More recently, in drafting proposed regulations to implement the Community Reinvestment Act the bank regulatory agencies attempted to minimize direct governmental intervention by relying on the self-regulatory process inherent in our democratic society. Rather than attempting to incorporate definitions of community and credit needs within the regulation, an institution would be required to develop these definitions consistent with guidelines provided in the regulation. These definitions would be made available for public review and comment. The agencies would review the definitions and the public commentary to determine whether each institution were acting in good faith and would assess the institution's record in meeting the credit needs of its local communities. The record would consist of statements of the institution's intentions, public commentary, and other information relevant to assessing the record. For the benefit of the institution, the public, and the examiners, the regulation would contain a listing of factors the agencies would evaluate in assessing the institution's record.

In effect, the object is to provide a forum in which the interests of both providers and users of credit could be brought to bear on the issue of the best uses for that credit. This approach was bound not to be wholly satisfying to any one group. On the one hand, institutions would have to give up some of their control over the granting of credit. On the other hand, neighborhood groups would not be able to dictate to whom and for what purpose credit should be granted. Nevertheless, this approach, which was adopted in substance by the four agencies early in the drafting of the regulation, is in the best tradition of the American democratic process.

As in the case with insider dealings, bankers, if they set their minds to it, can minimize the need for governmental intervention in credit granting decisions by intensifying their efforts to serve all parts of the communities in which their banks are located. I believe that financial institutions are in a better position than government or the supervisory agencies to assist their communities. They know firsthand the unique problems in their communities and those individuals and organizations that offer the best opportunities to deal with those problems. An institution that is committed to serving and improving its community, not only by serving its current customers but also those who for various reasons are not presently customers, will prosper because the community will prosper.

In line with reducing the complexity and unnecessary burdens of the existing system of law and regulations, I believe the entire body of statutes and regulations that form the basis of the bank regulatory system should be reviewed and evaluated. Using strategies such as sunset legislation, zero-based budgeting, and economic incentives, I believe that it is possible to devise regulatory systems that involve the least drastic, least costly, and minimum amount of governmental intervention necessary to achieve the desired public purposes.

This same kind of review and evaluation should also take place inside the regulatory agencies. At the present time the FDIC is conducting a study of its examination procedures. Similar studies of liquidation and internal budgetary and management procedures have been completed. In addition, an internal task force is reviewing all FDIC regulations to determine whether they are necessary, whether they should be updated, and how they can be simplified.

There are several problems that if dealt with properly would lessen the need for regulatory oversight and would simplify the regulatory process. These include:

- Elimination of usury ceilings on loans,
- Elimination of interest rate ceilings on time and savings deposits,
- Repeal of the prohibition against interest payments on demand deposits,
- Simplification of the Truth-in-Lending Law,
- Simplification of other statutes and regulations,
- Supervision of all holding company affiliates by one Federal agency,
- Simplification of the Federal regulatory structure,
- Modernization of Section 13 of the Federal Deposit Insurance Act to permit the FDIC greater flexibility in dealing with bank failures and banks in danger of failing, and
- Improvement in the quality of State banking departments.

About 200 years ago in his ***Wealth of Nations,*** Adam Smith spoke of bank control in this fashion: "Though the principles of the banking trade may appear somewhat abstruse, the practice is capable of being reduced to strict rules. To depart upon any occasion from those rules, in consequence of some flattering speculation of extraordinary gain, is almost always extremely dangerous, and frequently fatal to the banking company which attempts it."

The rules to which Smith referred were the prudential rules that banks impose on themselves — self-regulation, if you will. It is self-regulation that becomes one of the cornerstones of free enterprise; a basis to be supplemented by official supervision, not an outworn tradition to be supplanted by such supervision.

In short, I believe that effective mechanisms of self-regulation are the best hope we have for reducing or at least checking governmental intervention in private institutions. For this hope to become reality, individuals and institutions in the private sector must squarely acknowledge the existence of problems and seek creative approaches to their resolution. The only alternative, it seems to me, is evermore onerous strategies of governmental intervention in the private sector.

FEDERAL DEPOSIT INSURANCE CORPORATION
550 17th Street, N.W., Washington, D.C. 20429