FDIC

"A RETROSPECTIVE VIEW OF THE FDIC"

Address by

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It is a pleasure for me to speak before The Graduate School of Banking. As you may know, I retired from the Federal Deposit Insurance Corporation 2 days ago. Accordingly, tonight, I would like to share my retrospective view of the FDIC based on my 5 years of service on the Board of Directors, first as Director and then as Chairman. The events that occurred during these 5 years, the actions taken by the FDIC to deal with those events, and the problems that remain as yet unresolved are best understood in terms of several broad-based trends that have been taking place in our society and in our economy. Although my remarks are directed to what has happened, a discussion of my retrospective views would really not be complete without including the problems that exist and that will have to be dealt with in the coming months and years.

Although I did not realize it at the time, the tone for my 5 years at the FDIC was set immediately on commencement of my term of office on August 1, 1973. The FDIC at that time was confronted with the impending insolvency of U. S. National Bank of San Diego — the Nation's first billion-dollar bank failure. Little did I or others suspect at that time that this failure was a prelude to other large bank failures, and that the financial system and the economy were about to undergo greater stress than at any time since the 1930s.

During the last 5 years, our Nation has endured double-digit inflation, a serious liquidity crunch in 1974, a flood of petro dollars stemming from the energy crisis, a real estate market collapse, high loan losses, weakened earnings and capital positions, and other problems. The banking environment changed drastically during this period. Competition increased between thrift institutions and commercial banks spurred on by the development of NOW accounts, pay-by-phone, and other innovations. Technological developments in the area of Electronic Funds Transfer also served to heighten competition among different types of financial institutions. Bank holding company developments during this period contributed to increased competition by placing banks in direct competition with nondepository financial institutions in areas such as factoring, mortgage banking, leasing, certain types of insurance, and other financial services.

In the regulatory area, the FDIC was given considerable responsibility for enforcing consumer laws, a significant new responsibility in relation to the Corporation's traditional safety and soundness and insurance functions.

Finally, the strains and stresses of the last 5 years have revealed certain weaknesses in our existing financial regulatory structure, particularly in the area of bank holding company supervision.

Before discussing some of these problems, I would like to expound on four trends that have shaped the events of the past 5 years and that will be of continuing influence. These include: (1) the condition of the economy, (2) changes in the financial system, (3) changing social values, and (4) changing attitudes toward regulation and regulatory agencies.

TRENDS

Condition of the Economy

Probably the most notable change in the condition of the economy (and the one that has had the most far-reaching consequences) has been the development and persistence of high inflation rates. The problem began back in the mid-1960s when Federal expenditures increased sharply to finance the war in southeast Asia. However, inflation did not take on serious proportions until the early 1970s. Because of the oil embargo of late 1973 and worldwide shortages in key commodities and raw materials, inflation took off like a rocket during 1973 and 1974, reaching double-digit levels. Although the level of inflation has retreated, it still remains at a level that in the long run will cause difficulties to the stability of our financial system and perhaps other sectors of our economy.

Partly as a consequence of high inflation rates, partly as a consequence of the U.S. economy's much closer linkage to world economies, and partly because of other influences, our economy has been subject to much greater instability than at any time since the 1930s. This is reflected in price volatility, international weakness of the dollar, high unemployment rates, fluctuating rates in the growth of our economy, and numerous bank failures. The prospect is that inflation and economic instability will continue unabated.

Another factor that is bound to affect the condition of our economy and the effects of which are not yet clearly understood is the changing demographic composition of the American people and the labor force. Because of sharp variations in the birth rate over the last 40 years, the United States now faces the prospect of a significantly older population in the years ahead. This is bound to have significant implications for the financial system.

Changes in the Financial System

There are three discernible trends affecting the structure of the financial system. These trends have been at work for some time and became particularly evident during the last 5 years. The first trend is growing competition between financial institutions of all types including not only banks and thrift institutions but also insurance companies, finance companies, mortgage banking companies, and other providers of financial services. Among depository institutions, there has been a movement toward greater homogenization of powers. For example, checking accounts and control over the Nation's payments mechanism was once the sole domain of commercial banks. With the advent of NOW accounts, share-draft accounts, and other types of third-party transaction accounts, thrift institutions now compete directly with commercial banks. This competitive climate has implications for monetary policy control as well as for relationships between various types of financial institutions.

Technological developments — most notably in the area of Electronic Funds Transfer—have significant implications for the structure of our financial systems. These developments have led to the emergence of automated clearing houses and regional and nationwide switching networks to facilitate financial transactions.

By improving communications, such technological developments have greatly reduced geographical barriers to competition. For example, an automated teller machine allows a financial institution to enter a market at far lower cost than if it had to erect a brick-and-mortar office. In fact, point-of-sale machines allow financial business to be transacted in such places as grocery stores, department stores, and the like. Although this trend is evolving slowly, I expect that it will eventually result in a substantial change in the competitive and institutional structure of the financial system. More and more States have relaxed their restrictions on branching, and I would not be surprised to see movement toward interstate branching in coming years. The bank holding company has already provided a vehicle for interstate banking.

Change in managerial attitudes is a third trend on which I would like to comment. Bankers traditionally have been extremely conservative and cautious about taking risks. Such attitudes began to change during the 1960s as a new generation of bank managers took over. The advent of the one bank holding company in the late 1960s accelerated the diffusion of the new aggressive, risk-taking management style. Catchwords such as "liability management" and "go-go banking" are illustrative. The severe recession of 1974-75, and the extreme liquidity pressures that accompanied that recession, placed severe stress on a great number of financial institutions. The result was a movement back toward more traditional banking attitudes. However, in my opinion, this return to prudence has not been accompanied by the excessive caution and conservatism of the past.

Changing Social Values

During my term on the FDIC Board, additional social legislation was enacted by the Congress such as the Equal Credit Opportunity Act and the Community Reinvestment Act. This legislation mandates that regulators ensure that financial institutions respond to the needs of the Nation, particularly the needs of the poor and ill-housed. This new regulatory mission contains elements of consumerism, of civil rights and social action programs, and of traditional safety-and-soundness concerns. But this new regulatory mission goes beyond this. It amounts to a mandate to see that financial institutions carry out their duties in the spirit of public service.

This is particularly evident in the Community Reinvestment Act. The Congress found that regulated financial institutions have a continuing and an affirmative obligation to help meet the credit needs of their local communities. The Congress required each appropriate Federal financial supervisory agency to use its authority when examining financial institutions to encourage such institutions to help meet the credit needs of the local communities in which the institutions are chartered.

Role of Regulation and Structure of Regulatory Agencies

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 Nation's economy became increasingly complex and more closely linked.

There is a growing consensus, however, among those of all political persuasions that Federal regulation of financial institutions may have gotten out of hand. Yet, there is little consensus on what to do about it. No one really favors deregulation or regulatory reform in the abstract. Rather, each one's position seems to depend on the precise individual governmental action as it affects each person and that person's perception of relative advantage or disadvantage to be realized from the action.

I think we are all aware that regulation has gotten out of hand. But, by this statement 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. To complain about paperwork is a way of venting frustration, but that alone does not solve the problem. 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.

Another trend that seems to be gaining momentum is reorganization of the Federal financial institution regulatory structure. The difficulties of the early 1970s and the failure of several large banks prompted agency officials, members of Congress, and others to join in debate on restructuring the regulatory system. Although such discussions have taken place for decades, they have always waxed and then waned. This time, however, serious discussions have been going on for nearly 4 years and, rather than interest lessening in various structuring proposals, the prospect of serious action is becoming more likely.

For example, the FDIC and the Office of the Comptroller of the Currency have called for consolidation of bank holding company regulation and supervision. The FDIC has suggested in recent testimony that the Federal Reserve's monetary policy function may interfere with its supervisory function and has pointed out that there does not seem to be any real reason to link the two. Senator Proxmire, as you may know, has proposed that all bank supervision be consolidated in a single Federal agency. The financial regulatory agencies, in fact, recognizing the need for more formal coordination, have set up an Interagency Supervisory Committee. This Committee serves as a forum for discussing supervisory matters of common interest and for working out joint solutions.

To the extent that the trend toward greater homogenization of our financial institutions continues, it seems inevitable that we will move toward a simpler and more streamlined Federal financial institution regulatory structure.

PROBLEMS

As I stated at the outset, there are many problems in our present financial system that have not yet been resolved. These problems are linked generally to the four broad-based trends that I have been discussing. I would like to explore a number of these problems with you and suggest to you my thoughts on appropriate resolutions.

Interest Rate Ceilings

There was a time when the existence of interest rate ceilings had very little effect on financial institutions. However, the sharp increases in inflation and interest rates during the last few years have caused financial institutions considerable difficulty. For example, lending rates on loans frequently have bumped up against State usury ceilings. The problem has been particularly acute in thrift institutions. Rates that these institutions pay on deposits tend to adjust to market rates of interest very rapidly, but rates that thrift institutions earn on their assets adjust much more slowly, thus placing them in a serious earnings squeeze.

One way of avoiding such an earnings squeeze is setting deposit interest rate ceilings below market rates. Interest rate ceilings, and particularly the interest rate differential favoring thrift institutions, have also been supported as devices for allocating funds to the housing industry. In my opinion, interest rate ceilings on deposits simply do not work well as a device for allocating funds to housing. Although ceilings may protect thrift institutions from commercial bank competition to a certain extent, they do not protect thrift institutions from competition from unregulated money markets. At times of high interest rates, such as in 1973-74, many depositors take their funds out of depository institutions and invest them directly into money market instruments. As a result of such disintermediation, the mortgage market dries up and thrift institutions in particular suffer earnings and liquidity pressures.

Even if ceilings on deposit interest rates were effective in ensuring a stable flow of funds to the housing market, ceilings would still be highly objectionable because they constitute a regressive and inequitable tax on small savers. I have recommended on numerous occasions that the appropriate policy is to select a date when all interest rate ceilings will cease to exist. The time for doing this is already running short because nonregulated institutions such as Sears and Merrill Lynch increasingly are competing vigorously for the depositor's dollar. I have also strongly recommended that the prohibition of interest on demand deposits be repealed.

It is my firm conviction that free competition for deposits without price controls will remove an important need for regulation as well as result in a much more efficient economic system.

Capital Adequacy

Another direct consequence of inflation has been declining capital ratios. These ratios cannot continue to deteriorate without eventually seriously weakening the financial condition of many financial institutions and without impairing their ability to absorb unexpected setbacks and to strongly and aggressively compete.

Capital positions are supplemented primarily through retention of earnings. When the rate of earnings retention is less than the rate of asset growth, as is customarily the case during periods of high inflation, capital ratios necessarily decline. The best solution would be to get inflation under control. Obviously this is easier said than done. If inflation remains a persistent problem, declining capital ratios could be arrested by: (1) higher earnings rates on assets, (2) slower growth in total assets, or (3) additions to capital from sources other than earnings retention.

The record to date indicates that none of these solutions is particularly attainable. Thus, I must say that I am pessimistic about the future prospects for success. The best hope in the long run is to solve the problem of inflation.

Bank Failures

Today, in the aftermath of the most severe recession since the 1930s, and after 46 bank failures in my 5 years on the FDIC Board of Directors, including the 10 largest failures in the Nation's history, it is clear that the FDIC has succeeded in its mission to maintain confidence in the financial system. We learned during this period that disclosure of banking problems did not shake public faith in banks. While the press and even some bankers, Members of Congress, and bank regulators fretted publicly about the soundness of our banking system, the public even in those areas where it was known that a failure was imminent responded with confidence and not with panic.

Notwithstanding my belief that the deposit insurance mechanism has served the banking system and economy well and that it represents an example of governmental response that has not proved unduly costly and burdensome—based on the FDIC's experience in recent years, I believe certain changes to the Federal Deposit Insurance Act should be considered which would increase the FDIC's flexibility in responding to unique situations, particularly those that arise in very large banks. Where it is clear that an insured bank is insolvent or likely to become insolvent and where it is impossible to arrange an acquisition without FDIC assistance, there are four options: (1) the FDIC may make loans to purchase the assets of or make deposits in an insured bank to reopen it or to keep it open, provided that continued operation of the bank is "essential to provide adequate banking service in the community," (2) the FDIC may assist another bank with the purchase of assets and assumption of liabilities of a closed bank or a bank that is about to be closed, (3) the FDIC may create a deposit insurance national bank (DINB) to assume the insured deposits and the fully-secured deposits of a closed bank, or (4) the FDIC may pay off all insured deposits of a closed bank.

Historically the FDIC has used either the purchase-and-assumption method or the payoff method. The purchase-and-assumption method is used whenever feasible because it causes less disruption in a community than does a payoff. Deposit Insurance national banks have been created only four times since 1945, and assistance to an open bank has been extended only four times since the authority was conferred on the FDIC in 1950. Both of these methods are seldom used because of extremely restrictive requirements or conditions imposed by the statutes. For example, the statutory test "essential to provide adequate banking service in the community" in the case of assistance to an open bank can seldom be met. A DINB is in effect a soft-landing payoff. The bank has limited powers and must be closed at the end of 2 years if sufficient capital cannot be sold.

The deposit payoff and purchase-and-assumption methods also have their disadvantages, particularly in the case of large bank failures. On the one hand, a straight payoff for a billion-dollar bank could cause hardship to people who rely on an on-going relationship with their banker, and who normally keep both debit and credit balances. A straight payoff could also disrupt the financial markets. On the other hand, a purchase-and-assumption can raise serious antitrust problems. Also a purchase-and-assumption has to meet the "cost test" described in the statute; that is, the FDIC has to show that the takeover would cost the Corporation less than would a simple payoff.

It seems to me that Congress needs to update the FDIC's powers to deal with failing bank situations. Several possibilities should be considered:

(1) Some Form of Corporate Reorganization

Under regular bankruptcy rules, a debtor corporation can rehabilitate itself through a corporate reorganization by having claims and debts scaled down. Such a procedure might be applied to the uninsured liabilities of large banks.

(2) Less Restricted Conservatorship Powers

A deposit insurance national bank provides very restricted conservatorship-type powers. Relaxing the existing restrictions could provide the FDIC the flexibility it does not now possess to rehabilitate a troubled institution.

(3) Emergency Access to the Federal Reserve Discount Window

Emergency borrowings from the Federal Reserve Discount Window could be made available to a bank upon certification of the FDIC that the bank is in danger of failing and that such assistance is necessary for a temporary period until a merger, a receivership sale, or some other orderly resolution of the bank's problems is arranged.

(4) Expanded Authority to Assist an Open Bank

The FDIC could be permitted to provide funds on a medium to long term basis to an open bank subject to specified guidelines.

(5) Override the "Cost Test" in Certain Instances

The FDIC could be allowed to disregard the cost test if it finds that its loss from a purchase and assumption of a closed bank is clearly outweighed by the public interest in preventing disruption to the community, in preventing substantial lessening of competition, or in contributing significantly to the convenience and needs of the community.

(6) Interstate Branching

The Comptroller of the Currency could be empowered to authorize branches across State lines when the FDIC certifies to the Comptroller that the establishment of such branches is essential to facilitate a purchase-and-assumption transaction.

Obviously these and other proposals for improving the techniques for dealing with troubled banks should receive careful study before Congress acts. Although the financial system probably will continue to function adequately if the FDIC's powers remain as they are, it is my hope that serious attention will be given to streamlining and modernizing FDIC powers for dealing with banks in danger of closing. Based on experience I can confidently state that such streamlining and modernization would greatly facilitate smoother functioning of the financial system in times of difficulty and stress.

Other Problems

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

- Simplification of the Truth-in-Lending Law,
- Simplification of other statutes and regulations,
- Supervision of all bank holding company affiliates by one Federal agency,
- Simplification of the Federal regulatory structure,
- Improvement in the quality of State banking departments,
- Extension of interest bearing transaction accounts to all financial institutions,
- Broader lending powers for thrift institutions,
- Curtailment of insider abuse and adoption of codes of ethics,
- More effective communication between financial institutions and the communities they serve,
- Management of structural change in the financial system brought about by technological changes in the payments mechanism, and
- Resolution of Federal Reserve System membership attrition.

This list is hardly an exhaustive one. It is my hope that financial institutions, supervisory agencies, the public, the Congress, and the Government as a whole will address each of these problems in considered fashion and develop resolutions that enhance the flexibility and efficiency of our financial and economic systems.

In closing, I would like to voice a note of caution as articulated by James Madison more than 2 centuries ago:

"It will be of little avail to the people that laws are made by men of their own choice if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood; or if they be repealed or revised before they are promulgated, or undergo such incessant changes that no man, who knows what the law is today, can guess what it will be like tomorrow."

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