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# BANK SUPERVISION AND BANK STRUCTURE

by

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before

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# BANK SUPERVISION AND BANK STRUCTURE

Last May, a large state-chartered bank announced its intention to convert to a national bank. The move could be considered just another manifestation of a recent trend in which some $18 billion in bank assets have been transferred since 1959 from the state bank system to the national system. However, the conversion startled most close observers of the banking scene because the chairman of the board of the bank involved had been one of the staunchest supporters of the dual banking system.

About two weeks later I attended the International Monetary Conference of The American Bankers Association in Puerto Rico as a member of a panel on Bank Regulation where the conversion was widely discussed. The proposed conversion indicated to me that "a new duality" might perhaps be developing, which would tend to polarize large banks under national charters and the small and intermediate-size banks under charters of the 50 state jurisdictions. Such a trend would undermine the dual banking system -- as we have known it and as it has evolved from the tests of experience over the decades to its present state. Among the factors possibly responsible for the present turn of events I cited differences in Federal supervisory attitudes toward banking and banking activities as well as the shortcomings in state banking laws, despite efforts at modernization, and reluctance to pay the price for adequate supervisory manpower.

The ensuing dialogue about the issues and their implications has been spirited to say the least -- both in the public arena and within the more restricted confines of banking groups and bank supervisors. The discussions have been further enlivened by the subsequent announcement by another large state bank of its application for a national charter and by a series of announcements by various state- and Federally-chartered banks of the proposed formation of one-bank holding companies.

I think the discussions have proved most helpful. Last week the Board of Governors of the Federal Reserve System announced that it was reversing earlier interpretations relating to the formation or acquisition of "operations subsidiaries" by member banks and "loan production offices". The Federal Reserve will now permit its member banks, both state and national, to purchase the stock of operations subsidiaries to perform functions that banks are empowered to perform directly. In addition, member banks may establish and operate directly or indirectly "loan production offices" at any location in the United States. It is still too early to assess the full implications of these changes but they seem to be in the right direction.

The conversions to national charters and the formation of one-bank holding companies to perform various financial services have been explained in terms of the banks' need for greater freedom in organizing their activities for customer service and thereby meeting the comprehensive financial requirements of the immediate community. Avoidance of limitations that are geographical in nature (whether state boundaries or intrastate statutory restrictions) have also been mentioned as important considerations in meeting the financial needs of individuals and businesses that in effect operate internationally, nationally or at least regionally and require flexible financial accommodations. The similarity of reasons given for the proposed changes is, I think, noteworthy and significant. It has stimulated the Corporation to review once again the current position of banking and its structure.

Accordingly, it is time for us to concentrate more specifically on some of the fundamental problems attending these recent developments -- and even to look beyond the existing institutional framework in order to gain a sharper perspective. No attempt will be made to try to assess causes or place responsibility for the recent changes. The situation is much too complicated and the results would not help in solving the hard problems that confront bankers and supervisors alike.

What are some of the "real" problems that now clamor for attention? Is it the future of the dual banking system -- and the threat to decentralization of bank supervisory responsibilities? Is it the trend in the conversions from state to national charters? To some extent these are important matters, especially because to some extent state banks and state supervisors are finding their ability to respond to the times effectively hampered by state laws, inertia, ingrained local attitudes toward banks and bankers, and differences in supervisory policies and practices at the Federal level. A number of problems at the state level, furthermore, are not amenable to state action alone, particularly since states must operate within geographical boundaries that are not likely to be changed.

Even more basic is the question of whether a radically different type of banking system might not be expected to evolve in the future, with new kinds of financial institutions and a supervisory structure wholly unlike that with which we are now familiar. The economy and its institutions today are quite unlike those of yesterday; economic units have necessarily grown to meet correspondingly larger needs. And the needs themselves have often become more varied. Accordingly, large banks that can operate nationwide --

and worldwide -- are essential. At the same time, the continued existence of smaller institutions side by side with the large banks to provide financial services to small business and the consumer is not inconsistent.

On the other hand, with the advent and spread of computers and telecommunication networks, banking in the future may assume a completely different physical structure. The installation of electronic input devices could eliminate or minimize the need for banking offices or a single office could handle a greater volume of business. Moreover, the types of business could also be quite different. These eventualities are not as fantastic as they may seem; for example, the growth of bank credit cards may be an important step along the way. Under such circumstances, the existing banking structure and supervisory framework would be largely outmoded. How should the system be remodeled to meet the new circumstances?

Banking has often been described as a highly regulated industry. Usury laws have existed for many generations. Entry into the banking business is restricted; ceiling rates are prescribed for interest paid on time and savings deposits; and the supervisory agencies have the power to remove officers and directors for cause and to conduct periodic examinations covering pratically all phases of banking activity, for example. On the other hand, banks -- unlike public utilities -- are not subject to regulations promulgated by the supervisory agencies which establish standards for services and prescribe schedules of uniform charges for services to customers.

The reason for bank regulation at both the state and Federal level is due to the dominant role that banks play in supplying financial services to the public including the means of payment to facilitate business transactions.

Without these services our economic system could not function. To ensure that banks continue to perform their function efficiently and effectively, banking laws were enacted to oversee the soundness of these institutions. As a consequence, supervisory laws should not be administered in such a manner as to handicap them unnecessarily in the performance of their duties. As the leading supplier of credit to the economy, banks should be allowed to offer new financial services as they are needed.

To be sure, this characterization of the role of banks in the economy is much oversimplified. The interests of the public -- whether borrower or depositor -- are served by banks when they provide for their customers' financial requirements. Banks, however, are still private-enterprise, profit-making institutions whose operations are also naturally influenced by considerations of self-interest. For individual banks these considerations will dictate specialization in specific types of banking business or a particular form of business organization. But in any case the essential position that banks occupy in the financial mechanism necessitates the accommodation of self-interest to the broader objectives of public convenience and need and the preservation of a competitive environment.

One area of bank supervision which provides a good illustration of the complex problems involved in trying to achieve a proper balance between the public and private interest is in the area of bank mergers. How is the proper balance determined? Growth is a natural goal for most banks to strive for, and one of the ways in which a bank can grow is via the merger route. Of the approximately 150 merger applications approved by the Corporation over the calendar years 1964-67, at least two-thirds had --to a greater or lesser degree-- the effect of extending the merging bank's sphere of operations into new market areas. Among mergers involving relatively large banks, these were predominantly geographical extensions and resulted in the substitution of a branch of a large bank offering a wider variety of services in place of a smaller --possibly limited-function-bank. In some other cases, banks extended their market areas only minimally and at the periphery.

Assessment of the over-all effect of such mergers must be based on a fairly well-defined concept of the type of banking structure necessary to satisfy the financial needs of the various markets involved. This concept is, I think, not always well-defined or as clearly recognized as might be desirable. A number of State laws make no reference to competitive factors in merger situations. In some instances, a significant reduction in competition in one segment of the market is overlooked in favor of enhanced competition in another market where the additional competition may not be great enough to offset a loss in convenience for the public. Limitations on entry into a particular banking market may serve to reinforce the anti-competitive effects of the merger.

Optimum size for banking units is another important facet of banking structure. A market with a large number of small banks of less than optimum size may deprive the public of the most efficient and economical financial services, a reasonable choice of services and a truly competitive enviroment. On the other hand, it is not clearly established that size *per se* is a requisite for successful competition with other (larger) banks. Mergers of local competitors for the sake of achieving larger lending limits, for example, may involve a trade-off in terms of diminished convenience to local customers.

Moreover, optimum size could vary with the nature and extent of the market. In our diversified economy and geographical complex, the "ideal" banking structure for regional or national operations could well differ from the most desirable structure for a local market or particular section of the country. To the extent that the financial mechanism of the future differs radically from that of today, even greater shifts in our concept of the appropriate banking structure would be needed if supervisory authorities are to discharge their responsibilities conscientiously.

The Corporation is attempting to improve our knowledge in this area of banking structure -- especially with respect to the effects of statutes and other supervisory constraints. The impact that statutory provisions have on bank structure, competition and market shares can be illustrated by considering the application of the same kind of policy on banking offices to two different situations. In a unit banking State, a "liberal" policy permitting the opening of many new banking offices in outlying portions of a metropolitan community will result in the reduction in the market share of the larger bank and possibly increased competition for business among the banks in the outlying regions since the larger bank cannot extend its reach - or the market - geographically. Conversely, the same type of policy in a State permitting branch banking will allow the larger bank to retain -- or even increase -- its market share through the opening of additional offices. On the other hand, whether one alternative or the other contributes more to the preservation of competition and to meeting the convenience and needs of the public has not been unequivocally determined.

Another important issue highlighted by the developments of recent months concerns the appropriate scope and nature of banking activities. At the present time, banks are attempting to strike out into new territory -- to offer services never before offered by banks. Differing conclusions among the bank supervisory agencies as to what is and what is not a banking activity have been due partly to differences in the precise language of the statutes and possibly in part to differences in the interpretation of statutory terms. Statutory differences can be removed by legislative action once the situation has been recognized and a decision made that the difference may not be desirable. What is most important is the ability to recognize that a situation may need to be changed.

Should banks, for instance, be permitted to engage in any activity as long as it is safe, sound, and profitable or should they be expected to confine their activity to those fields historically deemed to be appropriate to their financial role in the economy? In a money economy, it is easy to find some link between every type of transaction and its financing, but the relationship should be more basic. Bank weakness and bank failures moreover, have a much greater adverse impact on the public's confidence than the failure of a single nonbank business. Nevertheless, the specialized role of banks should not subject their activities to more stringent constraints than those applicable to nonbank enterprises engaged in similar activities unless the additional constraints can be fully justified.

Banks should not engage in activities that would endanger their solvency or promote dealings on the basis of self-interest because they would interfere with the discharge of their function of providing financial services. This does not mean, however, that banks should avoid all activities that carry some element of risk; on that basis no innovations would ever be adopted. Certain activities that may have been closed to banks in the past could be acceptable today because both financial requirements and the economic enviroment are different today. The abuses that developed before should not be permitted to reappear.

Since the economy, moreover, may be on the threshold of a new era where automation and computers may completely alter they way in which banking is conducted and financial transactions carried out, a willingness to reconsider previous positions is essential. To foreclose in effect banking's participation in this exciting phase of our economic development through supervisory action or inaction would handicap banks needlessly and unfairly in the discharge of their basic functions.

To sum up, legal technicalities should not be permitted to perpetuate an environment unfavorable to banking. To some extent, the recent upsurge in the number of prospective one-bank holding companies was attributable to the decision of a number of banks that the one-bank holding company "route" would enable them to carry on certain activities that were not permitted under some banking statutes. The action of the Federal Reserve last week in reversing its previous interpretations prohibiting member banks from purchasing the stock of operations subsidiaries and to establish and operate directly or indirectly "loan production offices" could be a significant step in slowing the move to the one-bank holding company type of organization. It is an example of an intelligent adaptation of supervisory policies to the realities of the financial world.

The legislative history of the Bank Holding Company Act of 1956 indicates that Congress did not intend that the Act provide a loophole for banks to circumvent supervisory constraints. Failure to agree on what activities really are "proper" banking activities and what activities are not has constituted a significant part of recent problems. The legal niceties became entangled with the economics of the situation. In the long-run, the economics of the situation must predominate.

The present time is an appropriate time to stop and take stock of the banking scene. The economy is marking time and readjusting to a more sustainable rate of growth. The shift toward increased automation is in the process of picking up speed. Bank supervision should take this opportunity to review its own posture and prospects.

What I would like to urge on my fellow bank supervisors at this time is that we broaden our perspective -- both with respect to banking's future role in the economy and our own relationship to banking. Much can be said for the goal of "competitive equality" in bank supervision, but this competition must be a "competition in excellence."