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SHADOW AND SUBSTANCE

Address of

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at the

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In their efforts to implement regulatory authority today, bank supervisors find themselves necessarily responding to a complex of troublesome economic developments and bank reactions to these developments. Certain facets of the situation present old problems in new forms. Nevertheless, the demands upon banking and on bank supervisors alike are -- to say the least -- without precedent. A cooling off of an overheated economy is to be accomplished gradually and with minimun pain to the participants. Such efforts have never been tried before in situations like the present, and the endeavor to achieve the objective makes heavy demands upon the ingenuity and skills of bank supervisors among others in positions of responsibility both in and out of government.

Talking specifically to this point, it is a fact that a significant part of consumer and business spending is currently being undertaken in anticipation of higher costs in the future. To dampen the strong inflationary psychology that seems to have become fairly well entrenched in the thinking of many businessmen and consumers, the Federal Reserve System has embarked on a program of anti-inflationary measures. The increase in the rediscount rate and reserve requirements by the Federal Reserve earlier this month tends to confirm to banks and the market in general that the present policy of credit restraint will be maintained.

Further indication of strong upward demand pressures on the nation's resources is the current level of interest rates -- now at unprecedented heights for this generation. To be sure, certain short-term rates have receded from the highs reached earlier this year, but this has been due in part to the uncertainties created in the marketplace by recent economic -- as well as political -- developments and the accompanying desire of consumers and investors to remain fairly liquid.

This is an important part of the environment in which bank supervisors find themselves today. Many of the banks under our respective supervisory jurisdictions are attempting in various ways to accommodate themselves to the pressures that are bearing most heavily on them -- stemming from the general economic situation but complicated by existing regulatory policies and practices. As a result, bank response to economic pressures or to supervisory regulations through the development of new techniques or the refinement and adaptation of old techniques used in other fields -- presents bank supervisors with new and important questions. For example, in the current economic environment, are these innovations by banks a healthy means of providing flexibility or of cushioning -- if only temporarily -- the full impact of the pressures or are their expansion and extension a source of future serious supervisory problems? Are such developments the distinguishing characteristic of a dynamic banking system or will distortions be created in the structure of banking and artificial situations maintained only by an ever-increasing degree of regulation?

These are some of the questions that demand answers. There will be others fully as important that cannot be ignored by bank supervisors at both the Federal and the State level, irrespective of whether they function through a board or a commission or as a single administrator. Moreover, our problems today arise from the prevailing economic environment and from the adjustments that banks make while under these constraints -- and not from particular patterns or the existing structure of bank supervision.

During much of the postwar period, innovative adaptations could proceed at a more leisurely pace. Today this may no longer be possible. The rate of change has quickened. For convenience in this discussion, let us consider first some innovations evolved by banks in response to the general economic situation. Within this category might be grouped responses to balance of payments difficulties, higher taxes, and the continuing pressures on the economy stemming from our involvement in Vietnam. In a second category would be the flood of developments which may be making existing laws and regulations obsolete or irrelevant, such as state laws on branching or on the investment powers of state-chartered institutions and supervisory authority to set interest rate ceilings. With respect to the former category, supervisors -- like bankers -- can only react to events as they occur, but in the latter category wherein regulations and laws are important and sometimes controlling, supervisors can be a major, and perhaps the controlling, agent.

In response to current economic developments, a few illustrations may be cited. Banks in the past -- and more recently -- stepped up their recourse to the Eurodollar market to augment loanable funds or developed new types of consumer-oriented savings instruments to retain the funds of the interest-sensitive saver attracted by higher rates of return available in the money market. The Federal funds market developed as a means to make more efficient use of a given volume of bank reserves at lower cost than borrowing at the Fed, with the added advantage of avoiding the "stigma" of borrowing from the Fed.

The Federal funds market has helped to minimize fluctuations in the credit markets as a result of temporary surpluses or shortfalls in individual bank reserve positions, has enabled smaller banks to maintain a more fully invested position, and has influenced the asset mix of participating banks by facilitating short- and long-term adjustments. From the regulatory viewpoint, development of the Fed funds market demonstrates the ability of the banking community through its own efforts and within the existing framework of regulation to innovate successfully.

By contrast the authority to establish interest rate ceilings on deposits has created some difficulties at both the Federal and State levels of bank supervision. Where state ceilings on time money are lower than Federally prescribed ceilings, there have been sizable outflows of funds from one state into a neighboring state in which banks are permitted to offer higher rates. Or banks have tried to attract funds through instruments not technically subject to the state limitations.

A similar situation also developed in connection with the rate ceilings established at the Federal level. As the competition for savings intensified in 1965-66, a number of banks began to offer short-term promissory notes and similar instruments on terms that violated the permissible rate ceilings. Because there was some evidence that the proceeds from these bank obligations were being used to supplement the bank's lending capabilities over the short run, the Federal Reserve ruled that shorter term promissory notes and similar instruments were deposits and therefore subject to its regulations governing reserve requirements and payment of interest on deposits. The use of promissory notes subordinated to the claims of depositors and of more than two years' original maturity, to strengthen a bank's capital position, however, was not foreclosed by this ruling.

The intensity of the demands for credit today and of the competition among direct users and financial intermediaries for funds has focussed the energies of banks and bank management in two areas: in the search for loanable funds and in the search for earnings in an environment where both money costs and other costs are rising. In the process of pursuing these two objectives, banks may overextend themselves and increase their vulnerability to unexpected setbacks or to a major change in their economic environment.

Recently, there have been reports of several innovations introduced largely in response to the current economic climate. These include the use of loan participation agreements incorporating a repurchase feature, the sale of commercial paper by bank holding companies, and the possibilities of long-term bank borrowing in the Eurobond market. Each of these proposals or methods share a common feature; they would all enhance the ability of the bank to obtain funds in today's tight money and capital markets.

Although the development of new savings instruments has been going on for quite a long period of time, it now is demanding much supervisory attention. First, the large, negotiable certificate of deposit was introduced to attract the excess working balances of large corporations. As the rates paid on these CDs reached the ceiling, banks began to devote more of their efforts to draw in the funds of the smaller saver -- and we saw the promotion of various types of consumer-oriented savings instruments, such as the consumer-type CD and the time deposit open account "Golden Passbook Accounts." Quite likely these new savings instruments might not have been created in the absence of interest rate ceilings.

A number of unintended side-effects precipitated by the exercise of authority over interest rates have complicated the work of the monetary authorities and the supervisors of financial agencies. Possibly one of the most critical results of the rate ceilings was their role in reinforcing credit restraint -- the run-off in CD funds as market rates of interest reached the ceilings. Equity considerations in the treatment of savers might also have been slighted by the maintenance of a 4 percent ceiling on passbook savings accounts, thus possibly penalizing the less sophisticated saver. Rate ceilings also tend to provide some incentive to find ways to circumvent the ceilings -- through money brokers and dealers, overzealous advertising of essentially similar offering rates, and the like.

Worthy of note also is the fact that interest rate ceilings can operate as a protective cover for the high cost bank, thus perpetuating market inefficiencies. Other unintentional distortions in the market structure for savings may develop if the ability of banks and other financial intermediaries is restricted for any extended period of time without strong justification.

In administration of regulations of this type, there are serious difficulties facing the supervisory authorities in reaching decisions concerning the appropriate level of rate ceilings in a regulated market. Under such circumstances the guidance furnished by the free play of market forces is restricted, and as a result, the decisions may be inadequate or actually quite perverse. Existing misallocation of savings among lenders and borrowers could be perpetuated. A particular pattern of distribution of savings in the market could be "locked in" or other artificialities in the market created by administrative action. For instance, are we knowledgeable enough about the savings market to say with assurance that a quarter-point differential in favor of funds held in one type of institution over another is "correct"? Does this rate differential give adequate recognition to unique characteristics and basic differences? Furthermore, is it possible that such regulations inadvertently would mold institutional structures even though the demonstrated need for change was lacking?

I believe that freedom to operate in the market within the confines of the responsibility of banks to serve the banking requirements of their communities will produce the type of banking system best suited to our growing needs. The longer artificialities in the market are unnecessarily maintained, the more difficult will it be to regain the benefits of a competitive market. Aberrations become "built into" the financial system and the essential flexibility required by private enterprise is lost or weakened. Over the long run, the economics of the situation will have to prevail, but in the interim bank supervisors must guard against making their task more difficult by their own actions or lack of action.

Bank supervisors must be prepared to deal with unexpected developments such as these as well as innovations arising out of the prevailing economic and financial environment in which their institutions are operating and as a result of regulatory or supervisory actions that are taken. I would like to emphasize the importance of recognizing these possible reactions and side-effects as soon as possible and the need to evaluate their impact on the banking system and on bank structure as they develop.

The attempt to pursue two objectives simultaneously and within the same institutional framework -- the search for funds and the search for earnings -- is well personified in the recent upsurge in the formation of one-bank holding companies. Among the reasons cited for establishment of the one-bank holding company are as a vehicle to "overly restrictive Federal supervision, past, present, and future," a means of meeting growing nonbank competition in the financial markets, an avenue to diversification, lower costs, and increased earnings, and as a means of strengthening the banking complex' ability to attract new capital as well as short-term funds. It is difficult at this stage of development of the bank-initiated one-bank holding company to assess the validity of these claims. There are also the broader philosophical concepts involving economic and financial power and their use as well as the very practical question -- which is still unresolved -- of the kinds of activities in which banks and bank-holding companies should engage.

Moreover, it is probably premature to reach conclusions about the contribution that loan participation agreements with a repurchase feature, commercial paper sales by one-bank holding companies, and long-term borrowing in the Eurobond market will make to strengthening the long-term market position of either the individual commercial bank or the system in its entirety. Likewise uncertain is the impact that these developments might have on other banks and on the financial mechanism as a whole. But it is not too early to begin looking at the developments -- both from the standpoint of their overall impact on the economy and from the viewpoint of our supervisory responsibilities. Are they -- like some of the earlier "innovations" -- primarily an attempt to circumvent regulatory or credit restraints? Or, does the present economic situation just accelerate the introduction of these new ways of conducting a banking business in an economy with rapidly changing requirements?

These then are some of the major developments with which we should be concerned now. These are the types of developments that could be the cause of any future problems that we may have -- innovations and adjustments to the market that might create more problems than they solve.

These are the issues in which we share a common interest. Speaking for myself, I would like to say that I have enjoyed the fullest cooperation of all the State bank supervisors in discussing common problems and dealing with matters of supervision. Administratively, the structure of Federal and State bank supervision may not be ideal but I think it has worked well. At the present time, I think our primary attention and energies should be directed at a most critical period toward the development of a banking system responsive to the needs of the economy and of the community.

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