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FINANCIAL LESSONS OF 1974 FOR BANK REGULATORY AGENCIES

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Financial Lessons of 1974 for Bank Regulatory Agencies

The year 1974 brought out a number of important developments with regard to bank policy and bank actions. These alerted the bank regulatory agencies to certain unfavorable or dangerous trends to be addressed by the agencies. The same developments highlighted some inadequacies and conflicts within bank regulatory agencies which will need attention in the near future. The following comments will focus on these unfavorable trends noted during the year, recommend some actions for their correction and suggest some potential revisions of agency responsibility and authorities to encourage a continued sound, progressive banking system in the years to come.

While it may seem almost axiomatic to many of you, the banking agencies and perhaps even some banks themselves learned the fundamental lesson this past year that the larger the bank, the harder it falls. Stated in another way, bigness does not necessarily equate with safety, soundness, or optimum controls. Certainly the lessons of 1974 must emphasize the need to watch with great care the growth of bank concentration and the size of banking institutions and to require that such institutions maintain exceptionally careful and rigorous controls to assure their growth within the confines of safety and soundness.

A second lesson which was re-emphasized in 1974 is that it is difficult for a consortium of banks to establish the organizational framework which will insure effective policing of problem loans. Consortium loans may result in the banks involved being insufficiently informed of the basic credit with only the lead bank providing the full review needed to determine the creditworthiness and to appraise the effects of new developments in credit conditions for a particular loan. As a subset to this, we should note that consortium agreements with all-or-nothing clauses requiring each bank to maintain its share exposes the total group to the withdrawal of the smallest of the banks and in some cases exposes the group to potential court suits which endanger the entire credit. It is clearly evident that in consortium loans there should be careful and adequate communications among all banks in the group, including senior management communications to insure that even the smallest banks in a group do not feel that they are inadequately informed or slighted about the handling of the loan and the current status of the loan.

A third rather important lesson of 1974 in bank policy and actions is the rather evident possibility that bank growth by purchasing of funds from non-residents and non-customers of the bank can be a hazardous procedure. The consistent and large use of brokered funds has exposed a number of banks to the vagaries of rumors and consequently to a lessened availability of such funds. But perhaps more importantly it has been demonstrated that disproportionate use of such funds can be a difficult and potentially hazardous arrangement, especially when long maturity assets are so funded.

Similarly we should learn from 1974 that excessive loan expansion can strain the capital, liquidity, and management of a bank and can expose weaknesses in what were thought to be adequate internal controls. Capital adequacy is a relative term conditioned by the quality of management, the composition of assets and liabilities, the earnings and the position of the bank regarding sources of funds, classified assets, and concentrations of credit. It is to be hoped that we have learned that liquidity can be fleeting when rumors abound creating potential problems for a bank heavily funded in short-term areas as it seeks to roll over outstanding obligations. I believe we should recognize that a number of banks found that their internal controls were inadequate, especially in supervising international activity.

Though not new in 1974, the year clearly reinforced the lesson of prior years that quality management is indeed critical to the ongoing safety and soundness of a bank. We have learned that the innovators in the banking industry are often copied by less effective and less qualified managements, and that the use of such procedures as heavy purchases of brokered or borrowed money can often lead to problems for the less well-managed banks.

To meet these various challenges to sound banking, and to insure that the banking industry moves ahead in its most progressive and yet safety-conscious mode, the bank regulatory agencies have a variety of jobs to do. Some of these may include efforts to improve their own procedures and controls. In the area of examination it seems to me that standards and enforcement are not yet uniform among all bank regulatory agencies and that examination and overview may not be sufficient in the international area. Additional work to achieve improved coordination of rules and enforcement procedures is going to be necessary if the examination process is to do the job expected of it in the years to come. Such improvement can only be accomplished if there is a recognition of the need for high quality personnel who are well compensated. Since such examiners are scarce and costly, ways must be found to utilize this valuable resource most effectively. This latter might be accomplished to some degree by greater use of data processing terminals and information directly from commercial bank computers or, where the banks themselves are not yet fully computerized, with more frequent reports to maintain an overall surveillance of bank operations.

We have learned that early examination after a management change can help to avoid the development of unsound practices and might enable the examination authorities to move promptly before serious damage is done to the bank. These efforts will, of course, require increases in staffing by the examining authorities and perhaps closer communication with the management of such banks. A full understanding of either the domestic or international operations of a bank does not require simultaneous examination of the two areas. But if staff and space facilities permit, simultaneous examinations serve a very worthwhile purpose. Specifically, a review of both areas of operations at the same date provides an opportunity to check carefully inter-company and inter-bank transfers to determine risk and whether there exists the possibility of evasion of regulations or prudent banking policies.

Greater coordination of examining efforts involving both national and state chartered banks is also a clear must from the lessons of 1974. For example, some multi-bank holding companies own both state and nationally chartered banks. To me it would seem particularly important that examination standards for these banks be parallel, if not totally uniform.

Examinations are only one part of the bank regulator's work. Certainly the regulation of banks is an important adjunct, if not a separable unit to itself. We have learned from the past year that regulation by consensus is a slow process, and where individual agency rulings are issued without full agreement, they result in less than fully effective or uniform regulation. The efforts of the bank regulatory agencies to come to grips with the use of savings accounts as potential transactions balances is one illustration of how differing positions of the agencies can result in competitive inequalities between financial institutions of this nation. A lack of uniform regulatory responsibility and enforcement also quite often means less than the most effective regulation.

In another vein, the Federal regulatory agencies, including the Federal Home Loan Board, all have a policy which prohibits pooling of funds, on the basis that the pooling of individual amounts under $100,000 violates the interest rate regulations. The differences between the agencies are in interpretations as to what constitutes pooling and how active the financial institution has to be in arranging such pooling. For example, the Federal Deposit Insurance Corporation prohibits pooling and solicitations by the bank, while the Federal Reserve System has a position which prohibits poolings when a bank knows or should have reason to know that funds being offered result from pooling. Adding to this confusion is the fact that practical enforcement is quite difficult.

The regulatory agencies have learned that regulatory freedom occasionally encourages abuses. The freedom granted banks to purchase or sell unlimited amounts of Federal funds has encouraged some banks to overextend placement of risk assets on their books. A few banks have endangered their institutions by excessive short-term funding of long-term obligations. But the regulatory agencies are hopefully coming to recognize that regulation designed to catch a few banks is often undesirable if it penalizes many banks. In other words, regulation as a substitute for examination and enforcement is often a poor substitute.

Certainly, regulation and examination are incomplete without supervision and enforcement. In this area, too, the banking regulatory agencies may have learned something from the 1974 experience. Examination without follow-up is insufficient to correct problems. Mere statements of examiners, even if placed in the examination report, cannot be counted upon to correct unsound trends or other violations or abuses. It seems rather evident that the bank regulatory agencies need to work very closely with the boards of directors and managements of the banks and insist that the directors assume their statutory responsibilities for the conduct of the bank. Such insistence could include the establishment of committees of directors to review credits or portfolio acquisitions to assure themselves that the bank is following prudent credit standards, or could even include director follow-up on the examination criticisms by individual director letters to the relevant bank regulatory agencies. At the least, the directors should have an opportunity to meet with the examiner in charge and hear his appraisal of the overall condition of the bank, any potentially hazardous trends, and the relative position of the bank against that of a well-managed organization. This opportunity should provide directors the chance to ask any questions about their bank and the examiner's appraisal of its management.

Certainly the early detection of problems and the establishment of programs for correction with more insistent supervisory actions seem to be required to correct troublesome situations and in some instances to avoid failures. The agencies recognize that in some cases voluntary corrections will not be made, thereby requiring the use of supervisory tools. There is some recognition that the presently applied penalties for unsound banking practices may not be strong enough to complete the job. A careful analysis should therefore be made to determine if the authorities should make more vigorous and prompt use of existing powers such as "cease and desist" or management removal. Such a study might reveal the need for other types of penalties.

In another area, it is rather clear that a good many people in the United States believe that the bank regulatory agencies have adopted a no-failure policy. If this were correct, then the penalty for failure would be nullified both by the policy and by available insurance. Such an attitude could have strong implications as to banker conduct in the long run and would in effect encourage greater risk-taking with the certain knowledge that their only losses could be the capital that they have invested in the bank. For some bankers this could be a very small penalty indeed because they have borrowed the heavy portion of the cost of bank stock purchases. I do not believe that regulators have or should adopt a no-failure policy.

Similarly, the bank regulatory agencies have experienced instances where dominant stockholder influences have caused a bank to engage in unsound or unsafe practices. We have no interest in determining the authority or qualifications of our citizens to buy or sell stock of United States banks, but we do have an interest in policing the practices of such individuals where it can be clearly demonstrated that their efforts and attitudes are detrimental to the financial institution or to the nation's ongoing credit programs. One possible means of correcting this deficiency might be to extend the penalties for unsafe and unsound banking practices through the use of "cease and desist" or management removal to dominant stockholders who are fostering unsafe or unsound bank practices.

In another entirely different area, that of holding companies' supervision, the Federal Reserve and the other bank regulatory agencies well know that the holding company device is not a cure-all for unsafe and unsound banking practices. Quite the contrary, we have noted practices by some bank holding companies which appear to require a high degree of surveillance of their nonbank subsidiaries to avoid the possibilities that the nonbank subsidiary will transfer problems to either the parent holding company or to the bank subsidiaries. I feel that better reporting of intercorporate transfers is needed and we are working on that. Moreover, it appears to us that there may be inadequate safeguards to keep such transfers to an appropriate amount. While Section 23(a) does limit such transfers, the statute is not as effective as it would be if penalties were attached.

Correction of this problem will necessitate better information and also include review or inspection of the nonbank subsidiaries and perhaps greater surveillance of their activity in general. The fundamental question involved here, however, is whether bank regulatory and examination standards should be imposed on nonbank subsidiaries of bank holding companies, where similar activities would not be so regulated if a bank holding company were not involved. My answer to this question is a qualified yes. By this I mean that nonbank subsidiaries of bank holding companies can expect to be more closely supervised, simply because they are affiliated with a bank. Still another potential correction to this problem might be the authority to require divestiture by spin-off or other action and the more intensive use of "cease and desist" powers to require the holding companies themselves to insure divorcement of nonbank subsidiary problems from an impact upon bank subsidiaries.

In the field of monetary policy, 1974 had some interesting lessons for the Federal Reserve. First, it is clear that monetary policy cannot correct all the sins of the world, nor offset the excesses of Congress, business, consumers, or unions, nor enforce a moral code of financial responsibility. Monetary policy has its place in the overall framework of stabilization control but is obviously not the only tool, nor even in certain instances the most important tool. Secondly, I hope that more of us have learned that money supply is not the end-all or be-all, nor the sole measure of monetary policy. Monetary aggregates are an important measure to guide policy but should not be the sole governing target to the exclusion of interest rates, bank credit, and bank lending policies.

Finally, the prevailing attitudes in Congress, among bankers, and other regulators and the nonbank financial institutions have convinced me that legislation to redress the inequalities of the burden of reserve requirements may be delayed. Congress has thus far taken no steps to bring all depository institutions under the direct impact of monetary policy and in fact is enlarging the number and scope of nonbank institutional authority to handle what are essentially demand deposit transactions. Since the most appropriate and desirable resolution of the problem by Congress is not yet available and to protect the base of monetary policy pending Congressional action, the Federal Reserve in my view must act on its own to prevent the further erosion of membership and hopefully bring new members into the System. The actions necessary to accomplish this may include changes in policy which may reduce the level and burden of reserve maintenance, transfer some operational costs from members to the Federal Reserve, and broaden or strengthen existing or new services for members. Possibilities of charging nonmembers for services is another approach.

It still seems strange to me that the inequities between members and nonmembers are permitted to remain and that we tolerate structural inconsistencies which hamper the national policy efforts of a governmental agency. But until the situation changes, I feel the Federal Reserve must act, even if it means that some policies are modified to meet the membership problem. If choices of differing actions are available to accomplish our primary objectives we will need to weight our selection with the factors of membership. As most of you know, this attitude toward possible future actions would not be my preference. I prefer to set monetary policies strictly according to the needs of the economy and prefer that all regulatory and policy moves of the System be designed for the most effective and efficient results. However, membership is a vital ingredient to prompt and effective policy moves and so I feel that membership must be given stronger consideration in future policy actions.

Well, I must close my textbook for 1974 with many pages still uncovered in this brief review. I hope we have all learned some lessons and that we keep the text handy for future reference.

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