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PROTECTING THE PUBLIC INTEREST IN BANKING INSTITUTIONS

Remarks of

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PROTECTING THE PUBLIC INTEREST IN BANKING INSTITUTIONS

Banks have a unique place in the nation's business activity because they represent an extension of governmental interest in the money supply of the nation, provide a repository for private and public funds, and act as primary extenders of credit to individuals, corporations, and public bodies. It is not an exaggeration to say that in our highly developed complex economy financial institutions have a central role in the life and work of all the people and functions of our society. Of special importance has been, and continues to be, the safety of the money and deposit balances of all elements of our nation. Thus the public interest is a paramount consideration in the establishment, operations, procedures, and policies of the nation's financial institutions.

This central fact has been realized over the years in public regulation of financial institutions. Entry into the banking business has been limited by charter to help assure meeting requirements for competent management, adequate capital, convenience and needs of the community, and safety and soundness of the institutions as well as to protect existing banks from excessive competition. The whole paraphernalia of regulatory bodies--

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the Comptroller of the Currency, State Commissioners of Banks, the Federal Reserve System and the Federal Deposit Insurance Corporation--has at least one common objective to protect the public interest by assuring the safety and soundness of financial units. At various times in our nation's history, financial panics, mass failures of banks, or threatened solvency of financial units have accentuated the demands for greater regulation and protection of the public's money in financial institutions. Following the onslaught of the Great Depression, banks were constrained by regulations and restrictions which hampered the free flow of credit and discouraged the financial support needed for economic growth. It should be noted that these restrictions were not generally opposed because bankers were not eager to expand anyway.

Beginning in the early 1960's, there developed a trend to permit greater flexibility of financial institutions in meeting the credit needs of an expanding nation. During this time the public was becoming more interested in greater availability of credit, correction of alleged discrimination, and improved knowledge about banking activities. The higher rates of interest charged during periods of expansion and growing inflation motivated many to demand greater price competition among banking units and to encourage increased market discipline on financial organizations. Among the steps taken over the past 15 years have been: chartering of many

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new banking units; challenge to some of the legislative restraints on branching; development by the market of improved methods of transferring funds such as the Federal funds and certificate of deposit instruments; lifting of Regulation Q ceilings on CDs of over $100,000 denomination; and, the passage of the 1970 amendments to the Bank Holding Company Act.

Simultaneously, consumers and investors began to demand greater information about banks and other financial institutions and by this pressure developed increased price competition. With this change financial organizations began to shift to service pricing. It should be noted, however, that the spotlight of publicity has now begun to unify prices and apparently is having a similar standardizing effect upon credit approvals.

The move toward increased competition and market discipline in the financial industry has been aided and abetted by a number of recent regulatory actions. The primary regulatory agencies have permitted corporate savings accounts, authorized telephone transfers from savings to demand accounts and have proposed automatic over-draft privileges. Similarly, the growth of automated clearing houses, point of sale terminals, and other customer devices designed to make banking facilities readily available to the consumer have caused a new competitive service environment in the financial industry. In the credit and investment areas banks not only compete strongly with each other but also against other financial institutions.

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Congress and the regulatory bodies have pushed toward keener competition by permitting greater price competition and requiring more financial disclosure. Some legislative efforts not yet completed include proposed phaseouts of interest rate ceilings on time and savings accounts, elimination of the prohibition on interest payments on demand accounts, and broader authorities for thrift institutions to enable them to compete with banks.

In the midst of all those efforts to increase competition, the economic recession caused problems for the banking industry which faced heavy losses from loans, particularly real estate based loans. These problems along with the eroding capital cushion of many banks, and the disturbing bank failures that occurred both at home and abroad, brought renewed pressures for greater regulation and greater disclosure of financial information. Most recently the criticism of the regulatory agencies in the wake of these difficulties has in itself brought Congressional inquiries and proposals for new regulations, new reporting requirements, and a more stringent attitude toward bank policies. Of particular concern were the continuing evidences of management shortcomings and realization that some time would be required for the resolution of these difficulties. I should note that the U.S. banks have demonstrated their ability to overcome the problems which surfaced in the recent recession and are well along the road to recovery. In light of this experience, the

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regulators moved strongly toward more intensive surveillance systems designed to provide early warning of developing trends toward unsound banking policies or conditions. Spurred by Congressional and SEC activity, the banking regulators also moved toward more public discloure of banking conditions.

To a considerable extent, therefore, the recent years have brought both increased competition and market discipline to the banking industry as well as increased regulation, intensified reporting, and wider disclosure. In the midst of such a transition it is not possible to determine the degree to which the discipline of market forces will merely supplement or largely supplant regulatory control of the industry--or vice versa. As we travel these diverse roads it would be advisable to keep the basic fundamentals of the industry clearly in view. A dividing line between market discipline and regulatory constraints should be developed with greater precision and recognition of the debilitating features which each contains.

The public interest remains foremost among banking industry characteristics toward which either market discipline or regulation must be addressed. Banking is a public service industry with high public sensitivity and a critical need to maintain public confidence. To the extent that examination, regulation and supervisory pressure can avert bank failures and loss of confidence,

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they respond to the public need. If, however, banking is to be essentially a "no failure" industry because of its unique public interest responsibilities--and I do not agree that it should be--then public regulation and probably control would be necessary.

A second important fundamental of the banking industry is its risk-taking feature. Banks are expected to evaluate and measure the creditworthiness of customers and to accept a reasonable degree of risk in promoting the growth and development of their communities. There are no perfect guidelines which will permit bankers to assess the repayment potential of the borrower, to measure his trustworthiness, or to protect against major shifts in the economic environment. Therefore, banks, in serving the credit needs of the customer, routinely take risks of potential failure by the borrower and risks that adverse economic trends may create problems for selected industries.

Protection of the public against a banker who routinely accepts too great a degree of risk or who over-concentrates his portfolio of loans or investments is generally handled by regulatory surveillance. Market discipline can be exercised only when the losses from out-size risks or concentrations become evident and this may be too late to protect against the loss of the bank. Competition can exercise discipline effectively only if sufficient disclosure of information is available to the public and yet the type of disclosure desired for this purpose on certain loans could breach

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the confidential lender-borrower relationships so necessary for privacy. Moreover, excessive disclosure can lead to impairment of public confidence which is essential to the ongoing viability of a bank.

There is no question that increased market discipline of banks will require greater disclosure of banking data. Similarly improved and more time-oriented supervisory action will mean faster, more complete and more frequent reporting by banks. However, there must be a very distinct line between information for supervisory purposes and that for adequate investor and public release. One clear line of demarcation must be to withhold any data on individual customers or evaluative analysis of examiners. Until this year, release of such information was totally restricted to law and tax enforcement or regulatory agencies pursuing legitimate investigations of particular persons. Recently, however, over my strong objections, the bank regulatory agencies agreed to provide the GAO with complete examination reports including individual customer references. While I do not object to a one-time GAO study of the supervisory performance of the bank regulatory agencies, I do object to bank customer data being provided. My concerns over this breach of confidentiality are the invasions of privacy, the possibility of a leak, and the precedent this sets for future demands.

On the other hand, excessive regulatory restraints dampen innovation and tend to constrict banks into a world which would limit ordinary risk taking for the sake of catching a few overzealous bankers.

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Regulation of all banks to constrain the activities of a few has seemed to me to be a second best method of control. Perhaps greater use of specific restraints on the few by cease and desist orders or more frequent examinations would block the few but leave the vast majority of non-offenders relatively free of the restraint.

Thus our control of the banking system is evolving into a balance of market discipline and regulatory restraints. To some extent these reinforce each other but in other ways, especially if each moves toward an excess, there could be conflicts. The dividing line of responsibility for market discipline against regulatory restraints is likely to be less than fully determinant and there will probably be overlaps in both objectives and timing. Nevertheless, one should seek as clear an understanding as possible to identify the roles of each in the control of our banking system.

A significant amount of market discipline exercised through adequate disclosure seems to be both possible and desirable in the present environment. However, complete competition must be limited because such a system would demand free entry and right to fail. This appears unacceptable without 100 percent insurance for all deposits and even then could be fraught with problems of excessive credit allocation, unreasonable risks and perhaps unnecessary interference with monetary control. Full and free competition on a price basis runs the risk of loss of the individualized attention to credit needs of each borrower and the risk compensation necessary to grant the credit.

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Such competition might also encourage "loss leader" raids by a strong bank to enhance or extend its market position. Market discipline can reward or penalize the bank for routine performance over time and thus is a valuable addition to the regulatory efforts, but a system of control limited to market discipline would not recognize the legitimate public interest in the safety and soundness of institutions handling the public's money. Thus the place for market discipline appears to be in the time frame where banks are reporting operating results which permit investors, depositors, and others to reappraise present and future involvement in the bank.

Regulatory discipline of banks must not only have a shorter time dimension but also a quality measurement. The regulators should be in a position to quickly isolate deteriorating trends in lending and investing activities as well as spotlighting undesirable or unsound practices or policies in the bank. Early warning of such trends has become especially important given the long time lag needed to correct problems of a bank. Furthermore, early warning signals may be helpful in flagging broad industry trends which could threaten other units.

An ongoing responsibility of bank supervisors must be continuing surveillance to assure nondiscriminatory treatment by banks and to assure adherence to regulations, reporting requirements, and audits of bank policies and procedures. Even if a bank were accorded

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the highest rating by an examiner, the supervisors need to monitor bank policies and remain alert to the development of potential problems.

Finally, bank examination, regulation, and supervision must be heavily involved in seeking solutions to the problems of banks and in salvaging an institution whose troubles are such that solvency is threatened. This role of the regulators demands a broader scope of contingency planning and may in some cases require new legislative authority. While an explicit policy of "no failure" has not been enunciated, there is an implication of this in the route being followed in recent years. Perhaps one of the most difficult problems to face in such a policy is the need to exact a penalty from the management, directors and shareholders of the troubled bank while keeping the depositors whole. The latter would mean either full insurance or a procedure to achieve early merger or sale to avoid deterioration of assets. Perhaps some means of charging questionable assets against stockholder equity can be achieved which would not compromise the bank's capital position but would remove the questionable assets from the bank. Such a procedure would mean an early determination of deteriorating assets and a greater stockholder cushion to absorb them. This means more capital from existing stockholders or a willingness to have new stockholders enter the organization at a much earlier stage before insolvency threatens.

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Examination, regulatory, and supervisory activities have almost invariably fought last year's problems. The strongest surges in new regulatory restraints have followed troubled years for the banking system. In a dynamic changing economy the banking industry is reaching for new innovations while the regulators are often plugging loopholes in response to prior changes. In other words, bankers are innovating faster than we are regulating and to a considerable degree, I applaud this lagging posture of the regulators. If it were reversed, innovation would be dampened and economic progress slowed. But in areas where innovation constitutes a threat to sound banking policies or practices the regulators need to achieve a more coincident time frame.

The obvious lesson for the coming years from this past track record of regulation is to be cautious of the type of restraints imposed and look forward rather than backward about the credit needs of the nation and the best ways to achieve them within a framework of sound but progressive policies and practices. We should look toward avoiding the errors and slow responses of the past but not place the banking industry in a straitjacket of new limitations. A balanced perspective of the degree and relative participation in the problem areas of the past two years will be important in developing the most appropriate regulatory responses.

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I have said enough to give you the flavor of my expectations for market discipline and regulatory control of the banking system. The earlier the regulators can identify problems and alert the banking community so both can begin correction, the better off our banking system will be and the fewer the regulatory restraints that will need to be imposed. I look forward to greater market discipline but think the regulators will have an even more exacting and delicate responsibility to perform.

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