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Statement by

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before the

Subcommittee on Bank Supervision and Insurance

of the

House Committee on Banking and Currency

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I am pleased to appear, on behalf of the Board of Governors of the Federal Reserve System, before your Subcommittee on the subject of bank examination and regulatory structure and procedure.

We at the Federal Reserve are much concerned with this subject, and we believe that reforms are urgently needed. The general thrust of our concern has been highlighted in Chairman Burns' address on this subject before the American Bankers Association last October. I hope that the text of that speech will be made a part of the record of these hearings.

The recent two largest bank failures in the nation's history have stirred public interest in such banking questions, and the record needs to be carefully examined for evidence of possible weaknesses in our banking system and possible shortcomings in our bank examination and supervisory procedures. We welcome your Subcommittee's decision to focus attention on these issues, and the Board of Governors looks forward to working with the Subcommittee and the Congress as a whole in analyzing the problems and evaluating alternative solutions.

We can take considerable encouragement from the fact that the recent failures, worrisome though they were, did not seriously damage our financial system or our economy. We believe that our banking system is basically sound and is entirely capable of meeting the

current and prospective needs of the economy. We believe that our bank regulators wound up these two bank failure cases successfully. And we believe that in these cases the Federal Reserve fulfilled its traditional responsibilities as "lender of last resort" effectively.

Nonetheless, this is no time for complacency. We must endeavor to learn from the difficult financial experiences of the past year or two if we are not to repeat them. In that spirit, we at the Federal Reserve--and I am sure others as well--are hard at work poring over the past and trying to devise appropriate measures to improve the performance of banking and bank regulation.

To give our work focus, we have concentrated on what we regard as key problem areas. In our work to date, a half-dozen such areas stand out. Certainly one is the attenuation of bank capital. Rapid expansion of bank assets, particularly in the larger banks, over the last decade has far outpaced the additions that have been made to bank equity capital. Furthermore, greater leveraging of organizational capital has entered the picture by such means as bank holding companies' issuing debt securities to raise funds to buy new issues of common stock from their bank subsidiaries.

To finance their rapid asset expansion, many larger banks, in particular, have turned to heavy reliance on liability management, involving the issuance of market-type deposit certificates and other liabilities to raise whatever added funds are wanted. Such instruments

have proved not only highly interest-sensitive, but also highly confidence-sensitive in time of stress.

Undue banker confidence in their abilities as liability managers has sometimes contributed to the making of excessive loan commitments. Such promises to lend are a practical part of everyday banking, but those promises have not always been prudently limited to amounts which banks could effectively handle in times of strong credit pressures.

A companion problem has been some deterioration in the quality of bank assets. This development seems to result partly from the cost-income squeeze that has been suffered by many borrowers, and partly from the overly aggressive lending policies followed by some banks in recent years.

In certain specialized areas of bank activities, some trouble signals have also been flashing. One involves foreign exchange risks. In the new world of flexible exchange rates, the opportunities for profit by bank foreign exchange departments can loom larger, but so do the risks of loss. Also, the sharp fluctuations and recent historic highs in interest rates have increased the risk of losses in bond trading departments of banks. These developments have placed heavy burdens on management systems for controlling risks and on the systems of audit control relied upon to discipline these two departments in many banks.

Finally, recent experience has suggested to us that the public interest would be well served if there could be more expeditious resolution of problem bank cases. In the end, such cases have been resolved, but often the time consumed in dealing with these difficulties has aggravated uncertainties and concerns within the financial community.

The Federal Reserve believes that now is the time to begin to develop and implement corrective action in each of these areas. As we see it, some needed changes in basic legislation will have to be brought to the attention of Congress. Other problems can probably be dealt with by means of well-designed regulatory or administrative changes. Some of these problems are comparatively easy to diagnose and cure; others are extraordinarily complex and difficult. All our Board members are giving close attention to these questions.

I am now chairing a wide-ranging variety of task forces within the Federal Reserve System that are studying these supervisory and regulatory problems and trying to develop appropriate solutions therefor. This study, which covers all the problem areas discussed above and more, has been organized in six major sections. These are: resolution of problem banks and bank holding company cases; foreign exchange supervision and regulation; bank examinations; bank capital and liquidity standards; longer-run bank holding company supervisory

and regulatory policy; and the structure of bank regulatory agencies and related reforms.

One of our priority items is to find ways of resolving problem bank (and problem bank holding company) cases more speedily and efficiently.

Our work on the resolution of this subject starts with a searching examination of the adequacy and efficacy of existing regulatory powers and present practices as a guide to any needed legislative, regulatory, or administrative changes. Closely paralleling this work is an assessment of the best methods of ensuring that stockholder and director responsibilities are met in problem cases.

It seems reasonably clear that these are areas in which we will need to ask the Congress for legislation. For example, in the Bank Merger Act the Congress wisely granted an exception to the 30-day waiting period before a merger may take place when prompt action is necessary to prevent the probable failure of a bank. There is no such waiver authority in the Bank Holding Company Act. We are considering proposing legislation to permit such a waiver.

Another legislative suggestion under consideration is to modify the geographic restraints on acquisitions by a bank holding company in emergency situations. It may be that the public interest would be better served by permitting out-of-State acquisitions in those undoubtedly rare emergency cases when it might be found that

such action is necessary to protect the stability of the regional or national economy and the competitiveness of the banking system.

Turning to the subject of foreign exchange supervision and regulation, reviews are underway of the operations of banks engaged in foreign exchange activities. Our studies are giving particular attention to the banks' information and audit systems, to their policy controls over foreign exchange positions and trading, and to the question of whether further measures may be needed to limit the risks involved. Bank examination treatment of foreign exchange operations is an important part of this subject.

Our consideration of bank examinations encompasses all aspects of bank operations. We are interested in possible improvements in bank examination practices and procedures, the early detection of unsound practices, and the possible use of management information systems for bank examiners and auditors. As a part of this project, attention will be given to ways to monitor and constrain excessive loan commitments and other off-balance-sheet promises to lend, methods to detect and discipline poor quality bank loans more effectively, and measures needed to minimize bond trading risks. An important segment of this work is a critical analysis of banks involved in recent failures in order to identify

possible inadequacies or failures of the banks' internal management and audit controls.

In the area of bank capital and liquidity standards, our analysis is directed toward reviewing and sharpening the concept of what is "adequate" capital and liquidity. We are hopeful this work will lead to the formulation of clarified standards for bank capital and liquidity. In coordination with the study on bank examinations, attention also will be given to the need for more effective surveillance and enforcement measures.

Because of the great importance which bank holding companies have assumed in the banking system in the last few years, one section of our study is devoted to longer-run bank holding company supervisory and regulatory policy. Work is now going forward on efforts to design an information system to monitor activities and changes in bank holding company operations. Attention is also being given to the relations of nonbanking affiliates to bank holding companies, with particular focus on the possible contribution of nonbanking affiliates to banking difficulties.

The last project relates to the structure of bank regulatory agencies and related reforms. This subject quite properly occupies a concluding position. The analysis involved in all of the other projects described above will contribute to our understanding of the inadequacies--and accomplishments--of the Federal bank regulatory



and supervisory structure. This information should supply a factual foundation for judging whether changes should be recommended in the structure of the Federal bank regulatory agencies. One project in this section is looking at the relationship between field examining forces, both Federal and State, and to means for improving those relationships. It is perhaps appropriate to note that many alternatives will be considered before the Board reaches a conclusion on this sensitive subject.

I might mention that we have been in touch with our sister regulatory agencies regarding these studies, and we will continue to confer with them as our work progresses.

We realize fully, as I am sure you do, that this reexamination and study is a massive undertaking. I want to assure you, however, that we at the Board are fully committed to moving forward with it as speedily as possible. We view our work as an action program to be put into effect by legislative recommendations, changes in regulations, or reforms in administrative and operating procedures.

I can report the Board already has taken concrete action on several fronts. Beginning last June, we introduced a "go-slow" policy regarding bank holding company expansion. This policy remains in effect today; its future will have to be determined by the Board in the light of emerging economic and financial conditions. The policy is evident in cases in which we have felt that either an

organization's capital or its liquidity positions have been stretched. We have denied, in such cases, applications for acquisitions of other firms in permissible lines of activity, except when we felt the public benefits of a particular acquisition were exceedingly strong. We have also refused, for the time being, to add new lines of activity to the permissible list for bank holding companies.

In addition, we have stepped up our information-gathering and supervisory oversight with respect to banks and bank holding companies.

This fall, when circumstances seemed to us propitious, we restructured the reserve requirements of member banks, raising average reserve requirements somewhat on short-dated time deposits, but cutting requirements to the statutory minimum on time deposits with over six months' maturity. Such action, we felt, would be an encouragement to banks to lengthen the average maturity of their liabilities and thereby reduce the potential volatility of their funds.

More recently, in coordination with the other relevant regulatory agencies, we acted to raise somewhat the interest rates banks could pay to attract time deposits with maturities as far out as six years or more.

Finally, I might mention that we have just sent to the Congress a comprehensive proposal for legislation covering foreign banking operations in this country. The main thrust of this legislation is to treat foreign-owned bank operations in this country

like domestically-owned banks; one effect is to extend certain existing Federal bank regulatory and supervisory authority to such operations.

Many more actions like these will need to follow, we believe, in the weeks and months ahead.

These have been difficult times for us all, but they have served to emphasize the need for prompt corrective action. We intend to see that improvements in banking and bank regulation result from this experience, and we are now hard at work to find the best possible solutions. In this process, we would welcome comments and suggestions from members of this Subcommittee and other members of Congress who may wish to contribute to this undertaking.

Our aim is to complete our work on the legislative portion of our program some time in the first quarter of 1975 in order to allow ample time for the new Congress to study our proposals. We are not sure at this point whether we will be coming forward with a series of recommendations or with a single comprehensive program. In the meantime, of course, we intend to move ahead with regulatory and administrative changes as the need dictates.

Mr. Chairman, I appreciate the opportunity you have afforded the Board to outline what we are doing and planning in the areas of bank supervision and regulatory reform. The Board looks forward to working with you and the other members of the Committee in the 94th Congress.