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The Intent and the Letter of Bank Regulation

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The Intent and the Letter of Bank Regulation

Banking regulations, like any formal body of rules sanctified by observance or enforcement and serving as a means to an end, can, over time, be transformed from means to ends. Then regulation exists to preserve regulations. If the original purpose in public policy has been spent or eroded by environmental or institutional changes, allegiance to over-age regulations gives rise to unnecessary and frustrating operating obstacles. Under such circumstances, obsolete regulations can stunt banking growth and divert the fruits of progress and innovation to non-regulated institutions. They can retard or even smother adaptation in the entire financial sector of the economy.

Banking regulations of substance, therefore, need periodic reappraisal in terms of their need and applicability to present-day problems and environment. While uninhibited reappraisals are always possible, inertia and the precedents of ways of thought are intractable barriers to timely and objective reviews of the status quo.

When your program chairman invited me to address you today on the problems of bank regulation he specifically said he would have to disqualify a regulatory or legal technician. I am neither of those, never having examined a bank nor drafted a rule. I could not, therefore, assume either such hat on this occasion.

In my remarks today I will not attempt to trace the evolution and the present appropriateness or inappropriateness of banking regulation generally. The field is too vast, too entangled, and too encrusted with prejudices for a post-prandial occasion. Neither am I prepared to generalize the grievances experienced by the regulators and the regulated in resolving conflicts between the public and private interest. Though it might be expected, I will not touch on "truth in lending" or "bank safety" regulations because both are implementations of explicit Congressional policies adopted very recently. The agencies have given a great deal of attention to both of these regulations and while you may fault their need or our interpretation of Congressional intent I can only say that we have done our best and that neither regulation is obsolete.

It is tempting to deal with regulatory constraints on banking structure, as this is a fertile field for the general thesis that regulations tend to outlive their usefulness. I abandon this opportunity because, with the exception of required Federal approvals for mergers or combinations, and for holding company formations or acquisitions, there is no uniform Federal regulatory policy on banking structure. Policy in this regard has been delegated to the States, and among the States there is great diversity. Attitudes in many States toward structure are constructive and forward

looking: but in others, stagnant and seemingly impervious to changes in our economic and social environment.

I will be concerned with regulations affecting bankers' management of assets, liabilities and equity positions, banking's ability to intermediate and maintain contact with money and credit markets, and the U. S. banking system's ability to participate in international banking, credit and equity markets.

Management of Asset, Liability and Equity Positions

The economic shock of bank failures in the Twenties and Thirties generated an overwhelming public demand for the protection of deposits. The Congressional solution was threefold: insurance protection for small depositors, constraints on asset and liability management by bankers, and the delegation to Federal regulatory agencies of a general overlooking concern in behalf of depositors.

But there seems to have been no clear, forceful statement of Congressional intent from which a genealogy of regulations leading to the present regulatory apparatus could be derived. The Bank Conservation Act, Title II of the Emergency Banking Act of 1933, authorized the appointment of conservators "necessary in order to conserve the assets of any bank for the benefit of the depositors or any other creditors." The preamble of the Banking Act of 1933 states that the act was intended "To provide for safer and more effective use of assets of banks, to regulate interbank control, to prevent undue diversion of funds into speculative operations and for other purposes."

The preamble of the Banking Act of 1935 states that the act was intended "To provide for the sound, effective and uninterrupted operation of the banking system and for other purposes."

Section 9 of the Federal Reserve Act states "No applying bank shall be admitted to System membership unless it possesses capital stock and surplus which, in the judgment of the Board of Governors of the Federal Reserve System, are adequate in relation to the character and condition of its assets and to its existing and prospective deposit liabilities and other corporate responsibilities."

The Federal Deposit Insurance Act authorizes the issuance of a cease and desist order if a particular violation or practice "is likely to cause insolvency or substantial dissipation of assets or earnings of the bank, or is likely to otherwise seriously prejudice the interests of its depositors."

The more recent legislative pronouncements have shown concern for the advantages of competitive banking facilities and the need to serve community convenience and need. For example, the Bank Merger Act and the Bank Holding Company Act provide that no proposed merger (holding company acquisition) shall be approved "whose effect in any section of the country may be substantially to lessen competition....unless it (the responsible regulatory agency) finds that the anticompetitive effects of the proposed

transaction are clearly outweighed in the public interest by the probable effect of the transaction in meeting the conveniences and needs of the community to be served."

These statutory excerpts indicate the very general nature of earlier Congressional direction to the regulatory authorities, a concern for banking institutions as well as depositors and a growing specificity as to the nature of conflicts in the public and private interest.

The successful experience with deposit insurance has undoubtedly greatly reduced public concern about the safety of bank money and the stability of banking institutions.

Insurance now fully protects nearly 99 per cent of the accounts in commercial banks although the coverage in terms of deposit aggregates is another matter. According to the 1968 Survey of Deposits coverage ranged from 11.1 per cent of the dollar total of deposits of State and political subdivisions to 90.6 per cent for savings accounts and 52 per cent for demand deposits IPC.[1/]

Another way of assessing the coverage is by size of bank. In banks with less than $5 million in total deposits, coverage was 86 per cent of total deposits; in banks with $5 to $25 million, 79 per cent. In the largest banks, those over $500 million in

1/ According to the National Summary of Accounts and Deposits as of January 29, 1968, 98.5 per cent of 78.8 million demand deposit accounts; 99 per cent of 69.8 million savings accounts; 98 per cent of 22.7 million other time accounts, and 69.7 per cent of 516 thousand State and political subdivision accounts were fully protected. At that time the ceiling coverage was $15,000, it has subsequently been increased to $20,000.

deposits, coverage drops to 39 per cent. Since deposits of the U. S. Government and of State and local governments in most States are fully collateralized, and since such deposits are of the order of 10 per cent of total deposits, it can be inferred that depositor protection by insurance or collateralization is nearly complete in banks with less than $25 million in deposits. Eighty-five per cent of the nation's banks are in this size group and they have 20 per cent of the nation's deposits.

According to the 1968 Annual Report of the Federal Deposit Insurance Corporation, losses sustained and expenses incurred in liquidation or assumption operations from 1933 to the end of 1968 have been only $55 million. The present insurance fund aggregates $3.75 billion. The Corporation's record of liquidation and assumption is impressive but so is the record of banking's limited exposure to economic vicissitudes which must be credited primarily to 35 years of reasonably sustained economic growth and -- alas -- to three war-induced inflationary surges.

In light of this record and in light of the fact that 99 per cent of the deposit accounts in U. S. banks are shielded by an insurance fund of $3.75 billion, one may question how much of the essentially pre-war superstructure of regulatory restraint and supervision of asset, liability and equity positions is needed. Detailed verification of accounts, and the item-by-item

evaluation of certain assets characteristic of older examination practices seems out of place with the in-bank standards and policies that the present generation of bank managers and owners are impelled to adopt in their own interest.

As a non-professional regulator, it seems to me that in our present-day banking environment the public concern for depositor safety and institutional stability would be adequately and even better served than it is now by something along the lines of the following program, which, so far as I can see, would be appropriate for all financial intermediaries as well as banks:

1. There is a need in every financial institution for an internal accounting system capable of protecting the integrity of the accounts and, so far as practicable, guarding against defalcation. It should be reinforced, of course, by bonding requirements similar to those generally in effect now. It should take into account size of bank and the role of owners as managers. Bank owners, if ownership and management are separated, have at least as much interest as regulators in these security measures.
2. Periodic outside audits are essential. Because of the costs involved, many financial institutions do not have independent audits, or they do not have professional audits or the audits are too infrequent. To the extent cost is

a real barrier, some subsidy from regulatory agencies for audits of suitable quality and scope would be appropriate. Since auditing techniques are becoming more efficient this objection is losing force if, in fact, it ever had validity. It is, of course, well known that a bank examination is not a substitute for an audit.

3. As a basis for explicit supervisory action a new periodic reporting system tied into a continuing computerized analysis is needed. For larger banks, weekly--or, for some types of information, even daily--reports of condition and gross flows in selected asset and liability categories would promptly reveal overexposure to liquidity stresses, undue asset concentrations or equity deterioration. Such a revelation of individual banking operation against a modal pattern for similarly situated institutions would provide regulators with such leads as they would need for swift and specific investigation. For the smaller banks monthly, or even quarterly, reports would probably suffice.

Former Chairman Randall of the Federal Deposit Insurance Corporation, writing in The Supervisor and Banker Review for July 1968, describes other techniques by which computer technology could be used to expedite and extend the effectiveness of bank examination and supervision.

4. The final component in such a plan would include those inspections that Congress may directly require and such policing as is needed to check the validity and integrity of the preceding programs and to guard against conflict-of-interest situations. These inspections, imaginatively treated, probably would not require large regulatory staffs. The banking institutions themselves should not require much prodding to adopt management policies aimed at avoiding legal penalties for statutory violations.

The trend in accounting and audit supervision today is, generally, strongly toward establishing techniques and practices for the future rather than holding post-mortems on past transactions. Bank supervision has always been primarily concerned with future practices but it has interpreted the public interest with more "don'ts" than "dos" and with more emphasis on specific episodes in the past than better systems for the future. As in tax audit and inspection, bank examination, because of its unexpected timing, has had an important therapeutic effect on marginal banking practices involving conflicts of interest, over-exposure to risk, and illiquidity. But these effects can and should be retained with more or less continuous informational scrutiny of the areas most sensitive to the public concern.

Regulating the International Operations of U. S. Banks

For over 50 years, the Federal Reserve Act has permitted member banks to operate foreign branches and to establish domestic subsidiaries which can compete with foreign institutions in international and foreign banking and finance. These domestic subsidiaries of U. S. banks, primarily Edge corporations, are empowered to do certain things in their foreign operations that their parent commercial banks are precluded, by law, from doing in their domestic operations. The most notable exception is the power to make equity investments. Conversely, the Edge corporations are prohibited from engaging in any operations in the United States not incidental to their foreign business.

Since the revision in Regulation K in 1963, most of the regulatory limitations on foreign activities of Edge Act corporations are simply those contained in the statute. However, in exercising its delegated responsibility to construe what is a usual activity for competing foreign institutions, the Board of Governors has taken a rather narrow approach to equity acquisitions or participations in joint ventures.

In approving acquisitions by Edge corporations involving a majority of shares in a company or otherwise involving effective control of a company, the Board has insisted that the acquired company confine its activities to those permissible to an Edge corporation. With regard to determining the activities that would be

permissible for an Edge corporation, the Board has said that such functions must be confined to the area of banking and financing and that it is inappropriate for an Edge corporation to acquire control of a company engaged in a nonfinancial business.

In accordance with this policy, the Board last year withheld authorizations for the Edge corporation of a New York bank to acquire a Taiwan life insurance company. Life insurance, it appeared, fell outside what normally would be considered financial. Again, the Edge corporation of another U. S. bank, a few weeks ago, was denied permission to acquire, indirectly, effective control of a Caribbean company engaged in real estate development even though the investment was intended to have been liquidated after the development was well along. It was believed that this form of equity investment, involving incidental management responsibility, was also sufficiently outside the bounds of financing to be inappropriate. The Board, for the same reason, also recently required a partial disinvestment of interest in a cattle feeding operation in Argentina.

What, you may ask, is the benefit of construing "financial" narrowly? The Board has been guided by the overall purpose of the statute, which is to encourage U. S. participation in activities related to international or foreign banking and financial operations. Serving that objective does not entail the right of Edge Act companies, or those in which they have a

large or controlling interest, to acquire substantial nonfinancial interests. Of course, the line between financial and nonfinancial is not easily drawn nor readily discerned in prevailing foreign banking mores. Both the degree and nature of nonfinancial participation are at issue in most cases, and the Board has been approaching the problem on a case-by-case basis. Looking at approvals since the relaxing revision in Regulation K in 1963, it appears to me the trend has been slowly toward somewhat increased permissiveness.

Bank Intermediation and Contact with Financial Markets

By far the most interesting and widely discussed regulatory action in recent years was the attempt to restrict the banking system's ability to expand credit in 1969 by limiting its access to money, credit, and time deposit markets. Experience with monetary restraint in 1966 had demonstrated that whenever market interest rates rose above those that could be paid for time money, banks were soon forced into a rationing posture. The efficiency of the process was noted in the Federal Reserve.

This relatively brief but poignant episode also impressed bankers. They foresaw a necessity to develop methods for shifting some of the monetary impact as Regulation Q ceilings closed in. Consequently, they were prepared when monetary restraint was renewed in 1969 with a determination not to be an entirely passive victim of Regulation Q ceilings. They had readied a panoply of

devices which would help them to pass on to the financial markets at least a portion of the restraint which Q ceilings initially imposed on them. As these devices--Euro-dollar borrowings, repurchase agreements, subordinated notes, commercial paper sales by holding company affiliates and banking subsidiaries--came into significant use, the Federal Reserve countered with additional regulations defining liability alternatives as deposits or increasing their cost or limiting their availability. In the process, an adequate measure of overall monetary restraint emerged--although that result is extraneous to the point of the present discussion.

We have been concerned with the effects of regulatory escalation and proliferation and how they may have affected the efficiency of the existing financial system. No doubt costs and frictions in its functioning have been a significant by-product of the 1969 type of credit control. But the longer run effects on the banking system and the implications for future banking operations, services and structure are more interesting and potentially more far reaching. These may not be altogether non-productive.

To consider these implications briefly, we can start with the well known fact of a persistingly declining trend in the role of demand deposits as a source of loanable funds, a trend, incidentally, that is not likely to be reversed. Between January 30, 1961 and June 30, 1969, net demand deposits grew only

38 per cent while GNP rose 85 per cent. Banks compensated for lagging demand deposit growth by aggressive intermediation efforts; as a result, time and saving deposits in the banking system rose 153 per cent in the 1960's.

Another well established fact is that Congress has created the machinery for limiting rate competition between banks and thrift institutions. There may be varying judgments as to who is the gainer from this procedure in the long run--banks or thrift institutions. In all probability it is neither, as the advantage is likely to go to the market and non-regulated intermediaries. However this may be, banks cannot expect to make direct inroads via rate competition on savings and loan associations' and mutual savings banks' market shares without incurring exposure to regulatory intervention.

Finally, as I indicated earlier, in 1969 banks attempted to establish a variety of links with the financial markets which would enable them to sell assets conditionally, borrow abroad or participate at home in the commercial paper market through affiliates or subsidiaries. These steps were hampered or obstructed by Federal Reserve regulations promulgated with the rationale that such steps were necessary to achieve monetary restraint. The fact that this judgment was widely contested--and in my opinion properly so--does not change the impact it must have had on corporate planning in banks. Where does banking's future lie if demand deposit growth persistently

lags the economy's growth and if banking's efforts to compete with other intermediaries and the market are stifled?

This is the question bankers have to answer. Some of the larger banks have turned to expanded foreign operations. Others have been trying, within the limitation of State laws, to extend their domestic markets, mainly through registered holding companies. Many institutions are obviously probing the possibility of significantly extending the character of their services. The evidence of the seriousness with which the approach is being pursued is evident in the controversy over the one-bank holding company bill, and particularly over the blank, white, and dirty laundry lists.

Overall, these developments seem to be pointing to a significant change in banking's corporate organization: a corporate splintering of activities; the isolation of demand deposit banking and its regulatory impedimenta; the substitution of a community of stockholders for wholly owned subsidiaries and affiliates so that customers can be retained or gained by the use of viable market practices.

Regulation alone has not brought this corporate soul searching to pass but it has tested the innovative capacity of bankers, causing them to reappraise the future of this corporate existence, to reappraise the way in which traditional commercial banking should be carried on and to reappraise the possible scope of diversification and new lines of service products.

This brief discussion of three regulatory areas points to the complexity of "doing something about"--that is, reconciling--conflicts in the public and private interest in banking by improved regulatory practices.

Clearly the line of conflict needs to be under continuous scrutiny as it changes with the times and the attitudes of the community. Allegiance to obsolete requirements and objectives are hard to overcome or replace as they become embedded in institutions and organizations. In the broadest sense, the interests of the regulators and the regulated are not always opposed or even usually so. They sometimes appear to be opposed because of the attitudes and views of extremists in both camps.

Finally, it is apparent that some regulatory conflicts and differences stimulate both parties to achieve a better solution to a particular problem. Beyond that, such conflicts may move both parties toward innovations in practices and techniques which will result in the substitution of market disciplines for regulatory supervision in the protection of the public interest.