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1975 - THE YEAR FOR FEDERAL BANKING REGULATION REFORM

Remarks of

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1975 - The Year for Federal Banking Regulation Reform

Having viewed at close range the operations of the Federal bank regulatory process during recent years in which several large bank problems occurred -- particularly the U.S. National of San Diego and Franklin National -- I feel that it would be useful to set forth a few observations based on those experiences and my own thinking about them. These are, of course, solely my views.

While I feel strongly on the centralization issue, I am making these statements today at a time when the Federal Reserve Board staff is hard at work on a host of projects which will culminate at the Board in a vigorous debate among the Governors relating to formulation of a Federal Reserve legislative package for consideration by Congress at its earliest convenience. Thus, while I feel quite strongly that change involving rationalization and greater simplification of Federal bank regulation is urgently needed, I am arguing here the principle of the matter, without prejudice to what precise course of action my colleagues and I may decide to recommend to the Congress, in the light of the unfolding of events, and the shape of the evidence after it has had expert attention.

First, a qualification. In speaking strongly in favor of a centralized Federal regulatory apparatus, I anticipate the retort that the Federal Reserve is grasping for more power. But I am perhaps

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better positioned than most to make these observations in an objective way. First, I spent some years on the staff of a large management consulting firm specializing in the efficiency of operation of large bureaucratic systems. Secondly, I am a professional manager currently engaged in a fixed term of public service. That is, I have no "vested interest." I can assure you that I have no personal interest in expanding the authority of the Federal Reserve Board, and that the Board's only interest is in more effective bank regulation and supervision, in the public interest.

Few who do not have to deal with the problem personally can understand the complexity, inefficiency, overlapping responsibility and confusion which are involved in the hodge-podge of bank regulation as it has evolved in this country.

Take the examination function. The Comptroller of the Currency, in the Treasury, examines the 5,000 national banks. The Federal Reserve examines only the 1,000 State-chartered banks which are also members of the Federal Reserve System. The 8,000 insured nonmember State banks are examined by the FDIC. In addition, all State banks are examined by their respective State chartering authority.

What a waste!

Why not one examining school, one examining force and management, and lower operating costs? Why not go further? The Federal Reserve System is experimenting by accepting examinations

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performed by the State of Indiana, and it has for some time examined jointly with several States.

Why not work more with the large pool of professional accountants employed in our private CPA firms? Given the nature of accounting and taxes, the work of our private CPA firms has a sharp peak and a deep valley during a calendar year. Why not help ourselves to the expertise these accountants can provide in the areas of bank audit, systems and internal controls? This would help those firms smooth out their work loads by drawing from them during their valley months competent professionals to supplement in these areas our staff of professionally trained examiners.

Having one school, one supervisory structure and a combined private/public examining force would seem to be an obvious way to reduce the cost of bank examinations and enhance its effectiveness. And it would be less burdensome to banks, because they would have only one set of rules to observe.

In the process of Federal bank regulation, the Federal Reserve is in the unhappy position of having responsibility without the necessary authority.

Let me explain. As is well known, the Fed's over-all responsibility extends beyond the banking system to the entire economy, both as the nation's monetary authority and its lender of last resort. When a member bank has liquidity problems, such as the Franklin did in May

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of this year, in effect a gun is put to our head. Either open the discount window for what can develop into a massive aid effort or risk a possible trauma in national and international money markets with the potential effects on the nation's and world's economies.

Let me emphasize that in stating this I am not confronting the question whether a large bank should ever be allowed to fail. This question can be argued both ways, and there may be no answer applying to all cases in all circumstances. It is obvious that in the two recent large-bank problems, it was our view that assistance should be given to avoid serious widespread harm.

I am concerned, in these remarks, with two quite different questions -- the question of how the problems these banks got into reflect upon our bank regulatory set-up; and, second, how the dangers to the public at large posed by these problems were handled by the bank regulators.

In general, I am concerned that the Federal Reserve has lender-of-last-resort responsibility for some 13,000 banks whose operations we do not examine.

The Franklin case provides a concrete example. In that case we were confronted with the need to suddenly inject hundreds of millions of dollars when the Franklin ship was "in extremis." The Comptroller was the primary regulator. Consequently, then and throughout the five months this banking shipwreck dragged on, we had inadequate information of our own, and we had to rely on the

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Comptroller's judgment as to the question of solvency. This is not a comment on the Comptroller. It is a comment on the fact that in such cases the Federal Reserve has vast responsibilities without concomitant authority. Further to illustrate this same point, in the end we were dependent on the judgment of the FDIC as to an appropriate solution. Again, I am criticizing the regulatory system, not its components. By law, the FDIC is concerned with a judgment as to "least cost" to its insurance fund, apparently in keeping with legislative intent. Is it necessary to point out that what might appear to be "least cost" to the FDIC might not be "least cost" to the economy?

Dealing with the matter of Federal supervision of banks is best done in terms of a specific situation. And, the Franklin case is such a searing recent affair as to be a useful example.

The questions raised by this case are of serious concern to me.

In one sense the nation is to be congratulated for the manner in which a solution was reached on Franklin National, particularly in contrast to how similar problems were dealt with recently by other nations.

Depositors of Franklin lost no money. Business was not interrupted. Franklin closed one evening and European-American opened its offices the next day. There was no significant disturbance. As far as the salvage plan is concerned -- as to its technical aspects, I believe that any knowledgeable observer who studies it will find it to be an admirable piece of financial craftsmanship.

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Now for the liability side of the Franklin ledger. It took over five months to effect the solution. Those were very nervous months and in the end some of the anxiety continues in the national and international markets.

The primary reason that things worked out well is that we were lucky. The bank regulators involved worked long and hard. Many years ago I learned that "the harder one works, the luckier one gets." But that is not the entire Franklin story. We worked hard, certainly, and we were lucky as well. But the next time, Dame Fortune may not be smiling. We need structural reforms to make the results less dependent on luck and more on hard work.

Federal regulators worked well together, given the circumstances. But those who had not been required to put on the line, as lender of last resort, $1.7 billion of the public's money, and who did not share the Federal Reserve's responsibility for maintaining order in the economy as a whole, and avoiding an expanding liquidity crisis, could not, consequently, share our sense of urgency. The pace at which the Franklin National problem was brought to a conclusion, in my estimation, was too leisurely. The need to coordinate each step among three Federal regulators, each with its own separate law, was a primary culprit in the exasperating delay.

At a minimum, I propose that when a problem bank becomes a borrower from the Fed's discount window that the Fed immediately -- by law -- become the primary regulator responsible for working out a

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solution. But I believe that the Congress should go further and centralize all Federal bank supervision in the Federal Reserve System, incorporating the powers of the FDIC and the Comptroller's office. I will not at this juncture attempt to spell out further details of the structural form I envision. But I am deeply impressed with the form of the Federal Reserve System -- with its seven-man Board of Governors -- with long terms. Such a governing board is necessary for a number of reasons, not the least being insulation from short-run political pressures.

Further Rationale
for Centralizing
Responsibility

Aside from the considerations in dealing with individual problem cases, there are also persuasive arguments in the area of monetary policy.

Any decision on monetary policy must be grounded on good knowledge of the state of the banking industry as well as of the economy in general. And the monetary authorities must be able to readily effect changes in the regulatory policy and the supervisory apparatus and action which they believe to be necessary to carry out their responsibilities.

Furthermore, there is an inextricable link between the Federal Reserve System's lending function and banking supervision and regulation. The function of lending to commercial banks which

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are faced with either temporary liquidity difficulties or longer-term problems necessarily lies with the monetary authorities, serving, as discount lending does, as one of the vehicles of reserve creation. And the lending activity with its attendant reserve creation must be taken into account in determining the magnitude of other operations implementing monetary policy such as open market actions. Whether the need for a bank to borrow is brought about through management ineptitude or through forces outside of management control, I have difficulty with the logic of separating the supervisory control over the borrower from the lending institution.

Hence, I believe that the responsibility for monetary policy and banking supervision and regulation should not be separated. The same people who are carrying out the monetary policy must have firm control over the regulation and supervision of the banking industry.

On Capital
Adequacy

Another area of concern I would like to touch on today concerns some of the actual regulations which are intended to insure a sound banking system, in particular, capital adequacy of bank and bank holding companies, and bank holding company debt.

I am distressed with the current state of the debate on bank capital adequacy. Much as been said on the subject and yet little of it truly relates the role of capital to bank soundness. Let me briefly backtrack by repeating again that capital has become

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a major source of concern and disquiet to many persons involved in the industry because of the rapid and drastic fall in the relative level of equity capital to banking assets. Rather than go over what I and many others have said about capital before, I want to focus my comments on the relationship I as a regulator see between the quality of earnings and bank capital.

It is essential that a bank have "quality" earnings if it is to be strong and sound. When considering the make-up of "quality" earnings I think of several factors: the over-all soundness of the earning assets, a reasonable additional earnings margin on higher risk assets, stability of earnings resulting from diversification of earning assets, sufficient earnings to offer stockholders a reasonable return on their investment and finally, enough growth in the measure of earnings to both equity and assets to make investment in the bank's equity desirable to investors.

But the importance of earnings in maintaining bank soundness, as I see it, does not lessen the importance of capital adequacy. Indeed the importance of earnings can make capital requirements a potent regulatory tool in protecting the banking system. Let me elaborate. Sufficient earnings to finance necessary growth in the capital account as well as paying reasonable dividends to stockholders must be realized if a bank desires to grow. Capital requirements could help to insure the quality of these earnings by curbing growth which is beyond the ability of management to manage. Setting capital

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standards would in effect act as a brake on the ability of the bank to leverage its growth and would insure that earnings would have to remain high in relation to assets if expansion is desired and is to be achieved.

It has been my observation that for some time in the banking industry, growth for the sake of growth has been one of the primary motivating factors in some institutions. Usually, this growth has been brought about through leveraging the equity and has resulted in a decline in the return on the incremental assets and therefore on total assets. In some cases this decline in the return on assets was intentional and under control. By leveraging the equity, many banks have been able to expand their loans by accepting lower spreads between the cost of funds and the return on assets while, in most cases, increasing the return on investors' equity. Where there was weak management, however, which did not understand the pricing mechanism involved in banking, growth brought about through leveraging was virtually out of control. We are all aware of the unfortunate results.

But, whatever the circumstances of bank assets growth via leverage, the result has been a decline in earnings on assets, and hence, in my opinion, in the quality of earnings. Since 1970 the ratio of earnings to assets of all insured commercial banks declined from .82 to .76, a 7 per cent decline. Looking only at the 50 largest U.S. banks, the decline is even more striking, in terms of both absolute level and the percentage decline. In 1970, earnings to total

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assets was .66; in 1973, .58. The percentage decline was 12 per cent. If the banks had been required to maintain a certain level of capital, then in all probability these banks could not have expanded at the rate they did, and therefore in all likelihood they would not have been taking on poorer quality assets.

To further emphasize this point, let me look again at the case of Franklin National Bank. Some in the banking industry have contended that the failure of Franklin was related, not so much to the losses they experienced in their loan portfolio or in the foreign exchange market, but to the fact that the management did not know how to price its product, and hence management took on many unprofitable loans. As a result, its profits suffered to such an extent as to undermine the public's confidence. Thus, it is reasoned, it was an earnings problem, not a capital problem.

But, I see the situation somewhat differently. For the eight-year period between 1964 and 1972, the assets of Franklin National Bank expanded 187 per cent, or at a compounded average annual rate of 14 per cent per year. During the same period, its equity capital and loan loss reserves expanded only 71 per cent or at a compounded average rate of 7 per cent. In asset growth Franklin was a leader in the industry which averaged a growth in total assets for the same period of 131 per cent and a growth in equity capital and loan loss reserves of 83 per cent. My point is obvious: had Franklin been required to maintain its capital ratio at some level,

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its growth via taking on high risk and low margin earning assets would have been more difficult and perhaps management would have benefited by having more time to understand the situation in their bank. In such cases, the expansion of large banks would be sounder and more stable and without sacrifice of profits.

Of course, the use of capital in this fashion by regulators is a crude tool. While it could have some influence on the quality of earnings of banks, particularly of large banks, it would not prevent a decline in the quality of earnings and assets stemming simply from poor management. There is no substitute for competent and well-qualified management. But using capital standards as a brake on the growth of assets can retard the decline in the quality of assets of large banks resulting from the growth of assets in excess of management's ability.

I do not think that using capital standards in this manner is at variance with current thinking within the industry. Indeed several of the largest banks have already made decisions to slow the growth of their assets until they have a clearer vision of the state of the economy and the financial situation. Many are planning now to improve their capital positions. Nor would it interfere with taking into account individual bank differences in setting certain capital standards. For example, I believe it is only fair and realistic to take into account a bank's size (as a proxy measuring access to the money markets), its geographical location, its assets as evaluated by examiners, its earnings and its management.

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Bank Holding
Companies

Another area of concern to me is the substance of regulation dealing with bank holding companies. Here again, there has yet to be agreement or common understanding on what regulatory standards, if any, should be set. The source of concern to the Board from the bank holding company movement centers on the effect that developments in the holding company structure have on the financial health and integrity of the bank or banks in the complex. In particular, the Board believes that the financial arrangements of the holding company preferably should serve as a source of strength to the bank, but at least such arrangements must be neutral in this respect.

Essentially I see three major principles which must be adhered to if the activity of the holding company is not to damage the image or financial condition of the bank. First, the holding company must limit its internal growth, acquisitions and new areas of market penetration to that which is consonant with the ability and depth of its management. In this respect there are two elements of particular interest to me: the level and quality of the debt and the capitalization of the bank holding company complex. Second, the company must maintain a cash flow which is satisfactory to service its debt. And third, the company should not over-leverage its equity capital.

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With respect to leveraging, I believe that short-term debt should be used for short-term purposes, and when such debt is commercial paper, it should be covered by firm back-up lines of credit. For longer-term debt, I believe that the level of acquisition debt should be kept at a moderate level, that there should not be major reliance upon cash dividends from the banking subsidiary for payment of debt service, and finally I have a preference for convertible issues. Furthermore, indenture provisions should be carefully constructed so as not to unduly restrict future decision-making flexibility and should not have clauses that may accelerate maturity.

The area of capitalization of bank holding companies is a further problem area. In deciding what is a satisfactory level, I lean toward the building block approach. This approach requires that each individual subsidiary of the holding company complex have a liability and capital structure in accord with standards existing in its respective industry. In effect, each unit is capitalized as though it were independent. The appropriate capital level of each holding company would then be the sum of the individual parts. Excluding the banking subsidiary, this approach offers much promise in arriving at appropriate levels of capital in that much comparative data and generally recognized standards on adequate capitalization and leveraging levels are becoming increasingly available. Of course, this still leaves the question of the appropriate capitalization of the bank to be decided, which I discussed earlier.

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Other
Observations

Before I end, I want to comment on a few other points of interest to the banking industry.

As a parenthetical comment perhaps useful in this "Watergate" era, I wish to commend the U.S. Congress. You are aware that the Federal Reserve System is responsible for administering the Bank Holding Company Act. In doing so the System has been acting on about 1,500 cases per year. Yet in three years I have not received one call from a member of the Congress attempting to influence the outcome of a case before us. Nor am I aware of any such calls to my colleagues. Occasionally a letter or call is received asking for more prompt treatment of an application, but never more than that, to my knowledge.

As I mentioned earlier, the Federal Reserve System is now hard at work preparing a comprehensive package involving the overhaul of our Federal regulatory apparatus. I do not yet know the final form this proposal will take, but I intend to argue vigorously in the Board's debates for a centralized Federal regulatory structure.

Within the package to be proposed, I feel that there should be another key element. In the event that merger or acquisition of a problem bank is the appropriate solution, that solution can be better and more surely achieved if out-of-State banks or bank holding companies can be invited to bid. This insures that potential bidders are present. Federal law should be changed to permit entry of

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out-of-State banks or holding companies when an emergency such as Franklin or U.S. National occurs.

It seems to me rather ridiculous that California or Illinois banks, for example, could not bid on Franklin. But six major European banks acting in consortium did bid successfully and were able to take advantage of a ten-year, $150 million maximum FDIC loan. In which nations of the world would an American bank be invited to compete and entry effected with a ten-year foreign government loan?

There will be those who fear competition and perhaps injury to the so-called dual banking system who will immediately denounce this proposal. But they should pause to carefully consider the likely potential damage to their own institutions or to banking competition in their States in the event that the largest bank, for example, in one of the many States without major money center banks, fails. The fact is that in most of our States there are only a few institutions strong enough to effect a rescue merger. Why not have at hand the strength of the entire fabric of American banking in effecting a merger in case of difficulty in those States where there is not a broad array of institutions from which to solicit bids?

Compensating Management

Banks are different. Professor Charles Williams at the Harvard Business School teaches that "a banker is a businessman's

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businessman." I would go further and suggest that the banking industry is the backbone of the economy. Banks are fiduciaries and their deposits are insured by Government. Comparing banks, then, to the great growth companies of our time is entirely inappropriate. For a bank or bank holding company to suggest to security analysts a growth in earnings of a given amount or per cent for a given number of years into the future is both unwise and unfair. Banks' earnings depend to a degree on Federal Reserve actions which private bankers cannot predict with confidence.

Banking is not the place for buccaneers and go-go boys, if, indeed they have a place in any sound industry. I suggest that boards of directors of banks and bank holding companies reexamine their compensation packages for senior executives. Compensation dependent upon skill in "chasing the multiple" with overly aggressive plans to build earnings while trading on equity has brought us, I think, at least some of the trouble we have been experiencing.

Profit bonuses for senior management and stock options are somewhat questionable devices given the nature of banking and the heavy quasi-public responsibility of the nation's bankers. Thus, while I do not rule these devices out, I do believe they deserve careful reconsideration, if they have contributed to the problem as I suspect.

This does not say that I think there is no room in banking for well-compensated executives, including bonuses and stock options.

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For one thing, aligning the interests of management and stockholders is fundamentally important to good corporate management. But the bank executive's rewards, particularly his bonus and extraordinary compensation, should be for demonstrated ability to build a sound bank, and, around it, a sound bank holding company structure, firmly capitalized, and paying dividends on quality earnings. The public will reward such banking with its trust and its money -- and such a bank will be earning good profits when go-go banks have had to spend time in the intensive care unit of the bank's regulator.

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