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Statement by

Stephen S. Gardner, Vice Chairman

Board of Governors of the Federal Reserve System

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Good Morning. Mr. Chairman, Members of the Committees. These introductory remarks will be brief. The General Accounting Office report on Federal bank supervision already contains the comments of the agencies. I would like to move on to an evaluation of major findings in the study.

The data and recommendations in the report viewed in the perspective of the entire U. S. banking system confirm the judgment that the industry is sound; that it has weathered the worst economic conditions since the thirties; that, as a result of this experience, some additional supervisory powers to control abuses are desirable; that formal coordination between agencies would be helpful; that the agencies themselves have begun many new programs to refine examination techniques; and, that no basic revision of the Federal structure of bank supervision is required.

The economy in 1974 and 1975 experienced the longest and most severe recession in the post Warld War II era. During this period, real GNP fell five consecutive quarters, industrial production fell sharply, and unemployment reached a post World War II high of 8.9 per cent. The 14,000 commercial banks in our diverse and regionalized banking system are the principal suppliers of credit to business. Their loan portfolios are a mirror image of America's industrial and commercial economy. Only the uninformed would not expect the banking system to be subjected to the financial pressures of an historic recession following immediately after a severe period of inflation. Banks, however, were generally able to cope with these extraordinary problems. And there are no conclusions in the GAO study that suggest we do not still have a viable and sound banking industry.

Federal oversight of banking and the performance of the supervisory agencies aided in the achievement of this result. In addition to supervising banks and other depository institutions, Federal and State experts annually examine banking and thrift institutions. No other private industry is subject to such detailed Federal and State financial reviews. The experience of decades, through periods of changing economic conditions, has gone into the evolution of this process. The system, which was essentially completed and enacted by Congress in the 1930's, has served the country well.

Let me substantiate this. The GAO study directs considerable attention to banking problems and "problem banks." Relatively few banks, less than 5 per cent of the 14,000 banks in the U. S., have been on the "problem lists" of the agencies at any one time. Moreover, as the data prepared by the GAO show, the composition of these lists changes frequently as problems are identified by the regulators and resolved by the institutions. Only a small percentage of problem banks actually fail. In the difficult period from 1970 through 1975, there were only 42 bank failures and most such institutions were relatively small. In the majority of these cases, the supervisory agencies were able to arrange takeovers of the failed institutions by healthy banks. Few were liquidated, and this permitted uninterrupted services to customers, and held losses to uninsured depositors to a minimal aggregate dollar amount. It seems unnecessary to compare the percentage and numbers of bank failures to the many thousands of business liquidations and bankruptcies, or to compare the number of bank failures in the early thirties to the entire period since that time.

I would also like to clarify the use of the term "problem lists." The GAO study based some of its conclusions of supervisory effectiveness on the length of time a given institution remains on such lists. The majority of banks on these lists are institutions that have experienced some difficulties and were identified as needing more than the usual degree of supervisory attention and monitoring. Supervisory performance should not be measured by the number of institutions that the supervisor believes warrant close attention and/or the length of time such attention is given. That may also be a measure of the supervisor's alertness. In addition, it should be recognized that there are banking institutions -- fortunately not many -- that are only marginally successful businesses, but that provide essential services to their communities. If the supervisors believe they can work closely with the bank and safely let it continue, they may find it necessary to maintain close scrutiny for a number of years. We believe this is a responsible policy that is in the public interest.

The GAO study has resulted in considerable attention being focused on the numbers of violations of law uncovered by bank examiners. The GAO study, however, quite correctly points out that many of these violations were of a technical nature and had little or no impact on the financial soundness of the institutions. Further, the very fact that examiners uncovered such violations demonstrates the effectiveness of the examination process. They found such violations, technical or otherwise, in reviewing tens of millions of transactions of the kind indigenous to the complex U. S. economy today.

In the important area of consumer affairs, the Federal Reserve has had the major responsibility for drafting companion regulations for the surging growth of legislation that has taken place over the past two years. The Board's newly organized Division of Consumer Affairs is working closely with the other agencies and has formed a task force to develop methods to enforce the newly enacted consumer credit laws. A cadre of examination specialists is being trained to concentrate on inspection for compliance with consumer protection statutes. Two schools on consumer regulations were conducted in 1976 and four are planned for 1977. In addition, examination manuals that deal with the full array of consumer regulations have recently been prepared. A new examination report form dealing exclusively with this area has been developed and is expected to be in use in the near future. In short, prior to the GAO study, we had been moving ahead vigorously to insure implementation of these new laws.

The percentage of problem institutions among bank holding companies is as relatively small as the percentage of problem banks. In discussing holding companies, it is again necessary to seek perspectives. Despite the flurry of acquisition activity in the early 1970's, most of the major bank holding companies continue to be primarily commercial banking operations with less than 5 per cent of their total assets representing nonbank activities. There are some 1,800 bank holding companies and they control banks which hold over two-thirds of the total U. S. banking deposits. While there are dramatic instances in which nonbank activities contributed significantly to banking problems, there are vastly more instances where this did not occur. This was due in large part to the tradition of sound banking that has been fostered across the decades by our bank supervisory system.

Following the 1970 amendments to the Bank Holding Company Act, there were some instances of excessive expansion, and in early 1974, the Board adopted a "go slow" policy concerning holding company and bank expansion. This policy, which curbed expansion, was instituted because the Board believed that managerial and financial resources in some instances needed to be used first and foremost to strengthen existing operations of bank subsidiaries, some of which had experienced sharply declining capital ratios. The Board took other actions such as the use of cautionary letters concerning credit expansion. These efforts helped to slow and discipline the accelerating growth of the U. S. banks in the early 1970's. The impact of the recession would have been more severe had these actions not been taken.

In October, 1974, the Board's request for cease and desist authority over bank holding companies was granted. Since that time, the Board has significantly expanded its supervisory efforts and concentrated primarily on bank holding companies exhibiting problems. The on-site inspection program for bank holding companies has been stepped up and refinement of the System's computer-based monitoring capabilities is underway. In the 26 months the Board has had the authority, it has issued 12 cease and desist orders and 12 written agreements against holding companies.

Far more important than the issuance of cease and desist orders have been the numerous instances in which Federal Reserve personnel have advised holding companies to defer expansionary programs. The withholding of supervisory approval needed by bank holding companies that seek to engage in additional activities or, in some cases, to expand their present operation has proven to be a most effective supervisory tool. I'm sorry that we do not have a precise record of the number of occasions when Federal Reserve personnel have advised holding companies against submitting expansionary proposals until bank deficiencies were corrected.

The GAO study makes a number of recommendations to assure greater uniformity in supervisory procedures among the agencies.

Senator Stevenson introduced the Federal Bank Examination Council Act (S. 3494) in May, 1976. Such a council would establish uniform standards and procedures for Federal examination of banks as well as uniform reporting systems and joint schools for examiners. The Board supports such legislation. A proposal along those lines would accomplish most of the objectives set forth in the GAO study's comments on uniform procedures. Even without such legislation, the Board intends to continue to work towards more effective coordination with the other agencies.

The GAO study also confirms the desirability of expanded supervisory legislation. The Board recommended such measures to Congress as early as September, 1975. The legislation proposed in H. R. 9743 and S. 2304 would have provided civil penalties for violations of a number of provisions of Federal law. It would have imposed new restrictions on a bank's transactions with insiders, and placed the agencies in a position to make more effective use of the Financial Institutions Supervisory Act of 1966. These bills were not enacted, but the Board intends to propose similar measures again.

The principal recommendations in the GAO study relate to refinement of examination techniques, changes in examination report form format and improved communications with the banks. Most of the recommendations appear sound. In fact, they involve concepts that have been extensively discussed and considered by bank supervisors, and some, to varying degrees, have been implemented. For example, the GAO recommends that the examiner meet with the banks' board of directors after each examination. The Federal Reserve has used a similar technique through its policy of insisting that the board of directors of all State member banks be informed of the examiners' findings. In most examinations, this is done by requesting the directors to approve the bank's reply to the examiner's report. Many meetings with directors have also been held. In addition, it is Board policy that such a meeting be required in those instances where there has been a marked deterioration in the condition of the bank. Reserve Bank officials are routinely expected to request meetings with bank directors whenever they feel it is appropriate.

The further evolution and improvement of the supervisory system will be aided by Congressional action on the legislative proposals which are supported in the GAO study. There is appropriate evidence in the GAO study that the supervisory agencies have adopted systems and procedures to meet significant changes that have occurred and will continue to occur in the industry they oversee. We have a comprehensive system of Federal oversight of banks. It has been improving, but it can be improved further as many of GAO's suggestions indicate. Nevertheless, the present system has been well conceived and, judged on the record of the industry it regulates, it has been successful.

I would also like to make an observation concerning the role of bank supervision. Bank examination and supervision should not only be directed at securing compliance with laws and regulations and assuring the safety and soundness of depositors' funds, but supervisors also should manage their responsibilities in the broadest sense of the public interest, so that the community and the economy have competitive, vigorous, and sound banking units. A system of bank regulation that goes beyond these goals imposes social costs and economic dangers. It is not the job of the supervisors to determine whether specific loans or types of loans should or should not be extended or even how a bank's resources should be used except when such actions contravene law or imperil the safety and soundness of the bank.

In closing, I wish again to note that the U. S. economy is in the process of recovering from a prolonged and severe recession which saw the near collapse of the construction and housing industries. The commercial banking system has made progress in managing the loan problems that have arisen from those hard-hit industries and from other borrowers adversely affected by the sharp economic downturn. The experience with the problems encountered during this recessionary period has increased the awareness of some bank managers to the risk factors in banking and improved their ability to assess and deal with such risks. It has also pointed to the need for some additional legislation and for some improvements in supervisory techniques. The Federal Reserve has taken steps to meet these needs.