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PROGRESS AND PRUDENCE
IN BANKING

Remarks of

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Member

Board of Governors

of the

Federal Reserve System

To Members and Guests of the

Boards of Directors
of the

Federal Reserve Bank of San Francisco
and Its
Salt Lake City Branch

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I am pleased to be with you and your guests today. I would like to take this opportunity to share with you some of my thoughts about tension in banking--at least, about one fundamental kind of tension that is being accentuated in banking today.

This audience, I know, is keenly aware of the importance to our nation's economy of a progressive and healthy banking industry. What I would like to do this afternoon is first to highlight some of the progress that we have seen banking make over the past decade or so. Then, I would like to turn your attention to some of the present and potential adverse situations facing banking. Such adverse developments have in certain instances been unwanted side effects of some of the progressive activities we have seen banks undertake. These, and other obstacles to further healthy progress in banking, appear now to require all of us to place renewed emphasis on a quality that historically has always been closely associated with healthy banking--prudence.

For assistance in the preparation of this paper, I am indebted particularly to Mr. Paul Metzger of the Board's staff. The views expressed herein, however, are my personal responsibility.

Banking Progress

Over the last ten to fifteen years progress in banking has virtually transformed the industry. When compared with the business of banking as it was practiced historically, at least through the Depression era, these recent changes have been sufficiently marked to warrant being called "revolutionary."

Consider, for example: the mushrooming reliance of larger banks on "liability management," namely, the issuance of large certificates of deposit and other money market instruments in order to raise loanable funds; the increased use of charges for services by banks to offset the growing reluctance of their customers to maintain any more than minimal demand deposit balances; the expansion and diversification of bank holding companies both here and overseas; the rise of the Eurodollar market; the almost universal employment of computers both within and between financial institutions; and the increasing interaction of the world's financial systems, especially among the more industrialized nations.

These changes I regard as by and large progressive ones. They benefit broad segments of the public, both in the United States and overseas, and are indicative of the greatly enhanced capacity of American banking to respond to continuing demands for change.

Our banks have been spurred by heightened competition, coming not only from within the banking industry but also from thrift institutions, insurance companies, diversified financial corporations and even nonfinancial firms that extend consumer credit. In turn, the competitive climate of our entire economy has broadly benefitted from banking's response to the challenges of rising competition.

What we have witnessed, in short, is the on-going transformation of banking. Our nation has been an ultimate beneficiary of the increased resourcefulness and sophistication of the banking community. It is a record of progress of which bankers can be justifiably proud.

Banking Prudence

Progress, however, is not enough. Something more is needed.

Banking has traditionally been treated--with justification--not just as a business but as a profession. When asked why they have viewed their occupation in this light, bankers more often than not would respond that theirs was no ordinary business, but one vested with the public interest. They dealt in other peoples' money. Funds were entrusted to them by broad segments of the public. This established, in a very real sense, a public trust that compelled them to act with greater care than individuals engaged in commerce and industry. In significant measure, it was because of this attitude on the part of bankers that the public came to have a high regard for, and confidence in, the banking system.

Over time, both legislation and watchful regulation of the banking industry have served to buttress the public's confidence in the safety and soundness of our banking system. Nonetheless, this attitude of bankers themselves continues, I believe, to be a substantial element in maintaining the public's trust.

If prudence and the promotion of public confidence have been basic ingredients of good banking, then surely an extra measure of those indispensable ingredients is called for today. Double-digit inflation and its attendant evils (not only in the United States but in most other highly industrialized nations) have produced a situation which has led to very considerable pressure being placed on banks. Monetary policy has assumed a major role in the fight to reduce the rate of inflation. Accordingly, the Federal Reserve has had to supply new bank reserves much less generously. Meanwhile, credit demands from would-be borrowers have been very strong. In this atmosphere, banks could and have charged high interest rates on loans, but they have also been pinched by sharp increases in the interest rates they have had to offer to attract funds.

These conflicting pressures have been so extraordinary as to generate a certain amount of market anxiety concerning the ability of some banks to bear them. Concerned customers are closely scrutinizing their banks'

financial condition, and some uneasy money could decide to seek haven elsewhere if signs of weakness should multiply.

To minimize such troubles, one simple slogan commends itself to each bank management today:

HUSBAND YOUR BANKING RESOURCES.

Try to preserve the bank's liquidity. Lengthen the average maturity of its purchased money. Buttress its capital position whenever the opportunity affords. Place a tight leash on officers in charge of new business developments, and tell them to concentrate on arrangements which will not place drains on bank liquidity or capital for a year or two. Tell loan officers to screen out non-essential loans.

At the same time, good bankers will not dodge their responsibility to lend to creditworthy regular customers, whether large or small, the minimum amounts needed to keep those customers' activities viable. It is hard work to pursue all these objectives at once, but being able to do so is the mark of a successful banker in 1974.

Progress versus Prudence

There is a kind of dynamic tension between the forces impelling the progressive activities of banks and the compelling need for prudent conduct of the nation's banking business. For example, when bank holding companies expand and diversify, they seek to enter bank-related businesses partly to reach new sources of earnings by performing various services for a fee as an offset to declining demand deposit balances. In so doing, holding companies have sometimes sought permission from the Board of Governors to go beyond the fairly extensive list of activities now permissible to bank holding company subsidiaries, in order to engage in significant new activities either in the United States or overseas. Such applications often represent a progressive step that will benefit both the bank holding company and the public. Occasionally, however, they can stretch the bounds of prudence. They sometimes involve the management of risks qualitatively different from those likely to be familiar to bank management. Sometimes, too, the proposed activity

may require a sizable amount of capital and specialized managerial resources. It may therefore divert capital and management talent away from the banking subsidiary where they might in fact have been helpful in shoring up a thin capital position or a shallow layer of management.

This question of the adequacy of capital is, of course, a major issue in banking today. It is a part of the underlying tension between progress and prudence. As you know, this issue has become one of particular concern to the Board, for many of our leading banking institutions have tended to pursue a policy of rapid expansion in both domestic and foreign markets. Prudence would dictate that such expansion be supported by a strong capital base and an adequate liquidity position. The tension of which I have spoken is heightened when a bank's management must make the hard choice between continuing expansion into possibly highly profitable fields or slowing that expansion to permit augmentation of capital and to ensure appropriate liquidity.

While I am well aware of the pressure bankers are under to show a record of profitable performance to current and potential stockholders, I believe that the wiser choice for bankers today is to go slow on expansion plans, and to emphasize instead actions to bolster the long-run strength of their institutions. The capacity to sacrifice short-term gains to protect a longer-term position has always been a mark of the prudent banker. While a measure of entrepreneurial aggressiveness by bank managements has helped make our banking system a progressive one, in the final analysis only a prudent management can assure that system's continued well-being.

In the ultimate test of banking, of course, public confidence is the key. It cannot be otherwise for institutions that have promised to pay a major part of their liabilities on demand. Bankers have a heavy responsibility to avoid actions that would result in weakening the public's confidence in our banking system, particularly in difficult times like these. That kind

of banker prudence is more important than Federal Reserve willingness to serve as lender-of-last-resort or FDIC insurance of deposits in reassuring the public of the fundamental soundness of our banking system.

Having spoken at some length now about bankers' responsibilities, let me say something about how I see bank regulators' responsibilities for attempting to achieve that same difficult balance between progress and prudence. You can be assured that I and my colleagues on the Board are sensitive to banks' needs to seek new sources of funds and to engage in profitable undertakings both at home and abroad. For it is only in this fashion in today's highly competitive environment that banks can hope to perform adequately their intermediating function of marshalling funds from savers and investors and dispensing them to meet growing public and private needs. The importance of this function may be made even more apparent in the future as rising world-wide demands for capital make their full weight felt.

We are also sensitive, however, to the even more vital need to preserve the basic health of this country's banking system. For if prudence is the hallmark of sound banking, it is even more the necessity of sound banking regulation.

We realize, I might add, that we are imposing a heavy burden on bankers by sometimes urging them to increase their equity capital and improve their liquidity positions at a time when tight monetary policy has made these more difficult to accomplish. But when we see some banks undertaking costly expansionary activities without providing commensurate capital and liquidity bases, we cannot help but think that the time has come, by denying certain applications, to urge such institutions to reconsider the balance they have struck between the dictates of progress and those of prudence. In such cases, a slowing of too-rapid expansion by holding companies has seemed to us to be the wisest course. Our responsibility as regulators of banking in the public

interest has impelled us to act in these instances to tip the balance in favor of prudence.

Conclusion

What I have been speaking about this afternoon has ostensibly been the tension between the need for a progressive, forward-looking and responsive banking system on the one hand, and the need for prudent conduct to assure the continued health and safety of our banking institutions, on the other. I have also been talking about the responsibilities of bankers and bank regulators to achieve a balance between these two sometimes conflicting needs. But actually, I have been discussing something that both underlies and encompasses these subjects.

My topic today has really been the nature of the public interest in our banking system and how bankers and bank regulators alike can better help to promote that interest. This is a joint undertaking, one made particularly difficult--and all the more important--by the troubling economic circumstances of our time. It

requires that we strive together to see that the public's interest in banking is both thoroughly protected by appropriately wise and prudent conduct and well served by soundly progressive and innovative undertakings. Our nation's economic and financial well-being is significantly dependent on maintaining a proper balance between these two goals.