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Statement by

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before the

Committee on Banking, Housing, and Urban Affairs

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I appreciate the opportunity to appear before this distinguished Committee today to present the views of the Board of Governors of the Federal Reserve System on S. 684 and S. 711. My testimony will develop the reasons for the Board's unanimous support for S. 711, the bill that would establish a Federal Bank Examination Council, and for its unanimous opposition to the creation of a Federal Bank Commission, as proposed in S. 684.

The establishment of a Federal Bank Examination Council, we believe, would represent a constructive evolutionary step toward formalizing the existing cooperative arrangements among the Federal bank regulatory agencies. But in the Board's judgment, complete centralization of bank supervision at the Federal level, as envisioned in S. 684, would constitute an unnecessary, disruptive, counter-productive change. In the short run it would almost certainly produce confusion and significant operating inefficiencies. And in the longer run, it might adversely affect both the quality of banking supervision and the performance of the banking industry. Such a restructuring, moreover, would tend to isolate bank supervisory policy from the monetary policy function, to the detriment of both. In short, the Board can find no compelling arguments for the proposed regulation of the Nation's banks by a single Federal agency that overcome the practical shortcomings and prospective loss of policy integration that this approach entails.

The Board's position on these bills is founded on our belief that the banking system currently is in sound condition, which reflects in no small part the substantial efforts of both the bankers and the

bank regulators over the last several difficult years. I make this statement even though it is well known that some banks encountered serious problems during the recent recession and that a few failed to weather the storm. The number of banks on the Federal agency "problem" lists--that is, banks requiring unusual amounts of supervisory attention--increased considerably over the 1975-76 period, and these included some of our very large banks. But continued favorable earnings flows, more conservative bank management policies and effective supervisory oversight--all in the environment of an improving economy--combined to forestall any important adverse economic or financial developments that might have arisen.

Today it is apparent, even to the casual observer, that there has been a strengthening in the condition of the banking industry. The number of banks experiencing increased difficulties has declined dramatically over the past year or so. Total bank net income for 1976 rose by over 8 per cent from the year before, and was about 11 per cent above the 1974 level. The ratio of total bank capital to total assets improved to 7.15 per cent at year-end 1976 from 7.11 and 6.86 per cent, respectively, in the two preceding years. Banks also have buttressed their liquidity positions by adding greatly to their holdings of liquid assets and paying off some money market sources of funds. In short, the financial position of banks has improved markedly over this period.

The volume of assets classified by examiners remains higher than any of us would like to see, although indications from 1977

examinations are that they are now beginning to decline. But bankers and regulators both learned hard lessons from the experience of the recession, and there is every prospect of continued good progress in the reduction of problem bank assets. The working out of problem loans is a lengthy and laborious process, so that loan classifications are necessarily a lagging indicator of banking conditions. The improvement in financial ratios that I have noted, however, leaves little doubt that the Nation's banking system has been coping successfully with its problems and is in a favorable position to handle the credit needs of an expanding economy.

Against this record of achievement, it is not clear to the Board why consolidation of the three Federal bank regulators is now being proposed, for there appears to be no compelling reason to replace the present system with one that is untried and unproven. The existing structure of Federal supervision of the banking system has evolved over a very long period, dating from establishment of the Office of the Comptroller of the Currency in 1863, the Federal Reserve System in 1913 and the FDIC in 1933. The division of duties and responsibilities among these agencies can seem confusing to the uninitiated and, at times, even to the well informed. But this structure of bank regulation has worked reasonably well, as evidenced by the stability of the U.S. banking system over the last several decades. During the recent period of severe economic and financial strains, the Federal bank supervisors, working together, were able to arrange takeovers of almost all of the failing banks by healthy

ones, thereby permitting uninterrupted service to bank customers. Public confidence in the banking system has been maintained, in no small part because of the combined efforts of the three Federal bank regulatory agencies.

These agencies have been criticized from time to time for not anticipating the banking problems of the 1970's and for failing to take measures to avoid them. As with any event, the advantage of hindsight always provides a much sharper perspective on alternative courses of action that might have been taken. But I believe that decisive efforts were made by the Federal Reserve as soon as the prospective problems were clearly identified. Our actions have been described to this Committee in other testimony, and I will not dwell on them here. But I would note for the record that, beginning in April 1973, the Federal Reserve took steps to slow and discipline the unsustainable growth of banking assets and liabilities. It employed supervisory tools ranging from "moral suasion" concerning the lending practices of individual institutions to a "go-slow" policy regarding approvals for the expansion of bank holding company and international activities. These measures did have an impact, and helped persuade many institutions to adopt more realistic plans for expansion. In their absence the recession might well have taken a greater toll on the Nation's banks.

To be sure, the supervisory system could have worked better in some respects, and our recent experience has helped identify areas of needed improvement. The banking agencies have recognized these

needs and are taking appropriate steps to improve supervisory performance. We are now engaged in a reevaluation and updating of examination procedures and other supervisory techniques, about which I will comment later in more detail. It must be recognized, however, that there will always be some banks that require special supervisory attention. Making loans is an inherently risky business, and banks must accept a measure of risk if they are to play their part in financing a dynamic growing economy. It should not be the purpose of bank supervision to prevent such functional risk-taking, but rather to guard against unusual or excessive risk concentrations and banking practices that may undermine an institution's viability. The bank supervisory agencies must also be alert to the spread of problems from one institution to another and must strive to prevent any large-scale adverse effects on either the local or national economy. Viewed from this perspective, the Federal Bank regulatory agencies have performed quite well.

Thus, before moving from the present structure of Federal bank regulation to the single agency concept proposed in S. 684, the Board would urge the Congress to weigh carefully the potential for damage that could accompany such wholesale reform. There are a variety of shortcomings and possible difficulties that we foresee.

First, it needs to be recognized that such an agency is unlikely to bring greater operating efficiencies. Indeed, after reviewing the existing structure of Federal bank regulation, the

Comptroller General concluded in Congressional testimony early this year that a single agency would not provide any cost savings.

Second, the creation of a single banking agency, whose mission is tied exclusively to a single industry, would increase the risk that regulatory policy could be shaped to an undue degree by the special interests of the industry. This has been a major Congressional concern, at least in other sectors.

Third, with a single Federal bank supervisor, the banking industry could be more exposed to the possibility of extreme shifts in the regulatory climate. Continuous consultation and cooperation among the three independent Federal banking agencies, on the other hand, provides a system of checks and balances which tends to attenuate marked shifts in regulatory policy with their potentially destabilizing ramifications.

Fourth, centralization of the bank supervisory function could have the undesirable effect of suppressing innovation and healthy competition in the industry. Since FDIC insurance is a virtual necessity in today's environment, creation of a single Federal agency would mean that practically every bank in the country--whether nationally or state chartered--would have to follow the guidelines set forth by that one supervisor, and the impetus to effect changes could be stifled.

Fifth, there would undoubtedly be significant transition problems associated with the organization of a new agency. In the Board's judgment, the Nation should not be needlessly exposed to the risk of a discontinuity in bank supervision while a new Federal

bank regulatory agency organized, grappled with the inevitable administrative problems and began to establish its operating rationale.

Sixth, the proposed Federal Bank Commission at the regional level would supplant many of the regulatory functions now provided by the Federal Reserve Banks. The important role of these Banks in the supervisory process is, I believe, often overlooked. They contribute a depth of understanding of local and regional economic, banking and financial conditions that is unlikely to be equaled by an agency devoted solely to bank regulation. And I find it doubtful that the authority of a regional administrator of the proposed Commission would often approach that of a Federal Reserve Bank President, who deals with local banking institutions over a wide-ranging variety of issues and has responsibilities on the national credit scene as well.

Finally, and most importantly, the Board remains gravely concerned that the removal of its supervisory and regulatory responsibilities, as called for in S. 684, would work adversely on the Board's effectiveness in carrying out its monetary policy function. We also believe that the quality of bank regulation would suffer. Our view continues to be that the conduct and formulation of monetary policy and the supervision and regulation of banking are so closely related functionally that they should not be determined in isolation. If supervisory standards for bank performance are independently set, there is the very real risk that

bank regulation could frustrate the objectives of monetary policy. Above all, a recurrence of the situation of the mid-1930's is to be avoided, when overly conservative bank regulatory standards tended to inhibit needed extensions of credit by banks and thus slow the financing of economic recovery.

Although S. 684 would place a Board Member on the Federal Bank Commission, our judgment is that this would not provide adequate coordination with, or a sufficient depth of information to, the Board. All of the Board Members are now involved on a continuing basis with both monetary policy formulation and the setting of bank supervisory policies. From this vantage point, the Board gains direct knowledge about how changes in monetary policy affect the condition of banks. And because of this dual responsibility, the Board Members are well apprised of the impact of changing banking supervisory policies on banking and financial markets and the implications for monetary policy. With a Federal Reserve Board Member on the Commission, it is true that information could be transmitted back and forth. If the new system worked ideally, this would include not only data on statistical trends but also qualitative insights into new banking practices and procedures. Even so, the advantages currently gained from the deliberations of seven persons with first-hand knowledge in all of the relevant areas would be lost.

The benefits that flow from integration of the monetary policy and bank supervisory and regulatory policy functions may be illustrated by citing a few of the situations in which such integration is needed. For example, careful attention must be given to the financial strength of banks during periods when monetary restraint is being applied. In such periods interest rates typically are high by historical standards, and trending upward. This can result in substantial declines in the market value of certain bank assets--among them long-term securities and mortgage loans--and place a premium on the maintenance of ample ready liquidity. In addition, a restrictive monetary policy often requires relatively substantial adjustments in certain sectors of the economy and in some local credit markets. As a result, bank loans in these sectors may be exposed to deterioration in quality. In implementing a restrictive monetary policy, therefore, consideration of the likely impact on the condition of banks and other financial intermediaries is essential.

Another source of potential difficulty in periods of high economic activity is the tendency to accumulate large backlogs of unused bank loan commitments--that is, promises to lend money on request--which are made chiefly to business customers. During the early 1970's, the bulge in bank loan commitments created problems for both monetary policy and bank regulation. It was clear that the overhang of outstanding commitments was slowing the restraining

effects of monetary policy; and there was a danger that under continued conditions of monetary restraint, some banks might have insufficient liquidity to meet their commitments. Under those circumstances, the Federal Reserve--with responsibilities for both monetary and bank regulatory policy--took the lead in exerting pressure on bankers to bring their commitment activity under better control.

A traditional responsibility of the central bank is to serve as a lender of last resort. While the purpose of this function is to cushion the financial dislocation that might threaten when general monetary restraint reduces the overall liquidity of the economy, its implementation involves actions to bolster the financial condition of individual banks--in particular their liquidity positions. In providing such support, the Federal Reserve draws heavily on the expertise provided by its staff of bank supervisors. If such expertise could be obtained only from a separate bank regulatory agency, the Federal Reserve might find it difficult to act quickly and appropriately to forestall a developing regional or national financial squeeze.

Finally, the supervision and regulation of international banking activities in an area that requires especially close coordination with monetary policy. U.S. banks are active participants in foreign exchange markets and international lending, and these activities influence foreign exchange rates, international capital flows and trade balances, all of which are of direct concern to monetary policy. Also, Federal Reserve monetary actions may affect international

financial markets, and these effects can have important implications for bank regulation and supervision, especially as they pertain to the operations of the Nation's largest banks. Through its contacts with foreign central banks and international institutions, the Federal Reserve has available more complete international economic information than would be likely for an agency whose sole responsibility is bank supervision. I cannot stress enough the importance of first-hand knowledge in this complex, critical area.

Just as bank supervision and regulation is interrelated with the monetary policy and credit functions of the Federal Reserve, so is it strongly related to the deposit insurance function of the FDIC and the national bank chartering function of the Comptroller of the Currency. Through cooperation and coordination among the three agencies, the examination and supervision of the Nation's banks has been divided so that each bank has only one primary Federal bank supervisor. Thus, duplication of effort on the part of both the banks and the agencies has been avoided, and a full exchange of information among the Federal bank regulators has been promoted.

The relationship of bank holding company supervision to the other functions of each of the three Federal bank supervisors is less well defined. A single primary Federal bank holding company supervisor is not always readily identifiable. For example, a holding company may have several bank subsidiaries, each of which is responsive to a different primary supervisor. Or it may have a variety of non-bank affiliates, the supervision of which is not readily integrated with the normal bank supervisory process.

The Board therefore would urge the Congress to maintain the bank holding company regulatory function in a single agency. Among the existing Federal bank supervisors, the central bank is best qualified to fill that role. In support of its monetary policy function, the System has insight into the operations of domestic and international financial markets and the workings of the economy generally. Such information is vital to the effective supervision of bank holding companies--and, in particular, to the regulation of nonbank affiliate activities at home and abroad.

With respect to its regulatory functions, I think the record shows that the System has not been a complacent supervisor, either of member banks or of bank holding companies. In testimony on S. 2298 before your Committee in December 1975, Governor Holland reported the major steps that the Federal Reserve had taken in recent years. Since that time improvements have been made in the training program for System bank examiners. Increased attention has been given to loan and credit analysis as well as compliance with regulations. Special schools have been established for examiners in the area of consumer credit statutes and regulations and in the complexities of holding company supervision and regulation. In addition, a new bank holding company inspection report is being developed in order to standardize the examination process and to enhance the System's ability to identify and supervise those holding companies that fail to act as a source of strength to their subsidiaries.

Improvements are also being made in our examinations of foreign branches and Edge Act corporations in order to better monitor and supervise the international activities of these banking organizations.

The Federal Reserve's supervisory capability is being augmented also by the development of a computer-based surveillance system which screens information collected periodically from banks and bank holding companies for any signs indicating a deterioration in condition. Early identification of potential problem organizations should aid in the System's effort to give especially close supervisory attention where it appears most warranted.

In addition, I would note that the System has not hesitated to apply supervisory sanctions. In October 1974, the Board's request for cease and desist authority over bank holding companies was granted by the Congress. Since that time, 43 cease and desist orders have been issued or written agreements negotiated, and 29 of these involved bank holding companies. And of course there are literally hundreds of cases where bank holding companies and banks, in response to supervisory criticism, have committed in writing to take appropriate corrective action.

The Federal bank regulatory agencies have a long history of cooperation and coordination on supervisory matters, and efforts are being made to strengthen the ties. A recent development is the establishment in February of this year of the Interagency Supervisory Committee. This new standing Committee of agency officers will deal exclusively with bank supervisory matters of a technical nature. The Supervisory Committee's immediate mission is to achieve coordination among the agencies with respect to bank examination policies and procedures.

During this initial year, the Supervisory Committee has developed--and the agencies have adopted--uniform policies on the definition and identification of concentrations of credit. At the Committee's recommendation, the agencies agreed to a survey of the level and types of risk being taken by U.S. banks as a result of their international lending. The Committee is also studying the feasibility of adopting a uniform bank rating system and a uniform approach to the treatment of nonaccruing loans.

S. 711 has our full support because it would build upon these existing cooperative arrangements and would provide an evolutionary framework for more effective interaction and coordination among the three Federal banking agencies. This bill, which closely parallels legislation that the Board proposed earlier this year, would require a Federal Bank Examination Council to focus on the matters most in need of attention now--the development of better and more uniform standards and procedures for the examination of banks. The proposed Council would conduct schools for examiners of all the Federal agencies, which would also be open to enrollment by employees of State bank supervisory agencies. The Council would develop uniform reporting systems for banks, bank holding companies and nonbank subsidiaries. The Council would also be authorized to make recommendations for uniformity in other supervisory matters and would be provided with a forum--via its annual reports--to propose legislative initiatives to the Congress. These are all steps in the right direction.

In addition, the Board welcomes the provision of S. 711 for participation by State bank supervisors. Section 7 of the bill provides that the Council shall establish a liaison committee composed of five representatives of State bank supervisory agencies which is to meet at least twice a year with the Council. This arrangement would foster more coordination with the State agencies, with the prospect of developing State and Federal uniformity in examinations on a mutually cooperative basis.

In the Board's view, the Council's responsibilities are modest but reasonable. Moreover, in the fulfillment of these responsibilities, significant progress could be made in a manner not disruptive to the continuing performance of the three existing agencies. Experience with the Council might well lead to the conclusion that some further coordination among or consolidation of certain functions of the bank regulatory authorities would be desirable. But in that event, such a finding would be based on a practical awareness of the difficulties that would have to be overcome.

The Board believes that it is much the wiser course to proceed in this manner, on the basis of demonstrated need, and that S. 711--the Federal Bank Examination Council Act--provides just the mechanism for doing so.

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