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Panel Discussion On Supervisory Issues

Colorado Bankers Association

June 7-8, 1985

I. Introduction

Economic conditions and the impact of a less regulated financial environment are having profound effects on the financial services industry. Economic problems in agriculture, real estate, and energy and problems with foreign loans have adversely affected the condition of many depository institutions. A record number of insured banks failed in 1984 (79 in the U.S., 23 in the District) and 43 banks (17 in the District) have failed through May 31 of this year. ~~Some individuals forecast that as many as 100 banks could fail this year.~~

Complicating matters is the uncertainty caused by widely publicized difficulties experienced by some of the larger banks in the country [Continental Illinois, Bank of America (mortgage pool fraud), Security Pacific (clearing agent for Bevill-Bresler), Worthen Financial Corp-- Little Rock (creditor of Bevill-Bresler)]. There are also the recent problems at various privately insured savings and loans in Maryland and Ohio, and the questionable activities by a number of essentially unregulated government securities dealers.

~~Against this backdrop, changes are continuing to occur within the financial services industry making it more competitive and more complex to manage. Nonbank institutions (Sears, Prudential-Bache, Shearson/Lehman/American Express, Dreyfus) continue their drive to offer bank-like financial services. Regulated depository institutions are seeking new powers and market expansion.~~

Regulators also are faced with the formidable task of meeting regulatory objectives, while coping with the uncertainty and change that buffet the system. They are being asked to deal with pressures for expansion, involving new participants, products and geography, but yet they must strive to assure a stable and competitive financial system.

With this setting in mind, I want to comment briefly on some of the issues that are receiving much of our attention today. Specifically, I want to discuss the use of increased disclosure and market discipline, nonbank banks, and interstate banking. I also want to ~~mention current~~ *Comment briefly on the current efforts of the* Federal Reserve ~~efforts~~ to improve coordination with state regulatory authorities.

the policy of the FDIC to make public the names of
 II. Increased disclosure and market discipline

Issue: Market discipline in the form of disclosure of supervisory actions may force managers to be more cautious but also may be disruptive to our banking system.

institutions and individual that are subject to
 Discussion: *Normal regulatory actions.*

In our economy, the market is generally viewed as the best disciplinarian. *I generally share the view that* ~~To a great extent,~~ banking should also be exposed to this discipline. ~~Individual banks should be allowed to enter or exit markets as the situation warrants, and management and investors should profit or lose by their decisions.~~ However, in terms of current efforts to require increasing levels of disclosure in banking, there are significant dangers that require further consideration before using it as a supervisory tool.

~~The premise behind the move to disclosure in banking is that investors and depositors can bring pressure to bear on an institution that is engaging in questionable or unsound practices. Consistent with this view, the FDIC has announced that it will disclose the names of banks subject to formal administrative actions, such as cease and desist orders.~~

The Federal Reserve System, so far, has chosen not to move its supervision of state member banks and bank holding companies in this direction. While it acknowledges that greater disclosure and market discipline can be a positive force in financial regulation, it is concerned that disclosure of administrative actions in today's difficult banking environment may run counter to the policy objective of promoting a stable banking system.

~~Administrative actions are initiated for a variety of reasons. Some require operational modifications while others require the complete removal of management. Because of these differences, the Federal Reserve is concerned that the public may not be capable of differentiating among actions and could misjudge the seriousness of individual cases.~~

~~The cost of moving deposits is relatively small and uninsured depositors, and perhaps insured depositors, have every incentive to move deposits from any bank which has problems and is subject to administrative action. This is market discipline at work. However, this movement of funds will also create serious liquidity problems for the bank and could lead to results inconsistent with the objectives of the administrative action.~~

~~This last outcome is particularly likely in today's troubled~~

~~environment~~. While increased disclosure might promote management discipline, it may also have destabilizing effects on financial markets. Thus, it may be more appropriate to conduct tests on the supervisory value of disclosure in a more stable banking environment.

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the next issue is the chartering and use of nonbank banks by banking and nonbanking organizations.

III. Nonbank banks

Issue: The acquisition of nonbank banks by nonbank organizations is bringing a new mixing of banking and commerce. Nonbank banks are also being used by banking organizations to circumvent interstate banking restrictions.

Discussion:

Nonbank banks originated as a method for nonbank firms to expand into banking activities. By chartering or purchasing institutions that do not meet the definition of a bank under the Bank Holding Company Act, nonbank commercial firms are able to offer to the public a variety of deposit taking or lending services. More recently, banking organizations also have chartered nonbank banks as a convenient means to circumvent interstate banking laws.

These uses of nonbank banks are inappropriate. They are inconsistent with current national policy on banking and are permitting the financial system to carelessly evolve.

Since July 1983, the Comptroller has approved over twenty applications for nonbank banks by securities, insurance, and retail firms. Since September 1984, the Federal Reserve has approved nearly 300 bank holding company applications for nonbank

banks to be located in nearly forty states. While the courts have temporarily stopped the process, these decisions can be reversed. This type of stop and go activity is ^{in my view} unhealthy for our banking and financial system.

Rather than the current administrative and court directed development of our banking system, we need a legislative program that clarifies our national policy toward banking. It should speak to ^{appropriate} the boundaries of banking and commerce, permitting some expansion of banking into nonbank areas so long as it is consistent with a stable banking system. It also might permit interstate banking consistent with a safe, competitive industry. In both cases, however, the emphasis must be on setting national policy objectives for our banking industry.

IV. Interstate banking

Issue: The principal issues associated with interstate banking are its effect on competition and the concentration of resources in banking and the extent to which public benefits might flow from freer entry into banking markets.

Discussion:

The nation is moving towards interstate banking. For example, fourteen states have passed regional interstate banking laws and five others have passed interstate laws with no regional restrictions. Also, six states allow out-of-state banking organizations to establish limited purpose banks. Interstate banking also has been promoted through the use of nonbank subsidiaries of bank holding companies and through nonbank banks.

Currently, bank holding companies operate more than 7,000 interstate offices, 1500 of which offer a full array of banking services.

Full interstate banking would expand the number of entrants into local banking markets, thus potentially increasing competition and the level and availability of services to customers located within these markets. In this sense, there is every reason to support interstate banking in this country.

The concern with interstate banking is its potential effect on the concentration of financial resources. Moreover, it is likely that deposit concentration in banking will increase somewhat with interstate banking. However, it does not appear that this concern justifies the continuation of our current policy toward interstate banking.

Banking concentration nationwide is quite low. For example, the five largest banks hold less than 15 percent of the country's domestic deposits. Also, such factors as the ability of small and medium sized banks to compete with the largest institutions and the increasing competition from foreign banks and nonbank firms suggests that our financial services industry would remain intensely competitive under interstate banking. Finally, although the effectiveness of the nation's antitrust laws have come under question recently, they represent a powerful force in assuring that our banking industry remains competitive.

It has been suggested that interstate banking would permit large organization to use local markets as a source of funding for other major customers and that they would ignore community

needs. However, studies of branching and multibank holding company expansion show no evidence of such discrimination. ~~From an economic perspective, such actions also seem unlikely because they would greatly diminish an organization's ability to attract local customers and compete in the community.~~

Other issues associated with interstate banking include its effects on the safety and soundness of the ^{financial} ~~banking system~~ and the dual banking system. While these are legitimate issues, they do not justify the wholesale prohibition of interstate banking.

V. Proposal for increasing Federal Reserve cooperation with state banking agencies

in supervising Banking operations

Current conditions in banking are placing a strain on supervisory resources at both the federal and state level. In response, the Federal Reserve is reviewing ways to improve cooperation with state banking agencies in the supervision of state member banks and bank holding companies. Our intention is to reduce the burden on banking institutions and reduce costs for both the states and the Federal Reserve.

Currently, the Federal Reserve Bank of Kansas City has cooperative arrangements with six Tenth District States (Kansas is the exception). These arrangements involve joint or alternate year examinations and the sharing of supervisory information. These cooperative efforts have worked quite well and we are looking for ways to expand them further. For example, we are attempting to develop programs to share training facilities and

data and monitoring systems. Such arrangements can not only save money for both the Federal Reserve and the states but also can improve the quality of bank supervision.