

T H E C O M M U N I C A T I O N S G A P

A position statement on certain
issues and problems of concern
to Pennsylvania banking.

By

David P. Eastburn, President
Federal Reserve Bank of Philadelphia

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This turbulent age is characterized by a breakdown in communication and understanding--between the younger and older generations, blacks and whites, liberals and conservatives, rich and poor, and between the Government and many not-so-silent minorities.

Communication and understanding between the Federal Reserve and commercial banks also have deteriorated; and the situation has been aggravated by tight money. I have talked to numerous bankers in the past few months and have the impression that many of them feel the Fed is either unsympathetic to or doesn't try to understand their needs; that the Fed is inflexible and unresponsive to change.

Some of these criticisms may be justified, but a significant part of them results from ineffective communication--on both sides.

I am especially happy for this opportunity, therefore, to tell you where I stand on some of the important issues that concern both my Bank and yours. These include: (1) monetary policy, (2) supervision and regulation, (3) mergers, (4) membership, and (5) Federal Reserve services.

Monetary Policy

One of the conflicts in monetary policy arises out of a failure to understand fully the objectives of the Federal Reserve and of commercial banks. The Fed exists primarily to further the public interest. We are not a trade association and, although we are sympathetic to the welfare of banking, we must sometimes frustrate your individual plans and desires.

But this is not news; you know pretty much what we are and what we must do. The problem comes in reconciling this need on our part with a new need on yours--something you have been more and more aware of in recent years--the need to innovate. It is now a cliché to say that commercial bankers today are a new breed, imaginative and aggressive in developing novel ways to grow and thrive. But it is a fact which the Fed must recognize and welcome in designing its monetary controls.

Unfortunately, a major tool of monetary policy in the past year or so--Regulation Q--has failed to recognize this need. Ironically, Regulation Q has sharpened your desire to innovate. Unable to pay competitive rates on large C/D's, banks have proved particularly ingenious in finding new and different ways to acquire lendable funds--first, it was the Federal Funds market, then Euro-dollars, holding company paper, mini bonds, and so on. Although many institutions have not engaged in such activities, enough have so that this situation has contributed to friction between the Fed and banking. It has put us in the position of appearing to frustrate innovation when we tried to shut off or slow down these new devices.

At the same time, Regulation Q has proved to be a discriminatory way to restrain credit. It has borne particularly hard on commercial banks vis-à-vis some other lenders. An argument can be made that banks should be expected to bear the brunt of monetary restraint. They have been given the privilege of creating money; entry into banking is controlled; monetary policy exerts much of its effects through the banks. On the other hand, it is becoming increasingly apparent that such an uneven impact may be unfair in view of the fact that banks are becoming more like other financial institutions which, in turn, are becoming more

and more like banks. This kind of impact of Regulation Q might be tolerable for short periods, but is unacceptable as a sustained policy. The Federal Reserve will have to subject Regulation Q to a thorough re-examination.

A second tool of policy that has opened the way to conflicts between the Fed and member banks is the discount rate. Although market rates climbed to record heights in the past nine months, the discount rate has been mired at 6 per cent. Regardless of the reason, the existence of an immobilized rate has created some problems. With such a "bargain" available, banks naturally have been tempted to use the window to increase earnings. I know our discount officer has worked hard to convey the "rules of borrowing" to our member banks but, nevertheless, some misunderstanding of those "rules" continues to exist.

At the first opportunity the discount rate should be made consistent with market rates and trends and kept so through flexible administration. It should once again become an active tool of policy. This move should not necessarily wait for inauguration of the proposed "new discount window."

Supervision and Regulation

Some people have proposed that the Fed get out of the business of examining banks--that all banks should be examined by one super agency. I can see certain efficiencies in such an arrangement, but I am opposed to it. It is important for the Federal Reserve to retain its supervisory functions.

In the first place, the Fed must have frequent contacts with banks on the working level if we are to implement monetary policy and

perform our other functions in the most effective manner. This again is part of the communicating and understanding that I discussed earlier.

Experience and information gained from examining banks are valuable in administering the discount window. It is not a matter of evaluating credit risks, or protecting ourselves, but of getting an appreciation and instinct that enable the discount officers to better serve the needs of banks within the legal framework of Regulation A.

My final reason for advocating the Fed continue its supervisory functions is one of personal philosophy. Any institution--regulator or regulated--which consistently withdraws and narrows its interests cannot remain dynamic and progressive. Before long the pull-in-your-horns attitude pervades the entire organization and everybody becomes more and more content to do less and less. This is a time of activism and involvement, and later in this talk I shall outline some specific ways we are planning to get further involved with Third District member banks.¹

Mergers

The Fed has been criticized for the way in which it has handled applications for mergers. One criticism has concerned delays in getting decisions. I am pleased to say that action has been taken by Chairman Burns to speed up the process, and, hopefully, this sore spot is a thing of the past.

¹Another aspect of communications is Federal Reserve Regulations. These have increased in both number and complexity in recent years. As a result we have established a new unit in the examination function to help banks interpret and comply with Regulations such as G, T, U, Z, and others. If you have any questions or problems, the officers in the department will be glad to help you.

The other complaint is about the merger decisions themselves. Bankers feel the Fed generally is stricter than the other supervisors, and this very well might be the fact.

In the Bank Merger Act of 1966, Congress tried to say that banks are special as far as the anti-trust laws are concerned. The trouble is the Justice Department and the courts have not seen it this way. As a result, the Fed, in ruling on mergers, has not been governed by how it might like the banking system to be structured, but by existing law as interpreted by the courts.

Although this position certainly doesn't improve our image with bankers, I don't see how we in good conscience could have adopted any different policy on mergers.

Actually, the branch and merger laws applying to Third District banks have not been as restrictive as many people think. They have not prevented the dramatic rise of major regional banking systems in the past two decades. In 1950, there were only two banks in the entire District with ten or more branches; in 1969 there were 34, and all but five had their home offices outside Philadelphia. Twenty-seven of these banks outside Philadelphia had assets over \$100 million. Since 1950 the share of all District banking resources owned by these institutions has increased from 14 to 28 per cent and their resources grew 341 per cent compared to 264 per cent for Philadelphia banks. Much of this growth in both branches and resources has been through merger, so you see existing laws and regulations have hardly strangled Third District banking.

This is not to say, of course, that branch and merger laws in Pennsylvania are ideal. In fact, when major banks relocate their home

offices a few miles just to take advantage of these laws, it would seem that something is wrong. It is time for a thorough reexamination of the branch and merger laws. Even if Pennsylvania laws were changed, however, the anti-trust issue remains. If bankers really want liberalized mergers, they may not succeed unless they can persuade Congress to pass clear, new legislation that will cause the Justice Department and the courts to treat banks differently.

Membership

We have a serious problem in Pennsylvania--not just a problem for the Federal Reserve, but for the national and state banking systems and for the well-being of individual banks. The major cause of the problem is the inequitable burden of reserve requirements. I stress the word "inequitable" because I believe this is the important problem--not simply membership in some mythical Federal Reserve "club."

I understand the pressures of rising costs and attractive interest returns that induce banks to consider nonmembership; banks do have obligations to their stockholders, and the threat of a proxy fight is always frightening. But in my view, nonmember banks are not making an equitable contribution toward supporting the vital financial mechanism that they, along with all other banks, depend on. The contribution of monetary policy toward economic stability and prosperity, the efficient collection of checks, issuance of coin and currency, the transfer of funds by wire throughout the Nation--these and other essential Federal Reserve functions are performed through banks. As it is now, member banks are paying more than their share to maintain the system of essential financial services and nonmembers are not pulling their weight.

What to do about it? The ideal approach is to take action at the national level. One way would be for Congress to authorize the imposition of universal reserve requirements on all FDIC members. Unfortunately, the political likelihood of this solution for the near future is remote--to say the least. Other action at a national level is also very difficult, but there are a number of possibilities, including paying interest on reserves, counting various kinds of assets as reserves, and lowering the overall level of requirements. The time is ripe to consider these and other possibilities in earnest because the new monetary commission hopefully will be taking up the question of equity among banks as well as equity between banks and other institutions.

A second approach is at the local level. Since the root of the problem here is Pennsylvania's unusually liberal reserve requirements, it makes sense to bring them closer to the Fed's. I am not optimistic about this happening, and I appreciate that the PBA itself would be divided on the question. But we intend to do what we can to see to it that responsible people in Harrisburg are made aware of the problem which these inequitable requirements are creating.

Finally, there is action the Fed can take within the areas of our responsibility. One area is the discount window. Nonmembers do not have access to the discount window. With all the economic uncertainties that lie ahead, with banks already at reduced levels of liquidity and likely to be under who knows what kind of liquidity pressures in the future, the value of this privilege for all Pennsylvania banks is greatly enhanced. It is true that the Fed could arrange to lend to nonmembers in an emergency situation, but the emergency must be critical and of national or regional

scope. The individual nonmember bank in Pennsylvania or elsewhere is on its own. We hope to be able to make this privilege an increasingly useful one to member banks.

A second area of action within our discretion is services.

Services

Federal Reserve Banks provide many services to the public through commercial banks. There is always a question about the nature and level of services to offer. Member banks, of course, would like to have as much as possible, free. I'm not saying this is wrong, but it doesn't give us much help in deciding what to do.

There are two general principles, however, which do help. One is that we should consider providing those services which we can do more efficiently than can commercial banks. This is one obvious reason why, for example, so many checks are ultimately cleared through the Federal Reserve System. A second principle is that--other things being equal--services to member banks should be used as an offset to the inequitable burden of reserve requirements. I realize they cannot be a complete offset, but they can go part way.

These two principles have led us to take a new look at the functions we perform for member banks. This reexamination comes at a time when, because of changing personnel and other reasons, the quality of day-to-day work in many of our institutions shows threats of deteriorating. For example, Jim Vergari, who is in charge of operations, including our check function, senses the possibility of serious trouble in the recent growth of return items, check kiting, and drawing on uncollected funds.

Part of the difficulty lies in a mounting work load combined with fast-changing computer techniques and a scarcity of experienced personnel. I can appreciate the problem because we have it ourselves along with many commercial banks. There is no quick and easy solution--much patience and cooperation will be required.

Nevertheless, we have resolved to do what we can to speed up the check collection system and make it operate more efficiently. We are now completing the installation of new 360/40 computers. Before the end of this year the Federal Reserve Bank of Philadelphia will accept unsorted deposits of up to 3,500 checks, provided they are amount encoded, and we will compute availability for these deposits by electronic means. Member banks will be able to save the time (and money) they now spend sorting such deposits prior to sending them to us. In another effort to speed up the collection of checks, we are studying intensively the desirability of setting up regional clearing centers throughout the District.

In order to discover other areas of service in which we might be more helpful, we are planning to sponsor a series of meetings and seminars next fall at our Bank for your operating people to discuss practical problems and technical matters. We are also organizing a trouble-shooting group to visit banks at their request and help solve operating problems that involve transactions with the Fed. These people won't be our regular field men, but department heads and other top operating people who will serve on a rotation basis. It should be a mutually beneficial experience. I expect our people will bring an increased understanding of commercial banking back to their regular jobs.

This is where we stand at the moment. We invite member banks to use the facilities available to them at their Federal Reserve Bank. I am sure this applies to the Cleveland Fed and the Pittsburgh Branch, as well as the Philadelphia Fed.

Conclusion

The Philadelphia Fed is not seeking great new worlds to conquer. We have quite enough duties and responsibilities as it is. Our goal is to discharge them as well as we possibly can and, thereby, provide maximum service to our member banks and, through them, to the District economy as a whole. As I have tried to indicate throughout this talk, we think we can do our job better by becoming more involved, or, as the kids say, more turned on to commercial banking, and we want you to understand us better, too. You will notice the changes I have proposed today are intended to narrow the communications gap between the Fed and commercial banking. In addition, we now have at the Bank an officer whose full-time job it is to streamline and oversee communications. One of his jobs will be to try to reduce the quantity and improve the quality of the material we send you. He also will edit a new, informal newsletter called BANK BRIEFS, which will present capsule discussions on matters of our mutual concern. The first issue is due in a few days.

Since effective communication is a two-way street, I invite the top officials of each Third District bank to write me, phone, or stop in when they have something to say on issues or operations. Obviously, I can't promise action in every instance, but the closer I am in touch with the banking community the better the Philadelphia Fed can do its job.

After all, we have very similar basic objectives--to make our banks as strong and innovative as possible and thereby provide the best possible service to the economy of Pennsylvania.