BUILDING CONFIDENCE IN OUR FINANCIAL SYSTEM

by

DAVID P. EASTBURN, PRESIDENT

FEDERAL RESERVE BANK OF PHILADELPHIA

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Bank regulators are under fire as they have not been since the 1930s. The criticisms are sharp and the questions pointed. What went wrong? Why do we have lists of problem banks? How could we be where we are unless supervisors fell down on the job?

The important issue is not who made what mistakes but what have we learned from recent experience. I'd like to examine three issues with you tonight: first, how can regulators anticipate problems; second, who should be doing the supervising; and, third, how much should the public be told about the condition of banks? In doing so I'll be making some broad generalizations about supervisors that obviously will have many exceptions.

How to Anticipate Problems

Examiners do many things when they go into a bank--review internal auditing, check for violation of laws and regulations, etc. They also pay attention to exposure on the liability side, profitability, and characteristics of management. But at the heart of the examination process is a judgment about the quality of assets and how that relates to capital. Loans are judged to be of acceptable quality or they are classified. Those that are substandard and below are totaled and related to capital. Basically, it's an asset-oriented, snapshot approach to whether a bank is or isn't up to acceptable regulatory standards at a given moment.

Supervisors are now aware that the main deficiency of this kind of approach is that it's after-the-fact--it focuses on what a bank has done, rather than on what it can do to avoid problems or work out existing difficulties. What is needed instead is an anticipatory bank examination and regulatory system.

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A basic ingredient in such a system is more use of economic forecasting, analysis and judgment by examiners. For example, loan quality is tied closely to the business cycle. Loan quality deteriorates during recessions and improves during recoveries. Anticipating movements in the economy--while never eliminating all misjudgments--can reduce the number of surprises. This, of course, is difficult, as economists have recently found to their chagrin. But by looking ahead more, regulators can be in better position to criticize before the fact rather than after. They can talk to bank management about developing problems and what options are available for avoiding them.

There is, of course, more to avoiding problems than being aware of the business cycle. Regulators also must be in tune with the thinking of bankers. In the '30s, bankers thought mostly of survival, after World War II they concentrated on soundness. Then in the '50s and '60s they caught the growth bug which evolved into the profit craze known as "go-go" banking. Bankers were not alone. The "go-go" spirit also pervaded the corporate merger and acquisition area, the "performance funds" of the mutual fund industry, the real estate market and so on. The point is that regulators must look at the big picture if they are to anticipate what's ahead--where the big picture includes movements in the economy as well as being sensitive to the attitudes of bankers.

In response to recent experience, regulators are spending considerable resources to construct surveillance systems that will help them monitor the impact of economic and financial developments on banks. Banks that are generating early warning signals can be scrutinized more closely.

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In this kind of anticipatory examination process, regulators can better judge the ability of bank management to cope with problems. The primary test of management should no longer be the magnitude of classified assets to capital per se, but rather what policies management adopts and carries out to avoid future problems or get out of current ones. Regulators would then be in better position to lean against the wind of collective excesses in the banking industry, or--perhaps a more immediate danger right now--collective timidity.

So much for anticipating problems. Let me now turn to who should do the regulating.

Who Should do the Regulating

My guess is that, although sentiment for reform appears on the upswing, the odds are still against reform of the regulatory structure this year. I say this quite aside from the merits of reform but because there are so many opposed to change for various reasons of their own.

One of the lessons of recent experience suggests strongly keeping at least one of the aspects of the present structure. That is, keeping some link between bank supervision and monetary policy. Basically, monetary policy works through altering the liquidity positions of banks. When we ease monetary policy, we increase bank liquidity and when we tighten monetary policy, bank liquidity is reduced. Supervisors also look at bank liquidity. Coordination between supervision and monetary policy is helpful so that the thrust of monetary policy can be reinforced by liquidity standards of supervisors.

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Bank capital standards set by supervisors also should mesh with monetary policy if national economic goals are to be achieved. Now, for example, in the aftermath of several years of rapid credit expansion, the capital position of many banks could use some strengthening. Yet, the need for more bank capital should not be so overwhelming as to impede banks in financing the economic recovery.

Finally, there is a tendency for central bankers to become too ivory towerish. Being involved in the examination process helps us keep our feet on the ground by having first hand exposure to what is going on inside banks.

Although I believe there is much merit in keeping the Fed in the examination business, I would be reluctant to see the entire regulatory authority vested in the Federal Reserve. The thought of combining so much power--regulatory and monetary--in one agency gives me considerable pause.

Where I come out is that what we have is not ideal and not what we would devise if we were starting from scratch. But given the practical obstacles to change, plus the desirability of maintaining a link between supervision and monetary policy, I shy away from changing the basic structure. A more productive route is to make changes within the existing framework along the lines of making supervisors more anticipatory and improving coordination among the supervisors.

How Much Should the Public be Told?

A final question is how much should the public be told about the condition of banks? The traditional position is that the public should be

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told very little. The rationale is that banking plays such a pivotal role that any public misunderstanding about released information could shake public confidence in the banking system and hence the whole economy. Besides, the argument continues, the advantages of close public scrutiny are more or less achieved through close supervision.

However convincing this argument once was, it has a hollow ring in a post-Watergate world in which leaks about problem banks have been taken rather calmly by the public. Let me make clear, I am against the pilfering of examination reports and related materials and I am against the subpoening of examination reports in their present form by Congressional Committees. However, I do favor increased public disclosure of the condition of banks. What's disclosed, how, and when deserves careful study, but the general proposition that more disclosure would be in the public interest makes sense to me.

The reason is that although banking is a heavily regulated industry, the marketplace can also be a most effective regulator. It can provide a strong incentive to do well and can be a harsh critic for doing poorly. But the marketplace can function only if investors, depositors, and customers have adequate information about the condition of banks. Rather than seeing the growing demand for more disclosure by banks as disruptive, therefore, I see it--if properly directed--as a positive step toward building increased understanding and confidence in our financial system.

Summary

Let me sum up. Building confidence in our banking system is essential to healthy economic growth and prolonged prosperity. We've learned some

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lessons in recent years. The first is that we need a forward-looking, anticipatory examination process--one that judges the quality of banks more by the way they are responding to ongoing and prospective developments rather than a static look at a set of ratios. The second is that, as a practical matter, more progress can probably be made now toward strengthening the examination process within the existing supervisory structure than trying to modify it, given the obstacles to reform. Finally, more public disclosure of banking conditions--if done prudently-- can be in the public interest by allowing the marketplace to do a better job. Building confidence takes time, maybe a long time, but the time to start is now and the people to start are you, the banker, and we, the regulators.

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