Research Department
Federal Reserve
Bank of
San Francisco

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# Regulator's View

Everyone within reach of a TV set must know by now that the bank regulatory agencies have come under heavy fire recently. The gist of the criticism seems to be that the Federal Reserve and other agencies permitted the era of go-go banking to get out of hand, and then locked up all the evidence of poor lending practices.

The barrage of press criticism has inevitably led to Congressional hearings, with about a half-dozen different committees and subcommittees looking into some aspect of the story. But after a series of hearings, a clearer picture of the validity of these allegations has begun to emerge. A useful summary of Federal Reserve views was presented by Governor Robert C. Holland before the House Banking Committee earlier this month.

Holland first discussed the precise meaning of the term "problem bank"—a term which suggests a more severe condition than actually exists in the bulk of the problem-bank cases. The institutions appearing on the regulators' lists have been identified, because of their difficulties, as being in need of extra supervisory attention and monitoring. But most have made substantial progress in solving their problems, and thus are in no danger at all of imminent failure. The banking system's self-corrective powers, plus a rejuvenated economy and decelerating inflation, have strengthened the financial situation far beyond what could have been foreseen a year ago.

**Handling problems**

Holland noted that overliberal lending policies in a period of severe inflation had created numerous problems in the early 1970's, but he pointed to a series of Federal Reserve actions taken to curb those excesses. In April 1973, Chairman Burns warned the banks of the dangers implicit in large loan commitments, and followed this up shortly thereafter with a plea to restrain the then-headlong pace of bank lending. Again, in September 1974, the Board released a letter from its Federal Advisory Council warning of the need for banks to tighten up, especially on loans for speculative purposes.

Throughout 1974 and 1975, the Fed adhered to a "go slow" policy concerning bank holding company expansion. (Although the Fed doesn't have direct supervisory authority over large nationally-chartered banks, it can influence their actions through their parent holding companies.) The Board's reasoning was that holding company resources should be used not for entering new fields but rather for strengthening existing operations—especially those of bank subsidiaries, to check the decline in shareholders' capital-to-loan ratios. Similarly, the Board denied a number of applications from major banks for overseas



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expansion, making the same point that their capital should be used not for new initiatives but rather for existing business operations.

Steady pressure was maintained on other fronts as well. In their discussions with bank managers, Fed examiners frequently argued the need for additions to capital, improvement in liquidity, and strengthening of lending policies. Also, many Federal Reserve officials in their public appearances urged that remedial steps be taken.

Increasingly prudent policies brought good results. In Holland's words: "A number of banks' and bank holding companies' managements recognized their problems and realigned their lending policies to obtain better credit decisions; improved, to the extent possible, their liquidity positions; added to capital by slowing the rate of increase in cash dividends; added to capital funds by sale of subordinated debt; and, finally, adopted more manageable growth and expansion goals." He added that the banking system was able to work itself out of its difficulties without the benefit of massive government assistance—without, for example, the benefit of a 1930-style Reconstruction Finance Corporation, which many thought would have to be created to bail out troubled firms that had borrowed in excess of their debt-servicing capacities. Rather, banks demonstrated their ability to arrange for the orderly workout of loans and, in the more difficult cases, to absorb necessary losses through their own earning power.

**Dealing with disclosure**

Turning to the controversy over the publicity given bank-examination reports, Holland argued that many informational reports already are in the public domain—but that examination reports should not be among them. Banks are required to file quarterly condition reports with the supervisory agencies and to publish those reports in the local press. (Following some changes proposed last fall, the amount of information contained in these published reports is due to be expanded.) All of the large bank holding companies registered with the Securities and Exchange Commission are subject to various reporting requirements, while banks seeking to market new capital issues must make available even more information.

"The issue is not one of disclosure, per se, but is the much more narrow issue of the desirability of disclosure of supervisory reports. The bank examiner has free access to all of the bank's records and most bankers, recognizing the confidentiality of their remarks, discuss very candidly the bank's most intimate affairs with the examiner. Disclosure of the examiners' reports would undoubtedly change the candid relationship between the banker and the examiner, and thus change the examination process itself. We should carefully consider whether or not we are prepared to risk these



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changes, particularly in light of the fact that these processes and procedures have served both the banking system and the public well for a number of years."

**Lessons of an era**

When the history of this turbulent era is written, the basic strengths of our financial institutions probably will receive much greater mention than their weaknesses. Murphy's Law aptly describes the happenings of this era—a brief period encompassing Vietnam, Watergate, OPEC, the collapse of Bretton Woods, and (almost contemporaneously) the worst inflation and recession of the past generation. The banking world experienced the demise of Franklin and U.S. National in this country and of Herstatt overseas, but the ensuing forecasts of a replay of the 1930's turned out to be far off the mark. Many problem situations developed during the 1974-75 period, but as of January 1976, only 121 of the nation's 15,000 banks—and none of its large banks—were listed on the Federal Deposit Insurance Corporation's checklist of serious problem cases.

Of course, many banks contributed to their own problems during this period, confusing what Henry Kaufman calls their fiduciary and entrepreneurial roles. (Banks play a fiduciary role when they act as custodians for peoples' funds, and an entrepreneurial role when they risk those funds to lend to those who need credit.) In contrast to their cautious fiduciary-oriented behavior in the early years following World War II, many banks became more entrepreneurial-oriented in the ensuing several decades—a period marked by an atmosphere of stable growth and apparently reduced risks. But now, the pendulum has swung back again. Responding to the riskier atmosphere of the mid-1970's, banks have adopted more cautious credit policies. As a consequence, they are increasingly able to work themselves out of problem-loan situations, as Holland noted.

It should be remembered, too, that banks played an essential role in stabilizing the economy at a critical time, at some cost to themselves. At mid-1974, bank funds were the only funds available to small and medium-sized firms, as money and capital markets tightened drastically in the face of double-digit inflation. Moreover, public utilities had nowhere to turn except to the banks in 1974, since they were unable to obtain needed funding from internal sources or through the capital markets. The resultant heavy loan demand strained the liquidity of many banks—but it helped to support the economy at the time it was most needed. In 1975 and early 1976, as capital markets improved and corporate profits expanded, business firms were able to pay down much of their heavy bank borrowing, thereby improving the banks' own balance sheets. With the curtain now drawn on a difficult period, historians will probably give the banks—and their regulators—rather high marks for their crisis performance.

**William Burke**





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## BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

| Selected Assets and Liabilities Large Commercial Banks | Amount Outstanding 2/11/76 | Change from 2/04/76 | Change from year ago Dollar | Change from year ago Percent |
|---|---|---|---|---|
| Loans (gross, adjusted) and investments* | 87,525 | – 92 | + 3,025 | + 3.58 |
| Loans (gross, adjusted)—total | 64,859 | – 24 | – 1,278 | – 1.93 |
| Security loans | 804 | – 74 | – 392 | – 32.78 |
| Commercial and industrial | 23,305 | – 19 | – 1,035 | – 4.25 |
| Real estate | 19,610 | – 26 | – 384 | – 1.92 |
| Consumer instalment | 10,360 | – 3 | + 435 | + 4.38 |
| U.S. Treasury securities | 10,063 | – 15 | + 4,529 | + 81.84 |
| Other securities | 12,603 | – 53 | – 226 | – 1.76 |
| Deposits (less cash items)—total* | 87,199 | – 811 | + 3,694 | + 4.42 |
| Demand deposits (adjusted) | 23,800 | + 613 | + 1,380 | + 6.16 |
| U.S. Government deposits | 323 | – 346 | – 60 | – 15.67 |
| Time deposits—total* | 61,763 | – 421 | + 2,294 | + 3.86 |
| States and political subdivisions | 6,944 | – 342 | – 183 | – 2.57 |
| Savings deposits | 24,371 | + 280 | + 5,777 | + 31.07 |
| Other time deposits‡ | 27,773 | – 233 | – 2,721 | – 8.92 |
| Large negotiable CD's | 12,862 | – 409 | – 3,821 | – 22.90 |

| Weekly Averages of Daily Figures | Week ended 2/11/76 | Week ended 2/04/76 | Comparable year-ago period |
|---|---|---|---|
| **Member Bank Reserve Position** | | | |
| Excess Reserves | 54 | 77 | 35 |
| Borrowings | 14 | 8 | 6 |
| Net free(+)/Net borrowed (–) | + 39 | + 69 | + 29 |
| **Federal Funds—Seven Large Banks** | | | |
| Interbank Federal fund transactions | | | |
| Net purchases (+)/Net sales (–) | + 1,592 | + 1,358 | + 1,344 |
| Transactions of U.S. security dealers | | | |
| Net loans (+)/Net borrowings (–) | + 224 | + 227 | + 1,104 |

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

**Editorial comments may be addressed to the editor (William Burke) or to the author. . . .Information on this and other publications can be obtained by calling or writing the Public Information Section, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 544-2184.**

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