BANK REGULATION AND THE PUBLIC INTEREST

Remarks of

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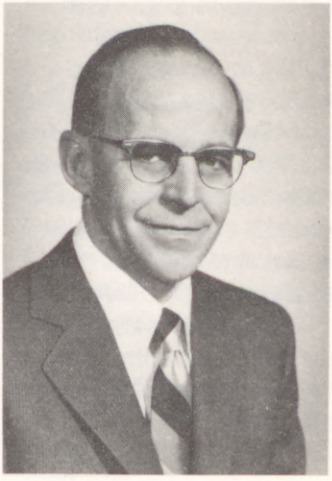

Simplification and reduction—and in some cases, removal—of regulatory burdens on banks is essential for the long-term health of the nation's financial institutions and of the overall economy, says Mr. Balles. The Federal Reserve is well aware of the problems created by a constantly changing and ever-growing set of regulations burdening the financial system. To cope with those difficulties, the Fed has begun to review every one of its regulations with a view toward simplifying or deleting wherever possible—in effect, zero-based regulating. But simplification of regulations can go only so far. What the banking industry must do is to convince Congress of the need to avoid regulatory overkill.

I feel honored by the invitation to give this year's Eccles Lecture, not least because it gives me the opportunity to pay tribute to the remarkable man after whom the series is named. The breadth of George Eccles' interests is well known to all of us. Along with his late brother Marriner, George has played a key role for many decades in stimulating the growth of the Intermountain West—in banking and finance, and in many other fields. And judging from his wide experience, I'm sure that George could discuss the topic of today's conference with more skill than the rest of us put together.

My theme today concerns the ways that the regulatory agencies and the people they regulate can best satisfy the public interest—how we can all work together to make regulatory actions conform to broad national goals at the least possible cost. Some of you may have seen the cartoon which shows two shepherds standing at the foot of Mount Sinai, watching a distinguished-looking gentleman carry some stone tablets down the mountainside. One man turns to the other and comments, "More damn rules and regulations!" That attitude, although perhaps overly critical in that particular context, still represents a healthy approach to the present debate, because it highlights the costs as well as the benefits of regulation.

The costs may be difficult to quantify, but there's no doubt that they are substantial. Many analysts argue that business firms as a whole incur expenses of roughly $100 billion a year in complying with government directives. These indirect costs, of course, far exceed the direct costs of about $5 billion needed annually for staffing and operating all the financial and nonfinancial regulatory agencies—and all such costs should be kept

in mind in any discussion of the future of regulation.

Let me declare my personal convictions at the outset. From my long experience as both a commercial banker and a central banker, I believe that the simplification and reduction—and in some cases, removal—of regulatory burdens on banks is essential for the long-term health of our financial institutions and of the overall economy.

Origins of Regulation

No one disagrees that banking is heavily regulated—perhaps one of the most heavily regulated industries in the country. In earlier decades, this stemmed largely from public and legislative concern with the safety and soundness of the banking system and the protection of depositors—particularly after waves of bank failures, such as in the 1930's. After all, banks are at the center of the nation's monetary and credit mechanism. They have a fiduciary responsibility for funds deposited with them, which are insured only in part. The supply of credit flowing through the banking system is essential for the growth and stability of the national economy. We have seen how failures of particular banks can have major ripple effects, affecting the state of confidence and the viability of the banking system, and hence the state of the entire economy. All of these considerations suggest the need to protect the financial cornerstone of the national economy.

Thus, one important body of restrictive legislation or regulations on banking originated from economic and financial crises, along with some accompanying abuses and unsound practices in banking. Especially important in this regard were the Banking Acts of 1933 and 1935 which, among other things,

established the statutory basis for the regulation of interest payments on bank deposits, provided for the separation of commercial banking and investment banking, established the Federal Deposit Insurance Corporation, and mandated numerous reforms in banking practices and bank supervision.

Even in the absence of a widespread economic crisis, abuses by a small group of banks, or even a single bank, can lead to successful demands in the Congress for further regulation of the entire industry. As a very recent example, I am informed that the Financial Institutions Regulatory and Interest Rate Control Act of 1978 is often referred to by bankers as the "Bert Lance" bill. Similarly, the emergence of consumer-protection legislation in the banking field was based on abuses which were perceived to exist by the Congress. Some of those abuses might have been handled more productively by vigorous enforcement of existing laws rather than by additions to an already large body of regulations.

As to a third area, it appears to many observers that key elements in restrictive banking legislation and regulations have arisen or have been retained because of successful demands by certain segments of the banking industry itself. Generally, these regulations have had the effect of restricting competition. Leading examples are restrictions on price competition, as in the case of legislation authorizing Regulation Q, which prohibits payment of interest on demand deposits and limits the payment of interest on savings and time deposits; and restrictions on market areas of competition, as is the case with limitations or prohibitions on branch banking and interstate banking. The latter group of

restrictions would include the 1927 McFadden Act, which limits national banks to the branching powers accorded to state-chartered banks under state law; laws of a number of states which limit or sometimes prohibit branch banking; and the Douglas Amendment to the 1956 Bank Holding Company Act, which prohibits a bank holding company from acquiring or creating subsidiary banks outside the home state, except where state law expressly permits such entry.

The rationale offered for measures restricting the scope of competition has usually run along one or more of the following lines: preventing undue concentration of economic power; preserving the vitality of local independent banking; guarding against overbanking and destructive competition; or preserving states' rights under the dual banking system. In terms of broad social and economic policy, such considerations are pertinent. At the same time, judgments need to be made and periodically reassessed as to whether the specific measures adopted that restrict competition are in fact justified by the national interest, in terms of costs versus benefits.

In the view of some observers, the net effect of industry-supported measures which place limits on competition in banking may have been largely to protect some individual competitors, rather than to protect and promote net public benefits. It should be noted, in fairness, that many fields of U.S. business have also been marked by similar intra-industry differences and disputes on the limits to competition.

As a personal observation, I am always surprised, and sometimes distressed, at the number of banks of all sizes which oppose

the liberalization of regulatory measures. Several instances from the past several years come readily to mind, in terms of vehement objections expressed to me personally from banks in the Twelfth Federal Reserve District. For example, bankers have objected to me about several liberalizations of Regulation Q, and more recently the actions to liberalize the provisions governing the international banking operations of Edge Act Corporations.

Types of Regulatory Burden

In summarizing the origin of much of the regulatory burden imposed on banking over the past half-century or so, it seems to me that it falls into several classes. First, there were actions limiting the scope of competition that either originated from, or were strongly supported by, a large segment of the banking industry. Unless or until this support changes, the outlook is not especially bright for relief, particularly since legislative action would be necessary. I am reminded of that famous line from Pogo: "We have met the enemy and they is us!" My own personal views are that the country and the banking industry would be well served by a phasing out of Regulation Q and a gradual evolutionary relaxation of present barriers to the geographical scope of competition in banking.

A second category of the bank regulatory burden originated in the banking "rescue and reform" measures of the 1930's, under the impact of the Great Depression. No doubt many of those measures were of lasting value and should be retained, such as Federal deposit insurance and improved standards for bank examination. But at the same time, my personal views are that a searching review should nevertheless be made of such legislation, to eliminate unnecessary restrictions that have become outmoded after

the passage of 45 years. Some observers question whether complete separation of commercial and investment banking still serves the country well. As a specific case in point, the studies made of the possibility of permitting banks to underwrite and deal in municipal revenue bonds, as they can already do in the case of general-obligation bonds of municipalities, have convinced me that a change would be to the net benefit of state and local governments. Specifically, if banks could compete in this area, it should mean expanded competition for revenue bonds and a lowering of the net interest cost. In this case, fierce opposition from the investment banking industry has thus far prevented enabling legislation from being passed.

A final category of banking regulation, of more recent origin and dealing with consumer protection, will also be difficult to modify or simplify. In recent years, Congress has imposed new responsibilities on the Federal Reserve and other bank regulatory agencies, through the passage of legislation which has focused increasing attention on constituencies other than the banking community. In 1968, the Truth in Lending Act ushered in a decade of extensive new legislation and rule-making responsibility in the consumer-protection and anti-discrimination areas. Such legislative mandates have created problems for regulators and regulated, and thus have led to loud cries for reform. As a preview of my personal views, I recognize that there were enough genuine abuses to warrant some corrective action. At the same time, I fear that in many cases, and considering the whole gamut of consumer-protection laws and regulations in the credit area, we may have gotten into an "overkill" mode. Because of the inherent cost and complexity of regulatory compliance, the net effect may

turn out to be counter-productive by raising the cost and reducing the availability of credit to consumers. This is a question of costs versus benefits, which surely deserves a searching review. Efforts now underway in the Congress, for example, to simplify Truth in Lending legislation, represent a needed start, and more such action may be desirable.

Avoiding Reg Q Restrictions

Let's consider next those restrictive regulations which were initially conceived to preserve market positions of financial institutions or to limit competitors' incursions into their territory—but which in fact have been self-defeating. A prime example, of course, is provided by the Regulation Q-type ceilings on interest rates paid by banks and thrift institutions. With the aid of inflation and a changing financial environment, the "creative destruction" of the marketplace undermined this restrictive regulation, long before the legislative process recognized the market reality. In this connection, it's hard to conceive that money-market mutual funds would even exist, much less hold $35 billion in assets, if depository institutions had been free to pay market interest rates during the past decade.

As you may have noticed, the legal process has begun to catch up in this field, although through the legislative rather than the judicial approach. Last April, a U.S. Court of Appeals panel decided against certain financial innovations which avoid the legal prohibition of interest payments on demand deposits. The court ruled adversely on the automatic fund transfers between savings and checking accounts offered by commercial banks, the remote-service units in shopping centers and elsewhere operated by savings-and-loan associations, and the check-like share drafts

on savings accounts offered by credit unions. The panel argued that "three separate and distinct types of financial institutions" created by Congress to serve separate needs now are offering "virtually identical services to the public, all without the benefit of Congressional consideration and statutory enactment."

Several weeks ago, the Supreme Court refused to hear the case on appeal, and the action shifted back to Congress, just as the appeals court proposed last spring. From all indications, Congress will act to legalize these financial innovations before the January 1 deadline imposed by the court, and we may begin to see a rough correspondence emerge between the legal and economic realities. Meanwhile, Reg Q rate ceilings continue under heavy attack, although they are unlikely to be phased out completely for a few years yet.

Avoiding McFadden Act Restrictions

Let's turn to the still evolving, and thus more interesting, subject of the geographic barriers to competition typified by the McFadden Act. For several decades, market forces have brought those barriers under heavy attack. Today, holding-company subsidiaries (with Federal Reserve approval) can engage in a number of specified bank-related activities without any geographic restrictions. Commercial banks can transfer funds and carry out government-securities transactions through the Federal Reserve's wire-transfer facilities, and they also can buy and sell excess reserves in that key national market, the Federal-funds market. Large banks can send the lending officers of their national divisions across the country to seek new customers, and in addition, establish representative offices or loan-production

offices in major financial centers to develop local business in those areas. Edge Act corporations can now set up branches in different states, after gaining the Fed's approval. And of course, credit cards can provide a form of interstate banking for consumers throughout the nation.

Holding companies provide a major example of the market's reaction to the McFadden Act; indeed, they now represent the dominant organizational form in banking. There are now more than 2,000 such organizations, and they control more than 70 percent of domestic bank deposits. The Federal Reserve processes about 1,000 cases each year involving holding-company applications to purchase existing banks, to form new banks, or to engage in one of the 13 permissible "nonbanking" activities approved by the Board.

The holding-company movement represents a response by the industry to the evolving framework of laws and regulations that constrain and restrict bankers' actions. During the 1960's, for example, the holding-company form of organization allowed banks to tap nondeposit sources of funds—mainly commercial paper and longer-term debt markets—at rates not subject to Regulation Q ceilings. These nondeposit sources of funds became very important to banks during those high-rate periods when Q ceilings were still binding on all time deposits. Again, borrowed funds raised by the holding-company parent have been downstreamed to bank subsidiaries in the form of debt or equity. This procedure has tended to increase the leverage of the overall organization, while maintaining or increasing the equity of the bank subsidiary.

Holding companies, through nonbanking activities, meanwhile have been able to avoid geographic and other barriers when competing with retail firms and nonbank financial institutions. These nonbanking activities account for less than 4 percent of holding-company assets, but they are important enough to arouse considerable opposition from affected economic interests. A prime example is a piece of legislation that was recently approved by a House Banking Subcommittee, called the Bank Holding Company Amendments Act, which would restrict activities of such companies in various ways. The fact that this piece of legislation was even introduced suggests that holding companies cannot expect completely free sailing in the years ahead.

McFadden Act restrictions meanwhile have hampered American banks in their growing competition with foreign banks. Traditionally, in state banking law, a "foreign" bank is considered an out-of-state bank, whether foreign or domestic. But many U.S. banks find it ironic that they are considered even more foreign than (say) Japanese or British banks. Thus, if the owners of a New York bank decide to sell out, because of financial troubles or other reasons, they can sell to a Japanese or British institution but not to a California one. And with state boundaries defining the size of markets, antitrust laws frequently stop banks within the same state from acquiring one another. Banking, alone among major industries, thus is constrained by the lines drawn on a map by surveyers a century or two ago, rather than by the needs of today's customers.

I don't want to prejudge the Administration's forthcoming report on the McFadden Act,

but I certainly believe that the regulatory environment will continue to evolve, as we try to balance today's economic and technological realities against the tradition of small-bank safeguards within the state/national dual-banking system. There are various forms in which new legislative authority might evolve. For example, we might see interstate branching within metropolitan areas, perhaps limited initially to EFT terminals. Again, we might see out-of-state bank holding companies acquiring failing banks, or out-of-state banks (say, in California and New York) establishing branches or holding companies on a reciprocal basis. Further down the road, the banking industry could develop into a several-tiered structure, made up of several dozen multinational banks in one group, several hundred regional banks in a second group, and thousands of small banks serving local markets in a third group. In a word, further evolution seems certain in our banking system.

Living with Consumer Legislation

Let's consider now another type of regulation—one which does not divide the industry as much as the McFadden and other restrictions that I've already discussed. I'm speaking of consumer regulation, an area where bankers generally stand united against Congressionally-imposed requirements and restrictions. Indeed, in trying to cure the real or perceived inequities created by the marketplace, Congress has created a massive and complex body of regulations for the Federal Reserve and the other banking agencies to administer.

This regulatory burden has developed in three different stages, the first of which covered roughly the period 1968–74, and dealt largely with the problem of disclosure. In that period,

Congress passed the first of the many laws that rewrote the rules governing the relationships between banks and their household borrowers. This group of laws included the Truth in Lending Act of 1968, the Fair Housing Act of 1968, the Consumer Credit Protection Act of 1968, the Fair Credit Reporting Act of 1971, and the Real Estate Settlement Procedures Act of 1974. In most cases, the Congress delegated to the Federal banking agencies the responsibility for enforcement, giving them a new and very unfamiliar role—the protector of consumer rights.

In a second period between 1974 and 1977, Congress added a different kind of law to the books. Through legislation such as the Equal Credit Opportunity Act of 1974, the Home Mortgage Disclosure Act of 1975, and the Community Reinvestment Act of 1977, Congress applied the Civil Rights Act of the 1960's to credit transactions. In effect, it outlawed rules of thumb which classify borrowers into groups based upon certain demographic characteristics for purposes of assessing creditworthiness. (An example would be the old rule which counted only half of the wife's income in lending decisions.) All credit decisions now must be researched and documented on an individual basis, thereby substantially increasing the cost of extending credit. Moreover, Congress during this period made it clear that it expected the banking agencies to play a more visible enforcement role than they had previously. Following an amendment to the Federal Trade Commission Act, each of the agencies established formal complaint-handling procedures. The Federal Reserve Board of Governors set up a unit, now called the Division of Consumer Affairs, to handle complaints and to formulate policies on

regulatory enforcement, and the Comptroller and FDIC established similar programs.

More recently, the regulatory agencies have vastly expanded their compliance programs while attempting to deal with the new responsibilities created by the latest spate of legislation. The Community Reinvestment Act of 1977 and the Financial Institutions Regulatory Act of 1978 portend expanded and intensified enforcement efforts. But enforcement has become systematized under the special consumer-compliance programs initiated in late 1976. Since then, the agencies have undertaken specialized training programs for examiners and have moved aggressively to improve compliance among banks, beginning with a series of major consumer-compliance examinations. All of these activities require expanded staffs; for example, the Federal Reserve Bank of San Francisco has doubled the size of its Consumer Affairs Unit in the past several years, mainly to develop advisory services for banks and to conduct in-depth examinations under the Fair Housing and Community Reinvestment Acts.

Congress and the regulatory agencies have received many complaints, especially from small banks or branches of state-wide institutions, stating that they have difficulty understanding and complying with the constant flow of consumer legislation. The problem may be difficult for the personnel of large institutions, but it could become almost insurmountable for, say, the loan officer of a small institution. His regular duties may include making instalment loans, buying dealer paper, overseeing credit-card

operations, making home-mortgage loans, extending construction credit and arranging for credit insurance. When he then has to take on the added responsibility of dealing with consumer-credit regulations, his task becomes difficult indeed.

The Federal Reserve is well aware of the problems created by a constantly changing and ever-growing set of Federal regulations burdening the financial system. To cope with those difficulties, we have begun to review every Federal Reserve regulation with a view toward simplifying or deleting wherever possible—in effect, zero-based regulating. But simplification of regulations can go only so far. What the banking industry must do is to convince Congress of the need to avoid regulatory overkill. As I noted at the outset, banks incur immense costs in complying with government directives, and it is virtually certain that these costs will have to be passed along to the users of bank credit. Thus it would behoove Congress to do everything possible to reduce the costs which consumers now have to pay because of the burden of regulation, and to avoid the danger of a lessened availability of credit to consumers because of the heavy burden involved in handling such business.

Concluding Remarks

By way of summation, let me cite several principles which were proposed in 1971 to the Presidential Commission on Financial Structure and Regulation (The Hunt Commission) by an American Bankers Association Special Committee, of which I was chairman. Basically, our committee argued that:

"1. Maximum reliance should be placed upon free market forces in order to assure an innovative financial system which is responsive to the public interest.

"2. Consistent with the need for safety, regulation of financial institutions should be subject to continuing review to make certain that the regulation is justified in terms of basic purpose and that its administration is not unnecessarily restrictive.

"3. To best finance the nation's social priorities, public policies should be directed toward mobilizing the resources of all financial institutions through measures which provide incentives to all lenders, rather than relying exclusively on subsidies to specialized institutions.

"4. As a corollary, the ground rules for competition among financial institutions must be equitable. Substantial differences in regulations affecting the relative ability of these institutions to compete with one another must be avoided if the nation is to move toward a truly responsive system of financial institutions."

I submit that these principles have held up well, and that they provide a basis for keeping the regulatory process in conformance with the public interest. We regulate in order to maintain a sound financial system as the foundation stone of a strong national economy. We recognize, however, that competitive change is a necessary element of future economic growth, and that change can sometimes be hampered by outmoded regulations. Thus, we can and must examine the wisdom of our regulations in a continuing review process. The cooperation of the private and public sectors is essential for keeping this process going, in order to fulfill the broad public interest.