

REMARKS ON DEREGULATION AND SUPERVISION

ANNUAL CONFERENCE OF THE
SUPERVISION, REGULATION AND CREDIT DEPARTMENT

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I AM GLAD TO HAVE THIS OPPORTUNITY TO TALK WITH YOU AT YOUR ANNUAL CONFERENCE. I HAD TALKED PREVIOUSLY IN 1982 ON THE ECONOMIC OUTLOOK AND WAS SO IMPRESSED BY THE PROCEEDINGS THAT I CHANGED JOBS SO THAT I WOULD BE INVITED BACK.

FOR SOME TIME, I HAVE FOLLOWED BANK REGULATION AND SUPERVISION AS AN INTERESTED OBSERVER, IN PART BECAUSE OF MY BACKGROUND AS AN ECONOMIST, BUT ALSO BECAUSE SECURITY PACIFIC, LIKE ALL BANKS, IS A RECIPIENT OF SUPERVISORY SCRUTINY. BUT NOW THAT I HAVE A DIFFERENT VANTAGE POINT, I EXPECT TO BE ABLE TO SAY THAT I ACTUALLY ENJOY BANK SUPERVISION.

I HAVE YET TO MASTER THE DETAIL OF THOSE MYSTERIOUS DOCUMENTS -- REGULATIONS H, Y AND SO ON. BUT WITHOUT THE BENEFIT OF SUCH KNOWLEDGE, I WOULD LIKE TO SHARE SOME OF MY OWN IDEAS ON BANKING AND SUPERVISORY MATTERS. I HAVE NO DOUBTS THAT I WILL MODIFY MY VIEWS AS I BECOME MORE INVOLVED IN THE WORKINGS OF SUPERVISION -- AND OF COURSE, AFTER GENE AND HARRY HAVE HAD MORE TIME TO WORK ON ME.

TO BEGIN, I WOULD LIKE TO SAY A WORD ABOUT ONE OF MY MAJOR RESPONSIBILITIES, MONETARY POLICY, AND ITS LINKS TO SUPERVISION. MONETARY POLICY DELIBERATIONS TAKE A LARGE PORTION OF A RESERVE BANK PRESIDENT'S TIME, AND DESERVEDLY SO. THE DECISIONS MADE BY THE FEDERAL OPEN MARKET COMMITTEE HAVE PROFOUND EFFECTS ON THE CURRENT AND FUTURE COURSE OF THE ECONOMY. TO IMPLEMENT MONETARY POLICY EFFECTIVELY, HOWEVER, REQUIRES SUPPORTIVE SUPERVISORY AND

REGULATORY POLICY FOR A NUMBER OF REASONS.

FIRST, THE BANKING SYSTEM IS CENTRAL TO THE MONEY CREATION PROCESS. IT WOULD BE DIFFICULT TO ARTICULATE AND MANAGE MONETARY POLICY IF THE BANKING SYSTEM WERE PRONE TO FREQUENT CRISES OF CONFIDENCE AND INSTABILITY. IN ADDITION, BANKS ARE CRITICAL ELEMENTS IN THE PAYMENTS AND CREDIT SYSTEMS THAT PROVIDE FINANCIAL LINKS THROUGHOUT OUR ECONOMY. A POLICY THAT ENHANCES THE EFFICIENCY OF THE FINANCIAL SYSTEM, HOWEVER, OCCASIONALLY MAY POSE MONETARY CONTROL PROBLEMS. THIS, TOO, ARGUES FOR COORDINATION OF MONETARY AND BANKING POLICY. THEREFORE, WE NEED NOT DEFEND THE PARTICIPATION OF THE FEDERAL RESERVE IN SUPERVISION, BUT RATHER FOCUS ON WHAT THE ROLE OF SUPERVISION SHOULD BE IN LIGHT OF TODAY'S MONETARY AND BANKING POLICY ENVIRONMENT.

ONE MAJOR FACET OF THAT ENVIRONMENT HAS BEEN THE RELAXATION OF A NUMBER OF LONG-STANDING REGULATIONS GOVERNING THE ACTIVITIES OF BANKS AND OTHER FINANCIAL INSTITUTIONS. THIS PROCESS OF "DEREGULATION" DOES NOT NECESSARILY IMPLY LESS SUPERVISION. IN FACT, DEREGULATION HAS INCREASED THE NUMBER OF WAYS IN WHICH BANKS AND HENCE THE BANKING SYSTEM MAY BECOME EXPOSED TO RISK:

- (1) BANKS NOW COMPETE FOR RETAIL DEPOSITS ON THE BASIS OF PRICE AS WELL AS THE LOCATION AND QUALITY OF SERVICES. ONE PROBLEM THIS POSES IS THAT UNDER CURRENT DEPOSIT INSURANCE

PROCEDURES, RISKY BANKS UNABLE TO ATTRACT WHOLESAL DEPOSITS CAN ATTRACT INSURED RETAIL DEPOSITS RAPIDLY, SIMPLY BY BIDDING UP THE PRICE. FOR BANKS ON THE BRINK OF INSOLVENCY, THEY -- BUT NOT THE BANKING SYSTEM -- MAY HAVE LITTLE TO LOSE FROM SUCH SURVIVAL STRATEGY.

- (2) BECAUSE REGIONAL COMPACTS ARE BEGINNING TO BREAK DOWN BARRIERS TO INTERSTATE BANKING, BANKS NOW HAVE GREATER POTENTIAL TO EXPAND THEIR ACTIVITIES INTO MARKETPLACES AND COMPETITIVE ENVIRONMENTS WITH WHICH THEY MAY NOT BE TOTALLY FAMILIAR. ALTHOUGH IN THE LONG RUN INTERSTATE BANKING, PER SE, POSES FEW RISKS, BANKS ARE MORE LIKELY TO MAKE MISTAKES EARLY IN THEIR EXPANSION INTO UNFAMILIAR TERRITORY.
- (3) NEW POWERS HAVE BEEN AFFORDED NEAR-BANK ENTITIES SUCH AS SAVINGS AND LOAN ASSOCIATIONS. THIS EXPOSES BANKS TO A NEW LEVEL OF RIVALRY IN MANY ASSET AND LIABILITY PRODUCT LINES.

THE TREND OF DEREGULATION IS LIKELY TO CONTINUE, PARTICULARLY THROUGH CONTINUED LIBERALIZATION OF INTERSTATE BANKING AND EXPANSION OF PRODUCT-LINE POWERS OF BANK HOLDING COMPANIES.

LET'S LOOK FIRST AT INTERSTATE BANKING. TO BE DIRECT, I AM IN FAVOR OF INTERSTATE BANKING. THE PRINCIPAL FINANCIAL MARKETS ARE NATIONAL. THEY ARE COMPETITIVE AND WILL REMAIN SO. ALTHOUGH

NATIONWIDE INTERSTATE BANKING WOULD RESULT IN INCREASED BANKING CONCENTRATION NATIONWIDE, SMALL BANKS WOULD STILL SURVIVE AND LOCAL MARKETS MIGHT EVEN BE SERVED BY MORE ATTRACTIVE BANKS BECAUSE OUT-OF-STATE BANKS WOULD BE ABLE TO ENTER LOCAL BANKING MARKETS. SIMPLY LOOK AT THE NUMBER OF SMALL BANKS IN CALIFORNIA, ARIZONA, AND OTHER STATES IN THE DISTRICT TO SEE HOW THESE INSTITUTIONS FLOURISH AND INCREASE IN NUMBER ALONGSIDE THE GIANTS.

WE ARE ON THE WAY TO NATIONAL BANKING IN ONE WAY OR ANOTHER. TODAY NON-BANK SUBSIDIARIES PROVIDE NATIONAL CHANNELS FOR INTERSTATE ACTIVITIES OF BANK HOLDING COMPANIES AND REGIONAL STATE COMPACTS FOR BANK HOLDING COMPANIES HAVE BEEN CLEARED BY THE SUPREME COURT. UNFORTUNATELY, THE PROCESS OF GEOGRAPHIC DEREGULATION IS STILL HIT OR MISS.

THE BEST SOLUTION IS TO CHANGE NATIONAL LEGISLATION RATHER THAN RESORT TO PIECEMEAL CHANGES IN STATE LAWS. THE DOUGLAS AMENDMENT, SECTION 3(D) OF THE BANK HOLDING COMPANY ACT, WHICH RESTRICTS INTERSTATE ACQUISITION, SHOULD BE REPEALED. IN THIS CONTEXT, A TRANSITION PERIOD THAT WOULD ALLOW REGIONAL ORGANIZATIONS TO PREPARE FOR NATIONWIDE INTERSTATE BANKING HAS SOME ATTRACTIONS ALTHOUGH IT IS NOT ESSENTIAL. A STRONG CASE ALSO CAN BE MADE FOR REPEAL OF THE MCFADDEN ACT TO ALLOW INTERSTATE BRANCHING, ALTHOUGH THIS ROUTE SEEMS UNLIKELY AT PRESENT.

IF INTERSTATE BARRIERS WERE LIFTED, NON-BANK BANKS -- A CONTRADICTION IN TERMS -- WOULD NOT BE NEEDED AS A VEHICLE BY WHICH BANK HOLDING COMPANIES ENTER OTHER STATES. A PROBLEM WOULD STILL REMAIN, HOWEVER, ABOUT THE OWNERSHIP OF NON-BANK BANKS BY UNREGULATED FINANCIAL CORPORATIONS. THIS QUESTION IS ONE FOR CONGRESS TO FACE NOW THAT THE SUPREME COURT HAS GIVEN THE GREEN LIGHT TO LIMITED SERVICE BANKS.

AS FOR SPECIFIC LINES OF BUSINESS PERMITTED BANK HOLDING COMPANIES, I AM ALSO IN FAVOR OF OPENING UP MORE ACTIVITIES AS LONG AS THEY REMAIN PRIMARILY FINANCIAL. BUT IN DOING SO, IT IS BETTER TO CHANGE THE RULES WITH FEDERAL LEGISLATION RATHER THAN TO USE LOOPHOLES CREATED BY PIECEMEAL STATE LAWS THAT CATER TO SPECIAL INTERESTS.

THE ISSUE OF PRODUCT LINES IN BANKING HAS SEVERAL DIMENSIONS:

- (1) REGARDING SECURITIES UNDERWRITING, BANKS OF COURSE ARE BOUND BY THE GLASS-STEAGALL ACT. WE CAN EXPECT THAT THE BASIC SEPARATION OF COMMERCIAL BANKING FROM INVESTMENT BANKING WILL REMAIN. RESTRAINTS ON PARTICIPATION IN UNDERWRITING OF CORPORATE STOCKS AND BONDS ARE NOT GOING TO BE RELAXED COMPLETELY, BUT WE COULD ALLOW MORE FLEXIBILITY. CERTAINLY, TRANSACTIONS INVOLVING SOPHISTICATED CORPORATE CUSTOMERS IN THE COMMERCIAL PAPER MARKET ARE CLOSELY RELATED TO BANKING

AND ARE AN AREA WHERE BANKING REGULATIONS COULD SAFELY BE RELAXED.

- (2) THE ABILITY OF BANKING INSTITUTIONS TO ENGAGE IN REAL-ESTATE-RELATED ACTIVITIES ALSO COULD BE EXPANDED. WITHIN BANK HOLDING COMPANIES, THERE ARE THE SKILLS NECESSARY TO BECOME INVOLVED TO SOME EXTENT IN REAL ESTATE OPERATIONS AND WE PROBABLY COULD ALLOW EXPANDED REAL ESTATE POWERS THROUGH NON-BANK SUBSIDIARIES.
- (3) IN ANOTHER AREA, WE HAVE THE ANOMALY THAT INSURANCE COMPANIES ARE ALLOWED TO OWN DEPOSITORY INSTITUTIONS, BUT BANKS ARE FORECLOSED IN MOST CASES FROM OFFERING GENERAL INSURANCE SERVICES. ALTHOUGH CREDIT-RELATED INSURANCE CAN BE OFFERED, ONLY SMALL BANKS AND A FEW GRANDFATHERED EXCEPTIONS ARE ALLOWED TO OFFER GENERAL INSURANCE LINES. THIS RESULTS IN SERIOUS ASYMMETRIES IN THE ABILITIES OF VARIOUS FINANCIAL INSTITUTIONS TO OFFER THIS IMPORTANT SERVICE.
- (4) BANK HOLDING COMPANIES ALSO CANNOT OFFER ADVISORY AND SECURITIES BROKERAGE SERVICES WITHIN THE SAME SUBSIDIARY. YET, BROKERAGE FIRMS ARE ABLE TO OFFER SHORT-TERM CHECKABLE SAVINGS ACCOUNTS MUCH LIKE THOSE AVAILABLE AT COMMERCIAL BANKS. THE OBVIOUS EXAMPLE IS MERRILL LYNCH'S CASH MANAGEMENT ACCOUNT, BUT THERE ARE MANY OTHERS. THE LOGIC OF

THIS ASYMMETRIC TREATMENT DESERVES REVIEW, AT THE VERY LEAST.

MY VIEW IS THAT THE TREND TOWARD LESSER REGULATION IS HEALTHY. WE SHOULD NOT TRY TO STOP IT, BUT RATHER WE SHOULD "MANAGE" IT BY RELAXING LEGISLATION AND REGULATIONS WITH CARE AND BY BACKING UP THE MORE LENIENT RULES WITH EQUITABLE OVERSIGHT AND SUPERVISION. TO TRY TO STOP INNOVATION ULTIMATELY WOULD CAUSE COMMERCIAL BANKING TO BE OUTFLANKED BY UNREGULATED FIRMS THAT WOULD TAKE OVER MORE AND MORE BANKING FUNCTIONS.

AT THE SAME TIME, I AM COGNIZANT OF THE LIMITATIONS OF BANKING SUPERVISION, PARTICULARLY IN INSTANCES WHERE STRICT SUPERVISORY ACTION MIGHT CONFLICT WITH OTHER ECONOMIC OR NATIONAL OBJECTIVES. INTERNATIONAL LENDING PROVIDES A CLASSIC EXAMPLE OF THIS DILEMMA. BANKS PURSUED FOREIGN LENDING BECAUSE AT THE TIME IT APPEARED BOTH PROFITABLE AND MANAGEABLE IN TERMS OF RISK. SUBSEQUENT SURPRISES -- HIGH REAL INTEREST RATES, A STRONG U.S. DOLLAR, DECLINING WORLD COMMODITY PRICES, AND FLUCTUATING OIL PRICES -- HAVE THREATENED THE FULL REPAYMENT OF A SUBSTANTIAL AMOUNT OF FOREIGN DEBT. BY DOMESTIC SUPERVISORY STANDARDS, A LARGE AMOUNT OF LOANS TO SOUTH AMERICAN AND AFRICAN NATIONS SHOULD BE CLASSIFIED, BUT TO DO SO WOULD HAVE IMPORTANT FOREIGN POLICY IMPLICATIONS. AT THIS POINT, IT ALSO WOULD HAVE IMPORTANT IMPLICATIONS FOR THE STABILITY OF OUR DOMESTIC FINANCIAL SYSTEMS, SINCE MANY OF THE LOANS ARE HELD BY OUR LARGEST AND MOST VISIBLE

BANKING INSTITUTIONS.

THE DEPOSIT INSURANCE SYSTEM PROVIDES ANOTHER EXAMPLE OF HOW A NATIONAL OBJECTIVE OF PROTECTING THE WEALTH OF DEPOSITORS AND PREVENTING BANK RUNS ACTUALLY ENHANCES RISK TAKING AND CREATES A SUPERVISORY DILEMMA. AS ECONOMISTS, WE SPEAK OF THIS AS THE "MORAL HAZARD" PROBLEM: AN INSURANCE SYSTEM WAS PUT INTO PLACE WITH THE PURPOSE OF REDUCING RISK. BUT BECAUSE OF THE INSURANCE SYSTEM DEPOSITS (OF UNDER \$100,000) TEND TO STAY WITH THE INSTITUTIONS REGARDLESS OF RISK. HENCE, THE INSTITUTION IS TEMPTED TO TAKE ON MORE RISK, REQUIRING INCREASED SCRUTINY OF BANK PORTFOLIOS BY EXAMINERS. I AM NOT IN FAVOR OF DOING AWAY WITH DEPOSIT INSURANCE, BUT I CERTAINLY RECOGNIZE THE DILEMMA IT RAISES FOR BANK SUPERVISION.

ALTHOUGH SUPERVISION CAN STEP IN AND BE HELPFUL IN PREVENTING EXCESSIVE RISK-TAKING, NONE OF US HAS A CRYSTAL BALL AND IT MAY BE AS DIFFICULT TO PREVENT PROBLEMS IN THE FUTURE AS IT HAS BEEN IN THE PAST. DESPITE THE DIFFICULTY OF THE TASK, WE MUST LEARN FROM OUR PAST MISTAKES AND PUT BETTER CONTROLS INTO PLACE SO THAT WE CAN AT LEAST CURTAIL THE GLARING INSTANCES OF EXCESSIVE RISK-TAKING, AND OF COURSE, FRAUDULENT RISK-TAKING. SUPERVISION IS NEEDED ALSO TO REMIND BANKERS OF THE PRINCIPAL OF DIVERSIFICATION.

LET ME NOT FAIL TO MENTION THE OTHER FUNCTIONS OF BANK SUPERVISION. THE FEDERAL RESERVE ENFORCES VARIOUS STATUTES, MOST

OF WHICH ARE DESIGNED TO STRENGTHEN THE BANKING SYSTEM OR TO ACHIEVE SPECIFIC ECONOMIC AND SOCIAL OBJECTIVES, SUCH AS CONSUMER AWARENESS AND PROTECTION OR COMMUNITY DEVELOPMENT LENDING. THESE OBJECTIVES ARE MORE NARROW IN THEIR FOCUS AND HENCE DO NOT RECEIVE THE SAME ATTENTION AS TO THE GRAND ISSUES LIKE DEREGULATION. BUT THEY ARE IMPORTANT RESPONSIBILITIES THAT ARE PART OF BANK SUPERVISION. THEY ARE AS MUCH A PART OF BANK SUPERVISION AS IS THE REVIEW OF A LOAN PORTFOLIO.

FINALLY, WE HAVE WHAT ACTUALLY IS A PRINCIPAL ROLE OF A CENTRAL BANK, THE LENDER OF LAST RESORT. THE CREDIT FUNCTION CONTRIBUTES DIRECTLY TO THE STABILITY OF THE BANKING SYSTEM AND THE ECONOMY BY STANDING READY TO PROVIDE LIQUIDITY TO THE ECONOMY IN TIMES OF CRISIS. BECAUSE OPEN-MARKET OPERATIONS HAVE REPLACED THE DISCOUNT WINDOW AS THE PRINCIPAL MEANS OF CONDUCTING MONETARY POLICY, HOWEVER, THE MAIN ROLE OF THE CREDIT FUNCTION ON A DAY-TO-DAY BASIS IS TO HELP INDIVIDUAL BANKS AND POTENTIALLY THE BANKING SYSTEM, THROUGH TEMPORARY DIFFICULTIES. OPEN-MARKET OPERATIONS ARE A BROAD-BASED TOOL, WHEREAS THE CREDIT FUNCTION IS MORE APPROPRIATELY DIRECTED TO THE PROBLEMS OF SPECIFIC BANKS. THE IMPORTANCE OF THE LENDING FUNCTION HAS BEEN EVIDENT IN RECENT YEARS WHEN ACTIONS HAD TO BE TAKEN TO HELP LARGE AND SMALL BANKS THROUGH CRISES THAT COULD HAVE PRODUCED UNDESIRABLE SHOCKS TO THE BANKING SYSTEM.

THE NEW RESPONSIBILITY OF THE CREDIT UNIT FOR MONITORING

PAYMENTS RISK -- THE "DAYLIGHT OVERDRAFT PROBLEM" -- ALSO HAS ITS SUPERVISORY ASPECT. THE NEW PROGRAM CURRENTLY BEING IMPLEMENTED FORCES BANKS TO REVIEW THEIR ACCOUNTING PROCEDURES AND CONTROLS FOR LARGE INTRA-DAY DOLLAR TRANSFERS AND TO PUT NEW PROCEDURES INTO PLACE IF THEY INTEND TO RUN OVERDRAFTS. RISK EXPOSURE HERE, EVEN IF ONLY POTENTIAL, HAS CAUSED UNPLEASANT SURPRISES TO BANKERS IN THE PAST AND CONTINUES TO CREATE THE POTENTIAL FOR MAJOR DISRUPTION AND LOSSES IF NOT WATCHED.

TO SUM UP, I THINK DEREGULATION IS NOT A PROCESS THAT CAN OR SHOULD BE CURTAILED. U.S. MARKETS ARE ALWAYS CHANGING IN THE FACE OF NEW TECHNOLOGIES AND NEW PRODUCTS. THE FINANCIAL RULES OF THE GAME ALSO MUST ADJUST, AND IN GENERAL FEWER RULES ARE BETTER THAN MORE RULES, PARTICULARLY IN LIGHT OF THE RAPIDLY CHANGING ENVIRONMENT. AT THE SAME TIME, THE FACT THAT I FAVOR DEREGULATION DOES NOT MEAN THAT I AM NECESSARILY ADVOCATING A RELAXATION OF BANK SUPERVISION. STATUTES AND REGULATIONS ASIDE, SUPERVISION WILL ALWAYS PLAY A ROLE IN BRINGING FRAUD TO LIGHT, IN FERRETING OUT POOR MANAGEMENT, AND IN HELPING TO PREVENT EXCESSIVE RISK-TAKING BY INDIVIDUAL INSTITUTIONS. BANK SUPERVISION SHOULD BE DIRECTED AT MAKING THE BANKING SYSTEM WORK BETTER, AND THE FEDERAL RESERVE'S MORE INTENSIVE PROGRAM OF SUPERVISION SHOULD HELP ACHIEVE THE OBJECTIVES OF DEREGULATION.

SUPERVISION PLAYS AN IMPORTANT ROLE IN PUBLIC POLICY AND I HOPE THAT ALL OF YOU, PARTICULARLY THE NEW STAFF, KEEP IN MIND

THAT OUR OBJECTIVE IS TO ENCOURAGE SOUND BANKING PRACTICES. YOU HAVE AN INTERESTING AND RESPONSIBLE JOB, AND I AM SURE THAT YOU WILL CONTINUE TO ENHANCE THE FEDERAL RESERVE'S IMPRESSIVE REPUTATION FOR PROFESSIONALISM.

THANK YOU. I WOULD LIKE TO TAKE THIS OPPORTUNITY TO ADDRESS ANY QUESTIONS YOU MIGHT HAVE.