Maintaining the Soundness of Our Banking System

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This year, for the first time in decades, questions have been raised about the strength of our nation's, and indeed the world's, banking system. It is profoundly disturbing to me, as indeed it must be to all of you, that such questions should be raised.

Over the past century or longer, the American people have repeatedly demonstrated their determination to have a sound system of banking, and they have been willing to take whatever steps are necessary to assure it. The central role now played by American banks in international trade and finance imparts a new and global dimension to the need for confidence in our banking system. This international responsibility is made all the more compelling by the sudden and massive flows of funds to and from the oil-exporting countries. It is clearly of vital importance for the United States and the rest of the world that our commercial banks continue to measure up to the heavy obligation of financial stewardship now placed upon them.

In the past year, we have had the two largest bank failures in the nation's history. This fact has been widely noticed, as it deserves to be. But it is equally important to recognize that these failures did not cause any loss to depositors. Nor did they have serious repercussions on other banks or businesses. The ability of our financial system to absorb such shocks reflects credit on the safeguards that the Congress has developed in response to past experience.

One crucial element of our banking strength is Federal insurance of deposits. Another major source of banking strength is the Federal Reserve System's ability and willingness to come promptly to the assistance of banks facing a temporary liquidity squeeze. The financial world understands that our banking system can be and will be supplied with funds in whatever amount is necessary to forestall a credit crunch.

Nonetheless, it is important to ask why, for the first time since the Great Depression, the availability of liquidity from the central bank has become such an essential ingredient in maintaining confidence in the commercial banking system. The economy is operating at a reduced, but still very high, level. Bank profits are generally satisfactory. There is no danger of withdrawal of deposits for purposes of hoarding. Very few of our banks should need to count on Federal support in circumstances such as these. It is in order, therefore, to take a close look at recent trends in banking.

Commercial banking has been undergoing a profound evolution for well over a decade. The focus of bank management still embraces the traditional fiduciary responsibilities, but goals of profitability and growth have been receiving more and more attention. The recruitment and promotion policies of many banks nowadays emphasize entrepreneurial talent. Their internal controls are elaborately designed to weed out inefficient operations, and to stress the profits being generated by individual departments. Innovation has become one of the prime attributes of the pace-setting banks, and competition has sharpened appreciably in the process.

In seeking growth and profitability in an increasingly competitive environment, banks have generally succeeded in meeting the needs of their business customers more effectively. Deposit instruments have been tailored to meet the special needs of customers. New types of lending arrangements to serve business and institutional borrowers have proliferated. The capability of banks to assist their customers in financial management has also come to include "off balance-sheet" activities, such as bookkeeping, data processing, and financial advisory services. And as regional banks have entered national markets for loans and deposits, while local banks kept entering regional markets, the banking alternatives available to business firms have multiplied and the nation's money and credit markets have become more closely integrated.

For many years now, banks have been cultivating aggressively the area of consumer finance. Besides competing intensively for consumer deposits, they have been promoting instalment credit and increasing home mortgage lending. Where possible, banks have expanded their branch networks to facilitate the quest for consumer business, and the result has been a dramatic increase in the number of banking offices relative to the nation's population.

The larger banking organizations have also been driving hard to acquire foreign business—by soliciting deposits, making loans, and conducting other financial activities through their foreign branches or subsidiaries. Foreign exchange operations have assumed a larger dimension in the workaday world of banking, and this activity accelerated once exchange rates were allowed to float and forward markets became essential for the conduct of international business.

The quest for profits and growth has led, moreover, to substantial changes in the structure of the banking system. Bank mergers and acquisitions of individual banks by multibank holding companies have resulted in consolidation of small units into larger organizations, which have often added financial strength to individual banks and enabled them to provide a broader range of services.

Nor is that all. One of the most notable manifestations of the drive for profits and growth has been the development of diversified bank holding companies. These organizations now extend substantial amounts of credit through subsidiaries engaged in mortgage banking, factoring, consumer finance, leasing, and other specialized activities. Many smaller firms in these lines of activity have been rejuvenated through acquisition by bank holding companies. *De novo* entry into these lines of activity has also been widespread, thereby leading to more vigorous competition. And since the nonbank subsidiaries of bank holding companies enjoy the privilege of multistate operation, the growth of their activities has played an important role in the process of knitting together the nation's credit markets.

Clearly, the far-flung changes I have been describing have served the public in many ways. There is, however, another side of the ledger. The very forces that have produced innovative, highly competitive banking have also led to some trends that go far to explain the uneasiness that so concerns us in 1974. The most significant of these trends are, first, the attenuation of the banking system's base of equity capital; second, greater reliance on funds of a potentially volatile character; third, heavy loan commitments in relation to resources; fourth, some deterioration in the quality of assets; and, fifth, increased exposure of the larger banks to risks entailed in foreign exchange transactions and other foreign operations. These developments have increased the vulnerability of individual banks.

The first of these trends—the attenuation of the equity capital base—is directly traceable to the recent rapid expansion of the banking system. In the years immediately following World War II, commercial banks were able to accommodate increases in loan demand mainly by reducing the portfolios of government securities accumulated during the war. Commercial bank deposits therefore failed to keep pace with the growth of the national economy. But by the early 1960's, as loan-deposit ratios kept rising and competition became keener, a faster rate of growth became necessary to enable banks to expand further their lending activities. Thus, during the decade ended in 1970, total assets of commercial banks increased at an average annual rate of 9 percent, in contrast to a 7 percent rate of growth in the dollar value of our gross national product (GNP).

Then, during 1971-73, banking assets grew more than 15 percent per year. To some extent this faster growth was linked to the pace of inflation. But banking assets increased more than three times as fast as the price level, and about half again as fast as nominal GNP, which itself reflects the impact of inflation. To a large extent, therefore, the phenomenal pace of recent bank expansion reflects neither price level changes nor real economic growth, but an expansion of banking's share of total financing business, both at home and abroad.

Banks provided over half of total new financing during 1971-73 in several key domestic areas, including the markets for consumer instalment debt, corporate debt other than mortgages, and debt of state and local governments. Expansion in foreign markets has been even more dramatic. During these three years the assets of foreign branches and subsidiaries of American banks nearly tripled, reaching $117 billion. In fact, expansion abroad accounted for more than one fifth of the growth in total assets of the United States commercial banking system during this period.

The diversified bank holding company has also become an important instrument of growth for a relatively small number of banking organizations. Major banks or bank holding companies now account for over half of the factoring business, a major portion of mortgage banking, and a significant part of consumer finance and leasing.

And so I now come to my point, namely, that this enormous upsurge in banking assets has far outstripped the growth of bank capital. At the end of 1960, equity capital plus loan loss and valuation reserves amounted to almost 9 percent of total bank assets. By the end of 1973, this equity capital ratio had fallen to about 6½ percent. Furthermore, the equity capital of banks has been leveraged in some cases at the holding company level, as parent holding companies have increased their equity investments in subsidiary banks by using funds raised in the debt markets. Thus, the capital cushion that plays such a large role in maintaining confidence in banks has become thinner, particularly in some of our largest banking organizations.

It has been no simple feat for banks to grow so rapidly. A key tool of management in the drive for expansion has been a shift in emphasis from managing assets to managing liabilities. This is the second of the recent trends that I mentioned earlier.

Liability management requires tapping of external sources for liquidity—that is, borrowing funds as needed to meet the demand for loans from present customers, to accommodate new borrowers, or to adjust to reserve drains. Asset management, by way of contrast, involves adjusting liquid assets in response to changes in the volume of deposits or loan demand.

The development of liability management has led the larger banks to operate on the premise that, within wide limits, additional funds can be acquired at any time as long as the market rate of interest is met. The presumed ability to acquire whatever funds might be needed has encouraged banks to seek new channels for profitable investment; it has also reduced incentives to maintain the liquidity of their assets. Recent experience has demonstrated, however, what banking prudence itself should have dictated; namely, that the funds on which liability management depends can be quite volatile, especially if the maturities are short, and that banks may therefore have to wrestle with uncomfortable—even though they be temporary—liquidity problems.

The shift to liability management has occurred on a vast scale. During the 1950's, commercial banks obtained the major portion of their new funds from increases in demand deposits or equity capital. In more recent years, on the other hand, about two thirds of the new money raised by domestic offices of our banks has come from interest-bearing time accounts or nondeposit liabilities. Once the concept of liability management took hold, banks developed great ingenuity in tapping the markets for interest-sensitive funds.

Although the beginnings of modern liability management can be traced to the rejuvenation of the Federal funds market in the 1950's, the major breakthrough came with the introduction of large negotiable certificates of deposit (CDs) in early 1961. Private holdings of negotiable CDs now exceed those of any other money market instrument, including Treasury bills. Large, but nonnegotiable, time deposits have also figured significantly in liability management. Commercial paper has become another vehicle of liability management; some bank holding companies rely on it heavily to finance their nonbank subsidiaries. Still another method by which banks have attracted interest-sensitive funds is by borrowing Euro-dollars from their foreign branches for use in domestic banking.

Taken together, these several types of interest-sensitive funds have assumed huge proportions. Not only have they become the principal means of financing expansion at many of our larger banking organizations, but the apparent efficiency of liability management has tempted banks to make advance commitments of funds on a generous scale. This is the third of the recent trends in banking that I previously mentioned.

Beyond question, loan commitments have a legitimate place in the array of services offered by banks. But they should be made with caution, since they constitute a call on bank resources that can be exercised at an awkward time. This fact has been driven home in recent months as banks were being called upon with increasing frequency to meet their commitments. Excessive commitments have raised problems for some thoroughly sound banks, and they also have complicated the Federal Reserve's efforts to bring aggregate demand for goods and services under control.

A fourth disturbing trend has been a deterioration, albeit moderate as a rule, in the quality of bank assets. During recent years, as the role of credit in financing private spending increased and as interest rates rose, the debt service requirements of business borrowers have generally grown more rapidly than their incomes, and the additional debt has resulted in a rise of debt-equity ratios. These changes accompanied the efforts of commercial banks to assume a higher proportion of the lending done in the country. It should not be surprising, therefore, to find some tendency toward deterioration in the quality of bank assets.

Finally, both in this country and abroad, the freeing-up of exchange rates has made dealings in foreign currencies both tempting and risky. Not a few conservative bankers who previously had a strong preference for stable exchange rates suddenly discovered that floating exchange rates offered a new opportunity for profit, and some went at it with more enthusiasm than awareness of the risks involved. The large losses that a number of banks in Europe and the United States have experienced as a result of excessive trading or unauthorized speculation in foreign currencies have not only caused embarrassment to these banks; they also have tarnished the reputation of the banking profession.

The confluence of the closely related trends I have just discussed—declining capital ratios, aggressive liability management, generous commitment policies, deterioration of asset quality, and excessive foreign exchange operations by some banks—explains much of the recent uneasiness about banking. Clear understanding of the current situation requires recognition of the interrelated effects of these banking practices on the state of confidence. An increase in doubtful loans is of consequence because it raises questions about bank solvency. Maintenance of solvency is closely linked, of course, to the adequacy of capital and reserves for losses. Similarly, heavy reliance on potentially volatile funds is not dangerous *per se;* it is dangerous only in proportion to doubts about ability to repay the borrowed money. Such doubts can undercut the basic premise of liability management—that needed funds can be raised as required from short-term sources. Extensive loan commitments are dangerous only when too many takedowns occur at the wrong time. And losses on foreign currency transactions have serious implications for the public only to the extent that they bulk large relative to the basic strength of the banks that experience them.

The developments I have sketched are in large part an outgrowth of the overheating experienced by our economy since the midsixties. This was also a period in which corporate profits failed to keep pace with expanding business activities. During the past year, in particular, the demand for business loans grew with extraordinary rapidity, as more and more corporations found it necessary to borrow heavily and to do so increasingly through the banking system. To a significant degree, many banks—especially the larger banks—have met the recent credit needs of hard-pressed sectors of the business community with a fine sense of public responsibility. But that is by no means the full story. Some carelessness also crept into our banking system, as usually happens in a time of rapid inflation, and that is why I have commented at such length on several disturbing trends in modern banking.

Even so, only a very small number of banks can be justly described as being in trouble. Despite all the strains recently experienced in credit markets, the banking system remains strong and sound. There is no reason to doubt the ability of our banks to meet their commitments, even in these trying times. But, while faith in our banks is fully justified, it now rests unduly on the fact that troubled banks can turn to a governmental lender of last resort.

It goes without saying that the discount facility is available for use and that it should be used when necessary, but the banking system's strength should not depend heavily on it. In our free enterprise system, the basic strength of the banking system should rest on the resources of individual banks. I believe that bankers generally support this principle, and that their policies are already reflecting renewed respect for it.

It is not sufficient, however, to rely on a rethinking by bankers of their goals and responsibilities. This country, like others, depends on public regulation as well as private vigilance to assure the soundness of its banking system. While the profound changes that I have described were taking place, our bank regulatory system failed to keep pace with the need. To be sure, there has been a great deal of activity among the regulators. Examinations of America's 14,000 banks have continued to be made methodically by the Federal supervisory agencies and the state banking authorities. And hundreds of regulatory decisions concerning bank mergers, holding company acquisitions, and the like, have been handed down each year by hard-working regulators under Federal and state statutes.

But the public attention devoted to adequacy of the safeguards provided by the regulatory system has waned appreciably since World War II. The traditionally interested parties—legislators, bankers, financial analysts, economists, and the bank regulators themselves—tacitly assumed that the sweeping financial reforms of the 1930's had laid the problem of soundness and stability to rest, once and for all. They have therefore concentrated on other matters, such as improving bank competition and adapting the banking system to changing needs for credit.

The stresses and doubts that have characterized recent financial experience are, however, bringing sharply back into focus the essential role of regulation and supervision in maintaining a sound system of banking. The regulatory agencies are responding to this need. At the Federal Reserve Board, concern about the adequacy of bank capital has been increasing. Recent decisions have also reflected a determination to slow down the expansion of bank holding companies. As one recent ruling stated, "the Board believes that these are times when it would be desirable for bank holding companies generally to slow their present rate of expansion and to direct their energies principally toward strong and efficient operations within their existing modes, rather than toward expansion into new activities". The purpose of this pause is not only to encourage—and where necessary enforce—a husbanding of resources, but also to provide a breathing spell during which both the Board and the banking industry can give the most serious thought to ways in which commercial banks and bank holding companies should develop in the future.

In this connection, it is well to note the favorable action by the Congress on the legislation requested by the Federal Reserve for authority to prevent, through cease and desist orders, unsound practices by bank holding companies and their nonbank subsidiaries. I am glad to say that the banking industry supported this needed legislation.

A number of specific projects designed to strengthen the regulatory system are under way at the Board, including establishment of a new program of reporting and financial analysis for bank holding companies, a critical appraisal of the current approach to bank examination, and concerted efforts to deal with problems relating to bank capital, bank liquidity, and foreign exchange operations. Similar projects, I understand, are under way at the other Federal bank supervisory agencies.

I must say to you, however, that I am inclined to think that the most serious obstacle to improving the regulation and supervision of banking is the structure of the regulatory apparatus. That structure is exceedingly complex. The widely used term "dual banking system" is misleading.

As you know, each of the fifty states has at least one agency with responsibilities for supervising and regulating banks. Some states also have statutes relating to bank holding companies. At the Federal level, every bank whose deposits are insured is subject to supervision and regulation, but authority is fragmented. The Comptroller of the Currency charters and supervises national banks. The Federal Reserve System supervises state-chartered member banks, regulates activities of Edge Act corporations, regulates all bank holding companies, and controls the reserves and other operating features of all its member banks. The Federal Deposit Insurance Corporation (FDIC) insures nearly all banks, but supervises only state-chartered banks that are not members of the Federal Reserve. The FDIC also has certain regulatory powers that apply to insured nonmember banks.

Those of you who have been intimately concerned with regulatory matters will realize that I have oversimplified, that our system of parallel and sometimes overlapping regulatory powers is indeed a jurisdictional tangle that boggles the mind.

There is, however, a still more serious problem. The present regulatory system fosters what has sometimes been called "competition in laxity". Even viewed in the most favorable light, the present system is conducive to subtle competition among regulatory authorities, sometimes to relax constraints, sometimes to delay corrective measures. I need not explain to bankers the well-understood fact that regulatory agencies are sometimes played off against one another. Practically speaking, this sort of competition may have served a useful purpose for a time in loosening overly cautious banking restrictions imposed in the wake of the Great Depression. But, at this point, the danger of continuing as we have in the past should be apparent to all objective observers.

I recognize that there is apprehension among bankers and students of regulation concerning overcentralized authority. Providing for some system of checks and balances is the traditional way of guarding against arbitrary or capricious exercise of authority. But this principle need not mean that banks should continue to be free to choose their regulators. And it certainly does not mean that we should fail to face up to the difficulties created by the diffusion of authority and accountability that characterizes the present regulatory system. On the contrary, it is incumbent on each of us to address these problems with the utmost care. For its part, the Federal Reserve is now pushing forward with its inquiries.

The range of possible solutions is broad. Some will doubtless conclude that the proper approach lies in improved coordination among the multiple bank regulatory agencies, together with harmonization of divergent banking laws. My own present thinking, however, is that building upon the existing machinery may not be sufficient, and that a substantial reorganization will be required to overcome the problems inherent in the existing structural arrangement. I have no illusion that reaching agreement on these matters will be easy. But I have found much wisdom and a strong sense of responsibility among this nation's bankers. I therefore earnestly solicit your views. They will receive full attention as the Board searches for the best path to progressive but still prudent bank regulation.