

# BUSINESS REVIEW

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COMMENTARY

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## Bank Supervisory Trends in the '80s\*

By Edward G. Boehne, Senior Vice President  
Federal Reserve Bank of Philadelphia

Banking is in the midst of dramatic change as it tries to adjust to a fast-paced environment. Inflation is the root cause of much of this change, but also contributing are technological advances, social pressures, and a marketplace that is much more competitive than it used to be. Bankers and bank supervisors have to be sensitive to this rapidly changing environment if the public interest

is to be served. I would like to peer into the future to speculate about some of the supervisory and regulatory trends that might unfold in the 1980s.

One trend bankers would like to see unfold is deregulation. There is almost universal grumbling among bankers about the regulatory burdens placed on them during the last decade. A recent issue of the *Journal of Commercial Lending* was even poetic:

Wouldn't it be great  
To just deregulate  
To smash the fools  
Who write the rules  
And then go celebrate.

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\* An address delivered before the Robert Morris Associates, Philadelphia, Pennsylvania, February 7, 1980. The views expressed are my own and not necessarily those of my colleagues elsewhere in the Federal Reserve System.

I wish it were that simple just to "deregulate . . . and then go celebrate." But the cross currents in our economy and society make the regulation issue much more complicated. What I see happening in the '80s is less regulation on the liability side of a bank's balance sheet, particularly in the area of interest rate ceilings on deposits, but more supervision on the asset side.

#### LESS REGULATION ON THE LIABILITY SIDE

On the liability side, banks are under pressure both from their competitors and their depositors. Banks face grossly unfair competition from nonregulated intermediaries like money market mutual funds. At the same time, there is rising consumer clamor for a fair rate of return on savings deposits. From the point of view of regulators, there are two basic ways to relieve these pressures. The first is to put the same interest rate ceilings on nonregulated competitors as on banks. The second approach is to remove ceilings across the board and let the market determine what various financial intermediaries pay for funds.

The outcome, I believe, will be the demise of Regulation Q—the regulation that governs the ceiling rates on deposits. Already, Regulation Q has had a number of holes shot through it—for example, 6-month money market certificates, 2 1/2-year certificates, loop-hole certificates, and repurchase agreements. I realize that to predict the demise of any regulation goes against the historical tendency to increase rather than decrease regulation. The difference now, however, is that inflation has whetted the appetite of consumers for market rates of return on their deposits, and consumers have a great deal of political clout. In addition, realities of the marketplace make Regulation Q increasingly difficult to enforce. Financial entrepreneurs think up ways around Regulation Q almost as fast as regulators can find new ways to apply it. The question, therefore, is not so

much whether Regulation Q will continue to lose its effectiveness, but what course will deregulation take. The most likely end to Regulation Q is a phase-out period lasting several years. However phased out, the upshot is that in the '80s bankers can expect less regulation on the liability side of the balance sheet in the area of interest rate ceilings on deposits.

There are of course other regulatory issues related to the liability side of a bank's balance sheet—reserve requirements and disclosure issues such as Truth In Savings, where more regulation might be in store in the '80s rather than less. But they are topics for another speech, and I want to move on to the asset side which is your primary concern as lending officers.

#### MORE SUPERVISION ON THE ASSET SIDE

My prediction that you can expect more supervision on the asset side is based first on my reading of how social pressures on banking will develop in the 1980s. Ironically, the demise of interest rate ceilings could play a role in increasing supervision in the loan area. Regulation Q basically is a subsidy for housing—a protective device for thrifts so they can fund mortgages. Thrifts get a competitive break in attracting deposits by being able to offer higher rates than banks, but they are constrained on the asset side largely to making mortgage loans. The end of Regulation Q will not mean less social concern about housing; what it will mean is that some different way of giving housing a boost likely will be found. I see more pressure applied directly to the asset side of a bank's balance sheet to make mortgage loans.

Taking this idea a step further, government in the 1980s will be less able than in the past to finance social causes, such as community redevelopment and poverty programs, through the budget. At the Federal level, defense spending will take a larger share of an already tight budget. State and local

governments also will be under the gun budgetwise as they struggle to make ends meet in an inflationary environment. During these tight budget years, there will be an almost irresistible temptation on the part of elected officials to substitute private for public funds in order to help finance social investment. The Community Reinvestment Act, although perhaps not originally designed for that purpose, is an example of such an attempt.

Bankers would be wise to view this social and legislative prodding to meet community needs in the broad context of what the alternative is. The alternative, as distasteful as the thought might be, could be some form of credit controls to allocate funds to "socially desirable areas." Regulation for social purposes is a much broader issue than bankers sometimes realize when they complain about regulatory burdens. You may be better off than you think. And I urge you to have a longer run appreciation for the social pressures at work when confronting regulatory burdens on a day-to-day basis. Such an appreciation may be the most promising way to avoid direct controls.

There are also some traditional "safety and soundness" reasons to expect more supervision on the asset side of your business. Bank capital is a cushion between the asset and liability sides of your balance sheet—a cushion against mistakes and bad luck, a cushion against bad loans, a cushion against investments that go under water in an environment of high interest rates. As that capital cushion becomes thinner, bank supervisors become increasingly concerned. Although supervisors will continue to put pressure on bankers to improve capital in the coming years, the realistic outlook is for only limited success given the prognosis for bank earnings and the equity market. Therefore, to compensate for a thinner capital base, supervisors will want to scrutinize loan and investment risks even more closely to be sure that loan losses are held to a minimum and

that reasonable prudence is used in the securities portfolio, in terms of both quality and maturity distribution.

Banks will also face higher funding costs in the '80s, both because of the erosion of Regulation Q and the high costs associated with raising funds in an inflationary environment. A few banks will be tempted to "reach" for higher yielding loans and investments as a way to prop up earnings in the face of higher funding costs. Bank supervisors will have to be alert to this type of reaching in order to avoid unwarranted risk. Bankers as well as supervisors will have to be especially sensitive to the greater risk potential in the area of foreign lending. Bankers and supervisors have made major strides in monitoring country and currency risk exposure, but even with these advances foreign lending still poses major risks in the 1980s.

While closer scrutiny of assets can partially compensate for thinner capital and a tendency in some banks toward reaching for higher yielding assets, closer scrutiny of how well a bank is managed can also help compensate for greater risk. Supervisors will be looking even more closely in the coming years at the quality of bank management and the role of directors in running banks. The question supervisors will be asking: Are directors and management running the bank in a reasonable manner given the situation a bank finds itself in? If the answer to that question is yes, then supervisors will feel more comfortable about the safety and soundness of a bank. If the answer is no, then you can expect considerable prodding from supervisors to improve the quality of management and director involvement.

#### IMPLEMENTING SUPERVISION IN THE '80s

So, particularly for you as lending officers, a realistic outlook for the 1980s is that supervisors will be watching over your shoulders even more closely than in recent years both for social reasons and for traditional reasons

of safety and soundness. Now let me give you some thoughts about how supervision and regulation of banks will be implemented in the coming decade. I see three developments.

The first is that you can expect closer coordination among the five regulators of financial institutions. The framework for this closer coordination is the recently established Federal Financial Institutions Examination Council. This Council, which includes the Federal Reserve, Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, and National Credit Union Administration, is charged with developing uniform examination policies, uniform examination reports, and uniform training of personnel. You can increasingly expect that whether you are state or Federally chartered bank or thrift institution, you will be treated essentially the same way.

The recently established Shared National Credit system (SNC) is an example of this coordination effort. Under SNC, all loans over \$20 million where more than one bank is involved are classified the same for all financial institutions. So, if a loan from XYZ Corporation in your portfolio is rated "doubtful," then it will be rated doubtful in the loan portfolios of other financial institutions as well. Coordination of this type not only is efficient from the supervisor's point of view, but it also means fairer supervision from the banker's point of view.

A second development is that bank supervisors will be making increased use of computerized monitoring techniques to augment on-site inspections. Supervisors now have monitoring programs that focus on "key" ratios of bank performance, such as earnings,

equity, and capital. Computerized surveillance allows us to collect information about the condition of a bank on an ongoing basis. That makes supervision more timely and makes it possible to target examinations to problem areas. We can pinpoint more what we are looking for and put less burden on you in areas that don't require as much supervisory attention.

Third, you can expect increased reliance on internal bank systems by supervisors. For example, if a bank has in place an effective loan review system, then supervisors can reduce detailed examinations of individual loans. Likewise, if the audit function is performing effectively, supervisors can rely more on internal checks to turn up problems. In simplest terms this means that if you maintain effective quality control, supervisors will spend less time in your bank.

I view closer coordination among regulators, more reliance on surveillance, and increased reliance on internal quality control systems as ways to help us do our job as bank supervisors better and at the same time as a way of minimizing the supervisory burden on you.

The final thought I want to leave with you is that in the '80s more than ever before supervisors will need field examiners who see the forest rather than just the trees. Bankers and examiners will frequently have constructive differences, and that is as it should be. But nitpicking over details that really don't matter is inappropriate. We need constructive dialogue between reasonable, experienced bankers and reasonable, experienced supervisors. I look forward to dealing with you on that basis because I think it is the most positive way to manage bank supervision in the decade ahead.