Remarks by John P. LaWare

to the

Arizona Bankers Association

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Good morning ladies and gentlemen. It is a special pleasure for Margery and me to be here. Our old friend Howard McCrady and your association invited us and the Biltmore welcomed us back and is taking good care of us. The golf course has been none too kind, but I guess we can't blame you or the management for that. Thank you for letting us share your meeting and your good times.

My mission today is not to discuss monetary policy or the economy, and I am glad of that because that crystal ball is a bit murky at least to this banker member of the Federal Reserve Board.

What I want to do is gaze with you into another crystal ball, the one that looks into the future of the banking system in the United States. Let's look together at the long-term issues with which bankers will be dealing and the implications of those issues for the future of your industry.

One of the hardest parts of the transition from the private sector to the public sector, at least for me, has been the change from banker to regulator. No one chaffed more uneasily under the yoke of regulation than I. And, if you won't tell Alan Greenspan, I will confess that in a speech at an ABA conference at the Greenbrier several years ago I referred irreverently to "the dead hand of the Fed." Fortunately, no one found that out before I was confirmed by the Senate and sworn in. I don't think it's an impeachable crime, so I guess I am safe.

But, I would argue that this is a different Fed -- not at all constrained by historical policies, but rather committed to the proposition that U.S. banks should be fully competitive, both domestically and internationally. Strong support for interstate banking; for the legislative initiative of Senator Proxmire in 1988 on Glass-Steagall reform; and the watershed so-called Section 20 decisions which allowed bank holding companies to set up affiliates to underwrite and deal in certain classes of securities, are all clear evidence of this more recent and more constructive stance.

Indeed, we may seem too timid <u>yet</u> to some of you, but I would remind you that by statute we are compelled to make safety and soundness a high priority. That priority dictates a measured pace of reform, with time to learn from experience, rather than a headlong rush fraught with all of the inherent dangers of excessive speed. I assure you that our goal, subject to the will of Congress, is to move to broader powers to match the competitive requirements of today and tomorrow.

Now if you can accept the fact that this evolution is probable, let's look at some of the problems we both will face:

Capital will be a central issue for the foreseeable future. The thrift mess, the Texas snafu, and the LDC debt debacle all teach the same lesson. More capital, more capital! More capital would not have prevented any of those tragedies, but more capital would have made each more manageable and would have significantly reduced the casualty lists and ultimately the cost to the taxpayer.

As we move to reconstitute or assimilate the troubled institutions in the thrift industry, and rehabilitate the great Texas banking companies, and as banks absorb additional provisions to bring third world debt reserves to more realistic levels, the demands of banking on the capital markets will be huge. At the same time we are moving toward risk-based capital standards and some banks will need more than just retained earnings to get them there.

Will the markets be able to respond to that demand? Well, there is no question the capacity exists, but is there a will to do so? Securities markets tend to measure their appetites in terms of rates of return on investment. Will banks or holding companies with .80 returns on assets and 12 percent returns on equity be able to compete for capital at an acceptable cost? Perhaps. But I suspect the prize will go to the swift and lean, those with a better than one percent return on assets and 15 percent or more on equity. On paper the differences between .8 and 1.0 and 12 and 15 percent look small, but when you are a manager trying to close that gap it looks as wide as the Grand Canyon. I foresee a scramble for capital in the next few years which will force banks to rethink their strategies to see if they fit the changed world in which we find ourselves. New strategies to improve earning power and improve risk management will be searched for. Restructuring, downsizing, market targeting, narrower specialization and stringent cost controls will be common themes -- all in the name of capital. And as we expand bank powers, we inevitably add new elements of risk -- risk which must be matched against adequate levels of capital.

All Winston Churchill could promise Britain in 1940 was blood, sweat, and tears. All I can promise you in 1989 is the need for capital, capital and capital.

Another issue, much in the news these days, is LBO and takeover financing accomplished with heavy ratios of debt.

One emerging philosophy seems to be that investors using their own money are welcome to the junk bond market, and if they call it wrong they are simply wasting their own assets. But, there is growing concern whether it is appropriate for banks, using insurance-protected depositors' funds, to participate in these highly leveraged financings. In Congress the usual reaction to a perceived problem of this sort would be to regulate it or outlaw it. In my opinion, either course in this case would be a mistake since the real outcome would be to allocate credit, and credit allocation flies in the face of all that is holy in a free market economy.

But, I do think there is a new element of risk in this kind of lending. The risk is in failing to make a proper appraisal of whether the cash flow coverage of debt service requirements is sufficient to absorb changes in interest rates, revenue flows or asset values which are part of the forecast on which the loan is based. A stunning example is Campeau, where cash flows apparently failed to materialize as projected and a seemingly perfect deal quavered on the brink of disaster with unsettling effects on financial markets. For banks the seductive elements in these highly leveraged situations are large fees, new lending opportunities and just the sheer excitement of being part of big deals.

I urge bankers to be more skeptical and to impose higher credit standards in these transactions lest Congress be goaded into action you will all regret. Make sure credit policies and procedures are sound, determine a prudent level of exposure to highly leveraged financing in your overall portfolio and stick to it. And make sure your directors know what policies you are following and what limits you have imposed and that they approve. In short, if highly leveraged financings are administered prudently, you are not likely to encounter objections or interference from Congress.

All of this apparently defensive advice is to help preserve the creative initiative to produce new services and new ways to lend. Creativity is an important part of competitiveness and competitiveness is the key to banking's future success.

While the other issues I want to touch on this morning are structural, the basic question remains: Are American banks competitive domestically and internationally with other financial institutions offering similar services? If not, are there changes in the structure of banking institutions which would contribute to greater competitiveness without compromising safety and soundness?

These are not puny issues which should be abandoned to casual solutions. When you stop to think about it, many of them threaten long-held principles and sacred practice. All of the answers are not clear, but here are some of the issues which you who operate banks, we who regulate and supervise banks in the name of Congress, and legislators themselves will be wrestling with in the immediate future.

The United States has long held that commerce and banking should be separate; that commercial enterprises should not own and operate banks and banks should not substantially own or manage commercial entities.

This issue will inevitably emerge as part of the debate over further expansion of bank powers. The recent experience with the thrifts and the appropriate sensitivity to the exposure of the taxpayers will dictate that, to the extent additional powers mean additional risk, the exercise of those powers must be outside of the comfort of the federal safety net. In that case Congress is likely to turn to the financial services holding company structural concept. In such a holding company, additional powers would be granted to separate subsidiaries and the insured deposit-taking subsidiary could be insulated from the risks of its affiliates by appropriate prohibitions or limitations on inter-company financing or transfers of capital. Functional regulation of nonbanking activities would assure expert oversight for each activity and the integrated marketing of related financial services provided by multiple entities would significantly enhance competitiveness.

An inevitable question arising from consideration of such a structure is the ownership of the holding company itself. Could an insurance company own such a holding company? Actually, for many insurance companies the only item missing today from their subsidiary lists is a commercial bank. Could an automobile manufacturer own such a company? Well, Ford and G.M. and Chrysler are operators of huge finance companies and G.M. has a large insurance operation as well. Is there an inherent threat to the country if one of them or all of them were to own a bank? And what about G.E. or Sears or Gulf & Western and so on? By the same token, would it be wrong in some moral or economic sense for Citicorp's shareholders to also own a life insurance company, an investment banking company, a computer company and a real estate development company as long as _Citibank_ itself was insulated from whatever additional risks might exist in those other businesses?

This issue of commerce and banking will also arise because of the recent history of the thrift industry where the ownership of thrift institutions by insurance companies and industrial and commercial enterprises is well established. Thrifts and banks are operationally more _like_ each other every day, although the capital sections of their balance sheets may be somewhat different. Why then do we accept the relationship in one case and not in the other? It is high time we re-examined this ancient issue, and you bankers, whichever side you are on, should be vocal participants in the debate. It may well be that pragmatic considerations will override philosophy in the resolution of this issue, if we find that ownership by a commercial enterprise would significantly improve access of banks to capital markets. But, we should not rush this one. We need to be sure we understand <u>all</u> of the implications before we act.

Uncharacteristically, I am not sure where I am on that issue. My tilt at the moment is toward change, but it is too early on for final judgments.

<u>Interstate banking</u> on a nationwide basis is rushing at us like a fast freight train, and whatever your individual feelings are about that development, the trend is not going to be reversed. By the mid-1990s we will have <u>de facto</u> nationwide interstate banking without the <u>de jure</u> blessing of Congress or repeal of the McFadden Act. Indeed, the State of Arizona has been a pioneer in breaking down these obsolete geographic barriers. But, absent clarifying federal legislation, we may be creating a whole army of

Frankenstein monsters in the form of multi-state bank holding companies.

Consider for a moment some of the nightmare problems the manager of a bank holding company faces with banks in ten different states.

-- First, he is forced into a holding company or multi-holding company organizational structure because the McFadden Act effectively precludes branching across state lines.

-- That means ten different management teams; at least ten boards of directors; and compliance with applicable state banking regulations which may dictate ten different ways to approach the same transaction.

-- To the extent that there are state-chartered banks in each state, there will be ten different examination standards to be managed to and ten different examinations to be endured.

-- Advertising, marketing, pricing, etc. may be subject to ten different standards or sets of regulations and limitations.

-- And, if you are in more than one Federal Reserve District, where is your friendly, helpful, fatherly central banker? Is he in San Francisco, Kansas City, Dallas or St. Louis?

-- Given those operating constraints, can you really achieve the operating efficiencies you bragged about to the security analysts when you were trying to explain how you were going to eliminate dilution?

I predict that whether you are federalists or states-righters you will all be calling for reform to accommodate these changes by the mid-1990s. One approach which will inevitably be suggested is legislation to create a whole new class of federally chartered financial institutions -- multi-state banks or holding companies which would be federally regulated, overriding state authority entirely. In order to deal with redundancy, repeal of McFadden would be proposed and nationwide branching permitted making much more efficient operation possible.

Obviously many assumed values will change if all that comes to pass. Treasured axioms such as: "small is beautiful," "big is bad." "States rights must be preserved at all costs." "Local banks with local management and local directors are the only way to assure proper attention to the needs of the community." Or, "the bigger the bank, the more unmanageable it becomes."

Some of those axioms are treasured parts of our economic culture, but in the interest of adapting to the changing needs of the economy and the requirements of competitiveness we may have to discard them as we have done others in the past.

For example:

It took us 125 years and two aborted prior attempts in order to establish a central bank -- the Federal Reserve. By doing so we rejected the once popular argument that a central bank gave bankers too much power over the economy.

We chartered national banks and created a national currency system to provide a sounder base for financing the Civil War and to help stabilize the banking system.

To meet the financial exigencies of the depression we stopped redeeming paper currency with gold and ceased gold coinage.

We accepted control over securities markets and banks by the federal government in the 1930s in order to restore confidence in financial institutions in return for federal insurance of deposits.

All of those were painful, even heart-rending, changes for the bankers involved. But today we accept those changes and generally agree either that they were an improvement or at least were necessary given the call of the times.

Change is always threatening, almost always uncomfortable, but like death and taxes it is also inevitable. The issues I have presented for your consideration today are only a few of the more obvious ones with which we, you and I, will be dealing in the near future. I hope we can all approach the development of these issues with our focus on what is good for the United States. Too often in the past banking has been so divided on great issues along parochial proprietary lines that Congress has thrown up its hands and gone its own way -- always a risky outcome. As LBJ might have said, "Let's come reason together." If we do, I am confident we can achieve results good for the country <u>and</u> good for banking.