



I am pleased to be here with you today as part of the 14th Annual Thrift Industry Outlook Conference sponsored by the Federal Home Loan Bank Board. I think it is a first for a Chairman of the Federal Reserve Board. I suppose that history reflects the fact that there have been traditional and long-standing differences between the thrift industry and the banking industry, and some of that rubbed off in the form of suspicions about the respective regulators.

But I suspect Ed Gray's invitation reflected a reality today. By law and by circumstance, the central bank, as lender of last resort and as an agency concerned with financial stability more broadly, has to be concerned about the health of all depository institutions. And it's also obvious that, in today's environment, thrift and banking industries are becoming so intertwined they cannot be easily separated. Therefore, I will touch upon issues relating to both familiar central banking themes and those relating to financial institutions more generally.

You know central bankers have a unique, if not curious, reputation. It's said that, like puritans, we have a haunting fear that someone, someplace is happy. I'm not sure I need have that fear in the midst of a savings and loan meeting, because your industry, as much as any other, has been under more or less continuous strain and pressure in recent years. Some of those strains reflect high and fluctuating interest rates. But your industry, like the banking industry, also has strong new elements of competition from outside, and the nature of the industry has been changing more radically than at any time in its history.

Let me begin with a few comments about conditions in the thrift industry generally. Declines in interest rates late last year have provided a little breathing room for many associations. While the industry as a whole obviously remains vulnerable to any reversal of that trend, well and conservative v managed institutions have been actively reducing that

vulnerability. A solid core of the industry seems to be in a position to return to health, and to do so while maintaining a traditional orientation toward housing finance. I admire those many in the industry who have absorbed hard shocks, but have responded by finding new ways to conduct their business consistent with the need to maintain prudent standards, sound lending practices, liquidity, careful pricing of both assets and liabilities, and to the extent possible, conservation of capital. Those managers are conscious of the fact that the business of being a thrift is getting harder and much more competitive, but they remember the importance of confidence and self-reliance.

I would be less than frank if I did not also reflect my concerns that, faced with similar problems, a few associations at the fringe -- presumably not the ones represented at a conference like this -- seem to be, more or less consciously, reaching out in credit and investment areas -- areas typically

removed from residential housing that may seem to generate high fees and rates in the short-run, but at the expense of a level of risk not characteristic of the industry in the past or of the future stability of those particular institutions. That risk taking is, of course, in effect underwritten by a Federal insurance system designed with other purposes in mind. We have seen the incongruity of some weakly capitalized institutions with poor earnings growing at very rapid rates of speed. We wonder how prudently those funds are being employed in the effort to capture a quick return -- and how consistent that behavior is with the basic purposes of your industry and the Federal institutions that support it.

Against that background, I am particularly encouraged by the fact that the Federal Home Loan Bank Board, under Ed Gray's leadership, is aware of the challenges confronting the thrift industry and has taken steps to deal with excesses. The

Federal Reserve has been supportive of these efforts, particularly those designed to place some limits on direct investment, to encourage rebuilding of net worth, and to place constraints on extraordinary growth. It seems to us those approaches are valid efforts to help protect the stability of the financial system as a whole, and are indeed in the long-term interest of the savings and loan industry itself. Indeed, the approaches parallel and supplement measures we and other banking regulators are taking, or have taken, and we certainly welcome the Bank Board working in complementary ways in these areas. Over time, we believe there will be a need to take further constructive steps to limit risk and to encourage profitability and a rebuilding of real net worth on a continuing basis.

It is also worth noting the efforts being made by the Bank Board to strengthen its supervisory staffs and procedures. There has, as you know, been a lot of deregulation -- savings and loans today have a lot more flexibility on both the asset

and liability side of the balance sheet. I see no inconsistency between that kind of deregulation and an insistence -- backed by adequate supervision and regulation -- that this flexibility be used responsibly. In today's environment, with the myriad of complex financial arrangements and exotic financial products, more effort rather than less is required to encourage and maintain the prudential standards upon which confidence in the system -- and the insurance system itself -- depends. Those same comments might be applicable to the commercial banking system as well. I do think that we commercial bank regulators have been fortunate in inheriting an examining staff and expertise that is relatively well equipped, but we too are conscious of the added challenges of today's more complicated environment.

All of this is relevant to existing supervisory authorities and law, but I also believe all of us are sensitive to the need for new banking and thrift legislation to provide a clearer and more orderly framework for the operations of all depository institutions.

I wish I could deliver a brief, cogent analysis of the substance and prospects for legislation in 1985, but I can't. The Congress, as you know, has been preoccupied with other matters. I have sensed apparent consensus on important elements of a legislative package, including particularly the need to deal with certain loopholes that have been increasingly exploited. But, at the same time, that consensus apparently cannot be expressed in legislation without also dealing with other highly controversial issues. Moreover, additional questions -- such as interstate banking and deposit insurance -- are forcing their way onto the agenda. It's understandable that they have, but it does further complicate the legislative outlook.

I am also aware that two important issues for the thrift industry come up for renewal in October -- net worth certificates and interstate acquisitions of failing institutions. These matters provide a kind of deadline for legislation, but

it is hard for me to see those issues, urgent as they are, dealt with in isolation. We urgently need a more comprehensive approach.

The themes of last year's debate are familiar by now and I will not dwell on them. We still believe that it is vitally important for the Congress to close the nonbank bank loophole. To me, an essential corollary is also to close a parallel avenue for undercutting the traditional separation of banking and commerce -- what I call "non-thrift thrifts." Unless the Congress deals with both aspects, commercial firms that want to be in banking, and have direct access to the payments mechanism, will be free to seek savings and loan or savings bank charters instead of commercial bank charters. After all, the powers available under thrift charters overlap those of banks substantially, and thrifts could well provide a more attractive vehicle for commercial firms wishing to enter banking than a "nonbank bank."

The concept of a "thrift test" to determine whether a thrift would continue to retain certain broader investment powers and other traditional privileges -- including long-term FHLB advances and commercial ownership -- has gained rather wide agreement. But translating that conceptual agreement into a valid statistical test remains a challenge. To our mind, the essence of that test should be whether an institution in fact, from its own portfolio, supports housing credit, which is the traditional rationale for Federal support and encouragement of thrifts. In my view the "test" needs to be more closely drawn than in legislative proposals introduced last year if it is to be meaningful. Simply originating and selling mortgages -- an activity that is broadly and freely engaged in by commercial banks, mortgage banks, and others -- does not seem to me sufficient to justify that special Federal support for deposit gathering. The question is who is willing to hold that paper. I do not sense we are so far apart on a valid test that the

differences cannot be reconciled, but it is an important issue.

Another area of common concern among regulatory authorities is the strong movement among states to authorize new powers for both thrifts and banks far beyond those authorized at the Federal level. There has traditionally been a role for the dual banking or thrift systems. It provides room for flexibility and experimentation. But what is going on now seems to me to be assuming a quite different character from the traditional dual system. Liberalization of powers by the states is clearly driven by short-term competition for jobs, rather than any coherent well-developed conception as to what the financial system should be and what is consistent with safe, sound, and efficient thrift and banking systems as a whole. And, as more and more states are driven to action by job-protective incentives, there will in the end be no net job creation.

There are a number of areas of liberalization of powers that seem to me to pose no particular problem from a prudential standpoint. But wide open real estate development, now permitted by some states, to me and other Federal regulators, including the Bank Board, raises the most pointed concerns. It is an area where risks are particularly large and demonstrable.

Both bank and thrift regulatory agencies are attempting to deal with the issue within present law from the standpoint of their responsibilities to protect safety and soundness. While our approaches may vary, and we want to work with the affected institutions to develop sensible guidelines, the basic point is that at some point we must, as administrators of the Federal "safety net" which supports the system as a whole and individual institutions within it, assert a fundamental federal interest in what state-chartered institutions and their parents can do from the standpoint of safety and soundness. While our existing authorities provide us with some scope for defending that

fundamental interest, I also believe any new legislation should clarify Congressional intentions in that respect.

Finally, I should also record my concern about initiatives taken by commercial firms to set up so-called "consumer banks" or "family banks" all over the country, presumably with the intention of integrating those banking operations with other parts of their business. However attractively packaged in terms of purported advantages to the consumer, the possibility of commercial corporations using limited purpose banks or thrifts to get into deposit taking and to gain access to the payments mechanism seems to me a clear threat to the traditional separation of banking and commerce and to the competitive position of freestanding thrift and banking institutions. In the end, I believe the system as a whole would be weakened -- and consumers and businesses would be ill served. Indeed, that approach is difficult to integrate with the philosophy underlying deposit insurance and the Federal safety net, which was never intended to support ordinary commercial enterprises.

I recognize none of this is going to solve the pressures on your industry arising from external economic factors -- and particularly the historically high and volatile interest rates. The thrift industry has always been in the forefront of those supporting the effort to restore price stability, an effort that is absolutely fundamental to a more stable financial environment and sustained lower interest rates. The problems you face today are, in substantial part, an overhang -- perhaps I should say a hangover -- from the inflationary process, when confidence in financial markets was greatly impaired.

A lot of progress toward stability has been made. But the fruits of that progress in terms of lower interest rates and more settled markets have not yet been at all fully harvested.

Inevitably, that process takes time. But, as you well know, the state of the Federal deficit -- both because of its immediate economic and financial effects and because of its bearing on inflationary expectations -- has worked to limit

the benefits on markets from the progress against inflation that has been made.

The hard fact is we do not now, nor are we likely to in the future, have the capacity to save enough domestically to finance both federal deficits and the rising levels of investment needed to support growth and productivity. Thus far in the expansion period, we have been able to bridge the gap only by drawing on a growing net inflow of foreign savings to supplement our own. But that capital inflow implies a large cost. That cost takes the form of a huge and growing trade deficit, with sharply adverse impacts on the industrial, mining, and agriculture sectors of the economy. Looking ahead, it implies a growing external debt and interest burden for the next generation.

Let me cite a few figures. Net domestic savings -- by individuals, by businesses, and by state and local governments -- has in fact increased quite rapidly over the past few years, amounting to some 9 percent of the GNP in 1984. That's

near the higher end of the range prevailing over the postwar period. Nevertheless, about a quarter of our net needs for investment, including housing, and for deficit financing last year, amounting to 2-1/2 to 3 percent of the GNP, had to be met from foreign sources.

So far, that foreign capital has been readily available and has played a key role in containing pressures on domestic interest rates. Among other things, it has enabled us to maintain a reasonably satisfactory level of homebuilding and house sales. Even so, interest rates, as you know, have remained high both historically and relative to current inflation. Without that net flow of savings from the rest of the world, pressures on our financial markets would have been still greater and interest rates would have been still higher.

Monetary policy can't cure the basic imbalance between real savings and the demands on those savings. We want to provide enough money and credit to support sustainable growth in real output and employment, while moving toward greater

price stability. But too much money would only risk reigniting the inflation that we have worked so hard to bring under control.

As a practical matter, we probably can't do much right now, by monetary policy or otherwise, to change ingrained savings behavior. It seems to me that the only constructive alternative to balance internal savings and investment is to attack the problem from the other side of the ledger by reducing the Federal deficit. At current and projected levels, that deficit amounts to approximately 5 percent of GNP, an amount equivalent to over half our net domestic net savings. The large capital inflows -- and the related trade deficits -- will not be sustainable indefinitely. But, unless something is done about the deficit, declines in the capital inflow would be reflected in stronger pressures on financial markets. In that event, the thrift industry would be impacted from two directions. The credit sensitive housing industry would be

vulnerable, and the cost of your deposits could be under renewed pressure.

For those reasons, deficit reduction seems to me to be the main "bread and butter" issue for the thrift industry before the Congress. I know many of you feel the same way, and I know you will continue your efforts to bring the importance of the issue home -- home in the literal sense of explaining it to your customers, as well as to the Congress.

We have all, as the old Chinese proverb says, been destined to live in interesting times. The thrift industry has had more than its share of tough challenges. My respect and admiration of the way thoughtful leaders of your industry have faced up to those problems has only increased as we have consulted and worked together. I particularly appreciate the opportunities to work together with some of you on our Federal Reserve Thrift Industry Advisory Council. The lines of communication have been open with them, as well as with

the Federal Home Loan Bank Board. I can also tell you those lines are busy, but there is never a "busy signal." We have found large areas of philosophical and practical common ground.

I have also frankly explained to you our concerns -- our concerns as an institution concerned with the health of the financial system as a whole, with certain developments in the banking and thrift world. Some of those problems need legislative solutions, but many we collectively can work on together. The Home Loan Bank Board is helping to lead the way, and I sense they need and deserve your active support.

I know most of you share those concerns, and I believe that, in a context of responsible national budgetary policies and prudent attention to risk taking by individual institutions, we should be able to look forward to renewed strength and vitality in both the banking and thrift institutions. That is our common goal, and I sense that leaders in both the banking and thrift industries not only share that vision, but are working toward it.

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