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Remarks of

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Member
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before

The Association of Bank Holding Companies

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Introduction

I am pleased to be here today to share with you my reaction to entering the public sector after spending many years in private industry. I hope to show you the kind of adjustment this transition requires by discussing how my perspective on some of the major issues currently facing the banking industry has changed, given my new responsibilities.

As a commercial banker and chairman of your association, I worked actively to foster a vigorous, strong, and competitive banking industry. Of course, I continue to support these objectives. However, as a member of the Federal Reserve Board, I now find myself analyzing banking issues from a public policy viewpoint which is somewhat different from the perspective of a private sector C.E.O. While my experience at the Fed is limited to only a few months, I hope that the personal observations I make this morning will stimulate your thinking about the challenges ahead.

Expanded Banking Powers

Let me begin by discussing the subject of expanded bank powers since this is viewed as a critical issue by both regulators and bankers, and has received considerable media coverage recently. While Chairman of the Association of Bank Holding Companies, I was a strong proponent of expanded banking powers. I argued that expanded powers were desirable because they would enable banking organizations to diversify and compete more effectively, tap new sources of income, and better serve the needs of bank customers.

As a member of the Board, I continue to support strongly the expansion of banking powers, and for many of the same reasons. However, it is obviously critical that any new powers be managed and conducted in such a way as to avoid exposing banks to unusual or excessive risks. Before, when I was Shawmut's Chairman, I could see to it that adequate controls were in place to manage any new activities that the company undertook. Now, while I may be in a stronger position to influence national policies, I can only urge banks to be prudent. Strong internal systems and controls, a high level of staff expertise, and effective risk management are especially critical if banks are to conduct new activities, including expanded securities powers, with reasonable safety.

I also believe that it matters where these activities are conducted. Banks, which enjoy access to the Federal safety net, should be insulated from nonbanking risks, and the safety net protections should not be extended to nonbank activities. On these points I agree with the Board's long-standing position that new securities activities, as well as other types of nonbank activities, should be conducted in holding company subsidiaries, and that strong and effective fire walls should be established between banks and their nonbank affiliates.

For its part, the Board continues to urge Congress to grant banks broader securities powers in order to maintain an internationally competitive banking system. Banks must have the ability to adapt to market and industry changes, develop new products and services, and take advantage of new technology. The failure of Congress to repeal the Glass-Steagall Act's separation of commercial and investment banking is a tragedy and inhibits innovation and development of market solutions to customer needs.

The expanded powers bills should be resubmitted early next year. Hopefully, this time they will receive more favorable treatment, although there will be a lot of competition for room on the legislative agenda. I should also note that, outside the legislative process, some real progress was made to expand bank powers. The Board successfully defended legal challenges to its decisions to allow bank holding companies to underwrite and deal in commercial paper, mortgage-backed securities, consumer receivable-backed securities, and municipal revenue bonds. The Board also recently approved a bank holding company request to combine brokerage and investment advisory services. That kind of piece-meal reform may be better than no reform, but a comprehensive legislative approach to new powers would be better.

I cannot emphasize too strongly that the success and prudence with which banks conduct their present business will affect their chances to receive new powers. Public confidence in the banking system is essential to its stability, and any loss of confidence will undermine the support needed to achieve broader powers. As long-standing restraints on banking activities are dismantled, it is critical that you continue to manage your affairs in a way that maintains the public's trust.

Changing Structure of the Banking Industry

While I was at Shawmut, I guided the company through its emergence as a "superregional" banking organization. At the Board, I have a materially different role: Instead of managing a company, I must now participate in the administration of the Bank Holding Company Act and help formulate decisions on the financial, managerial and competitive implications of proposed mergers. At the policy level, I must decide such questions as, "What level of concentration is best for the banking industry?" And, "What implications do hostile takeovers have for industry stability?"

Changes in the U.S. banking industry are evident to all of us. Many of the barriers to interstate expansion have fallen due to state action, and we are now approaching de facto nationwide banking. During the past decade, the number of separate banking organizations, that is, the number of individual bank holding companies and banks not affiliated with holding companies, declined 17 percent. At the same time the market share of the 50 largest institutions increased by 8 percent.

This increased concentration primarily reflects the development of regional compacts and the emergence of multistate or "superregional" organizations. Partly because the New York banks were generally excluded from these compacts, their domestic market share actually declined. The large regionals, by contrast, have grown rapidly -- mostly through mergers and acquisitions. Prior to 1981, no merger had been approved between banks where both had deposits in excess of $1 billion. Since then, at least 87 such banks have combined. These changes in the size and geographic coverage of our banks will present both bankers and regulators with new challenges. For the most part these large mergers have been successful, and have improved efficiency and market share, but geographic reach, market diversification, and culture blending present new and more sophisticated management challenges.

Supervisory considerations are especially important in the case of hostile takeovers. Such takeovers are new in banking and raise a variety of policy questions for the Board. In reviewing applications involving hostile takeovers, the Federal Reserve has avoided taking sides; rather, the Board has focused on the managerial, financial, regulatory, and competitive factors it is authorized to take into account under the Bank Holding Company Act. We must, however, address any safety and soundness or other supervisory issues that accompany hostile takeovers. For one example, we will discourage payment of excessive dividends as part of takeover defense strategies. Institutions seeking to be the aggressor in hostile takeovers should be exceptionally well-capitalized to compensate for the potentially greater risks and expenses they may face. It is also important that the time and money spent initiating or defending against such takeovers not weaken the banks involved or distract management from its basic operating responsibilities. While the Federal Reserve will avoid taking sides in hostile takeovers, supervisory policies must be developed to discourage actions that would weaken or undermine the condition of subsidiary banks or the ability of a holding company to support its banks.

A final aspect of the changing banking structure worth mentioning is the increasing presence of foreign competition in U.S. markets. During the past decade, foreign-controlled institutions have increased their share of domestic banking assets from 6 percent to 20 percent. And in the commercial loan market, their share during this period has more than doubled. They now control more than one-half of business lending in New York; 42 percent in California; and more than 25 percent in Illinois.

As a banker, I worried about the additional competition these foreign banks would present -- although I never doubted the ability of U.S. banks to compete successfully given a level playing field. As a regulator, I can still see the challenge posed by foreign competition, but I am also obliged to consider the benefits that U.S. businesses and consumers derive from the services foreign banks offer. While our national policies supporting open markets in the United States have served us well, I feel strongly that U.S. banking organizations should receive equal treatment abroad. I plan to work actively to achieve that goal. In this connection, the concept of national treatment is especially important as the European Community moves to deregulate its markets.

Implementation and Refinements to Risk-Based Capital Guidelines

As financial markets cross national boundaries, cooperation between banking supervisors of different nations becomes increasingly important. In this area, authorities have made important progress, as indicated by the adoption of international risk-based capital standards. These common standards should strengthen the international banking system and lessen competitive inequities among banks of different countries.

In addition to these immediate gains, the Basle Capital Accord also represents an encouraging step toward greater international cooperation. The interdependence of financial markets and the global networks of the world's major banks require banking authorities to communicate more than ever and to develop consistent supervisory rules. I personally believe that the development of these capital standards sets a good example for further cooperation.

Although the first phase of the risk-based capital guidelines will be implemented this coming year, much work remains to be done. We still need to develop improved procedures to measure interest rate and foreign exchange risk and to assess the adequacy of loan loss reserves. And, once we gain some experience with the risk-based standard, we may need to consider refinements in our framework for matching capital standards to various levels of risk. These efforts require further international negotiations. However, the crucial role of capital in providing a cushion enabling financial institutions to absorb losses from unforeseen events and risks requires that the effort be made.

Source of Strength

In its long campaign to ensure adequate capital ratios for banks, the Federal Reserve has held that a holding company should serve as a source of strength to its subsidiary banks. I believe that policy, which I accepted and supported during my tenure at Shawmut, is very important. The policy requires a holding company to use its resources, including its ability to raise capital, to assist its subsidiary banks during periods of financial stress. The Board regards that "source of strength" policy as a critically important supervisory tool.

The policy also has implications for expanded bank powers that many bankers do not fully recognize. Congress has repeatedly indicated its preference that banking organizations exercise any new powers through nonbank affiliates of bank holding companies. However, if bank holding companies do not continue to act as sources of strength to their banks, or if they act as sources of weakness, it is probable that Congressional support for expanded powers would wane. The Board, and I believe the Congress, will continue to hold that banks play a very special role in our financial and payments system. For this reason, the Federal Reserve will continue to work to encourage holding companies to serve as sources of managerial and financial strength to their subsidiary banks under all circumstances in order to ensure the integrity of the system.

Condition of Savings and Loan Industry

The problems facing the S&L industry are particularly difficult and complex challenges for public policy-makers. Clearly, the magnitude of the problem will require a significant commitment of resources. Currently, nearly one-third of all thrifts are insolvent by any standard, and many continue to lose money at a rapid rate.

There were many developments that contributed to current conditions in the S&L industry, including interest rate deregulation, shortsighted asset/liability strategies by unqualified managements, excessive growth, imprudent lending, and speculative investment activities. Regardless of the causes, the problems in the industry have important implications for the banking system. In the short run, they affect the interest costs of banks as weak S&Ls are forced to raise deposit rates to attract funds. In the longer run, their problems could affect public perceptions about the strength and stability of the whole financial system and raise questions about how that system should be structured.

That last issue, in turn, raises a number of difficult questions: Is there a need for reforming deposit insurance? Should reform include risk-based premiums? Should we encourage banks and nonfinancial firms to acquire thrifts both troubled and healthy as a way to recapitalize the industry? There is even the question of whether there is a need for a separate thrift industry.

As we reconsider the nature of our financial system, it may be appropriate to consider the structure of the regulatory agencies and the deposit insurance funds. Without making any judgments on the outcome, any restructuring should permit the system to remain innovative and competitive on both a national and international basis. U.S. financial institutions must have sufficient powers to adapt to and, indeed, to be leaders in the continuing evolution of financial markets. We must be careful, though, to ensure that new powers do not further threaten the strength of the deposit insurance programs or undermine the integrity of the banking system. As the lender of last resort, the Federal Reserve has a clear concern for the strength of the banking and financial system and must remain intimately involved in understanding and addressing its problems as they arise.

Other Supervisory Issues

As a former banker and Boston Reserve Bank director, I am very sensitive to the whole range of issues and practices that have supervisory implications for banks. One area that is of concern to me is the risk associated with asset securitization activities. It is particularly critical that banks fully understand these risks at a time when more and more banks are moving to securitization as a device to regulate balance sheet size, reduce interest rate risk, and increase servicing income, while at the same time adjusting capital ratios.

Unfortunately, in many cases the securitized assets are the highest quality assets in order to be readily acceptable in the marketplace. As a result, the overall quality of the remaining assets may suffer. If carried to an extreme, this practice could undermine the validity of the risk-based capital standards.

In addition, some asset sales are structured in such a manner that the buyers are subject to little credit risk. Rather, the risk is retained either by the issuer or by a third party which issues a letter of credit or some other form of financial support in order to obtain an investment grade credit rating on the bonds. If banks retain these risks, or if they allow the average quality of their assets to decline, they must recognize that higher levels of capital may be needed to compensate. Clearly, banks must have policies and procedures that limit their contingent liabilities under these programs and systems in place which enable them to monitor the nature and degree of risk associated with asset securitization activities.

The growing volume of leveraged buyouts being financed by banks is another activity that begs for attention. Specific credit decisions are properly for banks to make -- not the government. However, it is important that lending practices do not raise the risk profile of banking organizations or weaken the financial system. Bank supervisors must be satisfied that banks have proper safeguards in place to control risks stemming from LBOs and other lending programs. And lead banks have a heavy responsibility not to be a pied piper to other banks to whom they offer participations.

Real estate is yet another area that bears watching. In recent years, banks have substantially increased their exposure to this sector. At the end of 1987, banks with assets exceeding $5 billion held 25 percent of their loan portfolios in real estate loans compared with only 14 percent at year-end 1978, and their real estate loans exceeded $225 billion. More importantly, the composition of their real estate portfolio has changed. In the earlier period, higher risk real estate loans for construction and for domestic, nonfarm, non-residential purposes represented 32 percent of the average real estate portfolio. By the end of 1987, these loans were more than 50 percent of the average real estate portfolio. Obviously, banks will be directly affected by any downturn in the real estate market. And the boom in equity credit lines adds a new dimension to real estate exposure, even if only indirectly.

Closing Remarks

In closing, I hope I have shown that there is no shortage of issues on my plate. Although I realize I have only raised -- not answered -- these questions, I hope that the thoughts I have shared will be helpful. They come from a newly-minted bank regulator with a long background in commercial banking. I look forward to working with you as we face the challenges ahead and hope that my experience on your side of the table will improve my performance on this side.