Remarks by

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to the

Bank Administration Institute, Delaware Chapter

Wilmington, Delaware

April 18, 1990

Good evening ladies and gentlemen. Tonight I want to talk to you about change. But wait! Before you yawn and say to your neighbor "not another one," hear me out. I know we have all been subjected for years to after-dinner speakers who try to gaze into the future and describe the different world it brings.

Indeed, the sixties brought several important changes. The negotiable certificate of deposit changed the way banks funded themselves. Debt appeared in the capital structure of the best banks for the first time in a respectable way. It was "smart banking" to develop a source of long-term funding as lending practice embraced longer and longer maturities. And, on the consumer side, bank credit cards and so-called overdraft checking fundamentally changed the way individuals could access credit.

In the seventies, commercial banks became seriously interested in real estate lending, seduced by the real estate construction boom in office buildings and both primary and vacation residences. The real estate and REIT boom and bust was one of the shortest and most damaging lending cycles in history. What a shame we bankers have such short memories. That the lessons of that fiasco were forgotten by the end of the eighties. Another phenomenon of the seventies was the participation by many banks in syndicated, so-called sovereign risk loans to developing countries. Some of the banks active in that respect had never had a foreign department, never traveled to the countries to which they were lending and probably couldn't even find them on a map.

In the eighties the LDC chickens came home to roost and do on the bankers what birds usually do on a roost. But there were new developments to excite the bankers and partially dispel the gloom. Junk bonds and junk loans to finance the buy-out, takeover and restructure mania of the decade brought high rates, high fees, high excitement, and high risk. Securitization of assets, beginning with mortgages and moving on into credit card receivables, auto loans and even commercial loans has become common with a highly beneficial effect on the ability of banks to manage balance sheets and capital ratios. Another stunning development has been interstate banking. Initially it was a suspicious experiment under the guise of regional compacts. More recently the compacts are being expanded with trigger dates for unrestricted interstate combinations. All, I might add, without any help from a Congress paralyzed by an unwillingness to take on the states rights debate which would have accompanied any attempt to establish a federal prescription for interstate banking.

So much for history. It is a history of evolutionary change. It has been primarily an expansion of products and services with little effect on structure other than the beginning of interstate banking.

Now, I believe, we are on the threshold of a very different kind of change. Competition, both foreign and domestic, has intensified and money center banks operate in a global market. Integration of financial services is a concept whose time has come. Technology not only makes possible things once thought to be flights of fancy, but it also creates new management challenges. We need changes in the structure of our financial services delivery system in order to provide greater competitiveness.

These are some of the issues which should be dealt with.

Capital will be a central issue. The thrift mess, the Texas snafu, and the LDC debt debacle all teach the same lesson. More capital! More capital! Now, more capital would <u>not</u> have prevented any of those tragedies, but more capital would certainly have made each more manageable and would have 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, and recognize mounting losses in commercial real estate, the demands of banking on the capital markets will be huge. At the same time we are beginning to implement risk-based capital standards and some banks will need more than just retained earnings to reach the appropriate ratios.

Will the capital market 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. I suspect the fresh capital will go to the swift and lean, those with a better than one percent return on assets and 15 percent or more on equity.

I predict a scramble for capital in the next few years which will force banks to rethink their strategies. New strategies to improve earning power and improve risk management will be required. Restructuring, downsizing, market targeting, narrower specialization and stringent cost controls will be common themes -- all in the name of capital. And when bank powers are expanded, new elements of risk will be added -- risk which must be matched against adequate levels of capital.

Clearly capital adequacy will be a central issue for banks in this decade.

Another issue, much in the news these days, is leveraged buy-outs and takeovers financed with heavy injections of debt. One emerging philosophy seems to be that investors using <u>their own money</u> 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 in some way or simply outlaw it. In my opinion, either course would be a mistake since the real outcome would be to allocate credit, and credit allocation contradicts the basic tenets of a free market economy.

I do think there is a substantial element of risk in this kind of lending. The risk is in failing to make a proper appraisal of the cash flow coverage of debt service. Is the cash flow 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 ended in the bankruptcy court 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 have urged bankers to be more skeptical and to impose higher credit standards in these transactions lest Congress be goaded into action bankers will regret. They must make sure credit policies and procedures are sound and loan documentation is complete. Each bank must determine a prudent level of exposure to highly leveraged financing in the overall portfolio and stick to it. And they must make sure directors know what policies they are following and what limits have been set. Finally, the directors should formally approve. In short, if highly leveraged financings are administered prudently, there are not likely to be objections or interference from Congress or supervisors.

Commercial real estate is a highly cyclical industry. In a time of boom, optimism runs away with good judgment and builders and lenders alike assume that healthy absorption rates will go on forever. Builders become more expansive and more speculative and lenders, believing they have found the mother lode, liberalize their terms so as not to be left out of the party. The biggest and most common mistake is the notion that the real estate itself makes the loan secure. This approach ignores the often repeated lesson of market volatility that can materially lower the liquidation value of a property in a matter of months. Bankers forget these lessons over and over again and supervisors have not done a particularly good job of identifying emerging real estate problems before they grow into crisis situations. We supervisors must develop better examination procedures to address the problem. We must also insist that bankers revert to sounder credit standards and stick to them. Much of the current concern over safety and soundness is real estate related. The problem is there and it needs remedial attention.

Having said all of that, we must do all we can as regulators to preserve and nurture 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.

The other issues I want to touch on this evening are structural, and 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 bankers, regulators, and legislators will be wrestling with in the immediate future.

Deposit insurance is long overdue for reform or at least reformulation. In the beginning, deposit insurance was intended primarily to prevent runs on banks and protect the banking system from the contagion of panic. After the 1929 market crash many otherwise sound banks failed because depositors lost confidence in the system and wanted their cash in hand rather than in the form of a call on a bank. Absent unlimited sources of emergency liquidity, no bank can survive a sustained run, because its liabilities on the whole are of much shorter maturity than its assets, and many of the assets are essentially unmarketable in a short time frame.

The original deposit insurance scheme was designed to encourage the confidence of small depositors who would see a FEDERAL deposit insurance system as keeping them safe from bad loans and bad management at their bank. In effect, it relieved them of responsibility for making a judgment about their bank. <u>Any</u> bank whose deposits were insured above the amount which an individual depositor was likely to put with it was by definition secure.

Without the discipline of potential runs, managers of banks were more relaxed about taking risks, believing that runs would not bring them to account. That more relaxed attitude toward risk-taking is what underlies the term "moral hazard."

Obviously most bank managements continued to respect and serve the interests of both shareholders and depositors by managing their banks to accepted standards of safety and soundness. But, relaxation of interest-rate constraints on deposits created new competitive pressures and, for aggressive risk takers, new opportunities. Legislators and regulators relaxed asset standards and the fox was in the henhouse.

I am convinced that the present sorry state of the thrift industry is not a function of broader powers but rather of the poor supervision of the way those new powers were exercised and who was exercising them.

In the 90's we will have to clean up the mess and try to make adjustments in supervision, regulation and the insurance system itself which will minimize the risk of a recurrence of the present disaster.

All kinds of schemes will be considered, and if you have one, don't be bashful about expounding it. In the final analysis, the Treasury will recommend adjustments which will primarily be aimed at eliminating moral hazard while retaining the confidence-sustaining characteristics of the present system. Paradoxically, most proposals to impose discipline such as deductibles and co-insurance tend to undermine the confidence elements. Given the ease of transfer, the threat of even a small loss will cause depositors to run. In a time of national malaise that could be very contagious and destabilize the entire system.

The answers don't come easy, but the need for change is compelling and it will be interesting to see what Treasury recommends.

Turning to another issue, 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 protection 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 different 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 obvious question arising from consideration of such a structure is the ownership of the holding company itself. Could an insurance company or 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 bout 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 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. For example, Ford owns the nation's second largest thrift. Thrifts and banks are operationally more <u>like</u> each other every day, although the <u>capital</u> 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, all of us, whichever side we 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. 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.

Interstate banking on a nationwide basis is rushing at us like a fast freight train, and whatever our individual feelings are about that development, the trend is not going to be reversed. By the mid-1990's we will have <u>de facto</u> nationwide interstate banking without the <u>de jure</u> blessing of Congress <u>or</u>

repeal of the McFadden Act. But, absent clarifying federal legislation, we may be creating a whole army of severely handicapped institutions 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 handle 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 Boston, New York, Philadelphia, or Cleveland?

-- Given those operating constraints, can the multi-state holding company really achieve the operating efficiencies that will justify to analysts and investors the high price paid to put the company together?

I predict that whether you are federalists or states-righters you bankers will all be calling for reform to accommodate more efficient interstate operations by the mid-1990's. One approach proposed will be 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 will be considered to permit nationwide <u>branching</u> in order to make operations more efficient.

Obviously many assumed values will change if all that comes to pass. Treasured axioms will be tested 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 deeply entrenched 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 some 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. A move opposed at the time by many states and many bankers, but one which was critically important to winning the war and stabilizing the monetary system.

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

We also accepted more control over securities markets and banks by the federal government in the 1930's in order to restore confidence in financial institutions. Bankers accepted more regulation as the price paid for deposit insurance.

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 that they were necessary given the call of the time.

Change is always threatening, almost always uncomfortable, but 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 resolution of these issues with our focus on what is good for the United States. Too often in the past banking and bank supervisors have been so divided on great issues along parochial proprietary lines that Congress has thrown up its hands and gone its own way, and that is always a risky outcome. But if we reason together objectively I am confident we can manage the revolutionary changes needed in the nineties to an outcome good for banking and good for the country.