Remarks by

John P. LaWare

Member, Board of Governors of the Federal Reserve System

to the

Houston Rotary Club

January 20, 1994

Houston, Texas

I am very pleased to be in Texas today to address the Houston Rotary Club. I intend to begin by briefly reviewing the performance of the economy last year and, on the basis of that review, offer a few comments on the economic outlook for the coming year. I will then turn to a very important issue on which I am spending a good deal of my time these days. I refer to the Treasury's proposal to consolidate federal supervision of the banking system into a single federal agency. As you may be aware, the Federal Reserve is strongly opposed to that proposal. Accordingly, after consultation with my colleagues, I have advanced an alternative that would keep the Federal Reserve directly involved in the supervision of banking organizations and avoid other serious drawbacks in the Treasury's proposal. At the same time, I believe my proposal would achieve most, if not all, of the benefits of the Treasury's scheme.

-o-

The economy ended 1993 on a relatively strong note. Following a weak first half of the year, growth picked up to a three percent annual rate in the third quarter and appears to have accelerated further in the fourth quarter. The consensus view of economists, I understand, is that the pace was about four percent or a bit higher. If that estimate proves to be close to the mark, the growth rate for the year will be about two and a half percent, in line with the relatively modest pace set in earlier years of the current recovery.

That pace of advance, relatively slow compared with earlier periods of economic recovery, is the result of a number of factors that have dampened the current rebound in economic activity. Many of these factors reflect corrections of imbalances from the 1980s. They include efforts by businesses and consumers to reduce debt and restructure their balance sheets, greatly diminished activity in the commercial real estate sector because of past overbuilding, and a credit crunch in certain regions where banking institutions reacted to substantial losses in their loan portfolios that began to show through clearly in the late 1980s and beyond.

Other factors have also worked to mitigate the strength of the recovery. Businesses have found it necessary to continue to down-size their work forces and to cut other costs to improve their ability to compete here and abroad. Reductions in defense spending have also caused costly transitions for firms and individuals involved with that sector of the economy. All of these developments heightened consumer anxiety, particularly with respect to long-term prospects in the job market. Cyclical weaknesses in the economies of our key trading partners, including Canada, Germany, the U.K. and Japan with obvious implications for the growth of exports, have been another important factor responsible for the relatively slow recovery.

There are signs, however, that the negative effects of at least some of these factors are waning, while more positive forces are gaining momentum. First, and from the perspective of a central banker, perhaps most importantly, inflationary pressures eased a bit further last year. The steady success in bringing inflation under control in recent years has been of prime importance in promoting the economic recovery as it reinforced confidence in the fundamental stability and fairness of our economic system.

Low inflation has also paid another major dividend in the form of the lowest U.S. interest rates in two decades. Consumers have seen their mortgage costs decline substantially either through a decline in rates paid on adjustable-rate mortgages or through refinancings. Businesses have also benefited not only by refinancing their maturing and callable debt at lower rates, in markets made more attractive by lower interest rates but also by issuing significant amounts of new equity. These actions have helped both businesses and consumers strengthen their balance sheets and have stimulated spending on new homes, autos, machinery and equipment.

Low rates have also had a salutary effect on the nation's banking system. As rates have fallen over the past three years, banks have been able to widen their interest margins and at the same time make substantial progress in working through their problem loan portfolios. During 1993, these events enabled the banking industry to exceed its 1992 record performance in just the first nine months. That, together with favorable capital markets conditions, allowed the industry to strengthen its capital base through retained earnings and new issues. Banks are now in a very solid position to provide credit when demand for loans picks up.

On balance then, these factors just reviewed combined to produce another year of moderate economic growth that not only lifted incomes but also provided over two million new jobs. And all this was accomplished with inflationary pressures not only held in check, but actually reduced to some extent. There are a number of indicators that suggest that growth is continuing in the current quarter, though perhaps not at as brisk a pace as the fourth quarter of 1993, now estimated by some to have been five percent in terms of real GDP. Favorable indications are new orders for manufactured goods, automakers' assembly schedules and durable goods production in the fourth quarter. Housing starts are also favorable. Indicators of consumer sentiment also suggest that consumers will support further growth in the economy. Retail sales are up. Taking all these factors into account, I think it safe to conclude that the economy will continue a pattern of modest non-inflationary growth in 1994. I would expect real GDP to grow at a rate of 3-3.5 percent for the year with inflation edging down to 2.5 percent barring any surprises.

The downside risks relate to job anxiety created by further corporate re-engineering and defense cutbacks. There are also the possible dampening effects of higher taxes and the remaining uncertainties about the Administration's health care proposal and how it will be financed. These are real concerns, but hard to quantify in the current environment.

-o-

I would like to turn now to the subject of reform of the bank regulatory structure and the Administration's proposal for creating a single, monolithic regulator for the banking system. Let me say at the outset that I find it disturbing that the issue of consolidating the regulatory agencies is at the top of the current banking legislative agenda. There are other banking reforms that would have more profound and salutary effects on modernizing our financial system, while relieving the regulatory burden on banks.

In particular, there is a great need to repeal antiquated laws that prevent banks from efficiently competing in the broader financial services area. Banks should be permitted to offer a broad range of securities and insurance products, provided they have the financial strength and management ability to carry out these activities in a safe and sound manner. There is no reason to think that they would not be able to do so. Such multi-purpose financial institutions have been successfully operating in Europe for years without major incident. Along these lines we need to give serious consideration to a zero-based reassessment of our financial system. We should in my opinion, not only permit but encourage the integration of our financial system to permit affiliation under common ownership of financial institutions of all kinds in order to remain competitive with a rapidly integrating financial system in other countries.

There is a compelling need to allow banks to branch on an interstate basis. Interstate banking, through the holding company structure, is already a fact of life in the United States. In that established context it makes no sense to prohibit organizations that wish to do business across state lines from having the choice of selecting the organizational arrangement that they believe will best enable them to serve the needs of their customers while minimizing their operating costs.

Another piece of needed legislative reform would be the lifting of burdensome regulations that are mandated by statute. For example, there are important sections of the Federal Deposit Insurance Corporation Improvement Act that, while well-intentioned, tend to result in an inappropriate and unnecessary micro-management of the way banks conduct their day-to-day activities. Even a cursory review of that onerous statute would suggest a myriad of opportunities.

With those points made, let me now turn to the regulatory restructuring proposal put forward by the Treasury. To begin with, my colleagues and I share the view of the U.S. Treasury that there is need for reform. The current regulatory structure of four separate agencies supervising insured depository institutions undeniably results in duplicative examinations and overlapping responsibilities that are not only burdensome and inefficient but terribly confusing to the banks. Something should be done to correct this situation. Actually, the current environment, with its particular sensitivity to the costs and burdens of government regulation, perhaps offers an especially good opportunity to achieve that end and I sense that

Congress is willing to act favorably if offered a rational proposal.

The Treasury's proposal to address the shortcomings I have just cited would combine the authority currently vested in the four bank and thrift regulators -- that is, the Office of the Comptroller of the Currency (OCC), the Federal Reserve, the FDIC and the Office of Thrift Supervision (OTS) -- into a single agency. On the surface, the proposal has a seductive appearance of simplicity and enlightened government reform. Closer examination, however, reveals that it is seriously flawed.

That proposal, by removing the Federal Reserve from the bank supervision process, would seriously compromise the central bank's ability to carry out its responsibilities for resolving crisis situations in the financial system and to formulate and conduct monetary policy. My colleagues and I believe that a daily hands-on involvement in supervisory matters is essential if we are to be able to move quickly and effective to deal with financial crises when they arise. In a time of financial crisis there is no leisure to study someone else's analyses. The central bank must move quickly and decisively, often in a matter of hours. Penn-Central, Drexel, the 1987 market crash, and the S&L runs in Maryland and Ohio are good examples.

We also believe that the Federal Reserve adds important value to bank supervision because it brings to the process a unique perspective gained from carrying out our other central bank responsibilities. I believe the framers of the Federal

Reserve Act recognized the important synergies to be gained from having the central bank actively and directly involved in bank supervision. In the Act's preamble they wrote that one of its purposes was, "to establish a more effective supervision of banking in the United States." That says it all.

Another serious flaw in the Treasury's proposal is that the single regulator would result in unintended but seriously adverse consequences. As Chairman Greenspan has noted, a monopoly regulator would surely become entrenched and inflexible -- as has proven to be the case with other monopolies. And that inflexibility would be all the more worrisome because the regulator would not have responsibility for economic stabilization. Thus, it might well be inclined to swing between extreme toughness and ease as it reacted to cyclical complaints. Such swings in supervisory policy could tend to exacerbate instabilities in the economy. A review of one agendy's S&L supervision is illustratsive of this point.

The establishment of a single federal regulator would undermine our traditional dual banking system. Indeed, without a choice of federal regulators, the dual banking system would become merely an historical artifact. Under a single regulator the opportunity for useful regulatory experiment and the safety-valve protection against inflexible supervisory policies would be lost.

In short, it is important that the central bank, with its responsibilities for economic stabilization and crisis management, have a significant and meaningful role in bank supervision. While some consolidation of the banking agencies is appealing creating only one supervisory agency could produce inefficiency and rigidity and ultimately destroy the role of states in bank supervision under a system which has served the country well for 131 years. Incidentally, we would oppose a single regulator even if it were the Federal Reserve.

Taking these points into account, I have developed, in close consultation with my colleagues at the Board, a proposal that I believe will achieve most, if not all, of the goals of the Administration's plan without having the adverse consequences that we see.

My proposal essentially consists of five components. First, merge the Office of Thrift Supervision and the Office of the Comptroller of the Currency as has already been recommended by many observers. Currently, they both report to Treasury. Second, remove the FDIC as an examiner of healthy institutions and focus its energies on the insurance function -- that is, on assuring that the fund's financial strength is maintained through the collection of adequate premiums and by the prompt and cost-effective resolution of failed banks and thrifts.

Third, reduce regulatory burden and duplication by having one, and only one banking agency, responsible for performing a comprehensive examination of each banking organization -- that is a holding company parent as well as all its bank and nonbank subsidiaries. That change eliminates a burden that many banking organizations find particularly objectionable. Responsibilities would be divided between the Federal Reserve and a newly formed Federal Banking Commission comprising the newly merged OCC and OTS. The Commission would examine any organization whose lead, or largest, depository institution is a national bank or thrift. The Federal Reserve would examine any institution whose lead bank is state chartered.

Fourth, make an exception to the rule of only one examining agency per banking organization in the case of a group of banking organizations that are particularly important to the stability of the financial system -- 35 or so, perhaps. For those institutions, the Federal Reserve would conduct examination of the holding company and its nonbank subsidiaries, as it does now. Importantly, the insured depository institutions of these organizations would still be examined by only one of the two agencies depending on whether the lead bank has a federal or state charter.

Fifth, keep the Fed as the rulemaker for bank holding companies and the supervisor and regulator of foreign banks operating in the United States.

For insured depositories, the Banking Commission would write rules for national banks and thrifts while the Fed would write federal rules for state banks with the requirement that both agencies make their rules as mutually consistent as possible.

The key benefits of my proposal can be summarized as follows: First, it reduces the number of federal regulators from four to two. Second, it further reduces regulatory cost by achieving one examiner per organization. Third, it maintains the healthy process of dynamic tension in bank rulemaking but with fewer regulators, reducing the chance of delay and stalemate. Fourth, it preserves the dual banking system by having separate federal supervisors and regulators for state banks and national banks and allowing banks to continue to have a choice of federal supervisors through a change of charter. Finally, it does not dilute the ability of the central bank of the United States to forestall and manage financial crises, to formulate prudent monetary policy, and to influence the development of supervisory and regulatory policy.

In conclusion, both the economy and banking system are continuing to improve, and the near-term outlook is favorable for both. However, we can be assured that there will be challenges and crises to face in the years ahead. Let us hope that when 1994 draws to a close we will have a central bank that is as fully able to perform its role in the economy and in the financial system as it is today. We intend to make every effort to assure that result.

#