

**FOR RELEASE UPON DELIVERY
THURSDAY, OCTOBER 14, 1982
10:30 A.M. EDT**

NOTES ON THE BANKING SCENE

Remarks by

Henry C. Wallich

Member, Board of Governors of the Federal Reserve System

at the Annual Meeting of the

Federal Reserve Bank of Boston

Boston, Massachusetts

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It is a pleasure to be able to address you here on the occasion of the 58th Annual Meeting of the Federal Reserve Bank of Boston. In the banking business, we are living through what an ancient Chinese proverb, expressing something less than good will, refers to as "interesting times." By another piece of Chinese wisdom, I see in our present situation a combination of danger and opportunity, although I do not see any crisis. As we look at the problems we face, we should remember also that we are building a more flexible and more competitive banking system, in an economy more free of inflation and with better prospects of growth than we have seen in many years.

International Lending

First, I would like to say a word about the international banking situation. Several important developing countries are experiencing difficulties in meeting their commitments. In assessing such situations, we must remain aware that fundamentally these economies are viable. It is

not a question of lack of resources to maintain debt service, but of the right policies. In some cases, current-account deficits have been allowed to get out of hand. The world recession has been an important factor, but so has been the very easy availability of international bank credit. There are lessons here for both borrowers and lenders.

It should be clear that the best way of correcting a period of excessive credit expansion is not to cut off credit altogether, even though the terms of lending may well stiffen. The debt burden, for some countries, has become heavy because it was allowed to grow much faster than the growth of their economies. By the same token, however, a growing economy can carry a growing debt burden, so long as the two move more or less in step.

We must remember also that there are considerable differences among developing countries. Difficulties experienced by a few countries need not call in question the creditworthiness of all the others. There is a need for a discriminating analysis of sovereign risk on the part of the bank engaged in international lending.

Finally, all banks need to remember that their actions in troubled situations impinge on all other banks. Their interests will be best served if they stand together in defense of a common position. The chance that any one bank would benefit by acting on its own to the detriment of the others is slight. United action has by far the better chance of success where dealings with a troubled borrower are concerned.

There is a lesson, and more than one, to be drawn from this situation for the future. The lesson is not, I believe, that developing countries are not creditworthy. One lesson is that more careful work needs to be done in

analyzing this creditworthiness, and that banks should seek out and make available to each other the necessary information. A second lesson is that lending should not exceed the rate of growth of the borrowing country once a certain debt level has been reached, as I have already said. A third lesson is that loans tied to specific investment projects are more likely to promote growth and provide the means for debt service than loans to finance general budget or balance-of-payments deficits. Finally, the terms of the loans, including fees and spreads, should be adequate to avoid dilution of the lending banks' capital. Indeed, they should provide some cushion against possible debt service difficulties. Finally, as I have said on other occasions, I believe that thought needs to be given to the development of a loan insurance scheme for international lending.

Legislation

One of the opportunities of our times to which I referred earlier appears in the guise of the Garn-St. Germain Depository Institutions Act of 1982. It is a tribute to the democratic process that this bill was able to pass, after cliffhanging struggles. Evidently it is not true that the financial sector of our economy is so riddled with discord that a majority can be found against every legislative proposal, although occasionally it appeared that way.

From a banker's point of view, the old saying applies "you win a few, you lose a few, and a few are rained out." In the "rained-out" category, one might put revenue-bond underwriting, which did not get included in the legislation but may be resuscitated next year. Among the "wins" for bankers

one would list the new instrument capable of competing with money-market funds that the DIDC (Depository Institutions Deregulation Committee) is mandated to provide, about which I shall have a couple of remarks in a minute. Also in that column there is the termination of the differential that thrift institutions can pay above bank-paid interest at the latest by the end of 1983. There is some degree of preemption of due-on-sale clauses. There is the increase in the national bank loan limit to a single borrower to 15 percent, and, if secured, to 25. There are broadened powers for bank service corporations with an as yet not well-defined potential for new activities. There is, outside the Garn-St. Germain Act, the export trading company in which bank holding companies may invest. Parenthetically, I want to remind you that I am listing these legislative goodies as they might appear in a banker's perspective, not necessarily in that of the Federal Reserve. Finally, for the hopefully very few banks that might encounter trouble, there is the "regulators' bill" for interstate and interindustry acquisitions of failing institutions. For banks with a high mortgage component in their portfolios, there is eligibility for capital support through the income capital assistance route.

Less enthusiasm will be felt by bankers for the expanded thrift powers, the failure to provide additional override of state usury laws, and the severe limitation of new insurance activities by bank holding companies.

From an overall point of view, the legislation strengthens the financial system, helps it adapt to changing conditions, and enhances its competitiveness. Not every provision, to be sure, serves each of these purposes. There are compromises among objectives of public policy, just as

there are compromises among competing interest groups. The full implications of some of the provisions are not yet discernible. That is the case particularly of the new instrument that the DIDC is to fashion.

A Competitive Instrument

The new deposit account is to be "directly equivalent to and competitive with money-market funds." There are to be no constraints on its interest rate and maturity, and no transaction account reserve requirements, while three transfers and three checks per month are permitted. The minimum balance, according to the conference report, is to be not more than \$5,000.

This gives the bankers the option long desired to meet money-market fund competition. The question for many bankers would be whether they should pick up this option. First, of course, it will be necessary for the details of the instrument to become known. But the basic alternative is not likely to be affected by details. Each bank must decide for itself whether to be competitive with money-market funds at a high cost, involving possibly substantial conversion of existing core deposits to the new instrument, or whether it wants to protect its core deposits against too easy conversion. Different banks may arrive at different answers. Careful studies will be needed to arrive at decisions.

Over all, availability of the new instrument is likely to add to the pressure on bank earning positions. I believe that bankers will be well advised to view this development as just one in a series of changes in their cost structure that will result from progressive deregulation and eventual

elimination of Reg Q in 1986. Hopefully, this process will take place in an environment of diminishing inflation and, therefore, a declining longer term trend of interest rates. It will require bankers to reassess and readjust the structure of their interest and noninterest costs as well as their interest and noninterest receipts. I believe, however, that an effective reassessment is entirely within the range of possibilities and that well-run banks will continue to be profitable.

Interest Sensitivity

This leads me to say a few words about interest sensitivity. Obviously the new account that Congress has mandated will increase the interest sensitivity of liabilities to the extent that it substitutes for liabilities still under regulation. It means one further step along the road on which bank balance sheets have moved for many years: increasing sensitivity of liabilities brought about by market factors and deregulation, and an effort to catch up on the asset side by substituting flexible- for fixed-rate assets and by shortening maturities. Happening as it did in an environment of rising interest rates, many banks have experienced an agonizing race between their sensitive liabilities and assets, with the assets sometimes in danger of lagging excessively. For large banks, reliance on interest-sensitive liabilities has been a way of life for a long time. Many smaller banks, however, have been pushed into this race only since 1978 as the explosive growth of money-market certificates moved them toward a negative gap, i.e., sensitive liabilities exceeding assets.

In an environment of falling interest rates, to be sure, negative gapping is profitable. If one believes, as I do, that inflation will be defeated, the long-term trend of interest rates is down. But short-term rate movements are harder to predict today than ever. Interest rates in recent years have not always moved with the business cycle, as they could be counted on to do pretty well in years gone by. Money-supply targeting by the Federal Reserve, while our best assurance of ultimate success in the effort to bring down inflation, can involve short-term interest-rate fluctuations that are not foreseeable. To complicate portfolio management further, the upward-sloping yield curve which was a reliable feature of the structure of interest rates since the depression of the 1930's, has become a sometime thing. Parenthetically, I might add that during the 1920's, a period mostly of marked price stability, the yield curve frequently was inverted.

In short, we seem to be living in a world in which the bank's ancient function of maturity transformation, i.e., converting relatively plentiful short-term money into relatively scarce long-term money, has become more than relatively hazardous. Maturity-matching is the course of wisdom, whether we look at credit portfolios that inherently are long term, such as mortgages, or at inherently short-term credit such as commercial loans.

This puts a premium upon the analysis of interest sensitivity. I do not believe that data on published bank statements are at all adequate for the purpose. A proposed new supplement to the call report, which is expected to be implemented in 1983, provides for more adequate, though still summary, data in this area. But each bank must develop the analytical tools needed

to measure interest sensitivity, if necessary by employing numerous and very narrow maturity categories that fit the nature of its business.

Purchased Funds

Interest-rate-sensitive liabilities have the advantage of being relatively stable -- the bank can retain them if it is willing to pay the price. It is the interest-insensitive deposits that are subject to disintermediation when interest rates rise. But there is a difference even among types of interest-sensitive funds. Some come from the bank's community and from a stable group of customers. Others come from the anonymous market. The first are in most cases probably cheaper and very probably more stable.

We have observed repeatedly that when a bank experiences significant losses, the suppliers of purchased funds make one of two choices. They may leave their funds with the bank, but charge a premium. Or else they may leave the bank altogether. The prospect that withdrawal rather than an interest premium will be the answer of late has increased owing to the growth of money-market funds. Given the nature of their business, and the lack of capital and reserves, they may find it necessary to demonstrate to their holders that they are not taking even the slightest risk. Hence the apparent tendency of many funds not only to discontinue the purchase of CDs when there is an occasion for a premium to appear, but also to dispose of existing holdings in the market, which, in turn, tends to increase the premium.

These conditions make reliance on purchased funds something that needs to be given thought. Use of purchased funds -- federal funds purchased, REPOs, large CDs, and parent-company commercial paper -- does not seem to have

increased very significantly relative to assets on the average of recent years, but it has increased somewhat. It is in this area, of course, that interest-sensitivity analysis is needed.

Research done at the Board seems to indicate that reliance on purchased funds is related to branching, in an inverse sense. It seems plausible that a bank with a branch system has more core deposits to draw upon than one without. Funds that, in a country with large branching systems like Canada or England, move to the national money market through internal channels, in the United States tend to move there via the federal funds market and other sectors of the money market. Accordingly, the large American banks probably are exposed to greater volatility of liabilities than their counterparts in countries where branching is the rule.

Given this structure of our banking system, one would assume that the market would generate a premium for purchased funds of a higher degree of stability, i.e., those with longer maturities. An upward-sloping yield structure at the very short end of the market would be the typical consequence. This, however, is not always the case. Given the recent experience with the volatility of purchased funds, this is another area of the financial system that requires more thought and analysis, both by bankers and regulators, than it has received.

Capital Adequacy

Most of my comments so far have dealt with various aspects of bank soundness. The bottom line of bank soundness is capital adequacy. I want to end my remarks on this subject. Personally I have always thought that there

is a better way of protecting bank creditors than to require each bank to have a large capital. That better way would be more comprehensive insurance. But that is not the direction in which events have gone. Therefore, I believe that the present regulatory push in the direction of greater capital adequacy, especially for the largest banks, is necessary. The climate in one respect is favorable: diminishing inflation is slowing the growth of bank assets and liabilities and in that sense makes it easier to achieve adequate capital. The preceding thinning out of bank capital ratios was the result not only of expansionist bank policies, but also of an inflation for which they were not responsible. There are opportunities for capital improvement now, even though there also are difficulties.

Banks can improve their capital ratios through a variety of channels. They can sell securities, they can slow down the growth of their assets, they can try to widen profit margins, and they can limit dividends. Some of these are more feasible at this time than others, and some are more in keeping than others with the improvement in economic conditions in which the banks have a stake. As in the early part of my remarks, when I discussed the role of banks in international lending, now at the end of this talk I revert to the need for bankers to look not only at their individual situation, but at the broader picture.