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CAPITAL AND DIVERSIFICATION: THE PILLARS OF BANK SAFETY

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Since coming to the Board two years ago, I have found regulatory issues to be enormously fascinating and challenging. Unlike monetary policy, where decisions are made affecting the economy for the next year or two, regulatory changes affect the future of the banking industry for decades to come. For instance, the Glass-Steagall Act is well over half a century old, but it is still the cornerstone of our current financial system -- although many would argue it is best described as a millstone around their necks.

Today I would like to update you on some of the regulatory issues currently being considered by the Board. Some of the issues are placed deliberately on the Board's agenda as part of the "rule-making" process, while other issues on the agenda are the result of bank applications or other bank actions forcing the Board to act.

Instead of telling you the Federal Reserve's position or my position on this or that issue, let me outline some of the basic principles that I have found useful in analyzing regulatory issues.

When confronting regulatory issues it is important to maintain a consistent perspective and a coherent view of the world. This is sometimes more difficult with respect to regulatory issues than it is in monetary policy. Everyone knows that it is the basic function of a central bank to follow policies that will foster price stability and economic growth.

In the regulatory arena, the maintenance of a stable financial environment constitutes the basic goal. But translating that objective into a precise action program is a rather complex task.

If I were asked to single out the two factors most important for the health of the financial system, I would name capital and diversification as the pillars of bank safety. In addition, equity and flexibility are also important.

<u>Capital</u> is of central importance because capital represents the cushion enabling financial institutions to absorb the losses that result from unforeseen events.

However, we should recognize that capital invested in a financial institution has to earn a sufficient rate of return to induce people to place their own funds at risk. Thus, there exists a creative tension between the quest for more safety, which presumably could be satisfied if banks were to invest all their funds in T-bills, and the quest for higher earnings, which, by necessity, involves a certain amount of risk. Managing that equation is the essence of good banking, as it provides the income to earn, or attract, the capital that makes the bank safe.

Perhaps the single most important tool for the banker to achieve that goal is diversification. The diversification of assets, liabilities, and earnings sources not only limits the exposure of an institution to any singular event, but enhances the safety of the entire financial enterprise, the safety of the depositors, and the stability of the earnings stream. In a way, diversification is the essence of financial intermediation and provides much of the value added by a financial enterprise.

I also mentioned equitable rules as an important regulatory objective, because without equity there can be no fair competition. This applies to the equity of the rules applicable to the various domestic as well as the international institutions that compete in the same marketplace. Equity also requires that the regulations fit into a consistent framework and be implemented in an impartial manner.

But with regard to all rules, a certain flexibility is required as well so that the financial system can respond to the needs of the economy and to unforeseen developments.

Flexible rules allow individual financial institutions the leeway they need to adapt to the changing requirements of their customers over time. That is, regulatory changes should be evolutionary rather than revolutionary. Uncertainty and abrupt change are not conducive to the development of trust and financial stability, without which the investments necessary for growth simply will not be undertaken.

That, then, is my regulatory ABC: All bank regulation (that's the A and the B) should emphasize adequate capital (here is the C) and diversification (my D) in an equitable and flexible manner. That takes me through the letters E and F.

SAFETY THROUGH ADEQUATE CAPITAL

Let me now take you through the various issues on the regulatory agenda and show how they relate to capital and diversification as the two pillars of bank safety.

Risk-Based Capital

These days, no discussion of regulatory issues can begin without mentioning the new risk-based capital rules proposed by the Basle Group of bank supervisors. While former international supervisory agreements typically relied upon reciprocal recognition of national supervisory standards, the proposed risk-based capital framework represents the first attempt to formulate a global set of regulations.

The proposal provides for the same definition of capital, the same risk asset classes, and the same leverage ratio for all internationally active banks.

The Basle framework sets a 4 percent equity capital standard and an overall 8 percent capital standard to be achieved by 1992. It also sets an interim target of 3.25 percent equity capital and 7.25 overall capital by the end of 1990.

In the meantime, the current 5.5 percent primary capital standard is still applicable. However, when considering capital adequacy of a banking organization, the Board may also consider, among other factors, how the organization's capital conforms to the new risk-based standard. Such considerations may be given particular emphasis in the case of foreign bank applications whose capital ratios, as reflected in their published financial statements, do not meet the current U.S. primary capital standard. As a matter of fact, the Board has recently approved several foreign applications, when an applicant's capital appeared to be adequate under the new risk-based capital standard.

The proposed risk-based capital standard has been put out for public comment, and certain concerns have been expressed about the detailed implementation of the proposal. Let me comment on some of the issues without committing the Board or myself on the specific details.

Holding Company Capital

The issue that has probably attracted the most attention is whether the risk-based capital ratios should be applicable both to banks and bank holding companies. There is little difference, as long as we talk about pure bank holding companies. In that case, if the sum of the individual banks' capital requirements are matched by the capital requirement of the holding company, no controversial issues are raised, because double-leveraging is not present.

But when holding companies borrow to help finance their acquisition of bank stock, the question of double leverage and the degree to which it should be permitted arises. In addition, with the broadening of the permissible holding company activities that has already taken place, and the further broadening of powers envisaged in the Proxmire Financial Modernization Act, controversial issues arise regarding the applicability of the capital requirements to non-banking activities. As you know, the Senate bill would exclude both the capital and the assets of a securities subsidiary from the calculation of capital adequacy for the holding company.

Most people would probably agree that the holding company's capital should not be less than that required for the banking subsidiaries. The more difficult question is how much additional capital should be required for the non-banking activities that the holding company engages in. That question the Board will have to resolve soon.

Goodwill as Capital

There is also the related question of goodwill. At the present time goodwill does not count toward the required capital in the bank. Furthermore, in processing applications the Federal Reserve has long followed the practice of routinely excluding pure goodwill from a holding company's capital. But we will consider intangibles that can be associated with an identifiable earnings stream. If one compares the existing capital requirement excluding goodwill with the proposed 4 percent equity standard, it becomes clear that the new standard is really not more burdensome, as far as goodwill is concerned.

Reserves as Capital

Furthermore, general reserves may be included in Tier II risk-based capital without limit until 1990, up to 1.5 percent until 1992, and up to 1.25 percent after that. This long phase-in period should give any bank an opportunity to establish appropriate reserve levels.

Source of Strength Policy

As you will garner from this extended discussion of capital requirements, the Federal Reserve considers adequate capital as central to bank safety. Last April, the Board reiterated its long-standing policy that the holding company should serve as a source of strength to its subsidiary banks and stand ready to provide additional capital funds in times of financial stress.

Failing Subsidiary Banks

This principle also applies in situations where one or several subsidiary banks may be in danger of failing, while other subsidiary banks continue to function well. Obviously, the financial integrity of the federal deposit insurance fund is involved here as well.

I also believe that an equity issue between branch-banking and unit-banking states is at stake here. One cannot allow owners to walk away from their obligations in unit banking states, while they would not be able to do so in branch-banking states.

Mergers and Acquisitions

Capital adequacy is of central importance in merger and acquisition cases. The Board has long believed that banking organizations undertaking significant expansions should maintain capital well above the regulatory minimum. In that context, we have discouraged the use of creative purchase accounting techniques that might be used to justify a payout of capital funds to shareholders. Obviously, this point also bears on the earlier discussion of goodwill as a capital asset.

Dividend Policy

The payment of excessive or unearned dividends by organizations whose capital position needs strengthening is another practice that we wish to discourage and stand ready to prohibit in extreme situations.

SAFETY THROUGH DIVERSIFICATION

Let us leave the capital adequacy issues and turn to actions that may increase the safety and soundness of the banks by providing greater opportunities for diversification of activities, assets, and earnings.

Increased Product Diversification

I stated at the outset that diversification is a key risk-reducing technique. Following that principle, the Board last year liberalized the rules regarding securities activities in subsidiaries and has now been upheld by the Supreme Court. The Board also endorses the removal of Glass-Steagall barriers by Congress allowing banks to offer a broader product range to their customers.

International Investment Powers

In the international arena, the Board has recently liberalized Regulation K to permit banks to engage in debt-to-equity swaps in developing countries with debt service difficulties. While in earlier days Regulation K was often cited as a block to progress in that area, things have been remarkably quiet since the liberalization was undertaken. It would be helpful to see more active use of the opportunities for debt-equity swaps to reduce the debt service problems of the developing countries.

Foreign Underwriting Powers

As you know, the limitations of the Glass-Steagall legislation do not apply to the foreign activities of U.S. banks. American banks are currently permitted to underwrite non-equity securities abroad without limits. However, Regulation K places a $2 million limit on equity underwriting abroad. We have recently granted approval to Security Pacific to underwrite up to $15 million in several foreign subsidiaries. We will review this issue to determine whether these limitations should be relaxed further.

Foreign Exchange Activities

Let me note that the draft bill in the House that would prohibit banks that are affiliated with securities companies from conducting their foreign exchange business in the bank would be counterproductive. Foreign exchange is an integral part of the banking business and the customary reciprocal credit lines among banks are based upon the capital position of the bank. Prohibiting American banks from engaging in foreign exchange activities would place them at a competitive disadvantage against foreign institutions and could have a negative impact on the profitability of American banks. Let's not tie our hands behind our backs in this intensely competitive international arena!

Real Estate Powers and Healthy Thrift Acquisition

As you know, broader real estate powers and the ability to acquire healthy thrift institutions are two issues that are of continuing interest to the Board. While we will review these issues from time to time, Chairman Greenspan has stated that we will inform Congress before taking action on these issues.

Interstate Banking

Greater geographic diversification should also enhance the safety of the banking system. This point is illustrated forcefully by the high failure rates encountered by insufficiently diversified unit banks in the agricultural and energy producing regions of our country. This situation contrasts with the one prevailing in other countries, where nationwide banking has increased the safety and soundness of the financial structure through diversification.

While the states have taken the lead in this area, interstate banking is by its very nature an area where a national policy is needed. Let's apply the interstate commerce clause, which has been the basis for a prosperous and competitive national marketplace, to the banking industry as well! Interstate banking will enhance diversification opportunities, and thereby increase the safety and soundness of the banking system.

In addition, we face equity and flexibility issues here, because current law prohibits Americans to do business as they please regardless of their domicile. Americans should be able to do business anywhere in this nation and not be subject to artificial geographic barriers. It makes no sense that American banks are free to do business around the world, but are not allowed to service the customer in an adjacent state.

Conclusion

As I stated at the beginning, our regulatory agenda is full and our life as regulators is interesting and challenging. I hope that I have shown that we are trying to make progress in enhancing the safety and soundness of our banking system. I need not tell you that this is a most urgent task. Last year, almost 200 American banks failed. This constant hemorrhaging has to cease if we are to maintain a stable financial system and if we want to be a leader in international financial markets.

I have emphasized the enhancement of safety through capital and diversification, while providing for equity and flexibility for the banking institutions.

In the capital area we will soon implement a global risk-based system of capital adequacy that should also enhance fairness. I have talked about the holding company as a source of strength for the bank and outlined our policy with regard to reserves, dividends, and mergers and acquisitions.

At the same time, we are trying to enhance bank safety by providing increased opportunities for diversification of earnings and assets. New international investment and underwriting powers will move us closer to that goal. Congressional action is needed to remove the Glass-Steagall barriers and in consolidating the move towards interstate banking.

All this has to be accomplished while providing for equitable treatment of all domestic and foreign competitors and permitting enough flexibility so as not to stifle the creativeness and inventiveness that we all need if we are to prosper in the future.