

Remarks by
John P. Laware
Member, Board of Governors
of the
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I have been asked in these remarks to comment on the banking system or perhaps, more broadly, the financial system, and on the current and future outlook for small and medium-size banks, particularly minority banks. I am happy to do so, but I must impose some caveats, the purpose of which I am sure you will understand.

You have before you today the oldest "new kid on the block" in the Federal government. I am still trying to find my way around the halls and remember the names of the people I meet. I would not presume, therefore, to speak in any way

for the Board of Governors. In any case, the Chairman is the proper spokesman for the Board, not I.

So, let it be understood that the opinions expressed by me are mine alone, not those of the Board. They have been developed by me over thirty-five years of broad experience in the banking system and represent my best judgment of the situation today and the outlook for the years immediately ahead.

Let's start with the broadly defined financial system. I would include in that term commercial banks, thrift institutions, credit unions, non-bank banks, mutual funds, investment banks, securities brokerages, finance companies, and the securities, commodity, futures, and currency exchanges. In short, the financial infra-structure of our economy and a large part of the world economy.

In the last fifteen years or so that system has undergone enormous change and has been challenged more severely than at any time in the last fifty-five years.

Consider with me the changes:

- First, instant global communications have integrated our money and capital markets with those of every other trading center around the world. As a result, currencies, securities, commodities and futures contracts of all kinds are being traded on a twenty-four-hour basis. If you miss the closing bell in London, New York is open and if you don't like the tone there, wait a bit and Tokyo will be up.

- Second, integration of financial markets has underlined the growing inter-dependence of national economies. A sluggish economy in West Germany or the United States affects the major trading partners of those countries and tends to upset equilibrium in trade and current account balances as well as currency exchange rates. Phenomena like the two OPEC-induced energy crises in the seventies send shock waves around the globe and send governments and private sector entities scrambling to restore balance. Incidentally, one of the side effects of OPEC price increases was a glut of so-called petro-dollars. Eventually those petro-dollars were "recycled" in the form of loans to developing countries -- mostly in Latin America -- and look at what that altruistic efforts spawned.

Only a few years ago we could brag that the United States economy was relatively self-contained. Today with increased dependence on foreign markets for energy, some raw materials, and large quantities of

manufactured goods, America is no more isolated economically than it is diplomatically from the rest of the world.

- A third startling change is the degree of complexity which has developed in our financial system. Thirty-five years ago the balance sheet of a commercial bank was a very simple seven or eight lines on the asset side and two or three on the liability side. Assets were essentially cash, U.S. government and municipal securities, loans (usually 90-day notes of companies to carry inventory and receivables), and a modest amount of fixed assets (typically a fortress-like bank building built in the twenties and almost fully depreciated).

The liability side of the balance sheet was essentially demand deposits, some passbook savings and capital, all in the form of equity. And, in 1953 the only United States bank which had its stock listed on the New York Stock Exchange was the Corn Exchange Bank in New York. Even that listing was removed in 1954 when the Corn Exchange was merged into Chemical Bank. In fact banks didn't have outside accountants until the sixties and most didn't even publish an income statement. The negotiable certificate of deposit was created around 1960 by Citibank and publicly held debt didn't appear in bank capital accounts until well into the 1960's.

And, just think of all the different, imaginative liability instruments we have created to replace demand deposits and passbook savings in order to fund our banks. Everything from federal funds through NOW accounts, MMDAs and IRAs to Eurobonds and adjustable-rate preferred stocks.

Another thing, management of banks is no longer inherited by the good-looking lending officer with the best new business record. Today bankers not only search out the best managers outside their own organizations but they have to grow them inside too through well thought out programs of management development which identify, early in their careers, the individuals with high potential for general management. Those potential stars must then be exposed to the education and experience that will ensure that they are ready when they are called. If they aren't, there is trouble with a capital T.

But, if the changes in commercial banking have been dramatic, the changes in the other sectors of the financial system have not been far behind. The hectic pace of creation of new financial instruments has necessitated creation of new markets to trade those instruments and cadres of new classes of professionals who understand them well enough to trade them: Mortgage-backed securities, interest-rate futures, interest-rate swaps, options, repos, Eurodollars, junk bonds, and on and on. In addition, deregulation, particularly of interest rates, has not only

created new challenges for bank managers, it has also complicated the analysis, formulation and execution of monetary policy by the Federal Reserve.

. While we can't examine in detail all of the changes in the system in recent years we would be derelict if we didn't look closely at the so-called thrift industry portion of the system.

Mutual savings banks, more significant in New England, New York and the Northeastern United States than elsewhere, have been around for more than one hundred and fifty years. They were created to provide a safe place for farmers and working people to keep money and earn a modest return.

The savings and loan industry, both mutual and stockholder owned, was fostered as a vehicle to make home ownership more generally available by channeling the savings of individuals into financing the building and ownership of homes. Ceilings were placed on the interest rates that could be paid on those savings in order to assure low rates of interest on the mortgages the thrifts provided -- again to encourage home ownership by all economic strata. That, of course, required ceilings on what commercial banks could pay since it was thought that deposits in commercial banks went only into business loans or loans to individuals for purposes other than home ownership.

Those conclusions and the actions they prompted were probably fairly accurate in the 1930s, but by the time Congress and the regulators got around to taking off the wraps, the game had long since changed. Commercial banks had become a major factor in home finance and the uneconomically low rates on mortgages made the thrifts, with most of their eggs in one basket, especially vulnerable to deregulation of deposit interest rates.

Suddenly funds costs far outstripped yields on assets. In a knee-jerk attempt to ameliorate the thrifts' plight, state and federal regulators permitted the thrifts' broader asset powers, greater branching freedom and unrestricted access to funding sources at whatever prices the market demanded. Faced with loan and operating losses, mutuals converted to stock companies in order to replenish decimated capital accounts, and pursued commercial lending. S&Ls who couldn't raise funds in the market had to fall back on Federal Home Loan Bank advances and FSLIC notes to remain nominally viable. As we all know, the chickens have all come home to roost at the same time. The plight of the thrifts was further aggravated by the farm belt problems of three or four years ago, the rust belt problems of the last five years or so, and the oil patch problems since the collapse of oil prices in the mid 80s. A once proud and critically important industry is now on its knees.

Those then are some of the changes to our financial system -- and I emphasize some. I haven't touched on the computer and communications technology which has made much of this change possible. Nor have I talked about the qualitative changes which have injected new factors to the equation. For example, leveraged buy-outs, proxy fights and competitive unfriendly tender offers. Those three were comparatively rare birds only a few years ago but increasingly common today. And the accelerating geographic consolidation as interstate banking becomes more widespread presents new challenges and opportunities for those institutions which choose to remain independent.

Let's turn now to the challenges to the financial system about which I spoke earlier.

. Deregulation. You may be surprised that I mention deregulation as a challenge, but after 50 years of rigid restraints on banks as to how they could raise liabilities and how much they could pay for them, bank managers were inexperienced in raising liabilities in a free and highly competitive market. Lots of mistakes were made. High rates were paid for market share which couldn't be offset with earnings rates on high quality assets. Maturity schedules on liabilities were short in order to attract funds while the market was demanding longer maturities for loans and longer term investments were the only ones capable of

justifying the cost of money. Bank managements in a sense were like a long-term peacetime army suddenly thrown into combat in a world at war. The first skirmishes are painful and the losses in learning the differences between blank cartridges and live ammunition are irretrievable.

. The blurring of lines between banking and investment banking and commerce have created competitive pressures hard to deal with under the best of circumstances. Non-bank banks have sallied forth onto the field with a different set of rules and different weapons not available to real banks. Mutual funds have attracted deposits from banks and thrifts with the lure of higher interest rates. And those higher rates are earned by redepositing the same funds back in banks at money market rates of interest. Foreign banks operating at regulatory parity with U.S. banks in the domestic markets but with different regulatory and market restraints at home have underbid U.S. banks until the rate spread has narrowed markedly and U.S. bank earnings are under severe pressure. For example, a bank with a .40 return on assets in Japan may be considered a fine performer, while a U.S. bank with that kind of return would be suspect in the securities markets and a focus of regulatory attention in the United States.

In addition, securities firms and insurance companies have encroached on the lending and financing territory of commercial banks, while on the other hand bank holding

companies have been expanding into certain parts of the securities business through more liberal interpretation of Glass-Steagall restrictions by the principal regulatory authorities. In the process of "leveling the playing field" the shape and size of the field are also being changed.

. Another challenge has been the sensitivity of the system to external events not of the system's making. For example, the crash of huge once invincible Texas banks triggered by a softening of the state's basic industry -- petroleum. The oil price collapse made uncollectable other loans on real estate and to businesses which were dependent on oil to shore up the whole economic structure.

But, no economy is more a one-industry economy than a farm town in Nebraska or Iowa or Kansas. In those farm communities agriculture supports the whole economic structure from real estate to shopping centers to gas stations and municipal governments. When farmers are in trouble, so too are the grocer, the pharmacist, the haberdasher and particularly the banker, who lends to them all. The collapse of farm prices triggered the collapse in farm land values and put the loan portfolios of hundreds of Great Plains banks under water. Similarly, generally depressed conditions in steel, automobiles and other heavy manufacturing industries seriously depressed the economies of much of the northern midwest, even at a time when much of

the rest of the country was doing well. The banks which financed the economies of those states were under siege.

. I have already mentioned the problems of the thrift industry. Those problems were certainly aggravated in certain locales by the conditions I have just described.

. Another challenge arose in 1982, and is still with us today. It is a crisis related to loans to lesser developed countries and their inability to repay them given the payment schedules imposed, the debt service uncertainties of floating interest rates and the lack of deposit and capital flows to the debtor nations. Much progress has been made in the last six years in building reserves, raising additional capital and shoring up the defenses of the banking system to sovereign defaults. But the basic problem of restructuring these huge debts in such a way as to give the debtors some realistic chance of repayment has not really been faced, and LDC debt remains a genuine threat to the integrity of the system.

. Perhaps the most dangerous challenge to our financial system was posed by the events of October 20, 1987. In only a few hours, 25 percent of the values in the stock market were extinguished and the experience was repeated around the globe. Statistically, the crash was

worse than 1929. By all historical precedent we should now we in a blood-curdling recession. Instead we are in the sixth year of economic expansion with manageable rates of inflation and almost full employment.

What does all this tell us about our financial system. It tells us that it is sound and remarkably resilient. We have met enormous challenges and weathered them in style. Certainly there have been casualties and genuine heartache and economic imbalance related to those casualties. But the financial system remains healthy and vibrant. The safety mechanisms built into the system over the years have worked well.

A few examples: Insured depositors have not lost their funds in spite of more than 100 commercial bank failures a year in recent times. And through the "purchase and assumption" techniques developed by regulators and the insurance funds, financial services to communities have rarely been interrupted even temporarily and even in one-bank towns.

In striking contrast to its reluctance in 1929, the Federal Reserve System stepped in promptly during last October's market debacle to make sure there was sufficient liquidity to ride out the immediate crisis.

To level the international playing field and promote greater capital strength the regulators and central bankers of the leading industrial nations have joined in establishing standard risk-related capital requirements to be phased in over the next four years. This is a major step in international cooperation and further illustrates the global economic interdependence about which I spoke earlier.

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In general, then, I think our financial system is in good shape. It continues to be the most adaptable and creative financial system in the world. But some elements still need attention.

Further orderly deregulation is a must if American banks are to compete effectively with their international counterparts. While interstate banking is rapidly moving toward nationwide acceptance through action of individual state legislatures, the states acting individually cannot deal with the issue of securities powers, real estate brokerage, and insurance. The Congress must legislate in these areas, and the most urgently needed are broader opportunities for banks to offer securities services to their customers including underwriting and distributing corporate debt instruments, municipal revenue bonds, and commercial paper and sponsoring, managing and distributing shares in mutual funds. I believe the indications are that

Congress feels these are ideas whose time has arrived and favorable action on much of that program is imminent.

I also believe the consolidation of the industry will continue at an increased pace both interstate and intrastate. At the same time, I believe more new banks will be formed, including more minority owned and managed banks, in order to fill gaps in customer service left by consolidations which create banks with strategies which, by design or accident, ignore one or more market segments which might be very profitable. The new banks I am talking about are the niche-oriented banks. There have been several formed in Massachusetts and New England in the last 18 months and more are in the works.

In a special way, minority banks are classic niche banks. They were not formed to meet the needs of customers abandoned by other institutions. Rather they were formed to serve a customer segment which had never been properly recognized by the establishment banks. As minorities find greater economic opportunity and larger rewards this should be a lucrative niche indeed. And the customers of minority banks should be particularly loyal because the banks were there when they needed them, there when no one else seemed to care.

In this era of consolidation there are great opportunities for small and medium-size banks of all kinds.

Personalized service for all kinds of customers and continuity of coverage are the two most difficult features for the big guys to provide. For many customers though, those two features are more important than being able to say that they bank with a household name.

Opportunity for small and medium banks abounds, but there are obstacles to full achievement. Access to capital may be the most critical. Big Wall Street houses aren't much interested in underwriting an issue for a \$500 million bank. Ironically the expanded securities powers for the big banks may be the best answer as a capital source for smaller banks. What a terrific addition to correspondent bank services it would be to offer assistance in raising debt and equity capital for your correspondent.

The second obstacle is the ability to attract the best and the brightest to work in modest sized institutions. But even there it is not all gloom. Lots of bright young high school, college and business school graduates prefer smaller companies for the same reasons customers do -- personal attention and personal opportunity as opposed to being a number in some sprawling giant.

Finally I want to deal briefly with two major problems which are lurking out there, which must be dealt with -- the sooner the better -- and for which I have no easy answers. They are the LDC debt problem and the crisis in the deposit insurance funds.

The debt problem is less critical today than four or five years ago. Reserves are healthier, debt equity swaps have helped a little and some portfolios have been written off or managed down to less panicky levels. But the fact remains that most of these debtor countries can't make any real progress in debt reduction until capital and deposit flows begin again and their economies grow enough to generate the reserves to service the debt.

Unmanageable debt service and unstable political conditions are not conducive to fresh investment or more lending. But we may be edging toward some kind of solution. Perhaps we should be thinking about exchanging short-term notes at variable rates of interest for long-term bonds at a fixed rate of interest with no principal maturities for 10 or 12 years in order to give these developing economies the time to develop. Under those conditions maybe interbank deposit flows would be re-established and fresh capital would be attracted. Certainly it is time to re-think our approach in some fashion, because what we have been doing simply hasn't solved anything.

On the deposit insurance question, we need action by the Congress, decisive action geared to long-term solutions, not band-aid measures such as the last time around. Essentially the so-called thrift industry is obsolete, but we can't wave a wand and wish it away. There must be an

orderly elimination of mortally ill thrifts through liquidation or sale to healthy entities. Then there must be a conversion of the remaining institutions to full-service banks. The process might take ten years or more but once the policy decision has been made to move in that direction it can be a coordinated development and need not threaten the system or any individual part of it.

A seductive stop-gap measure would be to merge the FDIC and the FSLIC. I hope that will be resisted. It would only weaken the FDIC without solving the problems of FSLIC. A possible non-cash solution might be to offer FSLIC securities to the public with some sort of Treasury guaranty rather than appropriate funds directly. To the extent that it buys time for FSLIC to liquidate foreclosed assets in an orderly fashion rather than a fire sale, the guaranty might never have to be funded.

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I have talked too long, but you gave me a big assignment. I am honored to have been with you today. Your organization has a vitality and purpose which many of your sister associations could use. You have fought long and hard for the things in which you believe. You have won some. I think you are on the brink of winning a lot more. Go get 'em!

Thank you.