LEGISLATION, THE ECONOMY, AND BANKING:
THE REGULATORS' PERSPECTIVE
Remarks by Robert P. Forrestal
President and Chief Executive Officer
Federal Reserve Bank of Atlanta
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I believe congratulations are in order for having survived 1991. It was truly one of the most difficult years for banking and the economy in my memory--and probably also yours. In the past, profits and growth came more easily to banks. Indeed, for a long while after World War II, when banks faced minimal competition from nonbank firms, the owner of a bank charter was almost guaranteed a stream of profits provided the managers of the bank were honest and minimally competent. However, competition has increased substantially, as you well know. Honesty and minimal competence are no longer sufficient to guarantee profits--and I might add that not even extremely competent bankers find it easy to succeed now.

Tonight, though, I am speaking with a group of people who have managed to survive in this competitive atmosphere, while also seeking out a strategy that may allow their banks to expand. Supercommunity banks is a new term coined, I believe, by our forum leader. In my view, successful banks in this category are the ones that combine the best of both worlds. They are keeping the consumer orientation of community banks as they begin to offer the big-time services of the superregional banks and to experience their economies of scale. From my perspective as a regulator, though, this newly evolving structure does raise concerns about two potential pitfalls that do not represent the best of both worlds, but rather the worst of any world:

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an emphasis on decentralization that could undermine strong credit controls and a focus on premium customers at the expense of a commitment to the Community Reinvestment Act (CRA).

Before I elaborate on these concerns, I have been asked to discuss the economy, as well as banking prospects and the legislative outlook--three rather large topics. It seems that just as supercommunity banks try to give customers all that they want, I must try to give a "superspeech" to encompass all that this group wants. For the sake of brevity, I will refrain from going into as much detail as I normally do on these topics.

Economic Outlook

In regards to the economic outlook for this year, I believe that, due to the slow start in this first quarter, the economy will grow at a moderate pace of around 1 1/2 percent on average. Since employment lags behind gross domestic product (GDP) and many businesses are consolidating, I think the jobless rate will remain pretty much unchanged from the average last year of 6.7 percent. Price pressures look more moderate than they have in some time, and the consumer price index (CPI) should turn out to be 3 percent or a bit higher as an annual average in 1992.

Generally speaking, the pace of business activity will accelerate gradually as current problems are worked through and more household and corporate income becomes available for spending. Of course, progress will not be even across the economy. The forces bolstering growth should be exports and consumer spending, particularly on services and, to some extent,

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nondurables. In addition, later in the year, we should see some increase in business fixed investment. Net exports should continue to provide support as our external position continues to improve, but the pace of expansion will be slower than in the last few years. The interest rate declines that have taken place should provide a boost to consumer spending through both lower rates for new purchases and increased discretionary income resulting from refinanced mortgages and equity lines. Nonetheless, spending growth will be quite modest compared to previous recovery and expansion periods. Even with lower interest rates, consumer spending is still constrained by high levels of household debt and the weak appreciation of housing--the principal asset of consumers.

I am sure that you are all familiar with the weaknesses in the economy. The construction industry suffers from lingering excess supplies due to past overbuilding as well as appropriate hesitancy among many lenders to finance new projects. Demographics are also contributing to the sluggish housing market. The aging of the population means there are not as many first-time home buyers as there were when we came out of the last recession in 1982. Besides the adverse demographics, we had eight years of expansion in which housing demand was very well met. That means very little pent-up demand developed during the recession. The latest new homes sales figures support this argument. In addition, although lower mortgage rates have induced a flood of lending activity, more than three-quarters has been for refinancing. Although there are some positive signs in the single-family market, it does not seem likely that a housing rebound will contribute as much to the recovery as it typically has in the past. Office building and other commercial construction will probably continue to decline for another year or more,

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though the rate of decline should diminish next year. Overall, though, construction will be less of a drag on growth in 1992.

In addition to lingering weaknesses in construction, consumer demand for durable goods remains poor. Aside from the slow pace of income growth, demographics are again a major factor. Fewer new households translate into fewer purchases of automobiles and household appliances, for example. Weakness in construction is exacerbating this pattern, since expenditures for furniture and other consumer durables tend to rise with growth in family formation and home sales.

The Outlook for Banking

Now let me turn to the outlook for the banking industry, a topic particularly relevant due to the complaints about the role of regulators in the credit crunch. More banks are beginning to see some improvement on their balance sheets--a hopeful sign that the industry is beginning to turn the corner. Although there are bad real estate loans still waiting to be written off, the flood tide appears to have abated.

As you know, the banking industry gained next to nothing in terms of new powers from the 1991 banking reform bill. Congress did not seem to have an overall plan in mind as it passed various measures late in the session, although there was a pattern, namely, an emphasis on safety and soundness. Besides refunding the Bank Insurance Fund, the measures set limits on the discount window, curb the use of brokered deposits, and require prompt corrective action

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for banks that have become undercapitalized. There is also a pilot for risk-based deposit insurance premiums. In addition, the law includes a least-cost resolution measure, designed to end the 'too big to fail' doctrine. This section of the act should remove some of the artificial incentives to grow. This change is certainly a step in the right direction toward allowing the industry to find better ways to survive in a competitive marketplace.

Apart from effects of the new legislation, the salient feature on the banking horizon should continue to be consolidation. We have come through a period of intense merger activity with such high-profile banks as Manufacturers Hanover, Chemical, C&S, and NCNB. Now comes the time when these merged institutions must transform their "on-paper" cost savings to real cost savings. This will take a certain ruthlessness. If banks cannot meet their targets for lower costs and higher profits, then there may be a slowdown in the number of mergers. While we will continue to see problem banks being forced to merge, strong banks will be able to wait for better deals. Overall, though, as bank stock prices and equity values go up, there should be another wave of mergers down the road.

What is the legislative outlook for the banking industry in 1992? Let me begin with the caveat that it is nearly impossible to divine what Congress will do, particularly in an election year. Having failed late last year to get Congress to pass a banking reform bill that included new powers for banks, the administration has promised to push for the bill again this year. Unfortunately, at this time, it appears unlikely that Congress will actually pass such a bill. Nonetheless, it is worth taking a brief look at how various new powers would be likely to affect

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supercommunity banks if--as I hope--they are passed. Since supercommunities are multi-bank holding companies, they should be interested in seeing interstate banking approved so that they can expand into any state, even though interstate banking already exists in some form in almost all states. Branching among states, on the other hand, which is of great interest to large superregionals like NationsBank, would be of little interest to supercommunities as I understand the term. Rather, supercommunities would continue to maintain separate charters in most cases, even if branching is permitted. Securities powers would be desirable, but they would not necessarily become a major source of additional revenues for supercommunities. The ability to sell insurance and mutual funds, on the other hand, would be a boon for both supercommunity banks and their customers. Unfortunately, though, there is little prospect of a change in this situation any time soon.

One banking problem that cannot be solved by legislation is the credit crunch, although we may continue to hear regulators being "jawboned" over this situation. I acknowledge that communications between regulators and banks on credit standards may not always have been optimal. Indeed, regulators have, over the past year or two, made a concerted effort to clarify examination standards. However, looking forward I hope that business executives, bankers, legislators, and voters will understand the real roots of the credit crunch, namely, tax legislation in the early 1980s that gave excessive stimulus to real estate development. By 1986 Congress recognized the imbalances that were building and sought to correct them through tax reform. Examiners likewise began to look more closely at portfolio problems. The resulting transition was, of course, painful, but also necessary. In my view, if policy makers and regulators had not

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taken action when they did, the inevitable market-led correction would have been far more abrupt and painful. As we move beyond this experience, I hope we will gain a more balanced perspective on this episode and what led to it.

Now, there are some things I would definitely like to see to help strengthen the banking industry. I would hope that in the next few years, banks will have finally earned the right to get into securities, mutual funds, and the insurance business. These new powers will be very valuable to allow banks to compete with nonbanks. Also, as I see it, further deregulation is desirable for the health of all banks because it should foster diversity. It is important for me to note that it is not the business of the Federal Reserve to say which organizational structure is best for any one bank. Looking at other industries with strong competition, such as retailing, one sees much diversity. I do believe that, as banking becomes more competitive, successful banks will target particular customer groups, much like retailers target their customers. In some cases, the customer group may demand the lowest prices and accept slightly lower service levels. Other groups may pay premium prices for certain services. All kinds of strategies may work. The supercommunity structure is a plausible one that offers the potential to provide superior services to those who demand them and are willing to pay for them.

Potential Pitfalls for Supercommunity Banks

That brings me finally to the potential pitfalls for supercommunity banks that I mentioned at the outset. I want to focus on two issues of supervisory concern: credit culture and CRA. From the point of view of a regulator, the fact that supercommunities are depending on a

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decentralized structure for pricing and transactions raises a question about whether they might get carried away with this strategy. If so, they could unwittingly undermine their credit controls. Well-established, successful organizations that operated like supercommunity banks before this new term existed know the importance of a strong credit culture, with loan standards defined and enforced at all levels of the organization. My warning is directed at those who aspire to supercommunity bank status. Local control with distant ownership requires a strong credit culture. Otherwise, profit and growth incentives may lead to bad loan decisions.

In a similar vein, a single-minded approach to trying to attract well-heeled customers who are willing and able to pay premium prices for services does not excuse a supercommunity bank from its CRA responsibility. Congress has charged the Federal Reserve and other regulators with the mandate of overseeing CRA compliance. It is the law of the land. Therefore, if banks drag their feet, complying in only a perfunctory way, society will find this unacceptable. In turn, Congress is likely to pass more legislation in order to guarantee a socially acceptable degree of compliance.

At the same time, I recognize that there seems to be a tension between these two issues of strong credit standards and CRA lending--a tension that does not make the life of a banker any easier. Let me reassure you that I am not calling for you to lower credit standards in order to make CRA loans--and no regulator would feel comfortable making such a request. The point is that all banks, including supercommunity banks, must be innovative to meet this challenge. In this regard, I would suggest that banks not focus solely on single-family housing to fulfill the

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CRA mandate. Credit needs in the community are diverse, and the most pressing need could be for water and sewage treatment, small or minority business credit, or education financing, for instance. After all, the CRA requires banks to meet the general credit needs of their communities, not just housing credit. With some creative thinking, supercommunity banks should be able to fulfill their duty and do the right thing. If they do, they may also benefit from the incentives included in a "greenlining" amendment in the 1991 banking reform bill, which is meant to encourage banks to supply credit and financial services to low-income neighborhoods.

Conclusion

In conclusion, the banking industry has entered some of the most tumultuous and difficult times of its history. Competition is fierce and growing fiercer every day. Legislation to help the industry is slow in coming. Only those bankers who can think of creative solutions to the problems in the industry will be able to survive and succeed. The bankers in this room have already shown a degree of creativity in dealing with competitive forces. Now you must also remember to hold true to the basics of good banking that brought you here: a belief in a strong credit culture and the desire to help all of those in your community in a prudent fashion.

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