

Remarks by Cathy E. Minehan
at
Annual Convention of the Massachusetts
Bankers Association
May 16, 1995

Today I'd like to give you an overview of economic conditions in the nation and in Massachusetts and some discussion of banking conditions in the Commonwealth. I'll end my remarks with a few things that are on my mind--and hopefully on yours as well.

The U.S. economy appears to be responding to the Federal Reserve's actions to slow the pace of expansion. The rate of GDP growth clearly abated in the first quarter and in April job growth nationwide plateaued as the unemployment rate rose. While it may sound odd to be rooting for a slowdown in the economy, under current conditions, it's good news.

Growth in the national economy last year was faster than is sustainable without accelerating inflation. The capacity of the economy to produce goods was strained, and unemployment came down to the 5½ percent range. Signs of too-fast growth prompted the Federal Reserve to begin raising interest rates early last year. And the slowdown we're (finally) seeing is focused, as would be expected, in the most interest-sensitive sectors, such as residential investment and durable goods consumption. A slowdown in housing actually began toward the end of last year and has continued in recent months - both housing starts and building permits have been declining. The consumption slowdown, including

weaker auto sales, showed up in the first quarter of this year.

Whether the economy will achieve the sought-after "soft-landing" remains to be seen. Even though a slowdown appears to be in progress on the real side, inflation will probably rise above last year's level before stabilizing. Unemployment is likely to level off or rise slightly. The runway is in sight, but we haven't touched down yet.

While the U.S. is slowing from too-fast growth, Massachusetts appears to be slowing from an already modest rate. Some observers have expressed concern that a needed national slowdown will have particularly adverse effects on parts of the country such as New England that were flying closer to the ground before this soft landing was attempted. I believe, however, that while Massachusetts and the rest of New England are likely to continue growing more slowly than the nation, our local economy will not be disproportionately hurt by more moderate national growth.

Massachusetts has been growing more slowly than the nation since both the regional and national recoveries began three-plus years ago. As you in the banking industry are especially aware, Massachusetts and the rest of New England were much harder hit in the 1991-92 recession than other regions of the country. You may recall that at the recession's low point, one in nine Massachusetts jobs had been lost.

While we went into the downturn more than a year before most of the nation, we began recovering at about the same time - the

end of 1991. Since then, we've been growing at a respectable pace, but more slowly than the nation. Because our job losses were so severe and our pace of recovery is slower, we've recovered just 40 percent of the jobs we lost, while most of the other regions and the nation as a whole have surpassed their late 1980s employment peaks and continue to add new jobs. Such a slow recovery is atypical for our region. Prior recoveries have seen faster overall employment growth, with manufacturing industries adding the most jobs. This time, manufacturing in Massachusetts has been beset not only by the general cyclical downturn, but by defense cutbacks and the ongoing restructuring of the state's computer industry. The slow pace of our job recovery can be blamed to a large degree on the absence of any boost, indeed a continuing drag, from the manufacturing sector.

The job growth to date has been generated primarily by two sectors of the economy: services and wholesale and retail trade. Firms in these sectors have accounted for over two-thirds of employment growth since the end of the recession. What do we know about these firms? Well, for one, all the available evidence suggests that they are small and medium-sized -- exactly the perfect customers for most banks in this audience. We also know they encompass a wide range of occupations--some very high end like consultants and software engineers, some low end like janitorial services. We also know that the increasing dominance of nonmanufacturing industries in the New England economy, particularly services, brings new challenges for the region.

From the standpoint of the worker, the market particularly for high-end jobs is placing a premium on education and interaction-related skills. In some cases this requires retraining and prolonged unemployment for displaced manufacturing workers.

Beyond employment, most other indicators show good performance by the Massachusetts economy in the past year, although the most recent data suggest some slowdown. Consumer confidence in Massachusetts and the region has been trending upward, and retail sales growth in 1994 was the strongest we've seen since the recession's end and exceeded the national average for the year. Sales towards the end of the year, however, showed some signs of slowing.

As is the case nationally, the housing sector in Massachusetts has been especially sensitive to rising interest rates. The performance of the housing sector has particular importance for the banking industry. The market for existing homes in Massachusetts slowed at the end of 1994, and housing prices have softened. New residential construction in the Commonwealth is also showing some signs of a slowdown, but remains somewhat stronger than in the nation.

In sum, the near-term prospects for regional growth remain good but certainly depend on how smoothly the macro economy comes into its landing. Interest-sensitive sectors of both the national and regional economy are definitely responding to the Fed's tighter policy in 1994, but a moderate pace of growth is still possible.

The banking industry has a key role in maintaining the region's future economic health, so I'd like to turn now to the conditions in our industry. A few comments on the hurdles already behind our banks may help us focus our sights on what lies ahead. The past several years have posed considerable challenge for New England and its banks in particular. As the condition of the regional economy swung like a pendulum from boom to bust during the mid-to-late 1980's, so did the health of our banking industry.

Most of us here today experienced, first hand, the changing fortunes ... the roller coaster ride taken by our Massachusetts banks over the past decade. During the mid 80's, seemingly nothing could go wrong, with banks growing rapidly and thriving during those best of times.

Then again, many of us personally felt the worst of times for our local banks, during the late 1980's and early 1990's, when hardly a bank escaped the weight of one of the most difficult economic downturns to effect banking in decades. Most recovered strongly, but some did not--over the period our state lost 28% of its banks, 45% of those due to failure. Our industry has now regained a great deal of its earlier luster, due in great part to a strengthening economy and your effectiveness in restoring earnings while resolving asset quality weaknesses.

Let me just cover some of the highlights of year-end 1994. There was major progress in three areas: asset quality, earnings and capital ratios. Non-performing loans declined to 2.36% of

loans, a stunning 80 percent drop from the peak in 1991, and better than a third below year-end 1993. At the same time, reserve coverage increased to more than cover non-performing loan balances by year-end. Earnings themselves improved despite spotty performance at one or two of the large New England banks, and the number of banks experiencing losses dropped by half to 5 percent of the total. Finally, capital ratios increased by more than 20 basis points, and 96 percent of banks are now considered well-capitalized or better. Clearly things are looking up in the First District, and in Massachusetts specifically.

Despite all this good news, it would not be appropriate, or wise, of me to leave all of you with the sense that I am a veritable Pollyanna about current banking issues. As a central banker, I am constitutionally unable to be such. Thus, I should note some areas, not necessarily of concern, but where some additional thought may be useful.

First, the advent of strong bank loan growth nationwide has prompted concerns about relaxed credit standards. In fact, senior officer loan surveys regularly done by the Reserve Banks do indicate a greater proportion of loan officers willing to say that standards have been relaxed, and of course anecdotes abound about the lousy loans being made by the bank down the street. Recently the Comptroller of the Currency focused on this issue and indicated examiners would be sensitive to it. Banks in New England have had slower growth than others nationwide, and perhaps have done less in the area of relaxing standards.

Certainly, our own senior officer loan surveys suggest this might be true, and I expect the hard times of the early 90's certainly have something to do with First District banking caution.

However, faced with soft loan demand, and the lingering effects of the banking crisis, First District banks increased their securities portfolios and lengthened maturities during the early 90's. Declining interest rates produced increased core earnings and bountiful securities gains, but these were largely reversed in 1994. When the economic pendulum changed direction as inflationary concerns surfaced, rising interest rates produced securities depreciation aggregating \$1.4 billion in Massachusetts banks or over 12 percent of tier one capital as of year-end 1994.

Under new accounting and banking regulations, these book losses did not affect core earnings or capital as long as securities were not held in trading portfolios. However, asset-liability management and the satisfaction of increasing loan demand were complicated by the prospect of real losses if securities had to be sold. Since year-end the pendulum has swung back again, particularly with the recent strong bond rally, but I imagine those bankers with large securities portfolios have felt more than a few moments of unease.

The moral of this story is, I think, that you can run but you can't hide. Banking is about taking risks, and clearly the last few years have proven there are no permanently safe havens--real estate, oil prices, even Government securities--have their risks--and there is no replacement for good old-fashioned credit

judgement and sound management oversight. Concentrations in either lending or securities portfolios can unduly expose institutions to changing economic conditions and that is a point that cannot be over-emphasized.

The second point I'd like to bring to your attention lies in the not unrelated area of derivatives. Derivatives trading has seemed to some as a way to increase fee income by providing services to customers, and also as a way to improve bank profits. It is true that derivatives if used correctly can aid in risk management. But end-users need to be aware of their misuse as well. Some of you may have attended a conference we ran a couple of weeks ago in Boston for end-users of derivatives. The lessons from that conference bear repeating. Derivatives can be used, either strategically, to hedge and reduce normal business risk, or speculatively, that is to bet on financial markets. Issues arise when those using derivatives don't realize the bets they're making, and, worse, double-up with leverage when the bet turns sour. Written investment strategies that are shared with counterparties, particularly when those counterparties give investment advice were recommended, as well as sophisticated, independent internal control areas, that can independently value and stress-test derivative portfolios. Again, there's no escaping old-fashioned banking caution even in a new high-tech world.

A third area worth watching is CRA. Quite recently the federal regulatory agencies issued their joint final rule on CRA

regulation. After what seems like years, and literally thousands of comments pro and con, I can only hope the period of drafting is finally over and the industry and regulators can look toward implementation. However, given the current political landscape, that may not actually happen. One scenario is that Congress will step in and attempt some changes of its own. Some of you may find that prospect appealing, and I would hasten to add that I do think the burden of the social goals of CRA is a bit unfairly placed solely on the shoulders of banks. Notwithstanding this, however, I think we have made great strides in Massachusetts on this issue and I would hate the forward momentum to be lost. My sense is many of you now find low and moderate income lending to be good business and business that can be done well within the rubric of safe and sound banking. I have traveled around the District visiting community economic development projects and meeting with local practitioners. I have been heartened by the enthusiastic participation of bankers that has resulted in tangible improvements--in Boston, in Springfield, in Burlington, Vermont, and in New Haven to name a few areas.

I have been told by a number of bankers that there is ever increasing competition for good community development deals, and banks are depending more on products developed by their own non-profit lending consortia. Whatever happens to CRA, the market has begun to work in this area in New England and my hope is it will continue to accrue benefit both to banks and to low and moderate income communities.

Finally, let me spend two seconds on a topic near and dear to my heart--the health and welfare of the national payments system. One of the Fed's primary jobs as a central bank is to bring about a smooth functioning system of payments--the plumbing without which the nation's financial and capital markets cannot exist and certainly cannot prosper. Reserve Banks have led improvements in the payment system historically by being the largest nationwide intermediary. That will be less true in the future as banking consolidation, nationwide branching, and the increased desire of large banks for fee-based business reduce our volumes. These changes are beneficial to the system as a whole, but there still needs to be a way in which the goals related to public good in the payment system--equitable access, increased efficiency, and reduced risk--can be pursued. We are quite serious about addressing these goals in the Federal Reserve System and have begun a strategic planning process and undertaken a reorganization of our financial services management structure to that end. I am happy to say that in this reorganization, we at the Boston Fed have been given significant responsibilities for retail payments--that is checks and electronic, low value payments like ACH and POS transactions. We will be looking to forge partnerships with you as we get into setting goals and strategies for the future, and I feel confident the interaction with the Massachusetts Bankers Association will be as fruitful as always as we address this important area.

These are just a few things on my mind that I think you should give some thought to as well.

Thank you for allowing me to speak with you this morning.