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**Remarks by Cathy E. Minehan
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**Massachusetts Bankers Association
Annual Convention**

May 6, 1996

It is always a pleasure to talk to the Massachusetts Bankers Association and doubly so in the beautiful surroundings of Bermuda. It seems only fitting that amidst the palm trees and ocean breezes we celebrate a year that was quite good for both the economy and the banking industry. When I addressed you last year, I was optimistic that the Federal Reserve had managed that rarely seen economic equivalent of nirvana-- a "soft landing." At that time, many forecasters doubted the Federal Reserve's ability to continue to achieve economic growth close to potential, with labor markets fully employed, inflation at levels that do not influence business decisions, and relatively low long-term interest rates. However, despite some forecasts that the economy would grow too slowly, possibly even approaching a recession, and other forecasts that we might grow too quickly and rekindle inflation, the progress since then has been just about right, gliding along after making a relatively smooth transition from 1994 to 1995 to a slower growth path.

At the end of May of last year, inflation was a little under 3 percent, GDP was growing at an annualized rate of 2 percent or so, the unemployment rate was 5.6 percent, and the 30-year Treasury bond was a little below 7 percent. At the end of the first quarter of this year, inflation is still under 3 percent, the unemployment rate is 5.6 percent, and the 30-year Treasury bond is approximately 7 percent. Taken together with 1994, one has to go back to the 60s to see such a long period of favorable economic data. My forecast, in part my hope, is that next year at this time I will be able to report the same results. So far the prospects for this seem good though we may have entered a period in which inflation trends bear close watch. Last week we saw first quarter GDP rising 2.8 percent, with favorable labor market news and continuing price pressures from oil and food commodities. Recent compensation data remain in line with experience over the last couple of years, but my sense is labor shortages are becoming more of a factor, and not just in high-tech.

But for now, my hopes are high that we'll continue the pattern of moderate growth and low inflation.

Turning to New England, the prospects are favorable as well.

With the release of new benchmark employment data recently, we see that New England as a whole, and Massachusetts specifically, has been creating jobs at only slightly below the national pace, and quite in line with historical trends. Unemployment rates are low, and I am told more and more frequently how hard it is to find qualified employees, even at the entry level for relatively unskilled jobs. The demand for labor is there, local firms are profitable, especially smaller sized businesses, and, as you all know better than I, credit is readily available. Certainly problems remain--defense downsizing, medical industry restructuring and so on--but it now seems less and less likely that the 90s recession was the beginning of a new period of slow growth for the region. Rather, like the Phoenix of old, we have risen from the ashes, stronger because our new engines of growth have

been forged in times of challenge, and capable of continuing New England's traditional solid growth pattern.

Like the economy, over the past year the banking industry has performed at very good levels. Net interest margins remain high and nonperforming assets are low, contributing to returns on assets and overall capital ratios that are at their highest point since the last recession. This positive news on First District bank profitability should be even better once the transitory effects of the rapid consolidation of New England banks are over. At the beginning of 1990, we had 630 commercial and savings banks; as of the end of 1995, we had only 436; a drop of 31 percent. At the same time, banking assets declined by only 3.7%. With many of the weaker institutions removed by the 1990 recession and by the wave of consolidation, and with New England's economy in really very good shape, the remaining institutions should be quite profitable in the future.

If projections from the largest banks are accurate, they should benefit from the economies of scale they are now achieving by consolidating their acquisitions. These banks have in most cases successfully reduced operating costs and improved efficiency, with District aggregate efficiency ratios improving significantly, and they should be profitable even in areas with relatively narrow margins. The wave of consolidations should also provide opportunities for those institutions not directly involved in acquisitions. Larger regional institutions may reduce emphasis on certain lines of business and geographical areas that are not consistent with their overall business plans. These business lines and areas may be profitable arenas for niche institutions, like community banks, to exploit. In fact, I often hear from the smaller banks on my Board of Directors that the mega-mergers we're witnessing in New England right now are quite good for business. They seem to be picking up the borrowers who may have become too small, or credits too specialized, for the bigger institutions.

As we often do, I think New England may be leading the country in this trend toward a bipolar banking industry with very large institutions at one end, and smaller niche players at the other. That may be a positive outcome, with both large and relatively small institutions remaining profitable by exploiting their comparative advantages.

That is not to say that banking consolidation raises no concerns. Community groups and activists fear inner-cities will be abandoned; local areas and state governments fear job losses through downsizing; small businesses fear their access to bank credit may be impeded and politicians and policy makers fear the costs that all of this could impose on economic growth in the short run. To a very large extent, this is why consideration of some of these mergers take time in the regulatory process--certainly we have our own level of inefficiency and we are working hard to reduce this regulatory burden, but by and large as these applications are reviewed we try to ensure that every aspect of the impact of a large merger has been considered and the potential

negative effects dealt with. Overall though, I remain convinced that the consolidation process can be managed in a way that ultimately brings benefits to all the communities served by banks in the First District. I must also say, all other things being equal, that I'm glad we're building strong First District-based banking organizations that should be capable of both serving local needs, and competing effectively on the national scene.

Despite my bullish assessment of both the economy and the New England banking industry in the near term, the theme of my talk is not "Don't Worry, Be Happy." While it may be the job of a central banker to worry, I do see significant risks that must be monitored by bankers and central bankers alike.

The first area involves the broad area of credit--both the competition for new lending and the possible reduction in credit standards, particularly in the consumer area. Coming off of the credit crunch period of the early 90s, there probably was some room for

easing of credit standards. However, that may have run its course. Anecdotes abound about the extreme competition for good credits, with stories about very easy terms which verge into reductions in prudent standards. I must say this is not music to a regulator's ears, nor are the most recent data on consumer loans a feast for the eyes.

Consumer installment credit has been growing rapidly for more than two years, substantially outpacing growth in disposable income. Installment credit as a percentage of disposable income is at record highs. Fortunately for consumers, interest rates remain relatively low, so that debt servicing costs are high, but not yet at an historical peak. The low interest rates have offset some of the rapid increase in consumer debt, but many consumers are beginning to be constrained. The amount of nonperforming consumer loans has been increasing both nationally and in New England, despite low interest rates and low unemployment rates.

My current expectation is that consumer credit soon will begin to grow more slowly and in line with disposable income, and we will avoid both an abrupt drop in consumption and an explosion of consumer credit to questionable borrowers. However, this is certainly an area that deserves to be monitored carefully.

My second concern involves the ever-increasing use of derivatives. The ability to manage and hedge risks effectively is one of the major contributions of financial intermediaries. The revolution in technology that now is radically altering financial markets and the risk management products that are offered cannot be ignored by banks. Properly used, derivative instruments provide inexpensive ways to hedge the risks inherent in the operations of a bank and to offer useful, profitable services to many bank customers. In fact, failing to adopt these new instruments may impair the viability of banks. Financial intermediaries outside the banking industry are using them, and banks

that cannot employ derivatives risk losing customers to banks and nonbanks not afraid of the new financial instruments.

Despite the opportunities represented by these exotic instruments, they also pose risks. They are an inexpensive mechanism for hedging some risks, but they also provide an inexpensive mechanism for taking substantial speculative positions. It is all too easy--and all too human--to "bet the ranch" knowingly or unknowingly on derivative positions, perhaps managed by your favorite in-house technician, an investment advisor counterparty. The widely publicized losses at Barings have highlighted the fact that a single rogue employee can accrue losses sufficient to significantly damage an entire company.

There is no replacement for overall sound risk management and a healthy degree of skepticism here. Management must ensure that they have a sound investment strategy; that their investment goals are shared with internal traders and outside investment advisors; that limits

exist on credit and market risk by product and that exposures against those limits are reviewed; and that those charged with auditing trading positions and investment practices are well trained, valued internally as highly as the traders themselves, and most importantly, are listened to. And, we must remember that the spectacular losses suffered in a Barings, Orange County, Kidder-Peabody or Daiwa situation stem not so much from the esoteric nature of the instruments involved, but from the lack of good old fashioned management controls and common sense. It never hurts to repeat two maxims. First, 15% returns in a 6% market always contain more than average risk. Second, never, ever, invest in anything the logic of which you can't explain to your mother.

My third concern involves the effects of geographic and product expansion by banks. Geographic expansion offers substantial benefits, as banks become better able to diversify local economic risks. Product expansion is becoming increasingly important as information

technology allows banks to provide a broader array of financial services. As the recent recession in New England highlighted, the costs of being too dependent on borrowers in only one local market, or too dependent on one product such as real estate loans, can result in substantial losses. Even smaller banks need to consider the possible benefits from greater geographic and product diversification. That expansion may be achieved by extending community banking services to regions underserved by larger institutions during this wave of consolidation, or it may be simply following the needs of your existing customer base.

Geographic and product expansion also carries some risks. Senior management needs to understand the characteristics of new markets, and how those markets are likely to be affected in the future by actions of bank and nonbank competitors. Improper understanding of new markets can turn opportunities into unexpected losses, endangering an institution that would otherwise be profitable. But the

greatest risk of all may be complacency in the face of incessant change. Bank and nonbank competitors are both innovating, in order to be ready to seize opportunities. All banks need to analyze their comparative advantages, and seek to exploit them. Banking is about taking risks; if it weren't, it would simply be accounting. No one expects risks to be eliminated; simply managed in a way that creates healthy, thriving financial institutions and a strong, sound economy.

While my comments have focused on risks to bank management, changes in the banking industry also pose challenges to regulators, as well.

First, we're no where near as efficient as we should be in either coordinating the conduct of examinations amongst ourselves at the Federal and State level, or in expeditiously processing applications. Recently a senior level team conducted extensive interviews with bankers, accountants and examiners. The results of these interviews point toward a need for strengthened communication, improved

coordination, and a less "event-driven" supervisory process. All of this and more will be necessary for the transition to interstate banking.

Another related issue involves the fact that Bank supervision traditionally has focused on periodic examinations of on-balance sheet activities, particularly credit quality. The increasing use of off-balance-sheet instruments, and growing activities in diverse, geographic locations, however, have proven a challenge to supervisors and have only been partially addressed to date.

The nature of this challenge is reflected in the fact that the combination of technology, new financial instruments, and, for some, global operations has made the financial statement, even when completely examined or audited in traditional fashion, less and less relevant as an indicator of financial health. Exposures can change in seconds, potentially obviating any well-considered examination evaluation rendered on the basis of old data. The answer is not more regulation or more on-site examination, or even more capital in and of

itself. In my view, the answer lies first in appropriate levels of risk disclosure that aid in improving the transparency of financial results, and overall market discipline, and second, in supervisory approaches that look to sound internal risk management controls and rely, at least in part, on the bank's own internal models to assess the amount of that risk against the bank's capital position. In particular, both the Basle Supervisory Committee and U.S. supervisors have accepted the value-at-risk approach to assessing capital adequacy for trading activities, subject to certain constraints designed to obtain a sufficiently conservative measure of risk. These groups have also espoused disclosure guidelines as well, though, as is usual, we probably have a long way to go before supervisory approaches as regards risk measurement or even accounting conventions are fully harmonized either internationally, or across the financial services industry domestically.

In employing these new approaches examiners, investors, analysts, and depositors will all need to become much more informed on the nuances of risk being disclosed, and on the nature of the internal modeling techniques used to develop an assessment of the institution's risk profile. We all have our work cut out for us here, but I would argue this new emphasis on internal risk measurement and management, and fuller disclosure are vastly superior to new regulations. And I have no doubt you would agree on that score.

Finally, new technology, and a proliferation of new products, including the development of the "virtual bank" on the Internet, pose challenges we don't even yet understand, much less know how to cope with. How is a "virtual bank" supervised when the services offered over the Internet can emanate from different regulated and unregulated sources, and can be provided by nonbanks, even by nonfinancial firms? I still believe banks are special, and that bank regulation and supervision properly done, contribute to societal welfare

by limiting the potential of systemic financial instability. But how to do it in such a changing environment is a critical issue for us in the regulatory world.

In summary, the outlook for the economy and the banking industry remains upbeat. Nonetheless, neither banks nor bank regulators can be complacent. Financial innovations, technological improvements, and regulatory changes are providing opportunities for banks to expand their geographic coverage, the services they provide, and the delivery of those services. With these enhanced opportunities come enhanced risks. These risks should not be avoided; instead, bank managers and bank supervisors must innovate with the market. To be effective, regulatory agencies must seek new ways to maintain prudent risk management, while avoiding burdensome regulation that stifles the ability of organizations to effectively compete in a rapidly changing market.