

MICHIGAN BANKERS ASSOCIATION
BANK MANAGEMENT AND DIRECTORS CONFERENCE

Dearborn, Michigan
November 30, 1995

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Perspectives from the Federal Reserve

Thank you. I'm delighted to have the opportunity to address the MBA's Bank Management & Directors Conference. I'm glad you mentioned my stint at Northwestern before taking over at the Fed. I'm sure you know Michigan's big win Saturday catapulted Northwestern into the Rose Bowl. So being here in Michigan today the first thing I want to do is say, "Thank-you." We've been waiting a long time for this!

I'd also like to take a minute to say a few words about a very valuable and dedicated staff member who is retiring today after 33 years of service to the Federal Reserve — Roby Sloan, Senior Vice President in charge of our Detroit Branch.

I'm sure many of you know Roby and have worked with him in one fashion or another over the years. Roby joined the bank's staff as an agricultural economist and served as assistant director of economic research for a number of years. For the last 11 years, Roby has been responsible for running our branch in Detroit. Three years ago he added responsibility for electronic services in the entire Seventh District. That was a natural progression for him because he's been a leader in Michigan in developing innovative electronic services.

Roby's Detroit Branch is one of the largest in the Federal Reserve System. This year staffers there will process over \$300 billion in checks, \$5 trillion in wire transfers, and \$500 billion in ACH transactions, as well as distribute over \$3 billion in currency. And the Detroit office has been a pioneer in the move from paper to electronic check processing.

Needless to say, Roby's contributions have been profound. He's truly been a valued member of our senior management team. I'm happy to note that Roby will stay active in the banking industry, continuing to speak and write on economic and banking issues. He will also have more time to pursue one of his favorite pastimes — fishing. All I can say is that if in his retirement Roby brings to that sport the same skill, talent and expertise he brought to the Fed ... I really feel sorry for the fish!

Good luck to you Roby and thank you for the many, many years of dedicated service. The Federal Reserve System will miss you, the Detroit Branch will miss you, and I personally will miss you.

Roby's successor will be David Allardice. David most recently served in the Economic Research Department as head of the division studying regional conditions. You'll have the opportunity to get a feel for David's wide-ranging expertise tomorrow morning, as he's going to be one of the speakers at the legislative and regulatory forum. David has some big shoes to fill, but judging by his performance in Chicago, I'm more-than-confident he's up to the task.

As we all know, the banking industry is changing dramatically. We're seeing fast-paced technological change, rapid consolidation of banks, and increasing competition from inside and outside the industry. Today I want to give you my thoughts on how we can better work with you, and how we can achieve more effective supervision in this very challenging environment. I also think you might feel a bit shortchanged if I didn't touch on the state of the national economy. We've seen some mixed signals lately, and I'll try to shed some light on where I see the economy headed as we approach 1996.

The performance of banks in the Midwest and Illinois has been quite strong. I don't think I need to tell that to this audience. But to continue thriving, it's clear that you need the flexibility to offer customers a broad array of financial services, and to offer them in a wide range of geographic areas.

There's been some progress on the geographic front with the passage of interstate banking and branching legislation. You're now better able to take advantage of economies of scale and to provide financial services regionally and nationally based on customer needs. Ironically, you're better able to compete, but you're now also facing more competition from out-of-state institutions. More than ever we're in a state of Darwinian banking, where only the strong survive.

Removing obsolete barriers encourages consolidation, which we have witnessed with the recent megamergers, such as NBD Bancorp and First Chicago. But I also believe that community banks will continue to play an important role — by finding their niches and providing a level of service that, in many ways, can't be matched by larger banks. In fact, the extensive publicity about bank mergers ignores the roughly 3,000 new banks that have been started since 1980. That's about one-half the number of institutions that were involved in mergers during that period.

To continue thriving, I also think you need expanded product powers. Unfortunately, there hasn't been much progress in eliminating product barriers. The efforts to repeal Glass-Steagall, for example, seem to have slowed, but I'm hopeful Congress will be able to address this issue. Obviously, expanded product powers would help you to be more competitive. But expanded powers also raise a host of other issues. For regulators, a key question is which organizational structure is appropriate to accommodate expanded powers. The goal, of course, is to avoid spreading the safety net and its associated benefits to the non-bank sectors without sacrificing the potential synergies of expanded powers. To me, the best structure will be one that effectively contains risk but also allows you to provide products in a "seamless" manner. That is, your customers should be able to buy a number of different products as easily as possible. Firewalls will be in place, but should for the most part be invisible to customers. In my view, the "holding-company approach," in which the bank is separated from non-traditional activities, accomplishes these goals. The key will be to establish firewalls that inhibit the spread of risks to the safety net, while allowing banks and their affiliates to offer products in the manner preferred by customers.

Enacting legislation to eliminate product barriers is certainly important, but to some degree we're all reduced to being spectators — watching the advances and retreats of various forces in the Congressional battlefield. Now, I'd like to touch on an area in which we can be active players — effective supervision of

the banking system.

I think this is an area in which we all share common concern. We all have the same goal — a safe and sound banking system. An important component of that is working together, finding common ground. At the Chicago Fed, we've sharpened our focus — on customers and on stakeholders — related to all of our activities. This applies to our supervisory functions as well as to our financial services and our research efforts.

Everyone in this room would agree that we should try to reduce the burden of regulation on financial institutions. The key, of course, is to reduce the regulatory burden while maintaining high supervision standards. I don't think the two are mutually exclusive. Ideally, they should work hand-in-hand. I spent over 14 years in the private sector. I know that regulation can be burdensome. Frank Dreyer, the head of our supervision and regulation department in Chicago, has played a key role in leading strategic initiatives on behalf of the Federal Reserve System to address these issues.

One effort is an exciting initiative that adapts our supervisory approach to the changing nature of banking and financial services. These are some of the steps we'll take:

- First, we'll consider how to incorporate market discipline and greater disclosure into the overall supervisory process.
- Second, we'll decide how to best respond to the fact that traditional distinctions in banking are blurring.
- Third, we'll develop exams that better reflect the way management runs the business, and focuses less on the review of financial records and individual transactions. We need to focus our resources on the areas of greatest risk within each institution.
- Finally, we'll study the potential for greater interaction with external auditors during the examination process.

Those are some of the key points, and we're hoping to have some final recommendations in place by 1996. But Fed officials have already started working with their counterparts at the FDIC and with state banking regulators to better coordinate the supervision of state-chartered banks operating across state lines. Earlier this year, state bank regulators at their annual conference approved having a single state regulator oversee state-chartered banks operating in more than one state.

Similarly, a state-federal work group has developed recommendations for sharing resources among regulatory agencies to maximize productivity and minimize regulatory burden.

As we move toward interstate banking, these steps are necessary to retain an effective dual banking system.

Another item of note is the adoption of GAAP for bank regulatory reports. The Federal Financial Institutions Examination Council recently decided to change the accounting basis for bank call reports. At the Fed, we believe that we should avoid requiring banks to maintain multiple sets of books, and I applaud the adoption of the GAAP standard.

An important aspect of the Fed's supervisory efforts is ensuring that banks have adequate risk-management and oversight capabilities. Toward that end, the Federal Reserve has directed examiners to separately rate banks' risk-management systems, including internal controls, during exams. Examiners will give this rating considerable weight in their overall evaluation of management — one of the five components of the CAMEL rating.

At the regional level, we've also been trying to identify specific methods to reduce regulatory burden. The Chicago Fed was one of the leaders among the 12 Reserve Banks in developing and implementing programs to increase the off-site portion of exams. This has enabled our examiners to spend less of their time on your premises and more of their time at our offices. We believe this will increase examiner productivity, reduce interference with your operations, and provide examiners with easier access to resources within the office, including the expertise of our managers. We're also looking at using new technology and computer-aided examination tools to enhance the performance of our examiners. We will definitely be expanding these programs, as the benefits to both sides are obvious.

Let's now turn to an issue we hear a lot about lately, and that's the appropriate regulatory oversight of financial derivatives. We've been bombarded with recent press coverage of stories like Orange County, Barings, and Daiwa, and there certainly seems to be some misunderstanding about these risk management tools.

I hope the response is not a knee-jerk reaction in which the risk-control benefits of derivatives are diluted. Currently, regulators are working on innovative approaches to the regulation of banks' involvement in these activities, in which we try to avoid heavy-handed and intrusive rule-making. Rather, we seek to align the incentives of the private sector with the public interest.

An excellent example is the work we're doing on bank capital standards for market risk. Now, most banks will not be affected by the new capital requirements for trading-account risk. Probably only the largest 30 to 35 banks will be affected. However, the regulatory approach should be of interest to all banks, and I hope it can be extended to other areas.

There are currently two proposals that are consistent with this approach. The first is called the internal models approach and is proposed by the Basel Committee on Banking Supervision, which is composed of bank regulators from the 12 major industrialized nations. That approach allows banks to use their internal models, but places constraints on these models and produces a capital charge based on a pre-set formula.

The other approach the Federal Reserve System, and the Chicago Fed in particular, are exploring is known as the "Pre-Commitment Approach." In this approach, banks commit to containing their cumulative losses in their trading portfolio below a certain level. They then set aside capital sufficient to cover this maximum loss level. If their losses exceed this pre-committed level, a significant fine is imposed.

Under Pre-Commitment, the bank simultaneously determines the risk of its portfolio and the level of capital appropriate to that risk. If the fine is properly structured, the bank's risk decision and capital decision will interact in a way that safeguards the public interest. If the bank wishes to take on more portfolio risk, it's free to do so. But it must increase its capital level if it wants to keep the probability of a fine to an acceptable level.

Pre-commitment exploits the entire set of risk-management tools available to banks. It encourages banks to use the best risk-assessment technologies available. And it also encourages them to use various investment tools to actively manage their risk exposure after the commitment has been made. As currently structured, there would be minimal regulatory intervention into bank operations. The regulator would verify that the bank has a well-functioning risk-management system in place, but there would be neither detailed standards imposed on risk-assessment models nor a required capital formula.

We are working with other Reserve Banks as well as with the staff of the Board of Governors to refine the details of Pre-Commitment. Much more work needs to be done, but I'm excited about its possibilities and personally favor moving in the direction of Pre-Commitment.

So much for banking issues. Let me now give you an update on the state of the economy. In the third quarter of this year, real GDP rose at a seasonally adjusted annual rate of 4.2 percent, which was much stronger than most economists had anticipated and we do not expect that pace of growth to continue. If that rate of growth were to continue, we might once again be faced with an economy expanding at a pace that could reignite inflationary pressures.

Inflationary pressures have subsided since the early months of this year. It's true that the core Consumer Price Index (CPI) increased at an annual rate of 4.2 percent in the first four months of 1995. Over the past six months, however, the core CPI has risen at a 2.8 percent rate, still higher than last year's 2.6 percent rate, but down considerably from the early 1995 pace.

Another sign of abating inflationary pressures is the downward trend in capacity utilization rates since January. While still high from a historical perspective, capacity utilization was down nearly two percentage points from its recent peak in January.

In addition, the unemployment rate recently has fluctuated within a range close to where you typically see no upward or downward pressure on wages or prices. The actual unemployment rate has been between 5.4 percent and 5.8 percent so far this year. The most recent figure was 5.5 percent in October.

Looking ahead — let's take a look at the consumer sector. In the third quarter, growth in total consumer spending moderated slightly, advancing more slowly than income. In addition, employment continued to rise, albeit at a more moderate pace than in 1994, and consumer confidence is at high levels. With these positive factors, we expect consumer spending to continue to show modest gains through the remainder of 1995 and into 1996.

Of course, what happens during this critical holiday shopping season is important for our overall economic outlook. Reports so far indicate that consumer spending was on the weak side in October, but picked up in November. Post-Thanksgiving sales reports have been mixed, but generally suggest that consumers were willing to buy at a good price. Indeed, retailers indicate that promotional activity this year started sooner and will be more intense than we've seen in some time.

As for autos, we keep close tabs on this industry because it has such a spill-over impact on the rest of the economy, especially here in Michigan and in the Midwest. While figures for 1995 should still be respectable, auto sales have been running below industry expectations virtually all year. October light vehicle sales were disappointing by almost any account. Sales came in at a 14.5 million annualized rate, down from September's 14.8 million pace.

In the international sector, export growth accelerated from the second quarter to the third while import growth slowed. Overall, net exports contributed positively to real GDP growth in the third quarter. Looking to the future, however, economic growth prospects for our major trading partners remain uncertain. Japan, Canada, and Germany all are experiencing slower growth than we anticipated earlier this year, and Mexico's economy is still struggling. At best, we currently expect that net exports will have a neutral effect on real GDP growth in the fourth quarter and much of 1996.

In the government sector, total purchases for all governments — federal, state, and local — rose at an annual rate of 3.1 percent in the third quarter. But we see this increase as an anomaly rather than a new trend. We expect the government sector contribution to real GDP to be essentially neutral in 1995 and 1996, with declines in federal government purchases offsetting moderate increases in state and local government purchases.

These reduced federal purchases of goods and services are important and welcome steps in the growing momentum for deficit reduction. It's clear that the President and Congress are moving toward reducing the

federal deficit, and I find those efforts encouraging. Meaningful deficit reduction will have a positive impact on the economy overall.

A key point to emphasize is that deficit reduction must be sustained over a number of years to be truly effective. Commitment is crucial. Commitment by Congress and the executive branch over a long period of time is essential to the success of any deficit-reduction plan.

And we're going to have to come to grips with more than just deficit reduction. The impact of an aging America is also a major concern. Americans are growing older at a startling pace. That's great from a social perspective — we all want to live longer. But we have to keep in mind that when Baby Boomers start retiring, they'll be paying less in taxes and receiving more in retirement benefits for a longer time than was true for previous generations. At the same time, relatively fewer younger workers will be contributing to the Social Security fund.

If the formulas used to distribute benefits stay the same, the revenue that will be needed to pay for Social Security and health care for retired Baby Boomers is going to be enormous.

Clearly, we need to address this situation over the long term when considering the question of deficit reduction. This is a problem we'll face after the turn of the century — in another 20 or 25 years. And it will be a problem of worldwide dimensions. Other developed countries such as Japan, Germany and Canada face even more severe problems in this area.

Returning now to the shorter-term outlook, where does all this leave us for a forecast? Our expectation is that growth next year will be about 2½ percent, which is near its sustainable potential growth rate. The key difference between 1995 and 1996 is inventory investment. For most of this year, businesses have strived to bring inventories into better alignment with slower growth in final sales. We expect the inventory correction process to be completed soon, so that real GDP growth next year should more nearly match growth in final sales, with both coming in around 2½ percent. With this rate of output growth, inflation as measured by the CPI should come in around 3 percent this year and next, and the unemployment rate probably will remain in the same range we've experienced so far in 1995.

In conclusion, I'm guardedly optimistic about the economic outlook. I have to admit that ever since I took my oath as a central banker, I find myself using phrases like "guardedly optimistic." I guess that's why we're called the Federal Reserve.

Seriously, while it's always hard to predict what lies ahead beyond the next curve, I don't anticipate any major roadblocks in the future. I think we're well-positioned to make continued progress toward our objective of healthy, sustainable growth with price stability.

Thank you very much.