

## I. Introduction

- A. It's a pleasure to be back in the Fourth Federal Reserve District, the heartland of healthy banks.
- B. There is an old Chinese curse that says, "May you live in interesting times." Someone must have placed this curse on the banking industry, because these are interesting times, to say the least.
- C. Today, I will
  - 1. Give an overview of the Purpose and Goals of the Federal Reserve Bank.
  - 2. Discuss what a central bank can contribute to a sound banking environment (i.e., a monetary policy that provides price stability).

## II. Overview of Purpose and Goals of the Federal Reserve Bank of Cleveland

- A. View the Federal Reserve as a banker's bank (as opposed to a central bank)
  - 1. Congress rejected the Aldrich plan
  - 2. Congress accepted Carter Glass' plan (decentralized structure of a banker's bank)
    - a. members of the Federal Reserve are owners
    - b. banks in the District are customers
  - 3. One of the goals in the coming years is to serve the changing needs of the District's banking industry -- continue to provide high quality and innovative services
- B. Strong financial system is important for a strong economy
  - 1. Purpose of supervision and regulation is to foster an efficient and competitive banking system
    - a. this is an ongoing challenge for eastern Europe and former Soviet Union
    - b. this is also a challenge to address the economic failures of Latin America
  - 2. Frustrated that many people lump banks together with thrifts
    - a. earnings of the nation's banks (reported by FDIC) was \$18.6 billion last year (15% increase over 1990 and the best performance since 1988)
      - i. capital is strong (total equity capital at about 6.5%)
      - ii. banks do not have systemic problems, unlike thrifts
    - b. Bank Holding Companies in 4-D continue to outperform the nation in almost every major financial measure
      - i. due, in part, to conservative nature of company management
      - ii. due, in part, to relatively low level of high risk commercial real estate loans
    - c. one of the reasons I accepted the position as president in the Fourth District was due to the strength of banks in the District -- good banking models

III. Price Stability and Sound Banking -- An environment of price stability helps industry managers price and assess risk correctly.

- A. Asset side of the Balance Sheet -- Credit Analysis
  - 1. Decisions to limit bank risk are based on
    - a. the value of collateral in secured loans.
    - b. and on projections of the ratio of a borrower's current assets to current liabilities in unsecured loans of working capital.
  - 2. Unexpected price changes can invalidate assumptions underlying the loan; the standards of loan evaluation can be preserved under conditions of price stability.
- B. Liability side of the Balance Sheet -- Bond Portfolio Analysis
  - 1. In an environment of price stability, banks can better stipulate and rely on future payments to and from others.
  - 2. Proper bond portfolio diversification is easier to accomplish in an environment of price stability.
- C. Price instability
  - 1. Accounts for many of the problems of financial institutions here and abroad, but also for the plight of U.S. deposit insurance agencies.
  - 2. Price fluctuations of the late 1970s and early 1980s coupled with the regulatory environment and deposit insurance limits of \$100,000 per account encouraged the system to undertake greater risks.
    - a. bank managers and shareholders are not penalized for poor management since depositors are all but unconcerned with risk.
    - b. insurance is not priced for risk (flat fee).
    - c. the manner in which deposit insurance agencies settle failures, guaranteeing non-insured parties not included under the deposit insurance system, tends to worsen already apathetic market pressures.
    - d. problems are compounded by the incentives of managers, once an institution is in trouble, to take greater and greater risks.
  - 3. Monetary policies of the late 1970s and early 1980s encouraged many banks to take risks in inflation-sensitive sectors (e.g., oil and real estate).
- D. If banking industry's managers can better assess risk, then banks can more efficiently and effectively assist in the economy's resource allocation process.

IV. Conclusion

- A. Federal Reserve should not wish a Chinese curse on the banking industry or, for that matter, the economy.
- B. For the long-term health of the economy, monetary policy should pursue an objective of price stability.