OHIO BANKERS' ASSOCIATION ANNUAL CONVENTION

COLUMBUS, OHIO

JUNE 6, 1992

"THE CENTRAL BANK'S CONTRIBUTION TO A SOUND BANKING SYSTEM"

JERRY L. JORDAN

In regards to that comment about the California economy, some people think that I came to this position because of work I did a long time ago in monetary policy--that FOMC (kind of) related thing, my work on a shadow committee. That's not really why. The real reason is, while I was at First Interstate, I became very involved in doing regional economic analysis; the more I understood about what was going on in the various regions of the country, the more it looked to me like it was time to get out. I went to California in 1985 just at the beginning of a boom period, especially during the years 1987 through 1989 when there really was an all out boom in that economy. As often is the case, when hangovers follow getting drunk, there is going to have to be a sustained period of, what we in polite company call, restructuring the California economy. So I thought it was time to go to "Heartland America" where the economy's real strength is at the time being.

In the early 1980s and in the recovery from the 1982 recession, we had a bi-coastal economy--the Massachusetts miracle and the strength we saw all up and down the West Coast--while this region of the country really was struggling in manufacturing, in agriculture, and especially in those sectors and, of course, the energy producing regions of the country were in trouble. Well, it is their turn to get rich! So I wanted to be in the part of the country where the strength was going to be for the early 1990s recovery from the recent recession.

Part of it also has to do with healthy banks. I had opportunities over the last several years to rejoin the Federal Reserve in Washington or in other Reserve banks. I had absolutely no problem at all saying "No thanks, I am happy where I am. I am not interested." But when the opportunity came along to replace Lee Hoskins at the Cleveland Fed, I couldn't say no. For one reason, Lee and I were classmates together at UCLA. We even went to the same junior high school. We have known each other a long time. I liked what Lee had been doing in the Fourth Federal Reserve District. Part of it was because I had lived and worked in Pittsburgh and had traveled this area a lot and so I was familiar with the industries, with the economy, with the banks. Part of it was the strength of the banking organizations. I wouldn't have wanted to go some place where I was going to spend all my time dealing with a lot of problems and a lot of headaches. The quality of the Fourth District banking institutions was a factor in my thinking this would be a good place to be.

I am going to come back and comment about the banking situation and industry especially in our district in a few moments. But first, I thought I would tell you some good news that I heard recently that effects the way the national political scene is unfolding. George Bush has been very, very depressed over what's happening to him in the polls and he was getting really kind of irritated and hard to live with. So Barbara sent him down last weekend to clean out the basement. While he was down there, he discovered this dusty old bottle. It looked like it was empty, but it had a cork in it. So being in the mood he was in, he pulled the cork out anyway, and a Genie popped out of the bottle. The Genie thanked him for releasing him and offered to grant him one wish. George thought for a little bit and said, "Well, the Soviet Union has crumbled, the Berlin Wall has come tumbling down, and we've seen the death of the great evil empire, the scourge of the twentieth century. What can I really do most to help mankind in the years ahead?" He thought about it a bit, and he said, "I know Genie, give us lasting peace in the Middle East." The Genie said, "Oh, you don't know what you are asking! Lasting peace in the Middle East? There have been centuries and centuries of animosity between the Jews and the Arabs. These people are just not going to get along. There are so many different factions on each side. I don't know how I could really grant you that wish. Can't you think of something else?" George says, "Well, all right. How about giving us 6% real growth for the rest of the year?" The Genie says, "Hmmm, let's go back to this idea of peace in the Middle East."

A part of what I do in my job is to think about, worry about, the issue of real growth and to try to promote a stronger national economy through monetary policy. I'm not going to spend much time talking about that, but if

I do have a few minutes at the end, I'll be glad to answer some questions about those kind of national economic events. The other two hats I wear are as a supervisor-regulator--the examination side and the enforcement side of our activities--and, of course, on the operations side of it.

I thought a lot about the kind of institution we are, the industry that we are a part of, what kind of a role I wanted our Reserve Bank to have, and the relationship we want to have with the other providers of the national services in our region of the country. It is easy for me, a lot of easier than it would be if I were in some of the other Reserve Bank districts in the country, because of the strength of the institutions that we have in this part of the country. The return on assets of Ohio banks alone, if you consolidate the banks and look at them as one institution, is way above the national average and is far less volatile than what we've seen on the national scene for quite a few years. That has given rise to a much higher market capitalization of our institutions. We have a higher degree of capital, what a lot of people like to talk about the capital adequacy, based on strong earnings performance and managerial talent. Ultimately, any banking organization's real capital is the strength of its management. It is human capital that determines a sound institution, not financial capital. There is also another kind of non-financial capital--the capital adequacy of the Central Bank. I am going to come back to that in a moment as well.

When you look at the Ohio banks as a group, five of the top forty organizations in the country are headquartered in this state. For some very unique reasons, you will not find that anywhere else in the country, with the exception of New York. When you look at Ohio-based banking companies compared to the nation as a whole, we had only .38% loan loss experience last year versus .06 of a percentage point. We are just over half the loan loss of our banks that are headquartered in this state versus the nation as a whole. Our non-performing loans relative to total loan were less than half of the national average basis. When we look at our banks on a district-wise basis, ten of the largest one hundred bank holding companies in the country are in the Fourth Federal Reserve District. The aggregate market capitalization of our banks exceeds every other district in the country, with the exception of New York. If you hold aside two large wholesale international money center banks who do not retail community-type banking in this country, then our aggregate market capitalization is significantly greater than any other district in the country, including Chicago and the big Twelfth Federal Reserve District of San Francisco. There are none of the top one-hundred based in the Eleventh District of Dallas, nor in Atlanta; only one in the St. Louis Federal Reserve District, the Eighth District; only two in the Minneapolis District; and so on. We have a much stronger banking system from this standpoint.

It is our District's banking organizations that are reaching out, rather than other districts' banks reaching into our territory. When I think about the capital of the consolidated banking industry, with its twelve thousand banking companies, I don't view the industry as under-capitalized in any sense, even depending on what kind of a factor you want to use for the distance of deposit insurance which does have to be considered. But holding aside how we want to treat that issue of deposit insurance, then the industry as a whole is well capitalized, but it is very poorly distributed. The banks of the United States, all twelve thousand strong, have a substantial amount of financial capital and a tremendous amount of earnings power. They earned $120 billion last year. But the distribution of that capital rolled to the strong managerial talent and away from the weak institutions. This has taken two forms. We see the weaker institutions shrinking in total assets the way you've proven a ratio not greater on either the numerator or the denominator; so my former institution, First Interstate, is shrinking rapidly as a company. They are down about $15 billion in assets in the last year alone. That is one way to get the ratio up, and the other, of course, is through the mergers and acquisitions process. Which, in a sense, means the assets move to the institutions that have strong management and strong capital. I expect that dynamic process to continue.

Just a few years ago, there were very few banking organizations in the country that went across state lines. Now that, of course, is more the norm. And, it was especially rare for a banking institution to operate in more than one Federal Reserve District. Now that also is becoming more and more common. As I have said to the governors in Washington, the least relevant thing I can say to banking companies is where the rail lines ran in 1913. Those old boundaries don't constitute a natural market area. At one time it was a metropolitan statistical area or a city or a town. At one time maybe it was a state. But it was not as today for a Federal Reserve District with the territory which we incorporated. It is just not going to be relative to the future environment we are going to be in.

In this Reserve Bank we are a banker's bank, the way Congress originally intended it in 1913. We are owned by commercial banks and we have an outside board of directors. We intend to function as a banker's bank owned by and operating as a part of the banking industry in our territory. Congress had considered in 1913 setting up a European-type monolithic central bank with fifteen operating branches throughout the United States. At that time it was called the Aldrich Bill, after Senator Aldrich. It was soundly defeated. Instead, what Carter-Glass wanted to do was to set up a system of Reserve Banks which would well represent the regional diversity of the country. Carter-Glass prevented a concentration of financial power and regulatory power in New York or later in Washington. The reforms of the 1930's tried to keep the regulation of the banking industry out of Washington, D.C. I think for the most part that system has served us very well. It is most important that we preserve the kinds of checks and balances built into this system of Reserve Banks.

The challenge to us though, in this district in particular, is to be as good as the banks that we serve. We have such outstanding banking organizations in our district. I think that puts ever more pressure on the banker's bank to serve well those kind of companies so that we don't become indifferent to what the banks in our region are doing. When I put on my supervisory-regulatory kind of hat, one of the things that has been positive to me is the good strong reputation which the Cleveland Fed examination force has. They are tough, but they are consistent and they are fair. And I think that the management and the owners of any banking organization should want the kind of examination that our examination team provides. It looks to me from the experience we had out on the West Coast and what we had down in Texas that the kind of examination which our people provide should be used as an asset that should actually be sought by banking companies.

When I have my monetary-policy hat on, I want to have a strong economy. But I know that depends on strong banks. Then I put on my supervisory hat and I want to help to strengthen the banking organizations. Both hats help promote a strong economy since I know that a strong economy is also going to help strengthen the banking industry.

One of the issues that I got involved in the last few years that I think is going to be a great challenge to us is how to do a better job assessing the real risks involved in the financial intermediary business.

Harry Keith of a bank rating firm once said the only thing that ever got a bank into trouble was lending money. Well, we can't stop lending money just to avoid certain types of risks. I have occasionally heard bankers, politicians, or regulators say that we need to avoid risk or minimize risk. As an economist, my response is: "That's nonsense!" Like physicists say about matter, risk can neither be created nor destroyed; it exists. But you can transform the nature of the risk, and you can shift risk from one party to another. When you engage in certain types of practices that we've come to call derivative products, there are hedging techniques, such things like an interest rate swap or so on. You are transforming the nature of risks. You can change something from being an interest-rate risk to a credit risk. The question is: Are you better able to assess what the risk really is if you transform it from interest-rate risk to a credit risk? Can you get paid for it; can you really price it and manage that risk? If so, then we have a very important role in the industry to take interest-rate risk off of the shoulders of non-financial firms that don't want that kind of risk, convert it into a credit risk, and get them to pay us for managing that kind of risk.

I heard it said by some of the regulators that derivative products are complicated; they really don't understand these instruments, and financial institutions better quit it. My reaction is, "These things are complicated; we are not sure we understand it, but we are going to learn and we are going to learn fast." Our people are going to be just as good as the people on the private side of things in managing derivative product risk. So one of my goals is to make sure that our team of people in the Research Department and in the Banking Supervision and Regulation Department work together with the banks at understanding this so we can improve the management of the risk associated with these new instruments.

Another thing I thought about are factors that go into so-called diversification. It seemed to a lot of people in Washington, as elsewhere, that the lesson of Texas was that the lack of regional diversification created a problem. If only we had nationwide banking before, then we might not have had those problems with the banking companies in Texas. But now I come to the Fourth Federal Reserve District and I look at this good lesson from this area of the country, and I discover the banks got into trouble when they got outside of their local markets that they know very well. Their bad assets came from out of markets not from being concentrated in the area. So the challenge will be, as our banking companies do stretch their reach out into other regions of the country, to make sure that they have the systems in place to assess, to get paid for, and to manage the kind of risks that they are going to be taking on. I don't think any of us are confident that we have a blueprint or model for doing that.

Sometimes, when I look at the way the credit policy process is set up in a banking organization and what is called regional diversification or industry diversification, I'm not too satisfied with what I see. Take the real estate portfolio, for instance. I saw banking organizations when I worked both in Pittsburgh and Los Angeles say, "Well, this is a real estate loan and we will sub-divide it further into industry exposure and construction exposure." So we are going to limit how much of construction industry and real estate-type exposures we have. To cite an example in my own experience, a loan might be used for building a high-tech industrial park in Palo Alto, California. I looked at that loan and said, "Oh, that's foreign exchange exposure." The credit officers rolled their eyes and said, "What are you talking about?" Well, this could become a bad loan; the dollar could soar in foreign-exchange markets and clobber the semi-conductor industry like it did in 1986 and 1987. If this happened, there would be no tenants in that industrial park. So the risk is improperly categorized; it ignores exchange exposure. Stop putting it in buckets called real estate, industry, and construction. You are simply mislabeling it if you think that you're managing or diversifying risks when you do that. In that sense, every taxi drive in Odessa, Texas is an oil loan and every hair dresser in Las Vegas is a gaming loan. We need to think freshly about what we mean by the nature of risk based by the type of economic activity that supports the community.

This, I think, is a very difficult challenge. How do we integrate regional economic analysis with industry risk analysis in a relevant way to say something about the nature of the real value of the firm and the risk that it is taking? With my prodding, our people in our Research Department and in the Banking Supervision and Regulation Department will be spending quite a bit of time learning and understanding that. We will share that with you and we will share it with the folks down in Washington, D.C.

Another concern is the question of capital. It is often said that we've got a problem with the capital adequacy of commercial banks in the United States. Well, be that as it may, certain firms definitely had a capital adequacy problem. My training in the banking industry has always been that you can't have enough capital, true financial capital, and especially equity capital. But there is another kind of capital that I think is extremely important--that of the central bank. But our capital is not on the balance sheet; instead, it is the credibility of our commitment to price stability. If we erode that capital, then financial institutions don't really have a prayer. Because when we erode our credibility of our commitment to price stability, we are debasing our nation's currency and reducing the purchasing power of the dollar. We also balloon your balance sheet. The nominal valuation of the assets of a bank company must go up corresponding to what is going on in the national economy; the balance is changed by the inflation rate. There is not a country in the world that has experienced sustained high inflation and has not seen the capital of the financial firms disappear; financial firms simply are not able to generate earning streams necessary to maintain the financial capital. It creates problems for you.

In the late 1970s and the early 1980s, asset valuation become the dominant mode of lending. The lesson of the 1981-82 recession was that asset based for valuation based lending was more secure than cash-flow based lending. Cash-flow based companies in agriculture, manufacturing, and energy ran into trouble. Things like real estate did very well. So the regulators said, "We'll nail down every piece of collateral you can get and use more asset evaluation lending and you'll be okay." Then we came through the disinflationary period of the 1980s and that turned out to be bad advice. Disinflation of output prices meant slower rates of increase. This must necessarily imply deflation of asset prices. To slow the rate of increase of inflation output prices, you must see an absolute decline in the valuation of certain assets.

I've sometimes heard it said in the banking industry that the purpose of inflation is to convert bad loans into good loans. Well, that is a very short-sided approach. It was inflation in the first place that gave rise to the conditions that caused the bad loans because it caused an incorrect assessment of what the real values of those loans were. The present value of the earning asset was based on some expectation about future revenue strains and asset prices.

When we in the Federal Reserve shifted our policies from that of inflation to disinflation, there should have been a strong clear message that asset valuations were going to be coming down. Those who had portfolios based on overly assessed assets were going to suffer some losses. High inflation also creates other problems on the liability side, i.e., what the true maturity or duration of liabilities are. We've heard a lot of commentary in recent months about mark to market accounting. The debate between the SEC and the Board of Governors in Washington is about the appropriateness of that. While mark to market accounting is a great theory and in the classroom it works fine as long as you do full mark to market accounting asymmetrically on both sides of the balance sheet, the theory is okay. The practice, I think, is something totally different again. Some people in Washington have thought that whole mark to marketing accounting would have prevented the S&L debacle of the 1980s.

This is something I'm not convinced of. But nevertheless, it is said that if we now go to partial mark to market accounting, we can make sure that we don't have similar problems pop up in the banking industry in the future. However valid the premise, the conclusion is wrong. It is not true that a little bit of mark to market accounting is better than none at all, especially if it is only done on some assets on the balance sheet and only done asymmetrically. In other words, since you mark down assets where current market is below book value but you are not allowed to mark up and you do not do it asymmetrically on liability side of the balance sheet, the real value of those liabilities are in a low inflation, low interest rate environment on the asset side. This is also one of the debates that we expect to be involved in during the period ahead. Let me wrap up and take a moment of questions.

There is an old Chinese curse, "May you live in interesting times." Well, we've lived in interesting times in the banking industry over the last eight or so years since the last recession. I sometimes think that a curse was imposed on us by very fiscal and monetary policies coming out of Washington. A lot of what happened to the banking industry over this period was made by policy in Washington. So far, what I want to be involved in is to stabilize the environment that you all operate in and not be a part of creating the problem. I don't look at those of us on the central banking side of things as the solution to your problems; I look at us more as somebody that needs to avoid being the cause of your problems.

The long term health of the national economy, I think, is going to depend crucially on whether or not we are able to achieve and maintain price stability, and make people believe that we are going to do so. The steepness of the yield curve today--the yield that is embodied in long-term instruments especially--carries an unnecessarily high inflation premium. But how do you persuade portfolio managers that you are going to move to and maintain a stable price environment when you have a fiscal policy regime that is out of control with $350 to $400 billion deficits? That makes our job much more difficult. Yet, when people come to believe that we in the central bank are not going to cave into political pressures to monetize the nations debt, we will see a lower interest rate environment as a result of lower premiums for future inflation. That is going to help to strengthen the banking industry as well.

Finally, any kind of financial reforms in which we engage in the future should be based on only one principle: strengthening the discipline that comes from market forces rather than eroding those market forces. What we can do best is improve the quality of supervision so that the discipline comes from better information in the markets. In this way, we can move away from the age old permission and denial regulatory system that we operated under for so long after the 1930s which I think is simply inappropriate in today's environment. Thank you all very much for your attention.