Speeches by Bob McTeer

Remarks before the Risk Management Association
Napa Valley, California
March 8, 2003

Good morning. Thanks for inviting me to this beautiful spot. I vaguely recall speaking to the Robert Morris Association many years ago. I'm glad to see you didn't have to change the initials on your stationery.

Risk management is a fascinating topic that I don't know enough about. Like everybody else, I enjoy the premiums that go with extra risk, but I'm still indignant when the risk bites me. Give me the 17 percent on Argentine bonds, but how dare they default. Thankfully, I'm not allowed to speculate financially, so most of my risks are personal but not numerous enough to benefit from the law of large numbers.

Personal risk reminds me of what Peggy Noonan wrote about Gary Hart. She said he played Russian roulette, got shot and became angry at the bullets.

I'd be better informed about risk management if Texas banks had been better at it in the 1980s. As the bumper sticker says, I got to Texas as soon as I could—but not soon enough to save its banking system. Three months after I arrived in February 1991, I testified before Congress that "from 1987 to 1989, more than 400 Eleventh District Banks failed, which accounted for over half the failures nationally during that period. They represented 44 percent of the banking assets in the region. Broadening the time period a bit, the number of banks peaked at just over 2,100 in 1986 and fell to about 1,300 by the end of 1990, a decline of almost 40 percent."

That was the good news. The bad news was the thrift industry, which declined by more than half during the same period. Part of the lore of the time was that Texas bank failures included nine of its 10 largest banks. The one left standing was Frost Bank, whose current risk manager is your immediate past president. But he looks too young to take the credit for that.

Ironically, I had interviewed for the job of chief economist at one of the largest failed banks in 1980 or '81, and I sometimes wonder if I could have made a difference. Probably not. Even if I had realized that oil and real estate prices can go down as well as up, I'm not sure I would have had the courage to fight the conventional wisdom and mania of the time. My hunch is that the hardest part of your jobs is not the analysis but getting it taken seriously enough when you buck prevailing opinion within your bank.

My only firsthand experience with such matters was the Maryland S&L crisis in 1985. One hundred two state-chartered, privately insured S&Ls in Maryland experienced a silent run that broke out into the open and resulted in their temporary closure until an army of bank examiners could come in and declare them fit to reopen. The reason—the only reason—for the run was that Ohio had just had a problem with a similar private insurance system. So 102 Maryland S&Ls were closed, even though most of them were healthy, as was their insurance fund. I doubt most risk managers could have anticipated that outcome by studying the financials. Once the pond was drained, though, some bad things were revealed in the muck. Several of the larger institutions had some shady dealings that might have caused problems eventually. It's possible that given enough time, they could have grown out of those problems. But they didn't get the time because of an institutional feature unrelated to those problems. Of course, the myth took hold that the shenanigans were responsible for the failures. They weren't. The risk was from guilt by association: from being in a deposit insurance system similar to one that had problems in another state. It's hard to quantify that type of risk.

These days we are fond of saying we're getting better at bank examinations. We don't just go in and examine a large pile of loan documents. We examine a bank's own risk management procedures and a smaller sample of documents. I'm told that RMA has had a lot to do with that. That our examiners are more willing to rely on the banks' own analysis is due in significant part to your association's work in measuring and quantifying risk. Largely because of your efforts, not only are banks doing it better, but the Fed is, too.

Which, of course, is the direction Basel II is taking. My colleague Bill McDonough, president of the New York Fed and chairman of the Basel Committee, tells me that the RMA has been helpful during the process and instrumental in convincing the committee to recognize and adopt what the banks are already doing in risk measurement. Your surveys and research analyzing how banks determine their economic capital based on internal risk rating systems

have convinced the committee that some banks are better equipped than their supervisors to determine what their economic capital should be. But supervisors will be supervisors. They want to trust, but verify—by making sure your risk models pass supervisory muster. But that's still a huge step. As your past president has said, giving banks the option of using what Basel calls the IRB approach could be one of this decade's most important decisions affecting banking. Now I've just said more than I know about Basel II, except to acknowledge some interesting congressional testimony on the topic last week. Vice Chairman Ferguson presented the views of the Board of Governors, which I gather were more positive than those of the other supervisory agencies.

Before getting to the economy, I might just mention the obvious and acknowledge that the emphasis on operational and enterprisewide risk was boosted dramatically by the events of 9/11. The Fed did some things right that day and that week, but we were also lucky. Since then we've had a massive reevaluation and strengthened our contingency plans.

At the end of last year we had 39 separate post-9/11 projects under way, most of which were already completed. They fall under the headings of:

Improving the resiliency of private-sector infrastructure
Ensuring market liquidity
Ensuring continuity of Federal Reserve operations
Ensuring effective communication during a crisis

Of course, the Fed probably isn't a good role model for the private sector when it comes to risk–reward trade-offs. We are too willing to incur costs to reduce risks below what the private sector might find acceptable.

We do pretty well on credit risk. Probably too well since all our discount window loans have been paid off. And when it comes to market risk, we may be more the source of the problem for you than the solution. (That was a joke.)

The truth, if I do say so myself, is that we have reduced macroeconomic risks over the past two decades. The reduction of inflation and inflation uncertainty has lowered the volatility of GDP growth and reduced interest-rate risk as well. We now have a more stable macro environment for banks and their borrowers.

One area, however, you might want to give some thought to, if you haven't already, is the implications of greater price stability for banking. Inflation has come down substantially over the years, to the point where we are nearing our goal of price stability. Indeed, some serious people worry that, from this point, disinflation might morph into deflation. I'm not too worried about deflation. But price stability—which is on balance very desirable, both in its own right and because of its influence on other things—does have a downside.

Price stability is good for consumers but is often hard on producers. On the producer's side, a bit of inflation can go a long way in covering up a multitude of sins, such as inadequate cost control and inefficiency. They say we should never confuse brilliance and a bull market. Likewise, inflation, even fairly mild inflation, bails many firms out of some tight situations. The loss of pricing power in recent years has been hard on companies that were used to growing revenues with price increases their competitors would match. Not so for more and more industries in a competitive global market.

As for banking per se, our research director believes that the 1950s are instructive since that's the last time we had price stability. Once price stability becomes accepted as the norm, nominal interest rates will lose the inflation premium and nominal rates and real rates will converge. Yield curves will decline and, he says, will flatten as well. As long- and short-term rates become more nearly the same, bank profits from borrowing short and lending long will be squeezed. Banks, therefore, should be wary of long-term commitments that require large net interest margins for success.

For the past three decades, interest has been the largest cost component for banks. That could change. Wage and salary expenses could once again replace interest as banks' principal cost. Business strategies that call for employee growth could fare worse than those featuring shrinking payrolls.

You may recall that one of the headwinds that impeded the recovery from the last recession and initially made it a "jobless recovery" was the weakened state of the banking system—the credit crunch. The policy easings that brought the target fed funds rate down to 3 percent from late 1992 until early 1994 helped banking recover by putting

additional slope into the yield curve. A 3 percent nominal funds target was below zero in real terms given the 3 percent plus inflation rate of the times. The current 1.25 percent target rate translates into a roughly comparable real rate, given today's lower inflation. Policy easing usually contributes to a steeper yield curve, but the scope for doing so diminishes at lower inflation rates.

So far the jobless nature of the present recovery is similar to the last recovery. Most of the income and output expansion over the past five quarters has resulted from continued growth in productivity—output per hour worked. There has been virtually no net new employment growth despite the limited rise in the unemployment rate. So far, the unemployment rate has not exceeded 6 percent—up from around 4 percent prior to the recession. That's a 50 percent increase, but it is still well below the 7.8 percent peak of the last recession and the 10.8 percent peak of the one before that. Like the executive in "The Full Monte," some job losers must be keeping it a secret.

The current expansion began in the fourth quarter of 2001, only shortly after 9/11, and continued through last year in sawtooth fashion, with a weak quarter following each strong one. The fourth quarter of 2002 was a weak one—with real GDP up 1.4 percent. The average annual growth rate over the past five quarters has been just under 3 percent. That's low compared with the New Economy period of the late 1990s, and too low to achieve adequate employment growth while productivity is growing as fast as it is, but it was considered adequate in the Old Economy days.

The main reasons for expecting a stronger recovery are the prolonged and massive monetary easing, fiscal policy's move toward expansion, lean inventories and the desire of all of us to expand our income faster. Passage of the president's tax cuts should provide extra stimulus in the short run and, perhaps more important, better incentives for the long run. Challenges include a consumer who has kept spending at a rapid pace for an extended period, but with declining confidence. One has to wonder how long falling confidence and rapid spending can continue to coexist. The bigger challenges, at least so far, include the need for renewed business investment in the context of depressed profits and limited pricing power, and the recent drags of higher oil and gas prices and prolonged geopolitical uncertainty.

As you know, corporate risk premiums have fallen some in recent months but are still high. This suggests to me that we won't have a double dip but that financial markets are still something of a drag on growth.

The spread between AA-rated corporate bonds and long-term Treasuries generally gauges the market's value for liquidity (with some prepayment risk thrown in to muddy the water). While this spread has been elevated since the Asian crisis a few years ago, it's recent narrowing reflects less pessimism about the economic outlook and probably a market judgment that corporate bond defaults have peaked and are headed lower.

A more direct measure of corporate default risk is the spread between Baa and Aa corporate bonds, with Baa being the lowest investment grade (non-junk). This spread has remained pretty high recently compared with others, reflecting, I assume, some lingering concern about corporate accounting, among other things.

The commercial paper/Treasury bill spread has fallen back close to normal, but that may be giving a too-optimistic picture since many corporations have felt market pressure to switch from commercial paper to bonds.

The spread between emerging market debt and U.S. Treasuries reflects what we tend to know already. Brazil's premium rose last year but has receded some. Argentina's debt, on the other hand, has been yielding some 60 percentage points higher than U.S. Treasuries. I've got to get me some of that.

The corporate equity premium (over corporate debt) still suggests, I'm afraid, that bonds remain undervalued relative to stocks. Put another way, stocks are still risky, if history is a guide. My honky-tonk hero, Billy Joe Shaver, has a song pleading "Let me down easy, Lord." Me and my 401(k) have been along for the whole ride down. It's not been too easy. But why get off now?