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Remarks of

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Chairman, Board of Governors of the Federal Reserve System

at the

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It is always a privilege for me to have the opportunity to meet, however briefly, with so many bankers. That's particularly true at a time of apparent challenge for the banking industry, and the financial system more generally, of which we are both a part.

History has, at times, a strange way of repeating itself. It was here in New Orleans at this convention six years ago that I talked to you about the dangers posed by an inflationary environment and the hard steps we at the Federal Reserve had decided to take to deal with that threat to our basic economic health. I suggested that "those measures were not designed to make your life as bankers easier." I suspect many of you would agree that assessment was accurate.

Happily, the turbulence and uncertainty surrounding high inflation, and the extremely high and volatile interest rates and recession that ensued, have subsided since we were last in New Orleans. I realize that even now, after three years of expansion and much greater price stability, some important sectors of the economy are still feeling the after-effects of the inflationary excesses. Some of your loan portfolios reflect the strains.

I hope and believe that we have learned -- I should say relearned -- an old lesson from that experience. Once inflation takes hold, once it builds up momentum and permeates expectations, the necessary effort to restore stability and a sound base for growth inevitably entails greater risk of transitional pain and dislocation. In that respect, the United States is no different from any other country, now or in history. Far better that we recognize the crucial importance of maintaining a sense of stability, once regained. That remains the basic point of departure for monetary policy.

Human experience is, of course, a succession of challenges -- of new problems emerging as old ones fade, in part out of the very successes of the past. I reveal no confidences when I say that Jim Cairns, in inviting me to speak this morning, told me of his concerns about a sense of uncertainty and drift in the banking community today.

New competitive pressures are affecting traditional conceptions of your role in the scheme of things. A stability once taken for granted has been threatened. The industry often seems divided in its responses, and the legislative calendar has been blocked. I am certain many of you share a vague feeling of uneasiness.

We would all be making a grave mistake if we were to assume this is simply a passing phase -- a mere problem of perception that can be dealt with by a kind of soothing public relations approach, or by individual institutions acting alone to exploit competitive opportunities. Reassuring the public with words while managing earnings for a quarter or two, seizing on perceived regulatory or legislative loopholes to steal a march on others, or simply defending the status quo -- none of those will do the job.

There are, in fact, real problems that demand a constructive industry-wide response. Some of those problems, to be sure, arise from events external to banking. They grow out of the very speed of economic and technological change. As I suggested a few moments ago, the disinflationary process itself, combined with other strong pressures on agriculture and many traditional manufacturing industries, has posed difficult questions.

In important respects, the legislative framework for banking _is_ outmoded. At the same time, the difficulties of achieving suitably broad and coherent new legislation from a Congress beset by competing demands is well known.

But we cannot avoid the fact that some of our evident problems must be laid at our own doorstep. Unfair as it may seem to the great mass of prudent bankers running demonstrably healthy and profitable institutions, the evident difficulties and excesses of a few banks and a larger number of thrifts inevitably have raised questions about the direction the industry is taking.

For one thing, that has not provided a favorable climate for forward-looking legislation. More important, as bankers and regulators, we have to ask ourselves whether a generation and more of growth and smooth sailing did not in fact dull our sensitivities to some of the eternal verities of banking -- first of all, that the faith and trust of the public not be taken for granted; that weaknesses in one link in the banking fabric can undermine the stability of the rest; that the first qualification of a lending officer is sound credit judgment and not salesmanship.

Let me be more specific. After years of inflation, was there a temptation to substitute an assumption of rising prices for careful credit appraisal including prudent concern for the longer-term prospects of the borrower, his character, and his cash flow? Has the attention paid to simple capital/asset ratios driven risks "off-balance sheet," and is "off-balance sheet" also "out of mind"? Have we too easily assumed liquidity simply is access to the marketplace, only to find that access quickly closing in when difficulties arise?

I know that most of you can properly answer no to those questions. Moreover, I think we can begin to see, in perceptions of analysts and in the marketplace, a clearer correlation between prudent banking and bottom-line results. I can't help but be encouraged by the evidence around me of renewed care and vigilance that, over time, can only reinforce both the image and stability of banking, and thus provide a strong base for growth. But we also can't be blind to the exceptions.

This isn't a plea to retreat into a shell, over-reacting to external pressures and isolated internal weaknesses in a way that would damage both the country and industry prospects. Nor do I suggest that banks do not have to reach out into new services or markets. What it does suggest is that, as new activities are undertaken, certain basic principles of banking need to be respected, including appropriate emphasis on capital, liquidity and controls.

The supervisory agencies naturally have a strong interest in supporting and reinforcing those principles, and in updating our own approaches in the light of the changes in the marketplace. Naturally, we want to identify problems as soon as we can, and once identified deal with them promptly. At the same time, we don't want our efforts to encourage prudence to run at cross purposes with your competitive strength and ability to respond to the needs of your communities; we, too, need to guard against an over-reaction that can only complicate matters or contribute to weaknesses elsewhere in the financial fabric.

One area that we are reviewing is the approach toward capital standards. As you know, all the bank regulatory agencies have tightened those standards in recent years. I believe the results have been healthy overall, and it is particularly encouraging that banks typically now wish to operate significantly above the minimums required.

At the same time, for all our words of qualification about taking other factors into account, our stated capital guidelines are crude -- they are simply capital/asset ratios that cannot really reflect the diversity of risk among banks. Significantly, they seem to provide some perverse incentives to reduce liquidity or relatively safe but low-margin assets to curtail asset growth, while encouraging extraordinary growth in off-balance sheet risks, particularly at very large banking organizations.

Consequently, we have been looking at the feasibility of supplementing (but not replacing) the current guidelines with a risk-based measure, in effect providing a "second opinion" on capital adequacy. Not so incidentally, such a measure would facilitate international comparison and eventual consistency, a matter of substantial importance to institutions in direct competition with foreign-based banks. Naturally, we will look forward to your comments. To that end, we expect to have specific proposals out for comment by year end.

In our inspections of holding companies, we will also be giving increased attention to the ability of each subsidiary, as well as the parent itself, to, in effect, stand on its own feet with respect to capital and liquidity. We fully realize that the fortunes of the bank, in practice, cannot be fully insulated from that of its owner or affiliates, or vice versa. But, if banking organizations increasingly undertake ventures beyond banking, we do not believe it appropriate that such ventures necessarily be financed like a bank, with the extra leverage that may imply, under the common shield of the holding company. In the interest of common standards, we will also shortly be setting out a guideline for the payment of dividends for banking organizations experiencing significant losses in earnings or earning power.

We are also taking a number of other steps to enhance he effectiveness of our supervisory activities. That will involve intensifying the frequency and scope of our examinations nd inspections of larger banking organizations, at the same time endeavoring to increase cooperation and coordination in the examination of smaller organizations with other federal agencies and state banking authorities. Indeed, if states are willing and have the required resources, we would plan to increase our reliance on their examination of smaller banking organizations.

Finally, I hope you will soon be able to observe the results of some new approaches to communicating the results of examinations and inspections to the boards of directors of organizations with problems. We want to make that process more meaningful for both of us, recognizing that in the end, it is the directors' responsibility to see that corrective actions are taken when problems have been identified.

Banking is, of course, a business. But it's not, in my judgment, just "another business." We are the custodians of the money supply and the payments mechanism. The stability and reliability of that system underlines the stability of the financial system and the country.

It is those simple propositions that demand that we work together, as a matter of first priority, to maintain and justify the confidence so central to the business of banking. It is those same propositions that justify the special federal protections for banking -- explicitly, the "safety net" embodied in the Federal Reserve and the FDIC. That system, I would submit, has demonstrated beyond reasonable question its ability to protect the public at large and the stability of the banking system as a whole from contagious infection of a few troubled institutions. But that system has not, of course, been designed to protect individual stockholders or managements, or to encourage financial acrobatics on a high wire.

Maybe all that sounds trite, but I don't think it's really old fashioned. Rather, it seems to me to provide a solid basis for an approach toward the future that should command broad support both within the industry and outside -- a valid framework within which we can, together, resolve the nagging questions of where we are going as an industry.

I do not, of course, suggest that any broad philosophical consensus, built on full recognition of the uniqueness of banking, can resolve all the particular disputes within the industry or outside, or provide answers to the complex questions of designing precise legislative provisions or changes in the insurance or regulatory systems. Nor do I have the time this morning to examine all that in detail. What I would insist upon, however, is the relevance of these considerations to any legislative effort, as well as to supervisory and bank policies.

Take the issue of nonbank banks that has been a matter of so much agitation. It is now before the Supreme Court, faced with two diametrically opposed Circuit Court decisions as to what existing law requires. One view is that, in administering the law, we in the Federal Reserve must interpret restrictions on nonbank banks very narrowly; the other is that we must prohibit them entirely.

Whatever the Court may decide based upon an interpretation of existing law, one implication of nonbank banks is plainly to violate the long-standing public policy differentiating between "banks" and other businesses. All our experience demonstrates that businesses combined under a single corporate umbrella cannot be fully insulated, one from another. Valid questions arise as to where the borderline should be legitimately drawn -- questions I will address in a moment. But there can be little doubt that breaking down the distinctions almost entirely -- whether under the beguiling slogan of "consumer" or "family" banks or in response to narrower motives of direct access to the payments system -- would fail to respect the "uniqueness" of banking. The ensuing questions of conflict of interest, undue concentration of resources, unfair competition, and the transmission of unregulated risks to the financial system would hardly be consistent with long-standing public policy and the operation of the safety net.

Specifically, in a nation of 14,000 banks and 4,000 thrifts, nearly all of them dedicated to "family" banking, the argument that we need look to retailers or others to provide services or competition is not convincing. The public policy concern lies rather in the effort of commercial corporations to skim off bits of business that are perceived to support profitable nonbanking operations, weakening the fabric of banking in the process.

Meanwhile, we have the spectacle of banks themselves actively exploiting the same legal loophole in an effort to expand their operations interstate. That effort, which takes many forms, does not raise those same fundamental questions of safety and soundness; it does not challenge the uniqueness of banking or the supervisory structure. But as things now stand, we cannot permit banks to establish "non-banks" without permitting commercial firms to do so as well.

The obvious way out of the impasse is to close the non-bank loophole and deal with the question of interstate banking on its merits.

I know leaders of your industry are struggling to arrive at an agreed approach, blending the legitimate concerns of different elements of the industry with approaches that respect both the national interest in broad and fair competition and the ability of particular states to "opt out" of interstate banking entirely. But I am also struck with the fact of how quickly painfully worked out constructive compromises unravel. In the circumstances, it's no wonder that legislation languishes, and the incoherence and loopholes remain.

In approaching these issues, all of us are conscious of the pressures on and from the thrift industry -- pressures on their own position and supervisory mechanism, and the pressures from competition as the thrift industry has assumed more and more banking powers. Effective competition is one important objective of public policy. What is at issue are the terms of such competition.

Special privileges for thrifts, in terms of access to federally sponsored credit, tax treatment, branching, nonbank ownership, and otherwise, seem to me historically rooted in one characteristic -- their concentration on home finance and savings accounts. As those institutions take on the full panoply of banking powers, the logic seems to me unassailable that all these depository institutions respect the same broad public policy objectives, explicitly including appropriate limitations on nonbanking ownership and certain nonbanking activities.

I also welcome the efforts and progress that the Federal Home Loan Bank Board is making, in most difficult circumstances, toward improving supervisory and regulatory standards. Its recognition of the need to work toward higher capital standards as conditions permit is particularly important. Full competition, in this, as so many other areas, should imply fair competitive ground rules.

All of this raises again the question of appropriate powers of both banks and thrifts and their holding companies. A broad separation of banking and commerce leaves a substantial "gray" area -- at what point should banks (or bank-like thrifts), in response to powerful forces of technology and competition, extend into areas that might not be banking, strictly defined, but might be a part of a more comprehensive package of financial services?

As you well know, an increasing number of states are, in effect, leapfrogging the issue by granting authority for their banking or thrift organizations to provide virtually any loosely defined financial service -- indeed, at the extreme, to enter any business. I find no evidence that the movement is based on any broad conception of what is appropriate as a matter of national policy. Rather, it's clearly driven by a competitive effort, not to add to the total number of jobs, but to attract some margin of bank employment from a sister state. The reductio ad absurdum is when a state provides authority for new powers only so long as the jobs are in that state but the powers are exercised beyond its boundaries.

The philosophy of a dual banking system seems to me implicitly dependent upon a sharing of broad prudential concerns -

a sharing reflected in the fact that the federal safety net encompasses state as well as federally chartered institutions. Competition among states for a larger share of a fixed number of jobs can't provide a sound basis for public policy when the safety and soundness of the system are at stake.

At the same time, I can well understand the frustrations of bankers in looking to any avenue for relief in the absence of constructive federal legislation. I also know our regulatory judgments in the Federal Reserve have not always coincided with the hopes and desires of some banking organizations pressing for aggressive expansion.

But the fact is we are already operating at the edge of existing law, and in many areas important to banks -- underwriting of revenue and mortgage bonds, sales of commercial paper, and a wide range of brokerage activities -- our judgment coincides with yours that neither safety and soundness nor other considerations should stand in the way of change in the law. In other areas -- including real estate development and insurance underwriting -- I believe recent developments only underscore grounds for caution.

My point is simply that the industry should be able to find common ground consistent with its historic role. It can accept competition, as from the thrifts or interstate, when the competitors play by comparable ground rules. It can properly resist intrusion on its regulated core business in the payments system. And it can properly insist on appropriate powers in the financial area consistent with its own safety, soundness, and unique characteristics.

All of this adds up to a large and substantive agenda for all of those concerned with the health and vitality of the banking industry. We need first to make sure our own houses are in order. In the legislative arena, perceptions of the public interest may differ among industries, and those differences must be reconciled. What can be more debilitating are conflicts within the banking industry itself.

Success on all these fronts will be dependent, in large part, on a sense of closer cooperation among yourselves. That is always hard in a fiercely competitive environment. But it is possible, in the mutual interest, so long as there is a common vision about the role of banking in our society.

That sense of common vision is today being tested in one area familiar to bankers -- how to deal with troubled debtors among different institutions when varied particular interests are at stake. What is unique today is the size of the challenge in the international area.

There are some $275 billion of loans outstanding from banks world-wide to hard-pressed nations in Latin America and elsewhere. The commercial banking community can take pride in its contribution to diffusing and managing the crisis that arose more than three years ago. Substantial tangible progress has been made over that time.

The debtors have been remarkably successful in restoring better external balance; as a group, the troubled, heavily indebted middle-income countries have reduced their aggregate current account deficits from about $45 billion in 1982 to some $5 billion this year and last. In a number of important countries, economic growth appears to be underway. The continuity of debt service has been largely restored. Bank creditors, within the framework of IMF agreements and strong efforts of borrowers, have provided a margin of necessary new funds to facilitate the adjustment process, which was bound to be difficult in the best of circumstances. Even so, the exposures of U.S. banks, relative to capital, have been appreciably reduced, by nearly 25 percent, over the past three years.

Nonetheless, there has been a clear danger of the constructive process losing momentum. Net new bank lending appears to have practically stopped this year, adding to a sense of political and financial uncertainty and frustration among borrowers as they face the need to achieve sustained growth.

That is why Secretary Baker, at the recent World Bank-IMF meetings in Seoul, outlined an important new initiative to support sustained growth. That initiative builds directly on the progress and approaches of the past three years, including a central role for the IMF. But it also implies much more active lending by the World Bank and the official regional development institutions -- lending that would be designed to support, and be dependent upon, the necessary restructuring of the economies of debtor countries. At the same time, resumption of moderate amounts of net new financing by international banks would be necessary to provide essential support.

The rationale is simple. There is a common interest in sustainable growth -- growth necessary to meet the legitimate aspirations of the borrowers and growth not unduly dependent on external finance. That same growth should progressively lighten both the heavy debt burdens of the borrowers, relative to the size of their economies, and the exposure of the lenders, relative to their assets and capital.

Success will require both financial discipline and fundamental economic change -- change toward more efficient, market-oriented economies, more room for private initiative and investment, more competition, and more openness. Happily, that is the direction in which new leaders in Latin America -- democratically elected leaders -- have repeatedly said they want to take.

Among other things, those countries will have to use their own savings more effectively. In a sense, the acid test will be whether their policies can command the confidence of their own citizens so that those savings can be put to work at home, building their own economies.

But even in the best of circumstances, growth will require some margin of external financial support -- only a fraction of what was lent so freely in the 1970s, but some nonetheless. International institutions dedicated to development can reasonably be called upon to provide some of that support. But success of the program will also require that the international banking system that has so much at stake do its part as well. Borrowers undertaking strong measures can legitimately ask that they have some assurance of such external support over a period of time, so long as they do their part of the job.

An approach capable of meeting those interlocking needs is the essence of the program outlined by Secretary Baker. The common goal of sustained growth requires mutual action -- by borrowers, by international institutions, and by the banking community together -- and the success of the whole rests upon each part. His challenge to the international banking community is clear. Can it develop a suitable approach for pledging that enough net new loans be made available at their risk, with such funds to be made available alongside IMF and World Bank participation, to provide assurance that countries undertaking the necessary economic reforms at home will also have a necessary margin of finance from abroad?

Participation in such a program is in the end up to the decision of individual institutions. At the same time, I think it's fair to say that, on a global scale, the situation is a familiar one to bankers, where the particular interest of each participant in the fortunes of a debtor needs to be judged in the context of the potential benefits of a concerted approach.

Indeed, from a broad perspective, there is a rare opportunity, not just in narrow financial terms but in terms of patterns of growth and political stability in Latin America and the world generally. Adversity clarifies choices. The yeast of change is at work among the developing countries. That change can be constructive for them and for us -- or the reverse. And the direction it takes is partly up to all of us, in our public or private responsibilities.

I can only be encouraged by the initial responses to Secretary Baker's initiative, by government and by banks alike. Clearly, many obstacles and difficulties remain to be overcome; moving from broad concept to practicality is an enormous challenge in itself. In the end, the decisions are up to individual bankers. I can only ask that the challenge be approached constructively, with recognition of what is at stake.

In a real sense, that is part of my larger message today. The evident strains, pressures, and uncertainties in the banking system require action. But we also have a lot of strength on which to build.

I believe bankers and supervisors alike are already moving effectively to deal with particular areas of concern. We need to take care in doing so that we support the continuing needs of customers and the economy.

We also need to take account of the future, and for that we need a larger vision -- and a common vision. That vision, it seems to me, should and can be rooted in principles of prudent banking and public policy that have remained valid for generations.

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