Future Priorities in Banking and Finance

Good afternoon, ladies and gentlemen It is always a pleasure to have this opportunity to address the Mid-Winter Meeting of the New York State Bankers' Association. Allow me to say at the outset that I find it hard to believe that this will represent the sixth year in which I will have addressed this group in my capacity as president of the Federal Reserve Bank of New York

In that setting, I am reminded of the well-known Chinese curse, "May you live in interesting times" However, I am inclined to the view "interesting," yes, but not *too* interesting! I say that because in reflecting on developments in banking and finance during the 1980s, I am truly struck with all that we have been through in ten short years.

In the early weeks of 1980 we saw the House and Senate reach essential agreement on the Monetary Control Act of 1980, which among other things was to usher in a whole new era of banking by virtue of its deposit interest rate deregulation provisions. But in precisely that same time frame we were also confronted with the first of the major financial disruptions of the decade the silver market episode Little did we know at the time that the decade as a whole would see a recurring pattern of serious financial disruptions that would crisscross financial markets and institutions of all types and sizes LDCs, LBOs, big banks, small banks, thrifts, government securities dealers, stock markets, junk bond markets — to mention some — have all, at one time or another, been sources of concern

Perhaps because of good fortune, perhaps because of good policies, perhaps because of the ability of individuals and institutions — public and private — to rise to the occasion, or perhaps for all of these reasons, the economy and the financial system weathered these storms in remarkably good order That is reassuring, but it should not delude us into the belief that our problems are in any way behind us Let me cite a few examples of what I mean

- Looking at money center banks, one cannot help but be impressed by the fact that over the last decade, the primary capital of these institutions has almost quadrupled in absolute terms and has more than doubled in relation to assets That's the good news, the bad news is that for these same banks, net charge-offs over the decade have exceeded net income, and at year-end 1989 — after the longest peacetime expansion in history — nonperforming loans were more than double their level at the end of 1982 when the economy was coming out of the deepest recession since the 1930s

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Remarks by E Gerald Corrigan, President of the Federal Reserve Bank of New York, before the 62nd Annual Mid-Winter Meeting of the New York State Bankers' Association, January 25, 1990

- The LDC debt situation — while not nearly the threat to the international banking system that it was in 1982 — still constitutes a major overhang on bank balance sheets and on the global trading and economic system Indeed, for both the banks and the individual LDCs the problem today may in some ways be almost as difficult as it was in the early 1980s. The major banks, for example, have strengthened reserve positions to the point that makes it very inviting simply to walk away from the problem and the process, even though in the aggregate that very act could only mean that reserves would become charge-offs and then some By the same token, the current environment for the LDCs is one in which the temptation to try to finance a country by accumulating interest arrearages or by otherwise ignoring or downplaying the need for ongoing relationships with private sources of credit flows might be very inviting but not in the best long-run interests of the countries themselves Indeed, either could drive a still larger wedge between the country and the ability to meet ongoing needs for external financing from private markets and institutions in a setting in which public institutions surely will not be able to do the job alone
- Despite all of the earlier experience with concentrations of bank credit in real estate investment trusts, in LDCs, in the oil patch, and in agriculture, we still see large concentrations of lending in such areas as real estate and highly leveraged financings, either of which can be especially vulnerable to changing economic or financial conditions

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- In securities and wholesale banking markets we see enormous pressures on spreads and margins amid recurring bursts of volatility, in a setting that seems to suggest an even greater preoccupation not just with the short run but with the very short run Indeed, I sometimes get the feeling that some market participants seem to view a long-term investment as one they hold overnight! Unfortunately, I also have an uneasy feeling that the lessons that should have been learned from earlier bouts with adversity may not have been fully retained For example, market participants still seem to me to suffer from the so-called illusion of liquidity, whereby positions are taken and strategies devised in the belief that markets will always be sufficiently liquid to permit such positions to be unwound or hedged with relative ease and at little risk of loss

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In this environment the need for very strong internal controls, risk management systems, and tight managerial oversight becomes all the more compelling, even though such efforts are very expensive
- To cite just one more example, despite the passage of several important banking laws over the decade, the basic structure of our banking and financial system remains outdated and in disarray In certain respects — especially in an international setting — I would go so far as to say that the structural flaws in the U S banking and financial system have actually gotten more serious, if only because we tinker while others progress

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I could go on to cite other examples but I think the message is clear and that, of course, is that while the economy and the financial system of the 1980s showed great progress and adaptability, we start the new decade with a major agenda of unfinished business The most important part of that agenda has to do with macroeconomic, structural, and trade policies Having spoken on those issues in another address only two weeks ago, I would like to concentrate the balance of my remarks today on some of the key priorities for the period ahead in the areas of banking and finance, with emphasis on a number of issues that strike me as having particular importance over the near to intermediate term

A very high priority, at least as I see it, remains the need to reform and modernize the basic structure of our financial system. While it may sound presumptuous, I still regard the framework suggested in my 1987 essay, *Financial Market Structure — A Longer View*, which was first introduced before this audience, as a very useful starting point in that effort. Having said that, I do not want to leave the impression that there may not be some specific areas in which events of the past three years may have shaded my thinking in one direction or another However, on the most basic concepts — including the case for a strong and *independent* banking system — the depth of my convictions has, if anything, increased. I also recognize that reform

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and modernization of the structure of the federal regulatory and supervisory system are long overdue, but I continue to believe that effort must follow, not precede, reform of the financial system itself. Finally, I continue to believe that whatever form regulatory restructuring might take, it is vitally important that the Federal Reserve, as the nation's central bank, retain a central role in the banking and financial market oversight and supervisory process.

A second area of importance relates more specifically to securities institutions and markets. Here I want to indicate my support for the broad thrust of S-648. The major provisions of that bill would (1) provide for authority for the Securities and Exchange Commission (SEC) to close markets in emergencies, (2) authorize the SEC to collect information on large securities trades, (3) authorize the SEC to collect information on the risk exposure of affiliates of securities firms, and (4) provide greater impetus for coordination of clearing and settlement activities within and across markets.

In many respects, the provisions of this bill are an outgrowth of the October 1987, and to a lesser extent the October 1989, breaks in stock market prices Whether in the context of this bill, the ongoing work of the interagency group formed after the 1987 stock market fall, the initiatives of the various stock and futures exchanges, the recommendations of the Group of Thirty regarding improvements in delivery and settlement systems for equities, or the efforts of individual firms to strengthen controls and procedures, much has been done to protect the system against the systemic disruptions that seemed so close at hand in 1987 But I have to wonder aloud whether we will have gone far enough, even if something along the lines of S-648 were promptly enacted

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For example, there are several areas in which I believe further steps should at least be considered. None of these is going to be very popular, but let me spell them out, if nothing else, as grist for the mill

> *First*, while it is true that the bill is designed to authorize the SEC to gather certain data on the overall financial condition of securities companies — including information at the level of the holding company — I am not persuaded that we should necessarily stop with information gathering. For example, as a longtime advocate of some limited degree of consolidated supervision in banking, it seems to me that careful thought should be given to the suggestion that minimal capital standards and a limited degree of consolidated supervision should apply not only to registered broker dealers but also to the securities firm as a whole, including its parent holding company. This may be par-

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ticularly appropriate in view of the fact that many of the more risky activities of such firms take place either at the level of the holding company or in an unregulated subsidiary of the holding company. Similarly, the opportunities for, and the possible risks of, excessive double leveraging are no less in the case of securities holding companies than they are for bank holding companies Finally, it is also true that a system that relies on at least a degree of consolidated supervision for securities firms would be much more in keeping with arrangements in other industrial countries. Of course, what underlies my view in this regard is that I remain strongly of the opinion that serious problems in any one part of a financial firm will inevitably impact the firm as a whole despite legal separations and regulatory firewalls.

Second, I am still not at all sure that margins for financial futures are as high as they should be, at least from the vantage point of their role as a financial shock absorber helping to ensure the safety and integrity of the clearing and settlement mechanisms for such markets. My concern in that regard was heightened by events after the market sell-off on Friday, October 13, 1989 The Chicago Mercantile Exchange increased margins on the S&P 500 contract by $1000 per contract for the opening of business on Monday, October 16, and again on Tuesday, October 17

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While such actions can be highly appropriate in particular circumstances — especially when motivated by the desire to protect the financial integrity of the clearing apparatus — it is also true that increasing margins in circumstances such as those prevailing at that time can create the very problem that such actions are seeking to avoid. In fact, a good case can be made that margins should be high enough in the first instance that they do not need to be raised in emergency situations. Indeed, to take it one step further, the mere fact that margins must be raised in an emergency suggests that they may have failed to perform their functions

Partly for this reason, and this is very much a personal view, I believe that margins in many financial-type futures instruments are typically — if not systematically — too low. In the case of the S&P 500 contract, for example, it seems to me that a significantly higher margin — perhaps as high as 15 percent or so — is always called for I also have serious doubts as to the wisdom of leaving the day-to-day establishment and administration of minimum margins to the exchanges In saying this, I know there are many who would take serious objection to this suggestion, primarily on the grounds that such higher margins would increase transactions costs and reduce liquidity in these markets There may or may not be something to that argument, but even if it were valid, it seems to me that achieving a somewhat deeper financial cushion in the clearing and settlement mechanisms associated with these markets may be worth these costs, especially to the extent that there is a tendency for such liquidity to be illusory in times of stress

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The ability of all markets to function well under adverse circumstances is crucial to their long-run health and competitiveness *and* their ability to fulfill their fundamental role of helping to achieve the best possible allocation of savings and investment in the economy as a whole It is in that spirit that I firmly believe that further debate and dialogue on this very controversial subject are urgently needed. The goal must be to find the proper balance between transactions costs and liquidity, on the one hand, and prudential standards, on the other This, of course, is a matter of judgment, but in my judgment the tilt should be in the direction of greater weight on the prudential considerations

The *third* area I want to cite in this regard relates to clearance and settlement procedures and systems more generally Here, great strides have been and are being made, as reflected in the effort to accelerate significantly final delivery and settlement of stock trades in the cash market Under the best of conditions, however, that effort will take several years to complete. And as revolutionary as these changes may seem to be, even so they do not come to grips with all the issues, especially the delicate relationship between clearance and settlement systems in the cash markets, on the one hand, and the derivative markets, on the other A goal worth striving for would be one in which the timing of final settlement in cash and derivative markets would be the same, since in these circumstances a strong case could be made that both the level and structure of margins in both markets could converge to a very significant extent. That may be a long way

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off since it presupposes, among other things, a comprehensive book entry system for equities It also implies that we make further progress in satisfying market participants that overall market infrastructure — including the all important credit decision-making apparatus — is fully geared to shortened time frames for final payments and settlement Finally, it implies that much of the burden for adjustment falls in the cash market, but I believe it is a goal worth striving for over time

This also is an area in which the need to keep in mind the international attractiveness of U S markets and market-related institutions is very important That is, as technology changes and as other countries and other financial centers improve the workings of their financial markets,

As technology changes and as other countries and other financial centers improve the workings of their financial markets, the relative position of U.S. markets can deteriorate unless we are making comparable or greater strides in improving the efficiency, effectiveness, and stability of markets here in New York and in the United States generally.

the relative position of U S. markets can deteriorate unless we are making comparable or greater strides in improving the efficiency, effectiveness, and stability of markets here in New York and in the United States generally The United States has an important comparative advantage over most other countries in this regard, and that is something worth preserving — consistent, of course, with the prior dictates of safety and stability

The *last* subject I want to touch on in this regard is circuit breakers, which I regard as something of a necessary evil They are necessary because patterns of extreme market volatility seem to provide little alternative but to allow intervals of time during which market participants can better absorb information and react in an appropriate fashion However, across-the-board halts in trading, and especially the closing of markets, can entail the risk of making things worse rather than better At the very least, we must keep in mind that once a market is closed, it must be reopened — a task that may not be easy

Having said that, I must reluctantly confess that I believe we probably do need a system of circuit breakers. However, I also believe it very important that such circuit breakers be closely and carefully coordinated between cash and derivative markets. For example, generalized trading

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halts and/or market closures should always be triggered in a context in which it is recognized that cash and derivative markets are in fact one At the end of the day, however, our goal should be to encourage patterns of behavior in markets in which circuit breakers, even though they exist, never have to be used.

In a very real way, I find it regrettable that my sense of uneasiness about patterns of behavior in financial markets brings me to the point where I feel the need to put these ideas on the table for consideration I say that for two reasons First, whatever else may be said about these suggestions, it must be admitted that they deal with symptoms, not causes. The causes lie with the fundamentals economic policies and performance, financial market structure, and the perverse incentives — for business corporations and institutional and individual investors — that produce such enormous preoccupations with the very short run. Second, and not unrelated, all of us would be much more comfortable with an approach in which the marketplace itself was free to both reward and punish without reliance on regulatory or legislative safeguards That, of course, raises the profoundly important question as to why such safeguards exist in the first instance.

The historic rationale for these safeguards has a number of foundations, many of which are, one way or another, tied up in the understandable desire to protect small and unsophisticated investors and depositors. Even more essential, however, is the age-old concern about systemic risk, or the danger that a disruption in one part of the banking and financial system will spread to other parts of the system, thereby undermining confidence generally and inflicting damage on the real economy. As I have mentioned on a number of occasions, concerns about systemic risk are neither new nor unique to the United States. For example, in *The Wealth of Nations*, Adam Smith presents the classic case for the regulation of banking on precisely the grounds of systemic risk Similarly, in every nation, regardless of size, state of development, or political persuasion, governments and monetary authorities are universally reluctant to tolerate the sudden and disorderly failures of banking and financial firms because of concerns about systemic risk and public confidence

In every nation, regardless of size, state of development, or political persuasion, governments and monetary authorities are universally reluctant to tolerate the sudden and disorderly failures of banking and financial firms because of concerns about systemic risk and public confidence.

Looked at in that light, it is not surprising that governments of all types have chosen to have so-called safety net features associated with the workings of the banking and financial system While the particulars of such arrangements differ from country to country, they are all deeply rooted in concerns about systemic risks, and they all give rise, to some degree, to the so-called moral hazard problem.

In its most straightforward form, the moral hazard problem has as many as three dimensions The first is that the mere presence of the safety net (regardless of its specific form) will encourage banking and financial firms to take on more risk than they otherwise would or could. The second is that depositors and/or other creditors will not subject such firms to the same tests of creditworthiness as they would firms that are outside the safety net. The third is that the mere presence of concerns about systemic risk will force the central bank or other authorities to intercede in some fashion on behalf of troubled institutions by providing some form of financial or other support in the face of adversity, thereby validating the behavior implicit in the first two factors cited above

As we have seen in the thrift industry situation, the moral hazard problem can be quite real and can give rise to sizable claims on the public pocketbook. However, as reprehensible as the thrift industry situation may be, I believe it important that it not cloud our vision as to what makes for good public policy In this regard, I believe that the basic approach to the safety net in this country is workable and sound, and while the point can be debated, I also believe that arrangements in the United States provide at least as much—if not a greater—role for market discipline than is the case in many other countries.

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Having said that, allow me to quickly add that there are constructive changes in emphasis that could tilt things in the direction of greater market discipline and less implicit reliance on the safety net. I have in mind such possibilities as finding ways to deal with the abuses of brokered deposits, the swifter and earlier resolution of capital-deficient—though still technically solvent—institutions, and achieving still higher levels of capital, especially equity-type capital and/or wholly unencumbered subordinated debt capital in financial institutions.

On the other hand, I find very troubling certain proposals that on the surface seem to have great intuitive appeal For example, I am unconvinced of the merits of extending deposit insurance premiums to offshore deposits in branches of U.S banks, not simply on competitive grounds but far more importantly on the grounds that this would extend the appearance of full insurance to the one class of depositor that has unambiguously exerted a clear pattern of market discipline on large banks that get into trouble. While on the subject of large banks, let me say that I am mindful of the widespread view that some banks are too big to fail. That view has very troubling implications and does not jibe with reality After all, a number of large banks have failed, and in the process managers and shareholders have been wiped out In other cases, market and regulatory pressures have forced troubled large institutions into major restructurings, shrinkages, and the need to raise large amounts of new equity-type capital despite the sizable dilution of existing shareholders. Having said that, care and discretion will always be needed in handling serious problems in major institutions in order to guard against the systemic dangers I spoke of earlier.

With any troubled financial institution, but especially in the case of large institutions, I believe the workings both of the safety net and of market discipline will be better served in a context in which the authorities maintain a policy of what I like to call "constructive ambiguity" as to what they will do, how they will do it, and when they will do it. In saying this, I recognize that financial market participants do not like uncertainty, but that is just the point! Moreover, while I fully understand the yearning in some quarters for something of a cookbook approach to problems in financial markets or institutions — large institutions especially — I regret to say that in my judgment such a cookbook does not, and never will, exist. The circumstances associated with a particular case, the setting in which it occurs, and the assessment of the relative costs and benefits of alternative courses of action will always have to be looked at case by case But in no case should it be prudent for market participants to take for granted what actions the authorities might take, and certainly in no case should owners and managers of troubled institutions — large or small — conclude that they will be protected from loss or failure

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I began these remarks with a series of references to all of the difficulties and disruptions our financial system and economy surmounted during the 1980s We can and should take a measure of satisfaction from that experience, but we must attend to the potential sources of problems down the road While many of the solutions to those problems lie with the economic policy fundamentals, steps that would improve the structure and workings of our financial system are an important part of that agenda for the future The case for such improvements seems to me clear on its own merits, but we should also keep in mind that the international competitiveness of our financial markets and institutions is very much at stake.

Looked at in that light, there are many factors that will, over time, be important in maintaining a competitive edge in banking and financial services However, one overriding consideration will surely be public confidence — both here and abroad — in such markets and institutions. In turn, that confidence will flourish only in a setting in which our major institutions are not just strong and sound, but the strongest and soundest, and in a setting in which the safety and absolute integrity of such markets and institutions are beyond question You can judge for yourselves where we stand on that spectrum, but I, for one, think we have some work to do

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