Our Changing Financial System

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The topic for this session—our changing financial system—is most timely. Of course, it might be said that it would be timely at any point in our history. Change is always with us, and our financial system has always been changing—more or less. But there are periods when change in some areas of our lives and institutions is more rapid, more pervasive, more forceful, than at other times, and it seems to me that our financial system is now and has been in the midst of such a period.

These changes, and the problems and prospects they have created, have been the subject of a good deal of public attention in recent months. There is no doubt that the attention is warranted and that there should be concern about the future course of change in the financial system. Perhaps what is not as well recognized, however, is that where we are today is the result of a profound, but subtle, process of change that began at least ten years ago. More recently, national and international economic developments of the last few years have had a particularly strong impact on our financial system. Only by understanding these changes in their longer perspective can we assess the implications of our present state of affairs for the future.

Anyone looking back over the period of the 1960's cannot fail to be impressed by the rapidity of the growth of the banking industry during these years and the speed and scope of the banking innovations that were introduced. The incentives for such growth, change, and experimentation are not hard to identify. The expansion of worldwide production and trade required increased financial services. Even more significant were the gathering forces of inflation, fueled in part by rising levels of governmental expenditures. Those inflationary pressures greatly magnified the underlying demand for bank credit.

Further, during these same years, the level of financial sophistication of bank customers advanced considerably. On one side, corporate treasurers—spurred by rising interest rates and competitive pressures—developed more sophisticated techniques in the utilization of bank services. On the other, consumers increased their demands for financial services and astute bankers recognized that consumer finance was a vast and growing market.

In the face of expanding demand for financial services, the concept of liability management gradually took hold among many of the nation's banks. With traditional sources of deposits past their peak of growth, these institutions turned to new instruments, new sources of funds, and new approaches to money management. The negotiable certificate of deposit provided banks with a marketable instrument to compete for interest-sensitive funds at fixed maturities tailored to specific investor needs. Federal funds activity swelled, as the nation's large banks sought to mobilize and put to work idle pockets of cash that were available throughout the country. The Eurocurrency markets, with their huge pools of dollars accumulated in part from United States payments deficits, were viewed as a viable source of liquidity.

It was only natural, with the increasing internationalization of world production and markets, especially the growth of United States multinational corporations, that United States banks would become increasingly international minded in their operations. United States banks developed sources of funds abroad, actively sought the overseas business of firms they served at home, and expanded their lending to foreign firms and governments. They greatly expanded their networks of foreign branches and subsidiaries, forging new links with the Euro-dollar and foreign currency markets. At the same time, foreign banks responded, though to a lesser degree, to the attraction of opportunities in the United States.

While these developments were rooted in the expanding financial needs of the world economy, the response of our major banking institutions also began to be influenced by certain attitudes that were relatively new to banking. The rapid growth of the banking industry was accompanied by the accession to managerial authority of a new breed of banker. Often these were individuals, trained in modern business management methods, who were willing to experiment aggressively to improve the profit performance of their organizations and who, for better or worse, had no personal exposure to the banking traumas of the 1930's. Moreover, these changes and experiments occurred at a time when the bank regulatory atmosphere was conducive to expansion and wider competition.

The combination of expanding markets, a more aggressive bank management philosophy, and generally accommodative regulation during the 1960's sparked a new dynamism in banking, as banking organizations expanded both their markets and their products. Banks were faced with increased competition from the commercial paper market, which provided a direct channel for short-term borrowing and investment by nationally known firms. In this environment, banks ventured further into term lending. Perceiving expanded possibilities for lucrative lending in real estate, many bankers enlarged their real estate activities, some by sponsoring REITs or otherwise forming relationships with these rapidly growing, new financial intermediaries. Seeking new opportunities to diversify, the more aggressive banking institutions formed one-bank holding companies which, until the 1970 Bank Holding Company Act Amendments, were not subject to the requirements of Federal bank holding company laws.

As the bank holding company movement took hold, the possibilities were soon recognized for expansion into such financially related fields as consumer and commercial finance, equipment leasing, and mortgage banking. These activities could be pursued by nonbank affiliates without the geographic limitations that apply to commercial banking. The momentum of expansionary forces introduced added competition to a number of areas of finance. Moreover, it has carried banks to the outer edge of activities, such as automatic investment and dividend reinvestment plans, private placements, and syndications of debt or equity, that the securities industry had considered its own province since the passage of the Glass-Steagall Act.

In many respects, the new dynamic posture of banking was a positive development. It engendered increased flexibility in our banking system, helping to ensure that financial resources would be allocated efficiently over a wide range of economic and financial activities. But I think it is also fair to say that the expansive philosophy on the part of a number of banks during the 1960's reflected an overexuberance born of an inflationary psychology that should have been recognized as unsustainable. In many cases, inflation helped to bail out both lenders and investors who, in earlier times, would have had to pay a price for the inefficiencies and cost overruns of those they financed. From this point of view, one of the most pernicious aspects of the inflation was the number of apparent success stories it created and the lure it set out for expansion plans that might best have been left in the drawer.

Most bankers recognized that rapid expansion would greatly increase demands on the managerial skills and financial resources of their organizations. Many of those that became active in liability management, therefore, sought to develop expertise in money management. Those that engaged in the more specialized forms of finance such as factoring, leasing, and foreign exchange lending and trading sought experts in those fields. Many of our nation's large banking organizations established staffs of economic and financial experts to aid in management decisions. And, while these changes met some of the new demands that expansion placed on bank management, they also contributed to overconfidence. They fostered the expectation that the timing and depth of economic reverses could be anticipated accurately and that necessary remedial measures could be taken in time to avert severe damage. Yet, as the 1960's came to a close and inflation began to outrun even the most pessimistic forecasts of a few years earlier, it seems clear, in retrospect, that the expansionary wave of the prior ten years was beginning to impose strains on bank liquidity, capital, and management that could not go on indefinitely.

Inflation also hurt other members of the financial community and the investing public. The thrift industry, which became increasingly exposed to disintermediation as interest rates soared, sought relief through wider deposit and lending powers. The securities industry underwent upheaval, as antiquated back-office facilities collapsed and inadequate capital forced retrenchment or merger for several well-known firms. Insurance company portfolios declined in value, as sharply higher interest rates exacted a heavy toll of both stock and bond prices. The investing public, including many individuals that could ill-afford it, suffered substantial losses from investments in common stock that they had hoped would provide better protection against inflation than fixed-dollar claims such as bonds or life insurance.

As we entered the 1970's, our financial system began to be buffeted by a succession of shocks and strains that few observers would have thought possible in so short a span of time. In 1970, the Penn Central crisis seriously disrupted the commercial paper market and unsettled our financial system. In 1973, the failure of the United States National Bank of San Diego, followed shortly afterward by a forced merger of the Beverly Hills National Bank, was a disturbing sign. Then, in 1974, the failure of the Franklin National Bank dealt a heavy blow to confidence in our financial system. The failure of the Herstatt Bank in Germany at around the same time suggested that banking difficulties had infected the international markets. Meanwhile, the $20 billion United States REIT industry, which was heavily indebted to banks, began to sustain large losses and was soon on the brink of collapse. And the drastic jump in oil prices threatened major, adverse economic and financial consequences. All of these events raised serious doubts about the ability of the free world's financial institutions to continue to function effectively.

It must be remembered, too, that this very adverse sequence of events struck our economy and financial system at a time when accelerating inflation and then recession were having a pervasive and profoundly negative effect on economic activity both at home and abroad. Many borrowers, especially those in the real estate industry, were severely hurt by increases in production costs and soaring interest rates, as well as energy scarcities—all of which served to undermine the economic foundations of their ventures. It is no wonder that the quality of bank credit deteriorated throughout the nation. And, I might add, more recently the crisis in New York municipal finance caused new and unforeseen pressures for our banking system.

That the financial difficulties did not culminate in an even more severe economic setback than we had is a tribute to the effectiveness of our built-in stabilizers in cushioning the impact of recession. It also speaks well for the monetary and fiscal measures that were taken to end the decline as swiftly as possible. The responsible actions of bankers to avoid a cascade of customer failures significantly contributed to economic and financial stability.

It seems clear to me that the shocks and strains of the past few years have constituted the most serious threat to domestic and international financial stability we have experienced in a long time. But I also think it would be a mistake to use these difficulties either to generalize about weaknesses in our nation's banking institutions or as evidence of a need for radical changes in our financial system. It should be recognized, first of all, that our financial institutions have proved to be extraordinarily resilient and durable. The number of banking failures has been quite small, and the consequences of each have been kept within reasonable bounds. Overall, our banking institutions have held up well despite the nation's recent steep slide into recession.

It is true, of course, that the past few years have seen some serious problems emerge for the United States banking industry, problems that merit the careful attention of both bank supervisors and the banking industry. Inflation and recession have created many more problem loans in our banking system than would be healthy for the long run. Yet, in viewing the credit situation at banks across the nation, we believe that the problems are far from insurmountable and many, if not most, of them are on the way to being resolved. In my view, the banking industry has reacted responsibly and constructively to get its problem loans on the right track. I feel reasonably sure that efforts to work out problem loans will keep the losses to a minimum that is well within the capacity of our banking system to absorb.

I believe that many bankers have gained a deeper understanding of the circumstances and decisions that led to the present state of events. The extremely difficult few years we have just come through represent an important watershed for bankers. The extravagances and excesses of earlier years have left a deep impression, and I doubt that those mistakes will soon be forgotten.

Nonetheless, it is understandable that the Congress, the public, and the bank regulatory agencies should scrutinize and take stock of our present position to determine what, if any, structural or regulatory changes may be desirable in our banking system as we approach the 1980's. Several proposals for change have already been brought before the Congress. One thrust of those proposals is to assist the thrift industry by expanding its powers, thus eliminating many of the present differences between the powers of banks and thrift institutions. In my personal view, a change of this type might be desirable. However, any such change should be approached gradually and phased in over time, so as to minimize the transitional effects, while at the same time ensuring that management attention is not diverted from the pressing current problems of working out the difficulties that have developed over the past several years. Some proposals would revise the role and structure of the Federal Reserve System to reduce its independence from the day-to-day pressures of the political arena. I think that there are serious risks to our economy in making monetary policy susceptible to recurring political pressure. It seems to me that far-reaching changes should not be made without a searching appraisal of their impact on our financial system and economy.

There are, fortunately, many promising signs today of economic recovery. We should not overreact to our problems and saddle our nation's banking system with new adjustment burdens while recovery is still under way. Our financial institutions, thanks in part to the protective legislation enacted during the 1930's, have stood the test of the recent past. We can and should afford ourselves the opportunity to probe and analyze the soft spots in our financial system and to implement considered changes based on convincing evidence of need.

I would like to turn now to an issue that has been the subject of intense interest on the part of investors and the general public in the past few months. That is the disclosure of confidential information concerning the financial position of certain of our nation's major banks and the ongoing reporting of bank financial information that hitherto has been unavailable. There is, I might say, a certain irony in the attention focused recently by the press on a relatively few "problem" banks at a time when the peak intensity of the difficulty had already passed. It is no accident that many temporary difficulties have been resolved without shock to public confidence. In approaching the question of financial reform, I would hope that we would avoid the kind of oversensitivity to banking problems that could work to discourage unduly the vital function of risk taking by banks. To do so would rob our national economy of the venture capital that is essential for the enlargement of our productive potential and the growth of our job markets.

Yet, we fully understand and appreciate a legitimate need for insight by the public into the current and prospective financial condition of our nation's banking institutions. We believe the public is entitled to relevant, up-to-date information on the financial condition of banks and bank holding companies. However, I think these needs will be met through the very considerable increase which is now being made in the frequency and degree of detail in the regular bank and bank holding company reports that must be provided to the bank regulatory agencies and the public. There is a substantial job to be done in evaluating how this information can best be employed to appraise the financial condition of banks and bank holding companies. In the meantime, I think it would be advisable to move cautiously with respect to new requirements or procedures for the reporting by banks of financial information. There have recently been growing pressures in the accounting field to require banks to make substantial loss provisions in connection with certain types of loans that have been revised, restructured, or exchanged for underlying assets to ease financial pressure on the borrowers, in many cases to improve the prospects for repayment. I would hope that these accounting approaches are subjected to wide discussion before any hard and fast rules are established.

I believe the lessons of the financial storms of the past few years suggest how we ought to revise and improve our financial system. I think most bankers would agree that a strengthening of bank capital, liquidity, and earnings should get top priority as we approach the 1980's, and it is already evident that progress is being made in these areas. The resolution of difficulties at individual institutions is getting prompt attention. Retrenchment and regrouping to strengthen bank management and financial positions seem to be in progress throughout the banking industry, as we would expect during a period of slack demand for loans.

Bankers will face a dilemma, however, as the economy picks up momentum and the demand for credit increases. A new acceleration in the rate of bank growth could bring with it a renewed stretching of bank capital and liquidity. Commercial banks, I think, must balance their expansion plans against tightened standards of financial prudence. There will need to be explicit recognition that there are limits on the extent to which expanding loan demand can be financed through increased dependence on interest-sensitive funds and that a new upsurge in loans requires growth of capital in a balanced manner. The strategy and tactics of the renewed commercial bank expansion that may lie ahead should include a careful appraisal of dividend policies and plans for infusions of capital through new issues of stock and subordinated debt. It seems to me that a much tougher stance by bankers with respect to loan commitments and other contingent liabilities will be in order, despite customer demands for accommodation.

I think the last few years suggest that it may pay in the long run to pass up some opportunities for expansion or short-term profits in order to avoid undue additional risks. This will not be easy to do, especially if competitive pressures increase. For example, powerful new competition in banking could be expected to emerge from the granting of checking powers to thrift institutions throughout the nation. Even if the thrift industry does not obtain checking powers, electronic payments technology will probably erode whatever remains of the traditional distinctions between demand and savings accounts.

In an environment in which the traditional boundaries for banking functions become blurred, it would be natural for banks to attempt to maintain their forward momentum by further expanding and diversifying into new markets, new products, and new technologies. Yet, the limits on expansion and diversification for an industry in which the public has so large a stake must be given careful study in light of the consequent demands on management and the necessary supporting resources. I would question the wisdom of most new incursions into nonbanking areas where banks have little knowledge or expertise and certainly into financial areas where past incursions have brought grief, such as the securities activities of the 1920's.

Bank supervisors have an important job of assisting in the development of realistic and widely acceptable standards that can be used to evaluate bank capital, liquidity, and overall risk. Wide agreement on those standards will help banks to avoid the danger zone of excessive risk. Bank supervisors also have a responsibility to assist the Congress in developing a means for measuring supervisory performance. This is not an easy task. For example, effective supervision does not necessarily mean the preservation of all financial institutions whatever the circumstances. It seems clear to me that good supervisory performance should not be measured primarily by the extent to which bank failures are prevented. If there were no failures over a period of years, it could mean that banks were not serving the needs of business firms and consumers.

We certainly do not want to constrain banking organizations to the point of preventing them from providing for the vital credit needs of our economy. This means that banks should be expected to have an improved capacity for measuring and managing risk. And we should be prepared to tolerate some bank failures or consolidations in cases where bank management persistently has proved ineffective and the damage is too great to repair. At the same time, widespread bank failures clearly would be damaging to public confidence and would be an undesirable consequence of market discipline. In any case, the Federal Reserve is intensifying its efforts to expand the scope and improve the effectiveness of supervisory and examination procedures. Our aim is to increase our capacity to spot deterioration at an early stage and to suggest corrective measures that could help banking institutions remain effective and viable. In addition to its regulatory responsibilities, the Federal Reserve has a strong interest in a sound and resilient banking system because monetary policy operates on and through banks.

Monetary policy must always be formulated with consideration for the consequences of policy actions on banks and other financial institutions. For the present, the easing of inflationary pressures in our nation's economy has enabled the Federal Reserve to pursue a generally accommodative monetary policy which, along with the respite from strong inflationary pressures, has provided commercial banks with an opportunity to strengthen their capital and liquidity.

Maintaining this strength as the nation's economy advances further and as loan demand develops renewed vigor will require banks to keep a close watch on their lending policies and on their ability to handle reasonable risks. This attitude of prudence on the part of the nation's banks would do much to improve the effectiveness of monetary policy in adjusting flexibly to changing economic conditions and thus help to keep our economy on a sustainable path of growth.