# Rebuilding the Economic and Financial Fundamentals: The Case for Vision and Patience

Once again it is a great pleasure to have the opportunity to address the mid-winter meeting of the New York State Bankers Association. The past year has not been an easy one for the economy or for banks and bankers, not just here in New York but around the nation and around much of the world. My main message today, however, is that despite the current problems, a strong case can be made that many of the painful but necessary adjustments occurring today are laying the foundation for a stronger, a more efficient, and a more competitive national banking system and national economy.

**Many of the painful but necessary adjustments occurring today are laying the foundation for a stronger, a more efficient, and a more competitive national banking system and national economy.**

However, if we are to reap the full measure of those potential gains, we will need vision and patience. We must also learn from our past mistakes, since it is now all too clear that many of the hardships of today reflect excesses of an earlier day.

Nowhere is that more apparent than in the very difficult process of unwinding the explosion of debt built up by governments, businesses, and households over much of the decade of the 1980s. In one sense, the fact that the economy and the financial system are impaired by debt and debt service burdens should not surprise us since the problem could be seen in the making. For example, in a September 1985 address I asked rhetorically whether it was reasonable—even then—to assume that so much more good-quality debt could be supported by a given GNP than had been the case earlier.

We now know the answer was that such an assumption was not reasonable. A massive amount of the debt accumulated in the 1980s was bad debt. Indeed, if we were to add up all of the losses that have been incurred by banks, thrifts, nonbank financial institutions, bondholders, credit card issuers, and others, it is clear that the bad debts of the 1980s ran well into the hundreds of billions of dollars. For example, if we look at just the fifty largest commercial banking institutions, actual charge-offs between year-end 1985 and the third quarter of 1991 aggregate to the astonishing total of almost $90 billion. And even with these charge-offs, nonperforming and other problem assets are still at postwar record levels.

**I am not surprised that we have a "credit crunch," but in a way, I am surprised that it did not come sooner, and I am thankful that it has not inflicted even more serious damage on the economy than we have seen.**

In these circumstances, I am not surprised that we

Remarks by E. Gerald Corrigan, President of the Federal Reserve Bank of New York, before the 64th Annual Mid-Winter Meeting of the New York State Bankers Association at the Waldorf-Astoria, New York City, January 30, 1992 have a "credit crunch," but in a way, I am surprised that it did not come sooner, and I am thankful that it has not inflicted even more serious damage on the economy than we have seen. I also believe that the term "credit crunch" as it is widely used and interpreted often misses the point as to the dynamics of the current situation. Allow me to elaborate.

To be sure, all measures of credit growth have slowed dramatically, even when adjusted for the slower pace of economic activity. To be equally sure, lending and underwriting standards have been tightened up across the board. And there are, no doubt, some cases in which creditworthy borrowers find it difficult to obtain credit. Finally, it is certainly the case that there are individual financial institutions that have been forced to curtail lending or otherwise shrink their balance sheets. All of these developments inflict hardship, but they also are symptomatic of a delayed, inevitable, and ultimately healthy response to the excesses of the past.

**What we are seeing is the desire of individuals, corporations, and financial institutions to strengthen and rebuild their balance sheets after the debt binge of the 1980s.**

To put it more concretely, what we are seeing is the desire of individuals, corporations, and financial institutions to strengthen and rebuild their balance sheets after the debt binge of the 1980s. Looked at in that light, there is an understandable debate as to how much of the credit crunch is due to the desire of debtors to shrink the rate of debt accumulation and how much of the credit crunch is due to the unwillingness or inability of creditors to lend. For my part, I would put more weight on the former but, in a sense, that debate is meaningless. What is meaningful is that balance sheets had to be strengthened, capital positions had to be improved, and lending and underwriting standards had to be firmed.

**A case can be made that we are further along in that healing process than may be widely appreciated.**

Having said that, I hasten to add that a case can be made that we are further along in that healing process than may be widely appreciated. Let me cite several examples that lead me to that view.

First, it is now clear that the origins of the adjustment process, as measured, for example, by various measures of inflation-adjusted debt accumulation by corporations and households, predated the mid-1990 business cycle peak by about a year. Given that perspective, the adjustment process has been under way for the better part of two and one half years.

Second, there are now straws in the wind to suggest that the buildup in nonperforming loans in the banking system as a whole may have peaked, even if the level of problem assets remains very high. Needless to say, however, the future course of problem assets in the banking system is not independent of the future course of economic activity.

Third, the combination of the buildup in capital and reserves, as well as rigorous cost containment efforts at major banking institutions, should pay off handsomely over time. For example, the overall capital and reserves at the seven (now six) major New York banking companies is now well in excess of $60 billion, and the mean tier I and overall risk-based capital ratios for those institutions are now about 5.5 and 9.5 percent, respectively. At the same time, operating expenses, which in the second half of the 1980s were growing by almost 15 percent per annum, rose by only 5.9 percent over the four quarters ending in September 1991. Indeed, over that four-quarter period, a number of these institutions experienced actual declines in operating expenses. Broadly similar patterns are taking hold in bank and nonbank financial institutions across the country.

**The overall capital and reserves at the seven (now six) major New York banking companies is now well in excess of $60 billion, and the mean tier I and overall risk-based capital ratios for those institutions are now about 5.5 and 9.5 percent, respectively.**

Fourth, nonbank corporate restructuring and cost containment efforts—as painful as they are—are paving the way for a leaner and more competitive corporate America, which will be better able to produce truly world-class goods and services, with commensurate returns to shareholders and other investors.

Finally, with nominal interest rates at low levels, debt servicing burdens have been reduced appreciably. In saying that, however, I ask you to keep in mind that nominal interest rates will remain relatively low only so long as inflationary forces in the economy remain in check and recede even further. To put it differently, lenders or borrowers who made the bet during the 1980s that inflation would bail them out were wrong, and they would be dead wrong to press that bet today.

While I can speak only as one member of the Open Market Committee, I believe I can say with confidence that the U.S. monetary authorities simply will not tolerate a return to the self-destructive process of inflation. Indeed, what we seek are further gradual reductions in the core inflation rate, even as the economy returns to a pattern of moderate growth in the period ahead.

**Lenders or borrowers who made the bet during the 1980s that inflation would bail them out were wrong, and they would be dead wrong to press that bet today.... I believe I can say with confidence that the U.S. monetary authorities simply will not tolerate a return to the self-destructive process of inflation.**

While I cite these positive developments, don't get me wrong. I am under no illusion. Problems, real problems, remain. The near-term economic outlook is very uncertain. Elements of the financial system are still under considerable strain. It will take a number of years to work off the inventory of excess commercial real estate. Confidence is badly shaken as major corporate restructurings and dire fiscal problems in state and local governments across the nation threaten what were once regarded as the safest and most stable sources of jobs and income.

While we are all mindful of these and other problems and threats, it is important that we not lose sight of the progress that is being made in rebuilding the fundamentals that are capable of ushering in a new age of

**We are at one of those points when frustration with immediate problems can all too easily give rise to a pell-mell rush to find shortcuts and quick fixes that will serve only to make things worse in the longer term.**

prosperity and global leadership for the U.S. economy and for the U.S. banking system. To gain the full measure of that potential will require vision and it will require patience. Indeed, we are at one of those points when frustration with immediate problems can all too easily give rise to a pell-mell rush to find shortcuts and quick fixes that will serve only to make things worse in the longer term.

Perhaps nowhere is that temptation to find shortcuts more dangerous than in regard to fiscal policy, especially in an election year. That is not to say that some constructive steps on the fiscal side are wholly beyond our national reach. But it is to say that great care and discipline will have to be exercised in evaluating fiscal

**A careful and disciplined approach to the evaluation of fiscal options should give important weight to the following considerations: (1) any changes should be surgically neat and clean, (2) any changes should give particular emphasis to the almost desperate need to rebuild the stock of productive plant and equipment in this country, and (3) above all, any changes must not do further damage to the deficit outlook for the intermediate term.**

options. For my part, a careful and disciplined approach to the evaluation of fiscal options should give important weight to the following considerations: (1) any changes should be surgically neat and clean, (2) any changes should give particular emphasis to the almost desperate need to rebuild the stock of productive plant and equipment in this country, and (3) above all, any changes must not do further damage to the deficit outlook for the intermediate term. Indeed, even under current law, the outlook for the budget deficit by mid-decade is not encouraging, especially since the out-year budget estimates already imply very substantial cuts in defense spending. Perhaps the outcome will be aided somewhat by a rise in the savings rate, but I, for one, would not bet the ranch on that possibility.

Beyond that, it is important to keep in mind that a rise in the savings rate necessarily implies a drop in the consumption rate—an outcome we should welcome if it occurs in a gradual and orderly fashion. We should also keep in mind that even a modest rise in the personal savings rate can be offset by a fall in the savings rate for state and local governments or for the corporate

**The only failsafe way to increase the national savings rate by nearly the amounts that are needed is to reduce sharply the dissavings rate associated with federal budget deficits.**

sector. To put it differently, the only failsafe way to increase the national savings rate by nearly the amounts that are needed is to reduce sharply the dissavings rate associated with federal budget deficits. Surely, that will require vision and patience.

The full restoration of the financial muscle of the U.S. banking system also will require vision and patience. The call for vision and patience in this specific context might seem so obvious as to be unnecessary. However, experience suggests that it is not. For example, whether it was LDC lending, highly leveraged transactions lending, or real estate lending, there was a point in the cycle when a few bankers or a few regulators said "enough is enough." But when the amber light flashed, it was ignored by most, in part because the loans then on the books looked fine and in part because new and enticing deals kept rolling in. With the passage of time, however, it became clear that enough *was* enough, but by then it was too late.

Regulation—even the most sophisticated system of so-called early intervention—cannot solve this problem. Indeed, experience tells us in a convincing manner that the only solution is to be found in a system of discipline and prior restraint that is created and maintained by the directors and top management of individual financial institutions.

**Perhaps the progress we are now seeking in the strengthening of the banking system suggests that some hard lessons have been learned. But even if that is true, we still have a very long way to go.**

Perhaps the progress we are now seeing in the strengthening of the banking system suggests that some hard lessons have been learned. But even if that is true, we still have a very long way to go. It is also true that some of the necessary ingredients of that rebuilding process are not directly controllable by banking institutions or, for that matter, by banking regulators.

The legislative framework within which banks must operate is a case in point. Here, I know most of you share the sense of deep disappointment that I have for the outcome of the banking legislation debate of last year. That is, while there are some distinctly positive aspects to the new legislation, the failure of the Congress to enact any of the badly needed structural reforms, such as the effective repeal of McFadden, Douglas, and Glass-Steagall, must be viewed as a major setback. Let us hope that the Congress will return promptly to these issues this year.

While progressive banking legislation and an improved economic environment will assist the banking industry in restoring the full measure of its strength, the fact remains that the lion's share of the burden for this adjustment lies with banks and bankers themselves.

In some ways the challenges facing individual banks and the banking system are quite straightforward: namely, individual institutions and the industry as a whole will have to generate the capital and the returns on that capital that are needed to restore the full measure of confidence of the marketplace and to satisfy the demands of increasingly selective investors and depositors. For virtually all banking institutions, that challenge will require strong and continuing efforts along several lines, including the following:

**While progressive banking legislation and an improved economic environment will assist the banking industry in restoring the full measure of its strength, the fact remains that the lion's share of the burden for this adjustment lies with banks and bankers themselves.**

First, the large—and in some cases, the truly enormous—drag on income and profits arising from nonperforming and underperforming loans will have to be worked down over time. Among other things, this will require still more effort at structuring workouts and the willingness perhaps to better recognize that fresh credits can be a constructive part of workout strategies for some troubled borrowers. It also is important that all members of loan syndicates—even the smaller participants—behave in a reasonable and responsible fashion in evaluating workout strategies.

Second, operating expenses must be reduced further. That process can be aided and facilitated by mergers and other steps that promote needed consolidation in banking and finance. But even absent such steps, recent experience suggests that further cuts in operating costs—with their powerful implications for the bottom line—are within reach.

**The historic dictates of (1) knowing your customer, (2) knowing how and when to say no, and (3) seeking strength through diversification must assume a still larger role in the banking marketplace.**

Third, the emphasis on growth, current earnings, and market share must be further tempered in favor of an even greater premium on capital strength and asset quality. This means that the historic dictates of (1) knowing your customer, (2) knowing how and when to say no, and (3) seeking strength through diversification must assume a still larger role in the banking marketplace. Part of this may require some fresh and very aggressive thinking about concentrations of credit exposures that takes greater account of the bigger picture. For example, we can all readily think of cases in which an individual real estate project looked fine on a stand-alone basis but proved disastrous when a particular market was later saturated with multiple projects of a similar nature.

Fourth, where it is relevant, you had all better take a very, very hard look at off-balance sheet activities, including the payments, clearance, and settlement risks associated with many of those activities. The growth and complexity of off-balance sheet activities and the nature of the credit, price, and settlement risk they entail should give us all cause for concern, especially when it seems so easy to accept the view that what counts is net, not gross, exposures. That distinction between gross and net may be relevant in some cases, and it may be fine when all else is well, but in the event of a major market disruption, I assure you that it will be the gross, not the net, that will really matter in most segments of the financial marketplace both nationally and internationally.

High-tech banking and finance has its place, but it is not all that it is cracked up to be. For example, the interest rate swap market now totals several trillion dollars. Given the sheer size of the market, I have to ask myself how it is possible that so many holders of fixed or variable rate obligations want to shift those obligations from one form to the other. Since I have a great deal of difficulty in answering that question, I then

**Off-balance-sheet activities have a role, but they must be managed and controlled carefully, and they must be understood by top management as well as by traders and rocket scientists.**

have to ask myself whether some of the specific purposes for which swaps are now being used may be quite at odds with an appropriately conservative view of the purpose of a swap, thereby introducing new elements of risk or distortion into the marketplace—including possible distortions to the balance sheets and income statements of financial and nonfinancial institutions alike.

I hope this sounds like a warning, because it is. Off-balance-sheet activities have a role, but they must be managed and controlled carefully, and they must be understood by top management as well as by traders and rocket scientists. They also must be understood by supervisors. In that regard, I can assure you that at both the national and the international level we are redoubling our efforts to ensure that supervisory policies for these activities are sensitive to the full range of risks they present to individual institutions and to markets generally.

**What makes banks truly special is that public confidence in their strength and integrity is their only stock in trade. When that confidence has been shaken—as it clearly has—the banks suffer, but when the banks suffer, the society also suffers.**

If these are some of the things that strike me as important in coming full circle in the restoration of the strength of the U.S. banking system, allow me to close on a note as to why achieving that goal is so very important. In recent weeks and months we have seen numerous examples—some good but most bad—of how vitally important the confidence factor is to our economic well-being. I point to this in a context in which I have long maintained that banks are special. But I also point to it in a context in which it is all too easy to forget

**Nothing would please me more than to see the U.S. banking system reemerge from these recent painful years as a true world-class leader in creativity and innovation, yes, but especially as the bedrock of confidence for the national economy and the international banking system.**

that what makes banks truly special is that public confidence in their strength and integrity is their only stock in trade. When that confidence has been shaken—as it clearly has—the banks suffer, but when the banks suffer, the society also suffers.

As I said earlier, there are some very positive developments taking hold in the economy at large and in the banking system in particular that can be an enormous source of strength to our country and to the world over the intermediate term. As a part of that process, nothing would please me more than to see the U.S. banking system reemerge from these recent painful years as a true world-class leader in creativity and innovation, yes, but especially as the bedrock of confidence for the national economy and the international banking system. That will not be easy, and there surely will be some bumps along the road, but with vision and patience I believe it can be done.