The Financial Disruptions of the 1980s: A Central Banker Looks Back

E. Gerald Corrigan

Group of Thirty, Washington, DC

The William Taylor Memorial Lectures 1

30

E. Gerald Corrigan worked in the Federal
until 1993. For the last 8 years, from Janua
President of the Federal Reserve Bank of N

This lecture was given on September 30,
first annual William Taylor Memorial L
Reserve Bank of New York.

The ideas presented in this paper are the au
imply that the Group of Thirty endorses th

Copies of this paper are available for $6 from:

Group of Thirty
1990 M Street, N.W., S
Washington, DC 20
Tel.: (202) 331–24
Fax: (202) 785–94

The First William Taylor Memorial Lecture

The Financial Disruptions Of the 1980s: A Central Banker Looks Back

E. Gerald Corrigan

Published by
Group of Thirty©
Washington, DC
1993

Table of Contents

I. Introduction

Good evening ladies and gentlemen. I am deeply honored to have been invited to deliver the Bill Taylor Memorial Lecture. I can still recall plainly the sense of shock and loss I felt late last August when I learned of Bill's death. Bill was a colleague and a dear friend; he was a master of his trade; his sense of commitment—to say nothing of his sense of humor—were legendary. But, for me, what set Bill apart was his integrity and his loyalty—a loyalty that extended both to purpose and to people.

There was, however, still another trait of Bill's that stands out in my mind. Namely, in any situation, Bill always had command of the facts and figures but, for Bill, that was never enough. For him to be satisfied, the issue at hand had to pass his own "smell test" and as many bankers in this room know, Bill Taylor had one helluva sense of smell!

II. Recent Developments

As Bill watches over us, I know he must feel a sense of satisfaction stemming from a number of recent developments on the banking scene. For example:

- industry profits are at record levels,
- the number and aggregate size of undercapitalized banks have shrunken dramatically,
- the capital ratios of internationally active U.S. banks are now at or near the top of rankings of national groups of banks as measured by the BIS capital standards,
- the FDIC is out of debt and well on the road to regaining its financial strength without the benefit of one nickel of taxpayer's money.

Knowing Bill, however, he would insist that these and other developments must be taken in context and that none of them should give rise to a sense of complacency about the future. And, as usual, he would be right. For example:

- By most measures, the level of troubled or problem loans in the banking system is still at an historically high level, despite the astonishing amount of charge-offs recorded in recent years. Indeed, while it's still hard to conceive, the total charge-offs (not provisions) of the 10 largest U.S. bank holding companies over the five years ending in 1992 were in excess of $50 billion. What's even more remarkable is the dramatic buildup in capital of these same institutions over the same period, even in the face of that unimaginable rate of charge-offs.

- A growing and now large fraction of the income and earnings of many major banks is attributable to trading and other non-intermediary activities; there is an obvious question as to the stability and sustainability of at least some of those sources of income and profit over time.
- It is quite clear that the technological and structural forces that have so fundamentally reshaped the financial sector playing field over the past decade or more—and the position of the commercial banks on that playing field—have far from run their course while the U.S. Congress still shows astonishingly little interest in the kinds of fundamental reform which could help create a legal framework more conducive to stability.

Notwithstanding the stunning gains that have been made over the past couple of years, none of us is smart enough to be able to foresee what the future holds with regard to the sustained well-being of the banking and financial system. Some things are, however, quite clear. For example, it remains true—perhaps more true than ever—that stability in banking and finance is a necessary, but not sufficient, condition for economic prosperity and stability more generally. It is also true that we simply cannot afford—either in financial, political or human terms—a replay of the financial turmoil which was characteristic of the past decade or so.

III. Three Questions

It is impossible to judge the risks of a repeat performance of the turmoil of the '80s, much less to prescribe with precision those public policies and private actions which would provide reasonable assurances against such an outcome. But, as a first step in that direction we should focus attention on at least three major questions. Namely:

- First, to what extent did the periodic episodes of financial instability entail truly systemic threats and to what extent did public policies or actions heighten, rather than limit, risk and instability? In this latter regard, I have in mind, of course, the so-called "moral hazard" problem.

- Second, to what extent are there apparent common denominators which can reasonably account for these episodes of financial instability?

- What lessons can be learned from all that we witnessed in the 1980s?

In order to begin to shed light on the answers to these questions, I want to start with three more general observations which I believe are necessary to help frame the analysis.

The first of these is that while my remarks are couched primarily in a U.S. context, we must remember that bouts of financial instability were by no means unique to the U.S. Indeed, the same general phenomenon arose in many other countries and in some cases those problems in other countries were at least as serious as they were in the U.S. Among other things, this suggests that we should be careful about attributing too much to events or circumstances such as tax law changes, deposit insurance formulas or financial innovations such as securitization, that were more or less unique to the U.S. These seemingly neat, clean and pat answers have some relevance but they are hardly sufficient explanations for all that occurred.

The second general observation is that for diagnostic and remedial purposes, the thrift industry crisis in the U.S. must be put aside. In suggesting that I am acutely aware of the enormous costs of the thrift crisis, in terms of taxpayer dollars, hardships for countless individuals, and understandable political backlash. I am also mindful that the overall situation surrounding the thrift crisis was fraught with both moral hazard dangers ***and*** realities. Thus, in putting it aside, I am not suggesting that it was irrelevant. Hardly. But, for the purpose of my three earlier questions it can be put aside on two grounds.

First, as a practical matter, the thrift crisis as such cannot repeat itself.

Second, at its core, the thrift crisis was a political problem in the broadest and most non-partisan meaning of that term. To paraphrase a political slogan of the distant past, when "a house on every lot" becomes a national priority of the highest order, it is not at all difficult to see why regulators of institutions that provided housing finance were enshrined in law as industry cheer-leaders. Nor is it difficult to see why it took so long to come to a national consensus as to how to deal with a problem for which the symptoms and potential consequences were so obvious.

The third general observation relates more directly to the nature and character of the financial disruptions of the '80s. We can all easily tick off the specific episodes of the period that were a source of concern. Some of us can even cite dates, days or time of days (or nights) when tensions were particularly great. In some circles, however, these episodes are already being referred to as the dogs that barked but did not bite. But, if there were dogs that barked but did not bite, there were also dogs that neither barked nor bit but they surely growled. For example, consider the number of non-bank financial institutions that squeaked through only because of massive financial support from parents.

Even more to the point, do not forget the period roughly beginning in late 1990 and continuing for some time thereafter when the marketplace—as indicated by bond and stock prices—was seriously questioning the very viability of a number of very large U.S. banks. In that time frame, even a distinctly minor shock could have unleashed a chain reaction of highly destabilizing events. For me, the circumstances prevailing in that interval were outright scary. The only person to whom I shared the depths of my concerns at that time was Bill Taylor and what really worried me was that he agreed!

One will never know whether that particular dog that growled could have barked or bitten but you don't take chances with a 1,000 pound dobermam. Today, that 1,000 pound doberman has more the appearance of a toy poodle but, there too, looks can be deceiving.

Systemic Risk

With that short handed attempt at perspective in mind, let me now turn to the three questions I raised earlier starting with the question relating to systemic risk. The first part of that question is very easy to answer in that there is absolutely no question in my mind that there were recurring episodes and time intervals throughout the '80s during which systemic risk was a clear and present danger. In saying that I recognize that others may differ in this judgment as it applies to specific episodes but nobody would seriously dispute the overall characterization.

But, I would go one step further and say that for sustained periods over the past decade, the stability of the banking and financial system was, for all practical purposes, dependent on the safety net and/or other forms of governmental, including central bank, presence.

The related question of importance is whether public policies or actions may have inadvertently contributed to the problems by encouraging excessive risk-taking in the belief that such risk takers would be protected from harm or loss. This is clearly the more difficult question, in part because it is impossible to judge what would have happened had different policies been in place or had the authorities taken a fundamentally different course of action with regard to one or more of the problems that arose. All of those "might have beens" aside, it is beyond dispute that over the period in question the extent of official involvement was unprecedented except for the 1930s.

Anything like that degree of official involvement simply is not good. But, and this may surprise you, I believe that a case can be made that the net result of all that occurred has worked to diminish the moral hazard problem and enlarge the role of market discipline. I recognize that such a suggestion on my part will be greeted with a great deal of skepticism, if not violent disagreement. Let me explain my reasoning. First of all, I have never found the moral hazard doctrine ***as*** compelling as some would suggest. The doctrine implies that consciously or subconsciously, top officials of banks deliberately and systematically take on uncompensated risks because they or their shareholders will be protected from loss or failure. While there is no doubt that institutions have taken on uncompensated or undercompensated risks, there is a real question in my mind as to the ***extent*** to which they have done so because of a belief they would be protected. I say that for several reasons including:

- First, the public policy response to banking and financial disruptions has not entailed protection for top managers or shareholders. In fact, any manager or shareholder who predicated behavior on such a belief would have to be incredibly stupid.
- Second, based on the events of the '80s, and the changes in policy and law that have been made over the last five to seven years, the principle of constructive ambiguity is alive and well. By that I mean, of course, that the track record with regard to whether and how the authorities will respond to a given situation is deliberately vague as it should and must be.
- Third, by and large, the solutions to most of the problems of the '80s, aside from the thrift crisis, relied very heavily on private risk capital along with strong supervisory initiatives to contain and remedy problems. In that regard, one of the interesting footnotes to the period is how little a role—aside from Continental Illinois—was played by the discount window.
- Finally, given the marked strengthening of the banking system over the past few years, the authorities now have greater degrees of freedom in shaping approaches to problems when they arise.

To summarize, my answer to the first question is that yes, systemic dangers were present throughout much of the period in question. Beyond that, the banking and financial system was so weak that specific problems that should have been minor events could not be treated as such. Finally, while there was no practical alternative to the virtually unprecedented level of public involvement, I believe we are now in a position where market discipline is playing a larger role in preventing and resolving financial disruptions. But, the deeply troubling fact remains that the banking and financial system of the 1980s flirted with meltdown and, in my judgment, almost certainly would have reach that point had it not been for large scale public sector involvement.

What Went Wrong

All of that brings me to the second question; namely, what went wrong and why? In seeking to answer those questions what is of particular interest is the extent to which there are common denominators across episodes that may be suggestive of steps that can be taken with a view toward reducing the risks that these events will repeat themselves. The subject of causation and common denominators is very large but a few items strike me as being particularly worthy of note. They include:

- Whether it was the silver market, the LDC debt crisis, the LBO frenzy or the real estate bubble, the behavior that produced many of the problems had to have been rooted in the reality or expectation of rising or accelerating prices. Not that it is needed, but this experience clearly constitutes another powerful reason why price stability should be among the highest of our national priorities and the overriding objective of monetary policy.

- A second generic factor that played a role in permitting the turmoil of the '80s was the application of increasingly high levels of technology and information processing in banking and finance. There are several channels through which these forces worked in that direction. For example, technology and information processing undercut important elements of the banking franchise, bringing multiple new sources of competition, probably encouraging situations in which risks were underpriced. It also dramatically increased the speed, volume, value and complexity of financial transactions thereby materially increasing payments and settlement risk. Technology also made it possible to structure transactions, instruments and trading strategies that were not even feasible at earlier times. Finally, the technologically driven changes in banking and finance have entailed elements of sheer complexity that elevate the risks of managerial miscalculation and, unfortunately, also raise the risks of abuse and fraud.

- A third generic factor was the broad environmental setting in the banking and financial arena. A legal framework that is a vestige of the past, a sharp but essentially unavoidable move toward deregulation, a desire to "get government off our back" coupled with the move to "high tech" banking and finance, all interacted to produce behavior and risks that simply were not always well understood by either the practitioners or the authorities.

- Then, there were the three "c's"—concentrations, capital and culture. That is, there were far too many concentrations of credit and counterparty exposure, far too little capital and a breakdown in the culture of banking and finance. Perhaps the movies and best sellers exaggerated that latter phenomenon, but not by much.

When all of these factors, and others, were combined we surely had a recipe for trouble and trouble we got. Nevertheless, and by some combination of skill, good fortune and determination on the part of many, a major systemic disruption was avoided. I could caution, however, in drawing too much comfort from that outcome. For example, we should not forget that to a very considerable degree, the pattern of subpar economic growth in the U.S. and in many other countries in recent years has been a direct result of the excesses of that earlier period. Nor should we forget that virtually all of Latin America went through a decade long economic horror story. In other words, while we managed to avoid meltdown, the contamination was of large and costly proportions.

Lessons

That, of course, is why the answers to my third question as to the lessons of the '80s is so important. Some of those lessons come in a few words, others require some elaboration. Turning first to those that come in a few words, I would tick off the following:

- if it is growing very rapidly, look out;
- concentrations will get you every time;
- workouts of troubled banks are long and painful;
- the self-liquidating character of large securities firms is largely history;
- contagion risks are very real;
- payment and settlement risks can be the killer;
- capital ratios can be very misleading;
- consolidated supervision is a must;
- on-site examinations are a must;
- case by case is the only way to go;
- surprises will occur.

Turning to the bigger picture, let me start with an observation which I firmly believe must guide our future thinking and actions. Namely, while it is likely that the statistical probabilities of systemic meltdown are lower than in the past, the potential for damage in the event of that less likely systemic episode are greater—perhaps much greater. The nature and extent of global financial linkages, by itself, seems to imply that conclusion. In turn, that creates a huge dilemma for public policy in that low probability events are very hard to guard against without imposing extremely costly rigidities into the picture. One thing, however, is clear and that is the need for a very high degree of flexibility in the use of the tools available to the authorities if they are ever faced with such an event. That, in turn, clearly implies that well intended policies that reduce flexibility, such as placing the discount window in a legislative straitjacket, can prove to be shortsighted and costly.

There are, however, constructive steps that can be taken to further strengthen the banking and financial system and guard against the occurrence and/or consequences of a major problem. I will conclude with several suggestions in this regard.

> ***First***, it should be obvious from all I have said that going forward the premium on sound macro policies and performance will be all the greater. In particular, we simply must not let the inflation genie out of the bottle again. If we do, the probabilities of major financial disruption and dislocation will rise and the costs of ultimately unwinding the inflation will be even greater than in the past.
>
> ***Second***, comprehensive structural reform of the banking and financial system—coupled with an undoing of some of the micro-management features of earlier legislation—should be a high national priority. I am under no illusions that such reforms will solve all—or even most—of our problems but they will surely help. It is often said that our political system is such that Congress only responds to a crisis. In this particular case, if Congress waits for the crisis, it may well get it, but it sure won't like it.
>
> ***Third***, now is probably the time to start thinking seriously about basic reforms in deposit insurance that might, for example, allow for elements of private co-insurance or extended insurance to be brought into the picture. In circumstances in which the health of the banking system continues to improve—as I believe it will—it may be possible to consider ideas that earlier would have been unthinkable—at least for me. Having said that let me strongly emphasize that even as the strength of the banking system improves further deposit insurance reform will remain an area in which caution is needed. It will also be an area in which gimmicks need to be cast aside. And, for me, narrow banks and uninsured banks, for example, remain gimmicks.
>
> A ***fourth*** area that needs attention relates to further efforts to strengthen the integrity and safety of payments and settlement systems as well as risk management systems, especially in large internationally active financial institutions. I recognize that great strides have been made in these areas in recent years but more—much more—needs to be done. I say that because there is little doubt in my mind that a major problem or failure in one such

system can all too easily become the instrumentality through which a particular problem can take on a more generalized character.

The efforts needed in these areas are costly and unglamorous. Three yards and a cloud of dust about captures it. But to extend the analogy, a sustained drive that results, for example, in the universal application of delivery against payment book-entry systems for ***all*** securities transactions would be more than worth the effort. Here too, however, we must guard against shortsighted approaches and policies. As an example, and with due respect to my former colleagues in the Federal Reserve, I do not share their enthusiasm for pricing daylight overdrafts. I fear this may induce more volatility and simply create incentives to shift risks to the point of least resistance and greatest peril.

Last, but certainly not least, I believe more work is needed in the area of supervisory policy and practice. Here too, real progress has been made both at the national and international level but much remains to be done. While time does not permit me to go into detail, I would note that effective consolidated supervision is not yet a universal reality, particularly for non-bank financial institutions. Similarly, the supervisory community has not yet gotten its arms around the concentration problem. Further, the Basle market risk and related proposals need consideration and implementation.

Further elaboration on these and related subjects will have to await another occasion. But, before closing, I very much want to cover one other vital issue on the supervisory front. Namely, it would appear that efforts to restructure and consolidate the responsibilities of the Federal bank supervisory authorities is again on the table. That is both understandable and appropriate for there may well be steps that can be taken to strengthen that structure and make it both effective and more efficient. It is inevitable, however, that a renewal of that debate will again bring with it the suggestion that the role of the Fed in supervision should be substantially curtailed or eliminated.

The intellectual argument for such a position is usually couched in terms of the potential conflicts between monetary policy and supervisory policy. I will concede that in the short run, the ***potential*** for such conflicts exists. But in my experience I have ***never*** encountered a situation in which that potential became a reality to the detriment of monetary policy. Moreover, at the end of the day, that potential conflict disappears because price stability and financial stability become opposite sides of the same coin. That is why the central bank, in my judgment, has an inherent and ongoing interest in supervisory policy and practice.

On a more pragmatic level, the Federal Reserve Banks are the very nerve center of the national and international payments system and, in partnership with the commercial banks, are the operators of the payments system. That alone creates the absolute necessity of the Fed having the intimate working knowledge of the character, condition, and "plumbing" of banks that can only come from the hands-on exercise of supervisory responsibilities. That ability, in my experience, is vital in time of crisis and it cannot be taken out of the closet only when needed and it certainly cannot be realized by reading another agency's exam reports.

Therefore, the real issue with regard to the role of the Fed in the supervisory arena needs to be put squarely on the table. Namely, in times of disruption or crisis, do we want (and does the world at large want) the central bank of the most important country in the world to have neither the authority nor the expertise to help manage and contain such financial disruptions? If it ever comes to a vote, those who would vote in favor of stripping the Fed of those necessary responsibilities may sleep better at night but I will not.

To conclude, we are now in smoother waters and the rebuilding of the strength of the banking and financial system has progressed significantly. But, the future is by no means secure. It remains to be seen how individuals and institutions will behave as memories of the problems of the '80s fade. But, if those hard lessons of the past prove durable and if we take full advantage of the time immediately ahead to make further progress, I believe we can look forward to fundamentally brighter times for our financial system and our economy at large. Bill Taylor would not have been satisfied with any other outcome; I ask you, why should any of us be content with less?

Thank you.

Group of Thirty Members

Rt. Hon. Lord Richardson of Duntisbourne KG
Honorary Chairman, Group of Thirty

Mr. Paul Volcker
Chairman, The Group of Thirty
Chairman, James D. Wolfensohn Inc.

Dr. Pedro Aspe
Secretario de Hacienda y Credito Publico Mexico

Mr. Geoffrey Bell
Executive Secretary, Group of Thirty
President, Geoffrey Bell & Company

Sir Roderick Carnegie
Hudson Conway Limited, Australia

Mr. Richard Debs
Advisory Director, Morgan Stanley

Sr. Guillermo de la Dehesa
Consejero Delegado, Banco Pastor

Professor Gerhard Fels
Director, Institut der Deutschen Wirtschaft

Dr. Jacob A. Frenkel
Governor, The Bank of Israel

Dr. Wilfried Guth
Member of the Supervisory Board, Deutsche Bank

Mr. Toyoo Gyohten
Chairman, The Bank of Tokyo

Mr. John Heimann
Treasurer, Group of Thirty
Chairman, Global Financial Institutions, Merrill Lynch

Mr. Erik Hoffmeyer
Chairman of the Board of Governors, Danmarks Nationalbank

Group of Thirty Publications since 1985

Reports:

The Foreign Exchange Market in the 1980s
The Foreign Exchange Market Study Group. 1985

Countertrade in the World Economy
Robert V. Roosa, et al. 1985

Outlook for Mineral Commodities
R. H. Carnegie. 1986

Inflation Stabilization with Incomes Policy Support
Rudiger Dornbusch and Mario Henrique Simonsen, with discussion by Mario Brodersohn, Michael Bruno, G. G. Johnson. 1987

Finance for Developing Countries
Richard A. Debs, David L. Roberts, Eli M. Remolona. 1987

International Macroeconomic Policy Co-ordination
Policy Co-ordination Study Group. 1988

Perestroika: A Sustainable Process for Change
John P. Hardt and Sheila N. Heslin, with commentary by Oleg Bogomolov. 1989

The Risks Facing the World Economy
The Risks Facing the World Economy Study Group. 1991

Financing Eastern Europe
Richard A. Debs, Harvey Shapiro and Charles Taylor. 1991

**The Summit Process and Collective Security: Fu
Responsibility Sharing**
The Summit Reform Study Group. 1991

Sea Changes in Latin America
*Pedro Aspe, Andres Bianchi and Domingo Cavallo, w
S.T. Beza and William Rhodes. 1992*

EMU After Maastricht
Peter B. Kenen. 1992

Special Reports:

**Clearance and Settlement Systems in the World'
Securities Markets**
*Steering & Working Committees of the Securities Cle
Settlement Study. 1988*

**Clearance and Settlement Systems: Status Rep
Spring 1990**
Various Authors. 1990

**Conference on Clearance and Settlement Syst
London, March 1990: Speeches**
Various Authors. 1990

**Clearance and Settlement Systems: Status Re
Year-End 1990**
Various Authors. 1991

**Clearance and Settlements Systems: Status
Autumn 1992**
Various Authors. 1992

Derivatives: Practices and Principle
Global Derivatives Study Group. 1993

**Derivatives: Practices and Principles, App
Working Papers**
Global Derivatives Study Group. 1993

**Derivatives: Practices and Principles, Ap
Enforceability: Survey of Nine Jurisdicti**
Global Derivatives Study Group. 1993

Occasional Papers:

16. **Policy Lessons of the Development Experience**
    Helen Hughes. 1985

17. **Japan's Role in the Emerging Global Securities Markets**
    Hamish McRae. 1985

18. **Japan as Capital Exporter and the World Economy**
    Masaru Yoshitomi. 1985

19. **The Dollar's Borrowed Strength**
    Otmar Emminger. 1985

20. **The ECU: Birth of a New Currency**
    Polly Reynolds Allen. 1986

21. **The United States and Japan in the International Monetary System 1946-1985**
    Robert V. Roosa. 1986

22. **The Japanese Trade Surplus and Capital Outflow**
    Michiya Matsukawa. 1987

23. **The State and the Market: The UK Experience of Privatisation**
    J. A. Kay. 1987

24. **Adjustment in the World Economy**
    Paul Krugman. 1987

25. **1992: The External Dimension**
    David Henderson. 1989

26. **Japan's Savings and External Surplus in the World Economy**
    Masaru Yoshitomi. 1989

27. **Reciprocity and the Unification of the European Banking Market**
    Douglas Croham. 1989

28. **Financial and Monetary Integration in Europe: 1990, 1992 and Beyond**
    Tommaso Padoa-Schioppa. 1990

29. **Implications of Increasing Corporate Indebtedness for Monetary Policy**
    Benjamin M. Friedman. 1990

30. **Europe in the Nineties: Problems and Aspirations**
    Wilfried Guth. 1990

31. **Two Views of German Reunification**
    Hans Tietmeyer and Wilfried Guth. 1990

32. **Interdependence of Capital Markets and Policy Implications**
    Stephen H. Axilrod. 1990

33. **Foreign Direct Investment: The Neglected Twin of Trade**
    DeAnne Julius. 1991

34. **Privatization in Eastern and Central Europe**
    Guillermo de la Dehesa. 1991

35. **International Trade in Banking Services: A Conceptual Framework**
    Sydney J. Key and Hal S. Scott. 1991

36. **The Economic Transformation of East Germany: Some Preliminary Lessons**
    Gerhard Fels and Claus Schnabel. 1991

37. **Are Foreign-owned Subsidiaries Good for the United States?**
    Raymond Vernon. 1992

38. **Why Now? Change and Turmoil in U.S. Banking**
    Lawrence J. White. 1992

39. **EMU and the Regions**
    Guillermo de la Dehesa and Paul Krugman. 1992

40. **The New Trade Agenda**
    Geza Feketekuty. 1992

41. **The Threat of Managed Trade to Transforming Economies**
    Sylvia Ostry. 1993

42. **Tripolarism: Regional and Global Economic Cooperation**
    Tommaso Padoa-Schioppa. 1993

43. **The Ten Commandments of Systemic Reform**
    Václav Klaus. 1993

Group of Thirty

Financial Disruptions of the 1980s

The First William Taylor Memorial Lecture

E. Gerald Corrigan

Group of Thirty
1990 M Street, N.W.
Washington, DC 20036

ISBN 1-56708-039-1