

**Remarks by Ricki Helfer
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Before the
Annual Convention
of the
American Bankers Association
Honolulu, Hawaii
October 5, 1996**

Banking rests on public confidence and public confidence rests on the soundness of the two insurance funds managed by the Federal Deposit Insurance Corporation. Legislation that the President signed Monday night will make both of our funds sound, benefitting everyone. I want to commend the American Bankers Association, the Independent Bankers Association of America, America's Community Bankers, and the other banking trade groups that worked to find a constructive solution to a problem created by no financial institution operating today, but from whose ill effects everyone would have suffered. Deposit insurance is one of the few certainties in an uncertain financial world. We can now all look to the future with greater assurance, and focus on the competitiveness and other issues that deserve and require our attention.

I am here today to talk about the state of the banking industry: where it is and where it is going. There are several measures that we could use to assess the condition of the banking industry and its direction in the future. Market share and profitability are two popular gauges. Both of these measures reveal important trends, but neither alone can summarize banking's condition today or its future tomorrow.

The banking industry's declining market share relative to other financial intermediaries has led to grim assessments about the industry's future. At the end of 1995, commercial banks held 24 percent of the total assets held by financial intermediaries, compared to 34 percent in 1980. This relative decline in market share merits our attention, but for three reasons, the picture is more complex than a single statistic suggests. First, financial markets have grown ever more sophisticated, new types of institutions, such as mutual funds and pension funds, have grown to meet evolving financial needs. Second, in absolute terms, the banking industry has not shrunk, it has grown, but much more slowly than many of its competitors. The industry has experienced about a one-and-a-half percent compounded annual growth rate over the past 10 years. By contrast, credit unions have experienced annual growth of about five percent, and mutual funds about 19 percent. Third, traditional market share measures, which are based on asset holdings, generally do not reflect the growing importance of bank income from off balance sheet products and services. The rise in the noninterest income share of bank earnings indicates less reliance on traditional lending activities. It also indicates that banks, too, are innovating and adapting to a changing marketplace.

Let's now look at profitability.

Banking has achieved record profitability in recent years -- and has attracted the attention of old and new investors. The industry's return on assets (ROA) has exceeded one percent every year since 1992. In the time since the FDIC was created in 1933, banking has never before achieved this level of profitability. Moreover, if the commercial banking industry maintains the earnings strength it displayed during the first half of 1996, it will earn more than \$50 billion in one year -- an annual record. These strong earnings are widespread in the industry, with 70 percent of banks reporting ROAs above one percent in the second quarter of this year. Standing alone, however, profitability, too, gives us an incomplete assessment of banking's condition and its prospects.

To achieve a more complete assessment, this morning I will examine three other factors for the industry as a whole -- capital, asset quality and management -- and I will indicate what they may mean for the industry's future.

First, capital.

Banking enjoys a pool of capital that is deep and wide. As of the end of the second quarter, the industry's equity capital represented 8.3 percent of total industry assets, the highest level registered since 1941. High capital levels are widespread in the industry: as of mid-year, 98.5 percent of all commercial banks were ranked as well capitalized under the FDIC's risk-based deposit insurance system.

Second, asset quality.

Banking's extraordinary turnaround from the most recent national recession and its record profitability has been supported both by improvements in the quality of existing loans, and by income from new lending. Since reaching an all-time high of more than \$83 billion in 1991, banks' inventories of troubled loans have declined by almost two-thirds, to \$30 billion at mid-year 1996. The sharp drop-off in troubled loans has allowed banks to increase their reserve coverage ratios while reducing their loss provisions. As of June 30, banks had a record \$1.77 in reserves for each dollar of noncurrent loans, up from only 73 cents at the end of 1991.

In the early 1990s, loan growth rebounded, helping banks to boost their net interest income even as net interest margins gradually narrowed from the historic highs reached in the early 1990s. In 1995, banks had 26 percent more net interest income than in 1991.

There has been a structural change in the composition of the industry's loan portfolio, however, that has implications for credit quality in the future. In recent years, consumer

loan growth has outstripped increases in other types of loans, which changes the nature of the industry's credit risks. Ten years ago, two-thirds of the portfolio consisted of loans to business, while one-third consisted of loans to consumers -- such as home mortgages and credit card loans. Now the balance is nearing even, with business loans representing 56 percent of the portfolio and consumer loans representing 44 percent.

Despite the inherent diversification in consumer lending, concerns have arisen regarding the quality of credit card loans. The amount of credit lines that banks have provided through credit cards has more than doubled in four years, increasing from \$730 billion in 1992 to almost \$1.6 trillion today. Of that amount, \$350 billion in credit card lending is outstanding.

We are closely monitoring the performance of credit card and other consumer loan portfolios at individual institutions, largely because of the rise in net charge offs in credit card loans and the significant increase in personal bankruptcies in the past several years. For commercial banks, the annualized net charge-off rate on credit card loans hit 4.48 percent in the second quarter of this year, its highest level since the fourth quarter of 1992. And, for the first time, annual personal bankruptcy filings are expected to exceed one million during this year. Some consumers in recent years have even gone straight from being current on credit card loans to personal bankruptcy without passing through delinquency.

These reasons -- and others -- make credit card lending a matter of concern.

Finally, let's turn to an assessment of management -- the hardest of the three elements to quantify in analyzing the state of the banking industry.

The market, as well as bank supervisors, assesses the quality of management, and bank management has clearly won a vote of confidence in the market. Bank stock prices have increased sharply, beginning in 1990. The improvement in bank stock prices is reflected in rising price/earnings multiples even as bank earnings have continued to increase. The stock market has traditionally discounted bank earnings when compared to other industries. Salomon Brothers notes, however, that in 1991, the average bank price/earnings ratio was 46.3 percent of the Standard and Poor's 500, but the average climbed back to 71.2 percent in 1995, which may be another signal that the market is having greater confidence in bank management.

Let's look at another factor in assessing management.

There is some evidence that banks are becoming more efficient -- in part, by leveraging technology. For example, analysis of Call Report data shows that the industry has become more productive by being able to increase its size without adding new employees. Ten years ago, on average the industry managed \$2.5 million in assets for

each employee, after adjusting for inflation. As of June 30, commercial banks were managing nearly \$3 million in assets for every employee, excluding the banks that specialize in credit card loans. Technology enables banks to be more efficient and effective. While it is clear that larger banks are taking advantage of technology, it is not clear that many smaller banks have accepted the benefits technology can bring.

There is more to management, however, than creating organizational efficiencies. Management must also prepare for the future and seek to shape events, rather than simply react to them. In this regard, the continuing consolidation of the banking industry is likely to test whether bank management can sustain the industry's performance. The number of banks, as well as thrift institutions, has been shrinking for the past 10 years, with mergers being the main cause. Last year, for the first time in modern times, the number of commercial banks fell below 10,000 -- while at mid-year the number of thrifts fell below 2,000 for the first time since 1937.

In addition, the number of acquisitions of very large companies is increasing. Since 1990, twenty-four acquisitions of companies larger than \$10 billion have been announced -- including 13 in 1995 and 1996. Of the 100 largest bank holding companies in existence in 1990, thirty-nine have been acquired or closed -- including 22 of the largest 50. While forty-two banking organizations controlled 25 percent of all domestic deposits in 1984, by March, 1996, only 13 banking organizations controlled 25 percent of domestic deposits.

Managing the larger institutions that result from consolidation may be a more difficult proposition.

We should remember, too, that there are almost 6,500 community banks today -- two thirds of all U.S. banks. There has been some shrinkage in their numbers, also, but based on past experience community banks will continue to fill market niches that other, larger institutions may not be serving. In addition, the recent increases in new charters suggest investors see those opportunities, as well. For all banks, however, it is improbable that the banking industry's extraordinary record of profitability since 1992 can continue unabated in the foreseeable future. The question mark is whether there has been sufficient industrywide attention to strong internal controls and sound approaches to risk management to offset future problems.

What is the state of the banking industry today?

In summary, strong returns over the past several years have positioned the industry well to compete in an evolving environment shaped by technology, changing demographics, and a widening marketplace. The fact that increasing profitability has been accomplished while competition has increased and market share has decreased only underscores this achievement.

Where is the industry going in the future? The answer will depend on a number of factors.

One, banks will have to maintain credit quality in the face of greater competition -- and that means banks will have to be better at identifying, pricing and managing risks than their competitors -- even if it means sacrificing market share.

Two, future profitability will also depend upon expansion of profits from less traditional off balance sheet business. Further diversification of revenue sources will help banks absorb rising credit losses when the economy is less favorable. The prospects for banks would be brighter if you are allowed to function effectively in the marketplace to offer credit and investment opportunities more broadly to serve the needs of the U.S. economy and the needs of all Americans. That is a legislative issue that deserves the immediate attention of the new Congress.

Three, in the long term the real test for bank management is how it addresses the interconnectedness of a worldwide marketplace and the growing risks that a highly competitive financial system presents -- and that is not easy to predict.

While regulation has a role to play in the future of banking, we regulators should not get in the way of market discipline more than necessary in meeting our statutory and prudential obligations. Balancing risks and rewards will not be easy for banks in the rapidly changing financial environment. In the final analysis, successfully maintaining the balance is up to bank management and boards of directors -- and not up to regulators. Regulators can set the parameters of behavior, but we cannot determine the results.

There is no way to measure quantitatively whether the management of America's banks is equal to the challenges ahead, but if the past is any guide to the future, bank performance in recent years gives us reason for cautious optimism.

Last Updated 06/28/1999