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HOW SOUND IS THE BANKING SYSTEM?

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An address by

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Attending another Assembly for Bank Directors is a pleasure as these meetings are very worthwhile for both bank directors and bank regulators. The Assemblies grow in importance as even greater emphasis is placed on the role of directors in setting policies for bank operations and in monitoring the performance of management.

We all appreciate the efforts of Dick Johnson in making the Assemblies possible and shall miss him. We are fortunate indeed to have gentlemen like George LeMaistre and Finley Vinson to keep the ball rolling.

My assignment today is to discuss "How Sound is the Banking System?" In doing so I would like to focus on the major forces influencing the condition of the commercial banking system rather than on a host of detailed statistics relating to it. These forces operate on your own individual banks in the same way they do on the entire banking system; hence, a review of them will provide a perspective for your future policy decisions. In identifying these forces, I want to distinguish the internal ones from the external ones. Both affect your bank, of course, but you can exercise some control over the internal ones while you simply must adapt to the external forces.

The banking system encountered difficulties in the 1974-76 period as a result of a number of factors. Among the external factors were a more intensely competitive environment, the 1974-75 recession and the accompanying increase in unemployment, and rapidly rising prices caused by government fiscal policies, by the quadrupling of OPEC

oil prices, and by reduced worldwide agricultural output due to bad weather conditions in the early 1970s. These problems were compounded by the emphasis bank management placed on asset growth, increased reliance on non-deposit liability sources, and the movement -- either directly or through subsidiaries -- into relatively new exposures such as real estate investment trusts.

Consequently, the banking system was not well-prepared to handle problems that occurred after domestic economic activity peaked in November 1973. Liquidity was impaired by imbalances in the maturities of assets and liabilities, by interim loans for capital investments made without firm take-out commitments, by the inability of borrowers to meet previously agreed upon maturity schedules, and by disintermediation resulting from higher interest rates available in the money markets. These factors in turn led to a squeeze on earnings and further pressure on capital ratios as loan losses increased markedly and banks paid higher rates to garner funds needed to meet their commitments.

The Performance of the Banking System, 1976-1979

Bankers responded to these problems, and the performance of the banking system improved steadily from 1976 to 1979 in spite of accelerating price pressures and the accompanying high and volatile interest rates. Net operating income to total assets rose from .72% in 1976 to .88% in 1979. Net interest margins improved steadily each year despite the inhibiting effect of interest rate ceilings on

loans and deposits. Asset quality improved substantially as reflected by the decline in net loan losses from .64% of total loans in 1976 to .34% in 1979 and the decline in classified assets from 3.45% of total assets to 1.78% over the period.

The total equity capital of the banking system increased over the 1976-79 period, but the ratio of equity to assets dropped from 6.1% at year-end 1976 to 5.7% at year-end 1979. The steady decline in capital ratios was due in large measure to the effect of inflation on asset growth and was accounted for entirely by banks with total deposits of $500 million or more. The average equity capital ratio of banks with between $100 and $500 million in deposits was 7.0% in both 1976 and 1979, and the ratio actually increased from 7.9% to 8.2% for banks with deposits under $100 million.

The liquidity of the banking system deteriorated modestly over the 1976 to 1979 period. Although the loan-to-deposit ratio increased moderately over the period for banks as a whole, banks were motivated to improve asset liquidity by the popularity of the 6-month certificate and the loss of deposits to money market mutual funds. By the end of 1979, 58% of all commercial bank deposits were in savings or demand deposits subject to immediate withdrawal, and 83% of total deposits were subject to withdrawal in 6 months or less.

Problem Banks and Bank Failures

In spite of the overall improvement in the banking system's performance during the years of recovery and economic expansion that followed, some individual banks encountered great difficulties. As their problems were uncovered through the examination process, these institutions were placed on the problem bank list. To the extent that the number of banks on the list is a useful indicator of the strength of the commercial banking system, the problem bank situation confirms the other evidence on the improvement of the system during the post-recession period. The total number of problem banks declined by 25% between year-end 1976 and year-end 1979, and the total assets of the banks on the list declined substantially more.

Caution should be used, however, when interpreting the problem bank data. First, the problem list is a lagging indicator of the condition of the banking system, as banks are placed on the list because of the findings of bank examinations which seldom occur more than once each year. Second, banks are placed on the problem list for a variety of reasons, some of which are independent of the harshness of the economic environment. Such reasons include abusive insider transactions, mismanagement, capital inadequacy relative to the volume and quality of assets, and liquidity problems. Third, it should be recognized that there is a high rate of turnover of banks on the problem list. At the end of 1979, for example, there were 287 banks on the list, down by 55 banks from year-end 1978. During 1979, 143 banks

were added to the list and 198 were deleted. The special supervisory attention given to problem banks, in conjunction with the efforts of management, results in the removal of the majority of banks in less than 3 years.

Despite the efforts of state and federal bank supervisors, and of management, some institutions do not survive. Since the inception of the FDIC, a total of 566 insured banks have failed, an average of about 12 per year. That translates to an annual failure rate of less than one-tenth of one percent of our nation's banks.

The liquidation and receivership functions of the FDIC were well-tested in the 1973-76 period. Prior to that time, the Corporation had contended with the failures of relatively small banks -- none greater than $100 million in total deposits. In the 1970s several sizeable banks were closed by their chartering authorities, and the total number of failures climbed. During those years the FDIC was called upon to handle the 10 largest bank failures in its history. Over the past 2 years, however, consistent with the improvement in the general performance of the banking industry, both the average size and total number of bank failures receded toward pre-1970 levels. For example, we had 10 bank failures in 1979, none larger than $30 million in total deposits. To date this year, we have had 8 failures, and the largest had deposits of $79 million. If the number of

failures continues to average around a dozen this year and next, the banking industry will have turned in a creditable performance in view of the unprecedented height and volatility of interest rates.

Adequacy of the Insurance Fund

Although it is generally agreed that the record of the FDIC in handling failures is excellent, occasionally the question arises as to the adequacy of the FDIC insurance fund to meet potential bank closings. Economic conditions at home and abroad, the strength of the financial system, and the condition of individual depository institutions all have a bearing on the losses that the fund may have to absorb in the future. A few figures are necessary to provide a perspective. At mid-1980, the insurance fund stood at $10.4 billion. It had grown by more than $1.1 billion over the previous 12 months, with nearly $800 million of the increase coming from the income on our portfolio of government securities in which the fund is invested by law. In contrast, the total losses sustained by the FDIC on all 566 bank failures since the inception of the fund in 1934 amount to only $290 million, or only about one-fourth of our current annual net income.

In addition to our own resources, the FDIC has by statute a $3 billion line of credit with the U.S. Treasury. The Corporation has never had to draw down this line, and we do not anticipate the need to do so. Nonetheless, this source of funds provides an added bulwark should the need arise.

Apart from the resources at hand to absorb losses, there are important controls over the risks to the fund and, thus, over the size of any potential losses. Through their bank supervisory activities, and particularly via the examination process, the FDIC and other bank supervisors carry out their broad objective of maintaining the safety and soundness of our nation's banks. Incipient supervisory problems, uncovered through bank examinations, are called to the attention of the bank's board of directors with suggestions for corrective action. Early and propitious measures taken by management to overcome emerging problems are almost always effective, so that few banks ever permit their difficulties to progress to the point where their chartering authorities must close the bank.

Another line of defense is the discipline imposed on banks by the financial markets. Substantial increases in the amount of information disclosed at least quarterly enable bank analysts and investors to follow closely developments in individual banks. Unfavorable events are noted relatively quickly and market forces stimulate corrective action. These observations apply primarily to the larger banks, but that is where the largest dollar risk to the fund could emerge.

Some observers have noted with concern the decline in the deposit insurance fund as a percentage of insured deposits, from 1.48% in 1960 to 1.21% at year-end 1979 -- a phenomenon due primarily to inflation of bank deposits

coupled with increases in the deposit insurance limit. The problem with this kind of analysis is that it fails to take into account the methods employed by the FDIC to handle failures. In nearly three-fourths of the failures over the past 15 years, the FDIC has arranged a takeover by another bank. These assumption transactions have substantially reduced the outlays required of the FDIC and have also had the effect of providing nearly complete protection for all general creditors of the failed institutions. In the 566 failures handled by the FDIC since 1934, 99.8% of all depositors -- both insured and uninsured -- have been paid in full. Thus, the ratio of the insurance fund to insured deposits is not of overriding concern. The fund as a percentage of total deposits has remained fairly constant over the past 20 years. If inflation slows, I would expect the fund to stabilize or even climb as a percentage of both insured and total deposits, particularly in view of the new, more conservative assessment rebate system established by Congress in March of this year.

The Outlook for Bank Performance

The outlook for the performance of the banking system through 1980 and beyond depends importantly on the competitive and economic environment. How your individual bank will fare in the coming years will depend on the steps you take to meet the challenges presented by these forces.

Major federal legislation was enacted this year which may portend profound changes in the competitive environment for banks. The Depository Institutions Deregulation and Monetary Control Act established a Deregulation Committee with a mandate to phase out interest rate ceilings on deposits over a 6 year period. Without interest rate ceilings, there can be no interest rate differential in favor of thrifts. To offset the loss of this advantage, and to better prepare these institutions for the future, thrifts were given additional lending and deposit-taking powers. The Act also authorized nationwide NOW accounts beginning in January, 1981. Thus, it should be anticipated that the competition among banks and between banks and thrifts will intensify in the years ahead.

We have also witnessed dramatic changes in the economic climate during the first three quarters of this year. The economy appeared to peak early in 1980, and in the second quarter we saw a steep drop in economic activity. Interest rates soared to new highs in March of this year, retreated sharply into June, and moved upward since. During the early months of this year, inflation was running perilously close to a 20% annual rate, which prompted the President to invoke the Credit Control Act of 1969.

The commercial banking system weathered the greater uncertainties in the economic and competitive climate reasonably well over the first half of this year. Although earnings growth slowed, net operating earnings rose at a

greater than 10% annual rate. Net interest margins contracted slightly; thus, operating income increases were due principally to asset expansion. Banks strengthened their capital positions by retaining approximately three-fourths of net operating income. As a result, the ratio of equity capital to total assets increased to 5.9% in mid-1980 from 5.7% at year-end 1979.

The slowdown in economic activity surfaced surprisingly quickly in net charge-offs, a statistic that normally lags significantly behind a decline in the economy. Preliminary figures for the first half of 1980 indicate that net loan losses rose by 28% on an annualized basis. However, the ratio of net loan losses to average total loans remained below the average of the past 5 years. At the same time, measures of bank liquidity declined only slightly.

Other depository institutions have not been as fortunate this year because of the basic imbalance that has developed between the maturity structures of their assets and liabilities. Thrift institutions have had to contend with relatively fixed-rate assets and increasingly variable-rate liabilities. Savings and loan associations showed only a small net income in the aggregate for the first half of 1980, and mutual savings banks in the aggregate incurred small losses. This outcome is of significance to commercial bankers for it shapes the environment in which regulatory decisions are made, and, in particular, the speed at which deposit interest rate ceilings are lifted. The timeliness

of rate decontrol will, in turn, influence the competition for funds among depository institutions, and between depositories and nondepository businesses such as money market mutual funds.

Thus, the banking industry entered the second half of 1980 with a creditable first-half performance, but with some signs of potential future difficulties. The outlook for the remainder of the year and into the year ahead will be determined largely by developments among external factors which emerged earlier this year. They include at least the following four factors:

1. The course of the economy. Have we experienced the full depth of the decline in economic activity, and are we about to embark on the road to recovery? Will the auto and housing industries rebound over the next few quarters? What will happen to the supply and price of oil? What will be the impact of this year's drought in the farm states?

2. Price increases. Will the rate of inflation accelerate, or can we expect subsiding price pressures? Will the federal government be able to achieve a measure of control over its fiscal policies? Will our nation be able to reverse the decline in productivity?

3. The cost of funds. How high will interest rates rebound from the lows of this June; where and when will they peak?

4. Depository institutions competition. What will be the impact of NOW accounts? How will they change the sources and cost of funding? What will be the effect of broader asset powers for the thrifts?

Implications for Your Bank

While it is true that it is not possible to exercise control over most of the developments that are external to your bank, you do have control over the extent to which the performance of your bank is affected. One of the key responsibilities of bank directors is to understand these external forces, determine the factors internal to your bank that make it more or less vulnerable to adverse changes in the bank's environment, and to take the steps necessary to reduce your bank's vulnerability to the forces outside its control.

Let me suggest some questions that bank directors might ask to better position their banks for the upcoming changes in the banking environment. I might add that in a number of these areas you should not only ask the right questions, but insist on receiving a good analytical response which compares your bank's condition and performance to a peer group of well-run banks.

1. Asset and Liability Management. A major responsibility of a bank's board of directors is to set asset and liability management policy. Taking your bank's position as a whole, including liability structure, asset diversification, and loan commitments or credit lines, is your bank exposed to the risk of rising or falling interest rates? What type of deposit structure do you seek? Is the nature and stability of your deposits changing? What rate are you willing to pay for liabilities? Is your asset and liability mix coordinated with an eye toward maintaining both liquidity and profitability? Are your variable rate assets and liabilities well-matched? How vulnerable are your customers to increases in interest rates and to adverse developments in the economy at large? For example, are your customers reliant on the performance of a particular sector such as automobiles or farming? Is your loan portfolio well diversified by customer and line of commerce?

2. Managing Profitability Over a Well-chosen Planning Horizon. A second major responsibility of bank directors is to establish goals for management and be willing to make personnel and other resource commitments necessary to achieve those goals over a well-chosen horizon. Has your board carefully selected a meaningful profitability goal, such as return on average assets, or

are you dedicated to simply maximizing asset growth? Have you assessed the trade-off between potentially lower current earnings and investment in capable successor management? Have you determined the level of management expertise and training required to implement successfully the technological advances in banking? What are the present and potential capital requirements to sustain your target growth rate? How well have you educated your shareholders on the importance of building strong future earnings and a sound capital base even if it requires some sacrifice with respect to current earnings? How will the introduction of NOW accounts and other new powers of thrifts in your market change your informational requirements on the cost of providing services? Will your present accounting system provide that information? Have you reviewed your branching, ATM, and other fixed-asset investment decisions in view of the changing competitive environment among depository institutions?

3. Longer-range Planning. Finally, there is the important function of long-range planning. Does your bank have a good perspective on how the markets it serves might be evolving? Do you have a plan for penetrating your bank's target markets?

In short, do you know precisely what kind of bank you are, and have you decided on the kind of bank you will be in the future? Do you have the marketing expertise on your staff to help you design new products and services for a rapidly changing financial services environment?

Some Closing Thoughts

Many of you have addressed these and other questions as part of your efforts to guide your bank through these uncertain times. But some of you may be new to the role of a bank director, and others may need to readdress these questions in the context of the current banking and economic climate.

The banking system is in generally sound condition today. That strength is attributable to a significant degree to the dedication and good judgment of bank directors. Current economic uncertainties and the increasingly competitive environment for banks present many challenges. The course of the economy, the struggle with inflation, the phase-out of deposit rate ceilings, and the new powers of thrift institutions will all influence your bank's future.

The effects of these forces will vary from bank to bank, partly because of differences in market location and types of customers served. To a large extent, however, the effects on your bank will depend on you -- on the skill, energy, and wisdom you bring to bear on the policy decisions

at hand. I have every confidence that if your bank, regardless of its size, addresses the questions I have outlined today and takes steps to reduce its vulnerability and position itself for the future, its prospects will be bright in any environment. Through your dedication and effort, your bank and the banking system will continue to be sound and prosperous.

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