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SOME THOUGHTS ON BANKING TODAY

An address by

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Conference of State Bank Supervisors

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I am particularly happy to be with you today as I was unable to attend your last annual convention in Las Vegas as planned. As you may recall, the remarks I had prepared for last year's meeting were delivered for me by Bob Shumway; the topic was the challenge to the dual banking system. This year I would like to follow up on those remarks by reviewing briefly how our state banking system is striving to enhance its performance and strength. I will then switch topics and offer some observations of mutual interest on the condition of our financial system.

It is clear to me that our dual or state/federal banking system has many positive attributes. First, state supervision of banks offers the advantage of local level jurisdiction -- of bringing government closer to the governed. This proximity to the regulated banks and their communities provides the opportunity to develop laws and regulations that are based on a more intimate knowledge and greater understanding of local problems and needs. Second, our dual banking system provides an important deterrent to undue concentration of government power by counterbalancing the federal presence in bank regulation. Third, our dual system allows for the development of a healthy variety of approaches to banking issues, giving us a greater likelihood of arriving at optimal programs or solutions. This potential for innovation by banks and bank regulators is, perhaps, the most significant strength of our dual system.

While the dual banking system has served our country quite well for over a century, it has come under increasing pressure for change in recent years. Some critics have even suggested abolishing the dual banking system and substituting a centralized structure for the chartering and regulation of banks.

A more concrete and specific threat to the system is last year's Depository Institutions Deregulation and Monetary Control Act. The Act's provisions establishing mandatory universal reserve requirements and uniform access to Federal Reserve services and the discount window have perhaps the most significant potential consequences for the dual banking system. After the new reserve requirements for nonmember banks are completely phased in, the current advantage that state nonmember banks have over national banks will have been eliminated, which may result in a greater incentive for banks to select a national charter to avoid dual regulation. If we are to maintain the vitality of our dual banking system, minimization of the burden of dual regulation is one of the most important challenges that the states and the FDIC must meet.

I believe we have made significant progress along these lines over the past year. Perhaps most noteworthy has been the increase in participation in the divided examination program. Under this program, banks that do not require special supervisory oversight are examined by the state authority and the FDIC in alternate years rather than by each agency each year. Currently 18 states participate in the divided exam program, up from only 7 a year ago; over 3,200 state banks now obtain the benefits of a more efficient, less costly system of oversight.

In addition to the divided examination program, the FDIC and a number of states are cooperating to reduce duplication and delay in the area of applications processing. Not only do we encourage simultaneous submission of applications to the FDIC and the state authority, we process the applications concurrently with the state whenever possible. Our goal is to virtually eliminate the time-lag between action by the state authority and action by the FDIC. Moreover, the FDIC and 18 states currently share common application forms, which further reduces the time and expense of such transactions as opening branches and consummating mergers.

Another area in which the FDIC has expanded its cooperation with the states is that of data collection and analysis. The number of states participating in the divided exam program that are tied into our data base has increased to a current total of 10. This access to the call reports and other information allows states to avoid collection and processing costs that they would otherwise have.

These are but a few examples of the progress that we have made toward bringing about a more efficient system of supervising state banks. I am confident that as the months and years go by, we will broaden our efforts and will devise additional means for enhancing the strength of our state/federal system and eliminating its weaknesses. We at the FDIC appreciate the close cooperation we have received from many of you during the past year in connection with these efforts, and we know we can count on your continued leadership and support.

Let me now turn to the condition of our financial system. This is a fascinating and challenging time to be in the field of bank supervision. We are witnessing a virtual revolution in the financial services sector; there are so many events, trends, and difficult issues confronting us and the banks we supervise.

Formerly distinct product lines that separate various kinds of financial institutions are becoming increasingly blurred: commercial banks make mortgage and consumer loans, brokerage houses offer bank-like services, and even retailers engage in activities that once were the exclusive province of financial institutions. Most dramatic has been the explosive growth of the money market mutual funds, whose assets are approaching $120 billion. This erosion of product distinctions among institutions was accelerated by last year's Depository Institutions Deregulation and Monetary Control Act. The Act called for the abolition of deposit interest rate ceilings and gave thrifts new powers, including the ability to offer checking accounts nationwide and to diversify their loan portfolios.

In addition to the increased homogeneity among banks and nonbank financial intermediaries, technological developments in recent years have allowed the geographic restraints that have traditionally limited banking markets to be bypassed. Improved transportation, computer, and communications systems have enabled banks and other financial intermediaries to reach out farther and farther for business. In addition we have seen a tremendous growth in loan production offices, Edge Act corporations, and various nonbanking affiliates, all of which have further contributed to the circumvention of geographic restraints on banks. These trends are not likely to abate in the years ahead. As the competition intensifies among financial institutions formerly isolated from one another by product and geographic market boundaries, pressures will intensify to fashion regulatory techniques and a regulatory structure that treat financial institutions in an equitable and evenhanded manner.

Perhaps the most difficult challenge that depository institutions are facing is the current harsh economic climate, with its high and volatile interest rates accompanied by substantial unemployment in some sectors and regions. Volatile rates make it more difficult to manage portfolios. High rates cause depreciation in financial assets. Unemployment leads to additional credit losses. The unsettled economic environment, combined with the heightened competitive climate, makes banking a more complex business today than ever before. Because of this, some people have raised questions about the strength of our banking system.

I can assure you that our banking system is in good health, that banks appear to be weathering these harsh and unpredictable conditions remarkably well, and that, while some individual institutions are suffering some ill effects, the banking system as a whole is coping in a way that attests to its underlying strength. I will be specific and give you some figures that reflect what happened in banking over the last year.

Total assets of all insured commercial banks grew approximately 10 percent in 1980, almost as much as in 1979. This growth was more expensive to fund, however, as interest rates soared and funds at commercial banks shifted from relatively low-cost, fixed-rate deposits to more costly instruments with market-related rates. These more expensive deposits increased from 55 percent of interest-bearing liabilities at all commercial banks at year-end 1979 to 68 percent at the end of 1980. The deposit shift was most pronounced at smaller banks (those with less than $100 million in assets). For these banks the percent of interest-bearing liabilities in deposits without fixed ceilings increased from 35 percent at year-end 1979 to 58 percent by year-end 1980.

Banks were able to offset the higher cost of funds and increased noninterest operating expenses by generating even higher operating revenues, so that net income after taxes rose by 14 percent. The median ratio of net income to average assets was 1.2 percent, up slightly from 1979. As in the past, earnings were inversely related to asset size, ranging from a return on assets of 1.28 percent for banks under $25 million in size to 0.63 percent for banks over $5 billion. Only banks of over $5 billion experienced a growth in assets exceeding their growth in net income.

Asset quality deteriorated somewhat, as might be expected in light of economic conditions, but loan loss reserves increased correspondingly. We saw an increase in loan losses during 1980 of 40 percent over 1979; however, this increase was lower than in the 1974-75 recession when net losses increased 69 percent in 1974 and 66 percent in 1975.

The liquidity of the commercial banking system improved in 1980, but with some offsetting developments. One measure of liquidity is the ratio of temporary investments (mainly federal funds sold and securities maturing in less than one year) to rate-sensitive purchased funds (mainly federal funds purchased and time deposits of more than $100,000). As of year-end 1980 this ratio was 135 percent as compared to 107 percent at year-end 1979 -- a significant liquidity improvement -- although there were substantial differences in this ratio between large and small banks.

This improvement in the liquidity position of banks was offset somewhat by shifts in the deposit structure to a greater proportion of short-term instruments. At the end of 1980, six-month money market certificates, passbook accounts, and large certificates of deposit, most of which had maturities of six months or shorter, constituted 53 percent of all domestic deposits in commercial banks. When demand deposits are included, 90 percent of all bank deposits were subject to withdrawal in six months or less. This is up two percentage points from the end of 1979.

Capital in the banking system increased last year, with the ratio of equity capital to total assets for all insured commercial banks growing from 8.06 percent in 1979 to 8.27 percent in 1980. This overall increase is attributable primarily to increased equity ratios in banks with under $1 billion in assets; banks with between $1 and $5 billion had approximately the same equity ratios in 1980 as in 1979, while ratios in banks over $5 billion declined slightly.

We have handled thus far in 1981 three bank failures with a total of $75 million in deposits. Projected out over the entire year, that is about the same failure rate as in recent years. Failures in recent years have resulted from internal factors largely unrelated to the economic environment. There are no detectable trends to relate these failures to the general condition of the economy.

The number of banks on our problem list continues to decline despite the economy and interest rates. As of March 31, 1981, 204 banks of all types were on the list, down from 217 banks at the end of 1980 and 287 banks at the end of 1979. I should note, however, the problem list contains a built-in lag, since it is usually about 18 months before poor conditions in the economy magnify the weaknesses that cause banks to go on the problem list.

The FDIC fund which currently exceeds $11.3 billion in size, is strong and growing. Our net income in 1980 was $1.2 billion; that was the first time net income exceeded $1 billion. For 1981, we project net income in the range of $1.3 billion.

Where once the bulk of the fund's income was attributable to bank assessments, today only about one-third comes from assessments, with about two-thirds coming from investment income. Moreover, our fund is highly liquid, with approximately $200 million in overnight obligations and an overall average maturity of 3.1 years, down from 3.9 a year ago.

We have never had to use our statutory right to draw up to $3 billion from the U.S. Treasury should we need it. Nor do we anticipate any circumstances that would cause us to exercise this right, although it does provide essential backup should we experience unusual circumstances.

From the figures I have given you, you can see that the banking system emerged from the turbulent months of 1980 relatively unscathed and, in fact, with a modest improvement in its overall condition. I think it is particularly heartening to consider the general condition of small banks -- those under $100 million in assets -- which often have been considered more vulnerable to the volatile interest rate environment than large banks. Despite the fact that these smaller institutions experienced a dramatic shift in liabilities from low-cost deposits to more expensive, market-sensitive instruments, they have been successful in generating sufficient returns on their portfolios to protect their net interest margins. The margins of these institutions increased in 1980, while the margins of larger banks -- over $1 billion in assets -- generally showed little improvement.

While I think we can take comfort from the strength of our banking system, it would be foolish to ignore the possibility that a prolonged continuation of current economic conditions could eventually undermine the stability of the system and sap its strength. The present vulnerability of some of our 341 FDIC-insured mutual savings banks stands as a reminder of the importance of the safety mechanisms built into our banking system. The Federal Deposit Insurance Corporation is cognizant of its responsibilities in this regard and is prepared to discharge them fully.

It is no secret that inflation and its accompanying high interest rates have dominated the economy over the past few years and have created serious problems for many mutual savings banks. Higher interest rates have significantly increased the cost of savings bank deposits. Yields on earning assets have risen, but much more slowly than deposit costs. Assets are heavily concentrated in long-term, fixed-rate mortgages and bonds which turn over slowly. The problem has been exacerbated by slow deposit growth resulting from a low personal savings rate, the diminished appeal of taxable, fixed-return investments, and increased competition from money market funds and market instruments. These conditions have severely limited the ability of savings banks to acquire higher-yielding assets.

Last year, FDIC-insured mutual savings banks lost money in the aggregate. The loss amounted to about 0.17 percent of average assets compared with net income of about 0.45 percent of assets in 1979 and 0.59 percent in 1978. The loss was not evenly spread throughout the country. New York City savings banks, which account for about 40 percent of the deposits of FDIC-insured thrift institutions, lost about 0.62 percent of average assets last year. The rest of the industry had net income of about 0.17 percent. The weaker performance of many of the New York City savings banks reflects a combination of factors, including past restrictions on permissible lending, past restrictive usury ceilings, extremely harsh state and city tax treatment, a relatively static mortgage market, and a high degree of competition from large money center institutions and money market funds.

Even if interest rates decline moderately over the next year or so, deposit costs at savings banks are likely to increase as deposits continue to shift out of passbook accounts and as certificates paying 7-1/2 and 7-3/4 percent mature. If interest rates decline markedly and remain lower for a sustained period, most savings banks should be able to adjust portfolio returns to bring them into line with the market and attain a profitable position. Savings banks then would have the opportunity to take advantage of the broadened lending powers authorized by the Monetary Control Act of 1980 and state laws, thereby reducing their exposure to future interest swings.

Late last year we established a high-level project team at the FDIC to monitor conditions in the savings bank industry and develop strategies for addressing the situation. We do not have the time today to go into detail regarding the work of our project team; suffice it to say that we have put in a great deal of effort, and we are confident that we know both the nature and extent of the problems and that we have the capacity to handle them. We have projected what is likely to transpire under a variety of economic scenarios. Even assuming very pessimistic interest rate environments, the FDIC's resources are more than adequate to deal with every contingency.

We may decide to seek legislation to provide us with additional flexibility in dealing with troubled institutions. We will not seek it unless we believe it is necessary to enable us to effectively perform our job. In the event we do propose legislation, I hope we can count on the support of CSBS and of all of you in the audience to ensure its swift passage.

I thank you for inviting me to participate in your annual meeting. Your gathering together at this meeting to share experiences and opinions about banking and bank regulation is testimony to the most positive attribute of our dual banking system -- that is, the strength that comes from diversity. As I look back over the three years I have spent at the FDIC, I am gratified by the cooperation and support we have received from so many of you. As I look ahead to the many challenges confronting the financial services industry, I feel certain that we must and will develop an even better working relationship -- a relationship designed to help us achieve our mutual objective of maintaining a strong, innovative financial system.

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