[Condition of the banking industry]

An Address by

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Good morning. It is a pleasure to be with members of the National Soft Drink Association.

In my early days as a CPA one of my most valued accounts was a 7up bottler - because every time I stopped in to give a little tax advice I departed with a case of Seven Up. Today I could probably choose from 10 different brands: things change fast in American business.

Today, I want to talk about the condition of the banking industry in the United States and the rapid changes taking place in the industry.

Thus as in the soft drink industry, banking today is characterized by rapid change and increased competition. U.S. banks are facing increasing competition -- much of it generated by technological development. Our banks have lost their dominance of world financial markets. Only 4 of the world's 50 largest banks are American -- 2 in the top 25. Now, 4 Japanese banks are in the top 10. In this country, banks are losing market share to both domestic and foreign competitors.

In considering the condition of the U.S. banking industry, one should note the environment for lenders like banks. Private debt levels, when compared with ability to repay, are very high by historical standards. This is true in all parts of our economy. Increased debt loads mean increased risks in the financial system.

All of industry and finance is operating in this environment of increased risks. Consider these facts:

- Household debt has reached a post-WWII high -- equal to 89% of disposable income. Prior to 1985, that ratio had never reached 80%. Consumer credit also reached a postwar high of over 25% of disposable personal income.
- Debt service now probably exceeds 30 percent of personal income. Personal interest payments now exceed 90 percent of personal savings. The historical average is about 30 percent.
- Between 1981 and 1986, business debts have grown twice as fast as their assets. Corporate debt, for example, jumped from 35 percent of net worth to almost 47 percent. Debt of nonfinancial corporations has risen to 91 percent of income, another postwar high. The prior high was only about 80 percent back in the mid-70's.

Overall in our society, there is now about 40 cents more debt for every dollar of income than there was just five years ago.

We are setting debt records, in all sectors of our private economy, on a regular basis. Higher debt burdens increase vulnerability to adverse financial events. Few would argue with that statement.

As proof of the effect of high debt levels on risk, we need only look to the depressed agricultural and energy sectors of our economy. High debt levels have increased the risk that debtors can not repay their obligations. When an economic recession comes along as it has in energy and agriculture, and is combined with weak credit, bank failures increase.

And we have experienced a record number of bank failures each year for the past 5 years. You also know of the serious financial problems of the FSLIC -- the agency that insures savings and loan associations. The insurance fund for S&Ls simply is not able to meet its obligations due to the large number of thrift failures.

These problems indicate that the financial industry is under some stress. The FDIC and other regulators recently reported to Congress that the system is <u>sound</u> but it has its problems.

° Thus, -- there is good news and bad news in reporting on the current condition of the banking system. First the bad news:

1. Last year a record 138 banks failed and another 7 required FDIC assistance to keep from failing. So far this year we have had 85 failures and the total number of failures or assistance transactions this year may exceed 200.

2. Currently we insure nearly 1,600 banks that are considered to be problem banks. That's almost 6 times as many as we had ten years ago. Problem banks are about 12 percent of all banks.

3. Nearly 2,800 banks lost money last year -- almost 20 percent of the industry -- compared to 5 percent five years ago. We expect at least as many unprofitable banks this year.

4. For the first time in 25 years, the aggregate earnings of the industry declined last year. If one excludes nonrecurring extraordinary items like capital gains, the industry's operating income was down 16 percent in 1986.

5. The volume of troubled loans in the banking industry has risen sharply. The proportion of loans charged-off banks' books has increased steadily from 0.56 percent in 1982 to 0.99 percent last year. Despite already having record charge offs, the proportion of <u>nonperforming</u> assets (those borrowers who are not paying interest on their loans) still on the books has risen to 1.95 percent. The FDIC's losses in failed banks have increased by 50 percent, to 22 cents per dollar of bank assets. These increased losses provide further evidence of deteriorating loan quality.

6. The figures on asset quality primarily reflect problems in the agriculture, energy and real estate sectors of the U.S. and world economy. In addition the exposure of U.S. banks in lesser developed countries -- particularly the Latin American debt situation are additional loan problems. This exposure is large - $<u>70</u> billion to Latin American countries. It's also concentrated -- nine money-center banks hold 65 percent of the Latin American debt. To illustrate, Brazil's decision to withhold interest payments has caused a significant decline in earnings for these large banks as reflected in first-quarter results.

7. To continue the bad news, the FDIC insurance fund grew only about $300 million last year compared to an increase of $1.4 billion the year before. The ratio of the insurance fund to insured deposits dropped to 1.12 percent in 1986, down from 1.19 percent the year before. We will be struggling this year to keep the fund from shrinking. Even if we manage to break even, the ratio to insured deposits likely will decline to around 1.00 percent.

8. The FSLIC -- the S&L insurance fund -- is certified insolvent by the GAO and must be recapitalized -- Congress is in the process of doing just that right now.

Now for some good news -- and this is the part that you're likely to hear less about -- good news is sometimes just not news.

- While the FDIC is being impacted by an unprecedented number of bank closings, the FDIC insurance fund is solvent, sound and viable. It has $18 billion plus in reserves. It can and will handle any reasonable forseeable problems among the banks we currently insure.

- While problem and failed banks are at record levels -- approximately 90 percent of insured banks are not considered problems and the annual failure rate last year represented only about 1 percent of the total number of banks.

- While perhaps 15 percent of the S&Ls are in trouble, 80 percent made profits in 1986. The failure of the FSLIC is due to the troubles of under 20 percent of the industry.

- While industry earnings overall are declining, performance varies widely. Ninety percent of the recent failures and 85 percent of the problem banks <u>are located west of the Mississippi River</u>. Banks in many parts of the nation are <u>doing quite well</u>. Banks located in depressed markets with limited opportunities for diversification have fared badly.

Part of this is a self inflected wound due to banking laws that restrict branching and competition. This created weaker units that failed under the strain of high debt levels and lack of diversification. This is called unit banking and is prevalent west of the Mississippi.

- While predicting the future is impossible, there are indications that the worst of the problem in some parts of the agricultural sector may be over. Some land prices have dropped to levels where, with a reasonable down payment, farming operations can generate sufficient cash flow to support debt service.

- While again it is too soon to tell, it also seems that oil prices have stabilized. However, the secondary effects of the oil-price decline are still working through the economy. The normal lag time between economic decline and a deterioration in the banking community probably has not yet run its full course.

- While the LDC debt problem continues, Citibank, Chase and many others have recently bolstered their reserves against international loan losses. To some, such actions may appear more form than substance because loan reserves are still regarded in our regulators language as "primary capital." (As a former accountant I'm really not sure we are right, but that's the way it was when I showed up). Still the decision to increase reserves brings balance sheets more in line with reality. It should be viewed as a step in coming to grips with international debt exposures and a move toward more long-term "substantive" solutions.

- It should be noted that neither the debtor LDC's nor the big banks can gain from failure to work out their problems. They will find ways to meet the problems because the alternative -- a complete breakdown -- is even less rewarding for both debtor and creditor.

- To sum up in one sentence: On average, the banking system is adequately, but certainly not overcapitalized; less profitable than in previous years; and becoming more efficient under the prod of deregulation and increased competition.

- While the banking system and economic and competitive factors are changing with unprecedented speed, to date, the response to this evolution has been a hodgepodge of ingenious private-sector initiatives that test the limits of existing legal frameworks. The archaic system of laws under which the banking industry operates has created an inefficient system that is contributing to some of the disturbing trends in the banking industry that I discussed here today.

It now seems that at long last a long-range financial-services restructuring has a good chance to be undertaken -- and soon. The issues are difficult and the turf to be protected is lucrative but the forces moving toward change are gathering force. Allen Greenspan, Chairman-designate of the Federal Reserve Board should be a great help in this effort -- he is a long time student of the legislative problems of the banking industry.

The financing of American business is at the heart of our free market system. Events that impact our financial institutions affect all of us. I think it's healthy to openly discuss these problems in business forums such as this and I welcome the opportunity to do so with you.

Thank you very much.