For release upon delivery
Expected at 9:00 a.m. E.D.T.
Tuesday, June 23, 1992

Banking and the Economy

Susan M. Phillips
Member, Board of Governors of the Federal Reserve System

Remarks Prepared for

Virginia Bankers Association
Annual Convention

White Sulphur Springs, West Virginia

June 23, 1992

It is a pleasure to be here with you today. In my remarks this morning, I would like to discuss a number of topics: the state of the banking system, recent developments in the national economy, and important elements of the FDIC Improvement Act (FDICIA) which was passed and signed late last year. All of these topics have significant implications for the banking industry and hopefully will generate some healthy discussion in the Q&A period following my remarks and for the remainder of your conference.

Condition of Banking System

I do not need to tell you that recent years have been difficult for the banking industry. A series of asset quality problems, weak economic conditions, and narrow margins have introduced stresses to the domestic banking system that are unmatched in recent decades. Asset quality problems have almost always been the principal risk to commercial banks, and the past decade saw problems with developing country loans, then energy, agriculture and finally real estate loans. These problem assets caused substantial damage to the profitability and capitalization of many banks.

Also during the decade, technological and financial market trends forced substantial changes in the nature and activities of U.S. banks. Many high quality commercial borrowers sought funding directly in the capital markets, especially the commercial paper market. Expanded powers for thrifts and the emergence of nonbank banks introduced much greater competition for banks.

In response to these market pressures, many banks expanded their lending to real estate developers and to other less creditworthy borrowers, including those with exceptionally high levels of debt. While these loans provided attractive yields and generated significant up-front fees, the initial benefits proved short-lived as credit losses began to mount. By late 1989, it was clear that many banks faced significant difficulties from highly leveraged borrowers and commercial real estate exposures.

During 1990 and 1991, the volume of nonperforming assets increased substantially, with commercial real estate loans accounting for a large share of that increase. Nonperforming assets of the 50 largest holding companies increased by $22 billion, or nearly 50 percent, during the two-year period. Smaller institutions were generally much less affected by real estate conditions and had fewer problems. Nevertheless, banks with assets less than $1 billion incurred a still significant 17 percent increase in total nonperformings during the same time. As a result, in recent years the industry's loss provisions and chargeoffs have risen to the exceptionally high level of nearly 1 percent of assets.

These problems, in turn, have clearly weakened industry earnings. During each of the past three years, the industry's average return on assets has been roughly 0.50 percent, a rate that is 10-20 basis points below levels generally seen during the past two decades. Earnings have been weakest among the larger institutions and in regions where commercial real estate markets have declined sharply.

Since 1985, record numbers of banks have failed. While the number of failures has declined in the past few years, the assets of the failed banks have been large. Even more troubling, the number of problem banks remains high, and their average size has grown significantly.

At this point, however, there are indications that conditions are beginning to improve. Most encouraging is the apparent turn in the pattern of nonaccruing loans, which have been declining in recent quarters. This apparent improvement reflects the process of cleaning up and strengthening bank balance sheets, with much commercial real estate having been charged-off or written down to estimated market values and foreclosed.

Lower interest rates have also helped strengthen the condition of banks by permitting the industry to widen its net interest margins to one of its highest levels in 20 years. Lower rates also contributed to a significant increase in unrealized gains on investment securities during the last eighteen months.

My net assessment, then, is that while much further improvement is needed, there is a basis for believing that the industry's current problems have peaked. We can expect the number and costs of bank failures to remain high for some time, but in many respects, the broader outlook for the U.S. banking system seems brighter than it has in several years.

Even during the past few very difficult years, many banks--including many large ones--have consistently performed well. In each of the past four years more than 40 percent of the industry, holding a similar share of banking assets, earned a highly respectable rate of 1.0 percent or more on assets. These strong performances do not represent only small community banks. During each of the past four years, more of the banking system's assets were in banks with ROAs exceeding 1.0 percent than was the case in any of the prior years in the 1970s or 1980s. That improvement could not have been achieved without strong performances by a number of large regionals and at least a few money center banks.

Virginia banks appear to have generally reflected national conditions and trends. Regional commercial real estate markets, like those in most other parts of the country, continue to show historically high vacancy rates. Nonetheless, asset quality for Virginia banks appears to have stabilized and has shown some improvement in recent quarters. Earnings for the first quarter of 1992 improved sharply due to both lower loan loss provisions and better net interest margins.

Virginia banks reflect another pattern that has emerged nationwide--that is, a growing separation between banks that are doing well, and have done well <u>consistently</u> throughout this troubled period, and those that are not doing well. Nationwide, roughly 45 percent of all commercial banks have earned more than one percent on assets in each of the past four years, while another 10-15 percent each year reported losses. So there clearly are differences among and between banks, but the industry's prospects are more positive than at any time in the recent past.

Progress, however, may come slowly, and will depend heavily on local and national economic conditions.

Economic outlook

Let me turn briefly to a discussion of the current national economic situation and the longer-run prospects for the economy. As I am sure you know, real GDP rose at a 2.4 percent annual rate in the first quarter, and economic tea leaves so far in the second quarter seem to be consistent with continued--albeit moderate--growth. The most favorable news comes from the industrial sector, where production has been rising at a 6.3 percent annual rate since its recent low in January. In the labor market, the news has been more mixed. In particular, as has been widely reported in the press, the unemployment rate jumped from 7.2 percent in April to 7.5 percent in May. At the same time, however, the number of workers on nonfarm payrolls advanced another 68,000 in May, continuing the expansion of employment that resumed in February. In addition, work schedules lengthened and overtime hours increased in a number of industries. Thus, seen from the demand side of the labor market--that is, employment and hours--it appears that income and economic activity have continued to expand at a moderate pace.

Let me now turn from employment and production to indicators of aggregate demand, starting with housing. This, of course, is a bellwether sector of the business cycle. Encouraged by declines in mortgage interest rates, construction picked up in the fourth quarter of last year and increased further in the first quarter of this year. The data on housing starts in April were somewhat disappointing, but the May figures showed a bounce back. More importantly, the fundamentals--such as mortgage rates and real incomes--point to further solid gains in activity in this sector. Favorable spillover from the strengthening of new construction that now is under way--if sustained--should affect a much broader circle of industries in coming months.

Recent data on consumer spending also have had their ups and downs from month to month. Retail sales, after rising smartly in the first quarter showed little improvement in April and May. In contrast, sales of domestically produced autos and light trucks have continued to advance through the early part of June. Looking ahead, real incomes and consumer confidence have been rising, which suggests the likelihood of a revival of the uptrend in overall household spending sometime soon.

Business spending for new equipment remains somewhat lackluster, perhaps reflecting an abundance of caution in the business sector. But a modest recovery in coming months may be in train. New orders for nondefense capital goods have traced an uneven, but generally upward, path since reaching their trough early last year. For computers, new orders have been rising, on balance, in recent months. With prices continuing to fall, demand is likely to expand further. For aircraft, by contrast, the outlook is relatively weak. In short, business investment is an area which bears watching in coming months to see whether recovery is sustained.

A discussion of the current economic situation would not be complete without reference to inflation. Over the twelve months ending in May, the overall consumer price index rose 3 percent, down from a 5 percent increase during the preceding twelve-month period. Granted, some of the slowing reflects lower oil prices. But even excluding the volatile energy and food categories, price increases have slowed from about 5 percent last year to slightly less than 4 percent this year. And, with nominal wage increases gradually easing, I think the odds of seeing a further gradual reduction in the core rate of inflation are quite favorable.

In summary, no one can forecast with confidence exactly when the positives in the outlook will completely outweigh the remaining negatives. In the fine tradition of a two-armed economist, I cannot discount the risk of a temporary setback. But, that said, there are clearly reasons to be encouraged about both the near-term and the longer-run prospects for the economy.

Recent Legislation

I am sure that nearly all of you are familiar with

FDICIA -- the FDIC Improvement Act -- that was passed late last year. While I do not want to attempt a detailed summary, I would like to discuss some of its important features. The Act contains a number of measures designed to prevent some of the many problems depository institutions have encountered in recent years. The Act calls for enhanced regulations regarding capital standards and safety and soundness issues.

Among the more striking aspects of the legislation is its emphasis on capital. This emphasis is brought out strongly in numerous provisions of the law. For example, the FDIC's recent proposal on deposit insurance premiums would tie premiums to a bank's capital ratios, tempered by supervisory assessments about the overall condition of the bank. The FDIC has also issued a rule to limit the unrestricted use of brokered deposits to "well capitalized" institutions, which are defined as those banks with total risk-based capital ratios of at least 10 percent, Tier 1 ratios of at least 6 percent, and leverage ratios exceeding 5 percent.

Prompt corrective action, another provision of FDICIA, requires the bank regulatory agencies to take specific and increasingly onerous actions as a bank's capital ratios decline. This provision largely reflects the supervisory actions regulators have generally pursued in the past. Now, however, those practices are codified into law, reducing some of the flexibility that was used, or some might argue, abused, in recent years. The details are forthcoming in proposed regulations, but the basic framework has now been decided by law.

I should note that the importance of capital ratios in this regulatory framework will lead to more emphasis on the adequacy of a bank's loan loss reserves by regulatory agencies. Examiners will be looking even more carefully at reserve levels in order to prevent banks from ignoring or minimizing loss provisions and thereby overstating their capital positions.

Both FDICIA and the risk-based capital framework have acknowledged the need to incorporate a measure of interest rate risk into U.S. capital requirements. FDICIA calls for this by August 1993. Staff of the Federal Reserve and the other banking agencies have developed an approach to measuring interest rate risk that could apply to all U.S. banks -- not only the internationally active banks that would be covered by the international risk-based capital agreements. This domestic approach would be compatible with international efforts but would generally be less complex and burdensome and would increase capital requirements only for those institutions that appear to be taking the greatest risk. The Federal Reserve Board expects to issue a proposal on this topic for public comment next month.

FDICIA contains a number of other provisions designed to promote a safer and more prudent banking system including limits on loans to directors and other inside interests and more stringent standards for real estate lending. The Act also requires that the regulatory agencies publish standards for loan documentation, credit underwriting, asset growth, compensation, and a variety of internal controls and operating systems. Proposals related to each of these areas either have been issued for public comment or will be in the very near future. I can report to you that with the exception of interest rate capital proposals, most of the FDICIA implementation initiatives are being jointly undertaken by the bank and thrift regulators. This has entailed a great deal of consultation and cooperation, but hopefully will result in eliminating the possibility of conflicting requirements or interpretations.

Regulatory Burden

Federally insured depository institutions are necessarily highly regulated simply because of the special role they serve in the economy and the huge volume of federally insured deposits they hold. The collapse of the thrift industry and the recent problems of commercial banks have only made the industry's regulatory burden problems worse, as the Congress reacted with new legislation. Through FDICIA, lawmakers have imposed restrictions intended to stem losses and limit the financial exposure of the government, and thereby the taxpayers.

However, the banking agencies, the Administration, and the Congress are receiving the message that this latest round of legislation may have gone too far, at least in some areas. Delegation after delegation of bankers has visited Washington to protest. I understand that a group from your organization (the Virginia Bankers Association) visited Washington in early May and met with regulators and Congressmen to voice your concerns and views.

The Federal Reserve did not support many elements of FDICIA, particularly those provisions that propel both the regulator and lawmaker into the micro-management of a bank. A somewhat different approach to banking legislation, one that strikes a more equitable balance between the costs and potential benefits of regulation, might go farther toward achieving more effective legislation.

FDICIA itself calls for a study of regulatory burden in order to identify revisions of policies and regulations that could reduce unnecessary burdens without compromising the safety and soundness of insured institutions. This mandate has been taken very seriously. A series of "town meetings" is being held across the country in order to collect more information on these issues and problems and to supplement the review currently under way. In addition, Governor LaWare is testifying today on behalf of the Federal Reserve regarding ways regulatory burden could be reduced.

The issue of regulatory burden must be considered in perspective. A certain amount of "burden" on the banking industry is justifiable on a cost-benefit basis. However, it seems clear that many aspects of the existing regulatory burden should and are being reconsidered. Regulators should continually monitor the burdens associated with oversight programs. Changes may be appropriate as economic or competitive conditions change or as the effects of new regulatory programs are more fully understood. Such a reexamination has led the Federal Reserve Board to participate in the Regulatory Uniformity Project (RUP) with other bank regulators and to undertake a number of initiatives to streamline application procedures, eliminate duplicate application and approval processes and re-examine certain exemptive levels or criteria. The fruits of these efforts should be evident in the Federal Register in the coming weeks. But even more broadly, a reconsideration of regulatory burden is likely to lead to additional legislative efforts -- not only to reduce immediate costs and reporting burden but to provide relief from outdated restrictions that prevent the U.S. banking industry from competing most efficiently.

Fundamental reforms to eliminate barriers to interstate branching and to allow expanded insurance and securities powers should be revisited. The structure and activities of the U.S. banking system are changing at a rapid pace. Allowing the industry to operate more efficiently and to compete more effectively with foreign banks and with various nonbank entities is the best approach to take in maintaining a safe and sound banking system.

Conclusion

At this time, the condition of the banking system appears to be improving, although many problem situations remain to be resolved. More active supervision should help deter future problems, but supervisory and regulatory oversight can be taken too far. The need for fundamental banking reform remains. The banking and financial services industries have changed markedly in recent decades. Broad reform must be undertaken if the U.S. financial system is to be strong and healthy and fully capable of meeting the long-term financial needs of the country.