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REMARKS ON THE ECONOMY, BANKING, AND BANK REGULATION.

Address ~~by~~

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before the

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We have been going through a period in which problem banks and failures have received more public attention than we have been used to. Even those of us who are in favor of increased disclosure by banks have been unhappy with those news stories which have been exaggerated, out-of-date, or simply inaccurate. I may just be overly sensitive on this, however, since there is substance to the impression one gets from them and from the accurate stories also published during this period. Our problem bank list is longer than it has ever been and it does include some sizeable banks. Bank loan losses were up dramatically last year and were more than double the figure for just two years ago.

I cannot explain everything that has happened to banks in the last two years. I have not seen any complete explanations for the very significant increase in bank problems that accompanied the recent recession. Unlike some observers, I do not find that the performance of the bank regulators, including the FDIC, is the cause of the problems, although had all of us done our jobs better, perhaps we could have blunted the impact on some individual banks -- more about our role later. What I want to do today is to set out three factors which I think account, at least in large part, for the severity of our recent problems and to discuss briefly the implications of these events for bank supervision. While I might make a prediction or two, this is not a speech about what is going to happen as much as about what has already occurred.

The major strands in the explanation for the increase in bank losses and in the number of problem banks include, first of all, the 1974-75 recession; second, a general trend toward greater risk-taking on the part of the banking system that goes back a fairly long time; and third, some unusual peculiarities of the recent economic and international situation.

The 1974-1975 Recession

It is important that we not underestimate the relationship between the economy and bank performance. Some analysts and reporters seem to assume that banking should be immune to the general trends and problems of the economy. But that seems an unreasonable standard for banks. The 1974-75 recession was much more severe than anything our economy has experienced since World War II, whether measured by decline in GNP or industrial production or increase in unemployment. Since banks play such a major role in our economy, we must expect the health of banks to mirror that of the economy as a whole. In periods of economic decline, the profits of business firms fall and the number of firms encountering financial difficulties and failure always increases. This will be reflected in nonaccruing loans and loan charge-offs at commercial banks. If this were not the case -- if banks were only making loans to firms whose financial condition was so solid that even a severe recession would not affect their ability to pay -- then the banks would not be doing their job. I think most of us can agree that banking involves taking moderate risks on individual credits, though we expect that a well-managed, diversified loan and investment portfolio will keep overall losses at reasonable levels. Maintaining that portfolio, however, is hard to do when there is very substantial weakness in the general business environment.

We have reviewed the figures on loan losses of commercial banks over the last 25 years and we find a definite cyclical pattern. The pattern is not perfect, partly because we only have loss data on an annual basis, and partly because banks do exercise some discretion with respect to the timing of charge-offs. Essentially, we have found that the percentage of loans charged off does increase during periods of business recession. This has been true in all of our post-war recessions -- 1949, 1954, 1958, 1960, 1967, 1971, and 1975. The year of recovery following those recessions always produced a reduction in the loan loss ratio. Of course, we don't know yet whether that will turn out to be the case for 1976, but if the pattern of those past 25 years continues then I would expect the loan loss ratio to decline this year.

While the pattern is rather clear, the magnitude of these year-to-year changes in bank loan losses was actually modest until we get to around 1970. I think that reflects the fact that the economic declines themselves were relatively modest. In fact, most of our recessions of the last 25 years really were slow-downs in the rate of growth of GNP rather than an actual year-to-year decline in the economy. Thus, it is not surprising to me that during the period of our most severe post-war recession, we should have a significant increase in bank loan losses and a significant increase in the number of banks on our problem list.

Risk-taking in banking during 1960-1976

Once I have said all this about the impact of the economic situation on banks, I am still left with the belief that the data on loan losses suggests more than a cyclical phenomenon. The extent of bank problems in the last two years was certainly influenced by this recession, but it also reflects some more basic and long-lasting characteristics.

I believe this squares with our general assessment of what has been happening in banking. Let me suggest a few numbers that illustrate this general trend.

The loan deposit ratio of large banks was about 56 percent in 1960 and 68 percent in 1975. The ratio of equity capital to assets of large banks was over 8 percent in 1960 and under 6 percent in 1975. The ratio of cash and U.S. Government securities to assets was over 40 percent in 1950 and about 25 percent in 1975. These are significant differences in meaningful ratios.

Since the early 1960s, many banks, and particularly the large banks, abandoned their traditional conservatism and began to strive for more rapid growth in assets, deposits, and income. "Liability management" became the essential phrase in the modern banker's lexicon. The larger banks also began pressing at the boundaries of allowable activities for banks. They expanded into fields which some felt involved more than the traditional degree of risk for commercial banks. These activities included direct lease financing, credit cards, underwriting of revenue bonds, foreign operations, and others. This list of activities and the bank financial ratios I cited, reflect a general trend towards increased aggressiveness and increased willingness to bear risks on the part of the banking system in general and large banks in particular. The holding company movement of the 1970s certainly accelerated these developments, though most of the activities of bank holding companies could also be, and were in fact, engaged in by banks directly. I am assured by our FDIC examiners that this increased aggressiveness showed up in lowered credit standards as well.

During the 1960s, banks generally were not noticeably harmed by the diversification of activities, the movement towards greater risk in their own financial structure, and lowered credit standards. After all, the early and mid-1960s represented a fairly extended period of relatively stable growth and moderately stable prices. The first half of the 1970s proved to be a much tougher economic environment in which to operate. Even apart from the recession of 1974-75, we should not minimize the impact on banks of operating in periods of very tight credit, very high money costs, and extremely erratic movements in commodities and other prices. These factors affected not only the banks directly, but also the stability and predictability of business operations, and that, in turn, had its impact on the repayment of bank loans.

I have mentioned some financial ratios and changes in activities that specifically apply to large banks. Many would argue that small banks have changed much less dramatically than larger institutions, and the loan loss data support this view. During the 1950s and 1960s, smaller banks generally had higher loss ratios than the larger institutions. That pattern clearly has been reversed in the 1970s. The loan loss ratios have been noticeably higher for larger banks over the last few years. This has been due in part to some failures of major corporations with substantial bank lines from large banks, in part to the large bank's greater exposure to construction lending and mortgage banking, and in part to their greater willingness over this period to finance new and sometimes untested operations or ideas. Moreover, since the large banks tend to have higher loan-to-asset ratios, their earnings tend to be more sensitive to loan losses.

The two factors I have mentioned in explaining the increase in bank problems, the general state of the economy and the increased willingness of banks to bear risk, are clearly interrelated. The increased aggressiveness of the banks would probably not have shown up to the same extent in increased problems if it had not been for the decline in the economy. Likewise the third factor I wish to explore is related to the general state of the economy as well.

Unusual characteristics of this period

In recent years, in addition to the general decline in economic activity, we have had some special problems. Some are directly related to the economy, some are unusual, one-shot events. These include such factors as the tremendous increase in energy costs, rapid rise in food prices, record high interest rates, and very severe problems in the real estate market.

Let us look first at the real estate problem, since many of our bank failures and major problems for the past two years have had severe real estate loan problems. While real estate markets have turned or appear to be bottoming out in many areas of the country, real estate loan problems in some areas may be with us for some time. It is difficult to tell what amount of nonaccruing real estate or REIT loans have been written off thus far, and what the ultimate write-offs will be on the volume of these loans presently on bank books. Some analysts expect that REIT loans still on the books of the banks will result in losses of up to 25 percent. While this figure seems high to me, even the more optimistic imply ultimate losses still to be taken by the banks over a period of a number of years to be in the order of a billion dollars. In some instances, loan swaps and refinancing have forestalled or eliminated immediate charge-offs, but these have been at the price of taking on long-term, low-yielding assets, which may penalize long-term earnings. It is possible, therefore, that bank loans to REITs will be a drag on the earnings of some large banks for several years. If successful, however, these work-out programs may reduce the number of REIT failures and lower future losses on REIT loans.

Why all the real estate loan problems? One answer given is that land booms are accompanied and fed by forces associated with price appreciation and "can't-miss" projection that feed on themselves. Beyond this, I think banks as lenders and as managers of REITs through holding companies deserve a considerable share of the blame. High rates on construction loans and REIT fee arrangements that encourage volume purchases and sales undoubtedly contributed importantly to a loss of perspective on loan quality. Too many projects required overly favorable sales or occupancy to break even and, though I recognize that the following is easy to say as a matter of hindsight, the lender's traditional restraint on the developer's perpetual optimism was not present. In many cases, bank real estate lending officers were too young and inexperienced to remember past periods of real estate lending problems.

There have been some well-conceived projects that ended up with foreclosures and bankrupt builders. These have been due to the general weakness of the economy, greatly increased building costs, and much higher energy costs, all of which contributed importantly to the failure of many real estate ventures that appeared sound when they were conceived. Very high interest rates added to the burden of carrying nonearning assets and accelerated bankruptcies. Now the economy is on the rise and money for permanent financing seems plentiful. Many of these projects will be bailed out by the rising tide of the economy, and, in the longer run, perhaps by inflation.

Some of the real estate developments, however, were poorly conceived to begin with. In some instances, costs were just too high for the market and sizable losses will have to be accepted. Some of the developments, particularly second-home or vacation area condominiums, were based on expectations of ever-increasing prices and eventual resale at a profit. Once it became clear that owning a condominium was not a sure fire route to ever higher and higher values, it became very difficult to sell any at all. Many of those projects seemed to be based on the "greater fool" theory of investment, that is, even if you foolishly pay too much for a piece of property, sometime in the future you will be able to sell it at an even higher price to an even greater fool.

Many banks have had problems with loans to REITs and real estate developers. A smaller number of banks have been affected by other particular problems, such as losses on foreign operations and loans on oil tankers. It appears that some of these problems have been greatly exaggerated. For example, there has been a widely cited figure of American bank vulnerability on oil tanker loans of something like $17 billion. It appears now that responsible analysts are saying that the correct figure for American banks is actually nearer $3 billion. Or to take another example, many of the loans to less developed countries that have been cited as a potential problem for large banks appear to be loans to foreign subsidiaries of AAA U.S. corporations. Nevertheless, these special problems, combined with the decline in the economy and the increased vulnerability of some banks, have led to increased loan losses and a larger number of problem banks.

Significance of these problems

Loan losses need to be viewed within the context of a bank's overall ability to absorb such losses through earnings and through reserve and capital accounts. I have mentioned the decline in bank capital ratios and the increase in loan-to-deposit ratios, particularly for the large banks. Some of the decline in capital ratios has been the result of rapid growth of foreign operations, increased reliance on purchased money, holding company acquisitions, and inflation, all of which contributed to rapid deposit growth for all banks. During the past year or so, however, many banks have made considerable progress in reducing their vulnerability. Bank capital increased faster than deposits last year and, as a result, capital ratios rose. The deposit mix of banks, and particularly large banks, has improved considerably from the standpoint of cost and stability. Banks have not bid aggressively for CDs, allowing a sizable runoff. Thus, while bank deposits have increased by over 7 percent since the end of 1974, that increase occurred despite a sizable reduction in large CDs. Bank loans are virtually unchanged from year-end 1974, whereas holdings of U.S. Government securities have increased by about $40 billion. Thus, the banking system is clearly in a more liquid and less vulnerable position than it was a year or so ago.

There is also reason for optimism when we look at bank earnings. In the aggregate, bank earnings have held up fairly well during this very difficult period. Bank earnings rose by about 2 percent last year, making it one of the few industries to show an increase in earnings during the recession. But that average increase masks some wide variations. Along with some sizable gains, there were a lot of moderate gains and some very sizable declines. Despite weak commercial loan demand and declining loan rates, banks generally maintained their spread between gross earnings and money costs. Money center banks actually improved their spreads. Banks experiencing the worst year-to-year comparisons generally did so because of loan losses.

Loan losses have come to play a major factor in determining bank net income. This is quite different than the situation only a few years ago when bank loan losses had a negligible effect on bank earnings. The increased importance of loan losses is shown in a recent report of Keefe, Bruyette & Woods, Inc., a leading bank stock analyst, which reported an average ratio of net loan losses to outstanding loans of .65 percent for 82 large banks in 1975. There was considerable variation among banks and among regions. The percentage for 10 New York banks was .72 percent and for 10 southern banks the figure was 1.1 percent. It was lower in the rest of the country and only .41 percent for 5 large banks in Texas.

It is difficult to predict bank earnings for this year. First quarter reports seem to indicate that most banks have declines as compared with last year. That reflects lower loan volume and lower interest rates as compared with the first quarter of last year, and an increased tendency of banks to spread out loan charge-offs throughout the year rather than concentrating them heavily in the last quarter. While it is hard to forecast the balance of the year, since much will depend on loan demand and interest rates, I would expect comparison with last year to get better throughout the year. I would also expect to see some improvement stemming from a reduction in loan losses.

Relationship to FDIC problem list and supervisory implications

The trends I have described so far have been reflected in our list of problem banks. The FDIC's problem list, which includes national banks and State member banks as well as nonmember banks, now totals about 370 banks. That number was increasing steadily all during 1975 but now appears to be leveling off. While that is only about 2-1/2 percent of all insured commercial banks, it is nevertheless at its highest level in 25 years.

We have compared figures of our problem list with data on the economy as a whole, in much the same way we did with loan losses, and found again a meaningful relationship. However, whereas loan losses appear worst just when the state of the economy is worst, our problem list tends to lag by an average of about 12 months. This should not be surprising since there tends to be a lag in the examination and analysis process and since our own examiners are not apt to be completely insensitive to recent economic and financial developments. Thus, it is not surprising that now, about a year from the low point in the recession, we are at a high point on our problem list. If the current relationship follows previous experience, I would expect the number on our problem list to get smaller later on this year.

Not only has the banking system gotten considerable attention over the last year or so, so has the bank supervisory system. There are those who say or imply that inadequate bank regulation was the cause of so many banks being on problem lists. That misses the point, however, since it is good bank regulation and supervision that spot the banks that are in trouble and puts them on lists for closer supervision. The question probably should be, could better regulation and supervision have prevented banks from reaching a condition which required closer supervision by bank regulators? What are the implications of this economic cycle analysis of bank problems for bank supervision?

It is my view that bank supervision as we know it in the United States, as opposed to its characteristics in other countries such as Japan, is limited in its ability to dictate the soundness of the banking system. It appears that a considerable part of the bank problems of the last couple of years has been due one way or another to the general state of the economy. That is clearly a matter beyond the control of the process of bank supervision. Some of the problems have been due to specific unpredictable events like the rapid increase in oil prices and a resulting decline in the demand for oil and oil tankers. It would have been nice if we had been able to anticipate and prevent the debacle of the REITS, for example. In view of the vast number of financial experts who failed to foresee these problems, I don't think it is surprising that bank supervisors failed also.

There is one area, however, in which we do have an ability to lessen the impact of the business cycle. We must be very careful in this area, however. It is the one covering bank attitudes toward risk and the willingness of bankers to increase loan ratios and decrease capital. We are giving more attention to these matters at the present time, and we will continue to demand more capital from banks inadequately capitalized, as well as demand that loan, investment, and operating policies and practices be reasonable ones. We have so informed members of the two Banking Committees who have expressed concern over capital adequacy. We are analyzing trends rather than static pictures much more intently than we did in the past. Computers are whirring constantly as we try to find ways to discover problems sooner. We are looking much harder at management and are willing to step in quicker with formal orders requiring action on management's part. We've asked Congress for more powers to deal not only with dishonest bankers but grossly negligent ones.

We recognize, however, that banking is a risk-taking business and we must rely on market forces, on management, and on owners, in addition to our supervisory judgment, to determine the appropriate degree of risk for individual banks. I do not believe that even the most outspoken critics of banking and bank regulators want the regulators to run the banks rather than the bankers. We can all agree that that is not our function. If we are too intent upon preventing <u>all</u> bank failures in our regulatory posture, we may have some success in shortening our problem lists, but the conservative banking philosophies we would have to adopt would retard the progress of the economy. So attempting to prevent all bank failures is not our function either. In some cases, Government policy, which I endorse, has encouraged a shift towards a riskier banking posture. We have issued regulations on "leeway investments" which have broadened the types of investments that can be made. By disapproval of redlining and promoting the concept of equal credit opportunity, we have actively pushed banks into lending that they may feel (though I do not necessarily agree) is more risky. The FDIC has been in the vanguard of those who insist that the Bank Merger Act be interpreted to permit more competition between banks: this approach has as its corollary an unwillingness to protect competitors from the results of competition -- i.e., one wins, one loses.

Frankly, I believe that the FDIC and the other regulators have done an excellent job of bank supervision during the past two or three years after the magnitude of the problems became apparent to us. Very large bank failures have been resolved by the Corporation working closely with the Comptroller of the Currency or the Federal Reserve System without the loss of a dime to any depositor and with only minimum disruption in the communities effected. Compare that with the result of the bank panics in the '20s or early 30s!

The Corporation and the other regulators should be praised, not berated, for this performance.

The jury is still out, however, on the question of prevention. Somehow, the regulators must do a better job of carrying out the full range of responsibilities given them by Congress, some of which have only limited direct effect on safety and soundness, must spot problem situations earlier, must be willing and able to move in more quickly with effective enforcement action, and must do all of this while recognizing that our economy needs the initiative, ingenuity and agressiveness of free enterprise, and competitive banking.

In any case, I believe that the movement since 1960 has been essentially healthy, though it may have gone too far in some respects. Overall, the system is not in bad shape and I do not think we have to be apologetic. Some individual banks made mistakes and have suffered forrr those mistakes. I would have preferred it if we could have spotted those individual situations earlier, and perhaps corrected them. No one, particularly a bank regulator, likes to see a bank fail. But the role of banking supervision in general, and certainly of the FDIC, is much more oriented toward soundness in the banking system and maintenance of confidence in that system rather than protecting individual banks. While I recognize the interrelationship of the two concepts, it should be kept in mind that they are different. As long as banking is part of the competitive enterprise system, there will be bank failures.

What the FDIC has done, however, is cushion the shock of a failure, and we've done an excellent job there. I am sure you have all seen the recent Gallup Poll which showed that 93 percent of Americans with bank accounts feel their money is safe there. This comes after intensive bad publicity about bank problems, and soon after the largest bank failures in our history. Frankly, we feel that this overwhelming display of confidence is a direct result of the FDIC's efforts over the years. Any suggestions that the operations, funding, or control of the Corporation be changed must deal with the possibility that this confidence may be eroded.

We certainly can improve our policies and our operations in many areas, and I intend to explore the possibilities during my term as Chairman of the FDIC. We cannot completely sever the links, however, between the performance of the economy and the performance of the banking system. If the economy continues to improve, next year will probably be a very good year for banks. I suspect that banks will be somewhat more cautious in their lending policies than was the case during the past few years. We will be more cautious as well and view unusual situations much more skeptically than five years ago. Whether or not that caution will prove warranted or perhaps overdone, will depend in great part on the performance of the economy in the years ahead.

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