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DIRECTORS' RESPONSIBILITIES IN LIGHT OF THE PRESENT ECONOMY AND THE BANKING OUTLOOK

Address by

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before the

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~~The Broadmoor~~
② Colorado Springs, Colo~~rado~~.
① September 5, 1976, to ②

This is the first Assembly for Bank Directors that I have attended, and I want to say that I am very impressed with the program that Dick Johnson and Bill Baughn have put together for this Assembly. In fulfilling my responsibilities on that program, I plan to make some comments on the economy and the banking outlook (the topic assigned to me), both retrospectively and prospectively, but I do not plan to spend all of my allotted time on that subject. I'd like to make a comment or two in addition about our problem bank list and the performance of regulators during the past difficult years. Finally, I plan to make some comments about the role of bank directors in the present economic and regulatory environment.

First, the economy and the banking outlook. Economic forecasting is always a hazardous activity, especially when it is done for a short period of time, say, six months or a year. Not only is it easy to be way off, but people tend to remember incorrect forecasts. My comments in this section, therefore, must be viewed as the best guesses of the Office of Corporate Planning at the FDIC, and somewhat outside the areas of primary expertise that the Corporation has.

Those making short-term modifications of forecasts have had their problems this year. Real GNP rose by a surprising 9.2 percent in the first quarter of 1976 after a sluggish performance in the fourth quarter of 1975. The first quarter GNP increase combined with an increase in the price level of only about 3 percent persuaded some forecasters to up their projections. However, second quarter performance turned out to be disappointing: only a 4.3 percent real increase in GNP (not too good considering the extent of unused resources in the economy) and about a 5 percent increase in the price level. The latter figure and the most recent rate of about 6 percent was helped by relatively stable-to-declining food prices. Most expect that third quarter GNP figures will not be better than the second quarter.

The unemployment rate fell dramatically during the first several months of the year, from 8.3 percent at the end of last year to 7.3 percent in May. That translates into a decline of about one million in unemployment. As a result some forecasters were projecting a fall in the unemployment rate to less than 7 percent by year-end. However, in the past few months unemployment rose considerably and the August figure was 7.9 percent.

Recently there has been increasing discussion about sluggish performance of the economy, possible slowing down, etc. Some of this may be warranted; but some is probably exaggerated; and, in any case, few expect any reversal of the upward movement of the economy before 1978.

The economy rarely moves in a smooth, consistent way with everything conforming to a single scenario. The real world just doesn't work that way, and the variations that exist may be exacerbated by data collection and measurement problems. Certainly, the rapid up and down movement in employment statistics suggests that seasonal adjustments and labor force estimates probably exaggerated the decline in the unemployment rate early this year and exaggerated the subsequent increase. As for the dramatic change between the first and second quarter GNP increases, a lot can be explained by a big increase in inventory accumulation in the first quarter -- the increase in final sales was about the same for each quarter. Also auto sales rose substantially in the first quarter and, while the level has been maintained in the second and third quarters, there was no further increase.

It is easy to be "whipsawed" if one focuses too much on monthly variations in statistical series. But what about the general economic outlook and what it means for banks?

Our Office of Corporate Planning expects that real increases in GNP will average almost 6 percent for the second half of this year and all of next, though there may be considerable variation from quarter to quarter. This would bring about a gradual, but not dramatic, reduction in unemployment to a level below 7 percent by the second half of next year.

Capital spending should rise considerably next year. This, combined with a moderate increase in housing starts and business inventories, should increase bank loan demand. The level of bank loans has been almost flat since the end of 1974. The prime rate should go up moderately along with short-term interest rates, while the movement in longer-term rates will depend importantly on the inflation rate. So long as the latter remains in the moderate range (around 5 percent or so) there should not be much of an increase in long-term rates.

Higher short-term rates and somewhat less liquidity in the economy probably will result in more modest gains in savings and other consumer time deposits than experienced during the past 20 months.

Banks should experience considerable improvement in loan losses next year if substantial REIT losses do not spill over into next year. Loan losses this year may approximate the very high level of 1975, although the basic strength of loan portfolios is probably improving more than these figures suggest. In assessing loan loss figures several factors should be kept in mind:

(1) While the cyclical low point in economic activity occurred in April 1975, the depth of the decline was such that we didn't get back to pre-recession levels in real output until almost a year later -- i.e., early this year.

(2) There is some discretion in loan writeoffs and some of the 1976 writeoffs reflect situations that occurred and were recognized and partially accounted for earlier.

(3) A lot of the bank loan problems have been real estate related, and while there is evidence of improvement in several areas of the country, some of these loan problems are taking a long time to work out.

To conclude the economic forecasting part of my comments, let me say that our Office of Corporate Planning expects that bank earnings for 1976 in the aggregate will be about the same as last year. However, the year-to-year comparisons will be favorable in the second half of the year, and banks generally will go into 1977 with rising earnings. Earnings should increase considerably in 1977.

We have found in recent analyses of bank loan losses and changes in our problem list that there is a definite connection between those bank problems and the general state of the economy. The problems develop and show up in our examination reports only with a lag, however, which in the past has averaged about 12 months. That is, the number of banks on our problem list generally does not start rising until the business decline is well under way, and it continues to rise well into the recovery period, in most cases approximately 12 months into it. Similarly, the size of the list depends in great part on the depth of the trough of the preceding business cycle.

The change in our problem list and its relation to the business cycle can be seen most vividly with respect to our most recent recession -- the most severe since the Great Depression of the 1930s. In this case, perhaps because of the severity of the recession, the nature of the credits extended by banks during this period and the time required to process the reports of the large number of banks involved, the time lag between the depth of the cycle and the peak of our problem list is even longer. Thus, although we are over a year past the low point in the recession, our problem list is at its highest level in 25 years. The number of banks on the list has been increasing since the Spring of 1973, but the increase of net additions has dropped dramatically in the last 6 months. The number of banks on the FDIC problem list has increased by only 18 during the eight months since January 1, 1976, for example, compared with an increase of 76 during the previous six months and an increase of 176 during the previous year. The total number of banks on the list now appears to be leveling off.

As of August 31, 1976, there were 377 FDIC insured banks on our problem list. This number is only about 2-1/2 percent of all insured banks.

Said another way, 97 1/2 percent of the nation's banks are not in even the least serious of our problem categories. Of those on the list, about 2/3 are in our least serious category of problem banks.

One aspect of the problem list warrants mention -- the list now, as distinct from a few years ago, includes a few large banks -- banks with over $500 million in deposits and a few very large banks -- banks with over $1 billion in deposits. That, incidentally, is one reason for the longer time lag. It simply takes longer to conduct and review the examination of a large bank. There are many explanations possible in answer to the question "Why so many large banks on the problem list now?" One mechanical answer is that there are a lot more banks now with over $500 million or $1 billion in deposits than there ever were before (even though the share of the domestic deposits of the top 50 has decreased). A more complete answer must discuss the increased risk assumed by larger banks on both sides of their balance sheets and the inevitable result of a severe recession for the industry which finances the economy. In any case, it is clear that my remarks and those of other speakers apply to those of you who are directors of large banks as well as small.

Problems of the banking system have gotten considerable attention over the last year or two, and 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 put 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 relationship between the economic cycle and 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 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. In the FDIC, we have three separate early warning systems in operation. We are looking much harder at management and are willing to step in quicker with formal orders requiring action on management's part. Already during just the first eight months of 1976, the FDIC has issued or authorized our lawyers to begin the process of issuing 27 cease and desist orders as compared with an average of only seven a year during the past five years. 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, on owners, and particularly on directors, 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. In some cases, Government policy 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. I feel the same way about restrictions on EFT developments which are designed primarily to protect less efficient banks.

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 and the Federal Reserve System without the loss of a dime to any depositor and with only minimum disruption in the communities affected. In just two banks, Franklin National Bank and U. S. National Bank, nearly one million depositors were fully and totally protected -- i.e., they had their entire deposit accounts always available to them without loss of even a day's banking services -- even though these huge banks failed. 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 part of their 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, must spot problem situations earlier, and must be willing and able to move in more quickly with effective enforcement action. But I want this to be done within a framework of reliance primarily on our free enterprise system. We must recognize that our economy needs the initiative, ingenuity and aggressiveness of free enterprise and competitive banking. Compatibility of those objectives with safe and sound banking rests only in part with the supervisory agencies. Success is more dependent on the efforts, dedication and wisdom of bank directors. In the final analysis, bank directors, not the regulators, bear the primary responsibility for the safety and soundness of banks they direct.

You have heard already, and will be hearing more about the responsibilities of bank directors. You have been warned about your legal responsibilities and the danger of law suits. As Chairman of the FDIC, I have a direct interest in your being alerted to these dangers. The legal responsibilities of directors are of particular interest to us since the FDIC is the plaintiff in many of the director's suits you are hearing about. In most bank failures, we end up with a suit against some or all of the directors of the closed bank in which we claim the directors were negligent in meeting their responsibilities.

Some cases of bank failures are a result of embezzlements that cannot be detected in time, even though the directors are giving due diligence to their responsibilities. But usually, bank failures result from imprudent or self-serving action that directors could have and should have found out about, and done something about. In some cases, the directors are directly involved in and benefitting from the self-serving policies of the bank that result in failure. Obviously, we hope to recover all we can from those guilty of such malfeasance. More commonly, however, we find directors guilty simply of nonfeasance, of not paying sufficient attention to the condition of the bank, the policies and actions of the bank, and the condition of the bank. While we may feel some sympathy for the plight of those directors who may have been simply duped by management or other directors, nevertheless, as a receiver, we have a legal obligation as representative of the creditors of the bank to seek recovery for losses from directors who did not meet their legal responsibilities. As a supervisor, we are insisting that directors pay more attention to their responsibilities. We have recently promulgated regulations covering insider transactions, for example, so that no director now can attempt to argue that he didn't know such transactions were occurring.

When a newly chartered bank seeks deposit insurance, we have something to say about the selection of directors of the bank. In general, however, we do not have any legal authority to determine who is or is not a bank director. We do not expect or want all directors to be bankers by profession, but bank directors must make some effort to learn about banking and to take their jobs seriously. We are troubled by situations where directors serve solely because of the honor or prestige attached to being a bank director, and where the person so honored does not intend to be an independent force in forming the policies of the bank. We want informed directors.

I will return to this responsibility of directors to not allow themselves to be kept in the dark but, before I do, let me make a brief comment on what I think is the single most important task of directors. That is the selection and continuous evaluation of management.

You will hear at this conference that the job of directors is to direct and the job of managers is to manage. I agree with the view that directors should not be running the bank on a day-to-day basis, but the board cannot escape responsibility for management of the bank.

Let me skip any discussion on how you select top management. Treatises can be written about that. Once a top management team is in place, however, the board must give adequate consideration to working out with top management specific goals and objectives for the bank. We see many problem banks that result from nebulous goals and objectives, from contradictory goals and objectives, and from a divergence between the board and the chief executive officer as to what are appropriate goals and objectives. Occasionally, the CEO and other officers are interested in quick but nonenduring results that dress up the financial statements and make good quotations for their resumes but create serious future problems. Often the problems created by these hot-shots do not appear until after their departure. Directors cannot escape the responsibility for those management mistakes, however, so be sure you do not become mesmerized by discussions of P/E multiples and leverage. Remember that you are a director of a bank, not an industrial corporation.

Once these goals are established and agreed upon, top management should be asked to prepare policy and procedure statements for implementing these obligations. These must be reviewed by the board to ensure consistency and reasonableness, and continuous control and measurement devices must be built into the system. It is highly important that progress be monitored continually and not on a one-shot or once-a-year budget review basis.

This leads into evaluation of top management performance. You can read in many books and articles about many methods for evaluating performance. It is my belief that performance evaluation cannot be an afterthought and done in a ritualistic manner. It must start by ensuring that the bank's goals, objectives, and policies be written and understood, and that they provide the necessary specific guidance to the top management of the bank.

The performance of management must be measured by these specifics. In a sense, then, these statements become an agreement which will be discussed with the officer at frequent intervals. Approached this way, evaluation of management can be fair, objective and thorough.

Let me return now to a primary responsibility of directors, simply knowing what is going on. That is easy when management makes an effort to see that directors are kept informed. I wish that were the universal situation but, unfortunately, it is not. But even when management is not doing what it should to see that directors are kept informed, it is possible, even for a non-banker director, to be knowledgeable if he asks the right questions and knows where to look for information. In banking, to a greater extent than in other businesses, I believe, there are sources of information that ease the job of of knowing how your bank is doing and what condition it is in.

Obviously, we regard the bank examination process as playing a key role in that process. The bank examination, whether by the FDIC, the Federal Reserve, the Comptroller of the Currency or the State supervisory authorities, provides a wealth of information and an excellent, even if usually a somewhat critical, picture of the condition and financial situation of the bank. These examinations are intended to be useful to the bank, and we think they are. Most managements feel the same way. Obviously then, directors should review the report of examination carefully. One way to be sure that you have ample time and opportunity to do so is to insist upon a copy of the examination report for your own use, and don't be content with just a summary.

In some cases, the examiners will seek a meeting with the board of directors to review the report, though agency policies on such meetings vary. FDIC examiners at the present time do not routinely meet with boards of directors following every examination, but do attempt to arrange such meetings if the examiner feels the bank's condition is particularly weak. I understand that the Comptroller of the Currency does follow a policy of having national bank examiners meet with the board of directors following each examination of a national bank. The FDIC attempted to introduce that requirement a number of years ago, and discovered that in many cases it was unproductive. Nevertheless, we feel that it is appropriate to consider that policy once again. In any case, I believe that it is a responsibility of the director to find out the substance of the examiner's comments, and not simply assume that because nothing has been brought to his attention that there is no need for him to investigate the report.

Incidentally, we do not officially notify a bank when it is placed on our "problem list." This is a hoary tradition in the Corporation and, as far as I can gather, exists because we are afraid that directors will talk about the news with others not on the board and, if that happens, everyone will attempt to withdraw their funds from the bank, thereby precipitating a bank failure. While this may prove to be the result, we cannot say for certain that it would be. More and more disclosure, both voluntary and involuntary, has been made by banks in the past few years of information that would have been judged to be highly sensitive (in fact, perhaps fatally sensitive) only a few years ago. In most cases, the disclosure has not proved disastrous or even particularly difficult for the affected bank. Whether it has proved beneficial to the bank or, on balance, to the public is a subject which has not been sufficiently explored, in my judgment, and one which must be thoroughly explored before any problem bank names should be published. It may well be, however, that the time will come when the FDIC will feel relaxed enough about the potential side effects to insist that the board of directors knows that the bank it is directing is in sufficient difficulty to have been placed on the Corporation's problem list.

Regardless of whether or not the board of directors of a bank on our problem list is told specifically that it is on such a list, every director of every nonmember bank that is on the list should know that the FDIC is unhappy with the condition and management practices of the bank. Board meetings, CPA audits, officers' reports, progress reports requested, the content of the examination report and supervisory letters -- indeed the entire tone and emphasis of our supervisory efforts -- should leave no doubt in the mind of the director of a problem bank that his bank is a matter of serious concern to the FDIC. When we turn down an application for a branch on the basis of the financial condition or management weakness of the bank, for example, or even when the most extreme possibility occurs and the bank is closed, there is no basis for a diligent director to be surprised. He has had ample opportunity to find out that the FDIC and others such as independent auditors think his bank is in difficulty, and has had equally ample opportunity to acquaint himself with its condition.

When FDIC officials speak about the responsibility of directors, we usually talk about responsibility for the safety and soundness of the bank. But I want to add something a little different today without in any way detracting from safety and soundness. I want to remind you of the responsibility to see that the bank is run profitably.

A good deal of research in recent years has led to the conclusion that sound, prudently generated bank profitability is crucial to the future soundness of the bank. We feel this strongly at the FDIC. In our economic system, "profitability" is not a dirty word and is, in fact, to be encouraged. We have been doing some work on the development of statistical early warning systems at the FDIC (in fact, as previously mentioned, we have three different ones in operation) and we have come to the conclusion -- a conclusion that has been defended by leading bank stock analysts for sometime -- that the most important key to the future of a bank is to be found in its income statement and in its bottom line. Sound, prudentially generated profits are crucial. This represents a change from the traditional view that the balance sheet and bank capital ratios are the sole reliable indicators of bank soundness.

Now this creates some difficulties for the director because, to a considerable extent, the earnings of a bank are not an accurate reflection of the skill and quality of management. To a considerable extent, the earnings performance of a bank depends on external factors, such as the general economy, the competitiveness of the relevant marketplace, Federal Reserve monetary policy, etc. But it is possible to compare the performance of your bank with that of other banks subject to these same external forces.

There is a great deal of information available to facilitate such comparisons. This information is made available on a routine basis by the FDIC, the Federal Reserve, several investment firms, and some firms whose major business is providing comparative banking data.

In fact, the problem for the director may be that there is too much financial data available, too many ratios. It may be difficult to see the forest for the trees. We can count on management to point out those areas in which the bank's performance looks good, but the director must take a broader picture than that. The FDIC, on a semi-annual basis, sends a good deal of comparative financial information to each insured bank. We have found that many banks use this information as a basis of a directors' meeting, and we have received many complimentary letters from bankers and directors about the value and usefulness of this information. When we looked into it a little deeper, however, we found that the banks that were pleased with this service, and were presenting this information to directors, were all banks whose performance looked very good in comparison to banks in their area or other banks of their size. I am afraid that data for the bank whose performance looks bad may simply be thrown in the waste basket, and the board of directors may see none of it.

If your bank looks poor in comparison with others in the area, or with the banks which you particularly think are comparable to yours, ask why. There may be a reasonable answer. But at least the question should be asked and management should be required to give an explanation.

The job of bank directors is not an easy one, and the task of sorting out economic predictions, their impact on your bank, and the actual condition of your bank is not an easy one. There are techniques and material available that will make the task possible, however, and I urge each of you to make use of them.