Chairman's Speech Binder

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LOAN LOSSES IMPEDE PROFITABILITY AT MINORITY BANKS

In a Speech to the National Bankers Association, Chairman Robert E. Barnett of The Federal Deposit Insurance Corporation pointed to the extremely high loan losses which minority banks continue to experience as the most significant factor preventing them from achieving a satisfactory level of profitability.

The number of minority-owned banks has increased from ten in 1963 to about 85 today. These include banks organized by blacks, Mexican-Americans, others of Hispanic descent, American Indians and Americans of Oriental ancestry.

The minority banks are significantly less profitable than nonminority banks and, in fact, as a group, lost money in 1975. While operating expenses of the minority banks seem to be somewhat higher than the average bank, the significant area of difference is the very high losses on loans experienced by the minority banks. Minority banks had losses equal to 1.2 percent of their total loans in 1975, while the average bank of comparable size had losses of .3 percent.

Earlier FDIC studies had indicated that the minority banks' performance was getting closer to the average as they matured. That trend seems to be continuing except for the problem of loan losses.

The loan losses are probably due in great part to economic conditions in the communities in which minority banks operate and to the minority banks' objective of serving as a source of financing to minority-owned businesses and other small businesses and consumers in areas of high minority population.

Mr. Barnett stressed the need for minority banks to show a profit if they are to become viable long-run suppliers of banking services to their community. He urged a more objective loan policy, if necessary to reduce loan losses and achieve profitability.

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CURRENT PERFORMANCE OF MINORITY BANKS

The rapid increase in recent years in the number of banks owned by black Americans and members of other minority groups probably has made your's the most closely watched and most intensely analyzed group of new banks in the nation's history. This is probably as it should be. On the one hand, this scrutiny has provided information which has helped in the development of programs such as the Government minority bank deposit program, the American Bankers Association Minbank, and in the programs of some private corporations to channel deposits to your institutions. At the same time, the results of research into your performance have provided useful information on the experience of the banks chartered soon after the new movement began in 1963. This knowledge should be of benefit to the younger members of your group in piloting their own institutions through those difficult first years of operation.

Whatever the reasons for the existence of only 10 minority-owned banks in 1963, the six-fold increase in your membership since that time in conjunction with a great increase in the role of minorities as officers and directors of nonminority banks, is a clear indication of the opening-up of opportunities in the financial sector. Just as important, this expansion is a tribute to your own ability to seize those opportunities once the initial barriers were removed.

In fact, it is no longer possible to keep accurate track of minority banks. Whereas 20 or even 15 years ago we could speak of the 10 black banks and the 14,000 white banks, the present structure is much more complex. We now have many more black banks, we have a number of banks with heavy involvement or control by Mexican-Americans, by others of Hispanic descent, and by American Indians as well as some banks managed by Chinese-Americans or Japanese-Americans, some of which are owned by large international banks. In addition, many more banks are multiracial in the makeup of their management, directors, and stockholders. In some cases, this consists of significant white involvement in predominantly minority banks. In others it consists of significant minority involvement in non-minority banks. Some of this started out as token representation, of course, and some remains just that. So be it. But there are many cases in which the involvement of each group with the other has grown significantly. Finally, in several cases, minority groups have purchased control of an existing non-minority bank. I view this fuzzing of the distinction between minority banks and others as a very healthy development even though it has the side effect of making more difficult the statistical comparisons of minority and non-minority banks. If I were forced to state the number of banks owned by people who are racially in the minority, however, I would say that there are about 85 such banks.

As this growth in the participation of minorities in the ownership of financial institutions has proceeded, there has been a continuing effort at the FDIC to maintain up-to-date information on the operation of your banks and to measure the success of many of those operations. The FDIC has conducted several studies of minority banks, and has provided financial and data processing support of other studies conducted by National Bankers

Association staff and by academic researchers. It is appropriate at this time, when total assets in all minority-owned institutions now exceed a billion dollars, to reexamine your progress and to reevaluate your operations. This evaluation must consider not only general banking goals of service to the community, growth, and profitability but also the special goals which you have often enunciated for yourselves. These, according to different spokesmen of the movement, include the financing of minority business enterprise, providing employment opportunity and experience in banking to the minority community, providing banking sources to economically deprived areas, and stimulating ethnic pride among minorities.

The first study attempting to compare the operations of minority and nonminority banks was done by Andrew Brimmer when he was on the Board of Governors of the Federal Reserve System. The minority banks came out very poorly in that comparison and the conclusions Brimmer drew from his study were extremely negative and pessimistic as to future prospects for minority banks. Another analysis was done soon afterwards by Ed Irons when he was Executive Director of this organization. He showed that a great deal of the negative results of the Brimmer study were due to the fact that the minority banks were much smaller on average than the nonminority banks and, of much more importance, a great many of the minority banks in the Brimmer study were recently established institutions. As we all know, it takes a few years for a new bank to become established and profitable. Later research has shown that it takes longer, on the average, for minority banks to become profitable than for comparably sized nonminority banks. When those factors were corrected for, the minority banks still did not look as good in terms of standard performance ratios as the nonminority banks, but the differences were not as great.

Several further studies have been done at the FDIC along this same vein, but with increasing sophistication in terms of making sure that comparable groups of banks were being compared, and in attempting to pin down just where the disadvantage of the minority banks lay. A study in 1973 by John Boorman of the FDIC staff confirmed that, even after making all appropriate allowances for differences in size, age, and location, black banks were less profitable than comparable nonminority banks. While this was not surprising, his research led to two findings with important implications: First, the difference in profitability between the two groups of banks was largely accounted for by loan losses. Second, the gap between black and white banks seemed to be narrowing over time. As a result of analysis of these factors, Boorman came to some conclusions about the prospects and appropriate role of minority banks:

> "[M]inority-owned banks can succeed in generating operating income . . . only when they manage to control loan losses. This in turn suggests that further retrenchment in local lending operations may be necessary if these banks are to survive. But this proposal involves a contradiction. On the one hand, commercial banks have traditionally been established to service the loan demand of small local markets with funds derived primarily from depositors in those same markets. Yet we are suggesting that while they maintain their function as local depositories, minority-owned

> banks contract those operations which involve the channeling of funds directly back to the same market."

Essentially, this conclusion says that in order to become viable, a new minority bank should be very cautious in its lending policies while its personnel, from top to bottom, learn how to run a bank. But the bank is also expected by the community and, in many cases, by its regulators, to provide financial assistance to minority businesses operating in its community. As the FDIC study put it "it may be completely unrealistic to think that both of these tasks can be accomplished simultaneously." The conclusion to be drawn is that despite the operating problems faced by minority banks, they can become successful institutions only if they give their own viability top priority. That brings us to an important question: Is there a significant role for such institutions to play even if they are not immediately as active in local lending as would be a completely experienced financial institution operating in a more viable market? The FDIC study answers that question in the affirmative:

> "They continue to be useful as financial depositories in their communities; they can still take some role in lending to new business enterprises through SBA guaranteed loans and other such mechanisms; they can be an important source of new financing to minority-owned businesses after these businesses demonstrate some initial success; and, finally, they can develop as the inner city develops and take on additional responsibility for continued development as the income and employment characteristics of the markets they service improves."

I will want to return to this question in a few moments.

What has happened since those FDIC studies in 1973. As all of you know, the last couple of years have been difficult ones for all banks. This has shown up in the statistics on bank loan losses, sensationalized publicity on particular banks, our own list of problem banks, and the failures of some very large banks. I want to take a look tonight at whether the worsening of loan losses that took place in most banks was experienced to the same extent by the minority banks. I also want to examine whether the gap in profitability between minority and nonminority banks has continued to narrow as the 1973 FDIC study suggested it would, and whether the performance of these two groups of banks has continued to converge.

The 1975 operating results of minority banks do not make very encouraging reading although they are not inconsistent with the analyses based on earlier years. In 1973 and 1974, those minority banks that had been in business for at least five years were profitable on average and as a group. This picture worsened in 1975. The banks in operation before 1963 had a loss on average, and the group established between 1963 and 1968 had only a very small profit. The newer banks also had an aggregate loss. While we do not have statistics for nonminority banks by age, we do know that all banks under $50 million in asset size earned about 90 cents per every $100 of assets in 1975. That performance is much superior to the performance of minority banks.

There are a number of differences in the average performance ratios of minority banks and nonminority banks, but because of the great variability in the operating results of the minority banks, generalizations are difficult to make and, in fact, most of the differences do not meet statisticians' tests of significance. Minority banks do tend to have lower loan-deposit ratios than comparably sized nonminority banks. Minority banks do tend to have greater holdings of U. S. Government securities and lower municipal securities. This reflects their lack of earnings subect to tax. Deposits of the U. S. Government are more important to the minority banks as a result of Treasury policy, but the volatility of these deposits may mean that they do not contribute significantly to net profits. Perhaps I am overly skeptical of such deposits because of the FDIC's experience with the Farmers State Bank of Delaware. That bank's exclusive status as depositary for State funds did not prevent its collapse; in fact it may have contributed to the bank's problems. It may be time for minority bankers to take a hard look at the long-run profitability of those deposits. In any case, Mr. Maxwell has pointed out that some minority banks, in bidding for Government agency deposits, may have cut margins below profitable levels. Those Government deposits and the liquidity they require on the asset side are partly responsible for the greater holdings of U. S. Government securities and for the somewhat lower loan-deposit ratios of the minority banks. The latter, however, is probably due in part to the efforts of the banks to control the loan loss problem.

On the income statement side, the comparisons are generally unfavorable to the minority banks, but the differences are not very pronounced on most items. Employee expenses and overhead are still somewhat higher for the minority banks, but expense ratios overall are not significantly different from those of nonminority banks.

In our earlier analyses of the behavior of minority banks, we found a rough trend to convergence in the operating characteristics of minority banks toward the national norm over time. This study compared the behavior of the minority banks that had begun business during the period 1963 to 1965, with the behavior of 46 nonminority banks which began operations within the same metropolitan areas during the same time period. By the end of 1975, these new banks were between 10 and 12 years of age. Thus if the conversion hypothesis is correct, these same banks should by now exhibit characteristics similar to the average comparable nonminority bank. Roger Watson of our Research staff has updated that earlier FDIC study through 1975. He found that net current operating income was higher for the nonminority banks, but results for individual banks varied all over the lot, so that these differences were not statistically significant. On the basis of comparisons we have made, other than some minor differences in revenue sources which can be explained on the basis of taxable earnings behavior and differences in clientele, the significant difference between the earnings expense behavior of the minority and nonminority banks appears to be in the loan loss area.

Loan losses of all commercial banks were $1.5 billion in 1973, increasing to $1.9 billion in 1974 and $3.2 billion in 1975. This represented 0.2 percent of loans in 1973, 0.38 percent in 1974, and 0.63 percent in 1975.

The loss experience of smaller banks was better than the very large; banks of under $50 million in deposits, a range that includes nearly all the minority banks, had losses equal to .3 percent of loans in 1975.

The loss experience at minority banks paralleled this description but at a substantially higher level. After improving for a few years, minority banks' loan losses were .7 percent of loans in 1973, but increased to 1.3 percent of loans in 1975. The provision for loan losses accounted for about 9 percent of total operating revenue for the minority banks and under 3 percent for the smaller nonminority banks.

Losses of this magnitude are simply not consistent with profitable bank operations. If loan loss ratios of the minority banks were equal to those of the nonminority banks, the minority banks would have had respectable profits in 1975. Their earnings would not have been equal to the nonminority banks, but except for the impact of those loan losses, the other aspects of operating experience were not greatly different from other banks of their size, age and location. Again, except for these losses, the trend toward convergence of operating results between minority and nonminority banks seemed to continue.

Losses of the amount I have described are very likely to lead to supervisory problems, and it is no secret that minority banks have had more than their share of serious problems. Over the last two years, we have had failures of three banks that, one way or another, might be classified as minority banks, out of a total of 27 failures. Over the last three years, we have had a very substantial increase in the number of banks on our problem list. I have pointed out in a recent statement that that increase appears to be a reflection of the severe recession that reached its low point early last year. We find that the problem bank list increases during every recession and the first 12 to 18 months or so of the subsequent recovery. The logical customers, both business and consumer, of minority banks probably are among those most adversely affected by downturns in the economy. The differential between white and nonwhite unemployment ratios, for example, increased during the recent recession. Furthermore, unemployment in certain central cities where many minority banks are located was higher than almost anywhere else. In view of these factors, it is not surprising that there has also been a significant increase in the number of minority banks on our problem list.

We are seeing, however, that the number of minority problem banks is leveling off just as the total number of problem banks in the economy seems to be leveling off. In fact, in some respects the number of minority problem banks reached its peak earlier than the total number of problem banks. Last year at about this time, there were 13 minority banks on our problem bank list, whereas this year, there are 12. Considering that there were far fewer banks on our problem bank list last year than today, the percentage of minority banks on the problem list has, in fact, decreased since last year. Unfortunately, part of the decrease is attributable to the failure of two minority banks over this period of time. Whatever the relative movement of the number of minority banks on the problem list shows, however, the ratio of problem minority banks to all minority banks is substantially larger than the ratio for the entire bank population.

Resolving these problems will require a combination of an improved economy and competent management. It appears that the economic situation over the next year is going to be favorable for banking in terms of general business activity, inflation and interest rates. This may not help minority banks greatly since unemployment is expected to remain high and improvements in the economy produce improvements in the banking situation only with a time lag. More importantly, the improving national economy does not produce an even expansion in all areas. Some communities will feel substantial benefits from the expanding economy while others may not. Large banks, with customers all over the country or the world, will gain in step with the general economy, but your situation depends much more on your local economy. You are more familiar with your local economic base than I and therefore can better judge to what extent it will improve; I simply caution you that the generally optimistic economic forecasts must be interpreted by you in light of the market your bank is serving.

That puts the burden heavily on management. Here also there is some reason for optimism. First of all, it appears that, by and large, minority bank management has coped well with most of the problems and challenges of starting and operating new commercial banks. As our studies have found, minority banks have tended to become similar in their operations and profitability, with the major exception of loan losses, to new nonminority banks, though it tends to take the minority banks somewhat longer to achieve profitable operations.

Second, it appears that improvement has been made in the stability of minority bank management. We have analyzed changes in the CEO of 71 minority banks that have been in operation for at least two years, counting changes in the CEO position since 1970. Thirty-two of the banks had no changes in CEO since 1970 or since they began operations. Most of the others had only one change in CEO, and only three had three changes in top management. It is not coincidental that those banks with greater stability of management have been more profitable. While such statistics are not available for nonminority banks, I might note that the FDIC has had a turnover of nine of its 14 top regional supervisory positions during the same time period, about the same rate of management turnover as most of your banks. It appears then that minority banks are overcoming the tendency toward management instability that has characterized many problem situations. This is a significant achievement since minority banks are subject to losing a CEO who is successful as well as removing one who proves to be not up to the task. Many large banks are taking affirmative action to employ qualified minority personnel and what better pool for recruiting can there be than the successful managers of minority banks.

Let me conclude by returning to the task faced by minority bank management in meeting the problem of excessive loan losses. I recognize that this is a particularly difficult problem. Minority banks are not organized frivolously. Spokesmen for minority banks have said that they are established in large part to meet a perceived need for financing by minority consumers and businesses. If that is one of the goals, and is an acceptable one, it is very difficult for the minority bank loan officer to turn down an application that promises to lead to an improvement in the economic climate in the minority community and, in particular, to provide a source of improved employment opportunities in the community. Minority bank managers must feel the weight of their responsibility to the community and do attempt to be responsive to these responsibilities.

I recognize both this responsiblity and the problems that too liberal a lending policy can produce. I would remind you that you have a responsibility in common with all banks -- a responsibility to yourselves and your investors to be a viable, profitable source of banking services in the community on a permanent basis. Survival in the long run, and the ability to provide banking services and loans in the long run, depends on achieving profitability. The conflict between the need for profits and the obligation to the customers you are attempting to serve is going to require some painful denials of loan applications in the months ahead. Indeed, each of you has probably already experienced that trauma. Saying "no" in some cases will continue to be an essential test of management courage and ability in the months ahead. In some ways it is easier now to take a more objective approach. Discrimination in financing is probably less serious than it was when this movement began in the early 1960s. On the consumer level, federal and state laws have been stiffened and enforcement efforts are more rigorous. The minority loan applicant who is creditworthy can now seek a loan with confidence that his application will be reviewed on a non-discriminatory basis, maybe not at every bank in town, but at most.

If you are tempted to make a loan because of concern that if you don't, no one else will, perhaps you should say "no" also. After all, you may be wrong as to how other bankers would evaluate the loan or, even worse, you may be right.

The raw figures from the past that I have recited tonight are not too encouraging; I recognize that. But I think it's also accurate to say that they come as no surprise to you. What you do with the implications of these figures, however, will be crucial in the months ahead. The sincerity and dedication of the bankers at this convention is certainly a hopeful sign.