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# NEWS RELEASE

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Remarks by

Robert E. Barnett, Chairman
Federal Deposit Insurance Corporation

before the

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Last week, the senior staff of the FDIC and I met in Boston with the chief executive officers of over 125 mutual savings banks in New England. In January, we had a similar meeting in New York City. These meetings followed closely the format of meetings first organized by Frank Wille when he was Chairman of the FDIC. The purpose of these meetings is to facilitate contact between the savings bank industry and the FDIC. We want to know the attitude of the savings bankers on a number of current issues and we want to learn about any problems that we may not be aware of. Likewise, we want the savings bankers to know our views on these issues and to have an opportunity for discussion of differences. The issues discussed range from legislative matters to matters of individual bank supervision.

The meetings were frank and lively with contrasting and conflicting points of view freely expressed. There was, however, a more cheerful tone to the meeting than others we have had in the past with representatives of the savings bank industry. For most savings banks, it was possible to look back on a relatively successful year last year, and look forward with optimism to 1977.

Nineteen seventy-six was a good year for the mutual savings bank industry. Deposits rose by over $5 billion on a net basis for the industry, a significant improvement over 1975 which was itself a good year in terms of deposit growth. Operating results for the year were also rather good.

Operating income as a percentage of assets rose by 21 basis points while interest expense had its smallest increase in many years. Even though operating expenses continued their increase in 1976, net income was well above that of the most recent years. Net income represented about 45 cents per $100 of average assets compared with 34 cents in 1974 and 36 cents in 1975. This is substantial improvement even though it leaves 1976 earnings well behind the average 55 cents per $100 of assets earned in the 1972-1973 period.

We look forward to continued improvement in 1977. Deposit inflows have been very strong so far this year, and we expect that favorable deposit trends will prevail throughout the year, though perhaps not quite at the record levels of 1976. We are looking for net income of about 52 cents per $100 of average assets in 1977. The only significant black lining I see on this silver cloud is the fact that earnings, despite their improvement in recent years, have not been sufficient to keep pace with the very rapid growth of savings bank deposits. Hence, capital ratios have tended to decline, albeit modestly, and this was a matter that warranted considerable discussion at our meeting with CEOs of mutual savings banks. It is also a matter of concern to savings banks trustees to which I will return shortly. We cannot really discuss the matter of capital adequacy, however, apart from discussion of the asset quality of the individual institutions that make up the industry.

Savings banks are important real estate lending institutions. The savings bank industry, however, has avoided many of the real estate lending problems that have plagued other real estate lenders, such as the commercial banks and the REITs. As compared with commercial banks, your real estate lending operations have been either luckier or smarter. Mutual savings banks loan losses have averaged about .03 percent of loans for the last few years. That is, losses have been about 3 cents per $1,000 of loans. As a percentage of total loans (real estate and all others), commercial bank losses have been about twenty times as high. Put another way, commercial bank loans are about eight times the volume of mutual savings bank loans, but their losses are 150 times as great. A great part of these losses are in real estate. Loans classified adversely by examiners ran about 3.6 percent of loans for mutual savings banks in 1976 as compared with 4.8 percent for the commercial banks.

These comparisons cannot be totally reassuring, however, because with respect to both loan classifications and loan losses, the trend over time has been unfavorable for the savings banks as well as the commercial banks. In 1970, for example, mutual savings bank loan losses were almost nonexistent, at about 3 cents per $10,000 of loans.

Because of these trends, increased attention has been given over the last year or so to the status of our problem bank list. That is largely, but not totally, a commercial bank problem. As of January 31, there were 383 FDIC insured banks on our problem list. This number is about 2 1/2 percent of all insured banks. Of those 383 banks, seven are mutual savings banks. Two of those are considered to be serious problems. These numbers of problem savings banks are very small, but it contrasts with the situation of a few years ago when we had practically no mutual savings banks classified as problems.

The issue has been raised in this connection as to whether a better job of bank supervision could have prevented the growth of bank problems in recent years.

But I think this misses the main point. The role of financial institutions in our economy is to take risks in lending activities. We recognize that banking is a risk-taking business and we must rely on market forces, on management, on depositors, and particularly on trustees in addition to our supervisory judgment to determine the appropriate degree of risk for individual institutions. 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, on both the state and federal level, has encouraged a shift toward 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 -- that is, one wins, one loses. I feel the same way about restrictions on those EFT developments which are designed primarily to protect less efficient banks.

This in no way suggests that the FDIC is indifferent to, or is pleased by, bank failures. Far from it. It is our desire to minimize both the number of bank failures and the results of such failures. Our review of our procedures and policies following the several large bank failures of recent years has led to several changes.

Of most significance to this group is our finding that most bank failures result from imprudent or self-serving action that directors could have and should have found out about, and done something about. In fact, 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 that the directors were negligent in meeting their responsibilities.

Some cases of bank failures, of course, are a result of embezzlements that cannot be detected in time, even though the directors are giving due diligence to their responsibilities. Normally, we would not sue such directors. In other 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 that 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, the policies and the actions 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.

The demise of the U.S. National Bank in San Diego, which helped awaken the country to the fact that a billion-dollar bank could fail, served to focus the attention of the public and bank regulators on the problem of insider abuse. As you undoubtedly know, the USNB insolvency was caused by the extension of between 400-450 million dollars in loans to more than 200 persons and entities controlled by or associated with C. Arnholt Smith.

Prompted by the U.S. National failure, the FDIC began a review of the matter of insider abuse and FDIC policies and practices with respect to it. Upon review, abusive self-dealing was found to be a significant contributing factor in more than half of all bank failures since 1960. Losses to the deposit insurance fund as a result of these failures are likely to exceed $175 million. Moreover, a review of existing and past problem bank cases also revealed a high incidence of abusive self-dealing as a source of serious difficulty. In addition to these clearly quantifiable effects, even when the immediate result is not a bank's failure or its designation as a problem bank, a transaction that is not effected on an arms-length basis may lead to a dimunition of the bank's earnings and an erosion of its capital. Also such transactions represent a misallocation of the community's deposited funds. In short, the review indicated a need for more vigorous supervision of insider transactions by both the boards of directors of banks and the FDIC.

Based upon this review, the FDIC adopted a regulation governing insider transactions of commercial banks and mutual savings banks effective May 1, 1976. Our experience with abuse of insider dealings leading to bank failure has come from the commercial bank sector, but it seemd prudent to extend coverage of the regulation to mutuals as well.

The regulation requires that the board of trustees of each insured mutual savings bank review and approve each insider transaction involving assets or services having a fair market value greater than a specified amount which varies with the size of the bank. The purpose of this provision is to insure that boards of trustees police insider transactions to insure that they are both sound and in the bank's best interest. In addition to the review and approval requirements of the regulation, certain record-keeping requirements are spelled out which are intended to foster effective internal controls over such transactions by the bank itself and to facilitate examiner review of such transactions.

In addition to spelling out review and approval and recordkeeping requirements, the regulation makes it clear that formal compliance with these requirements neither relieves the bank of its duty to conduct its operations in a safe and sound manner nor prevents the Corporation from taking appropriate supervisory action with respect to any insider transaction. The regulation makes it clear that such action, including legal action under Section 8 in the Federal Deposit Insurance Act will be taken where an insider transaction represents unsafe and unsound banking practices.

Although the Corporation has determined that insider transactions require special supervision by bank boards of trustees and close scrutiny by the Corporation's examiners in order to ensure their fairness, we have carefully sought to avoid unrealistic prohibitions or unduly burdensome recording requirements. Instead, the Corporation has attempted to develop requirements which will place responsibility where it belongs -- in the hands of the bank's boards -- and to strengthen existing bank and supervisory procedures for policing insider transactions. In doing so, we hope to correct a serious and continuing source of abuse without excessive bank or regulatory costs.

In the several months since its adoption, we at the Corporation have attempted to monitor carefully the operation of this regulation by seeking feedback both from our own examiners and from bankers. We have been pleasantly surprised. It appears that most banks which we regulate have been able to implement the requirements of this regulation without undue burden or cost and that many in fact feel that it has certain salutary benefits from their point of view -- something of a novelty in our experience with the adoption of new regulations. In some cases, management has told us that the regulation makes it easier to turn down unreasonable proposals of insiders for favorable treatment. This is not to say, of course, that compliance is perfect or that the regulation cannot be improved. Examiners in some regions report a significant number of violations of the review and approval and recordkeeping requirements of the regulation -- a phenomenon experienced early in life of any new regulation. A few bankers have complained about some aspects of the regulation -- most particularly about the inclusion of large deposits in the covered transactions. FDIC staff are in the process of evaluating banker and examiner criticism of the various facets of the regulation; I would expect that this evaluation will not result in any major modification of the regulation.

We hope that the introduction and enforcement of this regulation has reduced one of the more destructive elements of risk in banking.

While we recognize that banking should not be a perfectly riskless business, we are concerned that banks not move too far in the direction of risk. Finding the appropriate position for a bank based on its location, resources and management capabilities is primarily a responsibility of the trustee. Our policy with respect to supervision of commercial banks is to rely heavily on a board of directors. The role of trustees in mutual savings banks is even more important. I do not want to discuss the legal fine points of distinctions between responsibilities of commercial bank directors and mutual savings bank trustees, but there is a difference that is crucial to us. Commercial bank directors are elected by stockholders who have a financial interest in the performance of their bank. If the bank's performance is poor from the point of view of the dividends and earnings accruing to stockholders, we can expect pressure to remove ineffective directors. Savings banks do not have stockholders, so to a much greater extent than in commercial banks, longevity of trustees on a board is not directly related to the financial performance of the bank. The trustees thus are much more independent as far as their ability to determine policy for savings banks than are directors of commercial banks.

When a newly chartered commercial bank seeks deposit insurance, we have something to say about the selection of directors of the bank. The same would be true if a new mutual savings bank were established, or if a savings or loan association converts to a savings bank. In general, however, we do not have any legal authority to determine who is or is not a mutual savings bank trustee. We do not expect or want all trustees to be bankers by profession, but savings bank trustees must make some effort to learn about banking and to take their jobs seriously. We are troubled by situations where trustees serve solely for the honor or prestige attached to being a trustee, or because it is a family tradition to do so, and where the person so honored does not intend to be an independent force in forming the policies of the institution. We want informed and interested trustees.

While the range of responsibilities of savings banks trustees is broad, I would like to make a brief comment on what I think is the single most important task of a trustee. That is the selection and continuous evaluation of management. I agree with the view that trustees should not be running the bank on a day-to-day basis, but the board cannot escape responsibility for management of the bank.

Much has been written on the problems of selecting top management. I would prefer to stress the need for the board, after management has been selected, to develop with top management specific goals and objectives for the bank. We see many problem banks that find themselves in that condition because of nebulous goals and objectives, contradictory goals and objectives, and a divergence between the board and the chief executive officer as to what are appropriate goals and objectives. This again is a more serious problem for mutual savings banks than for commercial banks. For the commercial bank, we know that the long-run objective of the institution must be keyed to profits and perhaps the market's assessment of that in the stock price. This important measuring rod is absent or less prominent in a mutual savings bank, thus the need for you to be more explicit concerning your goals and objectives.

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

One specific aspect of this responsibility for setting policies and priorities has come to the fore this year and must be given serious attention by all savings bank boards and management. Nineteen seventy-seven may well be a year in which a key decision must be made between seeking growth or earnings. Nineteen seventy-six saw a significant drop in market interest rates accompanied by a substantial inflow of funds to savings institutions. Those trends are continuing, at least in the first part of 1977. A potential squeeze on earnings may develop for some institutions who find their portfolio interest income declining while interest costs on deposits are relatively fixed. Many institutions would like to reduce the interest rate they are paying on deposits, but fear the competitive consequences of such a step, though some number of institutions, both commercial and savings banks, have made that decision.

Several institutions have urged the banking agencies to solve this dilemma for them by reducing interest rate ceilings. While I cannot predict what the Federal Reserve, the Home Loan Bank Board, or even the FDIC will do in the months ahead with respect to administration of interest rate ceilings, and I certainly cannot predict what changes the Congress will make in the system, we must recognize that there are strong pressures opposing reduction of interest rates payable to consumers by Government agencies fiat. Thus, while I cannot say what the decisions of the agencies will be as the year develops, the well-run savings bank will not be counting on action by the Government to solve this problem for it, but will be making its own plans and decisions.

We are not indifferent to that decision. I noted earlier our concern about declining surplus ratios in savings banks. This concern could become more serious if we saw in 1977 a squeezing of the surplus ratio from both ends, that is, a rapid expansion in savings bank deposits resulting from attractive rates paid on savings bank deposits as compared with market instruments and simultaneously a reduction in earnings rates because of the decline in market interest rates.

Let me be clear that I am not urging the industry or any individual bank to either lower or not lower its deposit interest rates. What I am saying is that this is a particularly important decision this year that must be faced up to. Doing nothing does not avoid the problem. Maintaining current interest rates is a decision. The decision, whichever it is, will have an impact on the surplus ratio of the institution. This is not a decision to be casually made by management, but one that must be squarely put to the board of trustees.

Trustees will not be able to participate actively and appropriately in that decision or any other, for that matter, unless the board is an informed one. I think it is fair to say that the primary responsibility of trustees is simply to know what is going on. That is easy when management makes an effort to see that the board is 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 trustees are kept informed, it is possible even for a nonbanker trustee to be knowledgable 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 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 or the State supervisory authority, 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 banks, and we think they are. Most managements feel the same way. Obviously then, trustees 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 to review the report, though agency policies on such meetings vary. FDIC examiners at the present time do not routinely meet with boards of trustees following every examination, but do attempt to arrange such meetings if the examiner feels there is something unusual to discuss. I understand that the Comptroller of the Currency does follow a policy of having national bank examiners meet with the board of directors of national banks following each examination. 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 trustee 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.

When FDIC officials speak about the responsibility of trustees, 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's earnings are satisfactory.

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, 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 some time -- 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. This is even more important for a mutual savings bank, where earnings are the only source of capital.

Now this creates some difficulties for the trustee 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. And, as I mentioned, profitability is not necessarily the overriding concern for a mutual institution that it is for a stock corporation. 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 made available on a routine basis by the FDIC to facilitate such comparisons.

In fact, the problem for the trustee 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 trustee 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 board meeting, and we have received many complimentary letters from bankers, bank directors and trustees 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 their board, 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 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 savings bank trustee 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.