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PROBLEM BANKS AND BANKING PROBLEMS

Address by

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The first problem of any magnitude with which I was confronted when I began my term at the FDIC on August 1, 1973, was the impending insolvency of the U. S. National Bank of San Diego -- the nation's first billion dollar bank failure. Little did I or others suspect at that time that this failure was a prelude to other large bank failures and that the banking system and the economy were about to undergo greater stress than at any time since the 1930s.

Reflecting on the events and problems of recent years, it seems to me that some very basic questions should be posed and addressed. It is generally assumed that a competitive, innovative, and responsibe banking system requires risk taking. But, at what point does risk taking become excessive? How much risk should a banker undertake? What should be the supervisor's role in dealing with risk taking? Should it be directly through regulation, examination, and supervision? Should it be indirectly through mechanisms such as deposit insurance that protect the innocent from the untoward consequences of risk taking? Or, should it be some combination of both direct and indirect mechanisms? What are the unintended or perverse consequences of existing regulatory strategies? What is the appropriate organizational framework for implementing the chosen regulatory strategies?

Many of these questions have accepted answers; and a set of policies consistent with those answers has been developed which has remained basically the same for over 40 years. It seems to me that the changes in our society and economy as well as changes in other countries have been so significant that it is time that we reevaluate the old answers and policies.

Nearly 4 years ago, I stated that:

> We are in the midst of a period in which there lies potential for rapid and fundamental change. As the industry, the agencies and Congress face the future there are two possible courses of action for dealing with the changes that are occurring or will occur. There can be a common and concerted effort to control and shape events with the objective of creating a more sound, flexible financial system better able to meet the credit needs of our economy and more resilient in the face of frequent and varied shocks. Or, there can be a fragmented reaction to each change as has been characteristic of the past.

Although the latter course of action still holds sway, I believe my comments are just as timely today as they were nearly 4 years ago.

With this in mind, it is appropriate to review briefly the problems we have witnessed, the events that led to these problems, and the responses of bankers, supervisors, and the public.

In recent years double-digit inflation, the serious liquidity crunch of 1974, the problem of coping with the flood of petrodollars, collapse of real estate markets, high loan losses, weakened earnings and capital positions, and other problems stemming from the most severe economic contraction since the Great Depression, all placed great strains on our banking system.

Changes in the number of banks on the FDIC's problem bank list reflected these developments. After reaching a low point of 146 in April 1974, the number of problem banks increased until it reached a peak of 385 in November 1976. The increase during 1974 was a modest 37 from the April low. But, during 1975 the number of banks on the list increased by 166. Another 30 were added in 1976. To put these numbers in perspective, it should be noted that during this three year period, 599 banks were added to the problem list and 346 were removed -- a few because of failure but most of the banks were removed because their condition had improved significantly. Over this same period, there were 33 bank failures: 4 in 1974, 13 in 1975, and 16 in 1976. During 1977 the number of problem banks declined to 368 and only six banks failed. There have been only four bank failures in 1978. The number of problem banks as of May 31 had decreased to 354.

The principal cause of the increase in numbers of problem banks was the severe economic recession. Unsound lending practices and mediocre management often go unnoticed in a robust economy. In a downturn they are quickly exposed. Specifically, during the 1974-75 period many banks were hobbled by a severe depression in the real estate industry which also caused serious problems for REITs, thus compounding the problems of the larger banks which had lent large amounts to REITs. Other banks, particularly small banks in midwestern States, were adversely affected by drought and by low livestock and grain prices, resulting in the buildup of farm debt. Banks with heavy investments in securities with substantial depreciation or which had become dependent on rate sensitive funds also became prime candidates for the problem bank list.

In addition to these problems, abusive self-dealing continued to constitute a source of significant problems. In 62 of the 107 bank closings that have occurred since January 1, 1960, the principal cause of failure was abusive self-dealing.

To give you a further sense of some of the more typical problems which might lead to a bank being placed on the FDIC problem list, let me read to you a few excerpts from our problem bank memoranda:

> The chairman of the board has been associated with the bank for approximately 21 years and has developed an apparently insatiable need for credit to finance his obviously troubled business endeavors . . . Identified extensions to (the chairman) and/or his entities at this examination constitute 82.2 percent of total capital and reserves, 21.5 percent of classified loans, 64.2 percent of total loss classifications, 62.9 percent of total doubtful classifications, 29.8 percent of total substandard classifications, and 43.7 percent of total delinquent loans.

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> In an attempt to avoid an earlier loss, the president and the policy dominant (person), through his personal guaranty and that of an insurance agency owned by his wife, has become involved with an unsuccessful local manufacturing concern. Concern for this guaranty has resulted in abusive extension of credit to this venture and a lack of supervision for the remainder of the loan portfolio and overall administration of subject.

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> Seriously weak lending and collection practices have resulted in a massive volume of weak assets. Liquidity is a problem and there are violations of laws and regulations.

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A concentration in long-term New York City Bonds which are classified substandard, equal to 120 percent of total capital and reserves, and contain depreciation equal to 53 percent of capital and reserves, coupled with other adversely classified assets, has resulted in excessive classifications.

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A hazardous management team and a consenting directorate has involved the bank in loans to highly speculative real estate projects and other weak credits which have resulted in an inordinate amount of asset classifications, heavy losses, and inadequate liquidity provisions.

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Large amounts of contingent liabilities containing potential losses resulted from the acceptance of trust business which the staff was either unable or incapable of handling.

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Before considering the lessons that the experiences of the last few years have taught bankers, regulators, and the public, I think it would be useful to attempt to understand the context in which recent banking problems arose. Economic developments culminating in the 1973-75 recession and a general trend toward greater risk taking on the part of the banking system form the basic elements of that context.

Significant changes began to occur in the banking industry after bankers awoke in the early 1960s to the realization that thrift institutions had become significant and powerful competitors for deposits. Responding to competition from thrifts and other business enterprises and to the needs of customers, banking burst out of its stodgy and conservative shell. Geographic barriers to competition fell as the holding company mechanism allowed a multistate presence. Branching restrictions were modofied and banks developed extensive international operations. Innovative techniques in structuring and managing assets and liabilities allowed banks to respond to both the increased demand for consumer services and the sophisticated requirements of business customers. All this change was facilitated by technological breakthroughs in the processing and transmission of information, and further change was promised through implementation of EFT systems. In short, banks were in tune with and responded aggressively to the needs of a complex, prosperous, and expanding economy.

Holding company expansion, real estate lending, and liability management typically have been singled out as major problem areas that developed over this period. Holding company expansion occurred as a direct result of the desire of many banks to diversify into activities closely related to banking and to enter new market areas. Existing Federal and State laws made expansion directly through the bank or through a bank-owned subsidiary quite difficult. Although it is uncertain whether the new services offered through holding companies were any more risky than traditional banking services, in some cases these new services proved to be riskier in the short run because management lacked experience. Real estate lending in new markets through nonbank holding company affiliates was, perhaps, the most significant area in which inexperienced management and rapid expansion of lending volume often resulted in acceptance of inferior credit risks. The REIT debacle reflects this phenomenon most graphically.

At the same time banks began to use the holding company framework to alter the content of their asset mix, banks also began to manage the other side of their balance sheets more aggressively. To a large extent, this development, commonly referred to as liability management, resulted in a more efficient and productive employment of funds. By relying on the money market to supply needed funds, banks practicing liability management did not have to rely on their own assets for liquidity to as great an extent. In the aggregate, improvement in portfolio management tecnhiques was beneficial. However, it did involve risk taking, just as holding company expansion and increased real estate lending did. A few banks took on too much risk, as later became apparent in the 1973-75 recession.

These developments were paralleled by another development which, in many ways, was responsible for the banking industry's increased competitiveness, innovativeness, and riskiness. During the 1960s, a new generation of management began to replace an older generation that had been traumatized by the Great Depression. These young bankers responded aggressively and innovatively to the opportunities of the period and brought banking out of the shadows of the 1930s. The results for the economy and for the banking system were largely beneficial. But, in some instances, the eagerness of this new generation of bankers led to imprudent actions.

At the same time that significant changes were taking place in the banking industry, there were significant changes taking place in the economic conditions in this country and in the world. Starting in 1966 there was a decisive shift from the relatively stable upbeat economy that had persisted since World War II to an unstable economy characterized by wide fluctuations in interest rates, the inflation rate, industrial output, and housing activity. Although the change can be traced in part to the policies for financing the war in Southeast Asia, other unanticipated events, such as the drastic increase in oil prices in 1973 and the worldwide agricultural shortages, contributed substantially to the new economic instability.

If it had not been for the drastic downturn in economic conditions during the 1973-75 period, the increased aggressiveness of banks would probably not have resulted in increased problems to quite the same extent. Banks play a major role in financing economic activity. Thus, when the economy experiences difficulties, banks will develop problems. Those banks that have managed their risk taking, liquidity, and earnings positions carefully will suffer from economic downturns, but not nearly as much as those banks that have managed their operations less prudently.

Indeed, to my mind, one of the most remarkable aspects of the banking problems associated with the 1973-75 recession is that only a handful of banks got into really serious trouble. Rather than reflecting fundamental weakness, the events of this period served to demonstrate the basic strength and resiliency of the banking system. Indeed, one of the greatest dangers which we faced and continue to face is overreaction by bankers, bank regulators, and the Congress. In particular, we must be careful not to react to banking problems in ways which unnecessarily limit the risks that bankers are permitted to take. For example, certain portions of the so-called "safebanking act" may not be absolutely essential to enable Federal bank supervisory agencies to deal with banking problems.

Nevertheless, banking problems experienced over the last 5 years were real and have taught bankers, bank regulators, and the public a great deal about our banking system and about the economy. A partial listing of lessons learned and adjustments made by bankers is illustrative. First, the new generation of bankers is now aware of downside risk and that economic growth does not proceed indefinitely without interruption. Second, bankers are aware that uncontrolled growth may lead to future problems. Third, from the failures of Beverly Hills BanCorp and the Hamilton National Bank, bankers have learned that holding company banks cannot always be insulated from difficulties in a holding company system. Fourth, financing long-term loans with purchased money can be risky. And finally, emphasizing loan volume without ensuring liquidity and a good rate of return is dangerous.

Bank regulators also have learned certain valuable lessons and have made necessary adjustments. Many regulators, and I include myself in this group, were mistaken about the extent of public disclosure of a bank's financial condition that could be sustained by a bank without damage. To be sure, there were exceptions during this period. The hemorrhage of funds from Franklin National Bank did follow closely on the heels of sensational disclosures with respect to Franklin's condition and, particularly, its operations in foreign exchange markets. However, it should be noted that it was other banks and large corporations, not small depositors, which lost confidence in Franklin. At the same time, we at the FDIC were genuinely surprised at the calm reaction of depositors in the face of extensive disclosures of fraud and unsound operations in other financial institutions. Not only was the public, including small investors and large sophisticated investors, secure in the face of these disclosures in the press, the public received without fright, and rather welcomed the far more extensive disclosure requirements proposed by the SEC and the banking agencies.

The long and short of this, it seems to me, is that the adversity of the period which we recently went through, combined with the pressure of the SEC for further disclosure and the bad news revealed in the press, demonstrated conclusively that the banking system can tolerate far more disclosure than most bankers and bank regulators have ever thought.

This confidence in the face of adversity suggests another lesson: that is, the extent to which the fail-safe system of deposit insurance was tested for the first time in its history and found effective.

The importance of the deposit insurance mechanism has been underscored by two noted and diverse economists -- professors Milton Friedman and John Kenneth Galbraith. Professor Friedman stated some years ago, "Federal insurance of bank deposits was the most important structural change in the banking system to result from the 1933 panic and, indeed, in our view, the structural change most conducive to monetary stability since state bank notes were taxed out of existence after the Civil War."

A similar assessment was made by Professor Galbraith in his recent book entitled "Money: Whence it Came, Where it Went." Doctor Galbraith observed that ". . . the FDIC was what the Federal Reserve had not succeeded in being -- an utterly reliable lender of last resort. . . ." Noting that there had been only about 1,700 bank failures during the 10 years prior to the establishment of the Federal Reserve in 1913 and some 15,500 in the 20 years after its establishment, Dr. Galbraith pointed out: "The anarchy of uncontrolled banking (was) brought to an end not by the Federal Reserve System but the obscure, unprestigious, unwanted Federal Deposit Insurance Corporation." He concluded, "In all monetary history, no legislative action brought about such a change as this."

In the period between World War II and 1970, deposit insurance was of little national concern because there were few failures, and the failed banks were small. Between 1934 and 1970, only one bank with more than $50 million in assets, and none with more than $100 million, failed. In contrast, the 10 largest bank failures in the FDIC's history have taken place since October 1973, including the $3.6 billion Franklin National Bank and the $1 billion U. S. National Bank of San Diego. The assets of these 10 banks amounted to more than four times the assets of all other insured bank failures during the entire FDIC history. The confidence of the public in the face of these failures reflects the success of the deposit insurance mechanism in accomplishing its mission.

Bank regulators have responded to the banking problems of the last several years by establishing new supervisory procedures. A partial listing is illustrative. The Comptroller of the Currency recently overhauled examination procedures to deal more effectively with modern banking problems as well as the traditional ones. The FDIC has made some refinements in existing procedures and currently has in process an internal study of its examination procedures. The Federal Reserve Board late last year announced more comprehensive and vigorous examination and inspection procedures for bank holding companies. The Comptroller of the Currency and the FDIC have adopted the policy of meeting with a bank's board of directors to discuss with them the results of the examination. The FDIC also has adopted the policy of advising a bank's board of directors that its bank has been placed on the FDIC's problem list. All of the bank regulatory agencies have substantially increased the number of instances in which banks have signed formal supervisory enforcement agreements to correct violations of law and/or to correct unsafe and unsound parctices. And, the FDIC more than 2 years ago adopted a regulation that I believe will curb insider abuses.

Potentially, one of the most significant innovations on the part of the bank regulators has been the development of so-called early warning systems. The FDIC's Integrated Monitoring System relies heavily on the analysis of the most current information available from bank financial statements and recent examination reports. This system enables the Corporation to zero in with more accuracy on those banks, or those particular aspects of a bank's operations, which merit closer supervisory attention; it facilitates a more efficient use of limited examiner manpower; it alerts the FDIC to the presence of a deteriorating situation before it assumes serious proportions and thereby generates a swifter response. The Comptroller of the Currency's National Bank Surveillance System is similar in many respects to the FDIC's financial analysis and monitoring system.

To a certain extent these and other adjustments in the supervisory process represent fragmented responses to specific shortcomings. With discipline, these efforts can be developed into a coherent, forward looking, and comprehensive set of responses to existing problems and those that undoubtedly will develop over the next several years. Indeed, it is possible to identify most of the major elements of such a comprehensive approach.

One major element of such an approach is, of course, a review of the management and framework of bank regulation. Since Chairman Burns described the bank regulatory system as a jurisdictional tangle that boggles the mind, considerable time and effort have been devoted to various proposals for Federal bank regulatory agency reorganization. However, consistent with my view that we need to reevaluate the government's bank regulatory role, I believe that prior to effecting any comprehensive reorganization of the bank regulatory functions, a series of issues must be addressed. Among these issues are the implications for regulatory structure of financial institution reform, nondepository institution competition and electronic funds transfer systems, the appropriate locus of investor protection, consumer protection and civil rights functions, and the relationship of State and Federal supervision.

Notwithstanding my belief that regulatory reorganization should be delayed pending further study, the most serious inadequacy in the present regulatory framework at the Federal level is the fragmentation of bank holding company supervision and, in my opinion, this can and should be dealt with without a comprehensive reorganization.

Recent events have illustrated that the existing framework is not only unduly costly because of the overlapping and conflicting jurisdictions involved, it also has not functioned properly in some instances. In this regard, two points should be recognized by both the banking agencies and the Congress.

First of all, the notion that one segment of a holding company system can be insulated from the remainder of the system is untrue. It is the worst form of self-deception to think that the lead bank in a holding company is in a safe and sound condition because its last examination was satisfactory, if other facets of the holding company system are not undergoing equally rigorous scrutiny. The second point flows from the first; that is, it is not sensible for as many as four bank regulatory agencies to have jurisdiction over certain segments of an integrated business enterprise. Inevitably, this approach at times will be conflicting and uncoordinated. And, certainly it imposes unnecessary costs on both the government and the banking industry.

In my judgment, this problem should be remedied immediately by delegating to the supervisor of the lead bank in a holding company system the primary supervisory responsibility for the entire system. I would not at this time, however, shift the Federal Reserve Board's present role in determining permissible activities for bank holding companies. Nor would I shift responsibility for approving bank holding company formations and acquisitions.

Apart from the problems associated with the structure of bank holding company supervision, the relation between State and Federal regulation cries out for rationalization to a far greater extent than does the regulatory framework at the Federal level. For this reason on August 29, 1977, the Board of Directors of the FDIC commissioned a study, which is directed by Dr. Leonard Lapidus, to analyze and appraise the system of State and Federal bank regulation. The study will assess the costs and benefits of this overlapping structure and will develop recommendations for its improvement.

A fourth element involves reviewing and evaluating the entire body of statutes and regulations that forms the basis of the bank regulatory system. Using strategies such as sunset legislation, zero-based budgeting, and economic incentives, I believe that it is possible to devise regulatory systems that involve the least drastic, least costly, and minimum amount of governmental intervention necessary to achieve the desired public purposes.

This same kind of review and evaluation should also take place inside the regulatory agencies. Earlier I indicated some of the adjustments the agencies have already made in response to recent banking problems. We are continuing this process. At the present time the FDIC is conducting a study of its examination procedures. Similar studies of liquidation and internal budgetary and management procedures have been completed. In addition, an internal task force is reviewing all FDIC regulations to determine whether they are necessary, whether they should be up dated, and how they can be simplified. At the present time the FDIC is conducting a study of its examination procedures.

Long-run rationalization of interest rate controls on deposits and loans is an essential facet in any comprehensive and forward looking bank regulatory reform effort. It has been demonstrated time and again that interest rate controls are inefficient and cause severe dysfunctions in our financial markets. Deposit interest rate controls are unfair to depositors, and usury ceilings which are below market levels may prevent bankers from receiving a fair return on the funds they lend. These problems have long been recognized, yet they remain with us primarily because removal of interest rate controls without dealing with other problems, such as the mismatched asset and liability maturities in thrift institutions, would cause serious dislocations. So far, institutional jealousies and "turf-protecting" have prevented resolution of this problem.

Finally, notwithstanding my belief that the deposit insurance mechanism has served the banking system and the economy well and that it represents an example of a governmental response that has not proved unduly costly and burdensome, I believe that it is appropriate to reëxamine and refine that mechanism based on our experience in recent years. In the process of doing so, I believe that we will conclude that we need not fear bank failure -- even large bank failure -- as we have since the Depression and that, given the efficacy of the deposit insurance mechanism, our banking system can function safely and more efficiently with less, not more, governmental intervention in the operation of our financial institutions.

In conclusion, to highlight what I hope has been implicit throughout this discussion, I believe that the painful problems of recent years provide us with the knowledge and the incentive to construct a framework of supervision and regulation that will ensure the health and the stability of the financial system, facilitate financial innovation, and afford appropriate protection for investors and consumers with minimum governmental intervention.

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