New Jersey banking and several issues facing the U.S. banking industry

Remarks by

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Good morning, ladies and gentlemen. Its a great pleasure to be able to join you all here in Phoenix, and to have an opportunity to give you a report on New Jersey banking and also discuss several issues facing the U. S. banking industry.

I've been looking forward to this opportunity to talk to a group of bankers who are doing so well overall. As you might expect, I've had to speak to several groups from states that can't claim such distinction Their expressions said it all; they have obviously been facing some very difficult conditions. Believe me, its no fun being the guy called on to talk about bad news after dessert!

Of course, it's also no fun being one of those folks sitting around the table eating that dessert.

I was reminded, in fact, of one of our FDIC examiners who recently paid a visit to yet another "oil patch" thrift -- we've been paying a lot of those visits lately, you know -- and saw the desk trays on a senior executive's desk. The first read "Urgent" -- the second "Frantic" -- and the third ... "Too Late"!

[Pause]

Of course, there are also some light moments in all of this. I recently received a very nice letter from a small town in the southwest that invited me to be the speaker at a Memorial Day ceremony.

The letter read: "We invite you to speak on the town green Memorial Day. The program will include a talk by the mayor, recitation of Lincoln's Gettysburg Address by a high school pupil, your talk, and then the firing squad"...

[Pause]

Well, I said I had a pleasant duty today. Let me turn to the facts concerning New Jersey's banks -- that will explain why I have especially looked forward to this talk.

To begin with, the 1980's have been economically kind to New Jersey. The state gained over one half-million jobs during that period. Recent statistics show that unemployment stands at only 3.9 percent, well below the current national average.

Per capita personal income in the state remains among the highest in the nation. Construction activity, particularly nonresidential, is still at very high levels.

This is all good news for your banking system, and for the bank's insurer.

New Jersey's banking industry, reflecting both the state's strong economic performance and the excellent quality of bank management, continues in a healthy state.

Industry profits remain high, and not since 1984 has a New Jersey bank failed.

In other words, you are the kind of customers the FDIC relishes.

To provide a comparison, last year the FDIC handled more bank assets nationwide than it did during its entire first fifty-five year history. That resulted in our first operating loss ever.

Several components contributed to the overall health of your banks.

New Jersey's return-on-assets of 1.13 percent continues to exceed the rates for both other Northeast banks and banks nationwide.

Net income was up almost one-third from last year, despite narrower net interest margins. Growth in overhead expenses was restrained, while non-interest income increased moderately, contributing to this improvement.

Although slippage in the quality of real estate loan portfolios was evident, asset quality remained relatively strong.

New Jersey banks' net loan charge-offs and nonperforming rates are substantially lower than found in banks in other states in the region and across the nation.

That is good to hear given your high <u>Asset growth</u> last year -- over 12 percent -- which amounted to three times the national average. About half of that growth was accounted for by real estate lending.

Your ability to cushion future problems also improved. <u>Capitalization</u> grew, with 1988 ending with an <u>equity-to-assets ratio</u> of 6.51 percent -- well above the national aggregate.

What do I say to all this? That's easy: <u>Congratulations</u> on your fine performance, and keep up the good work!

Your state's record would make the banking industries of many other states literally green with envy.

So was there any bad news? Yes, every report card always has some imperfections. I have a friend, in fact, whose wife always manages to find the flaw in every silver lining.

When my friend was promoted to Vice President of his bank, her response was: "Vice Presidents are a dime a dozen". She even claimed that in the supermarket where she shopped, they had a Vice President in charge of prunes.

Furious, my friend phoned the supermarket in the expectation of refuting his wife. When he got through, he immediately asked to speak to the Vice President in charge of prunes.

"Which one", was the reply, "Packaged or bulk prunes!.."

[Pause]

The down side for New Jersey banks does highlight a few areas that require monitoring. The most significantly is that problem assets increased by two-thirds in 1988, despite higher net charge-offs.

While your averages are still better than regional and national results, special attention should be paid to avoiding concentrations in lending sectors.

This is especially so given your heavy reliance on real estate loans for the lion's share of total asset growth. This, coupled with the recent decline in real estate loan performance, is cause for some concern regarding the sustainability of current growth and profitability trends.

Remember loan concentration in real estate is the principal cause of the huge 1988 FDIC fund loss. Don't let it happen in your Garden State!

All in all, however, New Jersey banking has a strong performance record going, and I look for more of the same in the future.

I would also note that your state's record of forward-thinking in the banking area is something I applaud.

I note that New Jersey permits statewide branching, and that nationwide banking went into effect last year. Both of these structures will help your banks weather localized problems more effectively.

The problems of unit banking -- where risk becomes compartmentalized and unbalanced -- have become all-too-clear. Witness Texas, and especially MCorp, recently.

The President's plan for dealing with the S&L problem helps equalize the treatment between branching and unit states by requiring cross-guarantees. All depository institutions that receive deposit insurance will have to guarantee the insurer against costs resulting from the failure of an affiliated bank.

In blunt terms -- the stronger banks will no longer be free to walk away from their failing affiliates -- leaving the clean-up cost for the FDIC.

That is something well run banks like those found in New Jersey can appreciate. For this structure will help keep the cost of failures down, which means deposit insurance premiums should also stay down.

By the way, I noticed a Cleveland State University study found that residents of New Jersey will be paying, on a per capita basis, the third highest amount in the nation to address the S&L problem.

If it makes you feel any better, residents of the Capital will be paying the second highest amount!

The main issue I would like to discuss with you this morning is the minimum capital standards (called by some the gearing ratio) that the FDIC will continue to require in conjunction with the new risk-based capital standards.

The FDIC has one basic goal in going forward with our capital requirements.

We are going to make sure that the new risk-based standards do not result in the reduction of minimum capital requirements below current levels for any large number of banks, especially during a period of substantial risk in the system.

As you know, all regulators now require that banks maintain 5.5 percent in primary capital, and 6 percent in total capital. These capital requirements are based on total, non-risk adjusted assets, and do not cover off-balance sheet activities.

We intend to maintain those capital levels for the present. We also plan to introduce new risk-based standards to deal with off-balance sheet risks and other factors.

As the insurer, we plan to enforce the standard that provides, in a given bank situation, the greatest amount of capital to protect the insurance fund against loss. As the insurer, we want conservative standards for banking. Comptroller Bob Clarke says the FDIC is too conservative. We'll accept that as a compliment.

For about 90 percent of the banks, our position means that the current gearing ratio will continue to apply, and thus the risk-based standard will have no effect. We will make it easy to report that the risk-based method results in a lower requirement, and thus is not applicable. For most banks, it will be capital standards -- "business as usual".

Maintaining a leverage standard based on total capital is especially important since risk-based requirements will not be fully implemented until year-end 1992, and will need time to develop a track record.

Interest rate risk also needs to be factored in, especially as applied to S&L capital requirements.

Also a dual system with a leverage ratio will always be necessary to meet the situation where risk-based capital standards require no capital -- such as when a bank holds only 30-year government bonds.

The risk-based requirements will still play an important role in the system I describe, most notably by increasing capital requirements on larger banks that have traditionally maintained significant off-balance sheet activities.

The OCC has a slightly different perspective on these matters. The Comptroller and I usually agree on most issues. But when we don't agree, matters of substance -- where reasonable minds could differ -- are involved. And this is such an area.

We support the Comptroller's view that regulators should require a leverage ratio of 3 percent common equity capital. We disagree, however, with the OCC's position that only 3 percent is required and that there is no need to continue the 6 percent total capital standard.

We have taken that position for two primary reasons.

First, at a time when we are experiencing record bank failures, it is neither prudent nor wise to reduce capital requirements.

As I've said, if the risk-based capital requirements were the sole capital standard applied, almost 90 percent of the banks could actually reduce their capital cushion and hence their ability to absorb losses.

Thus, the actual dollars of capital available to support existing and ongoing risks that banks are exposed to could and no doubt would be reduced. This would result in a direct increase in the FDIC insurance fund's exposure.

That is simply bad public policy, at least from an insurer's viewpoint. It is fundamentally a position that the FDIC, as the institution that must write the checks to cover these problems, cannot endorse.

Indeed, our preliminary analysis reveals that supervisory problems exist in a vast majority of those banks that meet the risk-based test and a 3 percent equity capital gearing test, but fail to meet a 6 percent total capital test. [Those banks need more capital in any event.]

This leads me directly to the second reason that maintaining the current total capital floor is important.

Without that floor, many banks would find themselves with what they might think is extra capital on their hands -- at least on paper.

That could lead to two reactions, neither of which we consider safe or sound banking behavior.

Banks could use this apparent "excess" capital to grow rapidly. The banking system is already one of the most highly leveraged around -- creating enough incentives for risk-taking and growth. We don't need any more.

Moreover, banks might decide to distribute their additional capital to shareholders. Again, this would increases the net risk in the institution, and the risk to the FDIC.

The bottom line is that this is not the time to reduce capital requirements in the banking system. It is a time for increased capital requirements for those that are taking new risks with off-balance sheet activities.

The new risk-based capital standards were designed to deal with large institutions. They were not designed to deal with smaller banks and S&Ls -- and as a consequence, they must be backstopped with gearing capital standards.

One of our basic objectives is to protect your insurance fund. Protecting your insurance fund works directly, in turn, to prevent your premiums from increasing. [Lower premiums mean that you will be more secure even as you are more profitable. No magic here -- just good common sense.] [We believe that's what you'd like us to do.]

While on the topic of tough capital standards, I'd like to reemphasize the FDIC's support for the President's position on new capital requirements for thrifts.

As you probably gathered from my discussion on bank capital standards, the FDIC believes that sufficient capital is critical to maintaining a safe and sound system.

For that reason, we wholeheartedly agree with the President's proposal to enforce tough new capital standards for the thrifts, and not allow growth at institutions that fail to meet those standards.

All the federal bank regulators agree on this point, as well as do many S&Ls. The S&L industry is by no means 100 percent set against more stringent standards.

We believe the Congress, in its current proposals, may have gone too far in relaxing the President's capital plan. I want to say, though, that we do appreciate their efforts to establish minimum equity capital requirements and exclude subordinated debt and deferred loan loss reserves from core capital.

We can certainly appreciate Congress' concern about enacting standards that would unreasonably burden the thrift industry. And as the proposed insurer of the thrift industry, it would not be in our interest to support tougher capital standards that would drive viable institutions under.

But our analysis indicates that the capital standards proposed by the President are on target, especially since failure to meet these standards simply means no growth. After all, it was high growth at marginally capitalized thrifts that contributed significantly to the S&L problem in the first place.

I hope you all will lend your voices to those seeking stricter capital rules for thrifts. That will help create a more level competitive playing field, and a more stable financial system.

That final point concludes my remarks for this morning. I always believe it is better to stop speaking before your audience wishes you had.

That reminds me of the English gentleman who was once due to deliver the first speech of his initial American lecture tour. In anguish, he confessed to his agent that he was not the best of speakers. He felt certain his audience would all walk out before he could finish.

"Nonsense", reassured his agent, "You are an excellent speaker and will keep the audience glued to their seats".

"Oh, I say", cried the speaker, "That is an absolutely wonderful idea. [Pause] But do we dare!!!?

Thank you, ladies and gentlemen. I appreciate your attention. I will now prove that even the most conservative of deposit insurers are willing to live with great risk, now and then, by calling for your questions.