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STATE OF THE INDUSTRY AND FUTURE DIRECTIONS

Remarks by

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to the

Assemblies for Bank Directors

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Good morning everyone. Isn't it nice to be somewhere warm and sunny? I am very glad to be here and to participate with you in this important conference.

I have three missions this morning. The first is to debunk what is common copy in the media to the effect that the banking system is in a state of collapse and the end of the world is at hand. The second is to gaze into my crystal ball and share with you my view of the future direction of banking in the context of upcoming changes in the regulatory environment as the result of recent federal legislation. Finally, I have some thoughts about the role of bank directors in today's world.

On one point there is not much disagreement: The banking industry is battered and deeply scarred by the events of the last decade. Lending to lesser developed countries, once a cash cow, has become a cow giving sour milk. Leveraged buy-outs, junk bond financing, and the general multiplication of debt ratios for corporations and consumers soon reached the point where debt service became a major problem when a slowing economy cut back revenue flows for corporations and lay-offs made debt service almost impossible for many consumers. The junk bond market took a nose dive, corporate and personal bankruptcies escalated, and banks found themselves participating in creditor committees, foreclosing residential real estate and repossessing cars. But the biggest losses to the industry derived from the commercial real estate loan portfolio. Rosy expectations of ever-increasing asset values and higher and higher rents created a competitive feeding frenzy among bankers who adulterated sound lending standards in pursuit of market share. The price paid for a place at the table has been heavy in terms of loan losses, additional reserve provisions, and foreclosure and carrying costs on repossessed collateral.

At the end of the third quarter of 1991 there were 1,100 problem banks, almost 10 percent of the commercial banks in the United States, with $500 billion of assets.

While bad real estate constitutes the major portion of nonperforming assets, commercial and industrial loans and some consumer obligations are also included among the $96 billion of problem assets.

At the same date, other real estate owned through foreclosure totaled $24.9 billion, up from $21.4 billion at the end of 1990.

Net charge-offs for the first three quarters of 1991 were running at an annual rate of $31 billion vs. $29 billion in 1990.

Obviously these trends spell real trouble for the banks if they are not reversed. Indeed, the rate of deterioration has slowed, but the level of deterioration already realized remains a matter of concern to regulators and to the insurance fund.

Having recited that litany of gloomy statistics, I hasten to add that by no stretch of the imagination should we extrapolate those numbers to the whole industry. The overwhelming majority of banks are healthy. Many banks are more profitable today than they have been in many years. During the first nine months of 1991 almost 5,600 banks or 46 percent of the industry had returns on average assets in excess of one percent. That is the highest percentage since 1983. It is good performance in any year, and in 1991 it was very good indeed.

Obviously small banks constitute the majority of these high performance banks, but there are a number of larger banks with better earnings as well. It is interesting to note that during the first half of the Eighties only one bank larger than $10 billion reported an ROA for a full year of better than one percent. During the most recent two years, more than a dozen large banks have earned a better than one percent ROA.

In fact, during the years since 1988 more banks have had returns on assets better than one percent than in any other year in the last two decades. Those numbers reflect improvement in earnings performance of many large banks as well as smaller institutions.

Although 1991 was a very tough year, the industry earned almost $15 billion in the first nine months, or nearly $20 billion on an annualized basis, compared with $16.6 billion for the full year 1990. Projecting the results for the first nine months to the full year 1991, it looks as though the industry return on assets may have improved by as much as 10 basis points to about .60 and the return on equity one full percentage point to about 8.7. Those figures are certainly not wonderful, but neither do they represent an industry in a state of collapse.

Capital has become a focus of Congressional attention as attested to by the recent legislation and regulatory attention as the Basle risk-based capital standards are being phased in. On this front the industry has made real progress. Again, using third quarter 1991 figures -- the latest we have -- the industry had an equity to total assets ratio of 6.7 percent compared with 6.0 percent at the end of 1987. And I might add that that is the highest level for that ratio in at least 20 years.

In reference to the new risk-based capital standards, which become fully effective at the end of 1992, more than 96 percent of all banks currently meet those year-end standards. And, actually, they have capital in excess of minimum standards of about $70 billion. The two-tiered Basle capital standards require a minimum of 8 percent capital on a risk-weighted basis. In fact, the U.S. industry average at the end of the third quarter of 1991 was 10.7 percent.

But, let's not forget there are still some problems out there. Banks which do not meet the Basle standards have about $325 billion of assets or about 9 percent of the industry, and a few very large banks account for most of those assets.

We are not out of the woods yet. This will be another year marked by the failure of a rather large number of banks. Preliminary figures for 1991 show that 127 commercial banks with more than $63 billion assets failed. Conceivably 1992 might record similar numbers. That means that the FDIC will continue to incur heavy costs to resolve failed banks. Some estimate those costs could be as high as $15-25 billion in the next two years. Chairman Taylor of the FDIC has already indicated that those circumstances might require a further increase in insurance premiums which would be another blow to bank earnings just at a time when margins have widened and the general outlook has somewhat improved. A return to more vigorous growth in the macro economy and some firming of values in the real estate sector would help, but it is too early in the game to predict that outcome with any certainty.

On the whole, for those banks not struggling with massive nonperforming asset problems, the earnings outlook is quite favorable. Net interest margins have improved materially. The cost of funds has dropped far more than rates earned on assets, and the cut-throat competition that accompanied the aggressive pursuit of market share in the booming Eighties has diminished. Also, markets tend toward strong participants. Not only have the capital markets reopened to banks with high asset quality, but customers prefer to deal with someone they expect to be around for a while and in a position to meet their needs so strong banks will tend to reap the harvest of public concern about the health of weaker ones.

Bankers have also put their overweight institutions on strict regimens to slim them down. In the 21 months from January 1990 to September 1991, banks reduced staff by 2.6 percent or 40,000 jobs. And more of the same is in store in 1992. In fact, the pace of cost-cutting, largely through staff reductions, will probably accelerate in the next 12-24 months. Out-sourcing of services, particularly data processing and back-office operations, is too new to evaluate accurately as yet, but there are high hopes for further cost saving in that direction.

One major opportunity for improved earnings is inherent in the wave of intra-market bank consolidation which I expect to be a major characteristic of banking in the United States in the 1990's. The elimination of redundant facilities and personnel could materially improve operating efficiency and adjust the level of competition to the actual requirements of the market. Curiously, the industry's record in achieving economies from these kinds of mergers has been disappointing. Management determination to realize savings and materially improve earnings as fervently expressed to regulators and analysts before a merger has often moderated in the afterglow of consummation. The sometimes apparently ruthless staff reductions and branch closings which may be required to realize the expected benefits are relatively easy to rationalize away, and heartrendingly difficult to execute.

The winners in the 90's will be the tough-guy managers and directors who are willing to stick to pre-merger plans and cut the fat. The results will be ample reward. Eager capital markets will embrace new issues from aggressively managed institutions, shareholders will rejoice with the improved results and rating agencies will look favorably on upward revisions of credit ratings. The losers will be the fainthearted who have lifted expectations with rosy projections but have not had the courage to make them happen. This is a hard-ball game and its not fun to play, but the winners will be the real leaders of a revitalized industry.

As you know, the Federal Reserve Board has approved some mega-mergers recently which can be models for industry consolidation. The Chemical-Manufacturers Hanover merger is an example of an intra-market consolidation in a contained geographic area with little market concentration but many opportunities for cost reductions. The NCNB-C&S/Sovran deal has less overlap of facilities, but will still offer significant opportunities for enhanced earnings. The pending Bank of America-Security Pacific merger also involves a much bigger geographic area, but because of the extensive branch systems of both banks there is considerable overlap and cost elimination opportunity. Since 1985 alone 136 banks over $1 billion in size have been merged or affiliated with other institutions, and the trend will undoubtedly continue.

But make no mistake, the opportunity for intra-market consolidation and subsequent earnings enhancement is not just for big banks. Small and medium-sized banks in urban, suburban, and rural areas should move in the same direction. The earnings improvement opportunities for two $100 million banks in the same market are relatively as attractive as for giant money market institutions. The cry should be "come on in the water is fine!" There will be more of these moves in the future and I predict that the opportunities presented will not be ignored. Managers and directors will be tough and demanding and get all or most of the savings they saw in advance. It will be the beginning of a new era in banking -- an era in which management emphasis will be on asset quality, market segmentation, tight expense control and strong capitalization.

In order to look ahead intelligently to the future of banking in a changing regulatory environment, it is important that we understand one of the dominant phenomena in the current environment. The famous, or infamous, credit crunch has been a subject of controversy and concern for nearly two years. It has been coincident with the lapse of the economy into recession and its subsequent sluggish recovery. Indeed, Chairman Greenspan has suggested that the credit crunch has been a major inhibiting factor in the recovery process.

The classic definition of a credit crunch is a situation in which credit demand far outstrips the ability of the financial system to accommodate it. That is not what we are experiencing today. This credit crunch is more a psychologically induced condition than it is a function of supply and demand. Banks, adjusting to recent loss experience, new capital requirements and tougher examination standards, have been busy tightening credit standards, collecting problem loans, raising new capital or adjusting balance sheets to improve capital ratios. Recent experience with commercial real estate loan defaults has prompted some banks to exit that market entirely, and other loan categories having higher risk are being de-emphasized. Some bankers have retreated to the sidelines to wait out a more vigorous recovery and particularly more stability in real estate markets.

Consumers, badly shaken by the rise in unemployment statistics and almost daily media stories about corporate restructurings and accompanying job losses, have used available resources to reduce debt and are avoiding new commitments for cars, big ticket appliances and real estate purchases.

Businesses, many of which are still struggling under a heavy burden of debt incurred during the high-flying Eighties, are working down debt positions and postponing new investment in plant and equipment until they perceive real growth in the economy and a return of product demand.

In a word, ladies and gentlemen, confidence. A diminution of banker confidence has made banks less eager to lend. And depressed consumer and business confidence has resulted in slack demand. Put them all together and they spell credit crunch.

What to do? One wag has suggested we retain a behavioral psychologist to suggest ways to influence people's attitudes and alter behavior. But, before we bring in a shrink, we are participating with the other agencies in taking some discrete steps to promote availability of credit for qualified borrowers and ease pressure on real estate loans consistent with prudent supervision.

We have reminded examiners that the current market value of real estate collateral should not be the only criterion for assessing the quality of a loan. They should also consider normalized levels of cash flow, financial condition of the borrower, and other relevant factors.

Traditionally bankers cooperate with troubled customers to try to work out slow loans. Even banks with capital problems or in the process of working down loan concentrations should not abandon customers with soluble problems. We urge examiners and their supervisors to emphasize these points in their meetings with bank managers and directors.

Other areas under review as I speak include proper capital recognition of intangibles arising from purchase of mortgage-servicing rights and credit card loan portfolios. We are also considering changes in the definition of a "highly leveraged transaction" and the possible phasing out of the reporting requirement for these items on the call report.

The sum of these moves is to emphasize to examiners the importance of balanced evaluation techniques and to bankers the importance of continuing to make credit available to qualified borrowers.

The Federal Deposit Insurance Corporation Improvement Act of 1991 was a deep disappointment to those of us who worked hard to support the Treasury proposals for a significant restructuring of the U.S. financial system. In the context of perceived weakness in the banking system, scandals involving BCCI and Salomon Brothers, and intense lobbying by various special interest groups, Congress focused on refinancing the Bank Insurance Fund and tightening regulatory restraints. Much needed proposals for scrapping the obsolete Glass-Steagall Act, allowing closer ties between insurance companies and banks, permitting branch banking across state lines, and restructuring the federal regulatory apparatus were finally ignored. The resulting legislation not only tightens regulation of banks but it imposes additional reporting and compliance burdens as well. And to implement the legislation will increase the cost of supervision for all of the regulatory agencies.

I will mention a few of the requirements of the new law which affect most banks.

-- All banks must have a full-scope, on-site examination at least once each year.

-- A system of early intervention and prompt corrective action designed to prevent bank failures was adopted. Five specific levels of capitalization are identified and specific mandatory and discretionary corrective actions are associated with each. In implementing this section, federal regulators are charged with defining the appropriate level of capital at each level. The objective here is to provide a due process framework for intervention and specific authority for regulators to impose corrective measures of progressive severity.

-- Annual audits for all banks with assets in excess of $150 million are required. For subsidiary banks in a holding company the requirement is fulfilled by an audit of the parent. As it is, by 1990, 95 percent of all banks over $150 million assets met the requirement.

-- State-chartered federally insured bank powers are limited to those permitted to national banks unless they are adequately capitalized and FDIC determines that the activity does not constitute a significant risk to the insurance fund.

-- Regulators must develop uniform regulations regarding the standards to be used by banks in real estate lending.

-- The aggregate of all loans to insiders by a bank, including officers, directors and shareholders and their related interests, may not exceed unimpaired capital and surplus.

-- The regulators must adopt specific regulations establishing standards for banks' internal controls, information systems, internal audit, asset growth, excessive compensation, and other factors.

In addition, Congress has limited the Federal Reserve's ability to lend on an extended basis to troubled institutions. "Too big to fail" has been addressed tangentially by imposing a least-cost resolution requirement on the FDIC and shifting a "too-big-to-fail" determination to a formal action of the FDIC, Board of Governors, Secretary of the Treasury, and The President. The real hooker in this one is that, if such a course of action is pursued, any additional costs resulting will be recovered by a special assessment on the banks.

I could go on, but I think that gives you the flavor, and I suspect the flavor is bitter for many of you. In a sense the failure of this legislation to address basic needs of the industry is a failure of the industry itself. Bankers have always had difficulty among themselves in reaching consensus, although the ABA's bank leadership conferences have made some real progress in that direction. But when it comes to what is good for them, bankers fall into a multitude of common interest groups among which there is almost universal disagreement. The special interest groups which lobby against the interests of the banks, on the other hand, each have a single purpose. As a result, Congress finds itself in the middle of a cacophony of diverse pleas. At the end of the day Congress throws up its hands and does its own thing with the kind of result I have just described.

Finally, I would like to address briefly the role of directors in this changing world of commercial banking.

You bank directors carry a heavy responsibility and accountability. The shareholders who elect you delegate to you their authority to oversee management in the interest of protecting and enhancing their investment. If you fall short in carrying out that trust, they should throw you out, just as you would throw out a management which failed to meet its obligations. Sadly enough, shareholders for the most part are a widely diversified mass of individuals -- passive investors often investing through a third party money manager or other institutional intermediary. They are simply not organized to storm the annual meeting and dismiss the board.

I am sure that fact is a source of comfort to some, but it should also constitute a sober underscoring of director responsibility. For bank directors responsibility and accountability are also owed in two other directions which are sometimes less obvious. The first of those is to regulators and supervisors, for it is the responsibility of directors to oversee management's compliance with federal and state laws and regulations and that management conducts the affairs of the bank in a safe and sound fashion. The second is less obvious. It is the responsibility both management and directors have to depositors to use their money in a prudent fashion.

One of the most painful lessons of the last decade is that a headlong pursuit of rapid growth or greatly expanded market share is fraught with danger. Rapid growth in the loan portfolio in a competitive marketplace is often bought by making loan terms more attractive than those offered by competitors. Proceeding down that slippery slope usually involves cutting prices below measured risk or lending more than the collateral or cash flow will support. The experience of banks in the commercial real estate market in recent years is a perfect case in point.

Rapid growth through branch expansion or bank acquisitions is equally treacherous. In a highly competitive atmosphere it is all too easy to be persuaded that market expectations justify aggressive branching or that better earnings opportunities justify paying too much for another bank. Again, recent history provides many examples, the largest and most tragic being the Bank of New England failure last year. Steady growth with capital and reserves keeping pace with risk taking always provides the winners as in the fable of the hare and the tortoise.

As directors, you can and should be the balancing mechanism. In order to fulfill that role you have to be willing to say "no" even to management's most enthusiastically presented plan if in your objective judgment it is wrong. It is not easy to say no to the person who nominated you to the board in the first place, but remember it is the shareholders who elected you and it is to their interests you owe your first allegiance. You are, by definition, outside directors. That means you are not the captives of the manager even though he may be your best friend.

A well constructed board of directors for a bank will bring together persons of diverse background and experience from many fields of endeavor. It is that diversity which brings strength, but only if the directors are heard and if they express their opinions openly and freely. If your board does not provide an atmosphere in which you feel you can participate in that fashion you will find it difficult to discharge your responsibilities fully and may want to consider resigning.

Perhaps the key role of directors is to evaluate as well as advise management. The designation of senior officers, particularly the CEO, is the responsibility of the board. That means you must pick carefully, you must objectively review and evaluate performance against established standards, and you must be willing to cut your losses if you have made a mistake by dismissing anyone who has failed to meet those standards. The days when an officership in a bank was a sinecure are long gone even for the chairman of the board. The demands of a competitive marketplace and a stringent regulatory environment will not tolerate inferior performance and you must be the arbiters.

You may think this is tough-guy talk and uncalled for in a conference of this sort. But I need not remind you that these are tough times. You bear an awesome responsibility whether you are a director of a big bank or a tiny one. You are here because you take that responsibility seriously. I compliment you on that, thank you for being here, and I look forward to participating with you in the sessions ahead.

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