NOT RELEASED

CHALLENGES FACING THE BANKING INDUSTRY
IN THE DECADE OF THE 1990'S

Remarks by

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to the

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I want to discuss with you today the current conditions of the United States banking system, recent federal banking legislation, and the urgent need for further legislation to reform the financial system of the United States to assure its continued competitiveness in world markets.

The banking industry is battered and deeply scarred by the events of the last decade. Lending to lesser developed countries, once highly profitable, became a nightmare in the early 1980s. Leveraged buy-outs, junk bond financing, and the multiplication of debt ratios for both corporations and consumers reached the point where debt service became a major problem. The slowing economy reduced revenue flows for corporations, and lay-offs made debt service almost impossible for many consumers. The junk bond market collapsed, and corporate and personal bankruptcies escalated. In that environment banks found themselves participating in creditor committees, foreclosing residential real estate, and repossessing cars. But, the biggest losses to the industry were in the commercial real estate loan portfolio. Expectations of ever-increasing asset values and higher and higher rents, created excessive competition among bankers who weakened lending standards in pursuit of market share. As a result, there have been heavy loan losses, large additional reserve provisions, and unforeseen foreclosure and carrying costs on repossessed collateral.

The consequences of these events are still with us.

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

Bad real estate constitutes the major portion of nonperforming assets, but commercial and industrial loans and some consumer loans 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 for all of 1990.

Obviously these trends are 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 real concern to regulators and to the insurance fund.

Having recited all of those 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 of banks earning that level of return since 1983. It is good performance in any year, and in 1991 it was very good indeed.

Small banks constitute the majority of these high performance banks, but there are a number of large banks with better earnings as well. It is interesting to note that during the first half of the 1980s only one bank larger than $10 billion reported a return on assets for a full year of better than one percent. During the most recent two years, more than a dozen large banks have earned better than one percent on assets.

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 difficult 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 by U.S.

standards, but neither do they represent an industry in a state of collapse.

Capital has become a focus of Congressional attention as shown by the recent legislation and a focus of 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.

1992 will be another year marked by the failure of a rather large number of banks. Preliminary figures for 1991 show that 127 banks with more than $63 billion of 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 intense competition that accompanied the aggressive pursuit of market share in the booming 1980s 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. As a result, 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. But, 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-minded managers and directors who are willing to stick to pre-merger plans and cut the fat. The results will be an 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 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.

I want to emphasize that 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 will move in the same direction. The earnings improvement opportunities for two $100 million banks in the same market are as attractive as for giant money market institutions. There will be more of these consolidations 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 available. 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.

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. Because 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 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 and the cost of compliance for all banks.

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.

I could go on, but you are as familiar with all of this as I am. In a sense the failure of this legislation to address basic needs of the industry is also 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 beset by 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.

I can assure you without fear of error that, unless Congress enacts drastic reform measures for our financial system in the next few years, the United States will become a fading factor in world financial markets. Until now, the money and capital markets of the United States have been the largest, most efficient and most innovative in the world. They have been the model for the development of market institutions elsewhere, and they have been a major factor in maintaining a lead position for the United States economy.

Unfortunately, Congress, preoccupied with short-term political considerations, has failed to recognize that banking legislation for much of the last two decades has focused on regulation, reporting, disclosure, and compliance rather than financial integration, improved service to consumers and business, and competitive equality with the financial institutions of other countries operating in the same global marketplace.

If the United States is to remain competitive, we need prompt legislative action to reduce significantly the burden of regulation and compliance, which I believe may cost the banking industry alone several billions of dollars a year.

We also need legislation to rationalize the federal regulatory structure to eliminate the confusion of five different federal regulators of depository institutions. I would favor one regulator for all federally insured depository institutions and one deposit insurer which would also act as a back-up regulator.

The United States is the only country in the world I know of which builds geographic barrier around its banks' operations. We should permit branching across state lines wherever interstate banking is permitted.

Large and medium-sized banks, which are qualified, should be permitted to affiliate with securities companies or enter the securities business <u>de novo</u>. Through securities affiliates, they should be permitted to underwrite and trade in corporate debt and equity securities.

Europe is already moving to recognize the natural affinity between insurance and banking. Banks offer an efficient distribution system for insurance products and those insurance products would enable banks to offer a broader spectrum of financial services to their customers. We should permit banks and insurance companies to affiliate through ownership of one another or through contractual agency relationships where they can distribute each other's products and services on a mutually profitable basis.

I also believe that banks should be permitted to operate real estate agencies so that they may assist customers to find houses as well as finance them. This is a minimal risk business which is not capital intensive and is really only denied to banks by the special interest lobbying of the real estate industry.

The additional powers and relaxed regulation I have suggested are critically important to the future of the United States banking system and to those from other countries who want to participate in banking here.

Banks must find a way to reconcile the differences which exist among themselves and present a more united front or Congress may continue to ignore their plight.

At the same time banks must recognize that higher capital standards create a real need for more efficient operations in order to earn the returns expected by the markets.

The future is not an easy one for banks. Until reform legislation is transformed from dream to reality, banks must deal with oppressively excessive regulation and compliance while at the same time falling further behind competitively both at home and abroad.

I would personally favor a nongovernment commission of eight or ten widely recognized individuals from the private sector who would study our financial structure, determine its competitiveness, and recommend broad legislation to assure a competitive stance abroad and a competitive position domestically which is fair and equable to banks and other financial institutions.

Thank you for your patience while I have been on my soap-box. Now I'd like to try to answer your questions.

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