NOT RELEASED

Remarks by

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It is always a great pleasure for me to get back to New York. And this is a special occasion, because it gives me an opportunity to share with you my views of the banking industry, an industry in which we have a keen common interest.

I believe that a strong, aggressively competitive, and innovative banking system is vital to the economic health of the nation. I also believe that Congress is unintentionally smothering the vitality of banks under countless layers of increasingly restrictive statutory operating constraints and detailed consumer protection laws which are largely unneeded and compliance with which is a costly burden.

But before we consider what needs to be done, let's take a closer look at where we are today.

In the past 15 years, banking has been on a roller-coaster ride that was a rather dramatic change from the gentler passage of the preceding 45 years. Quite aside from the much discussed and probably over-analyzed S&L debacle, commercial banks have had to deal with a switch from regulated deposit interest rates to a free market. That eagerly sought change contributed fatally to the S&L mess and was in part mismanaged by the commercial banks. It was closely followed by the LDC crisis. Then the LBO, HLT and junk bond era came along while simultaneously the commercial banks were in a feeding frenzy to replace lost C&I loans with commercial real estate and pick up the slack left by the failed thrifts.

For the commercial banks the chickens came home to roost toward the end of the Eighties. Commercial real estate collapsed with a thunderous roar in New England, the Eastern Seaboard, and most recently in Southern California.

Less than two years ago alarming conditions were generally present in the industry.

From year end 1989 to year end 1991 problem assets increased by nearly $30 billion to 2.6 percent of industry assets. Provisions for loan losses over the two years totaled $66.1 billion or nearly double the combined net income of $34.5 billion for those two years]. During that same period, 263 banks failed with about $53 billion in assets. At the same time the number of problem banks stayed stubbornly high at about 1,100, and the assets of problem banks jumped from $188 billion to $528 billion. As a result of the high level of problem banks, the GAO required the FDIC to establish a $16 billion reserve for the bank insurance fund that placed it temporarily in a $7 billion deficit position.

Those trends and conditions prompted Congress to authorize the bank insurance fund to borrow up to $30 billion. At the same time Congress unleashed an onslaught of new bank regulatory statutes including prompt corrective action, annual audit requirements, real estate loan standards, safety and soundness standards, improvements to risk-based capital, and what I call the nonsense provisions of Section 132 which call for standards of compensation, earnings, growth rates, and most unbelievable of all a standard for the market to book value of bank stocks.

However, time, tide, a refreshed economy, lower interest rates and eager capital markets have changed the fundamentals dramatically.

1992 was a banner year. The industry had record annual earnings of $32.2 billion, nearly as much as the combined net income over the previous two years. And the industry return on average assets was 0.96 percent -- respectable by any standard.

There was a $12.5 billion reduction in nonaccrual loans and OREO in just that one year span.

Capital continued to improve to an equity-to-assets ratio of 7.5 percent, the highest level since 1965. Perhaps most surprising, 99 percent of banks meet the new total risk-based capital standard.

Ninety-seven banks with $16 billion of assets failed in 1992, down from 105 failures with $43 billion of assets in 1991.

At the same time, the number of problem banks has declined from 1,016 with $528 billion in assets at year end 1991 to 787 with $408 billion at year end 1992, and those numbers appear to be heading down further. Only a handful of banks are critically undercapitalized at less than 2 percent and the assets in that group are less than $7 billion.

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What the latest results show is that things can change and change dramatically in a relatively short period of time, and it is in that context that I think we should approach an effort to talk about the outlook for the industry with caution.

I will divide the remainder of my comments into a separate observations on the short- and long-term outlook for the industry.

Over the short term, I think we can rely on some of the recent trends as a guide to what to expect next.

The dramatic earnings improvements during 1992 over 1991 levels came primarily from wider margins and lower loan loss provisions. That raises the reasonable question whether that level of earnings is sustainable over the longer run.

Recent spreads have been high in historical terms . Net interest margins had trended up gradually throughout the 1980's but the 1992 margin jumped to 4.0 percent, That is, high relative to the 3.5 percent spread of just two years ago and the 3.0 percent level at the start of the 1980's.

What was the source of the recent sharp increase? Well, a declining rate environment during a time of weak demand for loans; lower need by banks for deposit liabilities; a general tightening in standards including pricing by banks, which was made possible in part by a pull back of foreign bank competitors, insurance companies and thrifts; and finally a reduced emphasis on asset growth.

recent years. Banks are also lagging market price reduction of commercial, consumer, and credit card loans. For example, prime is 3 percent above fed funds, compared to a more typical 1.5 percent spread historically.

The steep yield curve opened the spread between short-term liabilities and securities yields to widen. That spread in 1990 was about 60 basis points. In 1992 it was 240 basis points. The magnitude of that earning opportunity encouraged banks to add securities in the light of slack loan demand.

What will happen to those margins over the next year or so if rates remain unchanged? Certainly repricing of bank liabilities seems to be approaching completion, but asset yields will continue to adjust downward as assets reprice or cash flow is reinvested at lower yields.

In short, the flattening of the yield curve in the first quarter by 50 basis points or so will tend to narrow net interest margin as assets and liabilities fully reprice.

All this suggests that margins are susceptible, and unlikely to remain at present levels.

But we also need to ask what happens if rates rise? Some believe if that is the case margins will compress considerably more. That is because there has been a lengthening in the repricing of the banking industry's assets over the past several years as the industry has shifted the composition of its assets to some degree. All else being equal, this would cause margins to narrow if rates were to rise, but there is certainly a partial offset in the growth of adjustable rate loans and more sophisticated portfolio management. But the effect of these offsets is hard to quantify.

In any case, the record indicates the industry has been able to manage its repricing of assets and liabilities under both rising and falling interest rate conditions in the past. But it should not be assumed that there will not be temporary changes in margins of varying degrees during periods of rapid change in rates, either up or down.

It is a fact that when short-term rates shot from average levels of around 5 percent in the mid-1970's to around 10 to 14 percent in the early 1980's, the industry's net interest margin actually improved in some years and generally stayed between 3.1 and 3.3 percent.

In the current situation, given how wide spreads are right now, I believe the odds are that margins will narrow if rates suddenly increase.

Let's move on to other sources of earnings gains. The banking industry also had higher revenues from selling securities from the investment portfolio and from foreign exchange activities. Over the next few years, though, bankers may have to come to terms with a loss of revenue growth opportunities in these areas.

Gains on securities sales were $4 billion in 1992 and $3 billion the year before that. For the period 1989-92, those gains accounted for about 7 percent of pretax income for the industry as a whole. However, for banks with assets greater than $10 billion, securities gains represented over 12 percent of income.

The opportunity to realize gains on the investment portfolio is likely to become rarer. The principal reason is proposed accounting changes by FASB to introduce market value accounting for investments that are held for sale. In addition, increased focus by the SEC and banking agencies on institutions to distinguish between securities held for investment and those held for sale. Partly in response to this pressure, banks had designated 16 percent of securities on their balance sheets as held for sale.

Nevertheless, the industry had unrealized gains on securities of $16 billion at year-end 1992. Assuming no change in the markets, some of that may be used to supplement operating income in 1993. First quarter reports may indicate a trend.

Income from foreign exchange trading was $3.3 billion in 1992, up from $2.6 billion in 1991, which was the average level for the preceding five years. These foreign exchange revenues accounted for about 7 percent of pre-tax income in 1992. It should be remembered that a relatively small number of banks account for all foreign exchange trading for the entire industry. Whether those banks can continue to post such strong performance is open to question, but it does not seem likely that the conditions in the currency markets which foster the necessary trading opportunities will change much in the near future.

Another major source of recent earnings improvement has been lower loan loss provisions as a result of the improved outlook for asset quality. Last year's lower provisioning is likely to continue given the following trends: First, both nonaccrual loans and other real estate owned fell during the year for a combined reduction of $12.5 billion, or about 14 percent. Second, delinquent loans, that is to say 30-89 days past due and still accruing, are down 17 percent from year-end 1991. Third, reserves were a conservative 102 percent of nonaccrual loans at the end of 1992.

While certain pockets of the United States are obviously still troubled, notably New England and Southern California, there seem to be, in general, good prospects for a stable lending environment. That increased stability, coupled with what I hope is a wiser and more seasoned industry, should improve loan loss experience in the immediate future.

It is easy to forget that throughout the 1970's and early 1980's loan loss provisions as a percent of assets hovered around 20-40 basis points. That was considerably below last year's 77 basis point level and only a fraction of the 100 basis point level at the peak of the crisis.

What are the other sources of long-term earnings growth?

Well, the lion's share of noninterest income is coming from service charges on deposit accounts, and trust activities. Growth in those areas will depend on the industry's ability to retain market share and provide outstanding customer service at a reasonable cost.

Another source of recent earnings growth has been cost cutting. There is evidence that the industry has made some headway in this area. The number of employees in the industry has been pared back from a peak level in 1985 of 1.6 million to about the level the industry had in 1980 or 1.5 million. Noninterest expenses as a percent of revenues, which is a to measure efficiency, have declined from 69 percent in 1991 to 66 percent in 1992. Certainly that is an indication that recent restructuring initiatives are beginning to pay off. That 66 percent, by the way, is below the industry's average of 67 percent for 1969-92. I find this indication of better cost discipline particularly encouraging.

Finally, it is logical that, at some point in the next few years, deposit insurance premiums may decline, especially for well-managed institutions.

I believe the outlook for earnings in the next two to three years appears generally favorable. But should we conclude on that basis that all is well with the industry? I don't think so.

Competitive pressures facing the industry have gained strength and appear likely to continue to do so. Banks lost market share in the business finance sector, including their "best" customers, to the commercial paper market, to private placements of debt, and to finance companies and foreign banks.

Market share was also lost in consumer lending from finance companies, credit unions, and the credit card business of GM, ATT, Sears, and others.

The deposit side of banking has also suffered from competitive pressures: mutual funds and annuity products have made major inroads. Also demographic changes. Younger Americans are not automatically oriented toward banks for financial services. They get them where it is most convenient and where they get the best deal.

If you look at market share of all lending using flow-of-funds data you will see that banks are losing market share to their competitors. Breaking flow-of-funds data into two periods of 80-86 and 87-91, bank's share of the lending market declined from 17 percent to 11 percent. The capital markets and insurance companies have made the greatest gains. Each has gained 7-8 percentage points during those periods.

On the funding side, bank core deposits have been growing, but that growth may be less than its full potential. Mutual funds and annuity products may continue to capture a significant portion of available consumer funds. To some extent, there is an uneven playing field created by the regulatory restrictions on banks. On the other hand, maybe banks have not had a strong enough desire to keep their share of this market. It was easy to buy money from the market and less troublesome than wooing consumers.

So, competition has been and will continue to be intense, and that poses a major long-term challenge for the industry. Banks should not be shielded from competition. The various developments that have enabled competitors of banks to gain market share have occurred because customers were offered better terms on loans or investable funds. That is the way a market system is supposed to function.

But there has been and still is an important factor that places banks in an unfair economic position and impairs the industry's ability to compete. The impairment comes in the form of regulatory burden and unjustifiable legal restrictions.

FIRREA and FDICIA added to an already heavy structure of regulatory burden. It must also be emphasized that the various consumer protection laws, however beneficial they are, impose heavy costs on the industry. An Exam Council study, mandated by the Congress, reported that various private studies indicate costs of regulation range from $8 billion to $17 billion. That is excessive not only in direct cost but also in time-consuming management attention.

The agencies took some steps last year to relieve burden. But to achieve a material reduction, banking laws must be changed. The agencies are currently reviewing potential changes under the auspices of the Exam Council, and a report is expected to be available around mid-year.

It is imperative that legal restrictions be removed. The McFadden Act and Glass-Steagall should be repealed. Other powers including most insurance activities should be permitted as they are in European countries and Canada.

Banks should be permitted to carry out their activities in ways that are most efficient and cost effective; and they should be permitted to offer a range of services and products that best serve the needs of their customers. The general public will then be served.

In the interest of breaking the political log jamb which has blocked banking structure reform for the last five years, I have proposed a civilian commission to study the domestic and international competitiveness of the system and propose a legislative agenda to the Congress.

Such an approach might depoliticize the subject enough to enable Congressmen to vote for fundamental reform based on a zero-based reappraisal of regulatory structure and constraint.

So far there has not been a rush to embrace my suggestion, but Congressman Steve Neal has shown some interest.

Thank you for letting me share my views. Are there any question?

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