The Federal Reserve Board

Remarks by Governor Mark W. Olson

At the Economic Growth and Regulatory Paperwork Reduction Act of 1996 Outreach Meeting, St. Louis, Missouri
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Bank Management Challenges in a Low-interest-rate Environment

Much has been said about the challenges for monetary policymakers in the current low-interest-rate environment. It is important to note that the same economic forces that are confronting the Federal Reserve's Federal Open Market Committee (FOMC) are also creating new management challenges for the banking industry.

Because we are now in a blackout period following yesterday's FOMC meeting, I will not comment on monetary policy. Instead, I will focus on the challenges that I see for bank management in a low-interest-rate setting. These views are my own and do not necessarily reflect the views of my colleagues on the Board of Governors or the FOMC.

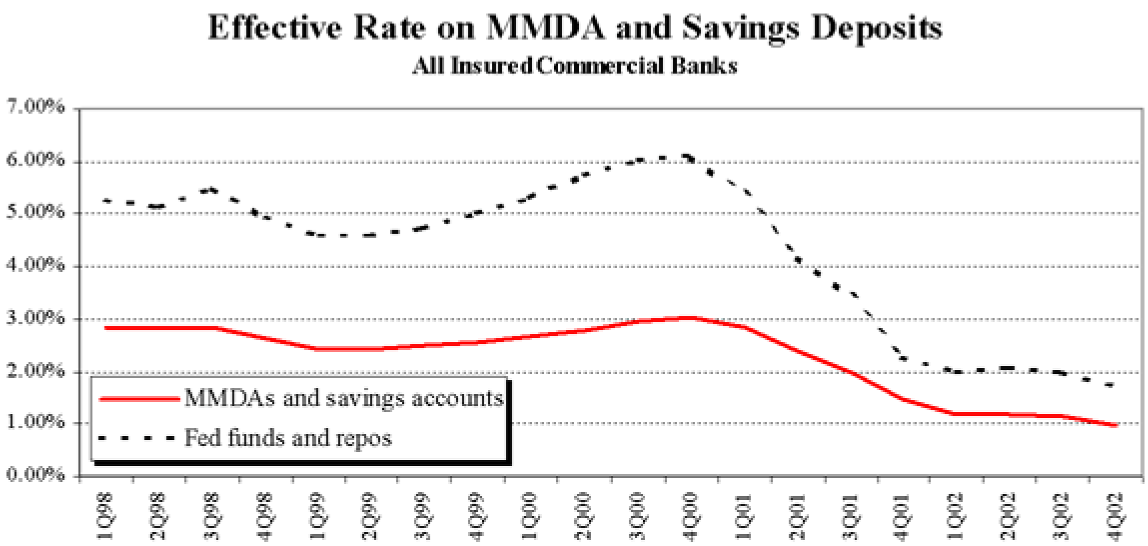
After posting record profits in 2002, the United States banking industry produced another new record in the first quarter of this year by generating $24.6 billion in earnings. Growth in core deposits, vibrant mortgage banking activity, and improved asset quality are some of the major factors contributing to the strong earnings performance.

A close examination of the first-quarter call report data, however, indicates significant changes in banks' balance sheets and income statements that reflect how the banking industry has adapted in this low-interest-rate environment. Let me first review some of these changes, then discuss what I believe to be the management challenges they present.

The most pronounced effect of the current climate has not been prominent in the headlines but is well known to the industry. We have seen remarkable and sustained growth in core deposits, especially money market deposit accounts (MMDAs) and savings accounts. Already a large component of bank balance sheets, these two accounts grew by an astounding 21 percent in 2001 and 18 percent in 2002. That growth rate--essentially 5 percent each quarter--continued in the first quarter of this year. MMDAs and savings accounts have historically been characterized as stable and slow-growing. Their remarkable transition to high-growth products reflects both the weak equity market and limited alternatives for higher yields.

Now, however, these two types of accounts fund approximately 30 percent of bank assets, which means the composition of bank deposits has changed quite a bit in a short period of time. For many years, banks relied increasingly on short- to medium-term wholesale deposits (foreign time deposits and large dollar, or jumbo, certificates of deposit) to fund much of their asset growth. As recently as year-end 2000, these wholesale deposits accounted for about one-fifth of overall funding, about the same share as MMDAs and savings accounts. Since that time, the remarkable growth in MMDA and savings deposits suggests that the proportion of funds provided by wholesale deposits has fallen off considerably. Smaller certificates of deposit--those under $100,000--have actually declined in absolute terms over the same period.

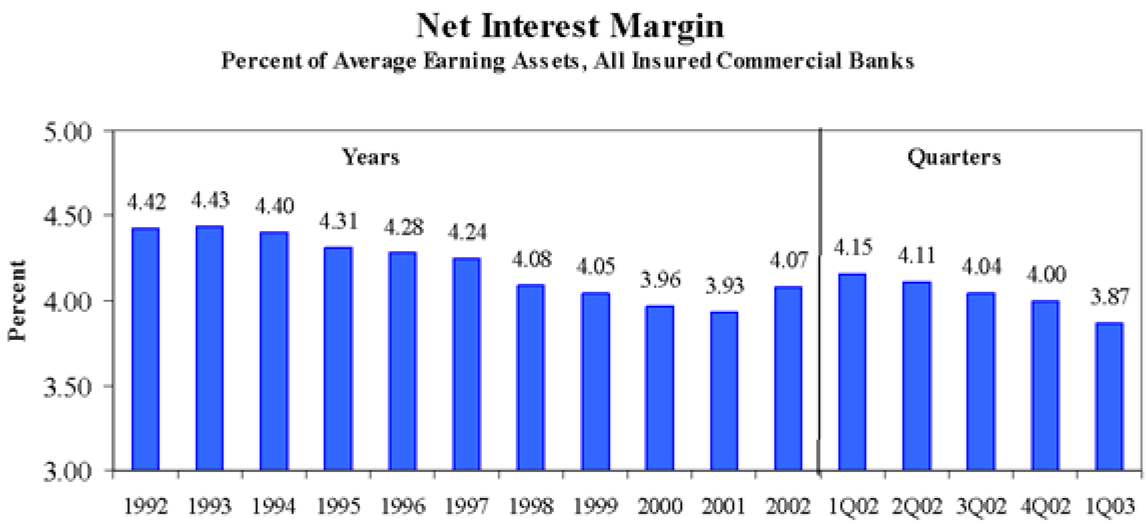
As MMDAs and savings accounts have continued to grow, low interest rates have also affected the pricing of these deposits. The rates paid on these accounts have generally moved in tandem with interest rates on short-term investments such as repos and fed funds. As market interest rates fell to very low levels in 2001, however, the spread between these deposit rates and market rates narrowed considerably. When the average effective rate on MMDAs and savings accounts reached about 1 percent in early 2002, banks seemed to become much more reluctant to reduce their rates on these accounts.



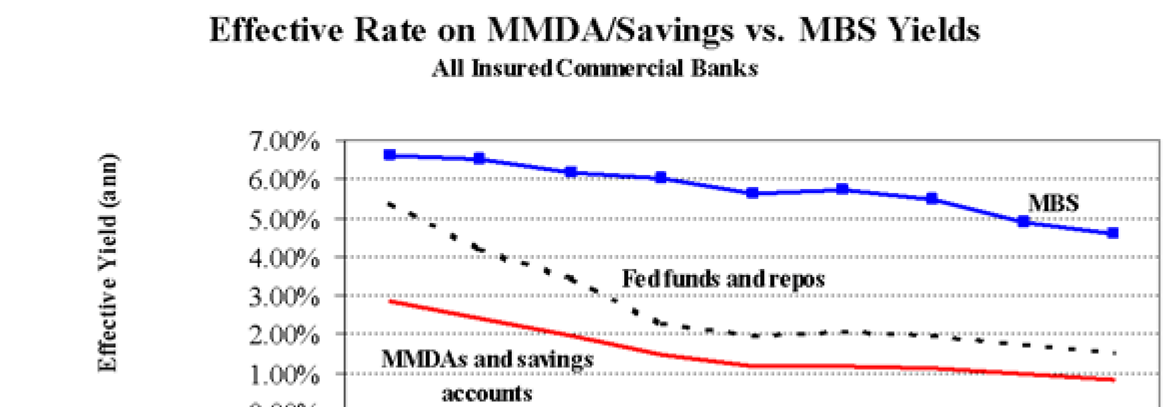
A second impact of low interest rates has been reflected in mortgage loan activity. Banks have accumulated mortgage-related assets both in their loan portfolios and in the form of mortgage-related securities--in particular, pass-through securities. Taken together, one- to four-family residential mortgage loans and pass-through securities grew by 10 percent in 2001 and by more than 17 percent in 2002. Residential closed-end mortgages and mortgage pass-through securities represented more than 20 percent of bank assets as of March 2003, up from 17.5 percent in 2002. Home equity lines of credit grew at an even more rapid 20 percent in 2001 and 39 percent last year. The underlying economic strength of the U.S. household sector made residential mortgages attractive to banks at a time when business-loan demand was low.

The continuing decline in interest rates that fueled the growth in mortgage lending has also, predictably, had an impact on yields in mortgage loan and mortgage securities portfolios. Yields on mortgage-backed securities (MBSs) have declined from 5.63 percent in the first quarter of 2002 to 4.58 percent in the first quarter of 2003. This decline of over 100 basis points represents both accelerating prepayments and declining rates for newly issued securities. Non-interest income from mortgage activity was both positively and negatively affected. While mortgage-origination fees increased, prepayment activity reduced the value of mortgage servicing rights and ultimately realization of income from that source.

As low interest rates have persisted, the key rate of revenue generation for banks--the net interest margin--has come under considerable downward pressure. Although low market rates initially helped to widen the spreads earned by banks, the industrywide net interest margin declined steadily over the past year, from 4.15 percent in early 2002 to 3.87 percent in the first quarter of 2003. That 28-basis-point decline in one year compares with a 35-basis-point drop during the entire decade 1992 to 2002.



The source of this recent margin compression can be traced to two primary influences: the self-imposed restraints in pricing MMDA and savings deposits and movement in the spread between residential mortgage assets and these deposits. In short, the two balance-sheet categories that have been most affected by the current environment appear to explain much of the movement in the industry's net interest margins.



	1Q01	2Q01	3Q01	4Q01	1Q02	2Q02	3Q02	4Q02	1Q03
MBS	6.63%	6.50%	6.15%	6.03%	5.63%	5.72%	5.49%	4.89%	4.58%
MMDAs and savings accounts	2.83%	2.39%	1.98%	1.46%	1.18%	1.19%	1.15%	0.99%	0.84%
MBS-MMDA spread	3.79%	4.10%	4.16%	4.57%	4.45%	4.53%	4.34%	3.90%	3.73%
Fed funds and repos	5.39%	4.19%	3.45%	2.29%	1.99%	2.05%	1.97%	1.72%	1.51%

Also contributing to the strong profit performance of the first quarter were securities gains. We have not seen such a sizable contribution to pretax profits from securities gains since 1993. To some extent, these one-time gains have been used to offset well-publicized and unusual expenses related to credit losses and anticipated litigation expenses. Though relatively large, the gains recorded in recent quarters are arguably not out of line with historic experience, if measured as a percentage of total unrealized gains on the securities portfolio.

Management Challenges

Decisions made by bankers in today's unusual interest-rate environment can have important long-term consequences. The compression of interest margins is alerting bankers to the fact that their ample supply of core deposits provides a liquidity cushion that is fairly expensive in this setting. A natural reaction for banks would be to move out on the yield curve to achieve better interest margins. With much of the asset growth for banks being funded by core deposits, it would be natural to assume that savings and MMDA accounts will continue to demonstrate the same relative stability and reliability as in past years. However, past experience indicates that depositors' behavior can change significantly as interest rates change, particularly under unusual or exceptional interest-rate conditions such as we have today. In another period of exceptional interest rates--the late 1970s and early 1980s--many banks that were funding long-term assets with four-and-one-half or six-year certificates of deposit found that depositors were accepting substantial interest penalties--as much as six months' interest--to shorten their maturities and considerably improve their yields. Banks and thrifts then faced significant, and in some cases critical, interest rate risk exposures.

Should interest rates return to levels of prior years, banks that rely on their savings accounts and MMDAs to fund long-term assets may be wise to consider the possibility of facing unexpected liquidity or interest rate risk pressures if depositors choose to shift deposit funds into other investment vehicles to enhance the return on their assets. Neither bankers nor supervisors have yet experienced such a situation, and it might present unusual challenges to both parties. For example, in such a setting, banks would be forced to decide whether to adopt deposit-pricing strategies to maximize near-term earning or, alternatively, focus on deposit retention.

A second example of how a decision made today might affect future performance involves the large volume of securities gains being recorded by the banking industry. Booking such gains will enhance near-term profits, but only at the price of sacrificing higher-yielding assets from future net interest earnings.

If the management challenges of this environment could be reduced to a single issue, that issue would be the need to balance the opportunities of the present with the prospects for the future. Through a surge in core deposits, today's low interest rates have given banks an unusual opportunity to regain deposits lost during the past decade to money market funds and other investments, without the need for massive investment in bricks and mortar. Through judicious management, banks may be able to retain some portion of these gains beyond this period of low interest rates.

Now that I have discussed the management challenges posed to bankers by low interest rates, I should note that this environment also affects their customers. Some, such as mortgage borrowers, obviously have benefited. For others, namely depositors on a fixed income, low rates are a challenge. We at the Federal Reserve do assess the impact that changes in interest rates can have on particular segments of the economy, both advantageous and disadvantageous, and we are, of course, aware that people on fixed incomes can be adversely affected as rates decline. The goals of monetary policy, however, are to foster conditions conducive over time to maintaining low and stable inflation and maximum sustainable economic growth. As policymakers, we must make decisions that provide the greatest benefit to the economy overall. When the economy is weak, for example, increasing rates would likely result in further weakness, a result that would not be in our nation's best interest.

Today's EGRPRA Meeting

Adapting to changes like these is part of the banking business. Supervision and regulation must also evolve and adapt to new developments. But shifting regulatory approaches unavoidably leave obsolete regulations in their wake. Business people and bankers in particular complain, certainly with some justification and perhaps with some exaggeration, that so many regulations are on the books that at any given time they are probably unknowingly in violation of some of them.

We at the Federal Reserve endeavor to review all of our existing regulations every five years in order to revise or rescind those that are unnecessary or out-of-date. Other banking regulators have adopted a similar approach. The current Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) regulatory review supplements these periodic reviews by the agencies. It provides a unique opportunity for financial institutions, the agencies, and other interested parties to step back and look at groups of related regulations and identify opportunities for streamlining regulatory requirements, implementing other burden-reducing actions, and identifying needed statutory changes.

We welcome this opportunity to revisit and streamline our rules. Some improvements can be made by the agencies; others will require congressional legislative action. Both regulatory and congressional efforts to eliminate rules that are not needed to protect the taxpayer are worthwhile. But we can make these improvements only with your help; so we welcome your suggestions. These suggestions can be most productive if you tell us how we can accomplish the goals of regulation--safety and soundness and consumer protection--in a less burdensome way. We look forward to working together--regulators, bankers, and the public--through this interagency EGRPRA review process to rid ourselves of unnecessary regulation and ensure the continued vitality and safety of our banking system. It is in the long-range interest of both bankers and regulators that the ultimate goal of this exercise be to improve both the efficiency and the financial stability of our banking system.

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