Remarks by Governor Mark W. Olson

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Current Industry Issues

Thank you for inviting me to your conference. The financial services industry--the insured depository sector in particular--has been accorded two unique responsibilities: It is the repository of the payment transfer system and the conduit for deposit insurance. Along with these valuable benefits, and because of the unique role they confer, your segment of the industry receives a high degree of legislative and regulatory oversight.

Also, your regulatory and legislative environment changes continuously as market forces and economic conditions evolve. Those of you who take time away from your financial institutions and your families to help formulate your industry's position on governmental issues do both your industry and your country a service, and I salute you.

Today I will provide a brief overview of community banking's economic health, review some recent regulatory changes, remind you of some issues currently on your legislative plate, and close with observations on what might be on the horizon.

Financial Condition of Community Institutions
The past year was interesting and challenging for many U.S. banks and thrift institutions. Economic weakness led to a steady decline in market interest rates, further deterioration in asset quality, and for many institutions, a year of slower growth in earnings or even losses.

Although the macroenvironment most heavily affected large regional and money-center banks, strains are also showing at smaller institutions. As a group, commercial institutions with assets of less than $1 billion--a common definition of "community banks"--reported smaller net interest margins for the year and weaker asset quality. Reserve coverage of nonperforming loans also declined, to less than 1.5 times problem loans compared with 1.7 for 2000. The number of problem smaller institutions has increased, and the costs of several recent bank failures raise the specter of a return to significant insurance premiums.

It is clear, however, that U.S. depository institutions, including commercial banks and stock and mutual thrifts, remain sound, with still historically strong profitability, capital ratios, and loan portfolios. Without becoming complacent, the industry can take comfort, so far, that it has withstood the recent economic weakness quite well. Importantly, the financial performance of community institutions over this past year reaffirms that the historic business model still works. Depository institutions can attract and maintain core deposits and find lending opportunities that generate a manageable spread. A combination of non-interest income generation and efficient management produce both return-on-asset and return-on-equity ratios that, for community banks, are consistent with historic norms. Continued growth in the number of de novo banks and branch offices also suggests that the outlook for community banks remains bright. The number of small banks continues to shrink, but, as with larger banks, this decline seems to reflect consolidation, not weaknesses in your charter. Your management challenges in the future, however, will not, in my view, be easy.

As a Fed governor, I should not miss the opportunity to sound a cautionary note to bankers. While clearly divorcing the following point from any suggestion about the future direction of monetary policy, I note that interest rates are historically low and that the effective maturity of many banking assets has increased. During the fourth quarter of last year, in particular, the industry enjoyed a large inflow of low-cost core deposits. These funds helped boost earnings and net interest margins throughout the industry. They may also, however, prove difficult to retain when market conditions improve and depositors leave the safety of insured deposit instruments for the potential higher yields of equities.

Lending and deposit-taking have long been the life-blood of community institutions, yet certain long-term trends may give cause for concern. For the past decade, for example, the share of banking assets funded by core deposits has steadily declined. Ignoring the performance of last quarter, fewer and fewer funds are being made available to banks at such low cost. The evidence clearly indicates that community banks have been as successful--if not more so--than the larger, even the largest, banks in obtaining non-insured deposits, but this success has entailed an increase in their deposit costs.

If, as recent economic studies suggest, economies of scale are more important in banking than previously thought, they will lead to continuing pressures on small banks. Studies conducted in the 1980s and early 1990s found that economies of scale were initially achieved by the largest institutions where size and technological sophistication could lead to greater efficiencies. This evidence is consistent with the increasing competitive pressure that community bankers feel and their growing need to adopt some of the larger banks' procedures while keeping the community touch that larger banks seem unable to replicate. Increasingly, the tradeoff between the relatively high-tech, market-pricing strategy of the largest institutions and the high-touch, personalized service of smaller institutions has become apparent.

Let's turn now to some recent regulatory actions of interest to community bankers.

Regulatory Developments in Consumer Financial Services
In the past few months, the Board has significantly revised two consumer financial services regulations. The new rules are designed to help ensure fair treatment of consumers seeking and obtaining mortgage credit. Regulation C, which implements the Home Mortgage Disclosure Act (HMDA), was revised after a comprehensive review to update the regulation. Regulation Z, which implements the Truth in Lending Act (TILA), was revised to address continuing concerns about abusive mortgage-lending practices. The Board adopted final rules after taking into account the views of interested parties and weighing the costs and benefits of different regulatory approaches.

Revisions to Regulation C (HMDA)
The recent amendments to Regulation C represent the Board's first comprehensive review of the regulation for more than a decade. During that period, the home mortgage market has changed in many ways. For instance, subprime lending has grown substantially. Prequalification of consumers for home-purchase loans is becoming more commonplace. Lenders have moved to risk-based pricing, and thus fair-lending analysis has shifted from a primary focus on loan denials to scrutiny of loan pricing, particularly of higher-priced loans.

The amendments published last month are intended to improve the consistency and the quality of data collected on home mortgage loans. In a changing market, such consistency and quality will help ensure the continued utility of the data. Among other things, the amendments expand the number of nondepository institutions subject to HMDA's reporting requirements, define applications to include certain programs in which applicants are "preapproved" for credit, and revise the definitions of reportable loans generally. These changes are intended to obtain more complete and consistent data about a financial institution's home mortgage lending. Most significantly, the amendments require the collection, through the reporting of a rate spread, of pricing data on loans for which the credit risks are generally higher than they are for prime loans.

Please note that we are requesting public comment on a few open issues. We have suggested the reporting of loans with a spread of 3 percentage points above a Treasury security with a comparable maturity for first-lien loans, and 5 percentage points for subordinate-lien loans (which generally have a higher annual percentage rate). As a result, approximately 10 percent of all first-lien mortgage loans and 22 percent of all subordinate-lien loans would be covered under the reporting rules. We are soliciting comments on whether these cut-offs are in fact the appropriate ones to capture loans for which the credit risk, in most cases, is greater than that for prime loans. We are also soliciting comments on whether lien status should be reported and whether information about race and ethnicity should be requested in connection with telephone applications. Our intention is to take final action on the cutoffs and other proposals by midyear 2002. The data collection under the new rules begins in January 2003.

Revisions to Regulation Z (TILA)
In December, the Board revised Regulation Z. As you know, the Home Ownership and Equity Protection Act--commonly referred to as HOEPA--amended the Truth in Lending Act in 1994 to address predatory mortgage-lending practices. The December amendments to Regulation Z were a response to continued concern about predatory lending.

The increase in subprime lending has been accompanied by an increase in reports of predatory lending, particularly in connection with higher-cost subprime loans, for which price variations can be significant and through which borrowers may be more vulnerable to abuse. In the past year or so, the Board has been concerned--as have members of the Congress, consumer advocates, federal and state regulators, and others--about the effect of predatory lending on certain borrowers and neighborhoods. In some instances, borrowers who are "house-rich and cash-poor" fall prey to predatory lenders.

In exercising its authority under HOEPA to address abusive and unfair lending practices, the Board has sought to adopt rules that are narrowly tailored to specific problems without unduly restricting legitimate subprime lending. This task is difficult and has certain tradeoffs. To some extent, regulations designed to deter predatory lending may unavoidably affect legitimate creditors and may limit consumer choice. Still, I believe that the rules issued by the Board are a measured response and they will help homeowners avoid falling victim to predatory practices without impeding their access to legitimate subprime lending.

Though the new HOEPA rules may deter certain predatory lending activity, we should be mindful that regulation alone will not eliminate predatory lending. Unscrupulous lenders may ignore the rules or find ways to avoid them. To be effective, attacks on predatory lending must be carried out on a broad front, including reforms to simplify the mortgage-lending process and better enforcement of existing laws.

Industry self-regulation and self-policing would also be beneficial. The revised HOEPA rules and other efforts will, we hope, send a signal to the marketplace that institutions should establish policies and procedures to avoid predatory lending practices, review their loan products and underwriter incentives, and reassess their relationships with brokers and other third parties. Finally, and perhaps most importantly, improvements in financial literacy are critical.

The Importance of Financial Literacy

The importance of financial literacy has been a recurring theme throughout the numerous discussions among regulators, lawmakers, lenders, and consumer advocates on how to thwart predatory lending. Knowledgeable consumers--those who know their options and understand their rights--are one of the greatest defenses against unscrupulous creditors. In recognition of this, various interested parties have undertaken comprehensive campaigns to increase consumer awareness of the marketing tactics and lending practices of these creditors.

The Congress recently held hearings on financial literacy, at which the Federal Reserve Board Chairman offered his perspectives on the importance of education to equip consumers--especially those who have been traditionally underserved by our financial system--with the information they need to participate in an ever-increasingly complex financial services marketplace. We are seeing a broad range of organizations, including government agencies, secondary market participants, and community organizations, undertaking financial literacy initiatives. Toward this end, the Federal Reserve System has made a commitment to financial literacy and has developed several initiatives to increase it. Some of the Federal Reserve Banks have web-based resources linking consumers to information on various financial topics, including the responsible use of credit cards, wealth-building strategies, saving and budgeting, and debt management. I understand that America's Community Bankers is launching a financial literacy campaign, and I applaud your interest in consumers' financial education.

Future Regulatory Actions

Let me now mention two regulatory matters on the horizon. One involves the Community Reinvestment Act (CRA); the other involves the Equal Credit Opportunity Act.

Interagency Review of Community Reinvestment Act Regulations (The Board's Regulation BB)

The banking agencies revised the CRA regulations in 1995 to develop a system that focused on objective, performance-based assessment standards. At that time, we made a commitment to review the effectiveness of the revised regulations in 2002. Last July, the agencies issued an advance notice of proposed rulemaking concerning the CRA regulations. We solicited comments on several issues, including the general question of whether any changes to the regulations are warranted. We also asked whether the regulations strike the appropriate balance between quantitative and qualitative measures and among the tests for lending, investment, and service.

Together the agencies received approximately 400 comments. I know that your organization has raised concerns about the investment test and would like to see the asset-size standard for what constitutes a small bank increased significantly. Many small and medium-sized institutions share your concerns about the current threshold. As you can imagine, most community groups take the opposite view. They do not want the number of small institutions covered by the streamlined evaluations increased, and they want to keep a required, freestanding investment test for large retail banks. Finding the right formulation for these and other issues will be our big challenge.

The agencies are now analyzing the comment letters received on the advance notice and are committed to making any necessary revisions to the CRA regulations as soon as possible.

Review of Regulation B (Equal Credit Opportunity Act)
In August 1999, after a comprehensive review of Regulation B, which implements the Equal Credit Opportunity Act, the Board issued a proposed rule. No further action was taken.

Among other things, the proposal calls for eliminating the prohibition on a creditor's collection of data about borrower characteristics, such as race and ethnicity, in connection with nonmortgage loans. This aspect of the proposal elicited strong reactions, both positive and negative. The Board plans to consider further actions on this matter sometime in 2002.

Industry Safety and Soundness
Finally, let me share some thoughts about industry safety and soundness. As everyone in the room understands, we have recently experienced a decade of economic prosperity followed by more than a year of weak economic conditions. For the past few months we have seen clear indication that economic conditions are improving and we are either at or near the end of the down cycle.

Because loan losses tend to be lagging indicators, this is the time that weaknesses in credit quality tend to emerge. I see reason for both optimism and concern. On the one hand, financial institutions seem to have learned from the severe credit conditions of the late 1980s and early 1990s. More-thorough credit administration, greater reliance on credit-scoring models, and real-time access to public records and credit data have allowed lenders to carefully screen and monitor credit applications, approvals, and loan performance. These improved techniques combined with a much shallower recession than seen in other economic cycles are all encouraging signs.

On the other hand, because we had ten years of unbroken prosperity, we have a new generation of lending officers whose experience has not yet been tempered by troubled economic times. Additionally, many of the new credit-scoring models have been developed and refined only during prosperity. Finally, new financial instruments that have allowed financial institutions to mitigate risk exposure have had the unintended consequence of creating new strains on internal controls. Additionally, institutions responding to market pressures for strong earnings performance are susceptible to aggressive and at times misleading accounting treatment.

On a related issue, recent public scrutiny of very high profile meltdowns has raised new concerns. While accounting, disclosure, regulatory oversight, and the role of market analysts will all attract new scrutiny, the primary responsibility will continue to rest where it has always been--on the shoulders of senior management. This organization represents the survivors of perhaps the most debilitating financial crisis of the second half of the twentieth century--the thrift industry crisis of the late 1980s and early 1990s. This group does not need advice on how to survive tough times. You have done it before, and though today's challenges are new, your previously demonstrated resilience gives reason for confidence that you can do it again.

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