

Remarks by Governor Mark W. Olson

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The Health of the Banking Industry

Let me congratulate the Conference of State Banking Supervisors on another successful and informative annual meeting. The dual banking system is critical to the remarkable diversity and flexibility of our financial system. This system encourages innovation and responsiveness, while serving as a bulwark against regulatory excesses. It supports a dynamic and competitive financial services market that yields tangible benefits for consumers, businesses, and the economy as a whole.

The dual banking system could not function without close cooperation and understanding between federal and state supervisors. As you know, the Federal Reserve has consistently been a strong supporter of the dual banking system, and I have every reason to believe that support will continue. We understand, as you do, the importance of a safe and sound banking system to the proper functioning of the economy. We also understand the role of effective supervision in ensuring that our banks are sound.

At the conclusion of your three days here, let me offer some perspectives on the financial performance of the banking industry and share my thoughts on what that performance might imply for supervisors.

Performance of the Banking Industry

The banking industry began this year with a lot of momentum: In 2004, bank profits exceeded \$100 billion for the second consecutive year and indeed the second time ever. The industry delivered this excellent performance as it adapted to rising interest rates and more-rapid economic growth, including a gradual improvement in business loan demand.

First-quarter earnings announcements by the major banks were generally quite positive, highlighting further acceleration in loan growth, continuing improvement in credit quality, and robust trading revenues. Call Report information tells the same story. Insured commercial banks reported record earnings of \$29 billion in the first quarter, an increase of 10.7 percent from the fourth quarter of 2004. These earnings represent an attractive return on assets of 1.38 percent. Overall return on common equity came in at 13.76 percent, damped a little by the significant increases in reported shareholders' equity associated with last year's banking mergers.

Loan growth was solid at about 2 percent, including a pickup in the growth of commercial and industrial (C&I), construction, and mortgage loans. Bankers have been pleased to report that C&I loans have shown greater strength, consistent with loan officer surveys and market reports that indicate loan demand has returned. That said, the rate of increase in loans was much lower at community banks than for the industry as a whole. Increases in home equity

lines of credit remained rapid at nearly 4 percent but were below the remarkable 10 percent increases seen in the second and third quarters of last year. We understand that much of the construction lending has been for residential construction, consistent with the very strong housing market.

Banks were not able to fully enjoy the benefits of growth in loans and securities, however, because banks' net interest margins narrowed further to 3.61 percent. Rising short-term interest rates, a flattening yield curve, competitive pressure on spreads, and rapid growth in assets funded with purchased money each played a role in the margin compression. The net result was that, despite solid asset growth, the industry's net interest income barely rose in the first quarter. This narrowing trend in margins bears watching, including the extent to which competitive pressures are playing a significant role.

Banks have been managing their core deposits carefully as one means to limit the narrowing of their margins. As market interest rates fell in 2000 and 2001, banks reduced the rates on their nonmaturity deposits more slowly than rates on comparable nondeposit instruments had declined. This strategy helped banks to retain their deposit customers and attract new balances; money market and savings accounts now fund 30.8 percent of bank assets. In addition, this approach allowed banks to reclaim some of the market share they had lost to nondeposit products. As short-term interest rates have risen, banks have repriced these deposits more slowly.

Steady improvement in already-strong asset quality has supported earnings growth by allowing for lower provisions. Many in the industry still expect provisioning to increase over the course of 2005, although that did not happen in the first quarter. At this point, it appears that such increases will primarily reflect growth in loan portfolios because asset quality has not yet shown signs of impending deterioration. For example, by the end of the first quarter, problem assets had fallen to 0.59 percent of loans, down considerably from 1.27 percent in September 2002, the peak level for this credit cycle. Improvement in economic conditions is a key reason for this sustained decline in problem assets, along with the liquidity and depth of secondary markets for troubled loans and, we believe, better risk management.

Fees in some market-sensitive businesses, especially trading, showed renewed strength in the first quarter. Service charges on deposits weakened as a result of fewer retail overdrafts and the indirect effects of increases in compensating balances--as higher market interest rates boosted internal earnings credit rates on such balances--that damped direct-fee revenue received from commercial depositors. Mortgage banking revenues from servicing activities have been robust, although those from originations are tailing off. Despite frequent reports from bankers that their compliance costs have increased significantly and that they have incurred some significant nonrecurring charges, expense control in the industry has been good.

At this point, the available indicators suggest that banks' earnings prospects remain favorable. Nevertheless, bankers would probably admit they would like to see a greater share of their earnings growth come from improved lending and margins rather than lower provisions.

Bank capital ratios remain very strong. Some 99 percent of banks in the United States are well capitalized, matching the highest proportion we have ever seen. Regulatory capital ratios are not affected by merger-related increases in nominal capital, of course, because intangible goodwill assets are deducted from regulatory capital.

Community Banks

The aggregate performance measures I have just described are quite significantly influenced by the largest banks. However, most commercial banks are community banks--banks with assets of less than \$1 billion. In 2004, community banks once again demonstrated their value to their shareholders and the marketplace, earning \$13.4 billion for a respectable return on assets (ROA) of 1.21 percent and a return on shareholders' equity of 11.72 percent.

Community banks also reported strong results in the first quarter of 2005. Profits of \$3.6 billion reflected mixed developments in key businesses, a significant and favorable seasonal influence, and many of the same factors that affected the industry as a whole. Compared with the prior year, community bank profitability improved somewhat with a ROA of 1.27 percent, up 5 basis points from the same quarter of 2004, and a return on equity (ROE) of 12.33 percent, an improvement of about 50 basis points. On this year-over-year basis, improved asset quality allowed for lower provisions, but margins were tighter. Only about 5 percent of community banks lost money for the year--and those institutions represented only about 2 percent of total community bank assets.

Community bank loans grew less than 1 percent in the first quarter compared with the fourth quarter of 2004, a rate that was about half the pace for the industry as a whole. Increases in C&I and one- to four-family mortgage loans were more subdued for community banks than they were for other banks. Commercial real estate loans continued to grow smartly, however, and I'll have a bit more to say about that in a minute.

Consolidation is continuing among community banks, and the data tell the story. There were 7,146 community banks at the end of March 2005, about 140 fewer (2 percent) than a year earlier and about 770 fewer (9.7 percent) than at year-end 2000.

Consolidation can also be seen at bank holding companies (BHCs), which own 97 percent of commercial banking assets. The number of BHCs has fallen slightly--about 4 percent--over the past decade, but this figure has increased a bit in three of the past four years. The number of multibank BHCs has decreased about one-third over the past decade, reflecting the tendency of banks to consolidate subsidiary charters in this era of nationwide banking.

Although bank consolidation largely reflects the search for efficiency and scope, it does not signal a threat to the banking charter or the community banking franchise. Consolidation and the growth of large banking organizations do not alter the fundamental competitive advantages that banks enjoy, namely, deposit insurance, reputation and public confidence, branch networks and other delivery systems, and technology.

The market for new bank charters makes this point clear. Some 124 new commercial bank charters were issued in 2004, and another 32 in the first quarter of 2005. Counting these charters, 718 charters have been issued since the beginning of 2000. Over that same period, for every three banks that disappeared through consolidation, another two new charters were granted. In total, the new charters represent about \$5.4 billion in new equity capital invested in community bank charters.

Issues That Bear Watching

As in the past, the continued vitality of the banking charter calls for strong and prudent management, something that can be a challenge in this dynamic environment. A key issue for management's attention at this time is the sustained rapid growth in commercial real estate lending--that is, construction loans as well as loans secured by nonfarm nonresidential

and multifamily properties.

Let me take a moment to put that growth in perspective. At community banks, growth in commercial real estate lending (CRE)--nearly \$32 billion in 2004 alone--has accounted for at least two-thirds of total asset growth every year since 2001; CRE lending accounted essentially for all of the asset growth at these institutions in 2003 and 2004. By March of this year, CRE lending had reached 28 percent of aggregate community bank assets, a new record for community banks that exceeded the previous record set in the early 1990s.

The bulk of CRE lending is in the form of commercial mortgages, which themselves have risen by an average of 10 percent annually since 1998. However, construction lending has also been assuming a larger share of the pie. Among community banks, construction loans increased at a compounded growth rate of 17.4 percent annually over the same period. This is a remarkable pace of growth--and a growing concentration for community banks.

CRE lending is a traditional and natural part of the community banking franchise. Underwriting practices continue to be much better than they were in the troubled days of the 1980s. There is no indication at this time that the overall credit quality of CRE exposures at community banks has deteriorated, although there are signs that some underwriting standards have been under assault from competitive pressures.

Nonetheless, credit risk concentrations are a critical "franchise" risk for bankers, especially community bankers, and they can assume even greater importance when they involve high-growth lines of business. Successful identification and management of these concentrations requires adherence to good credit fundamentals. Strong capital ratios--ratios that are well in excess of regulatory minimums--have been a key factor in managing credit concentrations and a striking attribute of the most profitable community banks.

More generally, the competitive drive to win borrowers should not be allowed to overcome the disciplines of prudent lending practice. As economic conditions and business loan demand have improved, we have expected and seen some degree of easing in commercial lending standards. Competitive pressures and the natural desire to generate loan volume, however, can provide ample temptation to make lending decisions that bankers and their supervisors will live to regret.

In a similar vein, supervisors have been attentive to indications that home equity lending standards and risk-management practices may not have kept up with the very rapid growth in this form of lending. Last month, the federal banking agencies issued guidance to the industry that was aimed at reinforcing sound practices for lending and credit risk management. I encourage bankers to review that guidance and consider its recommendations carefully.

Let me conclude with a few thoughts on managing interest rate risk. In the low-rate period that ended last summer, bankers faced a natural temptation to extend maturities in search of more-attractive rates of return. From 2000 to early 2004, the share of community bank assets maturing beyond five years had grown steadily from 16.9 percent to 18.4 percent, respectively. Since then, the share of these assets has been pared back to 16.3 percent, as short-term interest rates have increased.

Bankers continue to rely significantly on the interest rate protection provided by their stable and reliable core deposit base. If recent deposit growth has been fueled by low interest rates and weakness in the equity markets, unexpected liquidity and interest rate pressures may

develop if deposit customers shift funds to other investment vehicles. We need to remember that depositor behavior can change, as it did in the high-interest-rate environment of the late 1970s and early 1980s.

Conclusions

The U.S. banking industry is healthy, strong, profitable, and well positioned to support economic growth and prosperity. Banks have been able to adapt to changing circumstances and still generate record profits. The outlook for performance in the coming year is good.

Community banks continue to demonstrate their value to the marketplace and to occupy a prominent position in the economy. New challenges, and perhaps some new opportunities, will arise as we move ahead. Adapting to change is an important aspect of the banking business and an important strength of bank charters, and the ability to respond well to changing circumstances has been a key to sustained profitability. The continued vibrancy of the bank charter depends on prudent management and a recognition of both the risks and rewards of aggressive growth.

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