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Preserving Financial Stability

The Lessons of the 80's

Remarks by

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Thank you for your kind invitation to meet with you today. We at the Federal Reserve do appreciate such opportunities to discuss important current issues in banking and the economy with financial, business, and professional audiences. Given the dynamics of our nation's economy, this is a particularly challenging time for us in the Federal Reserve, not only because of our monetary policy responsibility, but because of our role as a regulator of banks and bank holding companies.

Today, I intend to wear my bank regulator's hat and to focus on current banking conditions and on some of the lessons to be learned from this period of stress among our banks. This topic seems quite timely in light of constant headlines about banking problems that have generated public concern about banking stability. But because the broad performance of the economy has a great deal to do with the performance and ultimate stability of financial institutions, I want to comment first on the economic situation and outlook.

As observers of the economic situation--whether we are policymakers, bankers, or interested business and professional people, we are confronted now with economic crosscurrents that cause considerable uncertainty about the outlook.

On the positive side, for example, we see that stock and bond prices are reaching new highs. Interest rates are down to levels not seen for eight years, and the value of the dollar is down sharply in the foreign exchange markets. Oil prices also have

declined sharply to mid-1970's levels, helping to cause declines in consumer price indexes in recent months. And, there are none of the signs of recession that might have been expected after some three years of business expansion.

On the other side of the ledger, though, recent good news may have obscured the fact that our economy has been sluggish over most of the past two years. Growth in industrial production and U.S. exports has been very weak. Even our consumers, who led the way with strong spending earlier in the expansion, appear to be taking a breather, as evidenced by weak retail sales and slower auto sales. Moreover, there are, as you know, near depression-level conditions in our agriculture and energy industries, accompanied by energy-belt problems in commercial real estate.

Along with these crosscurrents that muddy the economic waters, the uncertain outcome of current public policy debates further complicates the outlook. For example, what are likely to be the ultimate effects on the economy of pending decisions to reduce the federal budget deficits? How are reforms to our tax system going to impact consumers and businesses? At this point, we have no definitive answers to these questions.

However, as I assess all the positive and negative elements as well as the unknowns, I conclude that the nation's economy should experience good growth this year and into 1987, encouraged by declining oil prices, lower interest rates, and an improved trade balance resulting from a lower dollar. I hope my assessment is correct, because resolution of many of the problems in our banks depends on the health and growth of the economy.

Unfortunately, even a generally positive economic outlook may provide little comfort to the many banks that have taken it on the chin with farm, energy, and real estate loan problems as well as ongoing troubles with the debts of less developed countries. These high-profile problems have drawn considerable attention from regulators and have weakened public confidence in banks.

Thus, with these issues in mind, I want to focus today on steps that can bolster public confidence in our banking system. First, I want to briefly review our regional banking situation, then discuss what the Federal Reserve is doing to promote banking stability. Finally, I want to draw from our regulatory observations of recent years to suggest what bankers themselves can do to contribute to a sound banking system.

In supervising state member banks and bank holding companies, the Federal Reserve has had a firsthand look at banks' problems throughout the nation. Despite strong first-quarter earnings reports from major banks in recent weeks--based largely on bond market profits and healthier interest margin spreads, we all know that the problems of LDC debt and farm, energy, and real estate loans have not evaporated.

Ongoing problems are clearly evident in our own region. The Tenth Federal Reserve District that we serve at the Kansas City Fed continues to experience some of the most severe banking conditions in the nation. Last year, 55 of the nation's 120 bank failures occurred in our region. Three of our states--Kansas, Oklahoma, and Nebraska--had 13 failures each. And with the existing conditions in agriculture and energy, the environment continues to be troublesome for banks.

Standard bank performance measures clearly document the situation. For example, the average return on assets for banks in the District is only about one third its level five years ago, primarily because credit quality has decreased. Net loan losses as a percent of total loans have increased nearly five-fold since 1980. Banks' nonperforming assets have shown a similar and dramatic increase and now average over 4 per cent of all loans at banks in the District. Fortunately, bank capital has risen somewhat since 1980, but these levels may be difficult to maintain in the face of increased loan losses. Overall, in a region where bank performance once exceeded national averages, bank performance now trails the averages in many measures.

Despite this difficult situation, let me emphasize that only a small portion of banks in the nation and region had severe problems in 1985. While it is true that about one fourth of the banks in the region had negative earnings last year, most of these losses were not large enough to significantly affect bank capital or to threaten the viability of these banks.

Moreover, although fewer banks are doing as well now as in previous years and some are losing money, the vast majority of banks in the region are still sound, profitable institutions. In terms of return on assets, half of all our banks earned .74 per cent in 1985, and one-fourth had an ROA above 1.16 per cent. These are good, if not excellent returns, given the environment.

With that brief look at our regional situation, let me turn now to the Federal Reserve's response to current problems and outline the steps we are taking to help stabilize the

environment. As a Reserve Bank president, I have two perspectives. One emphasizes the Federal Reserve's role as lender of last resort and monetary policymaker and our broad interest in the stability of the banking system and the ability of banks to cope with a changing marketplace. The other perspective focuses on our sensitivity to the need to maintain effective banking services in all kinds of communities.

In considering these issues recently at the Kansas City Fed, we determined that one of our objectives is "to respond to problem situations with an appropriate balance of supervisory action and professional and financial support to assure a stable environment." This objective is in line with a number of steps the Federal Reserve has taken recently to better identify and respond to banking problems. Three of these actions are an expanded supervisory program, a capital forbearance policy, and a proposal for risk-based bank capital.

One of these steps, the expanded supervisory program, was announced late last year. This program seeks early detection of individual bank problems through more frequent on-site examinations, particularly at large institutions. If problems are found, we then intend to monitor the bank or holding company more intensively until the problems are resolved. The program also calls for more effective communication of our examination findings to the management and directors of institutions with significant problems.

In another recent action in response to the current banking environment, the Fed and other bank regulators announced in March

a capital forbearance policy. The policy is intended to assist sound farm and energy banks facing temporary problems. Such banks would be allowed to operate with capital below minimum standards so long as they have a suitable plan to restore capital and if they agree to control their expenses. In addition, the Federal Reserve will continue to allow banks to restructure loans without any automatic chargeoffs so long as the restructuring is consistent with generally accepted accounting principles. And so long as borrowers are meeting the new loan terms, the loans no longer will be reported as nonperforming.

A third response to the environment now under consideration by the federal bank regulators is a proposal for a supplemental, risk-based capital standard. This standard would measure the risk in a bank's portfolio in assessing its capital needs. Compared to current capital policies, the risk-based measure would better address off-balance-sheet exposures and temper existing incentives for banks to reduce their liquid assets.

In another arena, the Fed has suggested to Congress that current interstate acquisition provisions be expanded to include failed banks with less than \$500 million in assets and to allow problem banks to be acquired before they fail.

Although supervisory policies can indeed help banks achieve sound operations and weather temporary economic turbulence, there is no question that the fundamental responsibility for a bank's condition remains with its management and directors. The actions I just described reflect this reality because they are designed to provide time for basically sound institutions to correct their

problems. These actions will in no way help hide problems at troubled banks or delay any needed internal or supervisory steps.

Now that the regulators have strengthened the potential for many troubled banks to regain full health, if given time, it is appropriate now to consider some of the lessons of this difficult period. Drawing on our recent supervisory observations, there are four basic lessons or principles of banking practice which, in our view, seem to separate good banks from problem banks.

The first, and perhaps most valuable lesson of today's environment is that successful bankers recognize the cyclical nature of many industries and provide for the ultimate downturns. In contrast, banks with severe problems today have typically operated as if prosperity is a constant factor.

Unfortunately, a good example is the current decline of agriculture. Historically, farm income has fluctuated considerably. The current period, in fact, is far from unique. Two previous boom-bust periods in this century displayed similar magnitudes and patterns--increased world demand for U.S. farm products, rising farm income, land speculation in an inflationary environment, subsequent declining demand, and collapse. Thus, experience should bias rural bankers toward caution. Moreover, it seems clear that bankers cannot afford to speculate on boom conditions in cyclical industries.

A second basic principle that flows from our recent supervisory observations is that credit concentrations must be avoided whenever possible. Loan concentrations leave banks highly vulnerable to problems in a single industry--whether

agriculture, energy, real estate, or video games. Too often, loan concentrations also are achieved by relaxing standards.

The Penn Square failure in Oklahoma City is a prime example of what can happen when a bank's single-minded pursuit of one type of customer is combined with lax lending policies. As you will remember, Penn Square Bank generated more than \$2 billion in energy loans--about twice the bank's assets--largely through the efforts of one lending officer. Equally astounding is the fact that this shopping center bank was able to sell many of these loans, with little documentation or credit review, to several major U.S. banks also obsessed with energy lending.

Although Penn Square is admittedly an extreme example, this case is a strong reminder that banks should try to avoid tying their futures to a particular industry or group of customers. Banks which cannot escape business concentrations--and banks in rural areas face this situation--should compensate for the risk with higher credit standards and capital levels.

A third principle observed from recent experience is that any type of banking risk, whether from loan concentrations or other sources, should be backed with adequate capital protection. Bank stockholders--not depositors or the FDIC--should bear the risk. If risks are justifiable, adequate compensation should be built in through higher earnings potential.

Banks in our region, because of their size and the markets they serve, have traditionally maintained higher than average capital levels. This extra capital is now giving many banks the resources to weather the agricultural decline. However, we have

observed that many of the banks with more severe problems today followed strategies that carried above-average risks. With simple hindsight we also see that these banks generally have had no better earnings than their peers. Taking higher risks has not provided the earnings to cushion each bank's downside exposure.

A fourth lesson from our recent supervisory observations is that banks should avoid so-called "one-man shows" where directors and committees are simply rubber stampers. FDIC studies confirm that a weak and disinterested board of directors is a common thread in most bank failures. Indeed, the five largest failures in U.S. history were characterized by a concentration of power in one or two individuals concerned only with rapid expansion. We know that successful banks benefit from broad input and guidance.

There is no magic in any of the four principles I have noted, nor is my list all-inclusive. For example, some bankers would mention a traditional aversion to out-of-territory lending or other sound banking practices as being just as important.

Let me summarize: the current troubled environment for banking is testing individual banks' operating practices and principles. Though the supervisory agencies have taken steps to maintain stability and ease subsequent adjustments in banking, the primary responsibility for sound banking continues to rest with a bank's management and directors.

The four lessons or principles that I mentioned are but traditional guidelines for successful banking which are well understood by most bankers. But it is clear to us at the Fed that the current difficulties of almost every problem bank can be

traced to the ignoring one or more basic principles. Adherence to the basic principles of sound banking can help shield banks from near-term problems while, at the same time, positioning them to better withstand future downturns.

Let me say in conclusion that we at the Federal Reserve will do all we can to promote the sound, traditional principles of banking that will help preserve public confidence in our financial system. And let me assure you that, in the interest of overall economic stability, the Federal Reserve will continue to pursue a monetary policy course that contributes to a climate of moderate non-inflationary growth in which banks--and all kinds of businesses, for that matter--can compete and prosper.