For Release on Delivery
12:10 p.m. PST (3:10 p.m. EST)
March 7, 2001

Remarks by

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Board of Governors of the Federal Reserve System

before

the Independent Community Bankers of America

Las Vegas, Nevada

March 7, 2001

It is a pleasure to be here for the ICBA's national convention. From the largest, most complex institutions to smaller banks serving the needs of their local communities, our nation's banking system has thrived amid intense competition and has adjusted to a rapidly changing financial and technological environment. Clearly, changes in financial markets have prompted supervisors and bankers to re-evaluate past assumptions in this period of economic slowing and to initiate adjustments that ensure banking promptly adapts to conditions that are less certain and less robust than the extraordinary performance of recent years. In this context, I would like to review the lessons of the past year and some of the issues and opportunities now facing banking institutions and supervisors.

After a near decade of unprecedented prosperity, the banking industry has come to recognize, not for the first time, the embedded costs of lax credit standards and the overly optimistic assumptions about borrower prospects that seem the inevitable consequence of ever-lower perceived risk premiums. Today's problems generally relate to syndicated credits, especially those to leveraged borrowers. As problems materialized, earnings fell significantly for some of the larger banks, which in turn caused aggregate commercial bank industry earnings to fall slightly during 2000, thus bringing to an end the industry's string of ten consecutive years of higher earnings.

Nevertheless, though the effects of these excesses are likely to continue for much of this year in the form of moderately deteriorating asset quality and earnings at some of the larger banks, these problems, one hopes, will prove modest both by historical standards and relative to the resources of these institutions. Fortunately, we move into a period of uncertain times with the level of the industry's overall profitability well above the average of recent decades. Moreover, the source of banking revenues is better diversified than in the past, and most institutions hold strong capital and reserve positions.

Not surprisingly, in response to past laxity, a weakening economy, and general economic uncertainty, banks have tightened their lending terms and conditions. On commercial and industrial loans, our Senior Loan Officer Opinion Survey indicates that tightening started in late 1999 and has persisted through early 2001. The survey also indicated continued firming of the terms and conditions on corporate loans by nearly 60 percent of domestic respondents, up from 45 percent in November. In addition, more than 40 percent of respondents adopted more-restrictive terms on commercial real estate loans, compared with 26 percent in November. Yield spreads on corporate loans, consistent with risk premiums observed in the corporate bond market, have also widened. Adjustments in standards and pricing are clearly a necessary and important part of the transition that banks must make in moving from overly optimistic assumptions to more-realistic assessments of borrower prospects.

As I have said previously, however, lenders and their supervisors, should be mindful that in their zeal to make up for past excesses they do not overcompensate and inhibit or cut off the flow of credit to borrowers with credible prospects. There is doubtless an unfortunate tendency among some, I hesitate to say most, bankers to lend aggressively at the peak of a cycle and that is when the vast majority of bad loans are made. A more disciplined, less pro-cyclical, long-term approach to lending that provides higher average risk-adjusted returns to shareholders is obviously in the self-interest of banks.

It is interesting to note that the length of the current expansion, coupled with the absence of problem commercial loans until recently, has led to some depreciation in both bankers' and supervisors' skill in handling weakened or troubled credits. Such problems either are a faded memory or are outside the experience of some lenders and examiners, despite the serious credit work-out problems of the late 1980s and early 1990s. As a consequence, institutions have had to brushup and re-institutionalize their policies and practices for managing weakened and problem credits, and supervisors have had to similarly bolster their training programs.

Recent problems have also helped vividly illustrate the longstanding virtues of sound lending practices. For example, losses related to leveraged finance loans have reminded institutions that these credits present unique challenges for an institution's risk-management systems and that proper safeguards are necessary to conduct this business prudently and profitably. Leveraged borrowers, by virtue of their high interest costs and dependence on third-party funding, have a diminished ability to adjust to unexpected economic events and changes in business conditions. As a consequence, leveraged credits require more-intensive tracking and monitoring than typical commercial credits to ensure that their unique risk characteristics are adequately understood and controlled by the banking organization. Institutions with sound practices translate the results of their monitoring into appropriate internal ratings, classifications, and loss recognition to develop a timely and accurate picture of their institution's credit quality and risk exposure.

Though much attention has been focused on problems in corporate loans, other segments have remained fairly resilient. For example, commercial real estate loans are experiencing below-average delinquencies and net charge-offs, as are residential mortgage loans. Furthermore, credit card net charge-offs, which had escalated in recent years, have fallen to more moderate levels.

Still, prudent bankers will need to weigh the potential for less-agreeable credit conditions. In recent years, buoyant economic conditions raised expectations for continued growth in income and employment for consumers, which in turn have led to growth in household debt that has outstripped gains in disposable personal income over the past five years. That growth in debt has pushed consumer debt service burdens to levels close to the peak experienced in the late 1980s.

Neither borrowers nor lenders would enter into these obligations were they not optimistic about the prospects for repayment. Not surprisingly, lenders have recently tempered their outlook, tightening their standards somewhat for credit cards and installment loans. Concurrently, demand by borrowers has weakened moderately. If loans have been extended assuming little or no possibility for less-than-optimal conditions, then problems are likely to emerge. Indeed, loans made using credit-scoring models that are estimated only on data from the last five or so years may be too optimistic for more normal conditions.

History provides excellent lessons for banking institutions with regard to appropriate pricing, underwriting, and diversification. One of the most memorable, of course, was the real estate crisis of the late 1980s and early 1990s. However, it is clear that such memories and their lessons can dim over time. The exceptional demand for office and other commercial real estate in recent years has led to a rebound in the volumes of loans secured by these properties. This time, however, as demand has grown, larger organizations have managed to keep their holdings modest relative to their asset bases either through securitizations or sales or by avoiding originations altogether. In contrast, many smaller commercial banks have raised their commercial real estate concentrations relative to assets and capital. Though underwriting practices appear to be much healthier today than they were in the 1980s and standards have tightened somewhat recently, supervisors are paying particular attention to community banks with concentrations that make them materially vulnerable to a downturn in this market.

Although asset quality problems at a few of the largest banks may have received the most headlines, a more lingering and widespread source of concern has been shrinking net interest margins. As liability costs rose rapidly last year, nearly all of the largest bank holding companies experienced margin declines, with about one-fourth experiencing a narrowing of 25 basis points or more since a year ago. However, the aggregate net interest margin of community banks was essentially unchanged last year. The more-favorable margin trends at community banks are probably linked to their proportionally higher funding of assets with core deposits, which are less sensitive to rising rates. Moreover, in 2000 the average rate paid on both large and small time deposits by small banks declined relative to that paid by larger banks.

Despite pressures on funding, community banks have been relatively successful at maintaining their core deposit bases. For example, a decade ago banks with less than $50 million in assets funded around 80 percent of their assets with core deposits. Over the course of the past decade, that figure declined 7 percentage points, but core deposits remain a fairly high, 73 percent of assets. For banks with more than $10 billion in assets, core deposit holdings are only 39 percent.

Community banks have experienced only moderate diminishment in the share of core deposits funding assets, but when that trend is coupled with rapid loan growth, pressures on bank liquidity appear to have intensified. Community banks have funded the gap between loan and deposit growth largely by liquidating investments. For example, from 1990 to the end of last year, smaller community banks increased the share of loans on their balance sheet 8 percentage points, to 59 percent. Over the same period, liquid funds and investments *fell* 8 percentage points, to 38 percent of assets. The combined deposit and loan trends have pushed liquidity benchmark ratios, such as loans to deposits, to historic peaks. However, there are some signs of relief for bank liquidity. For one, the demand for loans by businesses and consumers appears to be moderating, and there are some early indications that consumers are returning to bank retail deposits in the wake of disappointing stock and mutual fund results.

Still, many of these liquidity pressures are likely to remain in one form or another, and banks will almost certainly continue to explore nondeposit liabilities to fund asset expansion. While this is not new to community banks, the growing volume, variety, and complexity of non-deposit funds creates new issues. To meet this challenge, community banks must strive to fully comprehend the implication of relying on these types of funds from both liquidity and earnings perspectives.

It is, of course, perfectly appropriate for institutions to consider alternative funding strategies to meet customer demand. On the one hand, choosing to meet loan growth through wholesale funding rather than attempting to attract new money market accounts, for example, may avoid a costly rate hike on existing deposits. On the other hand, institutions should consider the costs of choosing wholesale funds in lieu of building the institution's retail funding base. Significantly, the accumulated effect of these decisions on an institution's risk and liquidity profile may not be noticed until difficult times place pressure on the institution's ongoing funding. Management should keep in mind that the value of the federal subsidy provided by lower-cost insured deposits is rarely appreciated until periods of crisis, when a stable funding base cannot be maintained at any price.

Management should ensure that complex funding products are well understood, especially those with embedded options that cause cash flows to change dramatically depending on market conditions. The funding products should also be consistent with the portfolio objectives of the bank and the sophistication of the bank's risk-management system. In addition, management should seek to identify liquidity pressures and other risks through stress tests so that appropriate contingency funding and hedging programs can be formulated.

It is important in this market to place the liquidity and core deposit erosion at both small and large banks, as well as the resultant increased reliance on managed liabilities, in a proper historical context. An unpleasant fact is that the wider range of choices for near-deposit substitutes, and broader understanding by consumers of what those choices are, may have decreased, perhaps permanently, the share of core deposits funding assets. This change may be as significant in the current banking landscape as the tax on state bank notes was in the nineteenth century. To be sure, the imposition of the tax was sudden, while the erosion of the share of funding from core deposits has been, and presumably will continue to be, gradual. But just as state banks responded to the tax by innovating deposit banking to flourish once again, community banks will, I am sure, adjust to the changing realities of the deposit market.

Moreover, it is also important to recognize that the reduction in portfolio liquidity is more a product of good business--high loan demand--than of the relatively slow growth in core deposits. Some liquidity pressures will be alleviated as demand for loans declines. Though core deposits may be more difficult to attract, they have in fact continued to grow, just not as rapidly as the loan portfolio. In fact, bank credit over the past decade has grown faster at community banks than at larger ones, and so have their deposits, both insured and uninsured.

But both the changes in financial markets and your success in credit markets suggest another important area of risk management that requires increasing attention from community bankers: maintaining enough capital and reserves so that your organization can absorb the losses that inevitably occur as part of risk-taking in a strong economy. As you know, supervisors are proposing to update the current Basel minimum requirements with a flexible system that is more finely calibrated to a bank's underlying risk-taking. However, such an approach does not come without cost, either to banks or their supervisors.

Recognizing that much of the new Basel Accord is tailored to the greater complexity and diversity and the substantial risk-management infrastructure of the largest internationally active organizations, supervisors issued an advance notice of proposed rulemaking on the potential use of simpler approaches. That notice was predicated on the assumption that community banks might prefer something even less complicated than the current standard. The responses we received are a lesson in the importance of seeking comment on proposals that are largely guided by general impressions and conventional wisdom. The responses to date indicate that community banks in general do not believe that the *current* accord is burdensome, mainly because the costs of adapting systems and reporting for such an approach have already been incurred. Indeed, some commenters indicated that a change to an even simpler system would in itself be more burdensome than sticking with the current regime.

The notice also asked whether the industry would be in favor of a blunt, stand-alone leverage ratio with much less complexity and reporting. The catch to that proposal was that in exchange for less risk reporting, supervisors would set the minimum ratio higher than is required by the current leverage standard, which is used in tandem with the current risk-based system. Many of the responses indicated that was not a favorable tradeoff, even though most community banks have exceptionally strong leverage ratios. I should emphasize that we are still analyzing your many excellent comments to determine what kind of response we should give.

In closing, then, the need for banking organizations to be flexible and adapt to the changes around them has continued to intensify. As the extraordinary economic performance of recent years has moderated, weaknesses that were once hidden have surfaced and have separated strong managers of risk from weaker ones. Those that use their recent difficulties as a catalyst for improving their risk-management practices are likely to flourish. In the coming years, institutions both large and small that focus on risk-management fundamentals can expect to both support a growing economy and provide strong returns to shareholders.