Mark W Olson: Business trends and management challenges for the banking industry

Remarks by Mr Mark W Olson, Member of the Board of Governors of the US Federal Reserve System, at the Annual Economic Outlook Conference, Middle Tennessee State University, Murfreesboro, Tennessee, 16 September 2005.

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Good morning. When I decided a few weeks ago to focus my remarks on the challenges facing the banking industry, I could not have imagined the challenges that Gulf Coast financial institutions and their customers would face in the devastating aftermath of Hurricane Katrina. So, before I turn to my planned topic of discussing banking and banking supervision more generally, I'd like to spend a few moments reviewing the efforts of the Federal Reserve, some of them in conjunction with other financial institution regulators, to maintain and restore vital financial services to the people of the Gulf Coast--including those who remain in the region and those who have been forced by the storm to relocate outside the region.

First, however, I want to express our heartfelt sympathy to all of the individuals and families who have suffered greatly in the past few weeks and to acknowledge the very brave efforts of many individuals to save lives, help the sick and displaced, and restore public order.

At the Federal Reserve's New Orleans Branch, essential employees stayed with the office to keep it secure despite the rising flood waters and limited contact with the outside world. In the end, the office barely escaped the flooding, and we are continuing to help our staff members whose lives have been totally disrupted. As of yesterday, all but one of the Branch's 176 employees had been accounted for. We very much hope that this individual will be located soon.

The Federal Reserve Bank of Atlanta is the parent Bank for our New Orleans Branch. I want to commend the Bank's staff for their hard work during this very trying time. The senior leadership in Atlanta took a number of important steps to work with banks, thrifts, and credit unions in an effort to ease, where possible, the burdens on these institutions and their customers. For example, in the aftermath of hurricanes or other disasters, the simple provision of cash from the Federal Reserve to banks and from banks to their customers becomes critical. The Federal Reserve Bank of Atlanta and other Federal Reserve offices quickly adjusted their operations so that the cash services normally supplied by the New Orleans office could be provided by other Fed offices surrounding the disaster area. To ensure that all banks got the cash services they needed, these offices remained open over both the Labor Day weekend and last weekend. They will be open again this coming weekend. Also, as we did following the 9/11 attacks, the Federal Reserve has assisted depository institutions with priority restoration of telephone service in cooperation with the Department of Homeland Security.

Check clearing was disrupted throughout the areas affected by Katrina, yet checks were being written by individuals who were seeking shelter and other necessities--and who needed to access their funds. As relief and recovery efforts began, the restoration of check clearing became increasingly important. We quickly shifted the check processing that was normally handled by our New Orleans office to Atlanta. We also worked with the banking industry in the immediate aftermath of Katrina on many issues affecting individual institutions. To help ease the check-clearing burden, starting the week of September 5, we began giving credit for checks deposited by banks in the New Orleans Branch territory as if the checks were still being processed normally in New Orleans. We also did not return checks when we were unable to present them to severely affected institutions. Instead we held those checks and worked closely with the institutions' primary supervisors to determine how and when we could restart operational contact.

The Federal Reserve Bank of Atlanta also reminded the depository institutions it serves that, as usual, the discount window was and is available to assist them in meeting their liquidity needs. We have been in contact with many depository institutions in the affected areas and are carefully monitoring the situation. At this time, we have not seen evidence of significant funding difficulties or problems in balance-sheet management.

In Washington, we have worked closely with the other regulatory agencies to encourage financial institutions to consider all reasonable and prudent steps to ease burdens on customers who have been so deeply affected by Katrina. At this point, the banking industry on the whole has shown resilience and flexibility in its response to this challenging situation. While the challenges have by no means passed, banks appear to be taking the appropriate actions to provide their customers with access to much-needed cash and banking services.

Meantime, the Federal Reserve's community affairs staff is working as a clearinghouse for information on available disaster relief and consumer protections. The Federal Reserve Bank of Atlanta also stands ready to assist community organizations and financial institutions directly affected by the hurricane, both by providing them with information and contact resources and by addressing the needs of displaced families.

So, mindful that our thoughts and attention are continually drawn back to the plight of Katrina's victims, let me now turn to my planned topic--banking in the United States.

The banking industry is an important subject for economic analysis, but one that probably gets less attention than it should. Including the banking industry in economic analysis is valuable because most major economic and financial developments become manifested in bank balance sheets and business performance. One possible reason banking does not get that attention today is that the banking system is strong, healthy, and vibrant, a condition that at least partially reflects our nation's economic well-being. When the banking industry experiences serious problems--as it has from time to time in U.S. history--the economy tends to suffer as well. This connection between economic health and the banking system, as you know, is what persuaded Congress to assign to the Federal Reserve an important role in supervising the safety and soundness of banking organizations, as well as the responsibility for the discount window. My remarks today will address the unique aspects of our banking system and its evolution, the special role played by community banks in that system, and other bank supervisory issues related to the current economic context.

A unique and evolving banking system

The starting point for any discussion of the importance of the U.S. banking system is to recognize that our system is unique in relation to the banking systems of other countries. The structure and regulatory framework of the U.S. system are complex, having developed over many decades. Reflecting the decentralized nature of our economy and the vast geographic expanse of this country, we have historically had a large number of banks, most of them very small. Initially, the chartering and supervision of banks both large and small was the purview of state governments. Following the Civil War, national banking charters were authorized by the National Banking Act, setting in place what we now call the dual banking system. Over the ensuing decades, the regulatory structure for banks was further shaped by financial crises, including the Great Depression; the creation of a national deposit insurance system; and other forces. More recently, technological advances, along with the increasingly rapid evolution of financial products and markets, have driven many marketplace changes resulting in a dynamic business environment that creates both opportunities and significant challenges for banks and their regulators.

The most visible change in the U.S. banking industry over the past quarter-century is the dramatic consolidation among banks. There are about 7,600 commercial banks in the United States today--quite a reduction from the approximately 13,000 banks that were operating in 1980. Reflecting banks' efforts to operate more efficiently and improve their market

penetration, mergers and acquisitions have been the main instrument banks have used to consolidate. In addition, consolidation has taken place through intra-company combinations of separate subsidiary charters within larger bank holding companies. Bank failures also played a role in bank consolidations, but failures have been relatively rare since the mid-1990s.

Along with consolidation, the current generation of bankers witnessed competitive changes that blurred the once-clear boundaries around the markets for different financial services products. New features were added to traditional products, features that often allowed for more direct competition among different types of financial services providers. New products and capabilities--frequently linked to developments in capital markets--emerged to challenge some of banks' traditional roles in financial intermediation and to create risk management and diversification opportunities. As product lines and businesses became less distinct across industries, banks naturally developed a greater interest in owning securities and insurance firms, and vice versa.

Legal and regulatory change followed, in recognition of the new market realities. The Riegle-Neal Act eliminated barriers to growth across state lines. Later, the Gramm-Leach-Bliley Act repealed major parts of the Glass-Steagall Act, removing obstacles to expansion across financial services firms.

Despite the dramatic changes in the markets for financial services products and in their regulatory framework, the banking system continues to operate well--indeed, it is thriving. Commercial banks earned $106.6 billion in 2004, the second year that profits exceeded $100 billion. The first year was 2003. With these earnings, commercial banks delivered an aggregate return on common equity of 14.22 percent and a 1.34 percent return on assets. Over the first half of 2005, industry profits have already reached nearly $57 billion, with rates of return only a little below those recorded in 2004. Demonstrating the breadth of strong earnings across the industry, only 5.7 percent of commercial banks reported net losses in 2004.

Robust growth in loans and deposits has contributed to banks' strong profits, as has strong fee income, including mortgage origination and servicing revenues. Now let me say a few words about two other factors that have supported improvement in banks' earnings: asset quality and operating efficiency.

Asset quality has been extremely strong, in large part because of favorable economic conditions. These conditions have a tangible effect on profits, allowing banks to set aside less of their earnings for future credit losses. Thus, banks' provisions for loan losses were only 0.25 percent of assets for the first half of 2005, well below the 0.70 percent for 2002. Net chargeoffs so far in 2005 amounted to less than 0.50 percent of loans, really a remarkably low figure. Returning to the present, problem assets at the end of June 2005 were also low, only 0.56 percent of loans, after having peaked at 1.23 percent in 2002.

Operating efficiency has also improved and contributed to strong profits. Consolidation and bank investments in new technologies are partially responsible for this improved efficiency. I like to use a productivity measure for banks called the efficiency ratio, which measures what proportion of total revenue is eaten up by overhead costs. This ratio shows that banks have achieved significant reductions in their cost structure. The aggregate efficiency ratio for commercial banks in 2004 was 61.7 percent, meaning that banks needed to spend roughly 62 cents to generate each dollar of revenue. That full-year 2004 ratio was fully 3.5 percentage points lower than it was ten years ago in 1994.

Community banks today

Although the number of banks in the United States has declined dramatically, as a general proposition we still have more commercial banks than other developed countries. The large number of banks in this country is neither an accident nor a vestige of a time before

telephones or the internet allowed businesses to overcome geographic distances. New reasons have emerged for this large number of institutions and for the demarcation between large institutions--with well-integrated regional, national, or global operations--and the smaller locally oriented institutions that I call community banks. In this new setting, community banks differentiate themselves by focusing on the specific needs of their local markets and by providing a high level of service and attention to the customers in those markets.

Community banks, that is, banks with assets of $1 billion or less, continue to be quite successful. These banks generated combined earnings of $13.4 billion in 2004, which translates into an attractive return on common equity of 11.72 percent and a return on average assets of 1.21 percent. Thus far in 2005, profitability has been a bit ahead of that pace, with returns on equity in the first half of 2005 roughly 50 basis points higher than for the same period in 2004. In the second quarter, return on equity reached 12.26 percent versus 11.80 percent in the year-earlier period, after a first-quarter 2005 return on equity of 12.33 percent compared with 11.81 in the same quarter of 2004. Seasonality is a significant factor for community banks.

On first review, it would be logical to conclude from community banks' earnings and profitability figures that these banks are less profitable than large institutions and thus are competitively disadvantaged. Indeed, large banks--those with more than $10 billion in assets--generate higher rates of profitability, with returns on average equity in the 15 percent range. This difference in profitability makes economic and market sense, for a number of reasons: Community banks are subject to less earnings volatility than large banks. Competitive conditions and the sources of earnings at community banks also differ from those of large banks. For example, in aggregate, community banks have historically paid 10 to 20 basis points more than the industry as a whole on their savings and money market deposits, demonstrating their interest in attracting and retaining core deposits. Further, the underlying business paradigm at community banks is quite different than that of large institutions. Many community banks are family owned, and many more are closely held, which means there is minimal pressure on quarterly earnings performance.

Comparisons of community and large banks naturally raise the broader question of how small banks can compete successfully with large banks. To answer this question, one needs to stratify these banks on the basis of profitability. This stratification reveals that, in nearly every area of bank performance, the financial results of the best-performing community banks match up well with results of the big banks--most notably in the area of efficiency. One might expect large banks to operate more efficiently because of their scale of operations. And in 2004, community banks as a whole did report an overall efficiency ratio of 65 percent, which was much less favorable than the 58 percent figure for large banks. Yet surprisingly, the top-performing community banks outperformed the large banks, delivering an efficiency ratio of 56.6 percent.

Another key strength of top-performing community banks is capital. The top one-fifth of community banks, in terms of their profitability, hold capital that is 40 to 50 percent greater than the industry average. The top quintile's leverage ratio was 11.10 percent in 2004, compared with 7.99 percent for all banks, or 38.9 percent higher than the industry average. When compared with the large-bank ratio of 7.41 percent, top-performing community bank capital ratios were some 49.8 percent higher.

The effects of consolidation are as evident for community banks as for the largest banking organizations. Comparative numbers show there are about 7,300 community banks, compared with 11,000 twenty years ago. Many different factors have contributed to this consolidation, as I mentioned earlier.

Critically, the reduction in the number of community banks should not be misinterpreted as a signal that bank charters have somehow become less attractive--far from it. Let's look at the past five years. It is true that as of June 2005 there were 1,033 fewer commercial banks than at the end of 1999. That decline, however, is really not the interesting part of the story. Over

the same period, according to the FDIC, some 718 new commercial bank charters were granted. Do a little arithmetic, and that figure suggests that for every five times that one bank acquired another bank, somewhere there were two new charters being issued. Moreover, those new charters brought more than $5.7 billion of new capital into the banking industry. Both the number of new charters and the magnitude of new capital injections are an eloquent testament to the attractiveness and vibrancy of the bank franchise.

Issues of interest to supervisors

Overall, the banking industry is healthy. However, some issues warrant the attention of bankers and their supervisors. One credit risk management issue that has been in the news quite a bit lately is home mortgage lending, particularly the surge in originations of nontraditional mortgages, such as interest-only loans, payment-option loans, and various hybrid forms of adjustable-rate loans. These types of mortgages typically involve a low monthly payment for the borrower. They are sometimes called "affordability products" because the low payment can make it possible for some households to qualify for higher-priced homes that they could not afford using traditional thirty-year fixed-rate mortgages. The credit risk concern is, of course, that households stretching to qualify for loans will be severely challenged if, for example, interest rates rise, causing the adjustable rate on a hybrid loan to reset at a much higher rate. Another concern is that despite the lower monthly payment, the households will eventually have to repay or refinance the principal on these loans, whether or not the current home price is sustained. This prospect is especially troubling if the pricing and payment structure of the mortgage leads to negative amortization of the loan balance. Federal Reserve reviews indicate that banks' holdings of these unconventional mortgage loans, while still small, have risen significantly in 2005. Therefore, banks' risk management procedures must take into account the unique characteristics and credit risk profile of these novel types of loans, especially because our experience with them is quite limited.

Moving to one last credit risk management issue: Community bank loans to finance real estate construction rose 7.4 percent over the second quarter. This increase continues a remarkable trend in which commercial real estate--or CRE--lending has accounted for virtually all asset growth at community banks. In 2001 and 2002, growth in CRE loans as a whole accounted for two-thirds of overall asset growth at community banks. In 2003 and 2004, CRE lending represented essentially all of that asset growth. Over the first half of 2005, CRE loans expanded by twice as much, in dollar terms, as total assets. The continued rapid growth in CRE lending was accompanied by declines in securities holdings, home equity loans, and other consumer loans.

This pattern of sustained and one-dimensional asset growth naturally raises questions about potential concentrations of credit risk in CRE loans. These questions are most striking in markets where commercial vacancy rates are particularly high, where competition among lenders is most intense, or where potentially overheated home-price conditions have contributed to a sharp expansion in new-home construction. There is still no indication that the credit quality of these loans has begun to deteriorate, but the potential for concentrations in lending exposure remains an ongoing area of supervisory attention.

Interest-rate-risk management is always a key issue at financial institutions, particularly in the current economic and policy environment. Although many large institutions have felt earnings pressure from the flattening yield curve, net interest margins at community banks were 4.12 percent in 2004--40 basis points higher than for the industry as a whole. The gap has been even wider in 2005. A look at community banks' balance sheets and how they have been managed tells us a lot about why community banks' margins have fared better. The sharp growth in construction lending, which is predominantly variable rate, is one element that has allowed community bank loan yields to keep up with their funding costs. Community banks also reduced their holdings of securities over the past year, while shortening the maturity of

their remaining holdings. As of June, only 15.8 percent of commercial bank assets had maturities beyond five years, compared with 16.9 percent at year-end 2004 and the peak level of 18.5 percent a year earlier. At the same time, community banks increased the proportion of their time deposits with maturities beyond one year, which allowed the banks to lock in then-current rates as they were rising.

In response to the credit- and interest-rate risk management issues I've just discussed, the Federal Reserve and other regulators have, of course, concentrated on evaluating banks' risk management capability. But the agencies are also paying significant attention to broader corporate governance issues, including internal controls and internal audit. Corporate governance is more than effective risk management. Corporate governance is the framework by which the different constituencies within an institution--owners, management, and staff--interact with each other to make sure that any actions taken are in the best interests of the corporation and its shareholders. The rules of governance established by the company determine the presence and effectiveness of internal controls, as well as the incentives for behavior within the organization.

The choices banks make when they establish their risk management and corporate governance systems have important ramifications for the institution and its well-being, and not just because of regulators. These systems affect how the institution functions and how others perceive it in the marketplace. Banks whose governance systems are weak risk episodes of fraud or other control failures that will draw adverse reactions from both their customers and the financial markets.

Conclusion

A healthy and vibrant banking system is an important element of a well-functioning economy. The unique structure and regulatory framework of the U.S. banking industry has been significantly shaped by our history and market forces. As the excellent condition of U.S. commercial banks suggests, this framework continues to strike the right balance between durability and adaptability. One key element of this balance is that, despite the ever-shrinking world and the emergence of mega-financial institutions, community banks continue to experience financial success and attract real capital from the marketplace.

In this generally positive setting, issues of keen interest to supervisors remain. Banks of all sizes have benefited from recent economic conditions, experiencing historically strong asset quality, the benefits of growth in household wealth and liquidity, and a surging demand for some financial products. At the same time, these conditions present both community banks and larger institutions with important credit- and market- risk management issues, as well as broader corporate governance issues.