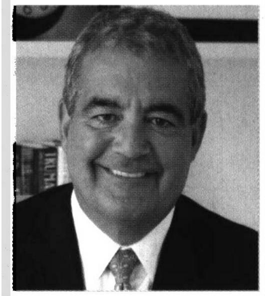
Challenges and opportunities lie ahead

Former FDIC Chairman Bill Isaac knows from personal experience that banks have been through even worse before this, and rebounded



William Isaac
Chairman of the Federal Deposit Insurance Corporation from 1978 to 1985, today Bill Isaac is chairman of the respected consulting firm The Secura Group. The consultancy was founded in 1986.

The group is now part of LECG, LLC, a multi-industry consulting firm headquartered in Washington, D.C. Isaac's insights from earlier tumultuous times in banking are well worth noting.

This article was written in early September, before some of the most dramatic recent events unfolded.

Isaac has opposed some of the measures taken this fall, including raising deposit insurance to a "temporary" general level of $250,000.

I extend my heartiest congratulations to the *ABA Banking Journal* on its 100th anniversary issue. I thought I would try to put 100 years of bank publishing in perspective. As *ABA Banking Journal* was getting off the ground in 1908:

- The Bank of Italy, founded in 1904 by A.P. Giannini, opened its new headquarters building at Clay & Montgomery in San Francisco. The bank was soon to become Bank of America and be part of Giannini's Transamerica empire.
- General Motors was founded, and Henry Ford introduced the Model T.
- William Howard Taft was elected President, and Pu Yi became China's Last Emperor at three.

What had not happened by 1908 were several major developments that were to have a profound impact on shaping the financial services industry:

- The stock market crash of 1929 and the ensuing banking panic and Great Depression
- Creation of the Federal Reserve System, the Federal Deposit Insurance System, and the Securities and Exchange Commission
- Passage of the Glass-Steagall Act, separating commercial banking from investment banking, nor passage of other laws limiting competition
- Passage of the Bank Holding Company Act, separating banking and commerce and limiting expansion by banking companies (largely to thwart Transamerica/Bank of America's expansion)

It's impressive to think about an industry and its leading magazine not only surviving, but prospering, through all of this change. It's also daunting to try forecasting what might come next.

Much of the regulatory regime imposed on financial institutions during the Great Depression crumbled in the wake of revolutionary technological developments and intense competition. Controls on deposit rates were eliminated in the early 1980s, branching restraints fell next, and the Glass-Steagall Act was repealed in 1999. The Bank Holding Company Act will be repealed, eventually.

Size versus success versus style

Strong, well-managed firms of all sizes will prosper in a market-oriented financial system.

In the "old days," before the barriers to competition unraveled, profits and growth in banking were stable. The distinctions in performance among banks were minimal. Earnings today are more volatile. The gaps between the performance levels of strong and marginal banks are wide and growing. Average and sometimes even good performance is not adequate protection against takeover.

Banks that prosper in the new environment will share some characteristics. Contrary to commonly accepted wisdom, size will not be one of them.

While scale economies exist in some of the businesses (*e.g.*, credit cards and mortgage banking), they do not exist generally in traditional banking activities. Where scale economies exist, they can be achieved by smaller banks through outsourcing. Moreover, technology is relatively inexpensive, and readily available to smaller firms.

One of the most critical factors for success is a quality management team. Organizing the team properly will also be critical, particularly in larger companies. A highly centralized organization, in which a handful of individuals make decisions that have impact throughout the firm, is at odds with the need to diversify risk.

The best model will be independent business units pursuing company-wide strategies, with centralized *control* systems. When the inevitable mistakes are made, they will likely be far more serious in a centralized company than in one composed of a number of autonomous business units.

A strong, focused sales and customer service culture is also critical. But banks will only prosper if they are in touch with customers, remain trusted advisors, and add more value than competitors.

Pro-cyclical threats must be changed

I would be remiss if I did not discuss briefly two clouds on the horizon: fair-value accounting and

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capital regulation. Bank regulation should strive to be counter-cyclical. Regulators should lean against whatever wind is prevailing in the economy and the financial system. We have it all backward today.

Fair-value accounting, imposed by the Financial Accounting Standards Board beginning in the early 1990s, is pro-cyclical and leads to exaggerated boom/bust cycles. Why? It tends to over-value assets when markets are strong and under-value assets when markets are weak to non-existent. Today's problems in the financial system have been aggravated greatly by it.

The Securities and Exchange Commission (SEC) took action against SunTrust Bank in 1999, alleging that it was manipulating earnings by setting aside what the SEC considered excessive loan loss reserves. There is no doubt in my mind that the SEC's action had a negative effect on reserving by banks during the late 1990s and early 2000s. Moreover, the earnings boost from the failure to increase reserves enabled banks to pay out more capital and/or expand their balance sheets. The one-two punch inflicted substantial, needless damage in the current credit cycle.

The Basel II capital models adopted by bank regulators are also pro-cyclical. One can only hope that regulators will rethink them.

Deposit insurance is in the same category. A reasonable level of deposit insurance premiums should be paid in good times and bad. Premiums should not be increased at a time when we are trying to encourage banks to loan money.

Tough times of the past

I was honored to serve at FDIC from 1978 through 1985 when our banks were faced with the most serious crisis since the Great Depression. Thousands of banks and thrifts failed from 1980 to the end of 1991, including the nation's eighth-largest bank (Continental Illinois), great numbers of large regional banks, many large savings banks in the Northeast, and hundreds of rural banks.

An important factor in enabling us to get through that period is that regulators were allowed to use judgment about what losses institutions should be required to recognize and which institutions were not viable and needed to be closed. The savings bank industry was $100 billion insolvent during the early 1980s —*if* its portfolios of mortgages and government bonds had been marked to market when the prime rate was over 21%. To put that in perspective, the FDIC fund stood at just $11 billion.

Major money center banks had vast amounts of loans to less developed countries on their books– loans that were selling in the marketplace at ten cents on the dollar. Had these banks been required to mark these loans to market prices, we would have had to nationalize these banks. (We had contingency plans for that.)

Despite all of the problems the industry faces, I have a great deal of faith in the ability of bankers to manage their institutions successfully through challenging times. They have, after all, been doing just that—through wars and depressions—for even longer than the *ABA Banking Journal* has been in circulation. ***BJ***