

OKLAHOMA BANKS
AND THE FEDERAL RESERVE BANK OF KANSAS CITY

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It is a real pleasure for me to be here, and I want to thank you for the opportunity.

The Oklahoma Bankers Association and the Federal Reserve Bank of Kansas City have an important relationship. Banks provide a key link in the implementation of monetary policy, and our relationship with the OBA is an important component in carrying out our responsibilities for the macroeconomy and for financial stability. The connections between our organizations extend into other areas as well, ranging from the credit available through our discount window to the work of our bank examiners to our role in the payments system. We know each other well and have for years.

When times are good, as they are now, we might tend to take our strong connection for granted. Today I'd like to reflect on our long working relationship: how it has worked during stressful times in the past and its importance for the future. I will also outline several banking issues we should be aware of even as we enjoy today's very positive banking environment. Finally, I will briefly discuss the current banking conditions in Oklahoma.

The Oklahoma Bankers Association and the Federal Reserve Bank of Kansas City

From their beginnings, both the Oklahoma Bankers Association and the Federal Reserve Bank of Kansas City have had a strong interest in serving their membership and the public. The OBA had its start in June 1897 – 110 years ago this month – 10 years before Oklahoma became a state. The Federal Reserve Bank of Kansas City opened in 1914 and our Oklahoma City Branch had its start in 1920.

There are many things I can mention in terms of a very positive relationship between Oklahoma bankers and the Federal Reserve. Many of you have participated at our conferences, economic forums and regulatory updates. We have also had a supervisory

relationship with nearly all of you, at either a bank or a holding company level. Moreover, Oklahoma bankers, including some of you, have been important participants on our board of directors in Kansas City and at our Oklahoma City Branch.

Oklahoma bankers, the OBA and Oklahoma legislators have also been very active in state and national legislative issues, including many key pieces of legislation affecting the Federal Reserve.

In discussing the Federal Reserve's connection to Oklahoma, I should mention first and foremost that the person who was responsible for writing much of the original Federal Reserve Act was Robert Owen of Oklahoma, chairman of the Senate Banking Committee. Without his efforts, and those of several other key legislators from the Midwest, it is unlikely that the Federal Reserve Act would have been passed in 1913 and that we would have the type of central bank that we have today.

On a more personal level, I would also like to mention my long personal relationship with Roger Beverage and Mick Thompson. They have been extremely helpful in providing me with their insights on Oklahoma banking and have been great to work with on a variety of banking issues of importance to Oklahoma and our region.

The Federal Reserve's Involvement in Supervision

The Federal Reserve derives many benefits from our connection with each of you.

Our Oklahoma City Branch office gains insight on the regional economy by staying in contact with bankers and local business leaders. We also place great importance on maintaining our relationships through our role in supervision and payments.

In the area of supervision, Federal Reserve Governor Don Kohn described the importance of this connection in a recent speech, saying, “The Federal Reserve’s activities as a bank supervisor provide us with important and sometimes critical information, expertise, credibility and powers to both deter and manage financial crises.”

From a personal and a very practical perspective, this supervisory experience and the resulting relationships with bankers on a regional level proved to be extremely helpful to me and others at our Bank during the energy, real estate and agricultural collapses in the 1980s.

This was particularly true in Oklahoma as energy prices dropped dramatically. We relied extensively on the firsthand knowledge gained through our supervisory responsibilities of major Oklahoma banking organizations. This knowledge provided us with an in-depth view into the Oklahoma economy and financial system – insight that proved to be of great importance when our Bank was called upon to give its views on macroeconomic policy and to take steps to help maintain a stable financial system.

While much of the rest of the country was still experiencing “boom-like” economic conditions, we were among the first regions to sound the alarm that the economy was not as strong as some thought.

In one instance – the failure of Penn Square Bank here in Oklahoma City – we were all reminded that a seemingly small organization can have a substantial impact on the entire banking system and that actions on a regional level can have important implications nationwide. Prior to its failure, Penn Square Bank had sold loan participations to eight of the 50 largest banks in the country. These participations served as the initial impetus in the failure of Continental Illinois National Bank in 1984, which was one of the 10 largest U.S.

banks, and in Bank of America's acquisition of Seattle First National Bank under a special Washington state failing-bank law.

Many of the steps taken in Oklahoma in the 1980s also benefited from a close relationship among the Federal Reserve, the Oklahoma Banking Department, the FDIC, the OCC and individual bankers in Oklahoma. This was a very stressful time for everyone, and one of my strong memories from that time was the effort by John Kirkpatrick to save Liberty National Bank and keep it under local ownership. The commitment of John and a number of others helped Liberty become one of only two major banks in Oklahoma and Texas not to fail or need FDIC assistance during the 1980s. Such efforts were of critical importance in terms of providing a starting point for turning around the Oklahoma economy, maintaining funding for many businesses here and encouraging investment in other banks, such as George Kaiser's willingness to support Bank of Oklahoma. These relationships and experience further made it clear to me that banking in the United States is best understood and nurtured at a regional level.

The Changing Banking Landscape and Financial Competition

Since the 1980s, the banking landscape has changed quite dramatically, and all of you now face a much different competitive environment. In this new environment, I would like to think the relationship to the Federal Reserve Bank of Kansas City is as important and solid as ever.

There has been a significant trend toward consolidation. The number of banks nationwide, and in Oklahoma, has declined to about half the 1980 level. During this same time period, the 10 largest banking organizations in the United States increased their share of

domestic banking deposits from about 19 percent to more than 44 percent. Interstate banking has also been an important factor in these consolidation trends, with banking organizations as a group now holding nearly the same amount of deposits in other states as they hold within their home states. In Oklahoma, 27 percent of deposits are held by organizations headquartered outside of the state.

While there may be fewer banks in Oklahoma, many of you are competing against larger institutions, including a notable number headquartered outside of Oklahoma. Moreover, the total number of banking offices – main offices and branches combined – has risen since 1980 by about two-thirds nationwide and somewhat more than that in Oklahoma. Competing institutions have wider footprints in your markets. As a result, structural changes in banking, along with several other factors I'll discuss next, are leading to a more intensely competitive environment – one that differs greatly from that of just a decade or two before.

On the lending side, a wide variety of factors are leading to more competitive credit markets. Financial information on borrowers is more readily available and at a much lower cost – both to bankers and to a wide range of nonbank lenders. At the same time, the cost of processing this loan data and making a loan has declined significantly, particularly with the advent of credit scoring, automated underwriting systems and other data processing advances. Loan customers can even be solicited over the internet, and funds are often extended with little or no personal contact.

Securitization is further bringing new investors into the marketplace, sometimes from all over the world, and increasing the volume of funds flowing into credit markets. Securitization is also creating lenders who are largely originators and hold very few loans on their books at any time. In addition, new financial instruments, such as credit derivatives, are

allowing credit risk to be transferred to other parties – ideally, to those who are in the best position to bear such risks.

An outgrowth of all these developments is an enormous expansion in the types of lenders and investors that serve credit markets, and, in turn, the creation of a much more competitive lending marketplace. These trends have further brought down risk premiums, and the spread between high-yield or junk bonds and U.S. Treasury securities has now dropped to near historic lows.

On the deposit side, a rising interest rate environment has meant a higher cost of funds for banks. Further adding to these funding costs is increased deposit competition. The internet is greatly expanding the choices that depositors have for placing their money. Local bankers are also facing increasing competition from other sources. Many large banks, for example, have rediscovered the benefits of retail banking and a broader office network, particularly as competition drives down profitability in their other business lines. In addition, a rising stock market and improving returns on other investments are now encouraging depositors to move more funds into nonbank investment options.

As all of you are aware, these trends are driving up the cost of bank funding and beginning to put pressure on bank net interest margins. During the past few years, increased real estate and business lending have helped Oklahoma banks to maintain or increase profitability in this more competitive environment and period of declining risk spreads. However, there are obvious limits to how far this strategy can be taken without adversely affecting a bank's risk exposure and potential loan losses. Thus, for all of you as Oklahoma bankers, an important question is, "How far can you go in this new environment and still maintain profitable and safe banking operations?"

Risks and Responsibilities

The current performance of Oklahoma banks indicates that many of you are meeting the challenges of this changing landscape. Net income for Oklahoma banks has been at or near record levels for the past few years. In fact, the average ROAA for Oklahoma banks was 1.4 percent in 2006, which may very well be the highest ever achieved in this state.

Other measures of banking performance, such as loan growth, interest margins, capital, nonperforming assets and loan losses have also remained at very favorable levels.

Based on this performance, it would appear that a challenge many of you face as Oklahoma bankers is not to become complacent and lose sight of the risks that are always inherent in your operations.

In this regard, I recently gave a speech titled, “This Time It’s Different (Or Is It?).” The idea behind this speech was that some bankers are now telling us, as well as their directors and stockholders, not to worry about their current strategies.

Part of their reasoning is that the marketplace has changed and that we are more capable of measuring and controlling risk exposures. Many also suggest that the United States economy has become much more stable, as based on our recent experience with several of the longest expansions on record and very mild recessions in between.

In some ways, though, this combination of great optimism, record bank earnings and declining risk spreads mirrors what we saw here in Oklahoma during the energy boom of the 1970s and early 1980s. Back then, many Oklahoma bankers saw little reason to worry about risk spreads since the price of oil could only go up.

And indeed it did – for a while.

From \$2.75 a barrel in 1973, oil prices rose to a peak of nearly \$37 in 1981 before dropping all the way down to \$10 in 1986. The optimism and rapid upward trend in oil prices made energy lending the hottest ticket in banking back then and ultimately contributed to previously mentioned collapses of Penn Square Bank, Continental Illinois and Sea-First.

For most of you, this is hardly new information. My point in drawing this quick comparison is not that I think we will repeat what happened then, but I believe we need to be a little careful at this point in the business and credit cycle. In my previous speech on this topic, I gave a number of examples of bankers in the 1970s and 1980s who thought they were following “foolproof” strategies only to find there was something they should have been much more skeptical about. Eventually, some of today’s strategies will be tested under more stressful circumstances – subprime lending is a current example – and we will then find out how “foolproof” such strategies might be.

Summary

One key to success for bankers is to be willing to ask the difficult questions about your bank’s operations and strategies: Is there anything that you should be more skeptical about? These are the kinds of questions that bankers and central bankers should be asking as we manage the present and prepare for the future. None of us can predict the future, my 30 years in banking and economics taught me that, but we can prepare for its uncertainty.

I would assert that each of you is in the best position of anyone in the financial marketplace to play this role, given your close customer relationships and the detailed knowledge and experience gained through your daily banking operations.

Finally, to come full circle, I suggest that the Federal Reserve Bank of Kansas City and the Oklahoma Bankers must continue to pursue the common objectives of sound banking and a sound economy. Our staff are observing best, and worst, practices. We can provide insight and help strengthen banking in Oklahoma. As Oklahoma bankers, you can greatly help the Federal Reserve as well, by sharing with us your valuable knowledge and personal insights on the Oklahoma banking industry and the economy.

I look forward to hearing your thoughts on the current banking environment and to continue our banking and supervisory relationships.

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