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**BRACING FOR THE FUTURE:
REFORMING THE U.S. BANKING SECTOR**

By

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BRACING FOR THE FUTURE: REFORMING THE U.S. BANKING SECTOR

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FRED BALDERSTON: BRACING FOR THE FUTURE: REFORMING THE U.S. BANKING SECTOR (Revised, April 23, 1991)

Executive Summary

There is urgent need for comprehensive reform of the U.S. banking sector: commercial banks, S&L's, savings banks and their support institutions and regulatory system. Recommendations:

1. Establish a single chartering and rule-setting Federal agency for all depository institutions.

   1a. Preempt state chartering and regulation and limitations on interstate operation of financial institutions.

   1b. Prevent industrial corporations from owning banks.

   1c. Install special capital standards and intervention triggers for large institutions to overcome "too big to fail".

2. Establish and enforce risk-adjusted capital standards.

3. Maintain adequate banking competition in all urban markets.

4. Continue deposit insurance, under restricted conditions.

5. Provide broader business authority for banks, with safeguards.

6. Set up unified supervision and examination. Assign each regulatory oversight function exclusively to one agency.

7. Require all depository institutions to publish quarterly reports of their condition.

8. Abolish the Federal Home Loan Bank System and revise FNMA and FHLMC.

Short of this comprehensive package, consider adopting now some key components compatible with it.

Financial distress, and perhaps crisis

Disarray and weakness in U.S. financial institutions --banks and S&L's -- are sufficiently evident to provoke a sense of crisis. The S&L bailout continues to ring on the national cash register, as the Congress struggled over voting $30 billion for the next phase of operation of the Resolution Trust Corporation; this money is needed to absorb losses in several hundred failed institutions. Timothy Ryan, Director of the Office of Thrift Supervision, divides the 2500 surviving S&L's into four categories as of March 31, 1990. Group I consists of 1,175 institutions with one-third of industry assets; Group II comprises 680 institutions with 1/3 of industry assets. Groups III and IV, together, are the 598 very weak and the already-failed institutions, having the final one-third of industry assets.

L. William Seidman, Chairman of the Federal Deposit Insurance Corporation (FDIC), has announced that FDIC's reserves are less than 0.6% of insured deposit liability, as against the expected standard of 1.25%, and that he has ordered examiners to be in place for continuous on-site monitoring of four hundred large banks. Chairman Seidman has asked for borrowing capacity in the amount of $75 billion to shore up FDIC's Bank Insurance Fund (BIF).

The US General Accounting Office (GAO) has reported that, of 300 large commercial banks it surveyed in September, 1990, 35 banks having assets of $45 billion had excessive problem assets and only 1.4% of equity capital. Numerous other large banks have significant problem assets and have percentages of equity capital considerably below the agreed primary capital target for 1992. The Bank of New England collapse signalled an additional serious portent.

Crisis as opportunity

Sidney Jones has pointed out that only in crisis has the nation managed to break inertia and deadlock and undertake effective financial reform. At all other times, the problems of the banking sector seem postponable, and the numerous well-financed lobbies collectively block comprehensive reform efforts. Legislative changes mostly occur in very small bites, as the contenders for market "turf" bargain with each other and with Congress. (See Jones, 1979, and Cargill and Garcia, 1985.) One indication of current urgency, if not crisis, is the call by Chairman Henry B. Gonzalez of the House Banking Committee for new legislation, including modifications of deposit insurance (Gonzalez, September, 1990). This may be a time for assessing how US financial institutions should be reshaped for the long run. Doing this may give some useful clues about the design of financial reforms for the 1990's and beyond.

Underlying shifts in financial institutions' markets

A. Global financial competition.

Major US banking institutions face global competition, much of it from "universal" banking organizations that can provide a very wide range of banking, securities underwriting and trading, and other services. To be better positioned for this, major banks should be well-capitalized and in a good risk position. There is concern that these two conditions are not currently met by a number of the large "money-center" banks. Further, they claim to be hampered by restrictions against doing securities business and against offering broader investment banking services.

B. Nationwide banking, and scale economies.

Within the US banking market, historic restrictions against interstate banking are now on the way toward being repealed, piecemeal, by means of various negotiated compacts between states. But the technology and the management methods that would enable financial institutions to operate effectively nationwide are now well-known. Congress could face up to the possibility of Federal preemption of geographical restrictions, and then authorize the US Controller of the Currency and other Federal agencies to license and monitor interstate branching by qualified institutions.

Although cost/efficiency studies in banking have in the past given somewhat mixed indications of economies of scale, it now appears clear that with the advent of large-scale computer networks and data processing and other management techniques, larger financial institutions will have permanent operating cost advantages over small ones. This will reinforce the drive toward consolidation of the structure and the survival of a smaller number of, on average, larger institutions.

C. Securitization.

Securitization of many previously unmarketed financial assets now permits flows of financial capital almost directly from organized markets to final uses. This reduces the significance of portfolio lending, and it offers a challenge to financial institutions to redefine their roles in the capital markets. In particular, housing finance has been greatly affected, so that "portfolio lenders" -- lenders which originate loans and then hold them until they are paid off -- are no longer so dominant.

D. Risk control and debt burdens in the economy.

A general buildup of risks in the financial system, and in Federally-guaranteed programs such as Farm Credit, VA-guaranteed home loans, and FHA, has been under way for many years. Government, consumer and business debt have grown far faster than the rate of growth of GNP. The financial sector thus contributes to the precarious state of the US economy.

E. Problematical status of deposit insurance.

The S&L debacle, plus the weakening of numerous commercial banks, pose serious problems for the Federal deposit insurance system. Serious questions are now being raised for the first time in many years concerning the wisdom of a deposit insurance system that has been abused by the industry and that imposes heavy costs on the general taxpayer.

An ideal US financial structure for the 21st century.

Several objectives should be served by the financial structure of the future.

* The financial institutions comprising it should be stronger and more efficient than they have been in the past.

* These institutions must be well capitalized, with adequate risk-adjusted primary capital.

* The system of regulatory oversight should be non-political and be simpler, stronger, and more competently managed than in the past,

and it should have statutory authority to intervene early if an institution gets into trouble.

* US-based financial organizations should be enabled to compete with a broadened range of financial services, <u>provided</u> that these additional activities are segregated from the deposit-taking institution in separate subsidiaries and that safeguards are built in against cross-transactions. (Tight restrictions against cross-transactions might reduce the attractiveness of having wider business authority, but poor risk management by S&L's that made heavy direct investments in real estate is a cautionary lesson.)

* Because financial services are provided in nationwide as well as quite local markets, financial institutions should be enabled to grow through interstate branching and acquisitions into nationwide institutions, but with safeguards to maintain banking competition.

* Deposit insurance should become a less prominent feature of the system than it has been in recent years, wherein large-scale brokering of Federally-insured CD's to weak and desperate S&L's and banks enlarged the eventual scale of their losses and their cost to the deposit insurance funds.

The actions recommended to achieve these objectives are:

<u>1. A single chartering and rule-setting Federal agency</u>

Genuine interstate operation of banks and S&L's will vitiate the traditional pattern of "dual banking" whereby states have engaged in chartering and branch-licensing in competition with the cognizant Federal agencies.

<u>1a.</u> Furthermore, as the financial services offered by S&L's

now approximate the full span of consumer financial services offered by commercial banks, it is probably time to abandon separate charter status for S&L's and have only a single, national bank, charter for all depository institutions.

A single chartering agency could then set and enforce uniform rules of depository institution operation. It could and should facilitate the rapid conversion to nationwide operation of multi-branch financial institutions. A significant inferential benefit of multi-state, multi-market banking is the reduction of the institution's overall loan portfolio risks *via* its involvement in numerous geographical markets whose economic conditions and cyclical movements differ. (See Quigley, 1990.)

1b. The US Treasury's banking reform proposals include provisions that would permit and encourage non-financial corporations to buy control of banking institutions. The American banking policy tradition has set a separation between financial intermediaries and operating companies. In a number of instances, S&L's that had ownership overlaps with operating companies failed to adhere to prudent controls requiring arm's-length transactions and avoidance of conflicts of interest. The subsequent losses added substantially to the taxpayer costs of the Bailout. While the argument is made that new capital could thereby be attracted into banking, this does not justify the public risks that could well arise.

1c. "Too big to fail" was the pragmatic position of the regulatory authorities in the Continental Illinois Bank failure and in other cases and was the main reason for very heavily-assisted merger, instead of liquidation, as the preferred solution. (See Sprague, 1986.) Very large institutions would increase in number if nation-wide banking is encouraged. To overcome the "too big to fail" problem, it would be worthwhile to take two steps: first, require that the large banks be permitted to grow through acquisition only if they meet capital adequacy standards <u>in advance</u>; and second, to install a publicized take-over trigger if such an institution falls below a specified positive percentage level of adjusted net worth to total assets, and to set the trigger at a higher percentage than that for smaller institutions.

If all state and Federal bank charters and all state and Federal S&L charters were reduced to one basic depository institution charter, industry factions would argue strenuously for the retention of previous marketing and service advantages and previous tax preferences. For example, the tax preference available to S&L's that meet the "Qualified Thrift Lender" (QTL) test would be a casualty of a simplified system. In fact, the pro-housing-finance theme that underpins the S&L industry would no longer apply, although the accumulated <u>expertise</u> of S&L's as housing lenders would undoubtedly cause many of them to keep their focus on residential mortgage lending. Housing finance would be a niche, not a commitment.

<u>2. Risk-adjusted capital standards: strict enforcement.</u>

Risk-adjusted capital standards for every financial institution impose greater incentives toward prudent management. Such standards are already built into the regulatory structure for banks and, with the passage of FIRREA in 1989, for S&L's. As the deadlines for meeting the fully phased-in capital requirements approach, institutions and their lobbyists will plead strongly for forbearance -- more time, or lenient accounting rules for valuing assets and liabilities. Such pleadings should be resisted, for the safety system will depend on the credibility of the standards and their enforcement. In the longer run, US institutions will have greater staying power in global competition when they are well-capitalized.

In addition to enforcing appropriate capital standards, the regulatory authorities should require institutions to report the "mark-to-market" value of their assets and liabilities to the extent possible. Some unmarketed assets can have, at best, proxy values. Also, the volatility of asset prices would cause net worth to fluctuate over a wide range in a full mark-tomarket balance sheet. These considerations may inhibit full adoption of mark-to-market, although in other respects it has merit as a means of avoiding reliance on unrealistic book values of assets and liabilities.

<u>3. Maintenance of an adequate level of competition in all metropolitan markets, under conditions of nationwide banking.</u>

A possible hazard of nationwide banking is that financial services could be dominated in many markets by few institutions. The Federal Reserve Board has traditionally had responsibility for approving or disapproving bank mergers in reference to the maintenance of competition. It should continue to have that role, which in the past, because of state-by-state geographical restrictions, has focussed mainly upon the competitive implications of within-state mergers.

Because each nationwide banking organization would have incentives to open branches in the attractive metropolitan markets, it should also be anticipated that branching competition would often, in fact, increase the number of competitive alternatives available to households and businesses. The main purpose of a pro-competitive policy would be to prevent mergers and acquisitions that would result in market dominance by one or a very few institutions in given metropolitan markets.

4. Continuation of deposit insurance under restricted conditions.

Deposit insurance fulfills two very different functions. First it protects the small account-holder who cannot typically judge the soundness of an institution. Second, deposit insurance eliminates incentives that would otherwise lead to a "bank run", based on rumors of the possibly weakened condition of an institution. Where deposit insurance does not exist, a run on one bank has on occasion spread to another and yet another, producing the danger of epidemic collapse of the financial structure.

These positive features of deposit insurance can be retained while, at the same time, the abuses that were so costly in the S&L debacle are prevented. The first step is to limit the present coverage to no more than one or two accounts per person, as Congressman Gonzalez has suggested. The person holding additional accounts could be required to pay separate, upfront deposit insurance or, alternatively, knowingly go without.

Some previous bank failures have provided de facto coverage to all deposits, without limit, and to other holders of debt instruments of the bank, under the "too big to fail" policy. Failure of a large bank is likely to have, at the least, regional repercussions if large depositors are wiped out. This was said to have been an important line of reasoning of the Federal authorities in the Continental Illinois bank case. (See Sprague, 1986.) On the other hand, the presumption that large deposits can be held without any risk immunizes the bank from careful depositor judgments, no matter how badly it manages.

FDIC should therefore establish new guidelines concerning deposit insurance coverage and the contingent losses to which deposits over the insured limit would be subject. Further, all other debt instruments of the bank should be categorically subordinated to the claims of the deposit insurance fund, both in liquidation and in negotiated, assisted merger. The management of the bank would realize that such subordination, with the likelihood of partial loss of principal if the bank were to fail, would cause the holders of such debt instruments to be sensitive to information as to the condition of the bank. These debt-holders could very well balk at reinvestment upon maturity if they became worried enough. (Indeed, Citibank found that its recent rollover of short-maturity preferred stock had to be undertaken at a (very high) thirteen percent yield (New York Times, November 2, 1990). Such difficulties of maintaining debt levels impose an additional cautionary control upon a bank that is weakened through bad management or poor market experience.

For simplicity of administration, separate accounting of FDIC's two funds as provided in the 1989 legislation should be terminated, and a single schedule of deposit insurance premiums should be set by FDIC for all insured accounts. At present, the Savings Association Insurance Fund (SAIF) and the Bank Insurance Fund (BIF) are kept as separate accounting entities, and the deposit insurance premiums paid by S&L's and banks are set separately. There would be no real need for this in a streamlined system.

Some have advocated risk-adjusted deposit insurance premiums. Most default risk accumulates over time; in the case of mortgages and other long-maturity financial assets, the full consequences of default and loss often do not become apparent for months or years. Risk-based premiums based on accounting records would often be too little, too late. However, the premium payment schedule could perhaps be devised with several risk categories at different premium levels. The institution could choose which category was appropriate to its management objectives and intended risks. Penalty rates could then be imposed if the ex post, observed risk exceeded the permitted risk level in the chosen category.

5. Broader business authority for financial institutions, with safeguards.

The case is persuasive for allowing a broader range of financial services to be offered in financial institutions. For example, the National Bank Act authorizes national banks in small towns to sell all types of insurance, and the Office of the Controller of the Currency (OCC) permits national banks generally to sell limited kinds of insurance. (US GAO, September, 1990). Although independent insurance agents oppose this invasion of their "turf", the banks in question apparently can gain some economies of scope and enhance profitability of operations.

Bank holding companies are now permitted to organize special subsidiaries to engage in underwriting and selling bank-ineligible securities -- chiefly, commercial paper. Banks and bank affiliates already have authority to underwrite and sell some "muni's" -- tax exempt securities of several types. The Federal Reserve Board requires the bank holding companies to establish and separately capitalize subsidiaries for bank-ineligible securities business, and it sets severe restrictions on the administrative relations and transaction relations between the securities subsidiary and the other affiliates of the holding company, particularly the bank subsidiary or subsidiaries. (See US GAO, March, 1990. Appendix VII reprints the Federal Reserve "firewall" regulations.)

As Glass-Steagall continues to crumble, the broader business authority of banks and bank holding companies should enable them to compete more actively with foreign banks and to capture economies of scale and scope in their own operations. One important sticking point is to protect the deposit insurance fund and the other supporting Federal facilities for banking from incurring risks as a result of these extended activities. The Federal Reserve regulations seek to accomplish this. Bank holding company spokesmen do complain that the "firewall" restrictions are excessive and unnecessary, but the Federal Reserve Board is likely to be cautious about relaxing them until there is an operating record to evaluate.

In the long run, it will make sense to allow a wide variety of financial services to be marketed through financial institutions' branch systems. Where a given type of service requires separate regulation -- e.g., securities underwriting and dealing, by the US Securities and Exchange Commission -- a separately capitalized subsidiary should be required. Then, to avoid conflicts of interest and other abuses, there should be appropriate restrictions on cross-transactions and overlapping of managerial duties.

5. Regulatory oversight

The S&L debacle provides several lessons. First, those in charge of the regulatory process -- rule-setting, examination, supervision, and enforcement -- need to be effectively insulated from capture by the regulated firms and their trade associations and from political intrusion into particular regulatory decisions. (By contrast, the Federal Reserve Board has managed over the years to maintain independence as a regulator while being accountable to both the executive and legislative branches.) Second, effective regulatory oversight requires an organization staffed at a high level of professional competence, which can obtain and analyze information of all the types required, and can do this in a timely way. Third, the regulatory authority must have both the statutory power to enforce regulations. It must have the power to intervene if an institution must be restricted or taken over, and the will to use that power. Finally, division of responsibility between Federal and state regulators has in the past impeded clarity in rule-setting and prevented prompt and firm intervention.

More unified administration of the regulatory process for all depository institutions and their affiliates would now make sense. At the same time, there are reasons both in history and in logic for allocating certain regulatory functions to different agencies. One possible assignment of duties would be:

1/ chartering, rule-setting, examination and supervision: OCC.

2/ examination and supervision, takeover, liquidation, pay-off to insured depositors, and asset disposal: FDIC.

3/ holding company regulation, oversight of largest banks; approval of mergers: FRB.

4/ regulation of additional financial services: each cognizant agency, such as SEC for securities underwriting and dealing.

As a practical matter, this streamlined scheme of regulatory oversight leaves nothing to the states and everything to agencies of the Federal government. The basic case for doing this is that dual and multiple jurisdictions are now more than clumsy: they are too dangerous to the public as a whole to be tolerated.

<u>6. Require all depository institutions to publish quarterly reports of their condition.</u>

If deposit insurance coverage becomes more restricted, there will be increased public need for information as to the true condition of every depository institution. This is one reason to require regular quarterly disclosure of each institution's balance sheet, problem assets, and income statement. Large depositors and investors will become more cautious about buying CD's of weak institutions and will likely allocate funds toward the stronger ones.

In addition, there is clearly some prophylactic effect from the publication of information concerning the financial institution. Its executives and board of directors have greater cause to exercise prudence if they are aware that the consequences of their actions will have to be reported promptly to the public. (However, we should not expect miracles. Publicly traded banks and savings institutions have for some years had to divulge much information as to their true condition, because securities analysts and the investor community demanded it. This may have induced some increase of prudential reasoning, but it has not prevented a good many publicly traded banks and S&L's from getting into trouble.)

Finally, regular publication of the condition and performance of every depository institution will force the regulatory authorities themselves more into the open. A fault of the old system of S&L regulation was that non-disclosure of the condition of the regulated institutions permitted the regulatory authorities, state and Federal, to maintain a veil over the industry which it was their public duty to regulate for safety and soundness. Egregious cases of speculation and bad management escaped public notice until the losses being accumulated by the worst institutions had already reached extraordinary size. If the regulators had had to answer to insistent and timely inquiries about their response to these problem institutions, they might have acted more quickly.

<u>7. Abolish the Federal Home Loan Bank System; revise the status of FNMA and FHLMC.</u>

Simplifying the charter to a single jurisdiction -- the national bank charter, under OCC -- would make all depository institutions members of the Federal Reserve System. This would extinguish the need for the lender-of-last-resort need for the Federal Home Loan Bank System (FHLBS), which was the main original motivation for establishing it. The twelve regional banks of the FHLBS would no longer be necessary. Their more recent supplementary function -- providing expansion advances financed <u>via</u> the agency-securities market at somewhat below-market interest rates -- would not be necessary either. Therefore, the Federal Home Loan Bank System could be abolished and its equity base distributed to its (compulsory) owners, the savings institutions that have been obliged to buy stock in the banks. Such a capital distribution would be a welcome one-time increment to the primary capital of savings institutions.

The Federal National Mortgage Association (FNMA, or "Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") were designed to help the portfolio lenders by providing a supporting, secondary market. Both institutions borrow in the agency securities market and thus receive an inferential Federal subsidy. This arrangement no longer appears necesssary, as both companies are now large and robust, and they compete with depository institutions.

<u>The transition.</u>

If it is agreed that the ideal framework sketched above is substantially more appropriate for the next twenty years than the present one, there remains the stubborn problem of enacting and implementing such broad-scale change. The most likely prospect for doing so would be a nationwide (or even worldwide) crisis of the financial sector, necessitating a far-reaching response. The lobbying protections of existing turf and the ordinarily overwhelming commitment to inertia might then be overcome.

If such an unwelcome crisis does occur, the chances of enacting a coherent and comprehensive package of financial sector reform will be enhanced by having a blueprint for the future ready to hand. To complete such a blueprint should engage the energies of people with many types of <u>expertise</u>. This paper is but one step in such a process.

Another and more limited, although valuable, purpose can be served by setting forth a proposed ideal, long-term framework. When piecemeal proposals come forward, as they do quite regularly in the normal political process, they can be evaluated both for their immediate appeal and, using this framework, for their validity as components of an appropriate long-term approach. This may help to us impart greater coherence to incremental change, if that is what we must settle for.

It is of interest to ask whether, <u>without a crisis as the spur</u>, there may be a possible strategy for bringing about the simplified, more effective banking structure that we have outlined. The political economy of such a strategy is very difficult to fathom, but a few components may be worthy of consideration:

1. Charter competition by the states and by Federal jurisdictions other than the Office of the Controller of the Currency would have to be eliminated. This would require Federal legislation to enact Federal preemption of the bank chartering authority. It would have to be supported by legislation and regulation that extended

Federal deposit insurance only to those institutions conforming to the new charter conditions and that would prohibit the states from attempting to provide deposit insurance on their own. (In several states, deposit insurance has previously failed, at great financial and political cost.)

2. Interstate banking could be reserved only to institutions possessing the national bank charter and meeting specific regulatory standards of safety and soundness. Interstate banking is sufficiently attractive to be an inducement toward support of a new design for the financial structure.

3. Bank holding companies could in future be reserved to those having national banks as their deposit-taking subsidiaries.

4. For a limited period, state-chartered banks, savings banks and S&L's, and Federally-chartered S&L's, could be offered conversion to the national bank charter through the offer of transitional steps toward full conformity to capital adequacy and other standards.

5. The Federal Reserve could consider whether to confine eligibility for its discount window to those institutions which transferred into the new system.

Finding a path toward full adoption of the blueprint of a simpler, stronger industry framework is in great part a question of political art rather than economic analysis. Perhaps, however, the list of elements given above would help to nudge the many contending participants toward accepting a new system.

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