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A Double Umbrella For The Banking System

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I would like to focus on the current problems besetting the American banking industry and a possible way to improve the situation by providing a "double umbrella" for the banking system.

I need not tell a gathering of financial analysts that many banks are experiencing extraordinary difficulties. Last year, 136 commercial banks failed and over 2,700 banks reported losses. This represents nearly 20 percent of all commercial banks in the country. In the last quarter of 1986, over 4,300 banks, representing 30 percent of the total, experienced losses. Clearly, these are troublesome figures.

Last year, provisions for loan losses in the amount of $21.7 billion exceeded total profits of $17.8 billion. Profits were down from the $18.1 billion reported in the previous year. Return on equity and return on asset ratios are now worse than in the recession year of 1982. Banks increasingly rely on securities profits and other nonrecurring gains to bolster their stated profits.

These difficulties are emerging when the American economy is in the fifth year of the current economic expansion. It would be difficult to argue that the problems confronting the banking industry are caused by a cyclical downturn. Instead, the problems besetting the banking industry are structural in nature and call for structural solutions. The time for bank reform has come.

Structural Causes of Bank Problems

Among the structural causes for the current rash of bank failures and the precarious position of many banks, four reasons stand out: the loss of a protected franchise, lack of geographic diversification, lack of product diversification, and bad management.

The Loss of the Banking Franchise

During the last two decades, banks increasingly lost their protected franchise. When I attended college in the 1960s, banks had an almost exclusive franchise in deposit taking. Banks took these low-interest deposits and transformed them into longer term loans, thereby earning a steady rate of return on the spread. Banks were the only institutions with access to credit information and the payments system.

Modern developments have eroded the value of the banking franchise on the asset side, the liability side, and the payment system.

On the asset side, the advent of the information revolution and the establishment of credit rating agencies for corporations and individuals, eroded the value of proprietary bank information on credit standings. Credit information is now as far away as the Yellow Pages of the telephone book. Standard and Poor, Moody's, Dun and Bradstreet, TRW and many other sources of credit information are available. This enables department stores, automobile companies, and other commercial enterprises to be active competitors in the credit business.

Furthermore, institutions with high credit ratings can now access the financial markets in their own right through the issuance of commercial paper and increasingly also through term notes. Individuals who live in areas with proper Zip-codes are now inundated with offers for instant credit lines from a broad range of institutions. Banks are left with the high risk customers.

On the liability side, competition is just as keen. Money market funds and integrated cash management accounts at brokerage houses offer check writing privileges along with alternative investment vehicles that are more flexible and diverse than the limited range of financial instruments that banks are allowed to compete in.

Banks are no longer the only institutions that can offer transaction services to their customers. At the same time, commercial and financial enterprises have gained access to the payment system through non-bank banks that can effect wire transfers just like commercial banks.

In sum, the communication and information revolution has permanently altered the financial landscape and reduced the value of the banking franchise.

Lack of Geographic Diversification

The American banking system is geographically more fragmented than that of any other nation. While everyone agrees that the interstate commerce clause of the Constitution has been the basis of much of our national prosperity, the McFadden Act and a host of state laws restrict the ability of American banks to branch across the nation. What is good for commerce, should also be good for banking.

Every finance major knows that diversification is the basis of financial stability. It is therefore difficult to understand that geographic diversification, which is the prerequisite for being able to reach different markets, is still prohibited in the United States.

The evidence shows that bank failures are concentrated in states that limit branching. In 1986, 89 percent of all bank failures occurred in such states. The ratio of failed banks to total banks was particularly high in unit banking states.

In contrast, only 15 bank failures occurred in states with statewide branching. It stands to reason that the statistics on bank failures would have been even more dismal if it were not for branch banking in some of our most populous states. In California, banks closed hundreds of branches during the last few years. These branches were certainly not closed because they were highly profitable. Virtually all of them incurred losses. Clearly, we would have had many more bank failures if it had not been for branching and the geographic diversification possibility that it affords.

<u>Lack of Product Diversification</u>

Over the decades, newly erected legal barriers have forced American banks to become increasingly focused on a narrow spectrum of banking products. In the early days of California, the State Constitution did not permit stand-alone banks, because there was the fear that the banker might abscond with the savings of the depositors and might never be seen again. Consequently, the law required that banks had to be connected to a commercial business that offered some security.

In California, the connections between commerce and banking were close. Wells Fargo Bank grew out of the stagecoach business, and Crocker Bank was connected to the railroads. Transamerica Corporation was Bank of America's holding company until the Bank Holding Company Act forced divestiture in 1956.

Historically, many American banks were engaged both in commercial and investment banking. But the Glass-Steagall Act told banks that they could not be primarily engaged in the securities business.

All these legal strictures were placed upon banks in an effort to make them safer by separating them from presumably risky commercial and other financial endeavors. But at the same time, the benefits of diversification were lost.

When the advances in technology and communications that I referred to earlier made it possible for the customers with the best credit risk ratings to bypass the banks, they were left with a shrinking and more risky customer base.

Now the credit ratings of banks are worse that those of commercial and other financial enterprises. There is only one major American bank left with an AAA rating.

At the same time, foreign banks who can offer a broader range of financial services and who are often part of larger financial and commercial conglomerates continue to be highly rated. Furthermore, some of their financial activities in the United States are grandfathered, so that restrictions of the Glass-Steagall Act do not apply to these foreign institutions. Foreign banks are free to engage in any commercial enterprise in the United States, as long as the majority of that activity is carried on abroad.

If we continue to hobble our American banks against foreign competition, we should not be surprised when American banks continue to lose market share against their foreign-based competitors.

Bad Management

Clearly, many bank failures are caused by bad management. Loans without proper credit checks, high credit concentrations, sloppy and incomplete documentation, and speculative mismatches are a road to disaster when economic or financial circumstances change. But even good managers can be severely tested when economic conditions change. In those circumstances it takes the very best helmsmen to weather the storm. I doubt that we have more than 14,000 of those experts around.

Overcoming the Crisis

What is the way out of the current crisis? From what I have said so far it should be clear that I believe that increased diversification along geographic and product lines is the key to strengthening the American banking system.

But there are also problems associated with opening the door to a much broader range of banking activities. Banks are special in that they are the custodians of the funds entrusted to them. Federal deposit insurance confers certain competitive advantages to banks, and access to the payment system brings with it special requirements for safety and soundness. Enterprises associated with banks should not enjoy a privileged position versus that stand-alone competitors.

How can we balance these potentially conflicting objectives? I believe that a legal structure that provides for a "double umbrella" protection for the banking system, while providing for the possibility of engaging in a broadly diversified range of activities, may be best suited to provide safety and soundness to the banking system.

A Blueprint For Bank Reform

One, full interstate branching should be permitted as soon as possible. At the present time, failing institutions can often be acquired across state lines. States with extraordinary banking problems have already opened their doors to any and all comers. But if we wish to strengthen the banking system, it makes little sense to permit mergers only among banks when one is already in grave peril. That does not provide the basis for future prosperity.

Two, I would permit the formation of financial services holding companies along the lines suggested by many observers, including the Association of Bank Holding Companies. The regulation of the various bank, thrift, insurance, investment, securities, and real estate subsidiaries would be along functional lines by presently existing authorities. Limits would be placed on the extension of credit by the bank to the associated institutions, and all transactions would have to be on an arms-length basis.

Three, I would add one additional provision to assure that the special position of the bank -- its access to deposits, the payments system, and the discount window -- could not be, under any circumstances, exploited by the holding company or other subsidiaries. This provision would require the holding company to serve as a "source of strength" to the bank by making a commitment to maintain the bank's capital. In other words, the bank would not be allowed to fail as long as the holding company has a positive net worth. This would constitute the first protective umbrella for the bank.

Finally, I would allow commercial enterprises to own a financial service holding company. Here, too, an undertaking should be made to downstream capital from the commercial enterprise into the financial enterprise. This would be the second umbrella of protection for the bank.

A Safer Banking System

The result of these actions would be banks that are at least as strong as the corporations holding them. The safety of customer deposits would be assured and there would be no incentive on behalf of the associated enterprises to "loot the bank".

The financial nerve system of the nation would be accessible to all corporations and financial institutions that desire such access, but it would be safeguarded at the same time.

The geographic diversification would not only lend greater stability to the banking system, but also provide access to national and international financial services to corporations all over America. I need not emphasize the importance of that point for the current drive to increase our international competitiveness.

The steady decline of America's banks in the world financial league tables would be arrested, and American banks would again be able to compete for the number one rating in world financial markets.

Most important of all, American banks would again be the most creditworthy institutions in the country.