The Federal Reserve Board

Remarks by Governor Laurence H. Meyer

At the Ohio Bankers Day Convention, Columbus, Ohio
November 21, 1996

The Transformation of the U.S. Banking Industry and Resulting Challenges to Regulators

Good morning. It is a pleasure to be here on Ohio Bankers Day. The over-riding theme of my remarks is the profound transformation the banking industry has undergone over the last 15 years or so and the challenges that these changes pose to bank regulators. At the end, I hope to have time to take some questions and learn where you think the banking industry is going, and how--consistent with our responsibilities--regulators can promote a more efficient, resilient, and profitable financial services industry. I plan to learn as much or more from you as you learn from me.

The Role of Banks

Let me begin with a few observations about the importance of the banking industry in the economy and why banking receives such special attention in terms of regulation. Banks, like other financial intermediaries, pool and absorb risks for depositors and provide stable sources of investment and working capital funds for nonfinancial industries. Banks also provide a unique mix of services among all financial intermediaries, including a "safe haven" for small, unsophisticated investors through insured deposits, an important source of funds for small borrowers who often have limited access to other sources of external finance, a smoothly functioning payments system that allows financial and real resources to flow relatively freely to their highest-return uses, a conduit for monetary policy, and a backup source of liquidity for any sector in temporary difficulty through its access to the discount window.

Throughout all the changes of the past, and through all the changes to the banking industry in the foreseeable future, banks will continue to perform these important functions, and a goal of bank regulators is to make sure that there is a healthy banking industry to do so.

▲ Return to top

The Rationale for Bank Regulation

But there are two particularly important characteristics of the banking system that demand our attention as regulators--indeed, are critical to understanding why there are bank regulators. First, banks have access to a government safety net through deposit insurance, the discount window, and payment system guarantees. This gives the government a direct stake in keeping bank risks under control, just like a private insurance company has a stake in controlling the risks of policyholders. Because deposit insurance can never be fully and accurately priced, it is necessary for us to monitor and sometimes to act to control bank risks in order to protect the potential call on taxpayers. It is also important to understand that an unintended consequence of the safety net is that it creates or augments incentives for some banks to take additional risks. That is, the safety net creates moral hazard incentives to gamble because the safety net--and potentially taxpayers--may absorb most of the losses if the gamble fails. Deposit insurance gets in the way of the depositors signaling a bank when it takes excessive risks.

The second characteristic of banks that requires the special attention of regulators is that banks are capable of being the conduits of systemic risk and crisis in financial markets. A breakdown of the payments system or other contagion effect that hampers the ability of banks to intermediate credit flows could have serious adverse consequences for the economy, again requiring the special attention of regulators to bank risks.

The challenge is to strike a balance in regulation so that, on the one hand, taxpayers are protected, extensions of the safety net are avoided, and moral hazard incentives are mitigated without, on the other hand, undermining the competitiveness of the banking industry and its ability to take risk, and therefore damaging the entity the regulators are trying to protect.

▲ Return to top

The Evolution of Bank Regulation

Although this rationale for bank regulation has not changed, in the last decade and a half there has been a significant evolution in approach of regulators toward maintaining the safety and soundness of the banking industry. From the 1930s through most of the 1970s, regulators focused on keeping the banking industry safe and sound by protecting banks from competition and by limiting the activities in which they could participate. This meant, for example, prohibiting interstate banking, restricting the rates that banks could pay on deposits, and preventing commercial banks from competing in other product markets, such as investment banking. During this period, the financial services industry was segmented into separate entities providing commercial banking, investment banking, insurance services, etc. This separation was largely due to legislative and regulatory decisions. A consequence of the separation was that firms in each segment of the financial services industry were protected from competition from firms providing the other services.

Starting in the late 1970s, the changed economic environment along with advances in technology, financial innovations, and globalization resulted in increased competition to U.S. banks by thrifts, nondepository financial institutions, foreign banks, and the capital markets. Higher and more variable interest rates, and the accompanying increased yield sensitivity of depositors and borrowers, contributed to the development of money market mutual funds as alternatives to bank deposits and the growth of finance companies and commercial paper as substitutes for bank loans. The increase in external competition brought a swift response from both banks and their regulators.

Banks responded to the challenge by expanding in ways that they could, also taking advantage of improvements in technology and applied finance. They expanded their roles as intermediaries through off-balance-sheet activities such as securitization, back-up lines of credit and derivatives, and, in the process, substituted fee income for some of the interest income lost through competition with other financial intermediaries. In addition, banks sought expanded powers to help them compete, including being able to cross state borders, set their own deposit rates and account types, and--by the late-1980s--expand into securities underwriting activities.

Regulators responded to the new environment by reducing the regulatory burden on banks and allowing them to compete on a more level playing field with nonbanking firms. That is, the new market realities required a reorientation in emphasis from protecting banks from competition to giving banks the opportunity to compete not only with other banks but with nonbank competitors as well. By allowing banks to enter other states, set their own prices, and engage in other than traditional banking activities, the orientation of regulators evolved toward protecting the safety net while allowing banks to deliver financial services to the public efficiently, profitably, and with sufficient capital to be protected against unforeseen events.

▲ Return to top

Structural Change in the Banking Industry
As a result of this process of structural change, the banking industry of the mid-1990s in many ways hardly resembles that of the late 1970s and early 1980s. Some of the major changes that I want to focus on are the increased consolidation of the industry, the decline in traditional banking services as a result of increased outside competition, the expansion in bank powers, including the move into nontraditional activities to offset the competition for their traditional products, the increased emphasis on risk management in response to the increased complexity of financial instruments and practices, and the evolution of capital standards and capital positions to keep abreast of the changing risk profiles of banking organization.

Consolidation in the banking industry
One of the most obvious and dramatic changes is the consolidation of the banking industry. The number of independent banking organizations--by which I mean top-tier holding companies plus unaffiliated banks--has shrunk by more than one-third since the late 1970s, from more than 12,000 to fewer than 8,000. The percentage of banking assets controlled by organizations with more than $100 billion has about doubled, and is now close to a fifth of all U.S. banking assets, while the percentage of banking assets in banking organizations with less than $100 million in assets has dropped by half, from about 14 percent to 7 percent of industry assets.

Much of the consolidation is a direct outgrowth of the removal of geographic restrictions on bank branching and holding company acquisitions by the individual states, a process that is now being extended by the Reagle-Neal Interstate Banking and Branch Efficiency Act of 1994. This deregulation encourages the banking industry to become more efficient at serving the public's needs by allowing the efficient competitors to succeed and manage more of the industry's resources. The banking industry has also become stronger through the geographic diversification of risks made possible by interstate banking.

Importantly, the interstate expansion of large banks does not mean the end of small banks. Past experience has consistently shown that when large banking organizations enter a new local market by acquisition, the existing small banks that are efficient can compete successfully and maintain their market shares and profitability. We fully expect thousands of small banks to remain in business even after nationwide branching is fully implemented.

The emergence of, and response to, increased outside competition: a decline in traditional banking and the growth of nontraditional activities
Over the last 15 years, there has also been a substantial increase in competition to the U.S.

banking industry from capital markets, less-regulated domestic financial institutions, and foreign institutions. As a result, U.S. banks have lost substantial market shares of many of the asset and liability categories that were the mainstay of traditional banking. However, these declines in market share for banks in traditional product lines do not suggest that the banking industry itself is in decline. After factoring into the analysis the rapid expansion of nontraditional off-balance-sheet activities, research suggests that the banking industry continues to grow, although not as fast as financial markets as a whole. The banking industry, for example, has grown at about the same rate as GDP and the new products of the banking industry--such as derivative contracts and other off-balance-sheet activities--have skyrocketed.

The most important indicators of whether the banking industry is in decline--measures of financial performance--are even more positive. The banking industry is profitable, able to raise capital in financial markets, and has a relatively high market-to-book ratio. These performance indicators also suggest that resources will continue to flow into the industry, rather than out of the industry. The evidence taken as a whole suggests that the banking industry is weathering the increase in outside competition and is competing well against it.

▲ Return to top

The expansion of bank powers
The powers of banking organizations also grew dramatically over this time period in two different ways. First, in the early 1980s, the Monetary Control Act gave banks the right to set their own deposit interest rates and offer new types of accounts, such as household transactions accounts that paid market-based interest rates.

Another major way in which banking organization powers expanded over this period was the increase in the number of banking activities permitted to nonbank affiliates of bank holding companies. Regulators allowed bank holding companies to enter more and more product markets over this time period. Bank holding companies can now have separately capitalized subsidiaries that offer investment advice, provide discount brokerage services, and underwrite both debt and equity securities, albeit under restricted circumstances. The market also played a large part in blurring the old distinctions between banks and nonbanks, as other financial services companies began to offer more products with characteristics close to those of bank deposits and loans. Again, the regulatory shift in orientation was in large part a reaction to the market--banks were given more power to compete with nonbanks in part because nonbanks were figuring out better ways to compete against banks.

It is also notable that over time banks have taken much greater advantage of the powers they already had. As I mentioned earlier, banks greatly increased their use of off-balance-sheet guarantees to follow some of their loan customers who chose to borrow their funds elsewhere, and banks were also active players in the new derivative products of the 1980s and 1990s.

Increased emphasis on risk management and the growing importance of market risk
Despite these many changes, the core business of banking has remained the measurement, acceptance, and management of risk, although a number of important developments over the last 15 to 20 years have improved the abilities of banks to perform these functions. The most notable developments are in the area of market risks. Derivative contracts such as futures and swaps are essentially new lines of business for banks in the last decade and a half,

which allow banks to measure, accept, and manage market risks to a much greater extent than in the past.

In the 1970s, banks primarily measured, accepted, and managed the credit risks of illiquid loans and dealt little with market risks other than minimal asset-liability duration matching. The rapid developments in market risk tools have facilitated an expansion of the core business of banking to put an increased emphasis on market risks, but banks are nonetheless still primarily in the same core business of measuring, accepting, and managing risks.

However, it is important to recognize that having access to improved risk management technologies does not necessarily make banks safer. Despite the improvements in the abilities of banks to understand and control risks, the risks of the institutions themselves ultimately also depend importantly on the incentives of bank managers and owners to control risks, and on the economic environment in which they operate. There is little benefit, and perhaps net costs, in having a bank manager know how to measure, accept, and manage risks accurately if this ability is used to take excessive risks that are largely borne by the federal safety net and potentially by taxpayers. Similarly, when the economic environment turns against bank investments, many banks will become risky and some will fail, even if they have managed their risks fairly well.

▲ Return to top

The source of the large number of bank failures in the 1980s and the dramatic improvement in the health of the banking system in the 1990s

These caveats are well illustrated by comparing the circumstances of U.S. banks in the 1980s versus the 1990s. During the 1980s, bank failures were increasing, and by the end of the decade banks were failing at the rate of about 200 per year. Even greater problems were experienced by the savings and loan industry. These problems have been largely attributed to two factors.

First, when banks or savings and loans get into very low or negative capital positions, the moral hazard problem I discussed earlier may become more severe. There is a possibility of purposely taking on additional risks to gamble their way out of trouble. When there is little capital at risk, the owners get much of the benefits if the gamble pays off, and the safety net and taxpayers bear most of the losses if the gamble fails.

Second, the 1980s saw a number of turbulent economic changes. These included fluctuations in interest rates and inflation rates, swings in the prices of commercial real estate and junk bonds that could not be easily forecast, and regional recessions that caused significant numbers of problem loans. These changes caused damage at many financial institutions, particularly those in geographically undiversified positions without sufficient capital to protect themselves.

Given the poor condition of many banks as late as 1991, it is amazing how healthy the banking industry is now, having written off most of its bad assets, raised large amounts of capital, and returned to profitability, likely having its fifth straight year of record profits in 1996. Bank failures have now retreated to at or near single digits per year. Clearly, this turnaround is too rapid to be completely accounted for by technical and financial innovations in the measurement, acceptance, and management of risk, or by improvements in the diversification and capitalization of banks. Changes in attitudes toward risk taking brought about by the higher capital standards and other factors, and changes in the economic environment have also played important roles in the improved health and wealth of the banking industry.

The evolution of capital standards and capital positions

The final development I will discuss is the evolution of the financial capital positions of U.S. banks, since capital is the cornerstone of defense against bank risks. Capital serves two functions in this regard. First, it helps improve the incentives of banks to keep their own risks under control, reducing moral hazard incentives to take those risks that are largely imposed on others. Second, capital is a buffer stock available to absorb risks and economic shocks without creating bankruptcy costs and systemic problems associated with the failure of financial institutions.

A goal of capital requirements--along with bank supervision and quality risk management by the banks themselves--is to make the safety net a moot issue for most banks. That is, by having enough capital available to absorb potential losses and having both the bank and supervisor carefully monitoring and acting to control portfolio risks, the moral hazard incentives of the safety net and the vulnerability of the deposit insurance funds can be kept to a minimum. It is similarly true that the more we can do to keep risk to the safety net under control using capital and other tools, the more powers we can safely grant to banks without placing undue stress on the safety net or meaningfully expanding safety net protection to other activities.

At the end of the 1970s, capital regulation was relatively ad hoc and depended largely on the judgment and discretion of the individual bank's supervisors. Starting in 1981, regulations required banks to hold capital equal to a flat percentage of their balance sheet assets. The next refinement was based on Basle Accord risk-based capital standards--adopted in 1988 and implemented starting in 1990--requiring banks to hold different amounts of capital depending on the perceived credit risk of different on- and off-balance-sheet assets. In addition, to reduce discretion in the enforcement of the standards and the closure of capital-impaired banks, Congress included "prompt corrective action" provisions in the FDIC Improvement Act of 1991 (FDICIA). Under prompt corrective action, or PCA, banks with capital ratios below certain threshold values are subject to increasingly severe mandatory and discretionary sanctions. Finally, risk-based capital standards which originally only covered credit risks are now being extended to cover market risks.

The process by which the new market risk standards were arrived at is indicative of the new orientation toward incentive-based regulation, allowing well capitalized, efficient banks to compete and imposing costs more selectively on undercapitalized, poorly managed banks. The standards also permit banks that are more efficient at monitoring and controlling their risks to hold less capital than inefficient banks. These regulatory standards are much like what the market would do in the absence of the safety net. The new standards, which apply to banks with substantial trading, allow banks to use their own internal models of risk that are employed in their everyday operations to determine the capital requirements on their trading books. This approach also reflects a new effort to develop refinements in regulatory standards in cooperation with the industry, in part by better understanding the "best practices" that are evolving in the industry and using these as a basis for regulatory standards across the industry.

A cumulative effect of the many changes in capital regulation in the 1980s and early 1990s, as well as other factors, is that banks have much higher capital ratios today than they did 15 years ago, and even 5 years ago. This is especially true at the largest banking organizations. For the banking industry as a whole, the equity-to-assets ratio rose from less than 6 percent at the end of the 1970s to over 8 percent in the mid-1990s. For the largest banking organizations, the capital ratio rose from less than 4 percent to over 7 percent.

▲ Return to top

The Implications of the Transformation of Banking for Bank Regulation

We should not be too sanguine about bank capital, however. While the current capital standards are significant improvements over what they replaced, they are still based on broad one-size-fits-all rules. Moreover, the market has begun to focus more on the capital-risk trade-off: no large bank or parent banking organization, for example, has AAA long-term debt, and only a handful are rated AA, despite the capital ratios I just quoted. Banks at the cutting edge are risk rating their loan portfolios and internally allocating capital to them for management and profitability analysis. Such allocations are superior ways of developing capital allocation for individual banks. Perhaps we will be able in the future to harness banks' internal capital allocations for regulatory purposes. Indeed, the reason for choosing the topics I have discussed thus far is that these structural changes represent an on-going process and are going to continue to challenge us in the future. In the final portion of my remarks, I will try to identify some of the most important challenges that regulators will face as a result of these changes.

Maintaining local competition in the face of continued bank consolidation

First, with regard to future banking industry consolidation, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 essentially expands the existing regional compacts to the nation as a whole, and overturns the McFadden Act prohibition on interstate branching. Interstate branching to almost all the states is permitted as of June 1, 1997. The removal of these artificial barriers to trade is beneficial and will likely improve efficiency and diversification of risks in the banking industry.

The exact future structure of the banking industry is unknown, but presumably will be driven not just by the removal of legal barriers to competition, but by shifts in technology, efficiency, and risk diversification. The firms with the greatest managerial efficiencies are expected to take over those with the lowest efficiencies and improve them. Research in banking suggests that these differences in managerial efficiency are much larger than any scale and scope economies. Various models predict that several thousand banking organizations are likely to disappear under nationwide banking, but that the remaining banks will still number in the thousands, as small community banks that serve their constituents well are likely to remain in business.

There appear to be two key challenges to regulators regarding consolidation. The first is to be sure that there is adequate competition from banks and nonbanks in local banking markets. Research has suggested that high local market concentration leads to prices that are unfavorable to bank customers--low deposit rates for retail depositors and high loan rates for small business loans. High concentration may also lead to reduced managerial efficiency, as the price cushion provided by market power allows a "quiet life" for managers in which relatively little effort is required to be profitable. Insuring an adequate amount of local-market competition is essential to avoid these potential problems.

The second challenge brought on by consolidation is to make sure that mergers and acquisitions do not create excessive risks. In this regard, it is important that capital be sufficient to cover any problems during the transition period when the banks and systems are learning to work together, on top of the normal risks of ongoing operations.

The interaction of bank powers and bank structure
The future expansion of banking organization powers also raises some challenges to regulators. Indeed, financial reform will likely be a high priority of the next Congress, perhaps including repeal of Glass-Steagall. One of the results of financial reform, along the lines of the bill Congressman Leach introduced last session, would be the emergence of financial services holding companies that could include both commercial and investment banks. There is also a prospect that banks might be able to expand into insurance activities as well. This would take to a perhaps logical conclusion the recent blurring of the lines between financial services firms.

Whether or not the Glass-Steagall Act is repealed, we face the challenges of insuring that the proposed recent expansion of bank powers through section 20 subsidiaries does not inadvertently expand the safety net protection afforded to banks to protect other, previously nonbank, activities. This would give an unfair subsidy to banking organizations.

While there is no perfect system for allowing financial intermediaries to gain the most from the synergies of joint production while avoiding expansion of the safety net, there are several steps that seem likely to keep this problem under control. First, we need to be sure to require plenty of capital in the bank to keep the value of access to the safety net low. Second, we need to provide reasonable insulation of the bank from the risks of the nonbanking enterprises. The Board believes that the best way to do this is by placing new activities in holding company subsidiaries, rather than in the bank itself or its subsidiaries. The further the separation from the bank, the better is the insulation. A third safeguard to protect the bank and prevent the expansion of the safety net subsidy is the adoption of prudential limitations through firewalls and rules that prohibit or limit certain bank and affiliate transactions. While firewalls may temporarily bend under stress, they nonetheless serve a useful purpose. On the other hand, we must strike a balance and not make the firewalls so rigid that they would eliminate the economic synergies between the banks and their affiliates. In this spirit, the Board last month made an effort to modify firewalls to allow banks to achieve efficiency gains with respect to security underwriting in Section 20 affiliates without creating excessive risks.

The issue of what bank structure is appropriate and prudent in light of expanded banking powers is a particularly controversial one. While the Board's view that the expanded powers should be carried out only in subsidiaries of the bank holding company was incorporated into the Congressman Leach's unsuccessful financial modernization bill in the last Congress, this preference is not shared by all parties to this debate. Some stress the costs associated with the holding company structure and question its benefits from a safety and soundness perspective and, as a result, favor either allowing the new activities to be carried out in a subsidiary of the bank itself or at least allowing banks an option with respect to structural form.

▲ Return to top

Staying up-to-date in the supervision of bank risk management as financial products and practices evolve

There will undoubtedly be further developments in the ways that banks perform their core functions of risk measurement, acceptance, and management as markets continue to evolve improved "best practices" in dealing with market and credit risks. This evolution will continue to challenge regulators to keep capital standards and other risk monitoring and control mechanisms from falling too far behind. One particular challenge is that the continued development of derivative products and other means of managing risks can also allow bank employees to take excessive risks and hide them from supervisors and perhaps from the owners of the bank. It is difficult for regulators to quantify these risks, and even more difficult to design risk-based deposit insurance and risk-based capital systems that accurately incorporate these risks.

In response, regulators will need to stick with capital as the cornerstone of defense against bank risks, both to reduce moral hazard incentives and to provide a buffer stock to absorb losses. A challenge will be to continue to update the capital standards in line with current or not-too-out-of-date risk measurement techniques. Expansion of the recently implemented "internal models" type of approach may be helpful in this regard, using, as I noted earlier, banks' own risk measurements to help set their capital requirements. In addition, many of the techniques used to quantify and control market risks may be transferable for use in quantifying and controlling credit risks in the future.

The task of measuring capital and risks can also be made easier if bank portfolios are made somewhat more transparent. Increased transparency would also facilitate market discipline--a highly desirable goal in our rapidly changing financial environment. A problem here is that it is not always clear how to best encourage transparency. For example, partial market value accounting may involve more costs than benefits. However, it seems clear that this is an issue that will remain on our plates for the foreseeable future.

In addition, the capital standards can and should be augmented by bank supervisors in individual cases. The risk-based capital standards and prompt corrective action rules are, and will remain, only minimum capital guidelines for normal circumstances. Supervisors need to require additional capital when banks are explicitly taking additional risks that are not captured by the guidelines, or when bank risks are excessively opaque and it is too difficult to determine if excessive risks might be undertaken. To accomplish this, it is important to continue to examine banks on a regular basis. There is simply no market substitute for the type of information that can be gathered under the auspices of a bank examination with access to the complete records of a bank.

However, as financial transactions become more complex, supervisors cannot be expected to monitor every detail. Increasingly, supervisors will focus on banks' risk management procedures. Banks will have to convince supervisors that they have prudent risk management procedures and policies and that the bank follows them. Increasingly, supervisors will emphasize your process of risk management and control, and proof that you are using those techniques, in order to determine whether your capital is adequate for your risk profile and procedures.

Reducing the burden of regulation and increasing the uniformity in regulation across banking agencies

While recent banking legislation significantly reduced the regulatory burdens on the banking industry, we all realize that keeping the costs of supervision and regulation low is an important on-going task for all parties. It is particularly important for the federal banking agencies to continue efforts at improved cooperation with each other, including standardization of certain policies and procedures and data collection. In short, we must try to reap the potential benefits of multiple regulators in terms of encouraging innovation and providing checks and balances on regulatory excess, without incurring the potential costs of "competition in laxity" and excessive overlap and duplication of efforts. I am optimistic that this can be done, perhaps by augmenting the role of the FFEIC.

Conclusion

I want to leave some time for questions, so let me just sum up with a few comments. The banking industry has been transformed over the last decade and a half, and regulators have tried to adopt policies to allow the industry to become stronger, more efficient, and better able to meet the competition without placing undue stress on the safety net. This represents a change from an earlier regulatory philosophy of protecting banks from competition, and I think the change is in the right direction. We still face a lot of challenges from the continuing evolution and consolidation of the industry, but we will do our best at trying to let the strong, efficient banks compete, so long as they are not imposing significant risks on the safety net and taxpayers.

Return to top

1996 Speeches
