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7 The US Financial Situation and Banking System – Implications for Regulation and Monetary Policy

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The US banking industry has had mixed reactions from legislators, regulators and the public in the last few years. What seems uppermost in most people's minds is the industry's exposure to developing countries, highly leveraged transactions, the real estate crisis and the collapse of the savings and loans institutions, with the attendant implications for deposit insurance. These events make the financial sector's headlines, though there are many other aspects to banking that provide a more welcome picture but are not reported.

This chapter will look at the shape of the US banking industry and the bad press the industry has been receiving.

In 1990 the earnings of the industry were $17 billion, an improvement on the average of about $15 billion in previous years. In other words growth was slow, but there was some growth. Eighty-eight per cent of the banks in the US earned a profit, only 12 per cent reported a loss and 40 per cent of institutions earned a return on assets that was greater than 1 per cent. Fully three-quarters of the institutions in the US had a return on assets greater than 50 basis points.

However asset quality has deteriorated – the US has nonperforming assets of about $80 billion compared with $65 billion in the late 1980s and $40 billion in the early 1980s. That $80 billion in nonperforming assets needs to be measured against capital of $210 billion and $50 billion in reserves. Equity as a percentage of total assets in 1990 was about 6.5 per cent following a gradual rise throughout the 1980s. The market value – that is the stock market value of US banks – in 1991 averaged about 10 per cent over the book value.

How does this compare internationally in terms of profitability?

Financial Strategies and Public Policies -- Banking, Insurance and Industry. Edited by Zuhayr Mikdashi. Great Britain: The Macmilllan Press Ltd, 1993, and United States: St. Martin's Press, Inc, 1993, pp. 50-55.

Cross-country comparisons, with differences in accounting methods and so on, are not altogether useful but it is apparent that a large section of the US industry compares quite favourably internationally in terms of profitability and capital, and it continues to be an innovative industry. So what is the problem? If three-quarters of this industry is earning 0.5 per cent or more, which looks pretty good internationally, why are US newspapers filled day after day with bad news? Whilst a third of the industry is doing quite well, another third is doing very well and that leads me to the subject matter of the newspaper headlines.

The most notable problem is that banks are failing. From 1940 to 1980, 200 institutions failed in the US – an average of five per year – and in the first five years of the 1980s a further 200 failed. From 1985 an additional 200 institutions per year failed – totalling 1300 in 1991 – generating losses that have reduced the bank insurance fund from $18 billion in 1987 to a level which will demand some recapitalisation in the near future.

Why is this happening? What is causing banks to fail? Some say it is because of unsettled economic conditions. But the economic environment in the 1980s was relatively benign compared with the volatile conditions in the 1970s. There was a recession in the early 1980s, but that was followed by the longest peacetime expansion in the history of the US. These were good times but still over a thousand banks failed. Economic conditions alone cannot offer an explanation – so other forces must be recognised.

One such force is that the 1980s were characterised by unparalleled innovation in finance and by growth in financial markets and organisations. These developments were facilitated by technological advances that broke down old barriers between banking and other areas of finance. There was growth in the number of companies going directly to capital markets, bypassing banking institutions. Securitisation in a wide variety of credit types also bypassed banking institutions. And non-bank competition – finance companies, insurance companies and so on – also found ways to compete profitably with banks. This was not restricted to the asset side of the balance sheet – money market mutual funds and other mutual funds competed with banks on the right hand side of the balance sheet.

Why were banks not able to meet this competitive challenge? Unlike their competitors US banks are highly constrained by restrictive regulations framed half a century ago to address the problems of that time. Banks were prohibited from competing across both financial product lines and geographical lines – interstate branching is prohibited. The EC is talking about allowing banks to go right across Europe – US banks are still prevented from crossing a single state line and so are not able to compete in the same way as many non-bank entities. For example they are not able to retain customers who move interstate.

With the evolution of technology, which brought sweeping changes to the market, many banks were able to cope by focusing on those market areas in which they still had an advantage. However these changes eroded competitiveness, reduced competitive opportunities and eroded the profitability of the industry. While much of the industry has been able to cope, the rest failed. This can't be quite the whole story though because many industries face competitive challenges and don't end up with thousands of institutions failing. The other part of the story must be the failure of normal mechanisms which should have forced banks to deal with diminished competitive opportunity. Relevant here is the effect of the Federal Deposit Insurance Corporation – federal safety net.

The federal safety net in the US has grown dramatically. Forty per cent of deposits were insured in 1940, a little over half of total deposits were insured in the 1960s and in 1991 80 per cent of total deposits were insured. With an implicit 'too big to fail policy', the figure may rise to 100 per cent.

The federal safety net shields banks from normal market forces which deny funds to banks that are not doing well. Market discipline is removed by deposit insurance, which allows firms lacking attractive investment opportunities to nonetheless attract deposits and to compete with better institutions – to the detriment of the industry. The safety net also provides an incentive to take risks. If things go well the shareholders of an institution benefit, but if things go poorly the insurance fund pays the bill. Of course as competitive opportunities have shrunk in some market areas, the supply of funds has not shrunk. As a result there is too much money chasing too few opportunities and this leads to asset quality problems, such as commercial real estate problems. When weak institutions are still able to attract money and compete for loans, asset quality problems are inevitable. So the federal safety net has prevented normal capital market discipline from weeding out weak performers, who have been allowed to continue to raise funds even as they descend into insolvency.

Unfortunately Congress simply will not touch deposit insurance in any fundamental form as it is a subsidy which is deeply embedded in the banking industry and which also affects the person on the street. As there may be no substantive direct reform of the formal part of deposit insurance, tolerance for undercapitalised institutions must be reduced.

The other area where discipline is inadequate is regulatory discipline. With the federal safety net inhibiting market discipline, the task falls to regulators to act as a surrogate for the market and deal with weak institutions. Many have argued that the US has not taken decisive remedial action early enough and has instead waited until these institutions have become insolvent, at great cost to the fund. Regulators in the US are hampered by having to bear the substantial burdens of institutions which have positive but insufficient capital. One of the proposals in current legislation is to shift that burden so that regulators will be in a position to intervene earlier.

So the problem confronting the banking industry is a combination of diminished competitive opportunity resulting from the evolution of finance, outdated restrictions on banks which prohibit them from capitalising on their expertise, and insufficient disciplinary mechanisms to deal with the fallout. Many in the US are calling for tougher regulation and tougher discipline, but until the fundamental problem of competitive disadvantage is dealt with there may be a more efficient resolution of weak institutions, but the number of weak institutions will not be reduced. As the competitive opportunities of banking institutions have been reduced, ultimately their only protection will be to build a more profitable and competitive industry. To this end the causes of failure and not just the symptoms should be treated.

It is not yet clear how financial reform legislation is going to go, but it has been designed with each of the following in mind: to broaden competitive opportunities for banks; to reduce the federal safety net, which politically is a very difficult task; and to increase regulatory discipline. Whether or not the legislation is passed, it is inevitable that some very dramatic restructuring of the banking and financial industries will take place, in the US. This will have very important implications for regulation and monetary policy. There are 1000 S&L's in the process of being resolved through the resolution trust corporation process and a large number of banks are also going to go through that sort of process. A very significant percentage of the US depository franchise is going to be up for grabs during the 1990s, and in a slow growth industry this will be a unique opportunity for firms to make dramatic changes in the way they are structured. Indeed three of the four largest US banks were created in early 1991 in corporate board rooms by mergers. So the process of change is moving along as institutions seek to improve efficiency.

The challenge for regulators is to design regulations that protect safety and soundness but also enhance the efficiency of the financial system. If efficiency is not increased the fundamental source of the problem of competitiveness will not have been dealt with. As for the weaker sections of the industry, I think the evolving principle there is clear. Capital – intolerance with poorly capitalised institutions and early and aggressive intervention as their capital falls.

Towards this end a study of unregulated industries could be of advantage. There are finance companies in the US that deal in the same sort of products as banks and lend to the same sort of customers with very similar types of instruments. They do not have the federal safety net to support them and generally they have been doing quite well. They are profitable, they have been growing, they have more capital – despite the fact they do not have the advantage of the safety net. The key challenge then is not try to raise the average level of capital, or the capital of the better institutions, but to find ways of dealing with the institutions that are undercapitalised.

More generally, the US has a fragmented regulatory system. The securities industry is regulated by the SEC and there are four separate banking regulators. The US should start thinking about financial regulation as a whole, not just banking and securities regulation. As technology has broken down the barriers between banking and finance, more uniform regulations are needed. I think we will move toward more generic regulations focused on risk-based capital guidelines and the like, rather than specific detailed regulation of individual industries. The convergence of international regulation through the BIS standards could serve as an example.

In terms of international competition, US banking institutions are likely to stay put for a while and focus their attention on the home market. The weaker sections will be trying to husband their capital, and the stronger sections will be concentrating on making dramatic structural and strategic changes. Obviously some institutions may be aggressive internationally, but I think in the main US banking is in for a period of inward focus.

As far as the monetary implications of all the above is concerned, the major effect has been that money is not growing at all in the US. For the broad monetary aggregate, M2, the growth rate in July 1991 was negative for only the third month since 1959. In August 1991 it was zero. Part of the reason for this was the supply effect of banks responding to regulators' requests for higher capital. Banks are restricting their growth, they are pulling back, and that is causing the growth aggregates to slow. Some of this is not so worrisome, but one has to be concerned about the supply of credit to the sections of the financial market which are still dependent on the banking system. It is not clear whether these changes in aggregates are having a substantive impact on the economy and are correctly signalling monetary conditions, or whether they are just distortions in these signals and are of little importance.

We turn now to the international implications of reforms in the US. How will continental European banks adjust to the new rules which are bound to be set up in the US in terms of firewalls and Chinese walls for various financial activities? Three scenarios are presented: first, by checking that the structures they have in their own country meet US requirements; second, by setting up special structures in the US to meet those requirements; and third, by giving up certain businesses in the US.

Congress and the US Treasury have proposed something which falls between scenarios two and three. The Federal Reserve was not pleased with the Treasury's proposal, which went against the principles set up in the US International Banking Act: the principle of grandfathering and the principle of not imposing the US banking structure on other countries, but rather as viewing the institution outside the US as the bank holding company. Considerable progress has been made in getting Congress to move away from the Treasury proposal – perhaps moving closer to the first scenario. What may eventuate is that the Federal Reserve may be given authority to look at particular foreign institutions and satisfy itself that they have an appropriate amount of capital. Scenario one would be best for the competitiveness of US institutions abroad and also for foreign institutions in the US, who have been important lenders at a time when lending by US banks has fallen.