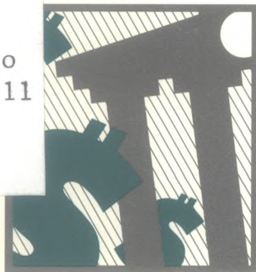
FRS
Chicago
#1991/11



ISSUES IN FINANCIAL REGULATION

Working Paper Series

The Diminishing Role of Commercial Banking in the U.S. Economy

George G. Kaufman

FEDERAL RESERVE BANK
OF CHICAGO

WP - 1991 / 11

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The diminishing role of commercial banking in the U.S. economy

George G. Kaufman*

Commercial banking and depository institutions in general were one of the great financial innovations of all times. Indeed, it would be almost impossible to envision the modern complex economies of highly developed countries without a large and strong generic banking sector. But recent and rapid advances in technology and outmoded public policies have, on the one hand, reduced the historical comparative advantage of banks and, on the other hand, restricted the competitiveness and endangered the safety of banks. As a result, the importance of banking as an industry is being dramatically reduced. Although the longer-run implications of this erosion on the macroeconomy is neutral, as nonbank lenders provide additional credit, shorter-run implications may be less favorable to some sectors of the economy and are likely to lead to the adoption of some public policies that may trade short-term improvements for longer-term accelerated deterioration.

Modern generic banking developed as economies passed through the commercial and industrial revolutions to encourage aggregate savings, improve the collection of savings, and make savings available to a wide range of potential borrowers. Before banking, savers (lenders) and borrowers had to search each other out and negotiate terms satisfactory to both parties. This process was time consuming, cumbersome, and inefficient. It frequently resulted in the failure to consummate agreements. In contrast, banks were able to tailor their securities more closely to the needs of almost every conceivable potential saver and borrower in terms of size, maturity, interest-rate sensitivity, default-risk, currency of denomination, and prepayment or other options. They increased greatly the flow of funds from savers to borrowers.

In addition, both because banks provide a large number of services to their loan customers and because they are specialists in lending, they were able to acquire more complete and timely information about the credit quality of their

---

*Loyola University of Chicago and Consultant to the Federal Reserve Bank of Chicago. An earlier version of this paper was presented at a Conference on the Crisis in the Banking Industry, New York University, April 29, 1991.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

customers and evaluate this information more accurately than nonbank lenders. In other words, they were the major beneficiaries of asymmetrical information.

But the tailoring process led to a mismatch of the characteristics of the securities on the two sides of the banks' balance sheets. Of particular importance both to the management of the bank and to public policy makers was the mismatch in maturity and liquidity. For banks, the maturities of their deposit liabilities were shorter than of their loan assets and the liquidity was greater. Thus, the banks were vulnerable to solvency problems from unexpected adverse changes in interest rates and runs that led to sudden withdrawals of deposits.

To protect against such problems, banks held sufficient capital and liquid reserves and managed their credit and interest rate exposures. Although throughout most of, at least, U.S. history, bank failure rates were not out of line with nonbank failure rates, the failures that did occur were highly visible and widely perceived to be more harmful to the community than the failure of a nonbanking firm of comparable size, particularly if the bank were liquidated.[1] Losses accrued to noteholders and depositors that, because bank notes and deposits accounted for the large share of the money supply, at times resulted in a decline in the money supply in the community, although not necessarily nationally as aggregate bank reserves were unaffected. The reduction in money in the community contributed to reduced spending in the community. In addition, loan relationships were interrupted, particularly in sectors, such as business lending, in which banks had very large shares of the market. This also impacted the community adversely.

Bank runs and failures were also perceived to spillover to other banks as the complexities of bank balance sheets were believed to make it difficult for most depositors to differentiate financially healthy from financially sick banks. Because the costs of transferring or withdrawing deposits is small, depositors would prefer to be safe than sorry and run on other banks in sympathy. If the funds were not redeposited at other banks either directly or indirectly, but held as currency outside the banking system, aggregate bank reserves declined and ignited a multiple contraction in money and bank credit. Thus, the difficulties at one bank, particularly a large bank, could infect other banks and adversely affect the economy at large.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The evidence suggests that these fears were more perceived than real and the costs greatly exaggerated. Nevertheless, through time as financial sectors became more important, banks became targets of progressively stronger prudential regulation, culminating in federal deposit insurance after the severe breakdown of the U.S. banking system in 1933. Unfortunately, the deposit insurance was structured perversely.[2] By reducing depositor discipline and not charging banks for greater risk taking, deposit insurance encouraged banks to rundown their capital-asset ratios and increase the credit and interest rate risk exposures of their portfolios. Moreover, by guaranteeing the par value of deposits regardless of the solvency of the bank, the insurance discouraged depositors from running on insolvent banks and permitted insolvent banks to continue in operation until closed by the regulators. But regulators became increasingly reluctant to resolve insolvent banks, particularly larger banks, on a timely fashion for numerous reasons, including fears of potential spillover to other banks, of loss of deposit and credit services to the community and of public embarrassment from admitting failure to protect safety and political pressures from the banks' managers, shareholders, and even larger loan customers. Thus, in more recent years, the reduction in market discipline was not offset by an increase in regulatory discipline on problem banks.

In earlier years, when banks had a comparative advantages in their deposit and lending activities, there was widespread fear of excessive economic and even political power by banks. This fear was particularly strong in the United States and resulted in restrictions on their product and geographic powers. What better way to limit bank power than by limiting their growth by limiting their ability to enter additional product and geographic markets! Thus, unlike firms in other industries, banks were not permitted to operate branch offices, except where permitted by state law, and in no instances across state lines. This made it difficult for individual banks to follow customers who moved or to service customers with operations in distant places. When some banks attempted to circumvent these restrictions as recently as in the 1950s by crossing state lines through holding company affiliates, they were stopped in 1956 by the Douglas Amendment to the Bank Holding Company Act of that year.

Banks had always been restricted in the types of activities they could conduct within the bank or in subsidiaries of the bank by provisions of the bank charter granted by the Federal government or the state. For example, national banks were restricted to:

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

> all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of this chapter.

But they were not restricted in what affiliates of their parent holding companies could do until the enactment of the Bank Holding Company Act of 1956 and its extension to one bank holding companies in 1970. In addition, the Glass-Steagall (Banking) Act of 1933 prohibited commercial banks from engaging in full service investment banking. This act and the accompanying separation of "banking and commerce" were strongly supported by the Federal Reserve. It is of interest to note that the conventional wisdom "historical" separation of banking and commerce in the U.S. goes back only some 35 years to 1956, indeed, only 21 years to 1970 from the date of the separation for all banks.

Similar to the restrictions on geographic locations, the restrictions on product activities prevented banks from participating fully in the provision of the many financial services that were innovated after the restrictions were imposed, in offering consumers a wide range of financial and nonfinancial services under one roof and in being able to generate any synergies or economies of scope that would permit them to offer packages of services at lower cost. Their competitors, including foreign banks, generally were not similarly constrained.

The restrictions not only limited bank profitability but increased bank risk by limiting the ability of banks to diversify either geographically or in product lines. Thus, the financial health of banks was closely tied to that of the local market area and the demand for the existing product lines. Before the 1920s for the geographic restrictions and the 1960s for the product restrictions, the adverse impacts of the regulations on the banking industry were not overly onerous as the relative primitive stage of technology did not favor wide geographic branch networks or wide product lines. Few banks took full advantage of the state branching powers that were available, the ability to acquire holding company affiliated banks in other states, or the ability to combine other financial and even nonfinancial activities within bank holding companies. But this experience changed dramatically in more recent years.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

II. Erosion of market share

Commercial banks have been losing market share throughout most of the post-World War II period. In 1950, total assets of commercial banks represented more than one-half of the total assets of 11 major types of financial institutions (Table 1). By 1990, this market share had eroded to only 32 percent. Most of the decline occurred between 1950 and 1960 and may be attributed to a rundown of the unusual liquidity built up during World War II, when consumer spending was curtailed and interest rates were maintained at very low levels. Thus, the opportunity cost of holding non-interest yielding demand deposits was small and nonbank institutions had few outlets for their funds.

Table 1

Asset size, relative importance, and market share of major financial institutions on the intermediary financial market from 1950-1990

	1990*		Percentage of total assets*				
Intermediary	Asset rank	(billions of dollars)	1950	1960	1970	1980	1990
Commercial banks	1	3,279	52	38	38	37	32
Life insurance companies	2	1,378	22	20	15	12	13
Private pension funds	3	1,194	2	6	9	12	12
Savings and loan association	4	1,159	6	12	14	15	11
State and local pension funds	5	753	2	3	5	5	7
Mutual funds	6	588	1	3	4	2	6
Finance companies	7	539	3	5	5	5	5
Casualty insurance companies	8	507	4	5	4	4	5
Money-market funds	9	453	--	--	--	2	5
Savings banks	10	284	8	7	6	4	3
Credit unions	11	213	--	1	1	2	2
Total		10,347	100	100	100	100	100

*Second quarter for 1990. Fourth quarter for all other years.
Source: Board of Governors of the Federal Reserve System, *Flow of Funds, various years.*

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

But this unusual competitive advantage disappeared in the post-war economy. Since 1960, the erosion in the banks' market share has been slower, although it accelerated again in the 1980s. The rapidly gaining financial institutions were primarily private and public pension funds and money market funds. Life insurance companies have also experienced a major continuing erosion in market share. After first tripling their market share through the mid-1980s, savings and loan associations saw their share drop abruptly in 1989 and 1990 to the lowest percentage since the mid-1950s.[3] The loss in the bank's market share may be attributed primarily to four factors: technological change, regulation, reversal of the federal deposit insurance subsidy, and quality deterioration.

Technological Change Commercial banks historically have had an important comparative advantage over most other lenders. They had more complete and timely credit information about current and potential borrowers at lower cost. They obtained this information not only from the same sources as did other lenders, but from their own ongoing contacts with their customers through deposit, financial advising, safekeeping and other relationships. This source was unique to the banks and greatly reduced the cost and increased the quality of their credit information for both the initial underwriting of a loan and the subsequent monitoring of its performance. As a result, many lenders found it more profitable to channel credit to borrowers through the commercial banking system indirectly than to buy the debt of the borrowers directly.

But this comparative advantage has been eroding in recent years from technical advances in computers and telecommunications. Large and complete credit files on major borrowers are now readily available to almost everyone quickly and at low cost. As a result, lenders are now finding it increasingly more profitable to buy securities directly from larger borrowers. This accounts in part for the rapid increase in commercial paper issued by borrowers in recent years. In the 10 years between yearend 1979 and yearend 1989, commercial paper issued by nonfinancial borrowers increased by more than 300 percent. In contrast, total bank assets increased only 140 percent and bank business loans only 100 percent.

Commercial banks and other depository institutions have traditionally also been able to collect funds from small and medium sized lenders (savers) at low cost at branch offices at which they could also provide loan and other services to the same customers. This has permitted the banks to enjoy synergies that reduced the cost of gathering the deposits. However, the same recent advances in computer and telecommunications technology that made

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

credit information more readily available to a wider population have also reduced the cost of collecting funds directly from small and medium sized savers. Branch offices may be bypassed and these offices have become increasingly more costly relative to funds collection via automatic, telephone and wire transfers. As a result, many bank competitors can operate profitably on narrower margins. In response, banks have increasingly sold loans out of their portfolios and concentrated more on generating earnings from fees for loan originations than from loans held as portfolio investments. Technology has also made selling existing loans easier by making it possible to create the information and monitoring systems necessary to securitize packages of whole loans. Securitized loans are more marketable, more divisible and more diversifiable than an equal dollar amount of whole loans and, thus, more desirable to nonbank investors.

Lastly, commercial banks have traditionally been granted a monopoly over demand (check writing transfer) deposits by the government and these deposits have been their major source of funds throughout most of banking history. But technology has now permitted almost anyone with access to large-scale computers and telecommunications to offer demand deposit-like services. The monopoly has been undermined. Thus, money market funds, owned either independently or by nonbank financial and nonfinancial firms, have grown rapidly in recent years and have captured significant market share from the banks. Besides dampening their asset growth, this change has eroded the franchise value of banks and thus the market value of their capital.

Regulation As discussed earlier, commercial banks are hampered in their ability to compete with their new nonbank competitors by excessive and outmoded government regulation of their product and geographic powers. Unlike most of their competitors, banks may not offer all types of financial services or most types of nonfinancial services. Thus, banks may not offer insurance underwriting, a full line of life and casualty insurance brokerage services at most offices, complete securities activities (except in recent years, relatively inefficiently by the very largest banks through separate subsidiaries), retail merchandising, automobile manufacturing, and so on. Also, unlike their competitors, commercial banks may not operate full services offices freely at any location of their choosing or in the organizational form that they may prefer. In many states, banks may operate branches at only limited locations and in no instances across state lines and have only recently been granted limited authority to operate full-service offices in other states in the form of holding company affiliates. These

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

restrictions have limited the profit potential both of individual banks and of the industry as a whole.

As noted, the reasons for these restrictions lie in the history of U.S. public policy towards commercial banks and in the primitive state of technology in earlier periods. But the recent advances in technology and increases in competitors that have reduced the market share of banks have also sharply reduced their potential for excessive concentration of power and abusive conflicts of interest.[4] As a result, the public policy concerns for restricting bank product and geographic powers appear to be less important today than in earlier years and justify a careful reexamination of the benefits and costs. Indeed, the major public policy concern being voiced currently against expanded product powers centers on the unfair and potentially costly use of insured deposits by banks to fund the new activities to the taxpayers. However, the efficient correction of this perceived problem lies in the appropriate reform of federal deposit insurance, rather than in restricting bank activities.

Restrictions of bank product and geographic powers have not only contributed to reducing the bank's market share by limiting their expansion relative to that of their competitors, but also by reducing the asset-to-capital multiplier that is consistent with safety. To the extent that product and geographic expansion results in increased diversification, bank risk is reduced and the market will permit banks to operate with greater leverage.

In addition, banks are prohibited from paying explicit interest on demand deposits and were restricted until 10 years ago in the interest rate they could pay on smaller time deposit accounts. The latter restriction, Regulation Q, was directly responsible for the establishment of money market funds, which have maintained a significant share of the market long after the regulation was removed.

It is of interest to note that market forces do not necessarily wait for legislated liberalization of the restrictions, particularly at the federal level. Thus, effectively all states have now adopted legislation to override the federal restrictions on interstate holding company imposed by the Douglas Amendment to the Bank Holding Company Act of 1956. Simultaneously, the regulatory agencies and the courts have combined to permit banks to offer an almost complete menu of securities activities.[5] But by limiting these activities to affiliates of the bank holding company and imposing restrictions on the relative volume of such activities to the bank's total securities activities,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

the current regulators effectively limit most of the newly granted activities to the country's largest banks.

Deposit Insurance As has been amply documented in recent years, improperly structured federal deposit insurance substitutes public capital for private capital and permits banks to operate with greater private capital leverage than otherwise. To the extent that the evidence suggests that federal deposit insurance has been underpriced in recent years, it has permitted banks to maintain a larger asset base than otherwise for the amount of capital they had and aided banks in maintaining their market share. However, recent and proposed changes in the insurance structure are likely to reverse this situation. Capital ratio requirements are likely to be increased. Insurance premiums already have been increased substantially and may be increased even further. To the extent that the premiums are now higher than necessary for the insurance fund to be actuarially sound and are imposed to help finance past deficits in the fund, they may be viewed as a nonuser tax imposed on banks. Like any tax imposed on only some competitors and not on others, this tax increases relative costs and reduces the equilibrium output of the industry.

At the same time insurance premiums are being raised on banks, they are not being imposed on an increasingly significant competitor that is widely perceived to be also covered by the federal safety net. This competitor is the government sponsored enterprises (GSEs) that specialize in housing and agricultural finance, such as the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Association (FHLMC), and the Federal Agricultural Credit Association. Although they are privately owned and managed, these agencies have authority to borrow from the U.S. Treasury and their debt trades at interest yields lower than that of comparable private firms.[6]

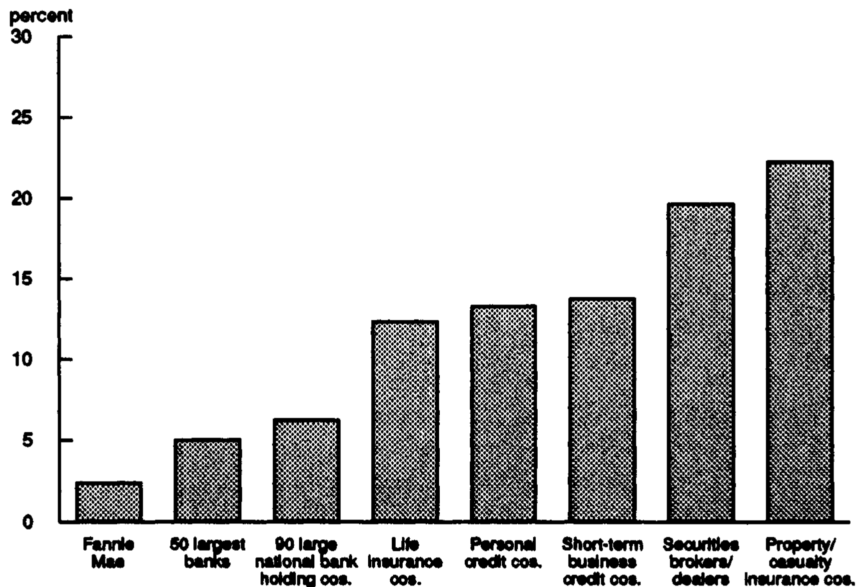
The lower interest rates indicates that the market perceives that there is a high probability that the federal government will not permit bondholders to suffer losses if the agencies encounter financial difficulties. This public perception is supported by the lower capital ratios of these firms relative even to commercial banks. As is shown in Figure 1, FNMA has a capital ratio of only 2.5 percent, less than one-half that of banks and less than one-fifth that of other financial industries. Despite this perception, the government does not charge the agencies explicit or implicit (regulatory) insurance premiums. Thus, they have a cost advantage and are able to accept a lower return on their investments than are banks. To the extent that these investments compete

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

with those made by banks, it reduces the profitability of banks and their asset size.

Figure 1

Financial institution capital levels; median equity capital-to-total assets ratios (December 31, 1989)



Source: U.S. Treasury Department, *Modernizing the Financial System*, (Washington, D.C., 1991).

It is sometimes argued that the deleveraging and consequent asset shrinkage associated with the higher private capital requirements being imposed on banks by regulators and legislators interferes with the continuation of healthy credit extension to businesses and households and produces a "credit crunch". To the extent that bank assets and therefore lending were greater than otherwise because of underpriced federal deposit insurance, a correction would reduce bank lending almost by definition. But this should not lead to a reduction in overall lending for economically sound projects by all institutions beyond a relatively brief transition period. Others, primarily the new bank competitors, should be able to expand their lending to offset any cutback by banks to borrowers who are willing and able to pay equilibrium market rates

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

of interest and new, adequately capitalized commercial banks would enter the arena if there were excess demand for unique bank credit at this interest rate.

This response would not differ greatly than the entry of, say, new grocery stores or the addition of grocery items to the services provided by previously non-grocery stores if individual grocery stores failed or were forced to cutback on storage space obtained temporarily from suppliers, but the demand for grocery products at a market price remained unchanged. Beyond the time necessary for the new providers to come on line, no "food crunch" would arise. In banking, the costs associated with the above transition, while significant for some borrowers and some sectors, are likely to be far less to the public as a whole than the costs of not correcting the existing combination of asset overcapacity and lack of market discipline that have contributed to the large increases in loan losses and bank failures.

Quality Deterioration Historically, banks have had higher credit ratings and reputations than most borrowers. Thus, the addition of a bank's signature to a private borrower's note would enhance its credit quality. Borrowers with lower than the highest credit ratings could borrow at banks at no higher and even lower interest cost than borrowing directly from lenders. But the financial difficulties experienced by many commercial banks in recent years have changed this scenario. In part, the poor current financial condition of the banking industry reflects the inefficient deposit insurance structure in place, which has permitted banks to operate with very low capital ratios. In recent years, commercial bank capital ratios have been near 6 percent in book value and considerably lower in market value. In addition, particularly for larger banks, off-balance sheet activities are substantial, at times even larger in volume than recorded on-balance sheet activities. Yet, these are excluded from the published capital ratios. The low bank capital ratios relative to other financial industries is evident from Figure 1. It does not take much of an adverse shock to asset values to wipeout such small capital and drive a bank into insolvency. And, the increased volatility in the macroeconomy during the past 15 years has produced such shocks.

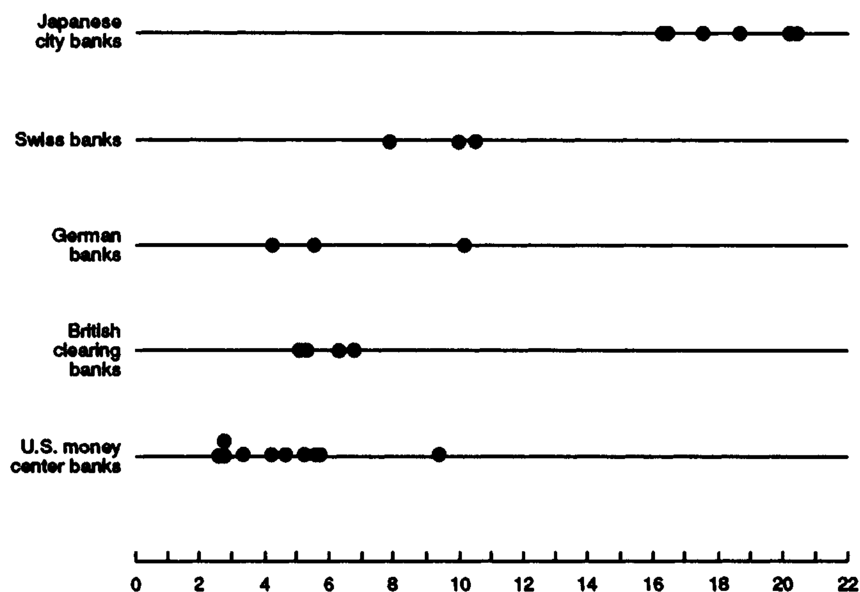
U.S. banks also appear to be in weaker financial condition than banks in other major countries. As is shown in Figure 2, in recent years, the market has valued the capital of U.S. banks as a percent of assets lower than it has for British, German, Swiss, or Japanese banks. A recent study also reported that, at yearend 1990, all three of the largest Swiss banks had AAA ratings and only two of the 11 largest Japanese banks and none of the largest German banks had S&P or Moody's credit ratings of below AA. French and British

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

banks were also rated highly. In contrast, only two of the eight largest U.S. banks had ratings of AA or above and three were rated below A. Many other U.S. banks had even lower credit ratings.[7] The erosion of the credit quality of U.S. banks has been occurring throughout the 1980s. Ten years ago, S&P rated 12 large banks AAA. In 1991, only the Morgan Guaranty rated this rating. Over the same period, the average large bank credit rating deteriorated from a low AA to a low A - high BBB rating.

Figure 2

Market capitalization of U.S. and foreign banks (percent of assets)



Source: Herbert L. Baer, "Foreign Competition in U.S. Banking Markets," *Economic Perspectives*, May/June 1990, p. 25.

Because the credit quality of banks have been downgraded, an increasing number of large business borrowers now find it cheaper to borrow directly on financial markets, bypassing banks. It is not profitable for them to "intermediate down", and the demand for bank loan services is reduced.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

This effect may be seen from the proportion of business loans made by banks, other financial institutions, and lenders directly in selected years from 1950 to 1989 shown in Table 2. The banks' share of loans to nonfinancial corporate business declined from near 90 percent in the immediate post-World War II period through the mid-1960s to near 80 percent in 1975, 70 percent in 1980 and only 60 percent in 1989. In contrast, funds raised through commercial paper increased from 1 to 12 percent in this period, loans from foreign sources from none to 8 percent, and loans from nonbank financial intermediaries from 6 to 16 percent. As a percent of bank business loans, commercial paper increased from only 10 percent in 1960 to nearly 100 percent in 1989.

Table 2

Composition of short-term credit market debt of nonfinancial corporate businesses, 1950-1989

	1950	1960	1970	1980	1989
			(percent)		
Bank loans	91	87	83	71	60
Nonbank finance loans	6	9	9	14	16
Commercial paper	1	2	6	9	12
Foreign loans	--	--	--	1	8
Bankers' acceptances	2	2	2	5	4
Total	100	100	100	100	100
(Billion dollars)	20	43	125	324	903

Source: Board of Governors of the Federal Reserve System, *Balance Sheets for the U.S. Economy, 1945-89*, October, 1990.

The longer-term decline in business lending by commercial banks is also evident from Figure 3. Since 1939, business loans have declined from 41 percent of total bank loans to 33 percent in 1989. In contrast, real estate loans have increased from 22 percent of total bank loans to 30 percent, or almost as important as business loans.

III. Public policy implications

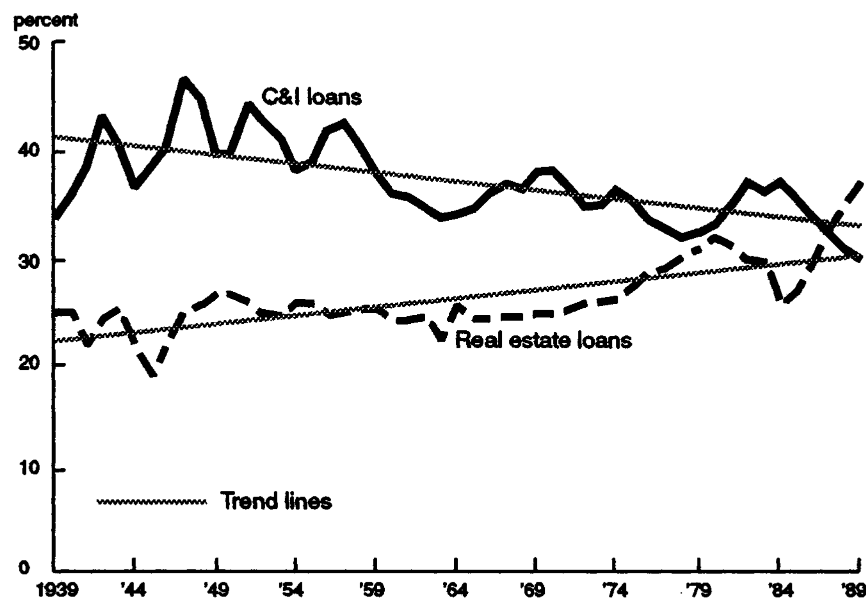
Why should the public be concerned with whether commercial banks, depository institutions, or any industry for that matter shrinks or even survives. Through history, many industries have diminished in size from their peaks and even disappeared altogether. Public policy should be concerned

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

only if a contributing force to the decline is public policy itself or if, particularly in the short-run or transition period, the reduction in aggregate size has adverse effects on the economy as a whole or on important sectors. As was argued earlier, banking is rapidly losing its historical comparative advantage as a result of technological advances so that its eventual demise will not impact the macroeconomy greatly.

Figure 3

Real estate and C&I loans as a percent of total loans
Insured commercial banks 1939-1989



Source: U.S. Treasury Department, *Modernizing the Financial System*, (Washington, D.C., 1991).

But its demise is being accelerated by public policies that both reverse the previous subsidy to growth from underpriced deposit insurance and place banks at an artificial competitive disadvantage relative to competitors, who in the absence of the constraints may not be more economically efficient suppliers. If this observation is correct, then extant public policy is encouraging a harmful misallocation of resources. Moreover, even though money and credit are fungible, there are transition costs if the curtailment of bank suppliers of credit is abrupt.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Displaced credit worthy borrowers other than the very largest have to search for nonbank suppliers who are compatible both geographically and product-wise, and reestablish credit relationships. At the same time, potential nonbank suppliers have to gear up operationally both geographically and product-wise to inaugurate credit relationships. In the short-term, some credit worthy borrowers are likely to be unsatisfied and a perceived "credit crunch" said to exist.

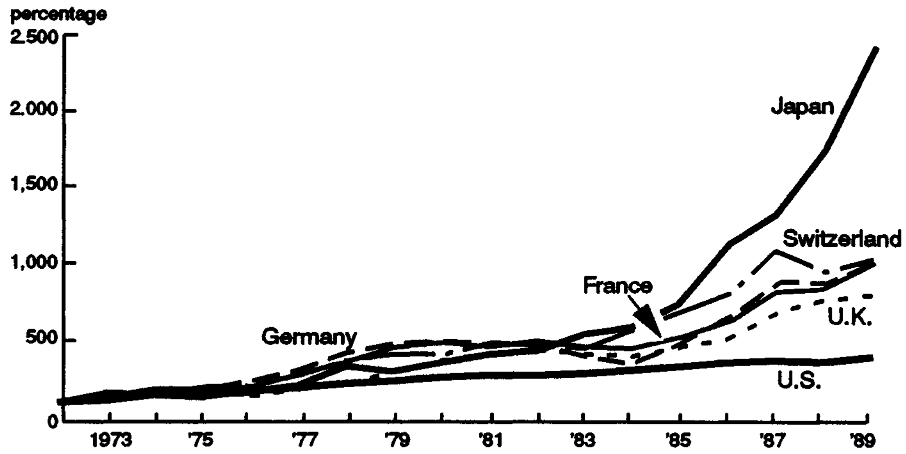
The credit crunch may be reinforced within banking if increased prudential regulation in the form of, say, higher capital requirements are imposed and all banks are not able to attract additional capital on equal terms because of differences in their financial condition. Credit worthy borrowers at capital deficient banks need to transfer their relationships to capital sufficient banks, possibly some distance away and specializing in different credit types. All credit, even all bank credit, is not perfectly substitutible instantaneously.[8]

But public policies to increase aggregate or sectoral bank assets by reducing prudential regulations is likely to be counterproductive. They are likely to result in a temporary larger but economically weaker banking sector that will increase its burden on the taxpayers so that the long-run costs will greatly exceed any short-run gains. Instead, public policy should be directed at removing the structural restrictions to the extent consistent with necessary prudential regulation and a competitive economy. The key is to reform federal deposit insurance both to price the insurance correctly and to restrict losses to the private sector.[9] This should lead to a lasting larger and stronger banking system consistent with both safety and preserving competition. If banking continues to lose market share in such an environment, then its erosion may appropriately be attributed to market forces only and its demise no loss to anyone but the industry itself and its remaining few customers. Can commercial banks survive in a brave new world of efficiently priced deposit insurance and broader product and geographic powers? It would be strange if the industry could not, even though all individual banks may not. The rapid growth of most nondepository financial firms indicates significant demand for their financial services. Moreover, this growth occurred without benefit of access to underpriced deposit insurance. As a result, as was shown in Figure 1, these industries operated with substantially higher capital-to-asset ratios than banks.

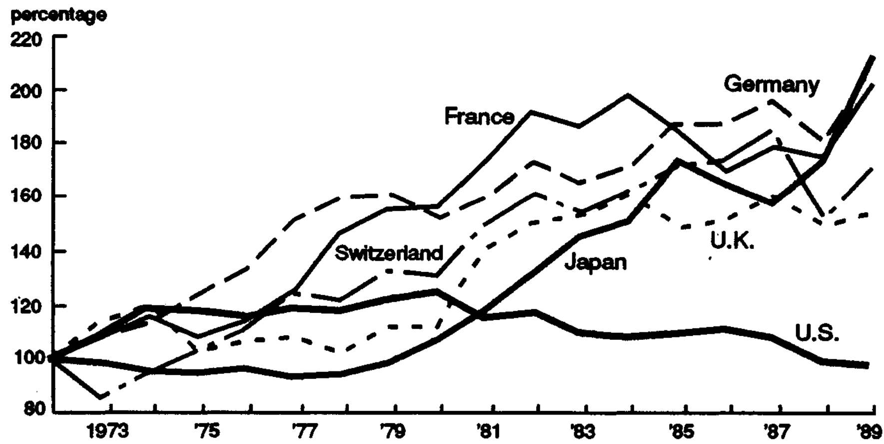
Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Figure 4

a. Total assets of multinational banking organizations by headquarter country (1972=100)



b. Total assets of multinational banking organizations relative to GNP (1972=100)



Source: George J. Benston, "U.S. Banking in an Increasingly Integrated and Competitive World Econmy", *Journal of Financial Services Research*, December 1990, pp. 311-386.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Moreover, banks in major countries also operate with substantially higher capital ratios, particularly when measured in market values. In most of these countries, banks have broader powers than in the U.S. Indeed, the reason Japanese banks have been able to expand worldwide as rapidly as they have in recent years is not that they have used artificially low cost Japanese funds or engaged in long-term predator pricing, as is commonly claimed. (The asset growth of banks on major countries is shown in Figure 4a and b). Rather, as is evident in Figure 2, they have the highest market value capital ratios. This has made them more attractive to both large loan and large deposit customers.

A market determined safer banking industry translates into a stronger, larger, and more efficient banking industry that can contribute to the economy rather than being a drag on it as in recent years in the U.S. The crisis in the U.S. banking industry in part reflects the failure of public policy makers to recognize that market-imposed, as opposed to government imposed, safety and efficient operation are compatible not conflicting conditions.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Footnotes

[1]George J. Benston et al., *Perspectives on Safe and Sound Banking*, (Cambridge, MA.: MIT Press, 1986) and George G. Kaufman, "Banking Risk in Perspective" in George G. Kaufman, ed., *Research in Financial Services* (Greenwich, CT.: JAI Press, 1989).

[2]Edward J. Kane, *The Gathering Crisis in Federal Deposit Insurance*, (Cambridge, MA.: MIT Press, 1985) and Benston et al.

[3]George G. Kaufman, "The Incredible Shrinking S&L Industry", *Chicago Fed Letter*, (Federal Reserve Bank of Chicago), December, 1990.

[4]A review of these issues appears in Anthony Saunders, "Bank Holding Companies: Structure, Performance and Reform" in William S. Haraf and Rose Marie Kushmeider, *Restructuring Banking and Financial Services in America* (Washington, D.C.: American Enterprise Institute, 1988) pp. 156-203; Franklin R. Edwards, "Concentration in Banking: Problem or Solution" in George G. Kaufman and Roger C. Kormendi, *Deregulating Financial Services* (Cambridge, MA: Balinger, 1986) pp. 145-168; and Richard J. Herring and Anthony M. Santomero, "The Corporate Structure of Financial Conglomerates", *Journal of Financial Services Research*, December 1990, pp. 471-497.

[5]George G. Kaufman and Larry R. Mote, "Glass-Steagall: Repeal by Regulatory and Judicial Reinterpretation", *The Banking Law Journal*, September-October 1990, pp. 388-421.

[6]For other lending activities covered by a federal safety net see George G. Kaufman, "The Federal Safety Net: Not For Banks Only", *Economic Perspectives* (Federal Reserve Bank of Chicago), November/December 1987, pp. 19-28 and U.S. General Accounting Office, *Government-Sponsored Enterprises: The Government's Exposure to Risk*, (Washington, D.C., August 1990).

[7]Randall J. Pozdena, "Recapitalizing the Banking System", *FRBSF Weekly Letter*, (Federal Reserve Bank of San Francisco), March 8, 1991, p. 3. See also George M. Salem et al., *Banking Industry Outlook*, (Prudential-Bache Securities), December 31, 1990, pp. 9-12.

[8]It is interesting to note that a credit crunch has not been perceived in residential mortgage lending despite the abrupt decline in the dollar assets and number of S&L associations. Kaufman, "The Incredible Shrinking S&L Industry".

[9]George J. Benston and George G. Kaufman, *Risk and Solvency Regulation of Depository Institutions: Past Policies and Current Options*, (New York: Salomon Brothers Center, New York University, 1988); George G. Kaufman, "A Proposal for Deposit Reform that Keeps the Put Option Out-of-the-Money and the Taxpayer In-the-Money", a paper presented at a Symposium on Innovative Financial Developments, Hofstra University, March 15- 16, 1991; and Shadow Financial Regulatory Committee, "A Program for Deposit Insurance and Regulatory Reform", Statement No. 41, February 13, 1989.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis