

Federal Reserve Bank of Minneapolis

1992 Annual Report

Banking's Middle Ground:
Balancing Excessive Regulation
and Taxpayer Risk



Banking's Middle Ground: Balancing Excessive Regulation and Taxpayer Risk

By Gary H. Stern, *President*
Federal Reserve Bank of Minneapolis

The views expressed in this annual report are solely those of the author; they are not intended to represent a formal position of the Federal Reserve System.

President's Message



Two themes predominate in this year's economics essay. First, we urge an approach to banking policy that balances the interests of bank customers with those of taxpayers. If achieved, such balance will avoid both an excessively regulated banking system unable to meet customer needs and an excessively accident-prone system potentially costly to the taxpayer.

The second theme is a renewed call for enhanced market discipline of banks. Market discipline can help to contain excessive risk-taking by banks and can help Congress and bank regulators assess the degree and pace with which deregulation of the industry should proceed. Major banking legislation passed in late 1991 (FDICIA) moves toward greater market discipline in several respects but also adds stringent regulations that seem, in some instances, overly intrusive and costly. Importantly, because the legislation contains action on so many fronts, it will be difficult to attain an unambiguous reading on the effectiveness of market discipline.

We believe that an emphasis on market discipline in future banking policy and legislation will help restore a balance to banking that is in the best interests of the industry, regulators, bank customers and taxpayers.

A handwritten signature in black ink, reading "Gary H. Stern". The signature is stylized, with the first name "Gary" written in a cursive script and the last name "Stern" in a more formal, blocky script.

Gary H. Stern
President



Granted that safety and soundness and limited taxpayer exposure are both legitimate objectives, is the balance between them proper or have we gone too far in assuring stability, at the expense of the taxpayer?

Banking's Middle Ground: Balancing Excessive Regulation and Taxpayer Risk

Most of us would agree that a safe and sound banking system is a high priority. Similarly, many would favor a system in which the taxpayer is not unduly exposed to the costs of resolving mishaps in banking. And most would prefer an efficient industry that serves its customers well.

Unfortunately, agreement on these broad objectives does not provide much assistance in addressing some of the issues affecting banking. The devil, or in this case the substance, really is in the detail. Promotion of a more efficient banking system better able to meet the needs of its customers suggests further deregulation and, many bankers argue, greater flexibility in offering products and services. But does such a step make sense in view of concerns about system stability and taxpayer exposure?

Put another way, what other policy changes are required if further deregulation is to occur? Granted that safety and soundness and limited taxpayer exposure are both legitimate objectives, is the balance between them proper or have we gone too far in assuring stability, at the expense of the taxpayer? If so, how do we best remedy the situation?

There are no simple answers to these questions; indeed, there are meritorious but competing objectives for banking that must be carefully balanced in formulating public policy. Proposals that simply advocate one issue—the advantages of deregulation or the need for an extensive safety net—implicitly favor one objective over others and in so doing may result in a financial system that is not only far from optimal but less satisfactory than the one we have today.

Deregulate Banking?

One major policy objective is to promote efficient banking so that bank customers are well-served. If this were the only objective, the appropriate recommendation would be to remove the bulk of the regulatory apparatus restraining

banks, freeing them to compete on the basis of product, service, location, and price, as do private sector firms generally. Freedom of management to decide which products and services to offer, how to price them, and where to locate geographically is central to assuring that the customer is well-served. In general, bankers will be better at identifying opportunities and taking advantage of them than regulators, and the public will benefit to the extent they do so. However, bank management is now precluded to varying degrees from making these judgments, and thus it is virtually certain that customers would gain from further deregulation of the industry.

However, these benefits may only be marginal because banks, after all, are only one of a plethora of providers of financial services, a group that includes, among others, insurance companies, investment banks and brokerage firms, finance companies, credit unions, pension funds, and a range of foreign institutions. In general, competition is fierce, both within banking and from non-bank financial services firms encroaching on banks' traditional turf. Whatever this competition may mean for banks, it is clear that customers already have a wide range of options when seeking financial services.

Heightened competition is undoubtedly changing the face of banking and is sometimes cited as an important reason to deregulate the industry. There has been a tendency in recent years to depict banking as an industry in decline, unable and perhaps unwilling to compete effectively in lending to many of its traditional business customers. Deregulation is viewed by some as central to the industry's survival.

To be sure, there are balance sheet data which suggest that commercial banks have lost an appreciable amount of market share. But other evidence leads to a different conclusion. Banks' off-balance sheet activities have increased considerably, as the volume of asset securitization has expanded and as banks have stepped up participation in the swap markets, issued standby letters of credit, and so on. The growing importance of these activities implies that balance sheets are at best an imperfect and increasingly unreliable indicator of the role of banks in financial transactions and in the economy generally. Sector data from the gross domestic product accounts tell a similar story, since they indicate that banking has grown more rapidly than the economy as a whole over the past 40 years. Finally, bank capital positions and earnings recently have been improving markedly, and it is interesting to note that some of the most successful institutions have concentrated on traditional banking businesses.

Even if the banking industry shrinks considerably at some point, it is far from clear that policymakers should be alarmed by this outcome. Public policy should focus on, among other things, the interests of customers of financial services firms, and not on the well-being of a particular class of institution.



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Even if the banking industry shrinks considerably at some point, it is far from clear that policymakers should be alarmed by this outcome. Public policy should focus on, among other things, the interests of customers of financial services firms, and not on the well-being of a particular class of institution. It would be foolhardy to argue that banking should be preserved in its current form if other institutions or markets perform banking functions as well or better. Even if that were not the case, the costs of any such preservation effort would have to be evaluated.

Irrespective of the strength of the case for deregulation, such action would conflict with other objectives for banking, namely concerns for a safe and sound banking system and limits on taxpayer exposure as a result of disruptions in banking. Since it is not clear at this time that these two objectives have been adequately addressed, it would be premature, in our opinion, to grant banks additional powers and permit them to engage in new activities. Deregulation should await conclusive evidence that it will not unduly compromise these other goals and, as discussed below, given the proliferation of new regulations, it may well be very difficult to develop such evidence.

As an alternative to deregulation, consolidation of the banking industry has at times been pushed on the grounds that it leads to gains in efficiency or more-than-proportional cost savings and that these results, in turn, will be passed to customers in the form of better service. This conclusion is doubtful, to put it mildly, because the evidence of many studies simply does not support the position that there are meaningful economies of scale in banking once an organization attains a fairly modest size.

From a narrow perspective, it is not of any great moment if there are, or are not, significant economies of scale in banking. Larger institutions will either compete effectively or they will not, and management and shareholders will benefit accordingly. But if mergers are approved by the regulatory agencies on the presumption of appreciable gains in efficiency, which at least in part will be passed on to customers, and this presumption is in fact in error, then public policy has a stake in this issue, a stake that ought to put the burden of proof on those who assert that considerable operational efficiencies are gained through combinations of sizable banking firms.

Indeed, much of the commentary surrounding the topic of consolidation in banking is confused, and largely beside the point from a public policy perspective. There, the principal issue remains antitrust, which is intended to get directly to the heart of service to customers. Will there be adequate competition

after consolidation so that customers are well-served? When regulatory approval is required, the agencies involved have the responsibility to assure that adequate competition will be sustained. Given the number and diversity of financial services firms in the country, it is hard to see consolidation proceeding so far and so fast as to appreciably alter the competitive landscape at the national level. Local markets may be considerably different, though, and there is reason to be concerned that some customers—small and mid-size businesses and consumers, for example—may be disadvantaged from “in-market” consolidation in particular.

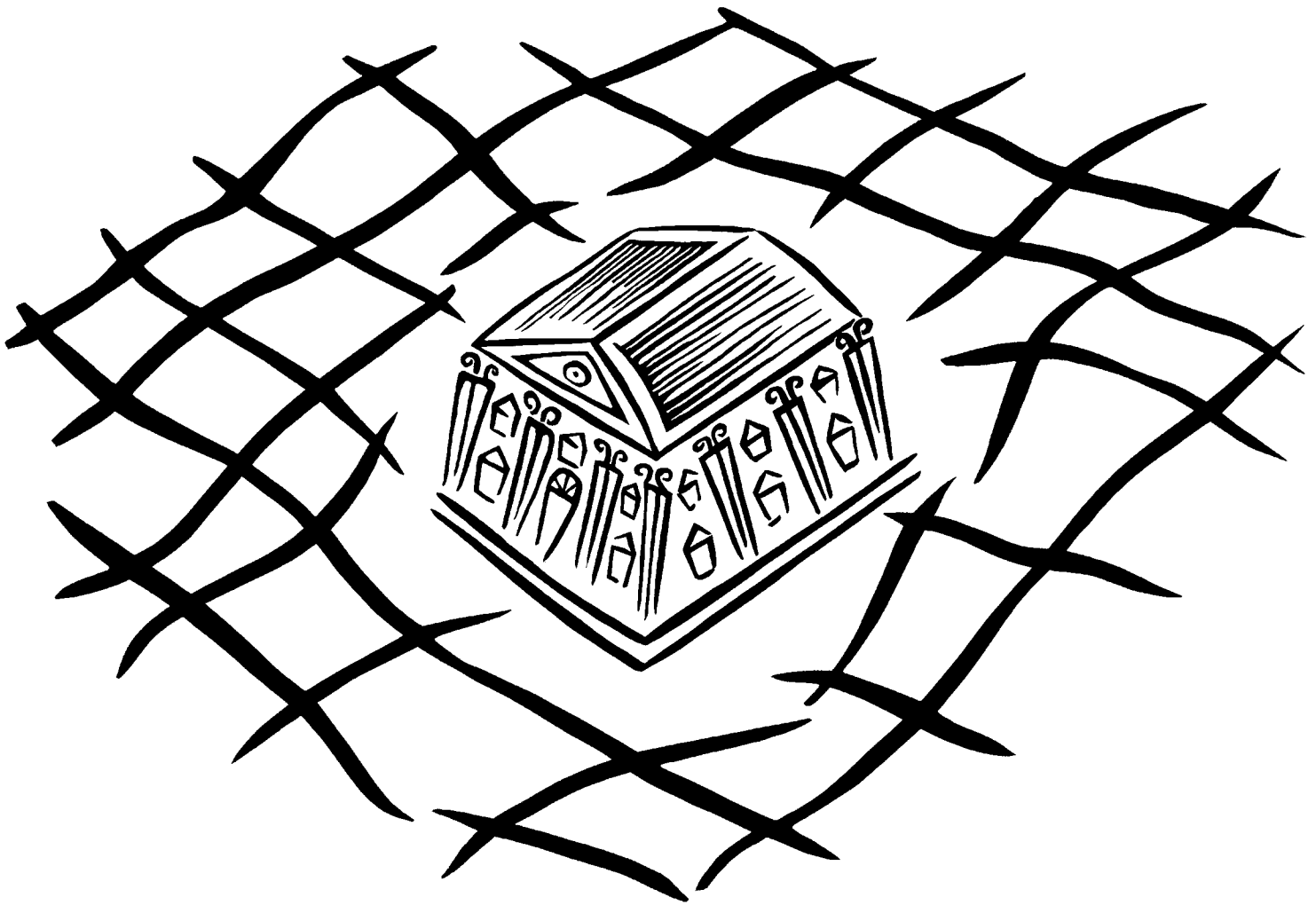
Where antitrust concerns are not an issue, there would seem to be no policy reason to oppose consolidation. Unfortunately, however, with all of the state and federal regulation in place, it is virtually impossible to get a reading on the scope and pace of consolidation consistent with market forces, so policymakers are without this guidance. Indeed, the situation may be worse if consolidation is propelled by considerations that size confers higher management compensation, continuing institutional independence, and the advantages of the “too big to fail” umbrella. To the extent that these or similar considerations go unrecognized, regulators may encourage consolidation, thinking it a desirable response to market forces.

Banking Stability and Taxpayer Exposure

A second major policy objective, and one whose implications at times conflict with those of the promotion of efficient banking, is to assure a safe and sound banking industry. Commercial banks are special institutions in that they offer demand deposits—accounts whose balances are payable on demand at par—which form the basis of both the electronic and paper-based payments system. Because of these deposits’ characteristics, banks cannot perfectly and profitably maturity match such liabilities on the asset side of their balance sheets, and thus banks can be subject to severe bouts of instability, to depositor runs. Deposit insurance is clearly central to containing such instability, for it assures the preponderance of depositors that their funds are secure should the institution fail. Federal Reserve discount window lending, for either short-term liquidity purposes or to help resolve longer-term problem situations, constitutes the second critical element of the safety net in place to promote stability.

While there is little question that a safety net underpinning banking is desirable, once one is in place bank activities must be regulated and supervised to at least some extent in order to offset the “moral hazard” problem. That is, with protection afforded by the safety net of deposit insurance and the discount

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window, depositors have little incentive to monitor the caliber of the institutions with which they do business. Due to this lack of depositor discipline, risk taking is priced too low in banking, and therefore too much risk is systematically assumed. By taking greater risk, banks potentially earn higher returns and, given the safety net, if the strategy fails much of the cost may be borne by the taxpayer.

As the financial experience of the 1980s forcefully demonstrates, a broad safety net not balanced by adequate depositor discipline and effective supervision is costly to the taxpayer. Witness the cost of honoring deposit insurance commitments in the savings and loan industry. While problems in banking were not as severe, the industry hardly distinguished itself. With hindsight, it is clear that a large number of federally insured institutions took excessive risk in dealings with developing countries; in lending to the energy, agricultural, and commercial and residential real estate industries; in support of highly leveraged transactions and through inordinate interest rate risk.

In light of this experience, there is a compelling case to reexamine the safety net and the resulting exposure of the taxpayer. To guarantee a stable banking system, 100 percent deposit insurance might be the answer, but protection of the taxpayer would require a regulatory apparatus that could be very expensive and perhaps infeasible. Banks might simply be unable to compete if regulations were too restrictive. Even more important, it is far from certain that supervision and regulation, no matter how intense, can fully replace market discipline as a means of influencing safe and sound banking. We need to find ways to restore balance between these objectives.

This is hardly an original observation. Congress recognized that taxpayer exposure had risen to indefensible levels and, late in 1991, passed the Federal Deposit Insurance Corp. Improvement Act (FDICIA). Although flawed, this legislation, in our opinion, is in some ways a good deal better than is generally acknowledged. At least implicitly, it recognizes that further deregulation of banking is ill-advised until the issues of risk taking and taxpayer exposure are addressed. And FDICIA attempts to control bank risk taking, and thereby to reduce taxpayer exposure, through both extended and more stringent supervision and regulation and increased reliance on market or marketlike discipline, which narrows the scope of the safety net.

FDICIA requires, for example, risk-sensitive deposit insurance premiums, limits on discount window lending to troubled institutions, inter-bank credit limits, and constraints on brokered deposits. Most significantly, it substantially reduces deposit insurance coverage relative to recent practice. Under FDICIA,



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with only very limited potential exceptions, deposits over \$100,000 are completely uninsured, and an individual's ability to maintain multiple insured accounts at any one institution is restricted. The FDIC is a good deal more constrained in extending insurance coverage than it recently has been, as is the Federal Reserve constrained in its provision of discount window credit.

Implemented as intended, this legislation should go some meaningful distance to achieve the greater degree of market discipline essential to reduce moral hazard in banking, which in turn should lead to decreased risk taking, healthier institutions, and less taxpayer exposure.

One reservation about this aspect of FDICIA centers on the issue of too big to fail, the practice of protecting all depositors, including the uninsured, of large banks for reasons of systemic instability. Although FDICIA has provisions to discourage the FDIC and the Federal Reserve from treating a bank as too big to fail, there is still the latitude to do so. To the extent that too big to fail persists, or market participants believe that it does, the largest banks will not be subject to adequate market discipline. To the extent this is true, such banks ought to be subject to more stringent supervision and regulation than others, if taxpayer exposure is to be limited.

The intensified supervision and regulation of FDICIA takes several forms. It emphasizes the adequacy of bank capital, limiting significantly the activities and opportunities of undercapitalized institutions and calling for prompt supervisory intervention in the case of weak banks. FDICIA also requires regulators to prescribe operational and managerial standards, allows regulators to impose limits on executive compensation, requires outside audits, and imposes additional limits on loans to insiders. In some instances, these provisions appear intrusive and costly relative to the potential benefits that might be achieved in terms of safety and soundness.

One troubling aspect about this side of FDICIA is the way in which it changes the role of the regulator. On the one hand, it sharply curtails the discretion available to regulatory authorities in addressing supervisory problems while, on the other, in some cases it almost substitutes the regulator for bank management. There is not only a broad array of new regulations under FDICIA, but also considerably less discretion permitted in the application of regulations to particular facts and circumstances. The premise, apparently embodied in FDICIA, that "cookbook" supervision and regulation is essential to limit the cost of moral hazard to the taxpayer is questionable. Indeed, its effect may be perverse. The "one size fits all" approach that the regulatory agencies have taken

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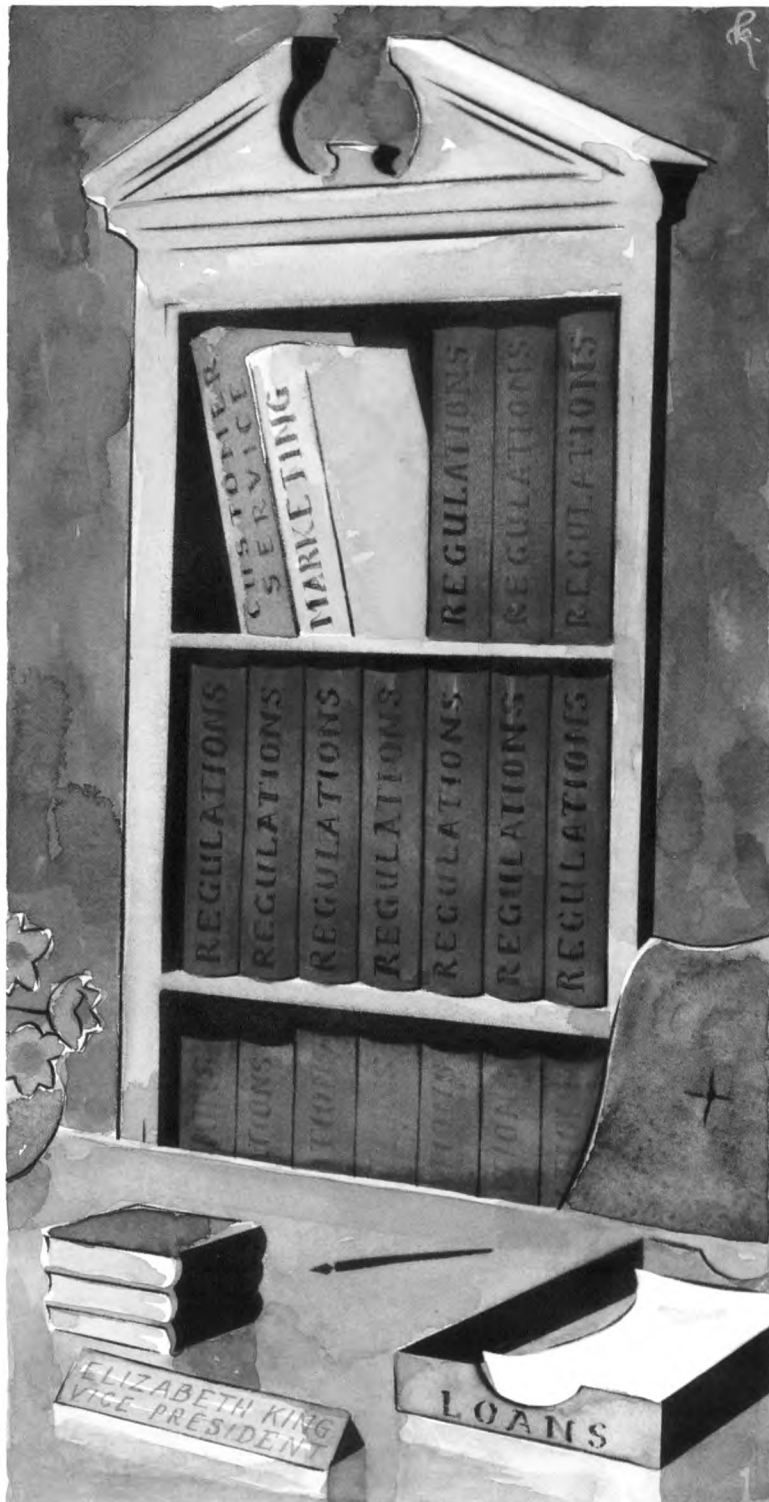
to implement FDICIA's capital-based prompt corrective action framework seriously reduces its relevance for the vast majority of banks.

Another important problem with FDICIA is that it gives little if any weight to the objective of enhanced efficiency and customer service. Indeed, FDICIA threatens to compromise this objective by curtailing management's latitude to make business decisions. To the extent this happens, customers will not be as well-served by banks as they could be. Moreover, while FDICIA's constraints on the safety net are a positive step, it will be difficult to judge the effectiveness of those constraints because they are coupled with tightened regulatory requirements and are implemented (approximately) simultaneously. Thus, we will not know when and if it is safe to deregulate, because we will not have a clear reading on the consequences of increased market discipline for stability and for taxpayer exposure.

Conclusion

We have to acknowledge at the outset that within banking policy are a number of legitimate but competing objectives. The appropriate course is not to declare one objective preeminent and pursue it single-mindedly. Depending on the objective selected, we could have a highly regulated banking system unable to meet the needs of its customers effectively, or an increasingly risk-prone system that could prove expensive to the taxpayer. The responsibility of public policy is to appropriately order and balance these objectives so that progress can ultimately be made on all fronts. This strategy would suggest, in our judgment, dealing first with the scope of the safety net and the issue of taxpayer exposure. After these issues are resolved, policy can move to the question of banking deregulation.

We are convinced that it would be ill-advised to grant banks expanded powers before we are sure the incentives are corrected that encourage excessive risk taking. FDICIA makes a start in this direction, but unfortunately its multitude of provisions will make it difficult to determine if and when deregulation is appropriate. In giving short shrift to the objective of efficiency and customer service, FDICIA does not represent the balanced approach we believe appropriate. Future policy, and subsequent legislation, should restore balance by more specifically emphasizing market discipline and by removing regulations that unduly limit management latitude for normal business decisions and that make the job of the regulator overly intrusive.



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	December 31, 1992	December 31, 1991
Assets		
Gold Certificate Account	\$195,000	\$171,000
Special Drawing Rights	186,000	172,000
Coin	15,746	13,688
Loans to Depository Institutions	1,400	0
Securities:		
Federal Agency Obligations	84,354	78,144
U.S. Government Securities	4,597,670	3,445,178
Cash Items in Process of Collection	414,847	544,358
Bank Premises and Equipment		
Less Depreciation of \$39,475 and \$34,525	42,374	44,161
Foreign Currencies	565,807	781,816
Other Assets	110,165	64,696
Interdistrict Settlement Fund	2,554,661	2,640,173
Total Assets	\$8,768,024	\$7,955,214
Liabilities		
Federal Reserve Notes ¹	7,458,324	6,690,635
Deposits:		
Depository Institutions	721,109	653,413
Foreign, Official Accounts	3,656	4,245
Other Deposits	5,374	37,620
Total Deposits	730,139	695,278
Deferred Credit Items	390,367	398,577
Other Liabilities	29,256	31,072
Total Liabilities	8,608,086	7,815,562
Capital Accounts		
Capital Paid In	79,969	69,826
Surplus	79,969	69,826
Total Capital Accounts	159,938	139,652
Total Liabilities and Capital Accounts	\$8,768,024	\$7,955,214

¹ Amount is net of notes held by the Bank of \$733 million in 1992 and \$1,427 million in 1991.

Earnings and Expenses (in thousands)

For the Year Ended December 31,	1992	1991
Current Earnings		
Interest on U.S. Government Securities and Federal Agency Obligations	\$255,108	\$266,252
Interest on Foreign Currency Investments	56,066	71,102
Interest on Loans to Depository Institutions	1,301	3,395
Revenue from Priced Services	40,733	39,930
All Other Earnings	449	426
Total Current Earnings	353,657	381,105
Current Expenses		
Salaries and Other Personnel Expenses	37,950	35,230
Retirement and Other Benefits	8,560	8,188
Travel	2,266	2,009
Postage and Shipping	5,738	5,880
Communications	458	492
Software	2,074	1,787
Materials and Supplies	2,161	2,189
Building Expenses:		
Real Estate Taxes	923	1,004
Depreciation—Bank Premises	1,244	1,298
Utilities	939	886
Rent and Other Building Expenses	1,167	1,396
Furniture and Operating Equipment:		
Rentals	687	1,113
Depreciation and Miscellaneous Purchases	5,108	5,828
Repairs and Maintenance	2,673	2,773
Cost of Earnings Credits	4,131	5,165
Net Costs Distributed/Received from Other FR Banks	429	2,014
Other Operating Expenses	1,752	1,305
Total Current Expenses	78,260	78,557
Reimbursed Expenses ¹	(4,899)	(1,798)
Net Expenses	73,361	76,759
Current Net Earnings	280,296	304,346
Net (Deductions) or Additions ²	(26,635)	13,769
Less:		
Assessment by Board of Governors:		
Board Expenditures	3,431	2,963
Federal Reserve Currency Costs	6,643	3,836
Dividends Paid	4,682	4,146
Payments to U.S. Treasury	228,762	305,855
Transferred to surplus	10,143	1,315
Surplus Account		
Surplus, January 1	69,826	68,511
Transferred to Surplus--as above	10,143	1,315
Surplus, December 31	\$79,969	\$69,826

¹ Reimbursements due from the U.S. Treasury and other Federal agencies; \$1,958 was unreimbursed in 1992 and \$3,993 in 1991.

² This item consists mainly of unrealized net gains or (losses) related to revaluation of assets denominated in foreign currencies to market rates.

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