FRBSF Economic Letter

2006-26 | October 6, 2006

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Safe and Sound Banking, 20 Years Later

Simon Kwan

The U.S. banking industry has enjoyed record profitability and very low failure rates in recent years. This scenario is a welcome contrast to the 1980s, when turbulent economic conditions, the crisis in the savings and loan industry, and a highly volatile interest rate environment put the banking industry under severe stress.

In those dark days, analysts and policymakers debated a variety of ways to address the factors that arguably precipitated the dire situation. Among the most comprehensive and influential sets of proposals was one developed by a task force of five academic researchers that was organized and sponsored by the American Bankers Association in 1986. In their Report (published as *Perspectives on Safe and Sound Banking: Past, Present, and Future* Benston et al. 1986), they identified the underlying problem as follows: the administration of the federal safety net at that time, especially deposit insurance, provided incentives for excessive risk-taking by insured depository institutions. The Report also recommended measures that could reduce the overall risk exposure of the deposit insurance system, align accountabilities for the administration of deposit insurance with those for prudential supervision and regulation, and help ensure that the deposit insurance system would be compensated for its risk exposure. To this end, the Report focused on changes in regulatory policies dealing with a wide range of issues including deposit insurance, lender-of-last-resort, market discipline, bank examinations and supervision, and expansion of banking powers.

On the twentieth anniversary of this Report, the Federal Reserve Banks of San Francisco and Atlanta, along with the founding editors of the *Journal of Financial Services Research*, held a conference named after the Report. This *Economic Letter* (based on Furlong and Kwan 2006) highlights four major areas of banking reform during the period, reviewing both the analysis and recommendations in the Report and comparing them to the actual outcomes.

Deposit insurance

Deposit insurance reform was viewed as an especially critical area for ensuring the safety and soundness of the U.S. banking system. A key shortcoming was the so-called moral hazard problem, in which the pricing and administration of deposit insurance distort depository institutions' incentive for taking risk. To remove the distortions and ensure that the deposit insurance system would be appropriately compensated for its risk exposure, the Report recommended using risk-related charges for coverage, including risk-related deposit insurance premiums and risk-adjusted capital standards. In addition, the Report argued that the risk assessment should be based on the consolidated banking organization—not just the bank subsidiaries; furthermore, it should also include off-balance-sheet risks.

Consistent with these recommendations, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 required the FDIC to establish a risk-based assessment system. However, the Deposit Insurance Funds Act of 1996prohibited the FDIC from charging well-managed and well-capitalized institutions deposit insurance premiums when the deposit insurance fund is at or above the Designated Reserve Ratio (DRR). As a result, the risk-based assessment system, bounded by the DRR requirement, did not have a meaningful sensitivity to risks. Indeed, in 2005, only about 6% of the almost 8,000 commercial banks paid deposit insurance premiums. The Federal Deposit Insurance Reform Act of 2005 (FDIRA) grants the FDIC more discretion to price deposit insurance according to risk by replacing the fixed DRR with a range.

In keeping with the Report's recommendations on risk-based capital requirements, the first Basel Capital Accord (1988) formally introduced them and included extending them to off-balance-sheet activities. The Accord has since been found to be vulnerable to capital arbitrage, which has been addressed in part by several supervisory initiatives, but its shortcomings have prompted changes that have been proposed in the new Basel II framework.

The Report also recommended keeping the insurance coverage at $100,000 and letting it decline in real terms with inflation. The rationale was to increase market discipline by gradually exposing more depositors to the risk of default. In real terms, the $100,000 coverage limit that was established in 1980 has been roughly halved by inflation since then. Recently, FDIRA raised the retirement account insurance coverage from $100,000 to $250,000, and it allowed the FDIC to adjust the general account coverage levels to keep pace with inflation starting in 2010.

To protect the insurance fund and uninsured creditors, the Report recommended closing a failing depository institution when its market-value net worth falls below some low, but still positive, number such as 1% or 2% of assets. While FDICIA embodied the concept of early intervention with the Prompt Corrective Action provision, the triggers for regulatory intervention are based on book-value capital ratios. Relying on book-value capital ratios may undermine the usefulness of early intervention when they lag their true economic values. However, in the absence of full market-value accounting (which the Report also recommended), using the book value ratios is necessary for implementation purposes. Going beyond early intervention, FDICIA's Least Cost Resolution provision requires the FDIC to resolve bank failures using the method that is least costly to the insurance fund. Furthermore, the act also clarified and formalized the conditions for protecting uninsured depositors or creditors at large banking organizations whose failure would have serious adverse effects on economic conditions or financial stability.

Market discipline

Under market discipline, a firm has private sector stakeholders, including management, shareholders, and uninsured depositors and other creditors, who are at risk of financial loss from the firm's decisions and who can take actions to "discipline" the firm or influence its behavior. The Report recommended increasing the reliance on market discipline by imposing costs on stakeholders as disincentives for taking risk. More specific recommendations included those for greater reliance on subordinated debt. The Report also recommended expanding the use of current-value measures for internal use by depository institutions, for deposit insurance purposes, and for public disclosures. The Report argued that one benefit of increased market discipline is that it can supplement supervision and thus lower the agencies' expenses. One recommendation also calls for examination reports to be shared with bank management.

Some of these recommendations for increasing reliance on market discipline are embodied in the collection of changes that have increased regulatory emphasis on bank capital, starting from the first Basel Capital Accord to the newly proposed Basel II capital regulation framework. Coincident with this has been the substantial turnaround in book-value capitalization in the banking industry, with nearly all U.S. banks being classified as well-capitalized by their regulators.

In addition, subordinated debt has become part of Tier 2 capital, which is counted towards meeting regulatory capital requirements. Contrary to the Report's recommendations, the debt can have restrictive covenants and its issuance need not be staggered. The current environment is more conducive to the use of such debt in meeting capital requirements. In fact, as part of the recapitalization of the banking industry in the early 1990s, banking organizations as a group did increase their reliance on subordinated debt. More recently, policymakers also have allowed trust preferred securities to meet part of Tier I capital requirements.

Several steps have been taken to improve public disclosure by financial institutions. At the policy level, improved disclosure is one of the three pillars in the Basel II proposal. Banking agencies also have improved disclosure by expanding the scope of regulatory reports, accelerating the release of the reports, and making the information more readily available.

Prudential supervision

The Report recommended several revisions to the bank examination process. It argued that, because fraud and insider abuse were major problems, the examination process should focus on uncovering them. Other recommendations included: directing examinations at verifying accounting and estimates of the current value of assets and liabilities; using existing data, statistical methods, and computer models to monitor risk, to predict risk, and to identify problems; increasing the reporting of significant information using computer technology.

Over time, the agencies have, indeed, taken advantage of advances in computer technology. A notable change directly affecting the examination process has been the adoption of the so-called risk-focused approach. This approach was formally announced by the Federal Reserve in 1997 and was supplemented with traditional transactions-testing of a sample of a banking organization's assets.

While improved risk management in banking could help protect the insurance fund, that was not the motivation for adopting risk-focused supervision. The motivation instead rested on the assumption that banks have incentives to measure risk accurately and to manage it. In fact, the risk-focused approach can be seen as arising out of financial institutions' own innovations in risk management.

The risk-focused approach, which emphasizes internal controls at banking organizations, is consistent with the Report's attention on fraud detection, as is the move toward more continuous supervision for larger banking organizations. Aside from having staff on-site at the very largest banking organizations and regular off-site monitoring for other banks, supervision involves a series of targeted examinations leading up to full examinations. The targeted examinations can focus on particular areas of risk, including credit risk, market risk, compliance risk, and operational risk.

At the same time, off-site monitoring among the federal banking agencies has been expanded and improved substantially, as the agencies have taken advantage of statistical models and advances in information technology. At the Federal Reserve, for example, off-site monitoring models are used to estimate probabilities of failures and to predict supervisory ratings, and new models that incorporate market-based variables are currently being developed.

Expansion of banking powers

The Report recommended that the main criterion for authorizing new activities should be the insurance agency's ability to monitor and to assess the total risk implications of the new activity for the consolidated entity as well as to price the risk to the consolidated entity. It viewed the legal separation of commercial and investment banking, and the separation of banking and insurance, as neither necessary nor desirable for reducing conflicts of interest. It also rejected the idea of housing the new activities in nonbank subsidiaries or affiliates because doing so would not protect the insurance agency from the risk of the new activities so long as the holding company can shift risk to insured bank subsidiaries.

Regulatory and legislative actions over the past 20 years have allowed greater affiliation of banking and other financial services. Even under the Glass-Steagall Act of 1933, bank holding companies were permitted to engage in securities underwriting and dealing on a limited basis through their so-called Section 20 subsidiaries approved by the Federal Reserve. On the insurance side, national banks exploited loopholes in the law by conducting insurance agency activities in small towns.

In 1999, the Gramm-Leach-Bliley Act formally repealed provisions of Glass-Steagall, allowing banking firms to be affiliated with securities firms and insurance companies. However, the new securities activities and the insurance activities of the banking organization must be conducted outside of the bank subsidiaries in nonbank affiliates. These measures allowing greater affiliation of banking with other financial activities are consistent with the views in the Report that such affiliation should not lead to conflicts of interests that are harmful to consumers. Even the continued restrictions on mixing banking and commerce could be seen as consistent with the Report's views, to the extent that the ban could be motivated by concerns over the ability of the supervisory agencies to assess and monitor the associated risks. Nevertheless, the use of the holding company framework for expanding banking powers is clearly at odds with the Report.

Conclusions

The task force Report, written 20 years ago when the nation's banking and thrift sectors were in serious distress, took a broad and deep look at the underlying contributory causes. Its recommendations were based on sound economic principles, including the theory underlying options pricing models and agency theory in finance. Today, we have much healthier banking and thrift sectors, and there seems to be little question that the safety and soundness of the banking system has improved substantially—at least for now. Looking back, one can point to several major developments that have shaped the U.S. banking system during the last two decades, including the recapitalization of the banking industry, the greater reliance on market discipline, and increased sophistication of risk management. These developments are broadly consistent with, and to some extent connected to, public policy measures recommended by the task force, whose primary thesis was to align risk-taking incentives among depository institutions more appropriately and to limit the scope of the bank safety net.

Simon Kwan
Vice President

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