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An Overview of Financial Restructuring

remarks by

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Introduction

Financial restructuring is not only a topic of obvious major importance, but also one to which the Congress and the regulators are increasingly adjusting, and, more recently, attempting to shape   Restructuring is occurring continuously   Even during periods that seemed at the time to be relatively stable, market processes were at work creating new and cheaper ways to deliver financial services or to erode regulations   What has changed is that the pace has apparently accelerated so rapidly in recent years that the restructuring process has become obvious to all participants and observers

Financial restructuring encompasses so many ongoing developments that I have chosen to limit my presentation today to a discussion of expanded bank powers and the related issue of regulatory restructuring

Why Expanded Powers?

The macroeconomic environment of the 1980s has been difficult, to say the least, for banking   This has been a period of wide interest rate and currency swings, of inflation and disinflation, and a time when many agriculture, real estate, energy and LDC credits — the vast majority of which no doubt appeared sound and bankable when they were made — have soured   Meanwhile, competition from nonbank lenders, foreign banks, and the open market has greatly intensified   Perhaps the most profound development has been the rapid growth of computer and telecommunications technology which has lowered the costs and broadened the scope of banking services, as well as facilitated the channeling of credit outside the banking system

The changing economic and competitive environment has contributed to sizable loan–loss provisions, which almost quintupled in the 1980s, while net charge–offs have almost tripled What tends to get lost in these well–known statistics, is that there are a significant number of banks that have done quite well throughout the 1980s For example, regional and community banks in the eastern half of the country have registered record or near–record profitability by engaging in old fashioned, straightforward deposit gathering and lending These institutions have been clever or lucky enough — perhaps both — to avoid most of the problem credit areas Offsetting these profits, and accounting for the decline in aggregate bank earnings, is the deteriorating credit quality experienced by most money center banks, and the large number of banks west of the Mississippi heavily committed to energy, agriculture, and real estate credits.

To be sure, many banks are facing actual losses and eroding capital However, many banks are doing quite well and the erosion of banks' <u>underlying</u> profitability has, at least to date, not been very dramatic The underlying profit positions, however, are being masked by non–repetitive, unusual macroeconomic and/or regional difficulties — many of which, but certainly not all, were beyond the control of individual bank lenders While the pace of <u>de novo</u> bank entry has slowed in the last couple of years, in 1987 new banks were chartered at somewhat above the average postwar industry rate, suggesting that banking is still regarded as a generally profitable endeavor.

While the available data indicate that many banks are doing reasonably well — and some are doing very well —there are nonetheless reasons for concern about the future fundamental profitability of banks. The balance sheets of the nonfinancial business sector have deteriorated in recent years as evidenced by the general decline of corporate bond ratings. Indeed, judged by historical standards, the current ability of the nonfinancial corporate sector to cover its debt servicing costs out of earnings is low, for many firms, it is uncomfortably low. Thus, at the same time that the highest quality business borrowers have been attracted away from banks to the money and capital markets for direct financing, the banking system has found its remaining customers to be less creditworthy than earlier in the postwar period.

These developments emphasize the need for banks to price their remaining higher risk assets so as to recover what may be a permanently higher rate of loan loss — although hopefully losses will be considerably below recent levels. Put another way, what appears to be the underlying profitability of banking will show through in future aggregate data, when the current special factors are behind us, if and only if the return on bank portfolios is at the same time substantial enough to offset the additional risks that are now a permanent feature of the loan structure of banks.

Only time will tell how these particular economic trends will affect the profitability of banking. But, technological developments are meanwhile irreversibly undermining the value of the banking franchise, that is, risk diversification through intermediation, and hence the future ability of banks to attract capital and operate profitably as presently structured

The heart of intermediation is the ability to obtain and use credit and market risk information This process has been changed dramatically by developments in computer and telecommunications technology One specialist has estimated that the real cost of recording, transmitting, and processing information has fallen by 95 percent in less than 25 years While this has lowered the cost of information processing and communication for banks, it also has made it possible for borrowers and lenders to deal with each other more directly in an informed way Service organizations or investors' own on-line data bases, coupled with powerful computers and wide-ranging telecommunication facilities, can now provide potential investors with virtually the same timely credit and market information that was once available only to the intermediaries

Investors are thus able to make their own evaluations of credit risk, to deal directly with borrowers, and — especially with the increasing institutionalization of savings — to develop their own portfolios and strategies to balance and hedge risk The franchise of intermediation, the core element of a bank's comparative advantage, and its main contribution to the economic process, thus has been made less valuable by the information revolution While not yet captured in bank profits data, it seems reasonable to conclude that the basic long-term competitiveness of banks as intermediaries has been reduced and that the trend toward direct investor–borrower linkage, that is, of more securitization, will continue

Banks have responded to the technological revolution by participating in it Guarantees and other off–balance sheet arrangements, short–term credit facilities, private placement activity, commercial paper placements, and loan participations and sales are examples of such responses These and similar techniques have permitted banks to continue to service those customers who increasingly turn to securities markets

The ability of banks to continue to hold their position by operating on the margins of customer services is limited Existing constraints, in conjunction with the continued undermining of the bank franchise by the new technology, are likely to limit the future profitability of banking Thus, despite empirical evidence suggesting that banking has so far remained a fundamentally profitable business, there are growing indications that such a position is unlikely to be maintained If the aforementioned trends continue, banking will contract either relatively or absolutely

Should we care? Is there any reason for anyone other than bankers, and bank shareholders to care if this occurs, so long as the public is being well served with an efficient and flexible financial system? The major reason for not acquiescing in a shrinking of banking services is that the system has in place capital and a cadre of knowledgeable and specialized human resources with an expertise that would be difficult to replicate The public interest would not be served if these specialized resources were to be repositioned in another institutional arrangement within today's structure, not because of their unwillingness to compete or innovate, but rather simply because of an inflexible statutory and regulatory structure that limits banks' abilities to respond to the new economic and technological environment

It is important to underline that the Federal Reserve Board's objective in its support of broader powers for bank holding companies is not to bail out banks, but rather to facilitate an efficient deployment of assets, capital, and human resources to meet the public's needs for financial services Indeed, new powers for banking organizations, while providing greater efficiency, flexibility, and synergy, are unlikely to result in unusual short-term gains in banks' profits Bad credits on the books still have to be worked off Moreover, it does not seem likely, thanks to the competitive nature of the U S financial system, that there are abnormally high profits in very many markets now closed to banks just waiting to be captured by banks once new powers are granted Rather, I suspect that the exercise by banks of proposed new powers will be, at least in the short-run, reflected in narrower margins by both banks and their nonbank rivals

These narrower margins mean, of course, lower prices for the consumers of financial services This illustrates that the public benefits of expanded powers include not only a stronger and safer banking system, but also the more efficient and convenient delivery of a wider array of lower cost financial services

Public Policy Concerns

While the expansion of banking powers is consistent with a flexible, safe, and efficient financial system and increased real benefits to consumers, there still remain reasons for policy makers to be cautious about such changes in financial structure

The federal safety net exists mainly because of the special role and place of bank deposits as both money and repositories for the public's liquid assets With the safety net comes a degree of supervision and regulation that is generally unacceptable in a free market economy Indeed, extension of the federal safety net to a wider array of activities — which might occur as a result of increased bank powers — is inconsistent with the maintenance of a free and competitive economy. At the same time, expansion of the powers of banking organizations should seek to minimize the chance that any increase in risk will be extended to the bank entity and, more importantly, to the depository system more broadly

These problems can be effectively dealt with, we believe, through use of the bank holding company organizational form The bank holding company form takes advantage of the legal doctrine of corporate separateness, which seeks to insulate a bank from its corporate affiliates However, in order to reinforce corporate separateness between the various subsidiaries of a bank holding company exercising those expanded powers that are riskier than existing bank activities, my colleagues and I support an even further strengthening of the insulating "firewalls" that already exist Thus, even though they tend to offset some of the synergies and economies of scope that would otherwise benefit both banks and the public, safety net concerns have led the Board to support the strengthened firewall provisions in Senator Proxmire's bill to repeal most of the Glass–Steagall separations of commercial and investment banking We also believe that similar provisions could well be relevant for other expanded powers

Expanded Powers Priorities

It is fair to say that, in the Board's view, the single most important step regarding expanded powers that could and should be taken now is to repeal the separations of commercial and investment banking in the Glass–Steagall Act

Of all the possibilities for expanded bank powers, repeal of Glass–Steagall is most consistent with addressing the fundamental market and regulatory developments undermining the long–run health of U S banks that I outlined earlier. Technological change is pushing financial markets toward increased securitization of all kinds of assets, and if banks are to remain viable competitors in the future they must be allowed to evolve along with the market

The rapid pace of technological change and competitive innovation clearly suggest that it is virtually impossible to know in advance which securities powers and products are likely to be demanded by customers and profitable to banking organizations One of the more attractive features of the Proxmire bill is that its near–complete repeal of the Glass–Steagall Act allows for a market driven evolution of financial services and products The Board strongly supports this generic authorization of securities powers so overwhelmingly approved by the Senate I would urge the House in its deliberations in the months ahead to adopt an approach similar to that of the Senate I believe it would not be useful to grant only specific, limited, securities powers to banking organizations since that runs the risk of product obsolescence as market innovation and technological change continue

The public policy concerns of securities powers can, as I have suggested, be dealt with effectively And here I would add that we are under no illusions regarding the riskiness of many securities activities The Federal Reserve, less than most organizations, does not need to be reminded that investment banking is risky Nonetheless, available evidence, including that from the October crash, suggests that the risks of securities activities can be managed prudently in the vast majority of situations

Regulatory Restructuring

Expansion of bank holding company powers and broader restructuring of the financial services industry raises the issue of the need for a restructuring of the financial regulatory process

Realistic reform has, I submit, already begun with the federal banking agencies' proposals for risk–based capital requirements for banks and bank holding companies I am sure virtually everyone in this room is well aware of the arguments in favor of some form of risk–based pricing system, be it risk–based deposit insurance premiums, or risk–based capital requirements In our view the proposed risk–based capital system, while subject to some deficiencies, is an important first step toward having in place market oriented regulatory policies that encourage banking organizations to maintain adequate capital and prudently manage their risk. This is especially needed, it seems to us, as we begin to expand bank powers into new, and sometimes riskier, areas We will surely always require supervision, monitoring, and regulation of some aspects of banking organizations But having in place an effective risk–based capital system — and one that is also widely used by the major industrial nations — would be a major step in the right direction

Development of a risk–based capital standard on which the industrial nations could agree has required considerable debate and compromise among all parties on a wide variety of issues, including the definition of asset categories, weights to be applied to these categories, and items to be included in the tier 1 and tier 2 capital components But virtually everyone agrees that a safe banking system requires that each banking organization have some minimum level of common equity While the appropriate minimum is obviously a complex question, our analysis of the historical experience of individual banks, coupled with experiments that assume future severe economic conditions, suggests that at a minimum a 4 percent equity ratio is needed to cushion banking institutions against the type of unanticipated contingencies that could arise in the 1990s And, as I have noted earlier, a banking system that cannot adapt to the changing competition and technological environment will no longer be able to attract and maintain even this minimum level of equity

The competitive equity aspect of the expanded powers necessary to achieve a strong competitive position for banking organizations raises the issue of functional regulation By functional regulation I mean the notion that specific functions, or specialized areas of activity, should be subject to the same regulatory constraints as equivalent or very similar functions at nonbank firms For the most part, the Board fully supports the concept of functional regulation Indeed, we have endorsed the provisions of the Proxmire Bill that would implement this idea for securities subsidiaries of bank holding companies. However, so long as some portion of a holding company has access to the federal safety net, our view is that it would be inappropriate to abandon the holding company to a piecemeal regulatory structure that leaves no agency responsible for seeing that the activities of the organization as a whole don't impose undue risk on the depository system This is not to say that corporate separateness will not be an effective shield in the vast majority of situations But it only seems prudent to insist that any company that owns an insured depository should have competent management, should have adequate capital, and should be open to review in as unobtrusive a manner as is possible by an agency responsible for the protection of the safety net

The need for a regulatory structure that allows for the resolution of issues that cross organizational form and existing regulatory authority was reinforced by the stock market crash of last October More specifically, many analyses of the crash have suggested the need for some reform of the regulatory structure for cash, futures, and options markets on stocks and stock indexes While it is clearly true that each of these markets is really only a component of one integrated market valuation system, and that such linkage implies the need for a coordinated regulatory approach on intermarket issues, my colleagues and I believe that we should proceed cautiously in this area

Any restructuring of securities markets regulation must address many issues, some of which we are only beginning to understand clearly The forces of technological change that I discussed earlier with regard to the changing role of banks, are also behind many of the issues arising from the stock market crash. For example, the pre–October level of stock prices may have been inflated in part by an erroneous anticipation that technology permitted rapid hedging or strategies that would permit entire portfolios to be liquidated rapidly Moreover, I believe that the severity and rapidity of the October crash was in many ways the outcome of tension between dramatically changing computer and telecommunications technology and the unchanged human tendency to disengage, or withdraw and avoid commitments, when prices become highly uncertain This clash resulted in massive demands for trading execution that the system simply could not handle Any regulatory restructuring must take the hard edges off this conflict, but still allow for the continued evolution of financial markets

More generally, we need to design a regulatory system to deal with the structure, both domestic and foreign, of our financial organizations Thus the need to <u>decide</u> on a structure for expanded bank powers is reinforced Once we decide on that, then how to deal with issues such as functional regulation, oversight of consolidated entities that operate in multiple markets, and how to ensure that sufficient private capital is available will become clearer.

The Presidential Working Group on Financial Markets has been struggling with many of these issues Its report, due out shortly, should at a minimum indicate the feasibility of an interagency approach to problems that cut across markets

Conclusion

In conclusion, then, the issues before us are complex, important, interrelated, and in some cases fraught with substantial risk However, change is inevitable, and a policy that attempts to maintain the status quo is already flawed and hardly risk–free More importantly, we know quite a bit about the causes and solutions to many of our problems, and we at the Board believe that in those areas we should move forward expeditiously