Financial Industry
ISSUES

FEDERAL RESERVE BANK OF DALLAS THIRD QUARTER 1991

A Perspective on Banking Reform

"Outdated banking laws that do not adequately reflect the changes that have occurred in financial markets have impaired the competitive position of U.S. banks."

Congress has introduced major banking legislation this year to reform the U.S. financial industry. The Financial Institutions Safety and Consumer Choice Act potentially represents the most sweeping financial and regulatory reform since the Great Depression. A concern that the U.S. banking industry has become less competitive in both domestic and international markets has been a strong motivating force behind the legislation.

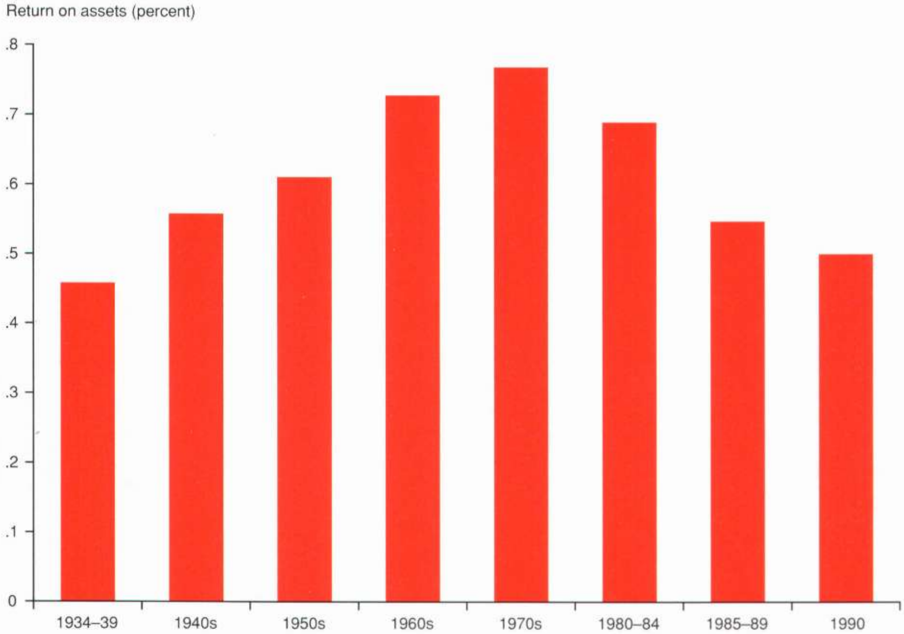
The debate surrounding this banking legislation has centered on several key issues, including expansion of geographic and product markets, regulatory restructuring and deposit insurance reform. The House Banking Committee approved a set of reform measures in late June that followed in large part the reform proposal released in February by the Treasury Department. The Senate Banking Committee approved its version of a banking reform bill in early August. While the legislation is still moving through the committee process, final versions of each bill are expected sometime this fall. Most analysts expect that a major banking bill will be passed this year.

While the debate continues on how best to proceed with substantive changes, there is now broad agreement that outdated banking laws that do not adequately reflect the changes that have occurred in financial markets have impaired the competitive position of U.S. banks. Technological advancements in the processing and transmission of information have enabled nonbank competitors to provide many new financial products. While consumers have benefited from these innovations, banks have suffered because regulatory restrictions have prevented them from competing fully in the expanded marketplace. As a result, most analysts now agree that banking reform is needed. In this issue, we review the major factors that have contributed to the changing trends in bank profitability and offer our perspective on the likely impact of the legislation on the banking industry.

What Caused the Decline in U.S. Bank Profitability?

Banks generally prospered throughout most of the post–World War II period. Separations in geographic and product markets protected banks from competitive pressures, and deposit insurance increased the value of the banking franchise. During the past decade, the banking environment has changed dramatically, partly as the result of technological innovations and the emergence of new competitors.

Chart 1
Profitability of Insured U.S. Commercial Banks



DATA SOURCES: U.S. Treasury Department (1991), *Modernizing the Financial System: Recommendations for Safer, More Competitive Banks* (Washington, D.C.: Government Printing Office); Federal Deposit Insurance Corp., *Quarterly Banking Profile*, various issues.

Chart 1 highlights the changes in U.S. bank profitability. After the tumultuous 1930s, the return on banking assets rose sharply and trended upward through the 1970s. Since then, however, bank profitability has dropped at an alarming rate, declining to 0.55 percent in the late 1980s and 0.5 percent in 1990.

In addition to the overall downward trend in profitability, regional bank earnings have been highly volatile. Banks in the Eleventh District, which comprises Texas, southern New Mexico and northern Louisiana, experienced huge losses during the late 1980s. However, the return on assets at Eleventh District banks increased to 0.44 percent in 1990 and strengthened further to approximately 0.7 percent during the first half of 1991. The turnaround in District bank performance is primarily attributable to improvement of the troubled asset ratio at the region's banks. The ratio of past-due loans, nonaccrual loans and foreclosed real estate to total assets fell to 2.4 percent in the second quarter of 1991, slightly lower than its year-earlier level. In contrast to this improvement, preliminary reports indicate that in the second quarter of this year banks elsewhere generated a return on assets of only 0.5 percent and had a troubled asset ratio of 3.3 percent. Other regions of the country, particularly New England, have experienced deteriorations in asset quality similar to the difficulties that emerged at Eleventh District banks during the 1980s.

Both the downward trend in profitability and the boom-to-bust banking patterns evident on a regional basis stem from fundamental changes in the financial services industry. The traditional role of banks has been to intermediate between depositors and borrowers by channeling short-term liabilities, including demand deposits, into longer-term loans. Because banks specialize in lending, they historically have been able to reduce the cost of acquiring timely information on the credit quality of individual borrowers, thereby lowering the cost of credit. However, recent technological advances in the processing and transmitting of information have enabled other financial intermediaries to compete more effectively with banks.

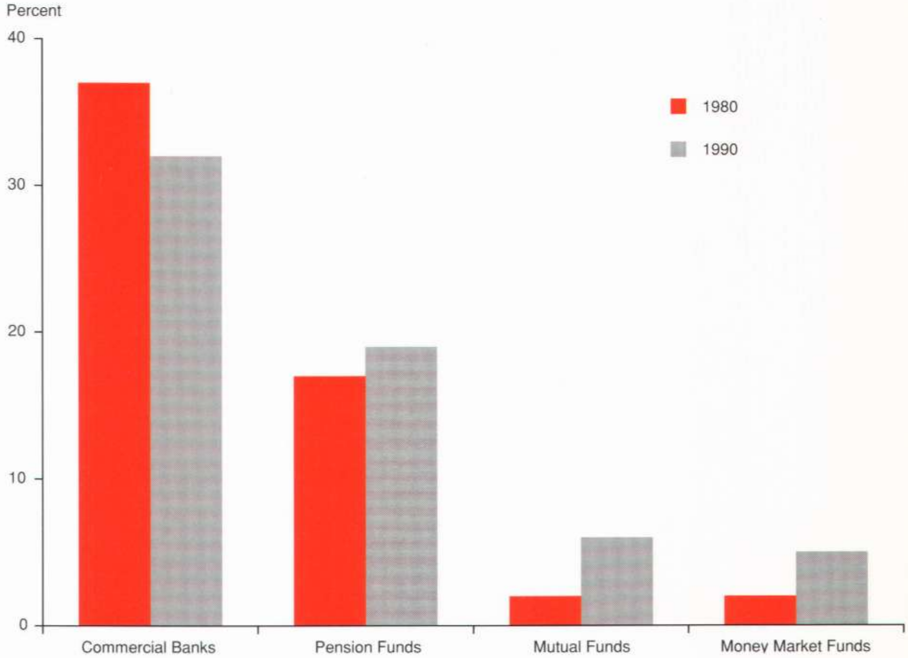
Nonbank competitors have made considerable inroads into banking markets. Chart 2 highlights recent changes in the importance of banks relative to other financial intermediaries. Commercial banking assets accounted for 32 percent of the total assets of major types of financial intermediaries in 1990, compared with 37 percent in 1980. The market shares of pension funds, mutual funds and money-market funds rose over the decade. Correspondingly, growth in commercial paper issued by nonfinancial borrowers has far exceeded growth in commercial and industrial loans extended by banks, as Chart 3 shows. Improved information technologies and the associated increase in the availability of credit information on large borrowers has helped spur the high growth in the commercial paper market relative to bank lending.

Banks have attempted to reconfigure their lending activities as business borrowers increasingly have turned to alternative sources of financing. As Chart 4 shows, most of the growth in bank loan volume over recent years can be attributed to increased real estate lending, which has been the primary source of recent bank losses. Many analysts contend that banks assumed increased risk through real estate lending to compensate for reduced profit margins in their traditional banking markets.

This reduction in the market share of U.S. banks has shifted the emphasis of banking policy away from the concern that banks, if left unrestricted, might gain excessive economic power and toward a concern that regulatory restrictions are preventing banks from competing effectively in global financial markets. Product restrictions, for example, have prevented banks from diversifying across product lines and reducing costs through the efficient production of a full line of financial services. Branching restrictions have made it difficult for banks to realize the benefits of geographic diversification, thereby making banks less efficient and more susceptible to regional economic downturns. It is now widely acknowledged that greater geographic diversification likely would have helped reduce the concentration of bank failures in the Southwest and, more recently, in New England.

The reductions in bank product and geographic restrictions that are expected from the pending legislation will help banks regain at least part of their lost competitiveness. But concerns persist that relaxation of product and geographic restrictions, while beneficial, will not be sufficient to establish a stronger, more efficient banking industry. Lessons from the thrift industry suggest that efforts to deregulate financial markets can be counterproductive if the remaining incentive structure does not complement the reforms. In particular, the 1980s demonstrated the unintended consequences of partial reforms that gave depository institutions expanded powers without reforming the system of federal deposit guarantees.

Chart 2
Market Share of Selected Financial Intermediaries



DATA SOURCE: Board of Governors of the Federal Reserve System, *Annual Statistical Digest*, various issues.

Deposit Insurance Reform: Has the Time Come?

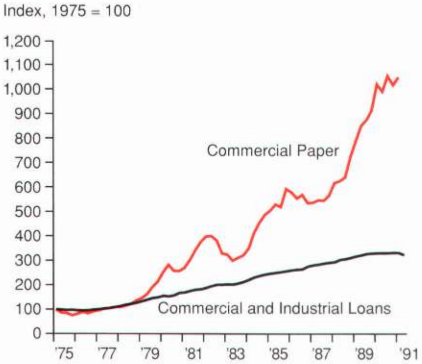
The current system of federal deposit insurance represents an attempt to protect depository institutions and the public from the potentially damaging effects of banking panics, in which depositors indiscriminately withdraw funds from the banking system by converting bank deposits into currency. Since its beginning in 1934, federal deposit insurance coverage has been expanded repeatedly, so now it is not uncommon for all deposits, regardless of size, to be protected from loss when a bank fails.

By guaranteeing the full value of deposits, federal deposit insurance greatly reduces the potential for banking panics, but the extension of federal deposit guarantees has created its own problems. Without deposit guarantees, the threat of withdrawal by uninsured depositors concerned about the safety of their deposits provides a disciplinary role in guiding banks to maintain sufficient capital and limit risk-taking. While the current system of deposit insurance reduces the likelihood of banking panics, it also effectively removes the incentive for depositors to monitor banks and withdraw deposits from banks that approach insolvency or assume increased asset risk, because the safety of deposits is guaranteed. This lack of deposit market discipline encourages banks to reduce their capital-to-asset ratios and pursue high-risk investments. As increased competition has reduced the value of bank charters in recent years, banks have had less to lose in the event of failure and, consequently, are more prone to respond to the risk-taking incentives provided by deposit insurance.

The system of regulatory constraints designed to substitute for the monitoring and disciplining role of depositors has not been fully effective. The difficulty of imposing adequate regulatory discipline in the current competitive environment is reflected in the unprecedented financial losses from recent bank and thrift failures. Losses at the nation's insolvent thrifts crippled the Federal Savings and Loan Insurance Corp. insurance fund, and banks are now faced with the growing expense of recapitalizing the Bank Insurance Fund when low profitability has already strained the industry's ability to compete in the market for financial services. To an increasing number of banks, the price of deposit insurance may become prohibitively high.

Reform measures currently under consideration link regulatory discipline to bank capital levels, culminating in bank closure before insolvency, as measured by regulatory standards. But concerns persist regarding whether such changes will be sufficient, particularly because it is widely acknowledged that difficulties remain in the measurement of regulatory capital.

Chart 3
Commercial Paper Issued by Nonfinancial Borrowers vs. Bank Commercial and Industrial Loans



DATA SOURCE: CITIBASE, Citibank Economic Database.

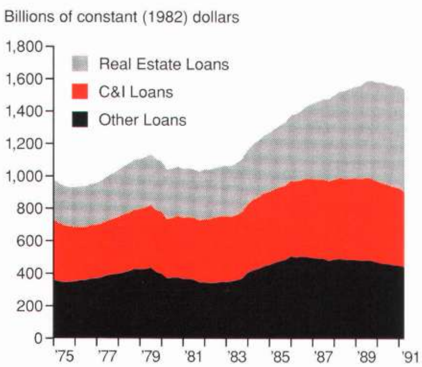
Can We Trust the Market to Discipline Banks?

Many observers agree about the problems associated with the current system of deposit insurance and the associated lack of depositor discipline. Considerable disagreement persists, however, over the degree to which reintroducing deposit market discipline will result in severe banking panics. A distrust of market forces has been the cornerstone of U.S. banking policy throughout most of this country's history. The key consideration is whether this distrust is warranted.

Recent attention to this topic suggests that the potential for banking panics to affect adversely the health of banks and macroeconomic activity has been exaggerated. Throughout most of U.S. banking history, financial losses on bank deposits were actually very small and similar in magnitude to losses from failures of nonbank businesses. Moreover, evidence suggests that a spillover effect from the failure of a large bank to other banks has been limited. Thus, it is possible that the failure of a large bank would not have a severe, adverse effect on general economic activity. Finally, even if a potentially damaging panic developed, the central bank can offset and reverse a generalized outflow of deposits from the banking system by extending credit to solvent banks through the discount window or by injecting reserves through open market operations.

It is thus plausible that changes that reintroduce a greater role for deposit market discipline in controlling bank risk-taking would improve the overall performance of the banking industry. Our concern is that if market forces are prevented from monitoring and shaping bank risk-taking because of implicit 100-percent deposit guarantees, expanded powers for banks and a capital-based system of regulatory oversight will not be sufficient to promote a sound banking system.

Chart 4
Bank Lending*



* Nominal value of each loan category deflated by the consumer price index.
DATA SOURCE: CITIBASE, Citibank Economic Database.

Concluding Remarks

Considerable evidence suggests that the appropriate policy response to current banking difficulties would be to relax the geographic and product restrictions under which banks currently operate while allowing market forces to play a much larger role in guiding bank actions. In our view, successful financial reform will rely increasingly on the incentives and self-correcting processes provided by the market to produce a safer, stronger and more efficient banking industry.

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