Banking Conditions and Legislation

What is the appropriate role of government in the economy?

On December 19 of last year, the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) ushered in sweeping regulatory changes on a scale not seen since the 1930s banking legislation. Among other things, the act addresses the recapitalization of the deposit insurance fund, prompt corrective action, least-cost resolution and standards for safety and soundness.

The focus of the legislation is to avoid a replication of the thrift industry debacle of the 1980s. The unprecedented cost of the thrift industry cleanup underscored the need for strong measures. But much disagreement remains about how this public policy objective can best be achieved.

The 1991 banking legislation adopted the same approach that was taken to deal with thrift industry problems in the 1989 Financial Institutions Reform, Recovery and Enforcement Act. The emphasis in both of these comprehensive bills is on tighter regulatory enforcement and supervisory oversight to constrain risk-taking at federally insured depository institutions. This narrow approach differs sharply from broader reform proposals that emphasized the need to expand geographic and product markets, streamline the financial regulatory structure and simultaneously reduce the scope of federal deposit guarantees.1

The FDICIA legislation was initially characterized as a “narrow” bill, primarily because the new powers and branching provisions included to improve the competitive position of U.S. banks did not survive the congressional markup process. But now attention has moved away from the bill’s narrow focus to heightened concerns about its impact in further impairing the competitive position of U.S. banks.

The U.S. banking industry faces two fundamental and interrelated challenges: to reverse the substantial decline in its competitive position in the marketplace for financial services and to work to scale back the current system of federal deposit guarantees that is encouraging the current legislative thrust toward tighter regulatory oversight and control. Under this new legislation, the regulations mandated by Congress will move banks increasingly toward a “single mold” of operations, with an emphasis on a low-risk profile. Thus, at a time when bank lending remains unusually weak, the FDICIA legislation may further skew the risk–reward trade-off in banking away from lending. This, in turn, has raised questions about the long-term earnings potential of the U.S. banking industry.

Will Profitability Trends Continue?

During the recent past, the banking industry has shown significant improvement, but questions about increased earnings from securities portfolios rather than from lending raise concerns about whether the relationship between the banking industry and the economy has changed. In the Eleventh District—which consists of Texas, northern Louisiana and southern New Mexico—banks have had positive net income for the past two years. As Chart 1 shows, since the end of 1990, return on assets (ROA) at banks in the Eleventh District has exceeded that of banks elsewhere in the nation. In the first quarter of 1992, two-thirds
of Eleventh District banks earned a healthy ROA of above 1 percent, compared with 36 percent of District banks in the first quarter of 1991. Similar improvement occurred at banks in the rest of the United States, with 62 percent of these banks earning an ROA above 1 percent in the second quarter of this year, compared with 50 percent in the comparable period last year.

Chart 2 highlights the improvement in Eleventh District banking performance by showing the distribution of assets by ROA. During the second quarter of 1992, 70 percent of bank assets in the District earned a return that exceeded 1 percent. This compares favorably with the year-earlier performance, when 46 percent of bank assets in the District earned more than a 1-percent return. Chart 3 shows that in the second quarter of this year, 46 percent of the U.S. bank assets, excluding those in the Eleventh District, were located in banks earning an ROA of greater than 1 percent, compared with 37 percent in the previous year.

Despite the continued upward trend in bank performance, there is some concern that this improvement is due to banks' increased holdings of securities in an environment with a sharp upward-sloping yield curve. In the second quarter of 1992, District banks earned almost 30 percent of their revenue from securities holdings, compared with 23 percent in 1990. Banks in the rest of the United States also saw an increase in the proportion of revenue derived from securities, from 13.2 percent in 1990 to 16.5 percent in the second quarter of 1992. Conversely, interest and fees earned from lending fell to nearly 46 percent of total revenue at Eleventh District banks in the second quarter of this year, from 51 percent at the end of 1990. In the rest of the United States, interest and fees earned from loans fell to 57 percent of total revenue in the second quarter, from 63 percent at the end of 1990.

These trends underscore the continued weakness of lending activity, both in the Eleventh District and across the nation. Sluggish loan activity reflects a combination of factors, including a weak economy together with continued efforts to pay down excessive debt levels accumulated in the 1980s. In addition, the new risk-based capital regulations have been cited as providing disincentives for banks to lend, since loan activity increases banks' capital requirements while holdings of Treasury securities do not. Moreover, concerns about the cost of the regulatory burden on bank lending decisions continue to be cited as a factor behind weak loan growth, and these concerns have increased markedly since the passage of FDICIA.

The FDICIA's Impact on Banks

The stated purpose of FDICIA is "to require the least-cost resolution of insured depository institutions, to improve supervision and examinations, to provide additional resources to the Bank Insurance Fund, and for other purposes." The principal features of the act include prompt corrective action, recapitalization of the deposit insurance fund, truth in savings, and standards for safety and soundness.

Prompt Corrective Action. Section 131 of FDICIA implements a system of prompt corrective action with the stated purpose "to resolve the problems of insured depository institutions at the least possible long-term loss to the deposit insurance fund." Banks' capital positions are a critical component of prompt corrective action. Institutions will be subjected to increased degrees of regulatory scrutiny and restrictions if their capital falls below acceptable standards. Five capital categories are established in the legislation: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. Capital standards that must include a leverage limit and a risk-based

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**Chart 1**

Return on Assets* for Insured Commercial Banks

<table>
<thead>
<tr>
<th>Percentage</th>
<th>80</th>
<th>81</th>
<th>82</th>
<th>83</th>
<th>84</th>
<th>85</th>
<th>86</th>
<th>87</th>
<th>88</th>
<th>89</th>
<th>90</th>
<th>91</th>
<th>92</th>
</tr>
</thead>
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<td>Eleventh District</td>
<td>1.0</td>
<td>0.5</td>
<td>0.0</td>
<td>-0.5</td>
<td>-1.0</td>
<td>-1.5</td>
<td>-2.0</td>
<td>-2.5</td>
<td>-3.0</td>
<td>-3.5</td>
<td>-4.0</td>
<td>-4.5</td>
<td>-5.0</td>
</tr>
<tr>
<td>Rest of the United States</td>
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<td>1.0</td>
<td>0.5</td>
<td>0.0</td>
<td>-0.5</td>
<td>-1.0</td>
<td>-1.5</td>
<td>-2.0</td>
<td>-2.5</td>
<td>-3.0</td>
<td>-3.5</td>
<td>-4.0</td>
<td>-4.5</td>
</tr>
</tbody>
</table>

*Ratio of net income after tax to average assets.

NOTE: 1992 data are through June 30, annualized.

DATA SOURCE: Federal Financial Institutions Examination Council, Reports of Condition and Income.

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**Chart 2**

Distribution of Eleventh District Bank Assets by Return on Assets

- **Second-Quarter 1991**
  - Over 1: 45%
  - 5 to 1: 32%
  - Under 0: 12%
  - 0 to .5: 10%

- **Second-Quarter 1992**
  - Over 1: 70%
  - 5 to 1: 11%
  - Under 0: 4%
  - 0 to .5: 15%

DATA SOURCE: Federal Financial Institutions Examination Council, Reports of Condition and Income.
capital requirement are to be determined by the federal banking agencies. The legislation specifically mandates that a ratio of tangible equity to total assets must be used in the determination of a critically undercapitalized institution, but also allows agencies to use other measures of capital in this particular category. Furthermore, the legislation requires a ratio of tangible equity to total assets of not less than 2 percent as one of the criteria for the designation of a critically undercapitalized institution. Finally, other supervisory criteria may be used in the classification of a bank’s capital position. An insured institution that is found to be operating in an unsafe and unsound manner may be reclassified to a lower capital category by the appropriate federal banking agency.

**Most Banks Meet Capital Guidelines.**

Most banks—both in the Eleventh District and the rest of the United States—will have little trouble meeting the criteria established for these capital categories. Based on second-quarter 1992 data, 89 percent of Eleventh District banks would be classified as well capitalized, while 5 percent of the District’s banks would be classified as undercapitalized, or worse. Similar numbers hold for the rest of the United States, where 94 percent of banks would be classified as well capitalized, with only 2 percent being placed in the undercapitalized category, or worse.

A slightly different picture emerges, though, when considering the distribution of capital categories by bank assets, as shown in Chart 4. For both the Eleventh District and the rest of the United States, about two-thirds of all bank assets would be in banks classified as well capitalized, with more than one-fourth of all bank assets found in those banks classified as adequately capitalized.

**Recapitalizing the Deposit Insurance Fund.** In addition to placing greater attention on capital adequacy, FDICIA mandates that the Bank Insurance Fund meet a reserve ratio of 1.25 percent, or $1.25 for every $100 of insured deposits, within 15 years. The legislation also calls for the establishment of a risk-based assessment system for insured depository institutions. To meet these objectives, the FDIC has proposed a fee schedule based on the risk profile of an insured institution. Each insured institution would be assigned to one of three capital groups to be defined by the federal banking agencies. Within each of these capital groups, the FDIC would then assign each institution to one of three subgroups, based on the agency’s evaluation of the institution’s risk. Beginning January 1, 1993, premiums will range from 23 cents to 31 cents for each $100 of domestic deposits.

While the debate continues about the amount of resources needed to recapitalize the fund, the schedule actually proposed by the FDIC would raise premiums to an average of 25.4 cents per $100 of domestic deposits, from the current 23 cents. Using year-end 1991 data, we estimate that this increase would raise assessment income by about $700 million and result in 38 banks’—with total assets of $7 billion—becoming unprofitable. If this same schedule had been in effect at the end of 1990, 36 additional banks—with total assets of $174 billion—would have become unprofitable. The smaller effect of the increase in deposit insurance premiums now reflects the improved state of the banking industry, particularly larger banks, relative to their more sluggish performance in recent years.

**Truth in Savings.** Title II, Subtitle F of FDICIA contains the Truth in Savings Act, which requires depository institutions to provide clear and uniform disclosure of interest rates and fees. The purpose of the Truth in Savings Act is to allow consumers to make more informed comparisons among the various services offered by depository institutions. However, many analysts argue that the requirements im-
posed on banks and other depository institutions from this section of FDICIA are beyond what is necessary for consumers to make an informed choice.

**Safety and Soundness.** Section 132 of FDICIA requires that each appropriate federal banking agency prescribe, for all insured depository institutions and their holding companies, standards for “safety and soundness.” These standards include, but are not limited to, items relating to internal control, loan documentation, credit underwriting, asset growth and compensation and, to the extent feasible, a minimum ratio of market value to book value for publicly traded shares of banks.

The controversy surrounding Section 132 brings into focus the current debate about the proper role of government in banking. Given the financial events of the past decade, legitimate public policy concerns do exist regarding the most appropriate way to maintain financial safety and soundness. However, legislation that, in effect, requires the imposition of regulations at the microlevel can only serve to reduce insured depository institutions’ flexibility to compete in a dynamic and internationally evolving financial marketplace. Moreover, this section of the act, in particular, underscores the extent to which government mandates are being imposed as a substitute for private decision-making in the business of banking. There is growing recognition that the acceptance of federal deposit guarantees now carries with it the additional cost of greater government scrutiny, thus focusing attention on the critical question of what is the appropriate role of government in the economy.

**Concluding Remarks**

The banking industry is one of the most heavily regulated industries in the United States, both at the state and federal levels. Concerns are growing that regulatory burdens on banks have become excessive and are placing banks at a severe competitive disadvantage. It now appears that federal deposit guarantees and the regulatory oversight and social responsibility agendas that accompany these guarantees pose a threat to the long-run viability of the banking industry.

Most of the regulations imposed on banks stem from the view that banks are “special.” This view derives from the banking industry’s unique role in the payments system and its role in the implementation of monetary policy. Because banks have historically been viewed as special, we now have a system of virtual 100-percent federal guarantees of bank deposits. The FDICIA legislation reflects one approach to dealing with these mispriced guarantees. But, rather than restoring the competitive position of the banking industry, the approach taken by FDICIA will make it increasingly difficult for banks to compete in today’s financial marketplace.

As we look to the 1990s as a decade of change, we remain hopeful that a more fruitful approach to financial legislation can be found that relies less on government decision-making and guarantees and looks more to the role of the individual decisionmakers in reaping the rewards and accepting the responsibilities of the risk-reward trade-offs in a market economy. Banks do not need 100-percent deposit guarantees to operate, and governments do not need a too-big-to-fail doctrine to maintain a safe and sound banking system.

— Genie D. Short
Kenneth J. Robinson
