A Central Banker's Perspective on Bank Reform

By Robert T. Parry*

The Federal Deposit Insurance Corporation Improvement Act of 1991 made some progress toward reform in banking. In particular, the act establishes a more objective framework for prompt corrective action that limits regulatory discretion and mandates risk-based deposit insurance premiums. However, the U.S. still is a long way from shedding the antiquated regulatory structure adopted in the 1930s. For the sake of economic efficiency, banking regulation should move toward greater integration of commercial and investment banking, broader insurance powers for banks, and a system of nationwide branching. To protect the deposit insurance system better, it is important to have regulatory standards based on market-value criteria and to establish a more credible position against the too-big-to-fail policy.

ALTHOUGH THE RECENT banking legislation made some strides toward reform, the U.S. still has a long way to go toward adopting reform in the true sense of the word: clearing away the abuses and faults that stem from an antiquated regulatory framework inherited from a bygone era.

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Broadly speaking, there are two spurs to reform. The first is the state of the federal deposit insurance system. In the mid-1980s, the FSLIC collapsed under the weight of the thrift crisis and left the taxpayer to bail out depositors. In the past few years, the Bank Insurance Fund (BIF), which covers commercial banks, has been depleted by the high rate of bank failures. Although the problem is not as severe for banks as it was for thrifts, it is still serious, and the deposit insurance system is now forced to rely on borrowed funds to cover the cost of resolving problem banks.

The second spur is the sweeping change in the financial services landscape, both domestically and internationally. With the growth of telecommunications and data processing and increasing consumer sophistication, banks now face competition in their traditional markets from nonbank financial institutions as well as from direct placement.

In spite of these pressures, reforms affecting the deposit insurance system and bank powers have been difficult to achieve. With respect to deposit insurance, important steps were taken to strengthen capital regulation in the 1980s, including the adoption of risk-based capital standards. However, since the Garn-St. Germain Act of 1982, which commissioned regulatory agencies to study deposit insurance reform, it has taken nearly ten years to implement other fundamental changes in public policy concerning the deposit insurance system.

In terms of broadening powers, over the ten years since deposit interest rates were deregulated, states have taken much of the initiative to permit geographic expansion by banks and to integrate banking and other financial services. By necessity, these efforts have been piecemeal, often taken by one state in hopes of gaining advantage over other states.

The pace of change at the federal level has been notably slower. The regulatory agencies have expanded the scope of banking within the limits of federal law; for example, the Federal Reserve liberalized underwriting powers for commercial banks. However, following the ardent support for deregulation in the Monetary Control Act of 1980 and the Garn-St. Germain Act, the Congress has been decidedly more cautious, which probably reflects not only the political reality of balancing countervailing interests, but also concerns about increasing the exposure of the deposit insurance system. I also suspect that, since many of the limits on banks and financial services tend to eat away at bank competitiveness and profitability only gradually, they do not raise the same sense of urgency as does the insolvency of the deposit insurance system.

From my perspective, banking reform is not about "rescuing" banks. Rather, it is about creating an environment to provide financial services more efficiently, while supporting the traditional regulatory aims of ensuring financial soundness and competition in banking.

Although the Federal Deposit Insurance Corporation Improvement Act of 1991 took a few steps in this direction, it did not address a number of critical areas. This article discusses the key issues in deposit insurance and bank reform that remain to be resolved.

THE PROBLEMS WITH THE BANK SAFETY NET

Deposit insurance was conceived with a worthy goal, namely, to eliminate runs on sound banks by nervous depositors. The side effect of this guarantee, unfortunately, is "moral hazard;" that is, deposit insurance creates incentives for banks to hold less capital and to take on more risk in their operations than they would without deposit insurance. This effect was apparent almost as soon as deposit insurance was adopted in the 1930s, when bank capital ratios dropped from 15 percent to around 6 or 7 percent.

The moral hazard problem, which seemed to lie dormant for many years, recently has become abundantly apparent, probably because of changes in the competitive environment and in the economy. The heightened competitive environment reduces the values of existing bank charters. The more a bank's charter is worth, the more the bank's stockholders have to lose if the bank is closed, so the threat of losing the bank charter can be expected to inhibit risk-taking (see Keeley 1990). Therefore, while stiffer competition is beneficial to consumers, it induces a decline in bank charter values, which reduces one check on the moral hazard problem for the deposit insurance system.[1]

Economic conditions in the 1980s also affected banks. First, developments such as the shocks to energy prices, LDC debt problems, the severe recession in the Northeast, and the weak market for commercial real estate seriously depleted the capital of many banks and contributed to a high rate of failures. Second, heightened economic uncertainty has increased operating risk for banks in general. To be sure, regulatory measures taken in the 1980s were reasonably successful in raising bank capital (Keeley 1988). However, the evidence indicates that the increases in operating risk among banks during the past decade outpaced the general improvement in bank capital positions, resulting in a higher overall level of risk in banking (Furlong 1988, Neuberger 1991).

Besides stiffer competition and a harsher economic environment, the administration of the deposit insurance system also heightens moral hazard. Three of the key problems are: flat rate premiums, forbearance, and the massive extension of coverage driven in large part by the "too-big-to-fail" policy.

The flat premium rate means that individual banks can take on more risks without paying higher premiums. As a result, the deposit insurance system's exposure is increased, but the insured institutions' costs are not. To mitigate the financial strains on the deposit insurance system, premium rates have been raised from $.083 to $.23 per $100 of deposits over the past several years.[2] Even though the higher rates help to cover the expenses of the deposit insurance system, they are no more of a deterrent to risk-taking than were the lower flat premium rates in the past.

The principle behind forbearance is that economically viable banks should be allowed to operate even if the book value of their capital is below some minimum. This principle implies that the book value of a bank's capital may understate its financial position; therefore, the true economic or market value of a banks' capital should be the deciding criterion. In practice, however, it is very difficult to judge whether book values for a given bank understate its financial strength without formal and systematic use of estimates of the market values of banks, so institutions with little or no market-value capital have been allowed to remain open. The problem this presents for the deposit insurance system is that banks with little or no capital at stake have a greater incentive to increase operating risk. (See Furlong and Keeley 1989.)

[1]See footnotes at end of text. A list of references will be provided on request to the author.

Over the years, deposit insurance coverage has undergone a massive expansion. To some extent this has been due to *de jure* increases in statutory coverage — from $2,500 originally up to $100,000 today. More important, though, coverage has been extended *de facto* to uninsured deposits as well as to other liabilities of banks and bank holding companies. The real driving force behind the *de facto* extension of coverage to uninsured depositors is the "too-big-to-fail" policy, and it has been one of the weakest links in the deposit insurance system.

The point of the policy is to avoid the possible economy-wide repercussions of actually closing large banks or allowing uninsured depositors of large banks to bear losses. One repercussion of liquidating a very large bank could be the disruption of asset prices as the bank's assets are "dumped" onto the market. This, however, could be mitigated through an orderly selling of the assets or through a "purchase and assumption" that does not entail fully covering uninsured deposits. Another is the adverse economic effects of disruption to long-standing banking relationships. This, of course, would be less of a problem if the failed bank were acquired by another institution. The primary concern, however, seems to be the "contagion effect," where the effects of the failure of one large bank spread through the banking system via interbank activities, such as correspondent relationships and federal funds borrowing. The irony is that a "too-big-to-fail" policy makes the banking system *more* susceptible to systemic shocks, because it leads banks to engage in more interbank activities, and hence to expose themselves and the system to more risk than they would otherwise.

RECENT CHANGES IN BANK REGULATION

The Federal Deposit Insurance Corporation Act of 1991 (FDICIA) provides for a number of fundamental changes to the deposit insurance system. Four of the most important are: a framework for ranking banks by risk-based capital, a program for prompt corrective action linked to capital positions, provisions for risk-based deposit premiums, and restrictions on the "too-big-to-fail" policy.

Ranking Banks by Risk-Based Capital. Using the current risk-based capital standards, the legislation established five categories that are intended to reflect banks' capital adequacy. When fully phased in during 1993, banks will be required to maintain a minimum 4 percent ratio of Tier 1 capital to risk-adjusted assets, and an 8 percent ratio for Tier 2 capital.[3] The five categories are: (1) *well-capitalized,* which includes institutions that significantly exceed the capital requirements; (2) *adequately capitalized,* which includes banks meeting all requirements; (3) *undercapitalized,* which includes banks not meeting at least one capital requirement; (4) *significantly undercapitalized;* which includes banks well below at least one capital requirement; and (5) *critically undercapitalized,* which includes banks falling below a predetermined critical capital level.

Prompt Corrective Action. The risk-based capital adequacy categories trigger specific regulatory responses in a protocol called "prompt corrective action" (PCA). As a bank's ranking falls, the bank faces more restrictions and the regulatory agencies have less flexibility in dealing with it. For example, for an undercapitalized bank, PCA requires a bank to submit an acceptable capital restoration plan to its primary federal regulatory agency. For a significantly undercapitalized bank, the regulatory agency must require the bank to take one or more of several steps including: selling shares, restricting activities, and conducting a new election of directors. For institutions classified as critically undercapitalized, the legislation specifies a number of specific limitations on the operations of such institutions and states that the institutions should be placed in receivership.

Prompt corrective action coupled with risk-based capital categories get at the problem of forbearance and the costs to the insurance funds, because timely action against troubled institutions will reduce the costs for the deposit insurance system. The details of implementing PCA still have to be worked out by the regulators. But providing for more automatic regulatory responses and less regulatory discretion sends the correct message regarding forbearance.[4]

Risk-Based Deposit Premiums. To address the moral hazard invoked by flat rate premiums, the legislation provides for risk-based deposit insurance premiums. The premiums must be based on the probability that an institution will impose a loss on the insurance fund. The legislation also provides for a reinsurance program which allows the FDIC to contract with private insurers, and mentions that the premiums charged by the private insurers could be used by the FDIC to set premium rates.

Too Big to Fail. The legislation addresses this problem by limiting the FDIC's discretion to cover the losses of uninsured depositors. Specifically, by 1995 the FDIC will not be able to cover uninsured depositors if doing so leads to a loss to the insurance system. Exceptions to this rule can be made in cases which the President, the Department of the Treasury, the Federal Reserve, and the FDIC jointly find that closing an institution without protecting uninsured depositors would endanger the financial system. In such a case, the FDIC must recover the higher costs through an assessment on the banking industry.[5]

THE BANK SAFETY NET: WHAT NEEDS TO BE DONE

Although the FDICIA has taken positive steps toward reforming deposit insurance, several areas for improvement remain.

Risk-Based Capital and Book Value. Because losses (and gains) are not automatically realized in book value measures, regulators would need to consider not only a bank's capital, but also the adequacy of its loan loss reserves to determine its category for PCA. While some objective guides to evaluating loan loss reserves are available, subjective assessments will be important, too.

The legislation calls for banks to disclose the fair market value of assets to the extent possible. However, it does not provide for regulatory guidelines to be based more generally on the market-value assessments.

The legislation should have moved more definitively toward establishing market-value standards, in spite of criticisms launched against it. One criticism is that the market values of banks, particularly those not publicly traded, would be estimated with error. This is unquestionably true. But book-value measures also are subject to error, because estimates have to be made of variables, such as the adequacy of the level of loan loss reserves. Although it is clear that *both* book-value methods and market-value methods are flawed, it is not at all clear that book-value measures must dominate.

Another criticism is that market values can move suddenly and by large amounts, while book values move more smoothly. The smaller volatility of a book value measure of equity, however, is not necessarily a virtue if the book value of capital is not a good measure of banks' ability to absorb losses. At the core of the volatility argument is the concern that the market's evaluation of banks (or, indeed, other firms) is not always rational. We cannot, of course, rule out positive and negative bubbles in markets. But we also cannot take them to imply that market values are more likely to mislead regulators than are book values.

Risk-Based Premiums. If market-value, risk-adjusted capital regulation were in place, then, in principle, coupling it with PCA would be adequate to address the moral hazard problem, and we would not need risk-adjusted deposit insurance premiums. Without such a system of capital regulation, however, it makes sense to pursue both avenues of regulation.

In keeping with the provisions of FDICIA, the FDIC recently proposed a multi-premium system to be implemented in 1993. Under the proposal the riskiness of a bank would be evaluated on the basis of the adequacy of its capital and supervisory examination. The system would have a range of premiums, with riskier banks paying higher rates. In addition, riskier banks would be subject to increasingly punitive penalties unless they reduced their levels of risk.

The details of the new premium system are likely to change after the public comment period. However, the system of risk-related deposit insurance premiums that is finally adopted should have two features: (1) premiums that vary with an institution's risk; and (2) premiums that are high enough to cover the expected cost of protecting deposits. With these features, the system should allow depository institutions themselves to choose the optimal level of risk.

Such a system is feasible without having a separate premium for each bank. Indeed, some interesting recent research suggests that a simple system with just a few premiums could be effective in eliminating much of the mispricing associated with a single set rate premium (see Levonian 1991).

In setting the premiums, information from the pricing of deposit insurance by private reinsurers could be useful. To make such a reinsurance program effective, however, regulators likely will have to surrender some control over banks to the private insurers. In particular, it is likely that private insurers would have to be able to take actions similar to those open to regulators, including closing banks.

Too Big to Fail. The legislation's heart is in the right place on the issue of too-big-to-fail. However, there *is* a loophole: Uninsured liabilities still would be covered if the FDIC along with the Fed and the Administration find that to do otherwise would disrupt the financial system and the economy. The problem with the loophole is that so long as there is the possibility that large banks will be bailed out, the private market will not monitor large banks' performance as much as they would otherwise. As a result, large banks are right back in the moral hazard morass — they are likely to take on more risk, which in turn both increases the risk to the banking system and increases the probability that a bailout eventually will be necessary.

Another problem is that the added cost of protecting uninsured liability holders of a "failed" large bank is borne by the banking system. If it is found that a bank is too big to fail because of the impact on the economy, the added cost should be borne by the Treasury — that is, taxpayers generally.

Further limitations on coverage of accounts would induce greater market discipline from depositors. The current legislation did limit brokered deposits activities to well-capitalized banks and eliminated pass-through insurance coverage for some employee benefit plans. However, eliminating such coverage altogether also would help contain the scope of deposit insurance, as would reducing coverage of multiple accounts. Lowering the statutory limit below $100,000, on the other hand, would not be fruitful. Smaller depositors are not going to add much in the way of monitoring, and it is probably politically unrealistic anyway. Moreover, more emphasis on capital, risk-based premiums, and abandoning "too big to fail" should introduce more market discipline in banking.

Geographic Expansion. Unfortunately, in the Congressional reform packages, interstate *branching* was tied to limits on insurance powers for banks and was not adopted. Federal inaction on this issue is mitigated somewhat, however, because all but three states allow some form of interstate banking by bank holding companies, and most states allow nationwide interstate banking. Still, from an operational point of view, crossing state lines could be done more efficiently through branching than through establishing separate banks. This is not to say that interstate banking or branching will be a major boon to banks, however. Available evidence suggests that interstate banking itself leads to a more competitive banking system.[6] Also, the most obvious potential effect of interstate banking, diversification, would not be expected to increase returns. However, it may have the effect of reducing risk, which would be a plus for the deposit insurance system.

It is also interesting to note that while the U.S. struggles with legislating interstate branching, the Second Bank Directive from the European Community authorizes branching across country borders. In sum, it would seem that, at a minimum, the Congress should allow interstate branching wherever state laws allow out-of-state banks to acquire banks or to enter *de novo*.

Diversified Financial Services. The tug of war over insurance powers and interstate branching raises the more general issue of allowing banks, or at least bank holding companies, to engage in a full complement of financial services.

A key set of powers is securities underwriting. The forced separation of commercial and investment banking has never made economic sense, and it makes even less sense today.[7] Bank lending, credit guarantees, syndicating, and securitization involve the monitoring, evaluation, and marketing expertise that are transferable to underwriting. Indeed, prior to the forced separation through the Glass-Steagall Act, commercial and investment banking were done together in the U.S. And looking around the rest of the world, we see that banking and securities activities are integrated in virtually every industrialized country except Japan, which adopted many features of the U.S. system after World War II.

Many of the functions of life insurance companies also seem to be consistent with expertise in banking. Both types of institutions are involved in financial intermediation. An important aspect of life insurance companies is their participation in the private placement of corporate bonds, in which they negotiate the terms of a bond issue with a nonfinancial corporation and take the entire issue into their portfolio. This is much the same thing banks do when making loans to businesses.

Insurance powers also would enhance banks' competitive position by giving them the capacity to offer customers a fuller array of financial services. However, to realize this enhancement banks would need only insurance brokerage powers.

Central to the debate over expanding bank powers is the concern that it would increase the exposure of the federal safety net. As a result, the reform proposals differed on whether expanded powers should be exercised within banks or through subsidiaries in a holding company. The extreme proposal is "narrow banking," in which institutions taking insured deposits would have to hold an essentially riskless asset portfolio. A more moderate version would allow banks to function more or less as they do now and allow them to offer services like underwriting securities through holding company subsidiaries.[8] Using the holding company route raises issues similar to those connected with interstate banking versus interstate branching, namely, the added cost of having separate operations. However, it is likely that if Congress allows banks general authority to underwrite securities and insurance, it would be through nonbank subsidiaries. In that case, it would be important that regulation not inhibit the subsidiaries from exchanging information, even if funds transfers continue to be limited. After all, powers should be extended to banks only if it means that financial services can be provided more efficiently. If there are to be efficiency gains, the subsidiaries in a holding company have to be able to share information.

Another key issue in bank powers is the mix of banking and commerce. Here the issues are: (1) whether nonfinancial firms should be allowed to own banks; and (2) whether banks should be allowed to own stock in nonfinancial firms. On the first issue, several years ago Congress authorized nonfinancial firms to own thrifts in the hope that they would bring more capital into the beleaguered thrift industry. The same justification has been used in proposals to allow nonfinancial firms to own banks. However, given the development of capital markets in the U.S., it is hard to believe that the adoption of such a proposal would bring much new capital to banking. Moreover, any conceivable efficiency gains are outweighed by the dangers of allowing commercial firms control over insured funds.

The second dimension in the banking and commerce debate, allowing banks to own nonfinancial corporate stock, has not been nearly as popular an issue in the political give-and-take on reform. Although some countries do allow banks to own equity, at this point it is more the exception than the rule. This may change with Europe 1992 and with reforms being considered in Japan. But even in Europe today, banks in countries like England tend not to exploit this power as much as they could. In any case, it seems unlikely that the U.S. will ease its long-standing restriction on bank's ability to own nonfinancial corporate stock in the near future.

CONCLUSION

Although some progress has been made in reshaping the banking system, a substantial agenda for further reform remains to be undertaken:

1. The appropriate steps for restructuring the deposit insurance system are greater reliance on PCA based on market-value criteria, risk-adjusted insurance premiums that explicitly price risk, a credible position against TBTF, and limits on insurance coverage.
2. Interstate branching makes economic sense and could easily be extended to be consistent with the interstate banking arrangements adopted by most of the states.
3. The U.S. would be better off if banking and securities services were fully integrated, including underwriting nonfinancial corporate equities as well as broader insurance powers.
4. If bank powers are expanded, information sharing by subsidiaries should be allowed as much as possible, while at the same time guarding against abuses stemming from conflicts of interest and insider trading.

Putting these issues into a global context clearly highlights the fact that among developed countries, the U.S. holds a minority position on banking powers. Ironically, this minority position is unlikely to affect the competitiveness of U.S. banks operating in Europe, because European regulations will allow U.S. banks the same scope of activity as European banks.

While this relieves some of the international pressure to reform the U.S. banking system, it does not lessen the importance of reform to our domestic financial markets and the economy. The challenge we face is to adopt a banking structure that makes economic sense in terms of providing financial services efficiently, while keeping the undesirable side effects of the federal safety net in check.

FOOTNOTES

[1]In the past, higher bank charter values reflected in part monopoly rents due to regulatory restrictions on entry. In effect, bank risk-taking was kept in check at the cost of a combination of higher bank rates and fees and lower deposit rates.

[2]The FDIC recently has proposed increasing the average premium rate to $.28 per $100.00 of deposits as of 1993. This increase is part of the FDIC proposal to implement risk-based premiums.

[3]Capital is divided into two components that are ranked according to the availability of the funds to cover losses. Tier 1 capital consists primarily of common equity, while Tier 2 capital can include subordinated debt and such instruments as cumulative perpetual preferred stock.

Risk-based capital standards assign risk weights to various bank assets. The weights are determined by considering the credit (default) risk of assets. For example, the lowest risk category includes cash and U.S. Treasury securities, and has a zero weight, which means that banks are not required to hold capital against these assets. The highest risk category includes most loans to private entities (but not home mortgage loans) and has a weight of 100 percent. The standards also account for credit risk of *off-balance* sheet activities such as interest-rate swaps and stand-by letters of credit.

The recent legislation directs the federal regulatory agencies to incorporate other aspects of risk into the risk-based capital regulatory framework.

[4]This message is reinforced by the law's provisions for improved examinations, including subjecting most institutions to an annual on-site examination and requiring independent outside audits for institutions with more than $150 million in assets.

[5]The legislation also prohibits the FDIC from covering foreign deposits and limits Federal Reserve lending to undercapitalized institutions, but with exceptions similar to those applying to FDIC coverage of uninsured domestic liabilities.

[6]See Pozdena and Laderman (1991).

[7]If commercial and investment banking were combined, laws relating to conflicts of interest and insider trading would need to be enforced.

[8]The Federal Reserve Board has approved applications for bank holding companies to engage in corporate debt and equity underwriting provided that the activities are carried out through a separately capitalized subsidiary and the security activities are not tied in any way to the customers' banking services.