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**The Role of Banks Where
Service Replication Has Eroded
Institutional Franchises**

by

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A. Introduction

Over the past decade forces of competition and adverse economic conditions--combined with regulatory forbearance and the moral hazards generated thereby--have contributed to severe erosion of bank profitability and a mounting number of insolvencies. At least three implications of this erosion may be identified. First, in response to pressures on capital and profits bank business strategies have begun emphasizing contraction and consolidation. Second, barring new elements of weakness afflicting other suppliers of financial services on which banks could capitalize, the role of banks in the future is likely to be reduced further. Third, the extent of this reduction will hinge to a considerable degree on whether new public policies applying to capital and deposit insurance are imposed. Life support policies will not restore the weak, but will impair the competitive viability of those remaining strong.

The material to follow is divided into four parts. The first consists of a brief summary of recent bank performance. The succeeding sections address the three implications introduced above.

B. Recent Bank Performance

A bank is a vehicle for the delivery of financial services. Banks and their affiliates are authorized to deliver virtually all finance-related services (see Table 1). These services are financial in nature because that specialization has been institutionalized in statute, regulation, and practice. There have been few strategic incentives to extend beyond "financial" roles, although the definition of financial itself has been expanding. For example, processing and informational applications having origins in financial services have developed into separate profit centers.

In the broad context of transactions, investment and liquidity vehicles, fund raising, insurance, and fiduciary activities only two classes of activities are subject to major proscriptions by statute: The underwriting of life (except credit life), casualty, and fidelity insurance and the sponsorship and distribution of open-end mutual funds. Two further caveats to the powers generalization are warranted. First, the execution of certain securities powers must be undertaken in separate subsidiaries and limited in amount; and, second, retail deposit collecting is

subject to geographic restraints--now primarily interstate.

Historically banks were accorded franchise status implying virtually exclusive business license covering several functions. The first may be characterized as the bestowed license: Deposits subject to check, funds transfer and clearing arrangements with direct access to bank clearing arrangements and to the clearing and settlement services of the Federal Reserve, borrowing from the Federal Reserve, and the application of government assurances on deposits and other liabilities. A derivative distinction was the ability to link deposit and payments services to other services in order to achieve scale and scope economies of production and distribution (suppliers' perspective) and consumption economies (users' perspective).

The value of both the original and derivative functions has eroded dramatically because of the introduction and development of substitutes. These substitutes were facilitated by information technology available to new entrants as well as to barriers to adaptiveness on the part of the banks themselves. Funding cost disadvantages have sustained the erosion

of bank positions in intermediation, especially those involving businesses. As is well known, non-interest-bearing demand deposits have declined almost without interruption over the past twenty years relative to other forms of financial instruments. In 1970 demand deposits constituted 77% of M_1 and 26% of M_2 . In 1990, the comparable figures were 34% and 8 1/2%. Similarly, the share of all deposits (banks and thrifts as well) in M_3 has fallen over this period from 92% in 1970 to 78% in 1990.

Though not as extensive, shares of bank asset markets (i.e., positions with debtors) have also eroded. Overall, bank shares of financial assets held by the financial sector dropped from 31% in 1982 to 26 1/2% in 1989.* The bank share of business lending has fallen from 33% to 25% over the past nine years, and the drop is even more severe (from 26% to 17 1/2%) if measures are confined to domestic U.S. banks. Part of this decline reflects pricing disadvantages attaching

*Source: U.S. Department of the Treasury, Modernizing the Financial System, February 1991, Chapter I, Table 7.

to bank loans. In addition, however, banks facilitated this development by promotion of "off-balance-sheet" letters of credit and commitments.

Another factor in the decline of share has been actions by banks to securitize and sell portions of asset holdings. The securitization development has enhanced liquidity management. It also has made asset markets--even those of relatively small size--more sensitive to national pricing patterns.

Until recently many banks increased their allocations to those credit sectors not yet subject to securitization--that is, where information asymmetries were believed to exist. Commercial real estate is a prime example. Between 1982 and 1988, the volume of net commercial real estate lending by banks comprised 32% of all bank net lending. This ratio is almost three times the share of such holdings in portfolio (12%) at the beginning of the period. The overbuilding to which this lending contributed has in turn subjected banks concentrating in this activity to major earnings and capital problems.

The dimensions of bank performance erosion are suggested by industry averages. From the 1960s through

the mid-1980s returns on equity for all banks averaged about 11% and asset returns about 74 basis points (see Table 2). The past four years provide a different picture. Specifically, over the period 1987-90 asset returns have averaged 49 basis points and returns on equity about 8%.

The current condition of the larger banks (assets over \$10 billion)--which account for 39% of all bank assets--has been weaker still (on average). First, as shown in Table 2, the average return on assets for 1987-90 was only 20 basis points. Second, in 1989 and 1990 one quarter of the large banks lost money and by the end of the period noncurrent loans were almost 4% of total assets. Also at yearend 1990 (not shown in the table), several large banks reported common equity-to-asset ratios at or below 4%. Many institutions--especially those active in real estate and consumer finance--face prospects that the weakness in the U.S. economy will cause further rises in the volume of problem loans. In many areas of the country, especially the Northeast, but also sections of Florida and California, loan delinquencies, office vacancy rates, and personal bankruptcies all are continuing to

rise. Moreover, even after the onset of general recovery, elements of loan growth in these markets are likely to be unusually sluggish. Third, reflecting uneven performance and apprehension over future performance, stock prices for the larger banks relative to the S. & P. 500 have been falling almost without interruption for the past five years.*

C. Strategic Shifts in Banking

Most of the new strategies undertaken by banks during the past decade fall into five categories. As noted earlier, one of the most important is the application of securitization to a wide range of customer loan categories. As capital constraints have become more binding, some of the intermediation function has been replaced by that of origination for distribution. Loans may be syndicated immediately or--especially if of smaller denomination--packaged and securitized. Some of this activity--e.g., in residential mortgages--has been shifted to nonbank affiliates within bank holding companies.

*See U.S. Department of the Treasury, op. cit., Chapter I, figure 9.

A second strategy entails expanded product offerings to current customers. On the business side, larger business-oriented banks have attained authority (generally in separate affiliates under so-called Section 20 approval) to engage in debt and equity underwriting, dealing, advisory functions, and syndications. With a few exceptions--and bearing in mind the cyclical pressures currently afflicting all firms engaging in these services--market penetration by banks has not been very high. On the consumer side, constraints on insurance underwriting and mutual fund sponsorship have imposed severe limitations on bank efforts to enhance penetration of customer asset positions. Some services, such as annuities and mutual funds, have been sold through banks acting as agents for others. Problems with incentives and service quality, however, have resulted in limited success. Where powers have been expanded--notably brokerage--banks (and holding company affiliates) have had little impact. Overall, banks generally have not been able to develop and distribute product offerings to sustain positions with customers or to offset their declining competitive standing in many deposit and credit markets.

A third development has been the use of the balance sheet on which to generate risk management services for others. These include swaps, caps, futures, and options covering interest rates, commodity prices, and currency prices. In this, U.S. banks appear to have attained recognition for innovative pricing and product development.

A fourth strategy is greater rationalization of the operations base. This involves two elements. One is expansion in present and contiguous markets aimed at capturing efficiencies in marketing, distribution, and so-called back office costs. Until recently this entailed a substantial amount of merger activity. Between 1983 and 1989, for example, an average of 15 amalgamations per year were announced between banks (or bank holding companies) where each party had total assets of \$1 billion or more. The average sale price per transaction over the period approximated \$325 million. In 1990, by contrast, the figures were 3 and \$250 million, respectively. The primary reason for this shift is great uncertainty in the valuation of loan portfolios. Highly profitable, sound institutions justifiably fear contamination from acquisition prospects not enjoying similar standing. Lately

acquisitions of parts of failed banks and thrifts on a "clean" basis has attained greater importance in filling in market positions without exposure to serious asset valuation risk. Another feature of the amalgamation process has been acquisitions of portfolios of credit card receivables and mortgage servicing. Valuations are subject to less error than with whole banks and operational integration is more readily achieved. The second element of operational change is popularly referred to as "outsourcing." It consists of shifting to separate entities (such as EDS) a variety of processing functions. The attainment of greater processing efficiency would, of course, facilitate market expansion.

Finally, a fifth strategy has entailed deliberate exit from specific product, customer, or geographic positions. Several U.S. banks have closed branches in Europe and Asia. Many banks have reduced commitments to corporate finance in general and business lending in particular. Other tactics have included dispositions of within-market branches, entire bank affiliates, credit card businesses, investment management functions, and mortgage banking. In short, candidates

for divestiture have been virtually as broad as the powers accorded to banks. Given the severe pressures remaining on the banking system and the expectation that loan problems will get worse before they get better, cost-cutting and business exiting are likely to remain dominant strategic adjustments--for many banks acts required for survival. An obstacle to such execution in the future may be the presence of unrecognized valuation losses or good will, the accounting recognition of which would reduce net contributions to capital.

D. Future Contraction

Further bank contraction is likely because of the combination of sustained service capabilities of others and existing bank vulnerabilities. Loan losses typically continue to rise even after the commencement of cyclical recovery. Given higher debt service requirements of businesses and consumers relative to income, the coming recovery may well witness a more prolonged than usual debt correction.

Assuming current economic dislocations will generate new requirements for loan loss provisioning,

many banks clearly face the need to enhance their capital positions. The magnitudes facing many institutions is illustrated by a recent Salomon Brothers analysis of money center banks.* In that work Salomon estimated a capital shortfall by yearend 1992 approximating \$8 1/2 billion. Although recourse to outside sources cannot be ignored, the alternatives treated in the Salomon review are internal adjustments--asset reductions, expense cuts, and elimination of common stock dividends. According to Salomon, reliance on asset shrinking alone would require a 37% reduction; only on expenses, 31%; and eliminating dividends alone was not sufficient. The formulation lacks a feedback mechanism--e.g., the effects on earnings from asset divestiture--and thus may provide an artificially optimistic scenario.

* Salomon Brothers, Money Center Banks: Will Capital Insufficiency Pave the Way for Mergers? March 1991.

In any event, while some combination of these stringent measures appears to be in prospect, large divestiture programs seem likely to play central roles.*

The urgency attaching to these adjustments will increase if requirements for higher capital are implemented. One recently proposed by OTS for thrifts applies new guidelines for interest rate risk. That measure would require thrifts to hold added capital equal to 50 percent of the estimated decline in a firm's equity resulting from a 200 basis point adverse change in interest rates. Such a requirement seems likely to be applied to banks as well.

An intriguing implication of these pressures on business configuration emerges from the shifting of processing from banks to vendors. There would appear to be a logical technological progression from check

*According to Salomon, during the last three years employment at money center banks fell 104,000, or 28%.

processing to payments processing generally to direct involvement in the payments system and settlements. A broad array of high-tech firms cannot fail to identify both direct and derivative business opportunities from bank outsourcing.

E. Regulatory Policy

Two elements of past regulatory oversight contributed to banks' current exposure to loss. First, managers and owners were allowed to take excessive risks utilizing insured deposits. This is often a "go for broke" strategy, although not always recognized at the time by managements. Second, regulators had (and still have) incentives to forbear in dealing with undercapitalized and insolvent entities. These reflect political pressures from Congress and the Administration, as well as aversion to an acknowledgement that taxpayer funds are at risk. In short, regulatory forbearance--often couched in terms such as "discretion" and "flexibility"--has accommodated the very risk-taking impulse for managers that on average leads to huge losses.

Three related actions are required to impose needed discipline on managers, owners, and regulators:

- (1) Commitment to early and predictable regulatory intervention in the event of declining capital;
- (2) a monitoring system to provide regulators with adequate information on which to base intervention; and
- (3) accountability for follow-up disclosure by which the public is able to judge regulatory performance against the tougher policy.

The purpose of early intervention is to minimize the likelihood of losses to insurance funds and (potentially) to the public. This would be accomplished by subjecting managers and regulators to binding rules that discourage managerial end games and regulatory forbearance.

The most important of these is to define capital as the difference between the market value of assets and that of liabilities other than subordinated debt and equity. Economic values, not historical accounting values, provide the cushioning function required of capital. The use of market valuations, implemented in a series of transition steps, will substantially enhance the rigor of capital discipline--on managers as well as their regulators.

This valuation program would be subject to

procedural standards and monitoring by internal and external overseers (including supervisory agencies). It would augment the role of bank examiners, who never seem to be able to catch up. As a recent GAO study reported, average assets including those "off-balance-sheet," adjusted for inflation, rose 14% per annum between 1984 and 1989. The examiner force rose only 5%; thus activity per examiner increased 8% over the period.*

With a market-value capital program in place, managers should be able to engage in whatever functions they prefer so long as (1) reasonable valuations are accessible, and (2) they are willing to face any adverse capital consequences.

The recent Administration proposal contains a partial implementation of this program, although it is basically inadequate. It consists of a system of five grades (or tranches) linking capital positions with degrees of regulatory oversight and operating restrictions. The greater is capital, the less would be operating constraints on banks.

*General Accounting Office, Deposit Insurance, A Strategy for Reform, March 1991, p. 76.

The Administration program is deficient in two critical respects. First, it does not require that equity be measured in terms of current market valuations. It is that element of discipline--despite difficulties of valuation in some respects--that provide the insulation against taxpayer loss. Recent experience clearly demonstrates the deficiencies of historical accounting in that respect. Second, it accords banking agencies the latitude to modify or defer mandated supervisory action against capital deficient banks "if in the public interest." This is an invitation to problem denial or forbearance.

The major benefits deriving from a rigorous economic capital program are three in number. First, more conservative behavior by the regulated and a clear-cut responsibility for action on the part of regulators would be likely. Second, resolving problem banks before they reach economic insolvency would substantially reduce the need for insurance reserves of the kind maintained heretofore--and now being replenished by higher deposit insurance premiums and taxpayer funds. Third, concerns about the connection between broader powers and bank soundness should be largely eliminated.

A counterpart to expanded operating powers for banks is the ability of others to engage in banking. In light of the prospects for greater operational linkages and given the considerable incidence of present non-financial ownership in financial institutions, continued adherence to the arbitrary distinction between banking and commerce is not realistic.

Much current political attention is being accorded not to fundamental reform, but to who cleans up the "old" mess. Politicians are intent upon devising means that avoid the appearance of taxpayer financial support. The fact is that the taxpayers are already committed financially to making good on past guarantees.

The dilemma of "who pays" basically constitutes efforts by government representatives to avoid accountability for a defective system. First, federal deposit insurance was not designed and has not been administered as insurance in the formal sense of that term. In the past insuring agencies made no effort to diversify risks; indeed, there was no effort to ascertain what diversification would entail. Capital-impaired institutions have not been identified and

resolved soon enough to avoid massive losses to agency. The insurer, rather than the insured, is the party to file a claim on the fund. To repeat, the combination of inclusive coverage and resolution delay has encouraged the weak and the risk takers to increase risky positions.

Second, coverage has been offered at a uniform price to all banks, regardless of riskiness.

Third, the insuring agency has covered losses not stipulated in the contract--that is, all deposits and some non-deposit liabilities.

Fourth, because of the large amounts of prospective losses to the agency, a sizable co-insurance cost--also not specified in the insurance contract--may be imposed on institutions not guilty of abusing their coverage. There is a risk that an open-ended put will reduce the availability of new capital. Furthermore, at some point higher deposit premiums will provide a sufficient incentive for sound banks to shift activities into nonbank vehicles.

Finally, the insuring agency is now clearly illiquid in addition to being probably insolvent. That is, it has a backlog of institutions requiring resolution for which it has insufficient cash and marketable assets.

Even on the basis of booked positions, the deterioration in finances is clear. In 1986 FDIC's cash and governments totaling \$16.5 billion were four times its liabilities. By June 1990 liquid assets were \$10 billion, only 1.6 times liabilities. The liquidity problem will become much worse even if infusions replenish the reserve fund. For instance, if it is assumed losses to the fund approximate \$50 billion over the next three years, and assuming that loss constitutes 20% of assets, the volume of assets to be handled would approximate \$250 billion. While a portion of that is readily marketable, at least half is not and will require holding prior to liquidation.

E. Conclusion

The genesis of banking was the facilitation of saving and payments. Over the years these services became linked with an ever-broadening range of other services--notably increasingly varied kinds of credit intermediation--which have accorded many banks the status of department stores of financial services. In recent years the competitive standing of most banks has eroded because of the proliferation of alternative services and portfolio positioning techniques and also

because of failures of adaptiveness by banks themselves. While adaptiveness has been impeded by regulatory policies, those policies have not constrained institutions from embarking on highly risky strategies for survival.

Virtually all services available from banks can be obtained from others. Indeed, in the absence of banks, utility-type funds transfer and clearing services could readily be assumed by others. Thus future banking prospects revolve around adaptiveness and regulatory reform.

As now constituted, deposit assurance provides incentives to managements to engage in risky bank end games. These impulses will continue unless contained. They are contagious for the banking system overall in that survival odds for healthier institutions are reduced. They do this by raising costs of current operations (especially funding), spurring new pressures for regulatory constraints on operating latitude, and imposing ex-post cleanup costs.

Adaptiveness in the future will entail for most narrower concentrations on selections from product, geographic, customer, and operating alternatives. Some

will benefit from narrower focus, but others will not survive. The critical issue facing national banking policy now is how to develop a mechanism so that in the future services and institutions which are not needed will not have to be paid for by taxpayers. Regulatory reform measures to accomplish this have been identified, but do not appear yet to be making much political progress with politicians or regulators. There is a risk to the public that muddling through or patchwork and ad hoc measures will suffice to avoid short-run drains on taxpayer resources. These are not viable solutions, however, and the eventual consequence is likely to be a costly recurrence of the experience of the past decade.

Table 1
CLASSES OF FINANCE-RELATED SERVICES

1. Transactions
 - a. Funds transfers
 - b. Payments processing
 - c. Clearing
 - d. Loan servicing
 - e. Securities purchases and sales
 - f. Foreign exchange purchases and sales

2. Investment and Liquidity Vehicles
 - a. Deposits
 - i. Immediately transferable
 - ii. Term maturities
 - b. Direct issues of fixed income instruments
 - i. Short-term maturities
 - ii. Longer-term maturities
 - c. Equities
 - d. Commingled funds
 - e. Futures and options
 - f. Swaps

3. Fund Raising
 - a. Borrowing
 - b. Equity issuance
 - c. Facilitating
 - i. Origination
 - ii. Underwriting
 - iii. Distribution

4. Insurance
 - a. Life
 - b. Casualty
 - c. Fidelity
 - d. Credit protection or enhancement
 - e. Market valuation
 - i. Interest rate
 - ii. Foreign exchange

5. Fiduciary
 - a. Investment management
 - b. Trust
 - c. Agency
 - d. Safekeeping
 - e. Advice

Table 2
 RECENT COMMERCIAL BANK PERFORMANCE
 1987 - 1990
 (In percent)

	<u>Return on Assets</u>	<u>Return on Assets</u>	<u>Noncurrent Loans Relative to Assets</u>	<u>Equity Capital Rates</u>	<u>Banks Losing Money</u>
	<u>All Banks</u>				
1990	0.50%	7.84%	2.92%	6.47%	12.6%
1989	0.49	8.13	2.28	6.21	11.6
1988	0.84	13.61	2.14	6.28	13.9
1987	0.12	2.00	2.46	6.04	17.7
	<u>Banks With Assets Over \$10 Billion</u>				
1990	0.40%	7.83%	3.82%	5.26%	24.5%
1989	0.10	2.20	3.12	4.86	25.0
1988	0.97	20.58	2.96	5.10	2.6
1987	-0.65	n.a.	3.47	4.41	n.a.

Source: FDIC