

Foreign deregulation, agricultural credit problems highlight bank conference

The financial services industry has been changing rapidly, and over the last year or so, marketplace events have accelerated change. Some of these events, such as the flood of applications for nonbank banks and the increase in interstate banking legislation at the state level have pushed the industry toward greater deregulation.

But several crises over the past year have provoked calls for re-regulation—or even more regulation. Continental Illinois in Chicago and Financial Corporation of America in California ran into liquidity problems. The number of banks in trouble because of agricultural loans has more than doubled since 1983. And the collapse of several government securities firms compounded the problems of the thrift industry, and called into question the viability of deposit insurance that is not backed by the federal government.

Issues raised by financial deregulation and by the crises of the past year were addressed at the twenty-first annual Conference on Bank Structure and Competition, held in Chicago at the Westin Hotel from May 1st to the 3rd. The conference, sponsored by the Federal Reserve Bank of Chicago, assembles a unique audience of bankers and other practitioners from the financial services industry together with regulators and research economists. This year's conference was attended by more than 300 participants who discussed issues concerning deregulation, safety and soundness regulation, the problems of agricultural banks, and deposit insurance.

Financial deregulation

Although the United States has been traveling on a deregulatory path, it is still uncertain which direction to take concerning some areas that have not yet been deregulated. The experiences of other countries may shed some light on the proper course for the United States. At this year's Bank Structure Conference, the deregulation experiences of a number of countries were explored. These countries include Japan, New Zealand, Australia, Canada, and the United Kingdom.

Herbert L. Baer, economist at the Federal Reserve Bank of Chicago, gave an overview of the financial structures in other countries. He pointed out that individual countries differ in their treatment of barriers to entry, geographic and product line restrictions, interest rate ceilings, and the mix of bank financing and financing from the money and capital markets.

According to research conducted by Mr. Baer and Larry Mote, a vice president at the Federal Reserve Bank of Chicago, most countries have restrictions on the financial activities of nonbank financial institutions, but the differences among countries in their treatment of banks and nonbanks are substantial. Product line restrictions also vary. Securities activities are permitted in most countries, but underwriting and brokerage are prohibited in Japan, while there are no such restrictions in the United Kingdom and Germany. Equity participations are also allowed in most countries, but they are usually limited.

Although countries' financial structures do differ, these differences can be isolated to some extent. The effects of regulation, therefore, can be measured through systematic intercountry comparisons of structure and performance. According to Baer, comparative banking studies provide "information on the effects of banking structure and regulation that is not available from studies based on purely domestic data." Comparative studies can help determine whether regulation merely alters financial structure or whether it also alters financial performance.

Most of the panelists tried to explain why deregulation occurred in the countries they studied. Thomas F. Cargill, professor of economics at the University of Nevada, said that Japan's "financial liberalization" occurred because Japan's former system, which was highly restrictive, no longer met the needs of economic growth for the future. Similarly, New Zealand's and Australia's highly controlled financial systems hindered economic growth.

In the United Kingdom and in Canada, deregulation has been market driven. John F. Chant, professor of economics at Simon Fraser University in British Columbia, reported that,

in Canada, the prospect of bank failures was becoming a reality and product line restrictions were becoming blurred as holding companies emerged that engaged in commercial lending as well as trust, securities, and insurance activities. Also in Canada, provincial regulations began to conflict with federal regulations as the province of Quebec, like Delaware and South Dakota in the United States, undertook its own financial deregulation. In the United Kingdom, according to Mervyn K. Lewis, professor of money and banking at the University of Nottingham in England, government controls were distorting the financial services industry and banks were losing business to nonbank institutions.

Deregulation in these five countries depended on the specific circumstances in each country. In general, however, deregulation included the relaxation or elimination of interest rate ceilings and product line restrictions. Most foreign countries have nationwide banking; therefore, the decontrol of geographic restrictions generally took the form of allowing foreign bank entry.

Drawing lessons for the United States from foreign experiences was not easy for the panelists. Andrew Carron, vice president at Shearson Lehman Mortgage Securities, did, however, discuss the lessons of financial reform in Australia and New Zealand. Carron noted that decontrol can be accomplished quickly, and partial deregulation—i.e., deregulation of some institutions while still restricting others—does not work because it only causes imbalances elsewhere in the system. Also, mergers and acquisitions among financial institutions are to be expected, and concerns over the safety and soundness and the survival of nonbank institutions may arise.

In New Zealand and Australia, the success of some nonbank financial services firms hinged on the restrictions placed on banks. When these restrictions were lifted, “re-intermediation” occurred; funds flowed from the nonbanks back to the banks. Money market mutual funds may provide an example of re-intermediation in the United States. To the extent that some nonbank financial services firms in the United States developed to fill a void left by regulation, deregulation may jeopardize the survival of some firms.

Safety and soundness

Safety and soundness regulation was the topic of a “gripe” session that included representatives from the commercial banking sector, the S&L industry, and regulatory authorities. Barry Sullivan, chairman and CEO of First Chicago Corporation, discussed dual standards in capital adequacy between banks and bank holding companies, domestic banks and foreign banks, and banks and nonbanks. Sullivan argued that, because foreign banks and nonbanks generally have lower capital requirements than domestic banks, domestic banks operate at a competitive disadvantage, which might cause them to incur increasingly more credit risk.

One group of nonbank financial institutions that supposedly have a competitive advantage over banks in several respects are the savings and loan associations (S&Ls). Joseph C. Scully, president and CEO of St. Paul Federal Bank for Savings in Chicago challenged this assertion, noting that there has not been a rush by banks to convert to thrift charters.

Scully also argued that S&Ls are not, in effect, turning into commercial banks. S&Ls are sticking to mortgage lending. “Home mortgages are about as safe an investment as you can make,” said Scully. S&Ls have not greatly expanded into commercial lending because they have no expertise in this area. Also, Scully reported that in moving into other product lines, such as real estate brokerage and insurance, S&Ls, in general, have not met with much success: “More [S&Ls] have lost money than made money in such service corporation ventures.”

Both Scully and Sullivan agreed that banks and S&Ls are two very different types of financial institutions and should therefore be regulated differently. And Sullivan, who is also a director of the Federal Reserve Bank of Chicago, noted that the rapidly changing financial services environment makes keeping pace with the contradictions and discrimination in the regulatory system a difficult task.

Thomas H. Huston, superintendent of banking for the state of Iowa, illustrated this point as he relayed the problems that his department faces in supervising banks in Iowa. Because of the poor condition of agriculture and the high concentration of agricultural lending among banks in Iowa, many banks in

that state are experiencing difficulties. As a result, Huston and his staff are now faced with valuing assets such as farm and nonfarm real estate and farm equipment for which there are no well-defined markets, and hence no unambiguous value.

Problems of agricultural banks

Problems facing agricultural lenders was the topic of another session at the 1985 Bank Structure Conference. Gary Benjamin, vice president and economic adviser at the Federal Reserve Bank of Chicago, outlined the situation facing farmers and their lenders. Citing a study by the U.S. Department of Agriculture, Benjamin said that one out of every six farmers are "financially vulnerable." Financially vulnerable is defined as insolvent or so highly leveraged that insolvency is imminent if present conditions persist for another one to five years. These farmers account for over half of all farm debt outstanding, and banks hold over 20 percent of this debt.

George D. Irwin, associate deputy governor and chief economist for the Farm Credit Administration, elaborated on the problems facing those institutions that lend to the farm community. Among the problems, according to Irwin, are the concentration of problem loans and the lack of diversification among agricultural lenders and the illiquidity of the system. As Gary Benjamin and other panelists pointed out, the restructuring and liquidation of farm assets are necessary, but markets for such assets are not big enough to handle such huge transfers.

Restructuring asset ownership is only one of four necessary adjustments to attain a healthy financial farm system, according to Michael Boehlje, professor of economics and assistant dean of the College of Agriculture at Iowa State University. The other three adjustments that are necessary, said Boehlje, are the elimination of excess farm capacity, lower land and other input prices, and lower farmer debt load.

Boehlje reviewed the policy options to achieve such adjustments. He opposes increases in price and income supports because they do not address the problems of farmers under financial stress, and he opposes a debt moratorium, which halts the adjustment process and disrupts the financial system. Boehlje

advocated asset restructuring by allowing lenders to hold farm assets on their books in the case of default and by recapitalization through debt-to-equity conversions.

C. Robert Brenton, President of Brenton Banks in Iowa, also suggested a few measures to improve the current situation of farmers and agricultural banks. Brenton advocated the freezing of price supports, equity financing by banks, and diversification into such activities as real estate and insurance.

James R. Morrison, senior vice president at the Federal Reserve Bank of Chicago, characterized the economic environment in the farm sector as poor, but he said "the outlook is not bleak." Citing the "strong capital base prevailing at most agricultural banks," Morrison said that such banks could withstand the impact of poor earnings performance. He also said, "This capital position together with a low level of dependence on uninsured funding suggest that liquidity crises will not be a major problem" for agricultural banks.

Deposit insurance

Liquidity has been a problem lately for some financial institutions. Prior to 1933, runs posed very serious threats to the macroeconomy. In 1933, the U.S. government adopted a system of federal deposit insurance to alleviate such problems. However, this flat-rate deposit insurance system does not discourage and may even encourage bank risk taking.

One often cited solution to this problem is private deposit insurance. At this year's Bank Structure Conference, a panel was assembled to discuss the viability of private deposit insurance as an alternative to federal deposit insurance.

Two of the panelists representing the insurance industry said that private deposit insurance written by conventional property and casualty companies is not feasible, at least not at this time. Russell VanHooser, senior vice president at MGIC Investment Corporation, said "substantial regulatory and economic conflicts and obstacles must be resolved before [private deposit insurance] can be a viable alternative to government insurance." Roger E. Lumpp II, vice president at CNA Insurance Corporation, felt that both the banking industry and the insurance industry, especially the property and casualty insurance industry, were

in "turmoil;" therefore, private insurance could not possibly insure the deposits of the banking and savings and loan industries at this time. Lumpp said that if private insurers were to insure these deposits, the premiums for comparable coverage would be staggering—perhaps 20 to 50 times the present federal deposit insurance premiums.

Two other panelists disagreed with the insurance industry representatives. They believe that private deposit insurance is a viable alternative to federal deposit insurance.

Bert Ely, a corporate financial consultant with Ely & Company, described a self insurance system in which each depository institution's deposits would be guaranteed by other depository institutions. Under Ely's "cross-guarantee" system, four parties would be involved: the depository institution to be guaranteed; the guarantors, which are composed of other depository institutions; an agent, or middle man, who organizes and administers the syndicate of guarantors; and the Federal Reserve System. The Fed would act as lender of last resort to guard against potential bank runs.

Catherine England, senior policy analyst at the Cato Institute, also advocated private deposit insurance. She, however, did not propose a self insurance scheme, but rather a system whereby the amount of deposit coverage would be inversely related to the amount of regulation to which the depository institution is subjected. An institution, for example, that

only insures 50 percent of its deposits would be more restricted in its activities than an institution that insured 80 percent of its deposits. Under this system, said England, each consumer would deposit his funds in an institution which offers the deposit protection that he desires; thus, this system would allow the market to determine the proper mix of deposit insurance and regulation.

Other BSC topics

Other topics at this year's Bank Structure Conference included issues concerning bank failures, financial disclosure, and risk management in banking. Papers presented on this last topic included a discussion of the use of interest rate futures by commercial banks and a discussion of off-balance-sheet behavior of Seventh District banks presented by Gary D. Koppenhaver, an economist at the Chicago Fed.

Silas Keehn, President of the Federal Reserve Bank of Chicago, in his opening speech to the Conference, remarked that "a more relevant set of topics could not have been chosen, given the issues confronting us at this time." The record attendance at the Conference, hosted by Harvey Rosenblum, vice president and associate director of research at the Chicago Fed, was ample evidence of the Conference's relevance and timeliness.

—Christine Pavel