

[This article summarizes a special issue of the *Journal of Financial Services Research* that was dedicated to a session at the 2007 Bank Structure Conference. The session highlighted authors that were some of the most prolific contributors to research sessions at past conferences. Included in that special issue was an analysis of the impact of the conference on financial regulatory policy and the financial research literature. For additional details see: Douglas D. Evanoff, Philip F. Bartholomew, Robert DeYoung, Cosmin Lucaci & Ronnie J. Phillips, 2008, "Bank Structure Conference Impact Study," *Journal of Financial Services Research*, Vol. 34, December. <http://www.springerlink.com/content/wj458j538416u122/fulltext.pdf> ]

THE BANK STRUCTURE CONFERENCE THROUGH THE YEARS:  
A SPECIAL CONFERENCE SESSION SPONSORED BY THE  
*JOURNAL OF FINANCIAL SERVICES RESEARCH*

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I. Introduction

In the Spring of 2006, coordinators of the Federal Reserve Bank of Chicago's Conference on Bank Structure and Competition and the editors of the *Journal of Financial Services Research* agreed to have a special invited session at the 2007 Conference. The purpose was to present an analysis of the effectiveness of the conference at achieving its stated goals of influencing public policy and academic research, and to showcase the research of the most influential conference participants over the past 40 years. Although the authors of the invited papers were not given guidelines as to preferred topics, a common theme seemed to run through all three invited papers: bank capital requirements and safety net issues. Session participants, including discussants, were invited from a pool of the most prolific contributors to research sessions at past Bank Structure Conferences. Below is a summary of the research presented at that special session. Subject to referee review, the plan is to have a special, 2008 issue of the *Journal of Financial Services Research*.

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## II. "Bank Structure Conference Impact Study"

The first Conference on Bank Structure and Competition was held at the Federal Reserve Bank of Chicago in 1963, and was an informal event attended by approximately 20 economists. That meeting was organized in response to the Bank Merger Act of 1960, and was designed so that the Chicago Bank could survey research by Seventh District academics relevant to the new legislation. Since that time, the Conference has become a venue for research on financial institutions and markets that brings together academics, regulators, industry personnel and policymakers from around the world. Over the years, the Conference has served to stimulate and disseminate policy relevant research on issues affecting the financial services industry and as a forum for debating the topical issues of the day.

In this study Douglas Evanoff, Philip Bartholomew, Robert DeYoung, Cosmin Lucaci and Ronnie Phillips analyze the research associated with the Bank Structure Conference (BSC). They provide a brief history of the Conference and the topics considered and show that most of the controversial issues in banking and financial regulation over the past four decades were critically evaluated at the Conference, typically years before the actual passage or enactment of legislative and regulatory reforms. Based on this observation alone, they argue that the Conference has served to disseminate policy-relevant research on issues affecting the financial services industry, has been an effective forum for debating and influencing the important financial policy issues of the day, and in some instances has played a relatively direct role in influencing policy decisions. However, they recognize that such a conclusion is based on rather 'soft' information and, as an alternative and more quantitative means to assess the impact of the Conference, they develop a variety of absolute and relative "impact factors" based on citation data from the Social Science Citation Index. They use these tools to gauge the impact that the Conference has had on the scholarly literature in banking and finance. Impact factors are a common tool used to compare the relative quality of academic journals and academic departments. The authors augment and extend this tool to measure the quality of an academic conference. The innovations are not BSC-specific and it is hoped that the "conference impact factors" developed in this study will be used by other researchers to measure the impact of other academic conferences.

To control for the fact that not all conference papers get published, the authors calculate both 'conservative' and 'liberal' measures of the impact of the papers presented at the Conference. They then use these measures to illustrate how the impact of the Conference has changed over time; to compare the general quality of the BSC research programs to the general quality of the research found in leading economics, finance, and banking journals; and to more specifically compare the impact of BSC research papers to non-BSC research papers after controlling for the quality of the journals in which these papers are eventually published. The authors find that the citation counts for the published versions of Conference research presentations have increased significantly through time, and that they are substantially higher than the citation counts garnered by the average article in the leading journals. They conclude that the

Conference has had a strong and systematic impact on the academic literature.

### III. "Why Do Large Banking Organizations Hold So Much Capital?"

Allen N. Berger, Robert DeYoung, and Mark J. Flannery observe that large U.S. bank holding companies (BHCs) hold significantly more equity capital than is required by bank regulators and these equity cushions have grown significantly since the early 1990s. To illustrate, as of September 2006, the top 50 U.S.-based BHCs as a whole held regulatory capital ratios of 6.21% for the Tier 1 leverage ratio (CAPLEV), 8.57% for the Tier 1 risk-based capital ratio (CAPTIER1), and 11.74% for the Total risk-based capital ratio (CAPTOTAL). All three ratios are much higher than the "adequately capitalized" minimums of 4%, 4%, and 8%, respectively. The two risk-based capital ratios are also significantly above the "well capitalized" minimums of 6% for CAPTIER1 and 10% for CAPTOTAL. Bankers frequently argue that high capital ratios impede their ability to compete because capital is significantly more expensive than debt finance. This raises the question of why these large organizations do not operate closer to the regulatory minimums.

The authors propose a number of hypotheses that might help explain these observations, and test these hypotheses using both linear and nonlinear econometric models applied to annual data for publicly traded U.S. BHCs from 1992 through 2005. They delete observations for which one or more of the three regulatory capital ratios is in the top one percent of the sample distributions. The concern is that these observations might otherwise distort the findings because they are likely determined by idiosyncratic factors outside of the models. The resulting data set is an unbalanced panel containing 3,867 annual observations over 14 years, or about 276 BHCs per year on average.

Some of the hypotheses focus on "target" capital, the level of capital that the BHC would hold in the absence of adjustment costs. These hypotheses are based on institution risk, market-to-book ratio, merger activity, scale, and other factors. Other hypotheses are about the speed of adjustment toward the target, given that it is often costly to adjust capital quickly. These hypotheses are based on the BHCs' recent capital positions and supervisory and market pressures. Finally, one hypothesis, 'earnings retention', is based on passive build ups of capital over time from high earnings.

An ad hoc linear model examines the adjustment of capital from one period to the next. The results suggest that most of the BHCs' net income is "passed through" to increases in capital. This model also finds that the vast majority of BHCs try to remain well capitalized or adequately capitalized, reducing their capital only slightly. Over the sample, 97% to 99% of the BHCs choose to be above the well-capitalized regulatory thresholds. In contrast, undercapitalized institutions appear to raise their capital quickly and by significant amounts, consistent with supervisory pressure.

A more complex nonlinear model takes into account variables that affect target capital, the speed of adjustment toward the target, and the starting point from which the BHCs adjust their capital. Thus, the nonlinear model is based on a partial adjustment approach in

which some of the key variables - such as bank risk, market-to-book ratio, and merger strategy - determine the bank's target capital. Other key variables - such as banks' recent capital positions, and whether the BHC recently had a "bad" supervisory rating (BOPEC of 3 or worse) and/or a "bad" market rating (BBB or JUNK bond rating) - determine the speed of adjustment toward the target. Still other variables - such as lagged capital, current earnings, and historical dividend policy - determine the hypothetical starting point for capital.

The findings support almost all of the hypotheses. However, the authors also find that the hypotheses concerning target capital tend to cancel each other out; with some suggesting increases in target capital over time, and others suggesting decreases in target capital over time. Much of the increase in capital over time appears to be due to passive earnings retention, but much of the change also remains unexplained. Future research on this project will include additional explanations of why bank capital increased, a break out of the results by size of BHC, and some additional variables for target capital based on the discipline of uninsured bank counterparties.

#### IV. "Evidence of Differences in the Effectiveness of Safety-Net Management in European Union Countries"

European Union directives and Basel agreements divide cross-country accountability for preventing and resolving bank insolvencies in Europe in an economically arbitrary way. If a multinational European bank were to fail, the European Union's 1994 Directive on Deposit-Guarantee Schemes makes host countries responsible for paying off at least the domestic depositors of any banking offices the failed organization might have operated in their jurisdiction. Although the host country is charged with supervising banking entities that operate within its borders, Basel arrangements make home-country officials responsible for supervising the accounts of the consolidated multinational organization to which a host-country subsidiary would report. This gives regulators in both countries authority to influence loss exposures and insolvency resolution at host-country banks. Thus, European Union financial safety nets are social contracts that assign uncertain benefits and burdens to taxpayers in different member countries. Unfair though it might be, cross-country differences in bankruptcy procedures and in the effectiveness of market and regulatory discipline exerted in different jurisdictions could force taxpayers of a home or host country to shoulder the bill for negligent acts of safety-net officials, auditors, or creditors in a partner country.

To help national officials to assess their taxpayers' exposures to loss from partner countries, Santiago Carbo-Valverde, Edward J. Kane, and Francisco Rodriguez-Fernandez develop a means to estimate how well markets and regulators in 14 of the European Union 15 countries have controlled deposit-institution risk-shifting in recent years.

The methodology traverses two steps. The first step estimates leverage, return volatility, and safety-net benefits for individual European Union financial institutions. For stockholder-owned banks, 1993-2004 data on stock-market capitalization are utilized. Parallel

accounting values are used to calculate enterprise value (albeit less precisely) for mutual savings institutions.

The second step uses the output from the first step as input into regression models of safety-net benefits and interprets the results. Parameters of the second-step models express differences in the magnitude of safety-net subsidies and in the ability of financial markets and regulators in member countries to restrain the flow of safety-net subsidies to commercial banks and savings institutions.

The authors conclude by showing that banks from high-subsidy and low-restraint countries have initiated and received the lion's share of cross-border M&A activity. The efficiency, stabilization, and distributional effects of allowing banks to and from differently subsidized environments to expand their operations in partner countries pose policy issues that the European Union ought to address.

#### V. "Bank Capital Structure and Profitability: An International Analysis"

When the Basel Committee on Bank Supervision published the first capital accord, it said it did so "with a view to diminishing an existing source of competitive inequality among international banks." The intent was to reduce differences in supervisory capital requirements for banks, removing what was viewed as a substantial competitive disadvantage for banks operating in countries with higher supervisory requirements. Yet, an analysis of the largest 100 banks, which are dominated by the internationally active banks targeted by the Basel Committee, finds that equity capital ratios vary dramatically across developed countries. The tier 1 capital-to-assets ratio (leverage ratio) varies by more than a factor of three from a high of 6.77 percent in Singapore to a low of 2.18 percent in Switzerland. Banks in the U.S. had the second highest ratio at 6.34 percent, whereas the banks from nine other developed countries in the sample had ratios below 4.00 percent.

Does the wide disparity in capital ratios imply that the largest banks in the U.S. are operating at a substantial competitive disadvantage relative to their international competitors? Elijah Brewer III, George G. Kaufman and Larry D. Wall analyze the relationship between book equity capital and bank book profitability to see if these variations in capital ratios across countries and banks appear to be a source of competitive inequality.

The sample of banks analyzed includes the largest 150 banks in developed countries annually from 1995 to 2005. The profitability of these banks, measured both by the return on assets (ROA) and return on book equity (ROE) is regressed by ordinary least squares on the bank's book value equity capital-to-asset ratio lagged one period and a progressively larger number of control and fixed effect variables for the country in which the bank is headquartered and the bank itself. ROA is found to be consistently significantly positively related to the capital ratio. This is not unexpected as higher capital ratios are associated with lower interest expense. However, ROE is also positively related to the capital ratio, although less significantly so, until bank fixed effects are incorporated into the expanded regression model. Thus, banks with higher equity capital

ratios do not have lower profitability. If this is correct, cross country differences in equity capital are not a primary source of any competitive inequality during our sample period and the higher capital ratios at large U.S. international banks do not appear to cause them to have poorer performance relative to other internationally active banks headquartered elsewhere.

#### ENDNOTES

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