Annual conference assesses banking risk

Richard D. Simmons

Banking risks—and how to deal with them—were major topics at the Federal Reserve Bank of Chicago's 22nd annual Conference on Bank Structure and Competition held in Chicago on May 14-16, 1986. Since last year's conference, the financial industry has been rocked by several major events. Privately insured thrifts in Maryland and Ohio were temporarily closed; a record number of agricultural banks failed; and the Supreme Court issued decisions upholding nonbank banks and regional interstate banking compacts. In addition, 31 states have now passed interstate legislation, and many large nonbank holding companies compete with banks.

Given these events, this year's conference addressed risk-related issues in the context of a deregulated environment. Some 375 bankers, regulators, and academicians had an opportunity to hear many different perspectives on risk in the banking system. Among the speakers were William M. Isaac, former Chairman of the FDIC, Walter B. Wriston, former Chairman of Citicorp, and George J. Vojta, Executive Vice President at Bankers Trust Company.

Risk in historical perspective

George G. Kaufman, professor of economics and finance at Loyola University of Chicago, stated that between 1875 and 1919, before either the FDIC or the Fed existed, relatively few bank failures occurred, due to high capitalization and significant market discipline. In addition, illiquid banks were closed immediately, which halted depositor losses. If a closed bank was still solvent, it reopened soon afterwards.

Kaufman continued that many depositors now rely on federal deposit insurance rather than bank capital for the safe return of their funds. Accordingly, capital and loan loss reserves have decreased, and the risk of insolvency has increased. Further, regulators are often lenient regarding loss recognition and slow to close insolvent institutions. In this environment, insolvent institutions with nothing to lose have a strong incentive to take imprudent risks in an attempt to regain solvency. Moreover, due to the discount window, illiquidity does not necessarily limit losses or force immediate closures. Therefore, while insolvent institutions are left open, costs to taxpayers will increase as loan losses escalate.

Kaufman drew the following conclusions from this analysis. First, to minimize economic costs, regulators must close a financial institution promptly when the market value of the institution's net worth reaches zero. However, large institutions should be sold instead of liquidated. Second, financial institutions should be required to rebuild capital and loan loss reserves quickly, in preparation for any future losses. On this basis, Kaufman disagreed with the capital forbearance program for agricultural banks. Third, since only the deposit insurance agencies have a monetary incentive to minimize the costs of failures, authority to declare financial institutions legally insolvent should be transferred from the chartering agencies to the FDIC or FSLIC. Finally, the FDIC/FSLIC should insist on higher capital ratios, just as depositors did before deposit insurance existed.

Risk from a banker's viewpoint

George J. Vojta, executive vice president at Bankers Trust Company provided a second perspective on risk in the banking system. Vojta described several problems in today's banking system. First, banks are too insulated from market discipline. Currently, nearly 8,000 banks are not audited, too little disclosure exists, and bank examinations are too confidential. Second, uniform capital ratios and insurance premiums contribute to poor risk pricing and encourage excessive risk taking. Third, unnecessary legal and regulatory barriers preclude banks from diversifying their product lines and hinder banks' competitive abilities. These problems increase failures, weaken the banking system, and threaten the system's long term viability.

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To solve these problems, Vojta argued for stronger examinations, increased disclosure, risk-based insurance premiums, and risk-based capital ratios. He also stressed that barriers to product diversification must be removed and that commercial banks must be allowed to satisfy the equity underwriting needs of their best clients.

Far from seeing a conflict between competition and safety, Vojta agreed with Kaufman that fostering competition and market discipline would provide the best path to a stronger banking system. Though some banks would fail, most would adjust successfully, resulting in a stronger global financial system.

Banking risk and the investor

Providing yet another perspective, Harry V. Keefe, Jr., Chairman and CEO of Keefe, Bruyette & Woods, Inc., an investment banking firm specializing in bank securities, said the problems are with individual banks, not with the banking system. Although the media have dramatized the 120 bank failures that occurred this year, Keefe stressed that this number is minuscule given that 14,400 banks exist in the country.

However, Keefe emphasized his belief that banks' capital ratios are too low. Many banks have lower price-to-earnings ratios than industrial companies with comparable earnings and growth because the market perceives these banks as undercapitalized. Keefe asserted that, by issuing additional equity capital, these banks could increase their stock prices and decrease their funding costs.

In addition, Keefe agreed that more disclosure and market discipline are needed. However, he disagreed with the FDIC's attempt to promote market discipline by requiring banks to maintain a capital-to-assets ratio of nine percent, of which up to three percent could be subordinated debt, because community banks would have to pay overly large premiums on subordinated debt due to the small size of their issues. He also stated that commercial banks should not be allowed to underwrite equity securities because it is inappropriate for commercial banks to own stock in their clients.

A regulatory perspective

The first luncheon featured guest speaker William M. Isaac, President of the Secura Group and former Chairman of the FDIC. A strong proponent of competition, Mr. Isaac emphasized that many of the problems in banking result from competitive inequities. He recommended reducing these inequities by equalizing capital requirements for banks and S&Ls, by including foreign deposits in the calculation of FDIC deposit insurance premiums, by developing a procedure to ensure that large and small bank failures will be handled similarly, and by allowing commercial banks to engage in insurance, real estate, and underwriting activities. In addition, he argued that risk-related insurance premiums, a stronger bank examination force, and increased disclosure would help bring about much needed market discipline.

Elaborating on the market discipline topic, Isaac stated that FDIC insurance could provide less than 100 percent coverage in order to promote discipline through uninsured depositors. However, he stated that the FDIC's capital proposal is a better approach. This capital proposal would gradually increase capital requirements from six to nine percent of total assets, and subordinated debt could be used to satisfy up to one third of the nine percent requirement. This debt should increase discipline by forcing each bank to pay a rate based on the market's perception of that bank's risk.

Contrary to Keefe's view, Isaac stated that banks under $100 million would not be significantly burdened by the increased capital requirement because their primary capital-to-total assets ratios currently average 9.1 percent and deficiencies at banks with lower ratios are small. Further, Isaac asserted that these small banks could place subordinated debt at reasonable costs through correspondent banks, insurance companies, and pension funds. Instead, the heaviest burden of this capital proposal would be on thrifts and large banks. According to Isaac, the proposal would equalize capital requirements for large and small banks, reduce the failure rate, and minimize FDIC losses.

A banker's perspective: Nonbanks vs. banks

The second luncheon featured guest speaker Walter B. Wriston, retired Chairman and CEO of Citicorp. Like previous speakers, Wriston emphasized the need to remove restrictions on banks so that banks could compete in the market on an equitable basis.

Throughout his talk, Wriston emphasized that banks are losing an increasingly large share of the market to large nonbank competitors such as GMAC, GE, Ford, Chrysler, American Express, and Sears. In the meantime, bankers and regulators quibble about how many yards from the head office a branch may be located. According to Wriston, if this mentality of looking at the trees instead of the forest continues, trivial issues such as allowable distance to a branch will be irrelevant because banks will have been supplanted by large nonbank competitors.

Wriston acknowledged that some banks will fail when a recession occurs. However, he argued that the purpose of bank regulation is to ensure a sound banking system, not to keep poorly managed banks afloat. Regulators must not try to restrict banks to "safe" activities in an attempt to limit failures. Banks must be at liberty to offer new products and to expand geographically.

Wriston continued that these procompetitive actions will not cause another depression because the Fed will not allow the money supply to decrease sharply; the discount window provides emergency liquidity to banks; and the FDIC guarantees deposits. Moreover, allowing banks more flexibility to compete will strengthen the banking system. Accordingly, Wriston argued that regulatory restrictions must be removed so that banks can survive among and freely compete with other financial organizations.

Encouragement of market discipline

In addition to being a common thread for the preceding speakers, market discipline was the topic for many of the research papers presented. Robert B. Avery and Terrence M. Belton of the Federal Reserve Board and Michael A. Goldberg of the Federal National Mortgage Association found that the interest rate spread between the subordinated debt of large U.S. bank holding companies and of comparable Treasury securities was not significantly related to bank size, capitalization, earnings, liquidity, or loan quality. These findings argue that subordinated creditors have not imposed market discipline on banks.

Looking at depositors instead of creditors, Herbert Baer and Elijah Brewer, economists at the Federal Reserve Bank of Chicago, presented evidence that uninsured depositors require higher risk premiums on certificates of deposit when a bank's market value of equity-to-total assets ratio is low or when the variance of returns on a bank's stock is high. These results, presented elsewhere in this issue of *Economic Perspectives,* indicate that uninsured depositors have been exercising market discipline and that more disclosure would increase this discipline. Risk premiums on CDs were also found to be much greater than the differences in assessments proposed by the FDIC for risk-based deposit insurance. In addition, any proposals to extend insurance to these uninsured depositors would increase bank risk taking and reduce existing market discipline.

John M. Harris, Jr. of Clemson University, James R. Scott of the University of Arkansas, and Joseph F. Sinkey, Jr. of the University of Georgia analyzed market discipline from a different perspective. They argued that the bailout of Continental Illinois Corporation discouraged market discipline and caused a cumulative excess return of forty percent to stockholders of the nation's largest banks, because the market perceived that regulators would not let these large banks fail.

Off balance sheet activities

Another risk-related topic receiving much attention at the conference was bank off balance sheet activities. These activities include standby and commercial letters of credit, financial futures, interest rate swaps, and loan commitments. Because these activities have grown rapidly in recent years, with potentially adverse effects on bank safety, regulators are considering including them in an adjusted capital ratio.

Lawrence M. Benveniste and Allen N. Berger of the Federal Reserve Board argued that standby letters of credit and other off balance sheet items improve the social allocation of investment funds because investors can make direct loans to a bank's customers by renting the bank's credit information on those customers. Elijah Brewer, Gary D. Koppenhaver, and Donald H. Wilson of the Federal Reserve Bank of Chicago argued that off balance sheet guarantees are priced by the market, and only the strongest and most creditworthy banks can effectively offer these guarantees. Finally, Marcelle V. Arak, Laurie S. Goodman, and Arthur Rones of Citicorp Investment Bank presented an approach for establishing credit lines for off balance sheet items. They considered both default and interest-rate risks in developing their approach.

Although the measurement and management of risks in banking were the dominant topics of this year's conference, some sessions were devoted to other issues of importance to financial institutions and markets. Among these were alternative banking strategies, market value accounting, interstate mergers and acquisitions, the use of economic models in banking, and the impacts of deregulation on banking performance.

Conference consensus

A surprising consensus seemed to emerge at the conference that banks are not special, that no bank should be considered too large to fail, that more disclosure is needed, that banking is in most respects like any other industry, and that more deregulation is needed. In such an environment, banks could freely compete with other financial service providers; well managed banks would thrive; poorly managed banks would fail; and a stronger and healthier banking system would result.

However, it is clear that regulators do believe banks are special. Regulators subsidize banks by providing federal deposit insurance and discount window access at below-market rates. Further, regulators are proposing tighter capital adequacy guidelines to decrease the number of failures and increase the safety and soundness of the banking system. Regulators also continue to judge banks' financial conditions and require improvements in various areas, again in the name of safety and soundness.

These conflicting views raise two unresolved questions: First, what advantages and disadvantages do banks have which make them special in comparison to other financial organizations? And second, how far should deregulation go in removing these differences to level the playing field between banks and other financial service providers?