

# Global banking, financial integration major conference themes

*Theresa Ford*

In the past few years, market forces and technological advances have accelerated the pace of change in the financial services industry. The communications revolution and financial innovations are yielding a stream of new computerized products that are radically altering the industry. On the domestic front, the boundaries demarcating banks from other financial institutions are becoming increasingly obscure. In the international field, both financial services suppliers and regulators are barely able to keep pace with developments in the highly charged and competitive environment of an emerging global financial system.

The expansion of bank powers and financial innovations were among the topics considered at the twenty-third annual Conference on Bank Structure and Competition, held in Chicago at the Westin Hotel from May 6 to May 8. The conference, sponsored by the Federal Reserve Bank of Chicago, drew a diverse audience of academicians, regulators, bankers, and others from both the domestic and foreign financial services industry.

The conference attendants discussed the opportunities and risks of expanded bank powers with representatives from Canada, Japan, the United Kingdom, and the United States. Participants from smaller community banks as well as the large commercial institutions, presented their views on the benefits of expanded bank powers. Frequent reference was made to the supplemental capital guidelines proposed by the United States and the United Kingdom on off balance sheet activities, and one session dealt specifically with interest rate swaps. Another topic that received broad attention was the current status of the thrift industry and the regulatory response to the industry's problems. More than 300 participants discussed these and other key issues facing the industry.

## **The Glass-Steagall debate**

The issues surrounding the trend toward the merging of commercial and investment banking activities focus on reform or repeal of

the Banking Act of 1933. The act, more commonly known as the Glass-Steagall Act, prohibits banks from underwriting securities and forces banks to choose between commercial banking and investment banking. Today, with their highest quality customers directly accessing the capital markets and bypassing the traditional bank role of intermediary, some money center banks are considering forfeiting their bank charters in order to engage more fully in profitable investment banking activities.

Although conference participants often disagreed about the type and degree of reform of the financial regulatory system, all seemed to agree that reform should yield fair competition and provide for the safety and soundness of the system. Alex Pollock, president and chief operating officer of Marine Bank, contended that Glass-Steagall has not succeeded in providing a low risk financial system or a low risk banking system in the 1980s.

"Securitization. Globalization. Integration. These are the hallmarks of the new finance," asserted Hans Angermueller, vice chairman of Citicorp. Twenty years ago, the forces of technology, the institutionalization and changing nature of household savings, and financial innovations began undermining the depression-inspired government regulation of compartmentalized finance, according to Angermueller. Although he conceded that recent reform in regulation has produced modest but important steps toward allowing financial firms to serve their customers, he advocated the reform proposal put forth by the Association of Reserve City Bankers as the preferred solution to the problem of meeting customers' needs. This proposal would allow the market to act as regulator for financial services holding companies and would allow any firm to own a bank.

Gerald Corrigan, president of the Federal Reserve Bank of New York, and author of a recent essay on financial reform that was

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widely cited at the conference, proposed a more distinct line between those who could own a bank and those who could not. Under his proposal the separation of banking and commerce would be preserved. A manufacturing company would not be allowed to own and control an insured depository, but a financial holding company or a bank holding company would. Banks could engage in the securities business, and securities companies could enter the banking business. He emphasized that any reform should have the guiding principle of strengthening the safety and soundness of the system, in part by providing greater room for self discipline and market discipline and in part by enhancing the strength and flexibility of the supervisory process itself.

Martha Seger, a member of the Board of Governors of the Federal Reserve System, warned that regulation has been slow to change given the dynamic environment and that efforts to deregulate have generally followed change rather than initiated change. She, along with many of the speakers, agreed that the status quo also carries risk. She stated that while banks are looking for new products for their corporate customers, they are also searching for any legal loopholes to provide these new products and keep up with the competition. Furthermore, she noted that the competition from nonbank financial institutions and nonfinancial institutions is currently not considered in the market analysis casework done by the Federal Reserve System.

Jack Guttentag, professor of finance and banking at the Wharton School of the University of Pennsylvania, expressing concerns about attempts to lower the barriers between commercial banking and the rest of the financial industry in reference to the Federal Reserve's assistance to insolvent banks, remarked that, under the current system, "The lender of last resort door, which is supposed to open to a hospital, now leads to a funeral parlor." Guttentag proposed a dual banking system with two kinds of firms: the depository firm and the finance firm. He suggested that firms whose liabilities include transaction deposits should be authorized to hold only marketable assets. All liabilities of these depository firms would be insured. Supervision would be simplified by using mark-to-market accounting standards; when capital requirements fell below the regulatory minimum, the depository firm

would be terminated. Guttentag emphasized that no depository institution would be too large to fail. Finance firms would be able to hold nonmarketable assets only if they could finance themselves through the issuance of long term debt and equity. Liabilities for finance firms would not be insured but would be supervised.

In a session focusing on expansion of bank powers through regulatory reform, the benefits of expanding bank powers for community banks were discussed. Michael Laub, director of economic and policy research for the American Bankers Association, cited six forces affecting community bank profitability. These include economic volatility, technological changes, regulation, securitization, the crisis in the thrift industry, and interstate banking. O. J. Tomson, the chairman and chief executive officer of Citizens National Bank of Charles City, Iowa, added to that list the competition of community banks with insurance and real estate companies, local investment bankers, captive finance companies, savings and loans, and commercial firms such as Sears and K Mart.

Laub remarked that the key element of survival for community banks would be the expanded ability to offer new products and services. Tomson reiterated this idea by stating that expanded bank powers are necessary not only to survive but to prosper. He added that community banks must carve out a market niche for themselves, although this is difficult in a political environment which historically has chosen to deal with banking legislation on an ad hoc basis.

As the debate over reform of Glass-Steagall continues in the U.S., many large U.S. commercial banks have established operations overseas where investment activities of commercial banks are less tightly restricted. They compete directly with investment banks in activities such as underwriting Eurobonds, Eurocommercial paper, and international equity issues. William Ogden, chairman and chief executive officer of Continental Illinois National Bank and Trust Company, pointed out that the historical distrust by regulators of the economic power of banks in the U.S. is unique in the world and has lost much of its relevance because of changes in the global economy.

## **International perspectives on expanding bank powers**

The worldwide financial system is becoming more sophisticated and complex. Financial innovation has yielded a veritable zoo of new global financial products such as NIFs, RUFs, COLTS, CATS, TIGRs, LYONs, STAGS, ZEBRAS and others. John Heimann, the vice chairman of Merrill Lynch Capital Markets, asked, "How will many new products invented during a bull market and in an environment of declining interest rates behave during a period of inflation, rising interest rates, or recession?" He responded that no one could predict, because the markets are growing faster than the players and the regulators can understand them. The speed with which new products are being created and the push of market forces are compelling regulators in many countries to rethink their current policies of financial regulation.

Allan Popoff, the director of the Financial Institutions and Markets Division of the Canadian Department of Finance, explained that the two sources of pressure leading to regulatory reform in Canada are the erosion of the compartmentalized industry structure and the increasing links between the financial and commercial sectors. Canada's response to these pressures has resulted in a proposed policy of financial sector integration and financial and commercial segregation. Commercial banks would be allowed to enter fully into investment banking but commercial corporations would not be allowed to own banks. Thus, Canada's near banks, the trust and insurance companies, which currently undertake an extensive range of banking activities, would be prohibited from further integration.

Not only are central bankers considering the safety and soundness of their own domestic banking systems, but also the competitive advantages or disadvantages of their commercial banks relative to other countries' financial institutions that result from regulatory differences across nations. This concern stems in part from the internationalization of markets and the growth of banks' off balance sheet activities. These financial obligations do not appear in the capital adequacy ratios currently used by the regulators.

A recent article in U.S. Banker magazine stated that the value of off balance sheet com-

mitments of U.S. money center banks now totals almost \$1 trillion dollars. Regulators in the U.S. and the U.K. have jointly proposed implementing capital requirements on some of these items. They realize the likely outcome of unilateral action would be to place their home banks at a competitive disadvantage.

Peter Cooke, associate director of the Bank of England, called for a leveling of the playing field by the international banking community. As an example of international regulatory convergence, he referred to the binding supranational banking laws of the EEC, effective in 1992, which cover half of the G10 countries. In his view, broader international agreement on capital adequacy and other supervisory measures for banks would improve the current situation. He stressed that some trends in global finance may require interventionist authority at the international level and emphasized functional regulation of financial institutions.

Yuko Oana, the managing director of the New York branch of Dai-Ichi Kangyo Bank of Japan, the largest bank in the world, argued that in formulating a policy of rules for the international market, one must take into account the long financial history, the different status of banks, and the differing accounting systems of the various countries. He also stated that the equivalent of the Glass-Steagall Act in Japan, Article 65 of the Securities Exchange Law, requires banks to choose between banking and securities activities. However, he noted, the universal banks of Europe are allowed to undertake both securities and banking activities. He stated that the Ministry of Finance in Japan was seriously considering this major disparity in banking powers.

## **The case of swaps**

The interest rate swap is one of the off balance sheet items on which the Federal Reserve Board and the Bank of England may soon impose reserve requirements. Mark Muffett, a mathematician at the Bank of England and a principal researcher on the proposal, presented the operational aspects that underlie the proposal, which focuses on credit or default risk in swap transactions. He outlined the methods for converting the principal of a swap into a balance sheet credit equivalent amount. The central features of the joint regulatory proposal

are a method for marking swaps to market and an estimation of future exposure over the lifetime of a swap.

A separate session of the conference was devoted to a discussion of the reasons for the growth in the swap market and the panelists' views on the proposed capital requirements. Gary Koppenhaver, a senior economist at the Chicago Fed, opened the session with the statement, "According to the International Swap Dealers Association, 1986 volume in the interest rate swap market was \$313 billion dollars, nearly double the 1985 volume and an increase from virtually zero in 1982." He explained that an interest rate swap is a variation of a currency swap, a financing tool developed in the late 1970s. Unlike the currency swap, in which two parties issue debt denominated in different currencies and then exchange obligations, the participants in an interest rate swap exchange interest obligations, not principal repayments.

Swaps may involve several participants. John Heimann of Merrill Lynch, in an earlier session, had cautioned that with a multitude of parties involved in a swap, the credit risk of the transaction was subject to the problems of its weakest participant and that if management did not know all the counter-parties, they could not fully determine this risk. However, Clifford Smith, a professor of finance at the University of Rochester, pointed out that swaps are very useful in hedging interest rate exposure and that default risk of swaps is dissimilar to that of loans.

Larry Wall, a senior financial economist with the Atlanta Fed, pointed out that much of the current literature on swaps claims that banks are saving interest expense by exploiting their comparative advantage in obtaining funds and by arbitraging the quality spread differential across markets. He noted that quality spreads could arise because of expected bankruptcy costs, contract provisions, agency costs, and the ability to force firms to reorganize, but that only the latter two may be exploitable. Furthermore, a quality spread differential due to a combination of these forces may be only partially exploitable.

Wall believes swaps are used and growing in use in order to manage interest rate risk, to exploit differences in regulatory and tax treatments across borders, to adjust a firm's debt, and to exploit information asymmetries. How-

ever, Linda Rudnick, a vice president at Harris Trust and Savings Bank, claimed that the quality spread differentials and comparative advantages were the reasons for her customers' participation in swaps. She remarked that Harris uses swaps as an asset/liability management tool; acting as an intermediary, the bank maintains a book of swaps for customer accommodation. She agreed with Wall and Smith that the current proposal by the regulators in the U.S. and U.K. grossly overestimates swap credit risk and therefore misspecifies the appropriate capital requirements.

### **Public policies toward failing institutions**

Problems of the thrift industry and the regulatory response to these problems were another topic of discussion at the annual conference. George Kaufman, professor of economics and finance at Loyola University, emphasized the questionable tactics of problem savings and loans (S&Ls) struggling to improve their earnings quickly. In some instances, S&Ls find themselves in a no-lose situation by taking on additional risky assets. In addition, he questioned the behavior of some S&L managers.

Eli Brewer, an economist at the Chicago Fed, reported on the current magnitude of the problem. Using current value accounting to calculate the market valuation of S&L net worth, he found that the S&L industry had a negative net worth of \$107 billion dollars at the end of 1982. Since 1983, S&Ls have suffered from poor asset quality, with credit risk replacing interest rate risk as a source of problems since the early 1980s. He found that of the 448 insolvent S&Ls at the end of September, 1986, 82 had also been insolvent as of September, 1982. Another problem affecting confidence in the industry was the spillover effects of the highly publicized cases of fraud in the industry. Many of the recent cases of S&Ls engaging in activities to defraud depositors, FSLIC, and taxpayers were illustrated by Brewer and Kaufman.

Gillian Garcia, a director of an economic analysis group at the General Accounting Office, cited six alternative regulatory actions taken by the Federal Home Loan Bank Board when faced with a problem institution. These actions include liquidating receiverships, conservatorships, placement in the management consignment program, and three types of

mergers. She found that the losers and gainers in all six types of actions were similar and that the losers of these actions, mainly the stockholders, managers, and unsound borrowers, were likely to gain in the short term through a policy of capital forbearance.

She remarked that if a policy of forbearance, which is politically popular in Congress, is used and completed quickly, then society might gain. But she warned that a prolonged policy of forbearance could result in great losses. According to Garcia, society would lose because of an inefficient distribution of resources and because of the resulting increased costs to marginally healthy institutions which might eventually be forced out of the industry. At the end of 1982, 145 institutions were insolvent to the extent of \$1.4 billion dollars. Four years later, eighty of these institutions remained insolvent to the extent of \$3.7 billion dollars. She reported that this figure, discounted back to 1982 at the one-year T-bill rate equalled \$2.7 billion dollars and concluded

that it was not clear that society had gained from a policy of capital forbearance.

### **Other conference topics**

Other topics discussed at the annual conference included the theory of financial intermediation, bank lending decisions and loan review policies, the structure-performance relationship in banking, bank equity markets, and asset sales.

During his welcoming address to the conference participants, Silas Keehn, the president of the Federal Reserve Bank of Chicago, referred to the many structural changes that were to be discussed: "We are no longer talking about the future as perhaps we were at the outset of our conference, but we really are, at this point, talking about the here and the now." This sense of urgency of 'the here and the now' was widely felt throughout this year's conference.