Challenges for the banking industry in the 1990s

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Remarks by Thomas M. Hoenig, President of the Federal Reserve Bank of Kansas City, at a conference on ***The Financial System in the Decade Ahead: What Should Banks Do?*** *organized by The Jerome Levy Economics Institute of Bard College. Research assistance provided by Kenneth Spong, economist in the Policy and Special Projects Department of the Division of Bank Supervision and Structure.*

Over the last decade, significant changes have occurred in banking and the entire financial system. Banking deregulation, new competitive pressures, and technological innovations in communications and information processing have led many of us to conclude that banking is no longer the same game with the same rules.

In my remarks tonight, I will take a brief look at the trends and challenges that are emerging for banks in the 1990s as they adapt to their new environment. I will focus mostly on how the banking industry appears to be evolving and what this may mean for future operations. I will then outline some of the implications of these banking developments for financial stability. And finally, regarding the appropriate public policy response to emerging developments, I will attempt to outline certain key considerations and possible options.

Emerging trends in the banking industry

Much of our attention over the last decade has centered on bank and thrift asset quality problems, deficits in the deposit insurance funds, and the creation of a new system of supervision. During this period, however, the banking industry itself has undergone a quite remarkable transformation in how it does business. Deregulation, rapidly increasing flows of financial information, an astounding rise in computer processing power, and the development of new financial theories and instruments have dramatically changed banking.

The transformation in banking, in fact, mirrors many of the innovations in our financial markets, which involve the breaking up of the bank balance sheet. Many of the traditional assets held by banks, although still important, will play a less significant role in bank portfolios, while a variety of services and relatively new off-balance-sheet activities will begin to dominate industry activities. These changes have been most apparent at larger banks. However, in a survey of community banks that our Bank recently conducted, we found that many small banks also had made or were planning a number of notable changes in their operations.[1]

While we could debate whether banks are gaining or losing market share, I think a more interesting question is what will banks actually be doing throughout the remainder of the 1990s to compete in the financial markets.

The lending function. It has become common to view bank lending as something that can be done more efficiently by the "market" in our new age of almost unlimited information flows. Despite a wealth of information, though, some of the biggest blunders in financial history have been made in recent years. To me, this record indicates that there still is a substantial premium to be placed on lenders who can carefully merge information with good credit judgment. Because of their experience in judging credit risks, banks seem destined to maintain a key role in lending, although not without some changes.

One such change is the fading from the bank balance sheet of many standardized credits and loans to highly rated corporations. Compared to investors directly

[1] *Catharine M. Lemieux, "Meeting the challenges: Community bankers' views" as presented in this issue.*

funding such credits, banks face many additional costs, including deposit insurance premiums, nonearning reserves, capital standards, and the burden of regulation. Consequently, the credits on bank balance sheets during the remainder of the 1990s will primarily represent lending to borrowers with unique characteristics, specialized needs, and limited access to financial markets.

While banks will be more specialized in the type of credits they hold, they nevertheless will expand their role in making credit judgments through other means. Many banks will focus more on originating and servicing loans to be sold or to be securitized or pooled for the market, thereby avoiding the costs of holding such credits directly. Examples of this include private placement activity and mortgage, auto, and credit card debt securitization. Banks will perform credit evaluations in granting letters of credit and liquidity backups to support the commercial paper and other credit markets. Commercial paper, for instance, has become a $550 billion market with banks providing a significant portion of issuers' backup liquidity and credit enhancements.

Overall, this evolving role, when compared to traditional bank credit activities, will mean leaving less bank lending on the balance sheet, while placing more of the credit judgment process and its associated risks on an off-balance-sheet basis. While the emphasis will be different, the point is that banks will still need to be attentive to controlling credit risks.

Managing market risk and other services. In addition to a changing lending function, banks also will be taking some new directions. These include, for example, helping customers manage interest rate, exchange rate, and other market risks. Such directions are an outgrowth of path-breaking developments in finance and economics in such areas as asset and option pricing theories, hedging strategies, and portfolio and market efficiency theories. In addition, vast increases in computing power have opened the door for these theories to be used on a much broader and more intricate scale.

In this regard, an enormous variety of derivative instruments have been developed to break up and partition risk factors and thereby help individuals, businesses, and financial institutions better manage their own risk exposures. At year-end 1993, bank off-balance-sheet derivatives amounted to nearly $12 trillion, which was a 62 percent increase from just two years before. While this is the notional amount of derivatives and the dollars at risk are typically much smaller, this notional figure is still 3.2 times as large as total banking assets.

Although these instruments and activities can help banks and their customers manage risk positions, an evaluation of all the inherent risks may be extremely complex for both bankers and regulators. In fact, a risk manager for a securities dealer was recently quoted in Fortune magazine as saying "If I woke up one day and, God forbid, I was a regulator, I don't think I'd know what to do. With derivatives there's leverage and sometimes illiquidity, and there's complexity. Three words." [2]

As an example of complexity, the pricing and perceived risks in these instruments are often based on a number of critical assumptions that may not be clear to many participants. These assumptions may reflect underlying market conditions, previous price volatility, and historical patterns for mortgage prepayment rates—factors which may never be repeated in the same manner if the financial environment continues to change. With this complexity, it may be extremely difficult to design simple and accurate bank disclosures, and the potential may exist for rapid and substantial changes in risk exposure.

[2] *As reported in Carol J. Loomis, "The Risk That Won't Go Away," **Fortune**, March 7, 1994, p 57.*

An example of such problems involved Franklin Savings, a Kansas thrift that had made a name for itself through its complex arbitrage operations, expert staff, and ability to "outsmart" major securities firms on trades. In a dispute over accounting practices, the Office of Thrift Supervision seized Franklin in 1990. What followed was a series of articles and court cases in which a number of well-known arbitrage experts took turns defending and criticizing Franklin's reporting of hedging gains and losses. In the end the courts deferred to the OTS, but two things caught my attention. One was the lack of agreement over Franklin's financial condition and the other was the potential for losses in an institution that was engaged in seemingly safe hedging and arbitrage operations. Several similar stories have since been repeated in the corporate world and in the funds management business.

Deposit competition. On the deposit side, banks will face strong competition in the savings and payments transaction markets from mutual funds, cash management accounts, and other savings and payment instruments. One advantage for banks has been their role in the payments system and their access to clearing and wire transfer facilities. These activities, along with extensive office and ATM networks, have given the banking industry a good link to many customers. This advantage, though, will be tested over the remainder of the 1990s as electronic innovations give customers more direct access to all of their accounts and investments. Banks consequently will be under pressure to offer a variety of savings instruments, and their success will clearly depend on whether they can provide competitive returns and meet customer expectations.

Banking consolidation. A final challenge facing banks is consolidation. Consolidation in banking will likely create an industry composed of three principal types of organizations: a handful of organizations operating on a nationwide level, a group of strong regional organizations, and a substantial number of community banking organizations serving both rural and metropolitan markets. This consolidation will allow larger organizations to diversify geographically and will give smaller community organizations the opportunity to combine with each other and become more efficient.

However, by bringing the banking industry closer together, consolidation also seems likely to concentrate payments transactions, off-balance-sheet positions, and other banking risks. Moreover, just like other aspects of banking in the 1990s, consolidation will entail a number of perils and no assurance of success. I would note that some of the early and most feared companies making financial acquisitions—most notably CitiCorp, American Express, and Sears—did not enjoy the success they had anticipated. Also, in a study our Bank conducted, we found that interstate acquisitions varied widely in their degree of success.[3] Thus, while consolidation can be expected to continue at a rapid pace, the most successful, as always, will be those where careful judgment is exercised in both the selection and execution of the merger.

Implications for financial stability in the 1990s

The changes and trends in our financial system not only pose a challenge for bankers, but also carry several important implications for financial stability. Gunnar Breivik, a sports philosopher to Norwegian ski jumpers, was quoted in the Wall Street Journal as saying, "Pure risk leads to self-destruction. Pure safety leads to stagnation. In between lies survival and progress." [4] While referring to the dangerous sport of ski jumping, this quote I believe does an excellent job of summarizing the challenge for the banking industry and its supervision in the 1990s.

[3] *Kenneth Spong and John D. Shoenhair, "Performance of Banks Acquired on an Interstate Basis,"* ***Financial Industry Perspectives*** *(Federal Reserve Bank of Kansas City), December 1992, pp. 15-32.*
[4] *Michael W. Miller, "At the Ski Jump, Philosophy in Motion."* ***Wall Street Journal****, February 24, 1994, p. A16.*

Banking competition, consolidation, and the rising levels of off-balance-sheet activities, if not handled properly, could lead to one of two extremes—a substantial leveraging up of the risks in the banking system or a heavily regulated and stagnant financial system. For survival and progress, banks will have to be both bold and careful while our supervisory system will have to find a balance between risk and safety. This is no easy task, but now is certainly the time to begin looking for this balance.

Changing the supervisory framework. Many of the ongoing developments in banking will undoubtedly complicate the task of supervision. For example, how will bank supervisors oversee the wide variety, complexity, and constantly changing nature of off-balance-sheet activities? What about the new forms of credit and market risk banks will face as they operate in an evermore competitive environment, and will public confidence be more of a concern as people struggle to understand path-breaking developments? Furthermore, what role should the market play through stockholder, creditor, and depositor discipline relative to that of the supervisory authorities?

In past years, we have relied on traditional supervisory techniques, deposit insurance, the discount window, and other elements of the federal safety net to protect the payments system and provide for financial stability. This system, though, has not been without cost, and, indeed, the 1991 banking legislation sought to change some elements of the safety net.

In the 1990s, we cannot afford these costs. We will have to become more adaptive and better able to evaluate in advance of crisis the risks of significant bank activities. One path to this end will be more highly trained and better compensated examiners and supervisors, particularly examiners that can fully evaluate a bank's internal controls, hedging operations, and more complex activities. To minimize the regulatory burden on banks, these examiners may further need to have the ability to understand a bank's own operational systems and internal controls and be able to judge their adequacy.

Supervisory and enforcement concerns are already being geared more closely to such factors as a bank's risk control procedures and its management experience and knowledge in offering and monitoring more complex services. In addition, the banking agencies have been making strong efforts to train examiners in evaluating derivative instruments and the internal systems used to track these operations.

Will these steps be enough? In spite of these recent efforts, reasons remain for doubting that the current approach will be the final answer and further suggest that something more is needed to deal with an increasingly volatile financial system. Indeed, several developments in banking will actually complicate any supervisory response to a crisis. Problems include the rising complexity in banking, the potential for rapid shifts in bank funding and risk exposure, and the matter of disclosing adequate information to stockholders, creditors, and depositors.

One answer may be to find a better, less costly way to protect the payments system, which historically has been an essential link in keeping financial problems from becoming systemic. We might, for example, bring back an old concept and place into insulated affiliates certain banking activities that involve substantial risks and are difficult to supervise. Alternatively, we might allow banks to expand services while protecting transaction accounts with a narrow banking format or an asset base similar to that of money market mutual funds. In both instances, knowledgeable investors and managers would have the responsibility for funding and withstanding the operating risks of activities outside the narrow bank.

Although this separation would not eliminate the risk of such activities, it would assure more stability to the payments system and would allow market discipline to play a more direct role in controlling other specific areas. In addition, it would be consistent with recent shifts toward mutual fund products, and might actually bring banks closer to the base of short-term business credit and government securities that once supported their deposits.

Structural steps needed to add more built-in stability. A related topic which will influence the stability of our financial system involves structural reforms within our economy. Good judgment by bankers and appropriate regulatory reform, in fact, will only go part way in answering the challenges faced by banks and our entire financial system. As the financial system becomes more efficient and innovative, market participants are becoming more adept at exploiting not only the opportunities within the general economy, but also the distortions.

A clear sign that perverse incentives exist is the fact that our financial system appeared to be at the forefront of every recent economic crisis, whether it was the credit boom and crunch or energy, agricultural, real estate, commercial, or LDC lending. In addition, the U.S. nonfinancial corporate sector took $640 billion in equity off its balance sheet between 1984 and 1990, thus channeling much of the credit growth of the 1980s into leveraging up our economy rather than into investment channels and asset accumulation.

Certainly a variety of factors played a role in this binge of leverage and there is no simple way to curtail what one financial columnist has called the "time-honored rhythm, [in which] financial success breeds excess."[5] A starting point, though, might be to place debt and equity financing under more equal tax treatment. Our corporate tax system has created strong incentives for selecting debt over equity, and many recent financial innovations have accelerated this process.

While there are obvious problems in substantially changing our tax structure, the failure to take such steps may leave us with a more fragile economy and a business sector without the equity base to focus on long-term investment and research. A number of other steps could also be taken, such as giving banking organizations broader authority to help with the equity needs of their customers. All of these steps could make it easier for both banks and their customers to maintain higher capital levels.

The role for central banks. A final matter to consider is how recent developments in banking and financial markets may have even broader implications for monetary policy and the international financial system. Our Bank's 1993 symposium, which included financial and monetary experts from around the world, addressed the topic of "Changing Capital Markets: Implications for Monetary Policy." A consensus view emerged from this symposium that financial markets were becoming more fragile at the same time that monetary policy was becoming more difficult to implement.[6]

These changes thus present new challenges for the Federal Reserve and other central banks throughout the world. The developing structure of our financial markets and the emergence of new financial instruments are opening the door for large and sudden shifts in funds within the United States and on an international basis. The 1987 stock market decline and some of the recent turmoil in our financial markets provide examples of the type of market volatility that is becoming possible. Moreover, as these changes are occurring, the relationship between the traditional monetary aggregates and the general economy is becoming more tenuous.

[5] *Christopher Farrell, "What Really Rattled the Bond Market Wasn't Inflation." **Business Week**, March 21, 1994, p. 43.*

[6] ***Changing Capital Markets: Implications for Monetary Policy.** Federal Reserve Bank of Kansas City, 1993.*

In this new environment, I believe one key factor to achieving more market stability will be central banks' success in establishing a framework for long-term price stability. The expectation of stable prices in the United States and in other countries is necessary to direct spending and investment into appropriate channels, while dampening a major impetus toward speculation in financial and other markets. Beyond this, another essential factor will be the ability of the Federal Reserve and other regulatory agencies to quickly restore stability to the payments system and the financial markets in the event of any disruptions. With the complexity and speed of today's markets and transactions, this objective will require close insight into the changing nature of our financial system.

Summary

Banks will face in the next decade a variety of challenges and we should not underestimate the possible problems. However, the end of banking is far from near. The information revolution of the 1980s was supposed to allow everyone to bypass banks, but in the end, it reaffirmed a fundamental tenet of banking—the value of sound credit and business judgment.

For banks and other participants to survive and prosper in a more complex marketplace, we will need to take several steps to ensure a stable financial system. These steps include maintaining a trained supervisory staff and perhaps separating banking activities that are consistent with depositor protection from those that should more appropriately be conducted through affiliates or other entities.

An additional step that will have to be pursued at some point is to minimize tax distortions and other aberrations that could make our markets even more fragile. Also, we must be sure that the Federal Reserve and other regulatory authorities have the ability to respond to the threats that may be encountered in this new marketplace. If we can follow these steps, banks and other financial institutions will have a clearer path to the future and our financial system will be headed in the direction of survival and progress.