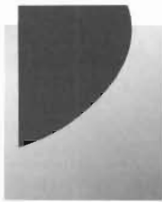
25th Conference on Bank Structure and Competition: Controlling risk in financial services

Mary J. Williamson



Risk management has always been a major challenge for the financial services industry. Today, however, the increasing number of failures of distressed depository institutions seems to indicate that managing risk has become more difficult. At the 25th annual Conference on Bank Structure and Competition, sponsored by the Federal Reserve Bank of Chicago, several industry leaders discussed their recommendations for controlling risk in today's environment. These participants shared several points of emphasis and presented some personal concerns about regulation, supervisory intervention, and deposit insurance.

Different perspectives

The panelists were in practical agreement about the fundamental issues affecting the industry, and all agreed that regulation has been used excessively to control risk. Each, however, had a different perspective on risk and, therefore, advocated different approaches for managing it.

"Banking by definition is the management of risk," began Federal Reserve Board governor John LaWare. This ex-banker-turned-regulator said that he resents the underlying assumption inherent in the regulatory structure that bankers do not know as much as legislators or regulators about how to run a bank. This false assumption has fostered excessive regulation and has created an anti-competitive atmosphere, said LaWare. He added, "it is increasingly creating a disadvantage for the American banking system in world markets, to say nothing about domestic markets." According to LaWare, "supervision, rather than regulation, ought to be the focus" for controlling bank risk.

Continental Bank Corporation chairman Thomas Theobald agreed with LaWare that regulation has gone too far. Taking a broad perspective on the future of the financial services industry, Theobald said that the business of banking will likely undergo "colossal restructuring," but it is not appropriate for "central planners," i.e., legislators and regulators, to decide "the finer points" of the restructuring. "I don't think . . . a sincerely motivated, highly intelligent, nationally interested bunch of people in Washington . . . are going to be able to design the proper response to these changes." Rather, according to Theobald, those decisions belong with the market participants – the consumers and the producers of financial services.

Early in the Conference, Carter H. Golembe, chairman and managing director of The Secura Group, asked, "Why is the market so distrusted as an efficient regulator of banking?" He conjectured that the reasons are that first, history has painted American banking during the first century and a half as "a chaotic black hole that was cured only by the establishment of the Federal Reserve System . . . and federal deposit insurance;" and second, "the market can be a brutal regulator."

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Federal Home Loan Bank Board member Lawrence J. White said that "depositories are special." According to White, their liabilities are special, and that is why they are insured and why controlling the risk of depository institutions is so important. But, like the other panelists, White did not advocate regulation as a primary tool to control risk. Rather, White preferred risk-based capital requirements and risk-based deposit insurance premiums as well as better and earlier supervisory intervention.

Regulation and re-regulation

Regulation is one approach to controlling risk, and according to the panelists, it is the approach most often used—and overused—in the banking and thrift industries. Said White, we regulate "with a vengeance." Many regulations, originally designed to protect the safety and soundness of the financial system, now are considered by some to be outmoded, anticompetitive, and too stringent.

Furthermore, Theobald pointed out that regulations do not always work as planned. He noted that the thrift industry has "just managed to lose $100 to $200 billion in a beautifully regulated business." He added that this loss is greater than the cost of all the land acquisitions throughout the history of the American republic.

LaWare said that regulations can create inefficiencies and used the interstate banking formula as an example. He asked why banks operating in a multi-state environment should be burdened with the operating restrictions of each state in which they operate. LaWare contemplated the possibility of interstate bank holding companies operating under one set of federal rules. This, he said, could stimulate managerial and operating efficiencies rather than replicate the whole regulatory structure in each state.

While all panelists agreed that regulation is not the best way to control risk, LaWare expressed serious concern that the thrift crisis, bank failures, and scandals in the investment banking industry "have created a counterbalance to what was beginning to be a very healthy tendency on the part of Congress to deregulate the financial industry. . . .What we do not need now is a re-regulation binge." Paul Horvitz, professor of banking and finance at the University of Houston, observed at the Conference that both the regulated and regulators have learned from their mistakes and that, given the proper incentive, these human errors will not be repeated. Nevertheless, Horvitz emphasized that the regulatory system does need some reforming, although not extensive restructuring.

Supervision and intervention

Rather than regulation, said LaWare, "we need intelligent supervision doing an in-depth job of monitoring what is going on in all these institutions and the authority to move quickly and peremptorily when something goes wrong." Supervisory attention should concentrate on institutions that threaten the insurance system. LaWare emphasized aggressive monitoring and authority to intervene quickly to change the course of action. Fellow Federal Reserve Board governor, Manuel Johnson, earlier had said "to prevent problem banks from becoming threats to the safety net and the financial system, it is necessary to give examiners stronger tools."

Rather than legislate against risky behavior, which would constitute credit rationing and asset allocation, LaWare recommended improvement in the supervision of banks. For example, LaWare suggested that examiners of financial institutions that are involved in highly leveraged finances need to determine that the proper credit policies are in place and that limits on the proportion of the portfolio that can be dedicated to this kind of lending have been established. As Joseph A. Manganello, Jr., an executive vice president at Bankers Trust Company, said, "Don't make the same bet in your whole portfolio."

In addition, directors should be informed and approve what is going on so that there is some feeling that there is control over the risk. This method is more effective than legislation, which is inflexible and hard to manage, concluded LaWare.

Information systems

White agreed that there is a need to strengthen the ability of regulators to intervene before an institution becomes insolvent. Insurance losses would decrease if supervisory authorities could force recapitalization before insolvency and subsequent loss to the deposit insurance corporations occurred.

Accurate information, however, is crucial to early intervention. Current information

systems make it difficult to detect risk exposure. In fact, financial reporting is based on accounting methods that do not necessarily provide an adequate assessment of present conditions or the value of assets. White, a strong advocate of market value accounting, said that relying on generally accepted accounting principles (GAAP) for banks may indicate financial soundness when market value measures would indicate otherwise. For example, book value measures of capital can be a very misleading measure of an institution's ability to absorb losses.

George Benston, professor of finance, accounting, and economics at Emory University, said that "the accounting system was not and is not designed to present economic values that regulators, economists, and investors might use. . . . It's to control the use of resources, particularly cash." Yet, a crucial piece of information for controlling risk and learning about risk is market information. According to Benston, market value accounting is generally difficult to do, "but not for banks" because of the nature of banks' assets and liabilities. "There really is no substitute for market value accounting," said White. Although initially "it won't be perfect," it would be "a whole lot better than GAAP accounting." GAAP is inadequate and will become increasingly divorced from economic reality, said White. Insurers and regulators need to have a better idea, even if approximate, of the market value of the assets and liabilities of financial institutions.

James Annable, chief economist at First National Bank of Chicago, said, however, that information between the regulator and the regulated is so unbalanced that "a cost-effective regulatory process may not be possible to design." Therefore, deregulation may be the best alternative.

Risk-based capital and insurance premiums

In the sense that capital is akin to an insurance deductible, risk-based capital requirements and deposit insurance premiums go hand-in-hand. As White pointed out, "every auto insurance company in the land will charge a lower premium . . . if you take out a larger deductible. And the same principle ought to apply to deposit insurance premiums." These two means of controlling risk were discussed by the panelists and strongly advocated by White.

"Capital is going to be the focus of managing risk in the financial industries," pointed out LaWare. Capital adequacy has played a central role in controlling the risk of individual institutions because capital protects the deposit insurance funds by reducing any incentives to take risks.

The definitions of capital and acceptable capital requirements are frequently modified and studied by the regulators, and the need to reform and substantially tighten capital requirements has been acknowledged throughout the industry. Recent risk-based capital guidelines, which incorporate off-balance-sheet items into the capital requirements, are certainly a step in the right direction.

Theobald observed, however, that the financial services industry is overcapitalized, while some individual institutions are undercapitalized. The banking industry has never earned more than 10 percent on equity capital, while the rest of American industry is earning 15 to 18 percent. "This is an unsustainable situation," said Theobald. "Now I understand that the regulators want to see more capital, but I think what they really want to see is more capital per enterprise. . . .You can't say you want more capital in the industry when it's already earning a nonmarket clearing return."

While more capital would lead to a lower premium under a typical insurance scheme, deposit insurance is not typical in that all institutions are charged a flat rate. Therefore, the current system overprotects some depositors, while it encourages other institutions to take on higher risks. White commented that he finds it "absurd that the [deposit] insurers do not and cannot charge premiums that are also risk-based."

White also said that practicing co-insurance, i.e., cutting back on coverage, is fine if bank runs are not a problem. He said, however, that he believes in 100-percent deposit coverage and employing other tools to control risk. Theobald disagreed: "What started off as a life vest is now a luxury yacht. We need to limit the deposit insurance . . . I submit that there is no logic that will get you away from the fact that if we don't limit deposit insurance we're going to forever be fighting futile central planning of the financial business."

Competitiveness

Theoretically, restrictions on financial activity prevent financial institutions from taking excessive risk. In practice, however, these restrictions increase risk when they prevent institutions from adapting to the changing needs of their customers. One type of restriction is the "firewall," which legally and operationally separates banking activities of a holding company from nonbanking activities.

"Firewalls that are too high can indeed create risks and inefficiencies, rather than minimize them," said Dennis Weatherstone, president of J.P. Morgan & Company, during the Conference. Referring to investment and commercial banking, he said "the business we do today weaves the two together so tightly that we really have to rip the fabric to separate the threads." Nevertheless, firewalls require that an investment banking subsidiary and a commercial banking affiliate maintain "separate capital, different people, and duplicate support functions." Manuel Johnson conceded that "firewalls will lead to some sacrifice of synergies," but he said that firewalls are necessary to protect the safety net.

LaWare addressed the issue of expanded powers in light of one aspect of the safety net, deposit insurance. He said that he supports the idea of a financial services holding company. If insured banks are isolated from nonbank affiliates, LaWare noted, there should be no limit to other businesses those affiliates could get into. In particular, LaWare said, as many others have, that such financial activities as insurance, real estate, and securities are appropriate for financial services holding companies. But LaWare added, "an industrial corporation cannot own a bank and a bank cannot own an industrial corporation."

This separation of commerce and banking needs to be reexamined. There may be better and cheaper access to capital markets by combining the two. The outcome of the current debate over controlling risk will significantly affect the strength of financial organizations in the years to come. Fundamental reform is needed for insuring deposits and regulating financial institutions. The ongoing appraisal of all risks facing the management of bank funds regardless of size and status is an important priority. The panelists agreed that the financial industry must adapt information, regulation, and supervisory controls to avoid unreasonable and excessive risk.