Banking Regulation and Supervision in the United States: Lessons for a United Europe

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Ne tournous pas nos regards vers l'Amerique pour copier servilement les institutions qu'elle s'est donnees, mais pour mieux comprendre celles qui nous conviennent, moins pour y puiser des exemples que des enseignments (Alexis De Tocqueville).[1]

Introduction

This paper begins with a justification of the topic chosen. Firstly, why study regulation? A short theoretical section attempts to show why regulation is necessary. A more practical section then shows how regulation is particularly important in the financial world of the 1990's. Then comes the question, why study the United States? At the risk of being disjointed, we shall look at the evolution of the different regulations, and their relevance to the European situation separately. It shall be seen that the practical disappearance in importance of certain instruments has meant the increase in importance of others - what the Federal Reserve has called 'new instruments with old names'. Before commencing, we note that what is presented in this paper is a summarised version of a vast topic.

Why study regulation?

If regulation is important, then the study of it is important in order to discover the most effective methods of regulation. Regulation is important for the following reasons:

- What Friedman and Schwartz have called 'contagion'; the failures of one bank can lead to instability, or eventual collapse, of the whole banking system, if it causes the public to doubt the health of other banks and to attempt to withdraw their assets all at the same time;

- Collapse of the banking system, as the sector which creates money, would have massive externalities for the whole economy ;

These two banking characteristics do not in themselves justify regulation, because if bank failure had a zero probability of occurrence, or if the market could control the risks involved, these characteristics would not worry us. However, the facts are that risk is fundamental to the concept of banking and it is a risk for which the market cannot account.

To explain this statement; risk

[1] We should not look to America with a view to copying her institutions servily but rather to understand better those which apply to us and to draw lessons rather than direct applications.

in banking arises due to asymmetry of information. Bankers can make investment decisions which do not take fully into account the interests of the depositors. This applies also to banks themselves as depositors on the inter-bank market. Ordinary market devices such as risk-pricing cannot take this into account, as depositors cannot charge banks for risks they do not know about. Coase's theorem states that when negative externalities exist in any social contract, there will be an incentive for economic agents to organise behaviour in order to internalise these costs. However, because control of risk is, in a way, a public good (risk-taking banks benefit from the reputation of conservative banks)[2] , free rider and prisoner's dilemma problems mean that a mechanism for the establishment or enforcement of risk-control is necessary.Thus it is the public good aspect of risk-control, both for the banking sector, and in turn the whole economy, which justifies regulation.

Why study the US?

De Tocqueville's quotation above applies as much to our inter-continental comparison of financial regulation today as it did to his comparison of political systems in the last century - we do not want to copy directly the US system as it clearly would not suit us and, in any case, we would prefer to avoid the present severe problems. Rather, we can see the US, with its complexity of regulations and its turbulent evolution over the past twenty years, as an "immense financial laboratory" (*The Economist*, 1991), offering us various examples of different regulatory policies. From this we can draw lessons on those which suit our European situation. Our free-riding on the American experience is all the more valuable when we take into account that the US financial markets are considered to be approximately twenty years ahead of their European counterparts.

The crucial question, however, is - how applicable is the American experience to Europe? - how similar are the two systems in question?

If we take any one country in Europe, comparison with the US seems practically worthless. For example, Belgium at the end of 1986 showed a market concentration of 45% for the largest five banks, while that of the US was only 10% (Baltensperger, 1990). Regulation in Belgium is covered by one law and one regulatory body, La Commission Bancaire et Financiere, while in the US regulatory legislation is complex and controlled by four bodies - the Federal Reserve, the Comptroller for the currency, the Federal Reserve Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC). The multiplicity of establishments in the US makes this control all the more difficult. Deposit accounts are regulated in Belgium and

[2]"These banks that run horrendously large deposits are to be deplored." The concern of the consertative banks can be seen in the remark of Godfried Bruder, GM of Commerzbank, London ("*Banker*" April 1989).

are now free in the US. The US was ,for a long time extremely restricted in product and market expansion. No such restrictions have been imposed in Belgian banking.

Thus the differences seem too important to allow constructive comparative study. However, if we compare the US with the EC as a whole more direct parallels can be made:

-market concentration in the EC is 13%; in the US, it is 10%;

-different national regulations make legislation complex and supervisory bodies are numerous, a situation that is similar in the US;

-many countries still have interest rate controls, but these are fast disappearing in the attempt to move towards harmonisation ;

-geographical restrictions and movement towards their abandonment is in direct comparison to those of the sovereign European countries and their move towards unity ;

Of course, there are still large dissimilarities (which will be covered in later sections) but the above similarities would seem to indicate such a study to be worthwhile.

What have been the most important policies of the US banking system and how have these evolved in recent decades?

Interest rate regulation

Regulation Q was one of the measures implemented after the 1929 stock market crash. This set a maximum rate payable on deposit accounts and, along with rules placing ceilings on usury loan rates, aimed at preventing competition from encouraging banks to take unnecessary risks. Such controlled rates meant that return was not related to market risk. Thus relatively risk-free clients were subsidising the risky clients as they were not earning what their funds were worth on the money-market. This problem became more acute during the 1970's due to higher banking costs and interest rates. Estimates by McKinsey show that by the end of the 1970's, on average 15-25% of clients contributed to profits of more than 70-80% (Bryan, 1989). This led to what was then called 'disintermediation' and 'securitisation', as depositors withdrew their funds from the banks and invested them directly in equities and bonds.

To prevent disintermediation from crippling the thrift institutions they were allowed to offer competitive rates on large certificate of deposits ($10,000), then banks had to be permitted to do the same. However, this did nothing to solve the problem of small depositors, and with the appearance of money market mutual funds (MMMF), accounts competition became worse. (MMMF offered shares in asset portfolio made up of highly liquid money market instruments offering competitive interest rates). This resulted in two things: (1) bank costs increased by 50% from 1976-79 as banks tried to keep their clientele by offering more services, and (2) these institutions took on even more risky projects in the struggle to remain profitable. Thus a regulation which was meant to be contributing to stability was causing instability.

A number of EC countries,

including France, Belgium , Greece and Portugal, still have controls; however it is expected that these will be phased out gradually due to the completion of liberalised capital movements and movement towards monetary union.

The American experience shows how a banking system which ignores the risk portions of its customers, using one group to subsidise another, cannot survive in the world of modern financial innovations. It also demonstrates the severely damaging effects of interest rate control in a sector exposed to competition in terms of both profitability and risk undertaken.

Geographical expansion

Santomero (1990) speaks of the "historical and deep-seated geographical restrictions" in US banking which seem to echo the European system. In fact, the banking systems of the United States have long since been even more separated than those of 'United Europe'. This does reduce the relevance of the comparison but, nevertheless, there may be some lessons to be learnt here.

As well as interest rate regulation, geographical restriction also had the aim of limiting excessive competition. Laws prevented inter-state banking but for various reasons these have been side-stepped in recent years.

Geographical expansion in the States occurred in a context where obstacles to inter-state commerce were practically non-existent. In Europe, however, the goals of1992 link commercial and financial expansion. Thus, the success of financial intergration may be dependent on that of commercial trade.

Product Market Expansion

The 'Glass-Steagal Act', more properly entitled the Banking Act of 1933, established product market barriers between commercial and investment banking by separating deposit-taking activities from under-writing and securities; this was to prevent any possible business crisis from leading to financial crisis. In the years of the depression and World War Two there was not much opposition to this Act. It was only in the 1950's that banks began to try to expand their activities by establishing bank-holding companies which avoided the regulations regarding wholly-owned subsidiaries. Legislation was implemented to control this and in doing so, sanctioned the bank-holding form. Interpretation of federal regulation in the 1960's and 1970s led to increased product expansion. Today the Glass-Steagal division is very weak in comparison to its previous position. Banks now offer a vast range of services to customers and are less constrained in their own activities (in June '89 the Fed allowed commercial banks participation, although limited, in under-writing of corporate debt). Today, the major area of market concentration defines the principal participants rather than separation on industry lines (Glastner, 1989).

European financial systems have never been as segmented as those of the US and perhaps in this respect

the US has more to learn from Europe than vice-versa. Much blurring of demarcation lines between formerly segmented sections of the financial system has occurred in recent years to varying degrees in the different countries, due to market forces, as in the States, and due to the monetary authorities trying to 'level the financial playing field'. The OECD points out the main developments:

-policies towards diversification, which have been most important in countries with traditionally more segmented systems. In some countries, institutions which traditionally were only guardians of savings have now become full-scale retail banks;

- the activities of the post-office, with its vast branching network, have increased rapidly;

-the bank sector has begun to be integrated with the securities markets institutions. Here, the German tradition of universal banking where there are no limits on bank participation in industry, stands in sharpest contrast to the American system for example the Deutche Bank presently controls 35% of Mercedes-Benz. Arguments in favour of this system include economies due to banks' access to information on businesses, and that it allows diversification of risk for bank investment. Against it, though, it can lead to monopolism in banking, and also the great effect an industry collapse would have on the financial system.

Belgium represents a country which is somewhere between the two extremes. Investment in quoted companies is permitted up to 35% of a bank's capital providing investment in any one company surpasses neither 5% of voting rights in the company nor 5% of the bank's capital.

Indeed, all of the different European systems differ in the degree of permission of band-activity on the stock exchange. In the move towards unification and the principal of home supervision, these systems are expected to converge due to competitive pressures. The question of supervision of these activities will therefore become even more important. The definition of the safety net will have to be defined so as to cover the banks only and not the non-bank affiliates. Santomero suggests the best way to do this would be to follow Federal Reserve regulation which prohibits various financial transactions (such as loan/sale of assets) between affiliates.

Deposit Insurance and Lender of Last Resort

Deposit insurance and the role of the Federal Reserve as Lender of Last Resort are relied on heavily in the US as a method of preventing bank runs, by guaranteeing the public the safety of their deposits should bank failure occur and by guaranteeing liquidity and solvency of the system. Every bank or saving institution can have deposit insurance up to $100,000 per client. The aim is thus stability. However, the changes in the financial system, especially the competition aspect, has called into question the effectiveness of these protective measures.

Firstly, since competition offers depositors a choice of different

institutions to invest in, and since they feel their deposits are safe, they ignore risk considerations in their choice of institution, looking only for the bank offering the highest interest rate. This means that inefficient banks which must take high risks to survive are supported by the federal guarantee system. Otherwise low-performing banks and S&Ls would have dropped out if competition had been permitted. The current system actually leads to a vicious circle. When in trouble, a bank undertakes ever more risky projects, thinking that if they succeed, well and good; if they lose, the insurance corporation will bail them out. The system has now reached such a critical situation that at the FSLIC estimates are that losses will reach $100 billion ($400 per head of population).

The response of the political practitioners has been to increase the cost of the insurance to the banks and S&Ls in order to cover the expected losses. Among the economic theorists, however, the calls have been for drastic reform or even abolishment of the system, replacing it with a private insurance scheme. This proposal is not feasible through as a private insurance scheme cannot cope if all claims are made on it simultaneously, which is what would occur in the banking system were failure to occur (due to contagion).

The European system is very different to the American (Baltenspeger, 1990). Firstly, the public is not aware of the existence of deposit insurance schemes - in Germany publicity is even banned in the fear that knowledge of their creation could cause loss of confidence in the banking sector. Secondly, systems are very different across countries, which could have a destabilising effect if depositors went searching for best coverage. Thirdly, deposits of foreign banks are insured by local agencies, but on the principle of home country control, these agencies cannot monitor the risks taken by the foreign banks. Fourthly, losses are not supported by the tax-payer by the inter-bank market. This could mean severe weakening of the Euro-banking system at a time when it is more exposed than ever to the American and Japanese competition.

Baltenspeger and Dermine's call for the abolishment of the deposit insurance system echo the same calls in the US. They recommend instead, reliance on LLR facilities given randomly. Herring (1990), however, argues that this could not work as the market participants would simply work on expectations of which banks would most likely receive LLR. Genuinely uncertain LLR assistance is unworkable.

The most interesting proposal for a modern deposit insurance system still comes from the States. These views consider modern financial innovations as perfectly substitutable for insurance schemes in guaranteeing stability and solvency. Glostner calls MMMF "run-proof", because shareholders have no fixed claim if the value of assets fall; shareholders bear the loss instantaneously. Thus incentive to withdraw is much less than that of ordinary depositors. If they do decide to withdraw they can only take their now reduced share of the fund and so cannot threaten solvency of the fund.

This is a topic on which there will obviously be much debate, especially considering the catastrophe of the US situation.

Capital adequacy requirements

This is a regulation whose existence has never been questioned. Banks must keep a certain ratio between their reserves and their deposit creations. At present, the US, like Europe and most of the other OEDC countries, are following the initiatives of the Cooke Committee on risk-based capital requirements. This international harmonisation of regulation is hoped to increase efficiency and reduce exposure to risk due to international operations.

Conclusion

Deregulation of interest rates and progression abolition of product market and geographic restrictions mean that deposit insurance and capital adequacy requirements are now the two pillars on which the American regulatory system rests. This massive increase in stature of the capital adequacy requirement has, in itself, meant that this is indeed a "new instrument with an old name", although it has been changed in form also (calculation of adequacy requirement based on risk already existed in the States so the inclusion of off-balance sheet activities in the calculation is probably the newest feature). The status of the deposit insurance system is not quite so sure however. The present crisis poses the question of whether this regulation is simply an "old instrument with an old name; begging to be replaced. However the only feasible replacement, such as suggested by Glostner or Bryan, would necessitate radical restructurating over an extended period of time of the banking system. Thus, the regulatory bodies at present are stuck with a Catch-22 situation - can't live with it, can't live without it. We note that this is mainly the result of the system in the sixties and seventies whose problems are only surfacing today.

With the removal of geographic barriers due to harmonisation of regulation, the disappearance of product market barriers due to harmonisation of regulation, and the disappearance of product market barriers and interest rate regulation due to competition, capital-based requirements and deposit insurance will increasingly become the twin pillars of European regulation . Deposit insurance systems are a relatively new creation, and at present do not seem to pose as many problems as the American system. Relative to the American situation, competition has not forced the European banks to take excessive risks, due to certain characteristics of the European situation: the smaller number of establishments, greater market concentration at each country level, interest rate regulation taking place in most countries before effective innovation, and less geographical restrictions, although I must say that I, personally, am not convinced that deposit insurance is the best solution to our regulatory problem, while admitting that the system at present does

necessitate it.

The US is indeed an immense financial laboratory and raises some very interesting and important questions for the future of European banking. Also interesting, as has been brought to the attention in writing this paper, is that Europe may have some very relevant lessons to offer to the States. This is seen most clearly in the fields of product market and geographic expansions. In the light of their present crisis, this information should be very valuable to the States. For us, in the light of European union, we can little afford to ignore any information beyond our own experience in deciding on the structure of our financial system, since the soundness of this structure will be a major determinant of the success or failure of the achievement of monetary union.

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