June 1991

Problems and Controversy: The U.S. Banking System
by
Eugene H. Rotberg

Almost seven years ago, in September 1984, I had occasion to write about the potential crisis for U.S. deposit-taking institutions.

"Continental Illinois Bank and Financial Corporation of America are just the tip of the iceberg. The commercial banks and the savings and loan associations are in a particularly vulnerable position."

"Are [not] banks imprudent because [the] administration has made it clear they will be bailed out..."

"...financial "deregulation" is simply a code word for a laissez-faire attitude among regulators and bank examiners which, in turn, has undermined the normal checks and balances..."

"People are scared about banks falling apart, and well they might be. It would be accurate and fair...to argue that banks must be regulated, their assets examined, proper standards applied, and their funding done prudently."

"...Few in the Administration are working on or thinking about the problem -- yet the implications and risks to what we value in this country are as significant as the concern over national security -- and the probability of disaster probably greater."

"...there remains great risk, and we are still without either controls or even a crisis plan should other, more visible, institutions fall apart."

Nothing was done. It was considered too complicated for the general public and without political appeal. We now pretend that the main causes of the S&L problem were fraud and self-dealing. Not so. While there certainly has been some illegal activity (and much more negligence), it is minimal compared to the damage done by regulatory and legislative initiatives. Specifically, the current mess has as its antecedents (a) the lifting of the interest rates that S&L's could pay on deposits; (b) the general deregulation over how S&L's might invest those deposits; (c) determined relaxation of supervision over such investments; and (d) the maintenance of an infamous accounting convention -- "a rolling loan gathers no loss." It was, and is, a structure virtually guaranteed to result in an unwise deployment of insured deposits because there is no private sector potential loser -- except the taxpayer.

EUGENE H. ROTBERG is an international banker and previously was Vice President and Treasurer of the World Bank.

Every incentive was created to invest the public's deposits, whatever their cost, in risk-intensive ventures. Indeed, the greater the risk, the better. If the investments worked out, the rewards to the owners of the thrifts, given their minimal capital commitment, would be astronomical. If not, the government simply would end up owning the worthless assets and pay off the depositors. Therefore, S&L principals, understandably, sought out the riskiness of investments: unimproved farm land, illiquid commercial real estate ventures, junk bonds, put and call options, speculative oil exploration ventures, etc. -- the stuff normally requiring the highest credit scrutiny. And banks did the same thing. But if one has nothing to lose (and depositors are protected), the normal checks and balances are gone with the wind.

In effect, almost every bad deal, every unwise investment in the country, was explicitly backed by taxpayers. It's a wonder the costs are not higher yet. Worse, the basic structure has not changed.

Generally, most commentators agree that U.S. banks (and those of other countries) are unique amongst competing financial intermediaries because of attractive accounting conventions and because of the nature of the resources at their disposal. These factors combined, however, in the United States certainly, have contributed, in the context of the deregulation of asset deployment, to some highly questionable activities. Savings and loan institutions and banks in the United States during the 1970's and 1980's took on fixed-rate assets, e.g., bonds or mortgages at, say, 2% over interest-rate sensitive liabilities (later the cost of funding could not cover the fixed rate returns); used insured and liquid deposits for illiquid investments; invested as equity participants, as well as lenders, in unimproved property or unproven and speculative ventures in real estate, agriculture and the energy sectors, all without marking their value to market -- even internally.

Unhappily, many did not concern themselves about interest rate or maturity mismatches, the changes in the real value of their new assets, or the risk imbedded in off-balance sheet commitments. Loans and investments were kept on books at par long after their value was impaired. Indeed, banks are still permitted to hold assets with little liquidity whose market value is uncertain and funded with minimal equity participation.

The bottom line is that deposit-taking institutions can take present pleasure for future pain. The concept is straightforward: a rolling loan gathers no loss. My own sense is that it is not likely that increased capital requirements will do much to address these kinds of systemic problems, for the current system encourages significant risk taking combined with minimal disclosure of the continuing nature of that risk and the market value of the assets at risk.

It is not an environment which encourages attention to credit or prudence -- not for banking institutions because they can "hide" mistakes on the deployment of their assets and use insured deposits as the primary source of capital, and not for the securities firms, who inevitably compete with banks in and outside the United States for an increasingly similar client base.

But, assuredly, it was not merely the lure of insured deposits. I believe banking is not a good business in the United States. There are profit pressures which are the result of (a) over-banking -- from both foreign and domestic competitors (there are too many banks); (b) the holding of illiquid assets which, once purchased, are difficult to divest, despite the advances in "securitization;" (c) an accounting treatment which does not mark assets to market, and which, in turn, tends to diminish, inexorably, attention to credit quality; (d) competition for funds from pension funds, insurance companies, securities firms and others competing for discretionary savings, as well as for clients to lend those funds; (e) a narrowing of spreads between the cost of funding (the percentage of costly versus "free" funding went up) and the return on loans (which went down in response to commercial paper and disintermediation); (f) diminished economic activity; and (g) rising skills, resources and requirements outside the United States. In short, at the same time banks were facing increasing pressures from their traditional clients who had new sources of finance outside the banking system, the banks found themselves, inexorably, paying more for deposits. And new clients were often domiciled in countries with monopolistic banking systems and, moreover, with economies and demand for capital more robust than in the United States.

Money center banks in the United States simply are not very profitable, if at all. But that problem -- caused primarily by over-banking and an unwise set of accounting conventions -- is not likely to be solved by permitting banks to enter into other lines of business which (a) are systemically unprofitable, or (b) involve fundamental issues of conflict of interest, or (c) which will entail great risk as well as raise serious questions of public policy. The U.S. Treasury has made, amongst others, three recommendations to "solve" the problem of the unprofitability of banks.

These proposals -- in particular: first, to permit non-financial corporations to hold a substantial equity interest in commercial banks, second, to permit banks to engage, generally, in traditional securities market activities and, third, to reduce the amount of insurance -- I believe are unwise.

The reason banks cannot raise capital is because informed investors aren't interested. Why, then, would an industrial corporation buy a bank -- except that it might provide a financing vehicle for the corporation, its suppliers, or customers which might not otherwise be available. I can think of nothing which would yet further diminish attention to prudence and credit-worthiness.

Indeed, the only profitable part of the securities business in recent years was M&A and leveraged buyouts, but these are businesses the banks can even now engage in. Under the Treasury proposals, however, a bank affiliate would be able to provide <u>both</u> primary loans as well as underwrite the junk bonds to take them out of their creditor position -- assisted, perhaps, by pension funds under affiliate management. All this while owned by the parent or parent-to-be corporation. Beyond that the bank asset/allocation committees inevitably would be pressured to withdraw lines of credit from competing industrial enterprises. The conflicts of interest, breach of fiduciary duty, unfair business practice, insider trading suits will keep us lawyers very busy.

It will be like shooting fish in a barrel. Besides, why would the U.S. government want to provide the "synergy" to facilitate corporate financial engineering of a style which caused so much pain in the 1980's. Not a smart idea, and certainly not one which will encourage banking prudence or integrity.

But perhaps most important, I am concerned that the implicit public safety net applicable to banks will result in the taxpayer not only insuring depositors for the mistakes made by banks, but also will end up, directly or indirectly, insuring the business failures of the commercial corporate sector. The links between the corporate sector and financial institutions are tight enough as it is, but to encourage significant cross ownership escalates the problem by making the American taxpayer the ultimate insurer of the financial integrity of the non-banking private sector.

We will hear a lot about firewalls. Firewalls won't work. (If the case for relaxing the constraints of the Bank Holding Company Act and Glass Steagall rests on such terms as "catalyst," "synergy," "firewalls," or "level playing field," the odds are there is trouble both in the logic and its implications for good public policy.) It is instructive here to note the testimony of E. Gerald Corrigan, President of the Federal Reserve Bank of New York -- certainly an official concerned with the financial viability of commercial banks -- before the United States Senate Committee on Banking, Housing and Urban Affairs, on May 3, 1990:

"...I remain strongly opposed to the merging of banking and commerce and any arrangements that would even remotely contemplate ownership and control of bank holding companies or financial services holding companies containing depository institutions by commercial concerns...

I...look with concern, if not alarm, at the economic financial -- and perhaps even social -- implications of Exxon owning Chase Manhattan, Ford owning Citicorp, or RJR Nabisco owning J.P. Morgan. Obviously, those examples draw on more than a little hyperbole in order to stress the point. But, once that door is opened, there is absolutely no way to anticipate how events will shake out over time.

...I would strongly urge that we maintain a strict separation of banking and commerce...

The need for great care in this regard is strongly reinforced by case after case which illustrates that the well-being of the company as a whole cannot be safely disentangled from problems or adversities affecting an affiliated company no matter how thick the firewalls nor how well constructed the legal separation. Indeed, in times of stress, not only does the marketplace fail to generally accept these distinctions, but the directors and managers of the firms under stress don't accept them either.

I have real worries about "firewalls" becoming "walls of fire".

[We cannot] dismiss what the marketplace tells us both here and abroad. And, what the marketplace tells us with almost unfailing regularity is

that in times of stress, some parts of a financial entity cannot safely be insulated from the problems of affiliated entities. Investors, creditors and even managers and directors simply do not generally behave in that fashion and the larger the problem the less likely they are to do so. Because this pattern of behavior seems so dominant and because the authorities throughout the rest of the industrial world generally frame their policies with this in mind, there seems to me little doubt that taken to an extreme, absolute firewalls can aggravate problems and instabilities rather than contain or limit them. Indeed, I don't have to stretch my imagination or my memory very far to find examples in which a heavy handed approach to firewalls could easily have been the source of significant problems.

There is also a matter of logic here: that is, if we are prepared to accept the proposition that greater flexibility in allowing combinations of entities providing financial services makes sense, we must be saying, at least implicitly, that such combinations make sense on economic grounds. Otherwise, the exercise is sterile. On the other hand, if we say such combinations are permissible but then insist on firewalls that are so thick and so high so as to negate the economics of the combination in the first place, the net economic result will also be sterile."

We also will hear a lot about international competitiveness. The idea of replicating the German, U.K. or Japanese banking systems -- each of which is different from the other -- is nonsense. The U.K. banks are minor players in the securities markets; the German banks have no securities firms as competitors; the Japanese banks are even more restricted than their U.S. counterparts. Moreover, given the mysteries of their accounting systems, hidden reserves, favorable tax treatments, monopolistic pricing, etc., we have no idea whether they are profitable. And if they are, it is basically because between four and ten banks control 90% of their nation's bank deposits. We cannot, therefore, clone that structure or facilitate bank profitability in the U.S. -- a country with 17,000 banks and 6000 securities firms.

The securities firms, of course, are not innocent bystanders -- to say the least. For two decades they invented and refined a wide range of products for themselves and their clients which have had the effect of shortening the maturity of debt and leveraging it and, of course, displacing the banks in the process. Moreover, everything seems to float. Credit evaluation took a back seat to providing liquidity, as if the former were unnecessary if the latter were assured. But liquidity is never assured, particularly where the same quality information is being processed simultaneously by relatively few and sophisticated market players. But that is another speech.

I have a suggestion: require all deposit-taking institutions to obtain a substantial percentage of their overall funding, not from insured deposits, but from the medium- to long-term bond markets, without any government insurance backing that debt. The buyers of uninsured bonds would assuredly watch over the deployment of their funds. Depositors, on the other hand, provide no market test whatever of the quality of management, or the wisdom of the investments. They know they are insured no matter what happens.

It is a perversion of logic to call the current system "market based" or "free enterprise" -- one where the principals put virtually none of their own funds at risk, where depositors are not interested in where or how their money is used, and where the federal government provides the insurance while dismantling the supervision over how the deposits are used. The test of market discipline is not the freedom to deploy assets without regulation or supervision, but whether inevitable losses are to be borne by the private sector or the taxpayer. Right now, there is no private sector potential loser. There should be one.

The crime, if that is the right word, is that few paid attention, in the early '80's, to the problem. It is compounded by the fact that, even now, little is being done to redress a quite distorted motivation and incentive structure. It will not be enough to increase the equity capital requirements. Sooner or later, they will be watered down.

I can't leave you tonight without a recollection of the antecedents of major banking problems: bad loans, moratoria and debt forgiveness. This whole business had its antecedents with Solon, the subtle Athenian lawgiver, who was born about 635 B.C. The "Athenian Constitution," a work attributed to Aristotle, but more likely written by one of his pupils, describes it this way:

"*...and he [Solon] made a cancellation of debts, both private and public, which the Athenians call the Shaking off of Burdens, since by means of it they shook off the weight lying on them.*"

Plutarch, writing some six hundred years after Solon, reminds us that little has changed over the millennia:

"*...the Athenians were in the habit of disguising the unpleasant aspects of things by giving them endearing and charitable names and finding polite equivalents for them. Thus, they refer to whores as mistresses, taxes as contributions, garrisons of cities as guards, and the common jail as the residence. Solon, it appears, became a pioneer of this device, when he referred to his cancelling of all debts as a discharge. The first measure which he put into force decreed that existing debts were wiped out...*"

Indeed, even the "menu" approach, including a devaluation of the value of money, apparently has its antecedents in ancient Greece. Again, Plutarch writes:

"*Some writers, however, Androtion among them, maintain that Solon relieved the poor, not by wiping out their debts, but by reducing the interest on them, [and by] ...the rise in the value of money which took place at the same time.*"

[Solon] "...fixed the value of the mina at 100 drachmas, whereas it had previously

consisted of seventy-three. In this way, although the actual amount of payment remained the same, its value was less, so that the debtors received a substantial benefit *without their creditors being any the worse off.*" (Oh?)

This business of debt forgiveness was not an incidental matter in Solon's life. Indeed, Plutarch tells us that the problem is said to have involved Solon in the greatest trouble of his life. It seems that Solon, having initiated such a far-reaching proposal, was expected to set the guidelines for the resulting redistribution of now unencumbered wealth -- a sort of nationwide debt-for-equity swap program. He wrote a poem instead:

"*They came for plunder, full of rich hopes,*
Each of them expecting to find great prosperity,
And expecting me to reveal an iron will behind my velvet speech.
Their talk then was vain; but now they are angry with me,
And all look askance at me as if I were their enemy.
It should not be. What I said, I have done with the help of the gods:
I did nothing in vain, nor was it my pleasure
To act through the violence of tyranny, or that the bad
Should have equal shares with the good in our country's rich land."

But rather than go off to a Greek island (he already lived there), he went off to Egypt for ten years, since it turned out that neither the debtors nor the creditors were very happy with him.

Solon even had to cope with the problem of inside information, for, unfortunately, he had confided his debt forgiveness plan to some intimate friends. Plutarch tells us:

"*They promptly took advantage of this confidence and anticipated the decree [debt forgiveness] by borrowing large sums from the rich and buying up big estates. Then, when the decree was published, they went on enjoying the use of their property but refused to pay their creditors. This affair gave rise to the most damning accusations against Solon and brought him into great discredit, for people could hardly believe that he was the victim of such a trick and concluded that he must have been a party to it.*"

Most ancient commentators say it was a bad rap, but his friends were forever after known as swindlers.

Solon had class. Aesop, the writer of fables, is reported to have had the following conversation with him:

"*I suppose, Solon, when we talk to kings, we should tell them either as little as*

possible, or else what they most want to be told." "*Not at all,*" *retorted Solon,* "*either as* *little as possible, or else what they most need to be told."*

It is in this spirit that I have written a poem:

On Forgiveness and Lending

These are mirrors of one another,
Choose the first or the latter
One or the other, it doesn't matter.
But if you reach to do the two,
Alas, bid prudence a fond adieu.

June 4, 1991