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LEARNING FROM ONE ANOTHER: THE U.S. AND EUROPEAN BANKING EXPERIENCE

by

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Learning From One Another:
The U.S. and European Banking Experience

> Learn from your mistakes but do not let
> them be your only source of knowledge.
>
> -- Anonymous

Introduction

In writing this article, we originally intended to draw out and discuss lessons that Europe could learn from banking experience in the United States. In analyzing European banking, however, we decided that U.S. policymakers had more to learn from the European experience than the other way around. Europe can still learn one important lesson from the U.S. banking experience, however: that government-provided financial safety-net system can undermine a healthy banking system.

Fewer geographical restrictions benefit banks by allowing them to better diversify their asset portfolios and reduce their risk of failure. Whereas European banks operate efficiently both inside and outside national borders, the U.S. banking industry is highly fragmented from state to state and is, consequently, inefficient. Despite great progress in the liberalization of branching laws and interstate banking laws recently, the characterization of the U.S. banking industry still includes numerous small banks that operate in small geographic areas, hold undiversified portfolios and are susceptible to failure.

European banks also demonstrate how expanded asset powers--the ability of banks to participate in nonbanking activities--allow banks to diversify their sources of income and reduce their risk of failure. In the U.S., considerable restrictions exist on the nonbanking activities of its banks.

And, although legislators and regulators are granting new banking powers on a piecemeal basis, a radical overhaul of product line restrictions has yet to occur.

Nowhere else are the effects of undiversified banking more apparent than in Texas. In 1985, the year in which the banking crisis in Texas began, the Houston metropolitan area (population 3.6 million) had as many banks as the entire nation of West Germany (population 61.0 million); the greater Dallas area (population 3.5 million) had more banks than France (population 55.0 million). More banks failed in Texas from 1985 to 1990 (454 banks) than existed in France, West Germany or the United Kingdom.

Exacerbating the problem of Texas'--and now the nation's--undiversified banks are the perverse incentives inherent in the government-provided financial safety nets for banks and other U.S. depository institutions. From this U.S. experience, Europe can learn a valuable lesson, or warning: poorly constructed safety nets can reduce the incentives for and the ability of banks to monitor their own risks resulting in less stability overall.

Development of U.S. Banks: Problems from the Outset

Problem One: Structure and Branching

Perhaps the most striking difference between European and U.S. banking is the geographical structure of their respective domestic markets. In Europe, a few large banks with extensive branch networks serve entire nations. And, with the impending changes in 1992, European banks will soon expand across national boundaries.

In contrast to the European experience, the banking structure in the United States reflects populist sentiment against large financial institutions and a misplaced concern that competition among banks produces a weak banking industry. These sentiments, which developed in the late 18th century, have persisted into the present and are reflected in national and state banking regulations. The result is a highly fragmented banking system with, arguably, no truly nationwide banking organizations. Distinguishing the system are the many small banks that operate in geographically isolated markets. As of September 31, 1990, there were 12,383 banks in the United States with total assets of nearly $3 trillion. Although the average bank held $241 million in assets, the nine large money center banks bias this figure upwards. The median asset size for a U.S. bank was only $45 million. Branches are still relatively rare in the U.S., with banks averaging only 5 branches each. In lieu of this, the existence of 5,425 unit, or single-office, banks in the United States is hardly surprising.

A brief examination of U.S. history illustrates how the nation developed such a fragmented or balkanized system. On two separate occasions, Congress initiated nationwide banking when it chartered the First and Second Banks of the United States. The charters were of limited duration (operating from 1791-1811 and from 1816-1836, respectively) and were not renewed. Both banks received a monopoly privilege to establish branches nationwide. This privilege provided them with a competitive advantage over existing state-chartered banks, which generally operated in a single state. Furthermore, because the U.S. government subscribed a large portion of the capital of these banks, politics influenced bank appointments and loan decisions. As a result, the concept of nationwide banking suffered from guilt by association with the real problems of monopoly power and political influence.[1]

To satisfy populist sentiment against big, nationwide banks, geographical restrictions became a part of U.S. banking structure to prevent banks from growing too large and obtaining undue political influence. The restrictions increased the difficulty of entering another bank's market. Existing banks, therefore, accepted the restrictions to gain protection from new competition. Those who believed that limiting competition was effective in preventing bank failures also supported geographic restrictions.

State laws restricting the branching of state-chartered institutions were the first type of geographical restriction. Many states passed laws that prohibited or limited branching to a small geographic area, such as a city or a county. When Congress reintroduced national bank charters in 1863, they prohibited the new national banks from establishing branch offices.[2] Eventually, with the 1933 amendment to the McFadden Act of 1927, national banks obtained the same branching privileges allowed state-chartered institutions located in the same state.

Over time, legislative and judicial decisions have eased many of these branching restrictions, and the majority of states now permit statewide branch banking. Still, 14 states permit only limited branching and 3 states do not permit banks to open branch offices at all.[3] In some cases, multibank holding companies have partially circumvented state branching laws, but the multibank holding company structure is an inefficient substitute for a branch network (Clair, Tucker and Siems, 1991).

The second geographical restriction prohibits banking organizations from operating across state lines. Interstate banking was permissible until 1956, though few organizations were developing extensive interstate bank networks at the time.[4] To cross state lines, banks formed multibank holding company that owned subsidiary banks in more than one state. Branching across state lines was virtually nonexistent because individual states determined branching powers, and one state did not have the power to authorize the operation of a branch located in another state. The Douglas amendment to the Bank Holding Company Act of 1956 prevented further interstate banking, unless specifically permitted by state legislation.

In 1978, Maine became the first state to pass legislation enabling interstate banking through the multibank holding company structure. Since then, 46 states and the District of Columbia have enacted some form of interstate banking legislation. Some states, however, limit interstate banking to a specific geographic region. Despite the proliferation of enabling legislation, nationwide banking is not yet a reality. The typical interstate multibank holding company operates in only two states. More than 80 percent of the 163 interstate bank holding companies operate in three states or less. First Interstate Bancorp, Inc. operates in the largest number of states but still has banks in only fourteen states. Even Citicorp, the nation's largest banking organization, has banking operations in only ten states (Clair, Tucker and Siems, 1991).[5]

The primary cost of geographical restrictions is increased bank risk caused by a lack of diversity. The 470 Texas bank failures during the 1980s are classic examples of the cost of an undiversified portfolio. These bank failures occurred while the U.S. banking industry was reporting profits. This suggests that, if a banking organization were well diversified across the United States, its profits elsewhere could have offset its losses in Texas.[6] By hindering their expansion into markets outside of their home state, geographical restrictions led Texas banks to concentrate heavily in energy lending and commercial real estate lending.

Problem Two: Separation of Banking and Commerce

Since 1933, U.S. bank regulations have restricted the nonbanking activities in which banks may engage. States also impose their own restrictions on state-chartered banks. Prior to 1933, banking organizations could enter nonbanking lines of commerce and many chose to do so. Commercial firms similarly conducted banking business. The typical organizational structure was a bank holding company with banking and nonbanking subsidiaries. The Glass-Steagall Act of 1933, however, mandated the separation of commercial and investment banking activities. The Bank Holding Company Act of 1956 further prohibited banks from entering into other lines of business that were not "so closely related to banking or managing or controlling banks as to be a proper incident thereto." Before this, bank holding companies owned such diverse business lines as insurance underwriting (including life, automobile, property and casualty) and insurance agencies; real estate development, sales, and management; oil development; title insurance; metals manufacturing; bottling; and catching, processing and selling fish and fish products.[7]

The current system of deposit insurance is the source of the confusion in ascertaining appropriate bank powers. To understand this, consider the following hypothetical case. Most people could not fathom that, as a matter of public policy, legislation should prevent grocery stores from offering certain products because of risk to their profitability. If the capital of grocery stores were underwritten with public funds, however, the question of whether the stores sold fresh vegetables or not would become a matter of proper public policy.

Proponents of these restrictions persist in justifying the action with several arguments. For the sake of clarity, it is best to separate the arguments that are opposed to mixing banking and commerce from those that oppose such a mix given the current structure of deposit insurance. Historically, the argument for separation has been based on potential conflicts of interest that can develop in an organization providing both commercial and investment banking services. The creation of banking/commerce conglomerates is often opposed because of the political influence such a large company would wield. Finally it is suggested that the commercial operations of such organizations would operate with an unfair advantage over their competitors that were not part of a banking/commerce conglomerate.

Financial firms are continually facing issues of conflict of interest, but banks are usually able to resolve these problems without the extreme response of exiting an entire segment of the financial markets. Following the stock market crash of 1929, the Senate held hearings on questionable financial practices by banks and their investment banking affiliates. Some problems did exist, but these problems were common to the entire investment banking industry and not unique to the affiliates of commercial banks. Consequently, separation of investment and commercial banking mandated in the Glass-Steagall Act of 1933 did not eliminate these problems, but only isolated them in the securities industry (White 1986). Furthermore, banks currently provide trust services which create potential conflicts of interests with other banking activity. Even commercial lending operations will create potential conflicts of interest because of lending to competitive firms or to firms that contract with each other. The crucial point is that banks find ways to resolve these conflicts of interests to the satisfaction of their customers without exiting entire lines of business.

The argument contended by critics of expanded bank powers is that allowing banks to grow into huge conglomerates could give them undue political power. If the populist argument is valid, however, it is valid for all industries. Yet policies to limit the growth of conglomerates in other industries do not exist.[8] Also, it is unclear whether an industry with many small firms but an effective trade association has less political clout than an industry with just a few big firms (Huertas, 1988).

The argument that commercial enterprises owned by banks or their holding companies would have a unfair advantage over other competitors is typically based on the idea that banks have some degree of market power and can set prices on credit. If this were true--and we do not believe it to be so generally--policy makers could better solve the problem by removing the barriers to entry that provide banks with market power in the long run. The greater competition would lower prices to all bank customers (Huertas, 1988). Further, among the "closely related" activities permitted for banks are mortgage banking, data services, and consulting. If they had an unfair advantage, banks would have driven their nonbank competitors out of these markets. Such has not happened, nor is it likely to.

Of course, a commercial enterprise owned by a bank might develop an advantage because of an economy of scope that exists in providing both banking and the commercial operation within one organization. An economy of scope, however, is hardly an "unfair" advantage and should be encouraged to reduce costs and benefit society.

The current structure of deposit insurance can also provide an explanation of a potential unfair advantage granted to commercial enterprises owned by banks. Federally provided deposit insurance could be a subsidy that banks could pass on to its commercial operations. Currently, however, it is likely that the value of this subsidy is passed on to bank depositors and borrowers through the effect of banking competing for their business. That banks are failing is some evidence that they are not retaining the value of the subsidy. If the subsidy is passed on currently, then competitors of a commercial operations owned by a bank could obtain the benefit of the subsidy from other competing banks. In any case, this problem is more an argument for restructuring deposit insurance than preventing the mix of banking and commerce.

Deposit insurance concerns crop up in other arguments against the mixing of banking and commerce. Some argue that a mix of the two could result in more bank failures because banks would be able to enter riskier activities. Such arguments, however, ignore the value of diversifying the income sources available to a bank. Based on modern portfolio theory, even a highly risky activity can be used to lower the variability of total earnings if its covariance with existing bank earnings is low or negative.[9] Furthermore, it should be clear to all that banks that so desire can take on sufficient risk to cause their failure without any new powers (White 1986).

Those who fail to see the value of diversification often argue that authorities should prevent banks from entering riskier lines of business if their funding sources are federally insured. This argument not only ignores the potential positive effects of diversification but also draws a fine distinction between the risky activity that banks already undertake and risky activity they have not begun. In the extreme, this argument suggests that perhaps banks should not make loans, as lending is a risky activity funded with insured deposits.

Learning From the European Experience

The contrast between the American and European banking experience could scarcely be sharper. The panoply of branching restrictions that characterize American banking is generally unknown in Europe, at least for commercial banks. What geographical restrictions exist tend only to come into play at national borders, and even these restrictions are already breaking down.

European banking regulations also typically grant a greater array of powers to commercial banks. Although a homogeneous structure does not exist across Europe, we can identify some generalizations. European banking has comprised two broad banking traditions (Lewis 1991, p.1). The universal banking tradition developed in Germany contrasts with the more traditional commercial banking approach taken in the United Kingdom. (The U.K. approach is closer to that taken in the U.S., though even the U.K. system is generally more liberal than the American.) As 1992 approaches, the U.K. and other European countries seem to gravitate toward the universal banking system. Contrary to this, until recently regulatory authorities in the U.S. have resisted the development of universal banking. Under Chairman Greenspan, the Federal Reserve System has relaxed restrictions on certain securities activities of commercial banks. But the scope for regulatory relief is largely exploited, and further asset powers await congressional action. As we write, it is by no means clear whether the U.S. Congress will vote enhanced asset powers for commercial banks (Garsson, 1991). Although the economic arguments favoring a system of universal banking are clear, the American political system has not learned the benefits to be derived from the European approach to banking.[10]

Developments in the European regulatory structure should foster further liberalization in banking. The principle of mutual recognition constitutes home country control over banking regulations.[11] This approach will tend to cause financial enterprises to domicile in countries with the most liberal banking regulations. This tendency will, in turn, cause other countries to reexamine their banking regulations and shape them along the lines of those crafted by more liberal governments.[12] The <u>political</u> competition to regulate banking and other financial firms will generate greater <u>economic</u> competition among these firms. The continued liberalization of regulations will free firms to enter into new activities and new areas.

In the United States, similar but more limited competition for banking exists within each state. In each state, the state banking regulator competes with federal banking regulators for the right to regulate banks. (This competition between state and federal authorities constitutes the "dual banking" system in the United States.) The absence of a principle of mutual recognition in banking among the states, however, severely limits the political competition.[13] In America, the state in which a banking firm or activity is proposed has the power to dispose of the application. Each state has the power to erect barriers to entry and liberalization. Until recently, most states chose to exercise this power. It is as if the states were in the situation of Europe before the White Paper.

Contrast the situation in the U.S. to the promise of Europe 1992, which will initiate home country control of diversified financial service firms.

The principle of mutual recognition will facilitate and hasten the liberalization of banking regulation compared to the slow pace in the U.S.

It is entirely possible that, in the 1990s, Europe, or at least the European Economic Community (EEC), will have freer trade in banking (and other services) than will the U.S. The difference between home country control and American-style banking regulation has potentially significant implications for competition. In America, each state can erect barriers to entry by "foreign" banking firms. The principle of mutual recognition -- an outcome of the Cassis de Dijon case -- will prevent this in Europe (Price, p.13).

Financial Safety Nets: Europe Take Heed

Although Europe illustrates for the United States the benefits of less restrictive banking, recent U.S. banking performance reveals one strong lesson for Europe. The debacle in the savings and loan industry is a product of bad public policy. Specifically, the American system of financial safety nets effectively encouraged excessive risk taking by depository institutions. The major share of the blame must go to the system of deposit insurance.

Since 1933, the U.S. government has underwritten losses on deposits in failed banks. Set initially at $2,500, coverage rose gradually to $40,000. In 1980, Congress raised the limits to $100,000. Within two years of raising the coverage limits, Congress gave savings institutions greater asset powers. Additionally, Congress accelerated the deregulation of interest rates paid for various categories of deposits.

The deregulation of deposit liabilities, along with the higher coverage limits, proved to be a deadly combination. Many savings and loans began to aggressively purchase insured (that is, guaranteed) deposits to finance rapid growth. In too many cases, rapid growth involved booking an unusually high percentage of bad assets, and thus losses. These institutions learned to finance past losses and continued growth by operating a Ponzi scheme with insured deposits (Kane, 1985, p. 159). Funds to pay for today's deposits would come from tomorrow's deposits. After years of operating in this manner, some institutions were paying daily operating expenses out of the daily quota of new deposits. In these cases, funds managers simply paid what was necessary to raise the funds required to keep the doors open.

Popular myth blames the industry's losses on the new asset powers granted to savings and loans in the early 1980s. This was not, however, the systemic problem in the industry. Some thrifts incurred losses by doing what they had always done -- financing long-term, fixed-rate mortgages with short-term funds. Other thrifts utilized new asset powers to diversify their portfolios, raising their overall returns. Rather, the systemic problem was the ability of thrifts to finance a "go for broke" strategy of rapid growth and reckless risk taking. The ability to finance this growth was the outcome of deregulating deposits and raising coverage limits without addressing the moral hazard inherent in the deposit insurance system (Kane, 1989).

Commercial banks have fared far better than the thrifts. Even recent difficulties in the commercial banking industry do not suggest that the problems will be anything like those experienced in the thrift industry. Superficially, the differing performance of the two industries lends credence to the idea that the thrifts' enhanced asset powers played a crucial role in their subsequent demise. (Commercial banks did not gain significant additional asset powers in the early 1980s.) But, what drove the thrifts to "go for broke" was the fact that so many of them were already broke or nearly so.

In the 1970s, high and variable inflation rates wrecked havoc with the traditional thrift strategy of borrowing short and lending long at fixed rates of interest. Average cost of funding rose above average rates of return in the industry. Hundreds of thrifts were driven into or near to insolvency. Regulators had neither the will nor the means to close all insolvent institutions (Kane, 1989). Institutions with little or no capital face an almost irresistible incentive to adopt a high risk investment strategy. They need to incur large risks in order to have a hope of garnering high returns. They are willing to make the gamble because, in a system of limited liability, there is no downside risk once capital is wiped out. Finally, and crucially, the institutions can finance the strategy because they are able to issue liabilities guaranteed by the government.[14]

We are witnesses to the recent failure of socialist economies in Europe. The failure reveals the impossibility of rationally allocating resources without market prices (O'Driscoll, 1989, pp. 348-49). In banking, public policy has injected an unhealthy dose of socialist practice into allocating investment funds. Blanket guarantees, like deposit insurance, anesthetize credit markets, dulling the senses to risk. With risk not priced, supervisory and regulatory judgments substitute for the unavailable information flows generated by price signals. By necessity, these judgments are categorical rather than incremental. Risks, returns and opportunity costs cannot be assessed at the margin because the market calculus is inoperative. The risk-based capital guidelines of the Basle Accord on Capital Measurement and

Capital Standards exemplify what happens when we substitute regulation for market pricing.

European banking does not, of course, operate with the same institutions and rules as does American banking. It would be understandable but unwise, however, for Europeans to be smug about the better performance of their banking system. European countries have been gradually adopting deposit insurance systems. The Second Directive on banking has called for harmonization of the various national systems.[15]

Moreover, deposit insurance is only the form taken by the policy of providing financial guarantees to banks. The policy can and does take many guises. In America, it also appears under the doctrine that some banks are "too big to fail." When such banks do become insolvent, public policy dictates that the central bank fund their continued operation until an acceptable resolution is devised. This policy increases the costs associated with the bank's failure, and shifts those costs from equity and bondholders to taxpayers.

With the size of its banking firms, Europe is more likely to adopt a policy of bailing out insolvent banks. To the degree they do so (or have already done so), European governments have sowed the seeds of American-style banking problems. As we write, the U.K. real-estate bubble bursts. The reports read like the early stages of what happened in Texas and, more recently, in New England. If this assessment is accurate, the British at least will be getting a taste of life in Dallas for the past five years. In this respect at least, Dallas life is best viewed from a distance.

The problem with governmental financial guarantees is that they do not eliminate but only shift risk. In banking, they typically do so by shifting risk from depositors and, sometimes bondholders or even equity investors, to taxpayers. In the process, they also greatly increase the total amount of losses incurred. They do so because, by interfering with efficient pricing of risk, financial guarantees permit too much risk to be incurred (given the expected returns). Looking at the Soviet economy, one marvels at how its agricultural sector can start with so much and end with so little. The same has been true of the American thrift industry, and for a similar reason. In each case, the pricing mechanism has been mucked up as a matter of public policy.[16]

Conclusion

As 1992 approaches, Europe's banking liberalization provides a valuable lesson for U.S. public policymakers. The European system offers a model of relatively free competition in financial services across national borders. This model will potentially result in a more open market than exists in the United States.

Recent U.S. banking experience unfortunately also provides a two-fold lesson for European policymakers. First, insolvent banks must be allowed to fail. Second, private economic agents must be exposed to losses from investing funds--whatever form that investment takes--in financial institutions. By encouraging excessive risk taking, the American system of deposit insurance has been a major contributor to the number of banking failures and to the magnitude of the losses incurred in those failures. American public policy towards banking and finance is one idea that ought to be stopped at the border.

1. See Clair and Tucker for details about the historical development.

2. In the United States, a bank must receive a charter from either the state or federal government. Those banks chartered by the federal government are referred to as national banks. Used in this context, the term national does not indicate that these banks operate nationwide.

3. North Dakota and Wyoming are both considered unit banking states, but both states have passed laws permitting the bank holding companies to consolidate their subsidiary banks into branch networks. Colorado is considering but has not yet passed branch banking legislation.

4. The exception to this statement was the Transamerica Corporation which held the Bank of America and a number of other banks primarily in other western states (James and James, 1954).

5. Citicorp provides banking services, especially some consumer products such as credit cards, in states where it does not operate a bank or branch. Its ability to provide full service banking, however, is limited to those ten states.

6. It is important to note that statewide branching is not sufficient to produce diversified bank portfolios. In Texas, many of the large bank holding companies failed despite their network of subsidiary banks located throughout the state. To some degree, these failures reflected poor lending decisions. But they also reflected the difficulty of diversifying the loan portfolio even in a state as large and as diverse as Texas. The problem is compounded in smaller states with less diversified economies.

7. See U.S. Congress., 1955 and Huertas, 1988. In the earliest development of bank holding companies, the banks were formed by established nonbanking enterprises in response to a lack of banking services being provided (Hyman, 1976). It might be argued that the restrictions on branching prevented some regions of the country from being well served by banks and encouraged nonbanking firms to establish banks.

8. Antitrust laws do exist to prevent monopolization of an industry, but these laws are not used to prevent the establishment of conglomerates. Permitting banks to enter new markets and industries and permitting nonbanking firms to enter banking would enhance competition not reduce it.

9. White (1986) offers a historical example. In studying the securities affiliates of commercial banks in the 1920s, he found that the addition of securities activities to commercial banks raised the banks rate's rate of return substantially but increased the standard deviation of income only slightly.

10. A system of universal banking still allows banking firms to limit themselves to traditional commercial banking activities if they so desire. Free competition allows for diverse organizational forms and, in large industries, one typically finds organizational heterogeneity. We would be surprised if U.S.- and U.K.-style banks did not coexist with universal banks in post-1992 Europe. We certainly see such coexistence in other industries, including among nonbank financial firms. If people prefer dealing with small, locally owned operations, some will surely continue to operate.

11. "La beauté de cette notion est sidérante. Les Etats-membres reconnaissent simplement qu'ils essaient tous d'atteindre les mêmes buts en édictant des normes nationales sur la sécurité, l'hygiène, la satisfaction du consommateur, etc., et admettent qu'il y a différents moyens d'y parvenir. Les fins sont communes, les moyens ne le sont plus" (Price, p.13).

12. In the United States, one sees this political or regulatory competition among states in their general laws of incorporation. States with liberal laws, like Delaware and New Jersey, have garnered a disproportionate number of corporate headquarters. This has compelled other states to liberalize their laws.

13. This absence is a great paradox. In almost all other areas, such a principle is enshrined in the Constitution. Article IV, Section 1 of the U.S. Constitution states that: "Full Faith and Credit shall be given in each State to the public Acts, Records and judicial Proceedings of every other State. And the Congress may by general Laws prescribe the Manner in which such Acts, Records and Proceedings shall be proved, and the Effect thereof." Section 2 of the Article states that: "The Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States."

14. Strictly speaking, the liabilities of the deposit insurance agencies were "moral obligations" of the federal government, but not backed by its full faith and credit. In practice, this was a distinction without a difference. While it might have been legally possible for the U.S. government to decline to honor the obligations of the agencies, it would have been politically impossible. Congress has since clarified the government's intention to stand behind these obligations.

15. See Bartholomew and Vanderhoff, 1990. In some cases, it appears that the introduction of deposit insurance merely formalizes an implicit governmental guarantee of deposits (Bartholomew and Vanderhoff, pp.9-11). M.K. Lewis has suggested to us (in private correspondence) that European central banks have deliberately made any financial guarantee ambiguous. By creating a degree of uncertainty about their intentions, the authorities have induced bankers to be more cautious than they would have been.

16. The analogy between American banking and socialist economies can unfortunately be extended even further. Kane (1985, p. 23) has found that "the federal government is already the leading supplier of equity funds to deposit institutions." As he aptly described the situation (Kane, 1985, p. 5), there has been "a de facto nationalization of the deposit institution industry" in the U.S.

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