

ATTACHMENT B

THE CHANGING FINANCIAL MARKETPLACE

Banking was a simpler business in the early decades of the Federal Deposit Insurance Corporation. Interest rates were regulated and stable. Competition from nonbanking companies was limited. Banks were the primary source of borrowed funds for even the strongest, best-established businesses. In more recent years, the financial services industry, technology and capital markets have evolved, creating new risks and new opportunities. Bankers have had to manage the risks, but the Glass-Steagall Act and other legislation limit the ability of bankers to mitigate risk by diversifying their sources of income.

Credit-risk exposure has increased dramatically since enactment of the Glass-Steagall Act. In 1935, approximately one-third of the industry's balance sheet was concentrated in assets that bear significant credit risk. Now, over 60 percent of banking assets are exposed to credit risk.

Beginning in the mid-1960s and lasting through the mid-1980s, the industry experienced rapid asset growth, typically exceeding ten percent per year. In that 20-year span, the assets of the industry increased nearly tenfold, from \$345 billion to almost \$3 trillion. This growth was achieved by increasing credit risk and decreasing the proportion of lower risk investments. During this period, commercial banks built up large portfolios of loans with concentrated credit risk including loans with large balances at risk to a single borrower.<sup>1</sup>

In 1935, about one-quarter of the balance sheet was invested in loans with "credit-risk concentrations." That level increased to almost 45 percent in 1984 (prior to the wave of recent bank failures), and has declined to 34 percent as of December 1994. Until the early 1980s, asset growth was fueled by commercial and industrial ("C&I") loans. C&I loan concentrations reached their highest level in 1982, peaking at nearly 25 percent of the industry's balance sheet. There were some notable lending excesses during these boom years, including real estate investment trusts, less-developed-country loans, and energy credits.

In the early 1980s, the largest commercial borrowers learned to bypass banks and replace loans from banks with lower-cost commercial paper. Burgeoning loan demand from energy-related businesses supported continued C&I loan growth for a time, but by

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<sup>1</sup>Credit-risk-concentrated loans include commercial and industrial loans, commercial real estate and construction loans, and loans secured by multifamily residential properties.

December 1994, C&I loans had declined to 15.4 percent of the industry's total assets.

When C&I loans began to decline, many banks turned to commercial real estate loans and construction loans for new -- but high risk -- profit opportunities. In the mid- to late-1980s, growing concentrations in commercial real estate loans and construction loans offset shrinkage in C&I loans. In 1976, commercial real estate loans and construction loans together comprised about five percent of the balance sheet. In ten years, the concentration increased to nearly nine percent of assets. It reached its highest level -- 11 percent -- in 1990. Banks were not the only providers of these loans. Savings and loan associations and other nonbank lenders also financed the speculative real estate development. Consequently, real estate markets in many regions became overbuilt, credit losses soared and commercial real estate loan demand diminished.

Loan growth since 1990 has been concentrated in loans where credit risk is more diversified. Credit card, consumer and home mortgage loans extend relatively small and often collateralized balances to a relatively large number of borrowers. Failure of a single borrower to repay does not have a significant impact on a bank's earnings or capital. Most of the growth in "credit-risk-diversified" loans has come from home mortgages. Concentrations in home mortgage loans have nearly doubled since 1984, increasing from 7.7 percent of the industry's balance sheet to nearly 15 percent as of year-end 1994. Credit card loans constitute 4.9 percent of assets and other "consumer" loans constitute 7.8 percent.

Beginning in 1990, the industry's risk profile began to change direction. Banks were able to take advantage of a widening difference between shorter- and longer-term interest rates to improve earnings while reducing credit risk. They shortened the average maturity of their liabilities and increased their concentrations of fixed-rate securities and residential mortgages. In effect, the industry replaced some of its credit risk with higher levels of interest-rate risk. The industry's asset composition has changed since the deregulation of deposit interest rates. In the early 1990s, the growth of investment securities held by banks -- primarily mortgage-backed instruments and U.S. Treasury securities -- accelerated. Market conditions also favored the growth of home mortgages, which have more than doubled since 1986, increasing from \$223 billion at year-end 1986 to \$568.9 billion as of December 31, 1994. While about 46 percent of these loans in the portfolios of banks carry adjustable rates, there is still interest-rate exposure, due to repricing lags, as well as caps that limit the amount by which the interest rates on the loans can increase.

In recent years, increased market volatility has made it more important for banks to manage risks other than credit risk, such as interest-rate risk, prepayment risk, and foreign-exchange risk. Banks have responded to this challenge by devoting considerable resources to asset-liability management and other risk management systems.

The tools for managing these risks have expanded considerably over the past decade, particularly with the increasing use of off-balance-sheet instruments such as swaps, options, and forward contracts. While smaller banks for the most part still use on-balance-sheet instruments to manage risk, these off-balance-sheet instruments have become an integral part of risk management for most large banks.

Banks are not only end users of these swaps, options, and forwards. Several large banks are major dealers of over-the-counter instruments. This activity has provided an important source of revenue and allowed these banks to respond to the needs of their customers. Nevertheless, a series of recent losses has raised concerns about the potential risks of these investments.

Record bank failures in the 1980s and early 1990s were quickly replaced with record earnings as the economy improved in a very favorable interest-rate environment. In the last ten years, the industry achieved both its lowest annual return on assets (about 0.09 percent in 1987) and its highest return on assets (1.20 percent in 1993) since the implementation of deposit insurance in 1933. Declining loan losses account for the wide swing in earnings. Declining loan-loss provisions have added roughly 25 basis points (pre-tax) to the industry's return on assets in 1992 and 1993, and 18 basis points in 1994. Interest margins have improved steadily since 1984, but these improvements have had relatively little impact compared with the reduced burden of loan-loss provisions. Ten-year growth in noninterest income has outstripped noninterest expense growth by a narrow margin, providing a relatively small boost to the industry's bottom line.

Bankers were not able to obtain expanded powers when the industry was in trouble, as in the late 1980s, owing to concerns about adding new potential risks to an industry struggling with existing risks. Now, opponents may argue that expanded powers are not needed, given the record profits the industry has reported for the last three years. Volatile swings in the health and performance of the industry may result in part from constraints that limit alternatives for generating profits. The data show that credit risk, interest-rate risk and competition have all increased since the enactment of Glass-Steagall. While the earnings trend recently has been positive, the wide swings in past performance indicate heightened uncertainty and increased risks in the industry.

### International Developments

Global competitive pressures also present a compelling need to reconsider the Glass-Steagall prohibitions between investment and commercial banking. Domestic financial deregulation in major industrialized nations, the development of new financial instruments, and advances in communication and computer technologies have contributed to the rapid integration of international financial markets during the past two decades. These changes in the financial marketplace, both domestic and international, have led several major industrialized nations to change their laws governing financial institutions, with the goal of creating a more level competitive playing field. In particular, there has been a growing worldwide trend toward easing traditional distinctions among the three major segments of the financial services industry -- commercial banks, investment firms, and insurance companies.

It should be noted that commercial and investment banking have long been combined in countries with universal banking systems, such as Germany and most of western Europe. Universal banks have the authority to offer the full range of banking and financial services -- including securities underwriting and brokering of both government and corporate debt and equity -- within a single legal entity, the bank. Although some financial services are provided through subsidiaries, the bank or financial services holding company structure is virtually unknown in other countries.

In contrast to the universal banking structure allowed in Continental European countries, Canada, Japan and the United Kingdom traditionally maintained barriers and restrictions against combining commercial and investment banking activities. These restrictions have been largely removed by legislation in each of these countries. For example, British banks were permitted to join the stock exchange in 1986 and to acquire or develop investment banking subsidiaries. These affiliations are important to the ability of British banks to compete within the European Union's single market.

Canada amended its laws governing financial institutions in 1987 and 1992, removing many of the statutory barriers separating banks, trust companies, insurance companies and securities firms, to allow greater latitude in bank ownership of institutions in the other financial sectors. As a result, most of the major Canadian securities firms are now owned by banks. Additionally, banks were permitted to offer more services "in-house," and to set up networking arrangements through which their branches sell the products of institutions in other sectors of the financial industry.

In 1992, Japan approved the "Financial System Reform Act," amending Japan's Securities and Exchange Law, and effectively removing the barriers between investment and commercial banking. By law since 1993, banks and securities companies have been allowed to enter each other's businesses through subsidiaries, although the establishment of securities subsidiaries by Japan's City Banks was delayed until July 1994. Additionally, the Ministry of Finance has elected to restrict the range of powers permissible for new subsidiaries of banks and securities firms. Thus, new trust banking subsidiaries are not permitted to manage pension funds and new securities subsidiaries of banks are only permitted to underwrite corporate bonds. In any event, Japan has had a moratorium on new equity offerings, with the exception of initial public offerings, since 1990.

As a result of these legislative changes in other countries, the United States stands alone among the 25 nations comprising the Organization for Economic Cooperation and Development (OECD) in continuing to impose domestic legal restrictions on affiliations between commercial banks and securities firms. Efforts to quantify the effect of these restrictions on the international competitiveness of U.S. banks are hampered by cross-border differences in accounting practices, tax laws, and other regulations governing financial institutions. Moreover, the data may be misleading due to currency fluctuations. Therefore, while we hesitate to provide any statistics regarding international competitiveness, some anecdotal evidence may be instructive.

Among the advantages of universal banking often cited are the cost savings derived from the ability to cross-sell a wider range of products and to offer highly-competitive products at a lower cost by subsidizing them with higher margins on less-competitive products. Universal banks may have a significant competitive advantage in customer loyalty through their ability to provide customers with all their financial services needs. Finally, universal banks have greater opportunities to spread risk and to smooth out income fluctuations in different areas of their business.

Not surprisingly, universal banks tend to be large and profitable institutions. The degree to which they dominate domestic market share varies according to the number, powers, and other structural characteristics of countries with universal banks. In Germany, for example, the four largest universal banks controlled less than 10 percent of total domestic bank assets in 1991; during the same year, the four largest Swiss banks controlled nearly 50 percent of domestic bank assets. These differences may be attributed to differences in their respective domestic markets: German banks directly compete with approximately 200 regional banks, over 700 government-owned savings banks, and nearly 3,000 cooperative banks, many of which

are also universal banks; in Switzerland, which has only about 600 institutions, most of the regional banks are small savings banks that specialize in mortgage lending.

There are several disadvantages inherent to universal banking as well. The one most often cited is the obvious potential for conflicts of interest among different areas of business. Another disadvantage is that capital markets are not as developed in countries with universal banking. It should be noted here that universal banks typically are permitted to own fairly sizeable equity positions in nonfinancial firms.

Banking and commerce links also exist in Japan, where banks are permitted to own equity investments in up to five percent in any one company. Studies comparing the German-style universal banking system and Japan's "keiretsu" form of industrial organization with the segmented U.S. banking system have concluded that the former may provide several important economic benefits. While these banking and commerce links no doubt have contributed to the industrial growth in these countries in the postwar era, they do raise serious concerns over concentration of power.

In Japan, these concerns are addressed through limitations on equity investments and the absence of bank personnel in the day-to-day management of nonfinancial firms. In contrast to Japan, where banks typically interfere only in cases of corporate distress, Germany not only permits banks to own shares, but also to serve on the supervisory boards of corporations and to exercise proxy rights over large blocks of shares through bank-managed portfolios. Other countries with universal banking have tended to curb bank control over industrial firms in recent years. Proposals to do so in Germany recently have been introduced as a result of the near-failure of several of Germany's nonfinancial firms.

These highly publicized cases were more of an embarrassment to Germany's major banks than a threat to their safety and soundness. These banks have been able to withstand losses due to their sheer size and strength, and to the very conservative accounting practices that allow equities to be carried at historical cost and allow banks to transfer portions of income to hidden reserves.

In fact, there are no cases in recent memory of a major bank failing in another country due to its securities activities or affiliations with commercial firms. The majority of banking problems in industrialized countries have been the result of traditional banking activities. For example, losses from foreign-exchange trading have caused isolated cases of bank failures, while real estate lending in "boom" years led to system-wide banking crises in the United Kingdom, most of the

Scandinavian countries and Japan, in addition to the well-known problems encountered by U.S. banks and savings and loan institutions.

If other problems have occurred, and no doubt there have been some, they have been dealt with quietly and effectively, without recourse to deposit insurance funds. This is largely due to the differences in the supervisory structure of countries that permit such affiliations, and to differences in failure-resolution methods and the role of deposit insurance. For example, while deposit insurance coverage is roughly comparable between the United States and Japan, the private sector plays a larger role in the operation of deposit insurance in many other countries. Consequently, the direct link to the government's "full faith and credit" is less explicit than in the United States. Major banks in other countries also are called upon more often to help in "bailouts" of other banks, voluntarily or otherwise, due to a traditionally close relationship with the central bank and more highly concentrated banking systems.

Given the greater potential for conflicts of interest between insured and uninsured functions, the governmental nature of deposit insurance in the United States, and the more dynamic and diverse financial marketplace in the United States, the universal banking model does not seem to be as suited to the current U.S. environment as other Models with which the United States has experience.