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THE CHANGING BUSINESS OF BANKING

In the 1980s, the banking industry and its regulators were hit by a series of economic shocks: the economy underwent periods of recession; energy prices fluctuated rapidly; the junk bond market collapsed; the stock market suffered a one-day plunge; and the agriculture, energy, and real estate sectors experienced rolling regional declines. The Congressional Budget Office's (CBO's) new study, *The Changing Business of Banking: A Study of Failed Banks from 1987 to 1992*, points out that although many of the problems that beset banks were externally induced, some of the industry's vital internal components--its managers and boards of directors--failed to meet the challenges.

Problems in the banking industry proliferated dramatically in the 1980s; the number of bank failures reached levels not seen since the Depression. From 1987 to 1992, during the peak years of the banking crisis, the Federal Deposit Insurance Corporation (FDIC) resolved more than 1,000 banks, at an estimated cost to the Bank Insurance Fund (BIF) of about $30 billion. CBO's study examines two important issues arising from this turbulent period: the major factors contributing to bank failures and the reasons that those failures resulted in such extraordinary resolution costs.

High and volatile interest rates during the late 1970s and early 1980s, coupled with advances in information processing, the study says, changed bank competition and depositor behavior fundamentally and irreversibly. By the end of the 1970s, market interest rates available on mutual funds attracted considerable amounts of money that depositors would have formerly placed in banks and thrifts. Moreover, blue-chip corporations, previously the mainstays of bank lending, defected during the 1980s for more favorable lending rates in commercial paper markets. As banks lost their traditional customer base and increasing competition chipped away at profit margins, many bank managers adopted excessively risky strategies in an effort to bolster their returns.

The higher losses on assets (and hence, higher costs of resolving banks) in the 1980s can be linked with riskier portfolios, but may also indicate less effective regulation. Because of the uncertainties inherent in identifying insolvency, the speed with which financial markets were changing, and the overwhelming number of banks that failed within a short period of time, bank examiners may not have been able to spot potential failures early enough to avoid additional losses through supervisory actions. In some cases, examiners identified severely undercapitalized banks but were unable to induce them to comply with corrective measures.

Concerned about the financial condition of the banking industry and ability of the BIF to cover losses from the alarming number of resolutions in the 1980s, the Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).

In 1992 and 1993, the banking industry, aided by a growing economy and favorable interest rates, earned record profits. In 1993, the FDIC resolved only 41 banks--a 10-year low. Today, the reforms of FDICIA and two years of record profits have reduced worries about the health of the banking industry. But if economic conditions change so that returns on interest rate spreads narrow, some banks could again be exposed to increased financial risk. The possibility that changing economic conditions may make the industry susceptible to periodic crises suggests an outlook of guarded optimism.

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