



Editorial

An overview of commercial banks: performance, regulation, and market value

1. Introduction

Commercial banks exist because of the various services they provide to sectors of the economy, e.g., information services, liquidity services, transaction cost services, maturity intermediation services, money supply transmission, credit allocation services, and payment services. Failure to provide these services or a breakdown in their efficient provision can be costly to both the ultimate sources (households) and users (firms) of savings, as well as to the overall economy. The affect of a disruption in the provision of the various services on firms, households, and the overall economy when something goes wrong in the commercial banking sector makes a case for the need to monitor performance and market value and to impose regulations that in turn affect bank performance and market value. For example, deterioration in a commercial bank's performance and value to the point that the bank fails may destroy household savings and at the same time restrict a firm's access to credit. Further, individual commercial bank failures may create doubts in savers' minds regarding the stability and solvency of commercial banks in general and cause panics and even runs on sound institutions. Although regulations may be beneficial to households, firms, and the overall economy, they also impose private costs that can affect the performance and market value of commercial banks.

This special issue of the journal is devoted to issues examining regulation, performance, and market value of commercial banks. The majority of the papers take a combined look at a specific type of regulation and how the regulation affects the performance and/or market value of commercial banks. Others look more specifically at the impact of a particular regulation on the commercial banking industry as a whole.

2. Regulations imposed on commercial banks

Five types of regulation seek to enhance the performance and value of commercial banks and thus the viability of the commercial banking industry. These include (1) entry regulations, (2) safety and soundness regulations, (3) credit allocation regulations, (4) consumer protection regulations, and (5) monetary policy regulations.

2.1. Entry regulations

Increasing or decreasing the cost of entry into a financial sector affects the performance and market value of firms already competing in that industry. Thus, the industries heavily protected against new entrants by high direct costs (e.g., through capital contribution) and high indirect costs (e.g., by restricting individuals who can establish commercial banks) of entry produce bigger profits for existing firms than those in which entry is relatively easy.

Wheelock and Wilson (*Consolidation in US Banking: Which Banks Engage in Mergers?*) examine issues associated with entry regulation and commercial bank performance. Specifically, this paper quantifies the regulatory, market, and financial characteristics that affect the probability of a bank engaging in mergers. The authors find that the regulatory approval process required for a bank merger is a real constraint on bank merger activity. For example, supervisory evaluations of bank performance and the quality of a bank's management significantly affect expected mergers. Further, in general the expected number of mergers falls with an increase in concentration of the market in which a bank is headquartered.

The study of commercial bank performance, regulations, and market value is, of course, not unique to U.S. banks. Canhoto (*Portuguese Banking: A Structural Model of Competition in the Deposits Market*) looks at the Portuguese banking industry and how the removal of entry barriers in the early 1990s affected competition in the deposits market. The results suggest that the Portuguese deposits market was operating under conditions that were far from perfect competition in the early 1990s. However, following deregulation progress towards more competition in the deposits market could be clearly detected.

In addition to defining who can and cannot establish a commercial bank, entry regulations define the scope of permitted activities under a given charter. The broader the set of financial service activities permitted under a given charter, the more valuable that charter is likely to be. Thus, barriers to entry and regulations pertaining to the scope of permitted activities affect performance and market value of a commercial bank.

Fields and Frasier (*Effects of IPO Mispricing on the Risk and Reputational Capital of Commercial Banks*) and Ely and Robinson (*The Impact of Banks' Expanded Securities Powers on Small Business Lending*) examine issues associated with regulations pertaining to the scope of permitted activities and bank performance and market value. Fields and Frasier look at commercial bank versus investment bank underwriting of IPOs. Their findings are supportive of the passage of laws that increased the scope of banks activities (i.e., regulations that repealed the Glass-Steagall Act). Specifically, they find that commercial banks are no more likely to misprice IPOs than are traditional investment banks, and that the market reaction to mispriced IPOs is not greater for commercial banks than for traditional investment banks. Further, Fields and Frasier find no evidence that commercial bank shareholders or the public are exposed to greater risk when commercial banks are allowed to underwrite securities.

Ely and Robinson look at whether the expanded underwriting activities allowed to commercial banks has resulted in greater small business lending at banks with securities affiliates. They find that small banks (with assets less than US\$1 billion) with a securities affiliate record lower portfolio proportions of small business lending than banks without a securities affiliate. For larger banks, the differences in small business lending proportions at banks with and without a securities affiliate are not statistically different. However, large banks with securities affiliates record significantly lower portfolio proportions of total small business loans. It should be noted that in looking at the impact of entry regulations on small

business lending, this paper also addresses issues associated with credit allocation regulations (see below).

2.2. Safety and soundness regulations

To protect depositors and borrowers against the risk of commercial bank failure, regulators have developed layers of protective mechanisms. These mechanisms are intended to ensure the safety and soundness of the commercial banks and thus to maintain the credibility of the bank in the eyes of its borrowers and lenders. In the first layer of protection are requirements encouraging commercial banks to diversify their assets. For example, banks are required not to make loans exceeding 10 percent of their own equity capital funds to any one company or borrower. The second layer of protection concerns the minimum level of capital or equity funds that the owners of a commercial bank need to contribute to the funding of its operations. The higher the proportion of capital contributed by owners, the greater the protection against insolvency risk to outside liability claimholders such as depositors. The third layer of protection is the provision of guaranty funds such as the Bank Insurance Fund (BIF). By protecting claimholders, when a commercial bank collapses and owners' equity or net worth is wiped out, these funds create a demand for regulation of the insured institutions to protect the funds' resources. The fourth layer of regulation is monitoring and surveillance itself. This involves on-site examination as well as a bank's production of accounting statements and reports on a timely basis for off-site evaluation.

While safety and soundness regulations help ensure that the performance and market value of a commercial bank is sufficient to maintain its viability as an ongoing concern, these regulations are not without costs for commercial banks. For example, regulators may require banks to have more equity capital than private owners believe is in their own best interests thus, decreasing the market value of the bank. Similarly, producing the information requested by regulators is costly for commercial banks because it involves the time of managers, lawyers, and accountants. Again, the incurrence of these costs is sure to decrease the overall performance of the commercial bank.

Chen, Robinson, and Siems (*The Wealth Effects from a Subordinated Debt Policy: Evidence from Passage of the Gramm-Leach-Bliley Act*) examine safety and soundness protection via minimum capital requirements by looking at the passage of regulations advocating a mandatory subordinated debt policy especially for large banks. They find that over the period of time in which the Gramm-Leach-Bliley Act was passed, a portfolio of banks with relatively high amounts of subordinated debt experienced positive and significant wealth effects. Portfolios made up of all banks, and those with no subordinated debt, however, experienced statistically insignificant wealth effects. The results suggest that policymakers should indeed consider the use of subordinated debt as a way to enhance market discipline and thus the safety and soundness of commercial banks.

Ors (*Post Mortem on the Federal Reserve's Functional Cost Analysis Program: How Useful was the FCA?*) examines monitoring and surveillance issues associated with safety and soundness of commercial banks. Ors looks at the now defunct Functional Cost Analysis (FCA) program sponsored by the Federal Reserve from the 1950s through the 1990s. Depository institutions voluntarily participated in the program, which was intended to provide detailed cost-accounting data (and therefore benchmark data) to bankers and regulators to assist in their decision making process. Ors assesses the costs and benefits of participation in FCA. The paper finds that FCA banks are not statistically representative of the universe of U.S. banks, but the differences are economically small. Further, participation in FCA adds little, if

any, improvement to performance. Thus, it appears that the Federal Reserve was justified in ending a subsidized service to commercial banks.

Kane (Continuing Dangers of Disinformation in Corporate Accounting Reports) also examines issues related to monitoring and surveillance. Kane points out that despite passage of the Sarbanes-Oxley Act of 2002 that requires top corporate officials to affirm the essential economic accuracy of any data their firms publish, officials of outside auditing firms are not obliged to express reservations they may have about the fundamental accuracy of reports they audit. The analysis stresses the weakness of social controls on interactions between the governance systems that prevail within corporations (including commercial banks) and the ethical codes of accountants and other external watchdog institutions.

2.3. Credit allocation regulations

Credit allocation regulations support the commercial bank's lending to socially important sectors such as housing, farming, and small business. These regulations may require a commercial bank to hold a minimum amount of assets in one particular sector of the economy or, alternatively, to set maximum interest rates, prices, or fees to subsidize certain sectors.

Booth and Booth (Deposit Insurance and Specialization in Commercial Bank Lending) examine differences in services provided by banks and other financial intermediaries as important for policy debates on bank credit allocation regulation. They find that the bundle of services (loan commitments and demandable deposits) that commercial banks offer makes them unique, and that access to deposit insurance assures banks a comparative advantage in providing these activities. Specifically, the analysis indicates that commercial banks have a funding cost advantage over other financial intermediaries in offering loan commitments due to their access to fixed-price deposit insurance. Thus, commercial banks' access to deposit insurance and the Federal Reserve's discount window provides them with a competitive advantage in this form of credit allocation.

2.4. Consumer protection regulations

Consumer protection regulations are intended to prevent discrimination and other unfair practices in lending. For example, the Fair Credit and Charge Card Disclosure Act of 1988 requires credit card issuers to disclose the annual percentage rate, fees, grace period, and method of calculating balances in all solicitations and applications. Consumer protection regulations are especially concerned about the assessment of unnecessary or unfair fees and charges for bank services as well as discrimination against commercial bank customers on the basis of age, race, sex, or income.

Berlin and Mester (Credit Card Rates and Consumer Research) examine consumer protection issues by looking at credit card interest rates. As the authors state, credit card interest rates have tended to be higher and stickier than other loan rates. Only over the past several years have these rates have fallen. Some have argued that the decline in credit card rates is due to the reduction of consumer search costs. In contrast, Berlin and Mester present evidence that suggests that search costs are probably not the best explanation for the drop in credit card rates over the past decade. Rather, the results suggest that stricter disclosure regulations for credit card providers may have less of an effect on equilibrium interest rates than intended.

2.5. Monetary policy regulations

A final motivation for regulation concerns the special role banks play in the transmission of monetary policy from the Federal Reserve (the central bank in the U.S.) to the rest of the economy. The problem is that the central bank directly controls only the quantity of notes and coin in the economy whereas the bulk of the money supply consists of deposits. In theory, a central bank can vary the quantity of cash or outside money and directly affect a bank's reserve position as well as the amount of loans and deposits it can create without formally regulating the bank's portfolio.

Wilson and Saunders (*Monetary Secrecy and Selective Disclosure: The Emerging-Market Case of Mexico's Monetary Reporting*) examine the behavior of Mexico's central bank as it implements and reports monetary policy. Specifically, Wilson and Saunders look at the frequency with which the Mexican central bank reports the details of its monetary activity. Through the early 1990s, the Mexican central bank publicly announced its monetary policies only three times per year. As a result of many factors, including mismanagement of the banking industry by the central bank, the Mexican economy collapsed in the early 1990s. In 1995, as part of an international aid package, the Mexican central bank was required to release weekly the details of its monetary activities, including changes to monetary policy regulations imposed on the banking industry. Wilson and Saunders examine the effects of this increased monetary policy reporting requirement.

3. Conclusion

Commercial banks perform several valuable services to sectors of the economy. The affect of a disruption in the provision of the various services on firms, households, and the overall economy when something goes wrong in the commercial banking sector makes a case for the need to monitor performance and market value and to impose regulations that in turn affect bank performance and market value. Although regulations may be beneficial to households, firms, and the overall economy, they also impose private costs that can affect the performance and market value of commercial banks. This special issue of the journal is devoted to issues examining regulation, performance, and market value of commercial banks.

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