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Efficient risk-taking and regulatory covenant enforcement in a deregulated banking industry

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Abstract

The deregulation of the U.S. banking industry has fostered increased competition in banking markets, which in turn has created incentives for banks to operate more efficiently and/or take more risk. We examine the degree to which supervisory CAMEL ratings reflect the *level of risk* taken by banks and the *risk-taking efficiency* of those banks (i.e., whether increased risk levels generate higher expected returns). Our results suggest that supervisors not only distinguish between the risk-taking of efficient and inefficient banks, but they also permit efficient banks more latitude in their investment strategies than inefficient banks. © 2001 Elsevier Science Inc. All rights reserved.

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1. Introduction

Over the last twenty years, a variety of measures aimed at deregulating U.S. commercial banking have been enacted. For example, intrastate and interstate branching restrictions have been substantially relaxed, interest rate ceilings on time deposits have been abolished, and

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thrift institutions have been permitted to enter product markets previously reserved for commercial banks. While the increased competition resulting from such measures can encourage banks to operate more efficiently, it can also increase banks' incentives to take risk, which can potentially threaten the safety of banks and the payments system.

Historically, barriers to competition supported banks' profitability, and the capitalized value of these profits increased the value of banks' charters. These high profits provided an important incentive for banks to limit their risk-taking to avoid insolvency and losing their valuable charters. But as increased competition has eroded both bank profits and charter values, banks have attempted to enhance their expected earnings by taking additional risk. The competition-induced incentives to increase risk can reinforce the already existing moral hazard incentives provided by the deposit insurance and discount window safety nets, which historically have not fully priced the risks that banks take. Thus, in a deregulated banking system, bank regulators face the challenge of monitoring and controlling banks' risk-taking, while at the same time not restricting competitive forces which can discipline banks and improve industry efficiency.

At the center of this regulatory challenge are banks' demand deposits—an unique form of demandable debt used by banks to finance their operations, and a key part of the economy's payments system. The regulation and supervision of banks' risk-taking protects the safety of bank deposits and, hence, the payments system. To a large degree, the role played by bank regulators is analogous to that of writing and monitoring debt covenants for the depositors, whose debt is not protected by standard covenants.[1] *Safety and soundness covenants,* such as minimum capital ratios and loan concentration limits, constrain banks' menu of feasible risk-return choices. When these safety and soundness covenants become binding, regulators can enforce *remedial* covenants, such as restricting asset growth or raising additional equity capital, that constrain the actions of banks further. Because *regulatory covenant enforcement* can impose substantial costs on banks that encounter financial distress, it provides an important incentive for banks to limit risk-taking.[2] If administered carefully, the threat of covenant enforcement can appropriately balance the risk-increasing incentives created by increased competition and mispriced safety nets.

Not all risk-taking is imprudent, and some banks are better at risk-taking than others. Banks that are more efficient risk-takers earn higher expected returns for the risks they take; that is, they enjoy a better menu of risk-return choices. Banks that are efficient risk-takers have a lower probability of experiencing financial distress, and have a higher probability of recovering from adverse exogenous circumstances that produce financial distress. Thus, effective regulation and supervision of commercial banks will distinguish efficient risk-taking from inefficient risk-taking, and will discourage the latter. In response to the risk-increasing incentives created by deregulation and increased competition, over the past decade bank regulators have introduced a number of measures that formally link the regulation of commercial banks to the level of risks they take. Risk-based capital requirements and risk-based deposit insurance premia are two prominent examples. More recently, regulators have changed the procedures for their annual examinations of bank safety and soundness to include an explicit assessment of banks' ability to manage risk.

In this study we look for evidence that, in formally linking regulation to risk, commercial bank regulators distinguish between a bank's level of risk and its efficiency at risk-taking.

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