Major international banks' performance: 1980–91

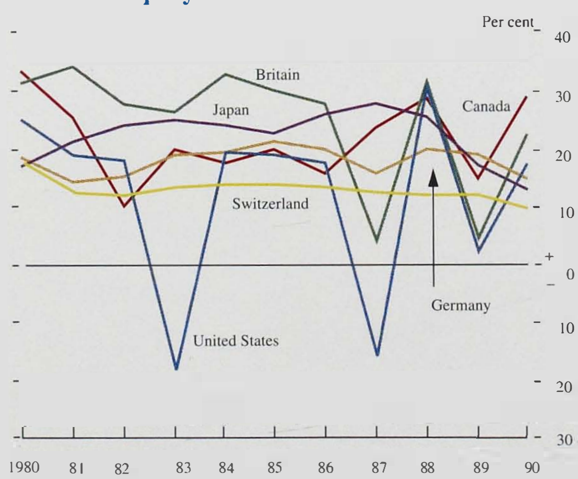
During the 1980s, deregulation and increased competition from other financial institutions and from rapidly developing securities markets altered the environment in which banks operated. These influences, together with wider economic developments, have had a significant impact on the banking sector's performance. This article[1] *describes the performance of major international banks throughout the decade, highlights common themes and divergences between countries, and assesses their implications. The main features of the 1980s were:*

- *Rapid growth in banks' assets, particularly in the mid to late 1980s, as financial markets liberalised and competition for international banking business grew. During the late 1980s, banks' assets in some countries grew more quickly than nominal GNP.*
- *A weakening in the profitability of most banks in recent years, as asset quality problems and competition intensified.*
- *Worsening asset quality, initially associated with the LDC debt crisis, and latterly with corporate and property-related lending in industrialised countries.*
- *A variety of responses by banks to developments over the past decade including: capital raising, better loan pricing, international retrenchment, cost reductions and a shift towards non-interest business and niche strategies.*

Overview

During the 1980s, banking and financial markets grew rapidly: for some countries in the late 1980s, banks' assets grew more quickly than nominal GNP. Over the same period, the performance of major international banks varied considerably, both between and within countries,[2] and by size and type of institution. This diversity reflects varying economic conditions, as well as regulatory and structural differences. The 1980s, however, contained some common themes: in broad terms, major international banks either improved or maintained their return on assets in the early to mid-1980s, although their return on equity was more volatile (Chart 1). Latterly almost all banks have faced growing pressure on profits (Table A); a common feature behind this worsening profitability has been a deterioration in asset quality.

Chart 1
Return on equity (a)



Source: Banks' annual accounts.
(a) Equity = share capital and reserves.
Return = pre-tax, net of bad debt charges.

It is difficult to compare *levels* of profitability across countries because of national accounting and taxation differences; for instance German, Japanese and Swiss accountancy conventions tend to smooth year-to-year earnings fluctuations (in the case of Germany and Switzerland via transfers to and from hidden reserves). By contrast, British, Canadian and US bank earnings, with less scope for smoothing, all tended to be more variable during the 1980s.[3] Nevertheless, provided that tax and accounting

(1) Written by Graeme Danton in the Bank's Industrial World Division.
(2) This article classifies countries' banks according to their nationality of ownership, not by the location of their business. The data are mainly from: *Bank profitability 1980–90*, (OECD), *International Banking and Financial market Developments*, (BIS) and from banks' annual accounts. Except for the United Kingdom and Canada, the OECD data are non-consolidated (ie they exclude earnings from overseas subsidiaries): the annual accounts data are consolidated for British, Canadian, French, German and US banks. Financial years differ, typically ending on 31 December but ending on 31 October for Canadian banks and 31 March for Japanese banks.
(3) For a detailed analysis of British banks' performance see 'The performance of British banks 1970–90' by Richard Colwell in the November 1991 *Bulletin*.

policies have remained broadly stable, it is possible to analyse cross-country trends in banks' performance.

Table A
Pre-tax return on assets

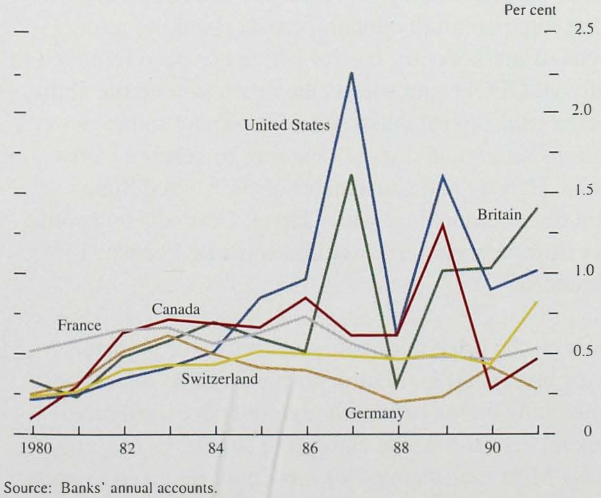
Per cent

	1980–82	1983–85	1986–88	1989	1990	1990(a)	1991(a)
Britain	0.99	0.88	0.93	0.03	0.50	0.50	0.36
Canada	0.48	0.76	1.02	0.70	1.22	1.24	1.14
France	0.34	0.21	0.32	0.35	0.31	0.37	0.31
Germany	0.50	0.92	0.83	0.92	0.83	0.51	0.55
Italy	0.82	0.48	0.72	0.83	0.90	0.72	0.59
Japan	0.40	0.46	0.60	0.46	0.33	0.20	0.15
Norway	0.63	0.80	0.03	0.17	-1.02	-1.33	-4.33
Sweden	0.36	0.38	0.77	0.47	0.22	0.45	-0.34
Switzerland	0.62	0.69	0.68	0.68	0.53	0.53	0.64
United States	0.83	0.78	0.98	0.62	0.59	0.70	0.65

Source: For countries other than the United Kingdom, 1980–90 data corresponding to large banks in each country are supplied by the OECD; data in columns (a) comprise a different sample. UK data comprise the 'Big Four' clearers.
Note: Returns are net of bad debt charges.

The less developed country (LDC) debt crisis was a dominant influence on banks' performance during the 1980s. In the mid to late 1970s, major international banks, primarily in the United States and the United Kingdom, but also elsewhere, sharply increased their lending to LDCs: the stock of total cross-border bank lending to Latin American countries approximately doubled between March 1979 and March 1982.(1) The onset of the debt crisis in 1982 led to a sharp contraction in new bank lending to the region and precipitated a long period of credit downgrades for the most heavily exposed banks. But the most visible effect on bank earnings occurred in 1987 and 1989 when large banks, principally from the United States, the United Kingdom and Canada, made large write-offs against their LDC loans (Chart 2).

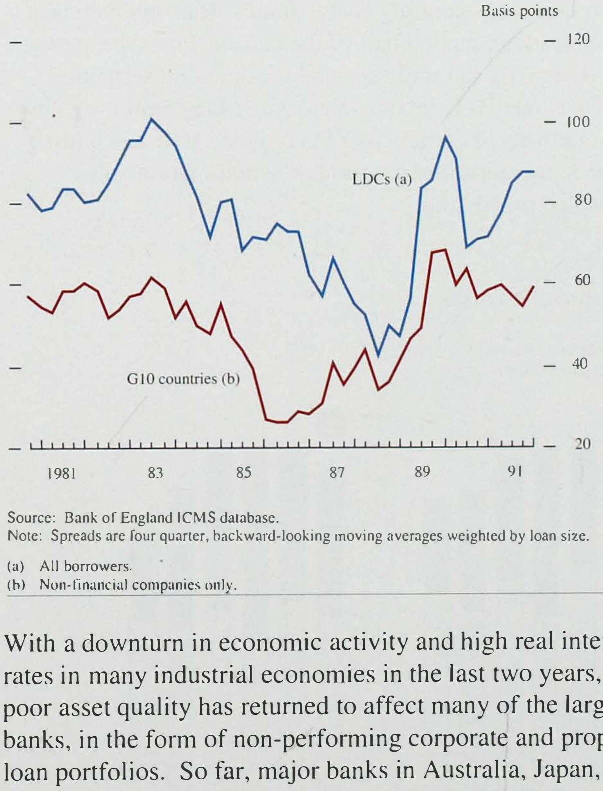
Chart 2
Bad debt charges as a percentage of total assets



Source: Banks' annual accounts.

The mid to late 1980s saw rapid growth in lending to borrowers from industrialised countries, at a time when other financial institutions and capital markets were beginning to compete more effectively with banks as sources of funds. In a number of major countries, notably Japan, the United Kingdom and the United States, the long economic expansion of the 1980s, combined with rising share and property prices, helped fuel the demand for credit; and banks, competing in an environment in which they were no longer subject to a variety of controls (eg credit ceilings or interest rate controls), met part of this demand. But, partly because of their own reduced credit ratings, the strongest growth in banks' lending was often to relatively more risky sectors, while higher quality borrowers were switching to direct funding via securities markets, where they could obtain finer terms than from lower-rated bank intermediaries.(2) Banks increased their participation in highly leveraged transactions (HLTs)—financing mergers, acquisitions and management buyouts—and increased their exposure to the property sector; in both cases lending decisions appeared sometimes to be based on an expectation that relatively benign economic conditions would continue. At the same time, aggressive expansion by many large international banks contributed to a narrowing of spreads in the mid to late 1980s (Chart 3), and encouraged some banks to lend in areas where they were relatively unfamiliar with the risks in an attempt to improve returns.

Chart 3
Spreads paid on international syndicated credits



Source: Bank of England ICMS database.
Note: Spreads are four quarter, backward-looking moving averages weighted by loan size.
(a) All borrowers.
(b) Non-financial companies only.

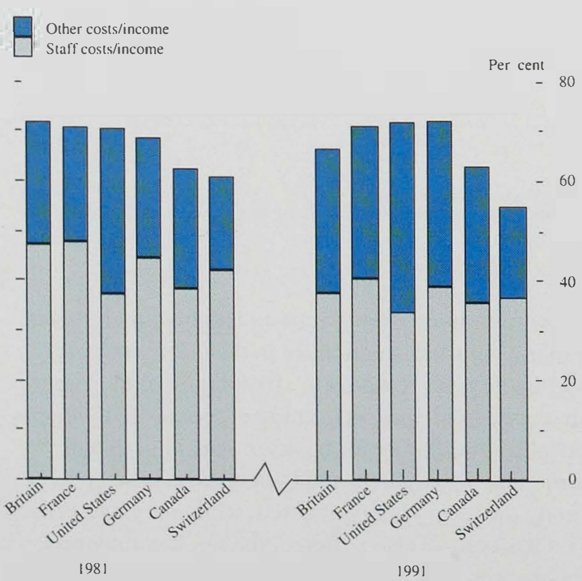
With a downturn in economic activity and high real interest rates in many industrial economies in the last two years, poor asset quality has returned to affect many of the larger banks, in the form of non-performing corporate and property loan portfolios. So far, major banks in Australia, Japan, North America, Scandinavia and the United Kingdom have been among the most visibly affected, while the large French and Swiss banks have also suffered, though less intensely. Bad debt charges as a share of assets were high at many large banks in 1990 and 1991, although there were differences in severity and timing between countries (Chart 2).

(1) See 'The LDC debt crisis' by M J Dicks in the November 1991 *Bulletin*.
(2) In the United States, special purpose funding vehicles have been established by large, high-quality corporates, some of which account for a substantial proportion of the funds issued in the US commercial paper and corporate bond markets.

Responses to deteriorating asset quality and earnings have varied. After 1982, banks attempted to restructure and reduce their exposure to LDCs. More recent problems associated with overcapacity in some highly-competitive segments of the international banking market have led some banks to withdraw from, and/or refocus their activities in, foreign industrialised countries. Banks have also reduced exposure limits to highly-geared sectors. Moreover, the progressive introduction of Basle capital adequacy ratios from 1988 [1] added to the increasing pressure on banks' return on assets, and led them to raise margins, to securitise more assets, and also to raise more capital—via issues of equity and debt or by selling 'non-core' assets. In response to longer-term pressures from other financial institutions and capital markets, banks from some countries have taken advantage of deregulation and structural change to boost their earnings from fee-earning corporate and consumer business and from securities underwriting and trading, though the latter has not always met with success.

At the same time, most large international banks made only limited progress in reducing cost/income ratios during the 1980s (Chart 4). Operating costs still consume more than 60% of most banks' total non-interest and net interest income, with staff accounting for the largest element of banks' costs: in 1991 staff comprised 56% of the 'Big four' British clearers' operating costs. Banks' staff numbers and costs rose in the second half of the decade, however, partly because activity in retail financial services and securities markets is relatively labour-intensive. Many banks are now making efforts to curtail costs via reduced staff and branch numbers, mergers, and investment in automation and centralised processing.

Chart 4
Cost/income ratios



Source: Banks' annual accounts.
Note: Income = net interest + non-interest earnings, pre-tax.

While many of the world's *largest* international banks suffered from the LDC debt crisis and from non-performing commercial real estate and corporate loans, banks in some of the smaller countries, and smaller banks in some of the major countries, have been much less affected. In the United States, for example, small and medium-sized banks, particularly in the south and mid-west, were far less affected by loan losses either to LDCs or latterly to commercial real estate: in 1991 small and mid-sized US banks made net charge-offs equivalent to 0.7% and 1.4% of loans respectively, compared with 2.4% for the country's ten largest banks.[2] Elsewhere, indigenous banks in countries such as Portugal, Spain and south-east Asia benefited from buoyant economic growth in the late 1980s combined, in some cases, with a desire by governments to protect domestic institutions and financial stability by liberalising the financial system gradually.

The following sections consider the regulatory, structural and conjunctural factors which have influenced major banks' asset growth, profitability and cost structure during the 1980s.

Regulatory influences

Overall, the dominant trend of the decade was one of *deregulation* of the extent of banks' permitted activities, accompanied by a strengthening of prudential regulation. Differences between countries' regulatory frameworks, and the intricate and constantly evolving nature of regulations within countries, make it difficult to disentangle the 'net' effect of regulatory influences on banks' performance.

In countries where deregulation occurred slowly, banks were sometimes afforded a degree of prolonged protection from overseas and domestic competitors—although over the long term such protection may serve only to entrench a high cost, and therefore potentially uncompetitive, banking sector. One type of market entry barrier which has been removed in virtually all OECD countries is the restriction on the ability of foreign banks to establish subsidiaries; but rather more restrictions remain on direct branching by foreign banks. Australia, Canada and some states of the United States prohibit direct branching, while Japan, Germany and some smaller European countries require separate licences for each branch.[3]

Controls on the price or quantity of credit, for monetary policy or prudential regulation purposes, have sometimes benefited indigenous banks (though not necessarily their customers), by prolonging cartel-like structures in some markets. Most major countries have now removed interest rate and quantitative credit controls (in part because the pressures for deregulated and open capital markets lessened the effectiveness of such controls as tools of monetary management). The United Kingdom was one of the earliest

(1) Under the Basle agreement, international banks' capital: risk-weighted asset ratio must reach a minimum of 8% by end-1992 (or end fiscal year, March 1993 for Japanese banks): 4% of banks' capital must be 'core' in the form of common equity, perpetual preferred shares or reserves. The requirements are detailed fully in *International convergence of capital measurement and capital standards*. BIS July 1988.
(2) Source: 'Recent Developments Affecting the Profitability and Practices of Commercial Banks', *Federal Reserve Bulletin*, July 1992.
(3) Source: 'Banks Under Stress', *OECD*, 1992.

countries to liberalise, with the introduction of Competition and Credit Control in 1971 and the abolition of exchange and most remaining credit controls in 1979–80. In 1980, the United States initiated the elimination of interest rate ceilings on all deposit accounts (except demand deposits) and by the early 1980s, Regulation Q had become largely irrelevant. Among other large countries, interest rate controls in France and Switzerland were removed relatively late in the decade. Deregulation is still continuing in some countries: in Japan, domestic deposit rate deregulation started in 1985 and is expected to be completed by 1994. Differences in the timing of the removal of these price and quantity controls have affected competitive conditions in different banking markets in the 1980s.

The experience of some banks from Norway, Sweden and Finland provides a vivid example of the effect of deregulation on credit growth and asset quality. In Norway, for example, the removal of banks' credit ceilings, the existence of tax-deductible interest payments (subsequently removed) and, prior to 1986, a buoyant oil economy, contributed to growth in credit demand of 15%–25% per annum in 1986 and 1987. Swedish banks witnessed a broadly similar deregulatory background and between 1985 and 1990 their assets more than doubled. The subsequent asset quality problems faced by some Nordic banks are not merely the result of interest rate and credit deregulation; they also reflect a broadly-based downturn in their economies.

In some circumstances, regulations may have weighed on domestic banks by limiting the scope of their activities. In particular, throughout the 1980s, US and Japanese banks were restricted in their *domestic* securities activity, thus affecting their ability to diversify earnings as traditional bank intermediation became less competitive. In the United States, however, barriers between banks and securities markets have been lowered progressively, enabling commercial banks to conduct trading and limited underwriting of domestic securities.(1) In Japan, bills to reform Article 65 were passed recently, allowing banks and securities firms to enter each others' business through subsidiaries and removing barriers between different types of bank.(2) Some banks from the United States and Japan also participated in underwriting and trading in foreign securities markets, where the restrictions did not apply. Over the last two years, for instance, US banks have offset poor domestic loan portfolios by improved earnings from overseas capital market subsidiaries, against a background of falling US dollar interest rates which have boosted underwriting and trading profits at securities firms and capital market subsidiaries worldwide. However, competition in securities markets, particularly the London-based euromarkets, has been intense; a number of foreign and domestic firms which invested heavily in securities business following 'Big Bang' in 1986 have withdrawn from, or scaled back, certain activities as overcapacity contributed to a narrowing of margins.(3) For example, some firms no longer underwrite or distribute certain eurosecurities and/or have scaled back their syndicated loan departments.

Banks from countries such as Germany, Switzerland, France and the United Kingdom are permitted to engage in a fuller range of retail and investment services than their US and Japanese counterparts. The ability to conduct so called 'universal banking'—the combination of traditional banking with securities and insurance business—is cited as a long-held advantage of the German and Swiss banking systems. But, while greater scope to diversify *may* have contributed to the stability of German, Swiss and French bank earnings, accounting and taxation policies and, in the case of France, public ownership, have also been important. Arguably, 'allfinanz' has not been a major factor in determining cross-country performance, perhaps because its full potential has yet to be exploited and because the domestic securities markets in Germany and Switzerland are relatively small. Nevertheless, increased domestic and cross-border links between European banks and insurance companies in recent years suggest that some financial institutions foresee greater opportunities for 'allfinanz' in an integrated European financial market.

Regulation in the United States, in the form of the McFadden Act, prohibits interstate branching and has led to some regionalisation in the provision of banking services. Some states have arranged bilateral agreements allowing banks to establish or acquire subsidiaries across state lines, though subsidiarisation is more costly than direct interstate branching. Nevertheless, the restrictions have the effect that small and medium-sized banks in particular, but also some of the larger banks, are concentrated towards particular regions and industrial sectors. Localised economic problems, such as in the south-west oil industry after 1986 or in the New England property market in 1989–91, may therefore have had more deleterious effects on US bank earnings than if banks had been able to diversify their loan books.

Structural influences

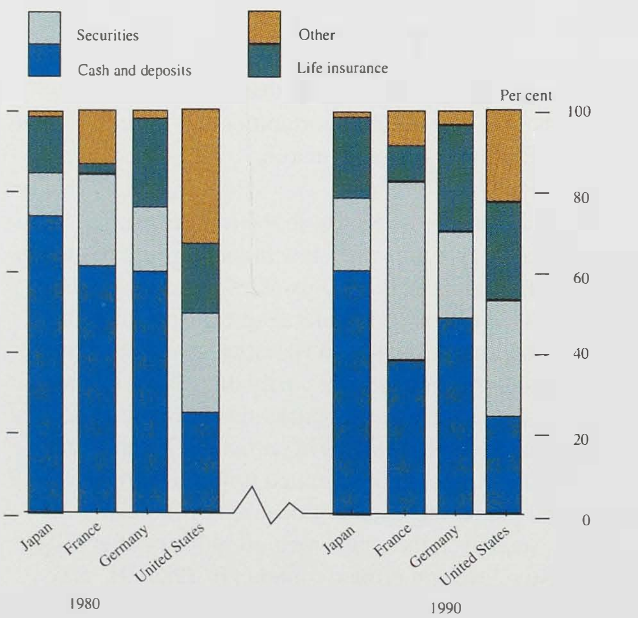
Structural influences have also affected performance. For example, traditionally close corporate-banking relationships in Germany and Japan may have restricted foreign banks' penetration of domestic lending, though foreign banks have sometimes captured niches where their domestic experience gave them an advantage; an example is foreign banks' success in treasury and foreign exchange business in Japan. In contrast, in the United Kingdom and the United States, foreign banks achieved greater penetration of the domestic corporate loan market, as companies, and to some extent

(1) In the United States the 1933 US Glass-Steagall Act prevents US commercial banks from underwriting and distributing securities. However, commercial banks' affiliates may conduct limited securities business in certain instruments, with approval from the regulatory authorities.
(2) Implementation of these reforms is expected in 1993. Banks have been able to underwrite and deal in Japanese government bonds since the first half of the 1980s.
(3) 'Big Bang' is the name given to the United Kingdom's stock market liberalisation of 1986; the principal features were the abolition of the distinction between specialist brokers and jobbers, the elimination of fixed commissions, and the influx of external capital and competition. Excess capacity was discussed on page 527 of the November 1989 *Bulletin*.

banks, encouraged the move to 'transaction banking' in which competition and the price of banking services became more important than traditional 'relationships'.(1) Between 1980 and 1991 the share of total outstanding UK bank lending accounted for by foreign banks rose from 26% to 35%; in the United States and Canada the stock of foreign-controlled domestic bank assets rose to around 20% and 12% in 1989, from 15% and 2% in 1983 and 1981 respectively.(2)

Among other structural influences, Japanese banks may have benefited from a relatively secure retail funding base reflecting regulated deposit rates, a high personal sector savings ratio (averaging 18% per year between 1980 and 1990 compared with around 10% in the United Kingdom) and a household sector which holds a higher level of its financial assets in cash and deposits than in France, Germany or the United States (Chart 5). Nevertheless,

Chart 5
Distribution of households' outstanding financial assets



Source: OECD.

Japanese banks' return on assets has been relatively low throughout the decade, partly reflecting a tendency, up until the late 1980s, to maximise market share by expanding internationally into low-return lending, and by borrowing and lending heavily in the interbank market.

State ownership, or the implicit state patronage of banks, has also affected the structure and performance of the financial sector in some countries. Public ownership in any industrial sector can prolong concentration and deter competition. In the banking sector, publicly-owned banks have benefited from cheap equity capital which other publicly-owned firms have sometimes been obliged to subscribe; and the implicit guarantee underpinning state-owned banks may have allowed them, formerly, to maintain lower capital:asset ratios than their private sector peers.(3) (Nevertheless, state intervention in banking has sometimes brought interference in lending decisions and hence inefficiencies, for example, by encouraging banks to lend at uncompetitively low spreads to state-backed industries.) Among large international banks, some French and Italian institutions are state-owned, although in 1991 and 1992 banking problems in Sweden and Norway led governments to nationalise some banks or to provide large capital injections.

The rapid growth of capital market finance, and the concomitant rise in the use of credit ratings, have had significant effects on banks' traditional intermediary role, notably perhaps in the United States and the United Kingdom where banking-corporate relationships were less strong. For example, the growth in the use of continuously offered commercial paper (CP) programmes allowed many large, highly-rated corporates, initially in the United States but latterly elsewhere, to raise funds quickly and more cheaply than from banks. In the United States, outstanding issues in the domestic CP market rose fourfold between end-1980 and end-1991 to $527 billion, making it one of the largest short-term securities markets worldwide. Although CP markets are much smaller in other countries, the euro-CP and Japanese CP markets both grew quickly after their opening in 1985 and 1989, to outstanding issuance of $80 billion and $99 billion respectively.(4) In Germany, a domestic CP market was permitted in early 1991, and is already growing quickly. The growth of CP and other short-term money markets have also put pressure on banks' liabilities. Large money-market funds(5) have been able to enhance returns, and hence their attractiveness to retail investors, by increasing their purchase of short-term, liquid, floating-rate assets such as CP which generally offer higher yields than bank deposits. (In the United States, there are no restrictions on interstate money-market funds, akin to the McFadden Act's interstate branching restrictions.)

Nevertheless, because banks often provide liquidity back-up to CP programmes (via letters of credit) and in some countries act as arrangers and dealers on CP programmes, the emergence of CP markets has contributed to banks' efforts to increase their fee-earning business. More generally, capital market developments have to some extent benefited banks by facilitating more flexibility in balance sheet management. The ability to sell loans, either by securitisation or via secondary market sales, has allowed banks to contain their balance sheet growth, while continuing to exploit their advantage in originating loans.

Asset quality

Asset quality problems occurred in two distinct phases in the 1980s. First, large provisions against LDC loans in 1987

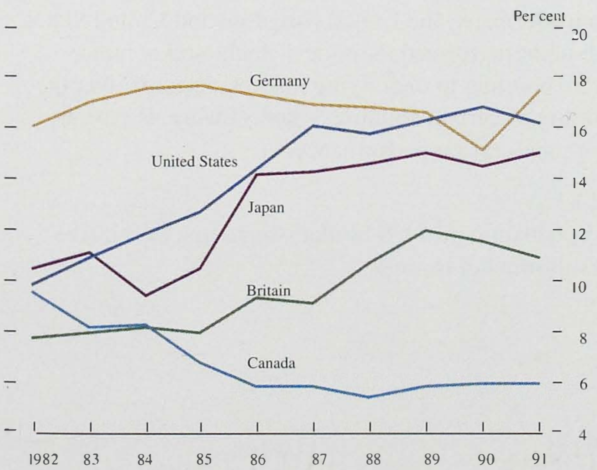
(1) See 'Corporate finance in the euromarkets and the economics of intermediation' by E P Davis and C P Mayer, *Bank of England Technical Paper No 45.*
(2) Canadian and US data from 'Banks Under Stress' *OECD*, 1992.
(3) The Basle Accord does not allow this to continue: the capital adequacy regime applies equally to privately and state-owned banks.
(4) Over the last year, outstanding ECP has remained flat, however, and the Japanese CP market has contracted.
(5) Money-market funds are mutual funds which invest solely in short-term money-market securities.

and 1989 reduced the profits of banks in the United States, and to a lesser extent the United Kingdom and Canada. Other countries' banks were affected less by provisioning in these years, reflecting a mixture of more prudent lending policies, fewer historical trading links, exchange rate movements and different accounting and taxation treatment which promotes timing differences over bad debt recognition.[1] Second, and more recently, deteriorating asset quality has been associated with property and corporate lending and, in some countries such as the United Kingdom, small business and personal lending. Recent asset quality problems have perhaps been most evident at Norwegian, and to a lesser extent Swedish and Finnish banks; in Norway some large banks reported losses for two consecutive years (Table A). Factors behind the recent deterioration in banks' asset quality are now considered in more detail.

(i) Property-related lending

Banks in many countries increased their exposure to property during the 1980s. Asset quality concerns, however, have been mostly related to lending to construction companies and property developers involved in the commercial real estate sector, rather than residential mortgage lending. Large international banks from Japan, the United Kingdom and the United States all increased their exposure to commercial real estate during the decade (Chart 6), as did some Nordic banks.[2] By contrast, Canadian banks' exposure to commercial real estate fell relative to their total loan stock, partly reflecting the greater geographic and sectoral diversity of their lending business, and also a significant rise in residential mortgage lending. Other countries' banks also increased their residential mortgage lending over the decade. In the United Kingdom, banks began competing for building societies' mortgage business in 1981. More recently, in the United States, banks increased their residential mortgage lending following problems in the savings and loan industry and because of the low risk weight applying to qualifying residential mortgages.[3]

Chart 6
Banks' commercial real estate exposure [a]



Source: National statistics.
Note: German data are collected on a slightly different basis than other countries and are therefore not directly comparable.
(a) Outstanding loans to construction and property companies as a share of total non-bank lending by nationality of bank. The data do not cover banks' indirect commercial real estate exposure, for example where bank loans to finance companies are on-lent.

Relatively low interest rates around the middle of the decade, and earlier deregulation of the supply of credit, contributed to increased lending for property development, aided by over-optimistic projections of the demand for office space during a period of rapid economic growth. During the last two years, commercial and residential property values have fallen sharply, although falls have often been restricted to particular regions within industrialised countries (such as London and the south-east of England, east and latterly west coast United States, Toronto, Tokyo and major conurbations in Australia and Scandinavia). In the United Kingdom and the United States, office vacancy rates rose as recession reduced the demand for office space, at a time when developments begun in the mid to late 1980s were nearing completion, and counterinflationary monetary policies were contributing to a readjustment of property prices. In some regions, falling property values were also associated with the puncturing of a bubble of speculative investment in land. Falling property values and higher vacancy rates undermined the viability of development projects, increased the indebtedness of many borrowers and reduced the value of banks' collateral, leading to increased provisions and write-offs and downward pressure on banks' profitability. Through their international lending, foreign banks were in many cases heavily exposed to property-related borrowers.

(ii) Corporate and other loans in industrialised countries

Counterinflationary policies adopted towards the end of the decade, combined with the increased indebtedness of many borrowers in industrial countries, contributed not only to an increase in banks' non-performing real estate loans but also to a more general rise in bankruptcies in many major countries and to an increase in loan losses to corporate, small business and personal customers. At least three factors have exacerbated the problems associated with banks' business loan portfolios during this recession. First, many corporate and small business loans are secured on a depreciating asset (ie property). Second, in the mid to late 1980s many banks provided increasing quantities of funds to large companies for highly-leveraged merger and acquisition (M and A) activity: in 1988 and 1989 approximately 36% (or $100 billion) of the funds intermediated in the international syndicated loan market financed mergers and acquisitions. Spreads on such loans were fine, averaging 25 basis points over Libor, compared with spreads of 35 basis points for non-merger-related corporate loans[4] (although fees were often a lucrative source of additional income in M and A

(1) In the case of Japan, the appreciation of the yen after 1985 reduced Japanese banks' LDC exposure substantially in local currency terms.
(2) Banks in some counties also have indirect exposure to property developers and construction companies which is less easy to measure. This is evident in Japan, for example, where loans to the less regulated 'non-bank bank' sector (including finance and leasing companies) were often on-lent for commercial real estate projects.
(3) See 'Recent Developments Affecting the Profitability and Practices of Commercial Banks' *Federal Reserve Bulletin*, July 1991.
(4) The spreads quoted were paid by non-financial companies in OECD countries on announced internationally syndicated loans, and are weighted by the size of loan.

finance). It is an open question whether such returns were adequate compensation for the risk borne by the lender in changed economic circumstances in which the high level of indebtedness taken on by the acquiring company became increasingly burdensome. Third, although many top quality corporates still raise funds from both capital markets and banks, disintermediation meant that towards the end of the decade a growing proportion of banks' loans were probably to lower quality borrowers.

As property values have fallen, both corporate and property-related borrowers have faced problems. Gearing has increased, causing some borrowers to breach their banking covenants and to seek to renegotiate and restructure their debt. This has highlighted the difficulty in renegotiating loan agreements among large numbers of banks, many of which have small individual exposures and little direct knowledge or historical relationship with the borrower.[1] (The growth of the international syndicated loan market in the second half of the 1980s brought a number of new banks into the market.) In general, such bank syndicates have been amenable to debt restructurings where there is a realistic possibility of enhancing their long-term asset value. Nevertheless, the problems of renegotiation and loss of relationship inherent in large syndicates have caused many corporates and banks to revert to bilateral funding during the last two years.

(iii) Exposure to Eastern Europe

Developments in Central and Eastern Europe over the last two years have highlighted western banks' exposure to the region and provoked some commentators to draw parallels with earlier LDC loan problems. But the scale of banks' exposure is far less than to LDCs: at end-1991 the aggregate stock of banks' cross-border lending to Eastern Europe and the former Soviet Union (FSU) totalled $92 billion, compared with $186 billion to Latin American countries. In addition, a large part of bank lending to the FSU is guaranteed by western governments which, although merely *transferring* the risk of borrower default to governments, provides security for the banks. German banks have the largest exposure to the FSU, although French banks are believed to have a similar level of non-guaranteed lending, at around $5 billion at June 1991.[2] Nevertheless, although cross-border lending exposure to Eastern Europe is low, banks, particularly from Austria and Germany, continue to support the region in less capital-intensive ways by extending and establishing advisory services and forming alliances with indigenous banks.

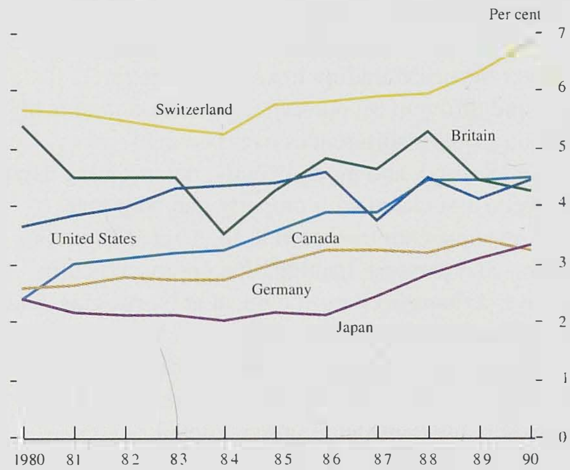
Responses to pressures on performance

Growing competition and deteriorating asset quality induced a variety of responses. Four broad trends stand out.

(i) Improved capitalisation and better risk-pricing

Despite high bad debt charges towards the end of the decade, large banks in most industrialised countries ended

Chart 7
Core capital/asset ratio (a)

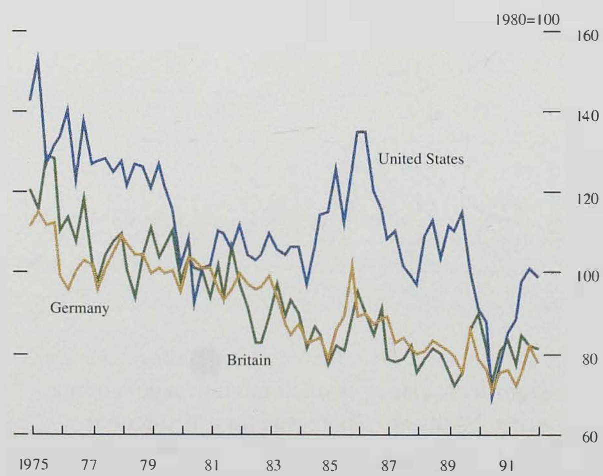


Source: Banks' annual accounts.

(a) Core capital = shareholders' equity and reserves, and is not the same as Tier 1 capital under the Basle Accord. Assets are not risk-weighted.

the period with higher core capital:asset ratios than in 1980 (Chart 7). The introduction of Basle capital adequacy guidelines in 1988, to be implemented fully by end-1992, focused banks' attention on improved capitalisation and at various points throughout the decade international banks have bolstered core and supplementary capital via equity and debt issues. For example, rising bank equity prices and improving sentiment towards some institutions allowed a number of banks to increase their debt and equity issues over the last two years, and to borrow in a wider range of markets, (eg foreign and domestic preference shares, profit participation certificates and subordinated debt issues). Over the long term, however, aggregate bank share price indices in Germany, the United Kingdom and United States have all underperformed their local stock market indices (Chart 8), pointing to underlying market concerns over the profitability of certain countries' banks owing, in part, to ongoing pressures on performance.

Chart 8
British, German and US banks' share prices relative to overall market indices



Source: Datastream and BIS.

(1) The additional presence of large numbers of bondholders, or other trade creditors, can make renegotiation more difficult.
(2) The latter estimates are published in 'The World Debt Tables' *IBRD*.

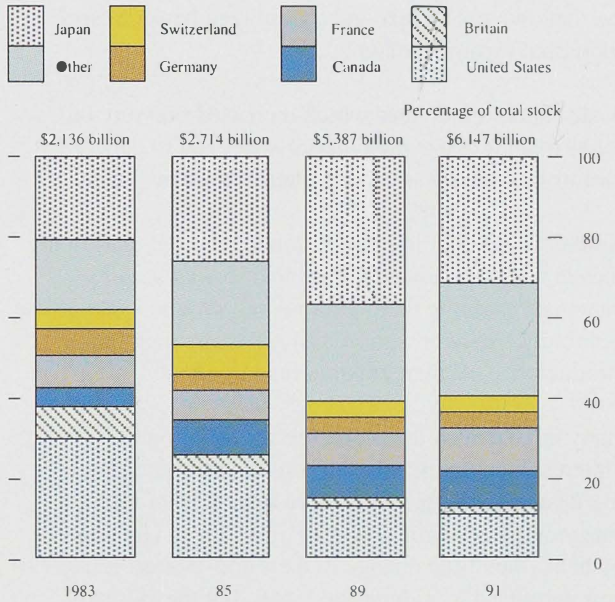
Deteriorating asset quality and Basle capital adequacy guidelines also focused banks' attention on risk-pricing. Banks have increased their spreads and fees (Chart 3) and tightened loan covenants during the last two years.[1] There is also evidence that more banks are now analysing loan propositions in terms of risk-adjusted return on capital. Current asset quality concerns may also encourage banks to monitor their exposure to particular sectors more closely and to review gearing levels at the sectoral level as well as among individual borrowers. (In the United States, in particular, higher loan prices and stricter covenants raised concern that banks were being too restrictive, but with the exception of certain industries and regions—notably real estate developers in the north-east United States—there is little firm evidence of creditworthy borrowers being unable to obtain funds.[2])

(ii) International retrenchment

Banks' LDC debt provisions were one of the most visible effects of credit problems in international lending. But banks' expansion into industrialised countries, in Europe, North America and Australia has also met with mixed results; the deterioration in corporate and property loan portfolios has often been worse in foreign markets, where a lack of detailed local knowledge may have been a factor. For example, some British and Japanese banks have witnessed deteriorating loan portfolios in California and the north-east United States, while some French, other European and Japanese banks have been forced to write off loans to UK property and corporate borrowers. These losses coincided with Basle capital guidelines and led banks' management to reappraise pure earnings and asset growth strategies in favour of (risk-adjusted) return on capital objectives. Thus, a number of banks which began the 1980s with global ambitions have been contracting their overseas assets recently via disposals, often selling retail networks or 'non-core' services back to domestic banks. As an illustration, the number of foreign branches of US banks fell from a peak of 916 in 1985 to 819 in 1989 (although in part this fall reflects mergers and acquisitions).

The cutback in some banks' physical presence in foreign markets has been accompanied by a slowdown in the growth of total international bank lending. Between 1985 and 1990 international bank lending (to non-bank customers) grew by an average of $290 billion a year, but slowed to $85 billion in 1991.[3] Underlying this trend lies a divergent country-level experience (Chart 9). The rise in Japanese banks' international business, and the coincident fall in US and British banks' share of international business, is evident. Japanese banks' share peaked at 38% in 1988, since when the need to meet Basle capital guidelines based on risk-weighted assets has put pressure on all banks to raise

Chart 9
International bank assets by nationality of bank [(a)]



Source: BIS.

(a) Stocks at end-year; includes cross-border and domestic foreign currency lending.

more capital and/or to reduce asset growth. (Japanese banks' retrenchment has been notable in the interbank market.)

Banks which sold some of their foreign retail networks, and retreated from sectors such as overseas 'mid-corporate' lending, have often refocused on overseas wholesale markets, benefiting from their experience in domestic securities markets. Others are attempting to capture foreign niches such as the provision of overseas credit and debit card services, trade finance with their home country or private banking for wealthy individuals. Foreign niches have been easier to capture in regions or countries with less sophisticated banking industries, often in southern Europe and the LDCs, though foreign banks are still finding opportunities even in major industrialised countries. At the same time, banks from some of the high growth 'emerging' Asian countries are still expanding internationally: the number of such banks in London rose from 24 in 1988 to 36 in 1992,[4] while the number of US banks in London fell over the same period from 81 to 58 (partly owing to mergers).

(iii) A shift to non-interest earnings

Growth in competition from capital markets and non-bank financial institutions (affecting both the asset and liability sides of banks' balance sheets), and ensuing pressures on their performance, have encouraged banks to enter fee-based retail and securities business. This trend to diversify earnings was also stimulated by:

(1) Disaggregated information on loan covenants is not made public, but the Federal Reserve's Senior Loan Officer Surveys reported a steady tightening of credit standards towards commercial and industrial borrowers throughout 1990 and 1991. In other countries, anecdotal evidence points to a similar trend, though the precise timing may differ.

(2) See 'Financial retrenchment in the United States' by Hugh Simpson, in the February 1992 *Bulletin*.

(3) Source: BIS. International bank lending includes total cross-border lending plus domestic foreign currency lending reported by banks to the BIS net of the majority of interbank lending (a proportion of interbank lending is included which is estimated to be destined for non-banks).

(4) Includes branches, UK-incorporated subsidiaries, and representative offices. The 'emerging' Asian countries defined here as Indonesia, Korea, Malaysia, Singapore, Taiwan and Thailand.

- a shift towards interest-bearing current accounts and more competitive deposit rates, which reduced the benefit of the 'endowment' effect and encouraged banks to seek additional forms of income;

- Basle capital guidelines which increased pressure on banks to shift assets off-balance-sheet and to generate earnings in other less capital-intensive ways;[1] and

- rapid development in information technology during the decade which enhanced the value of banks' retail franchise, enabling them to cross-sell products and utilise their branch networks more fully, thereby increasing the 'productivity' of their existing resource base.

At many large banks, therefore, the contribution of non-interest income increased throughout the decade (Table B) and now represents more than 40% of total income, compared with 20%–30% in 1980.[2] The large Swiss banks saw little change in their non-interest relative to interest earnings throughout the 1980s, but they already derived more than 60% of income from non-interest sources at the start of the decade.

Table B
Non-interest earnings/total income

Per cent

	1980	1984	1988	1990	1991
Britain	25	33	36	40	43
Canada	25	23	30	31	31
France	19	26	35	45	. .
Germany	31	30	39	41	39
Italy	27	35	34	30	. .
Japan	24	18	27	46	. .
Norway	28	33	33	26	. .
Sweden	29	30	29	26	. .
Switzerland	66	62	63	63	66
United States	27	31	42	47	47

. . not available.

Source: Banks' annual accounts and OECD.
Note: Total income = net interest income + non-interest income, pre-tax.

The contribution of alternative sources of non-interest earnings (fees, commissions, securities and foreign exchange trading and underwriting income) varies greatly between banks. Such variation reflects regulatory and taxation differences, and also different strategies towards retail and wholesale non-interest business. Some of the large US moneycentre banks have devoted substantial resources to trading and underwriting in overseas securities and derivative markets, following the early growth of the eurodollar market in London. Latterly, some of the larger European banks have also widened and increased their treasury and foreign exchange activities; such banks appear to be placing growing emphasis on enhancing their investment banking capabilities in order to generate and diversify earnings and to manage risks more efficiently (eg via interest rate swaps rather than traditional interbank activity). Other banks, such as those in Europe, which are permitted to conduct a wide array of financial business, have diversified into non-banking retail niches, such as selling life insurance, property management and travel agency.

The introduction of information processing technology has been an important stimulus to non-interest business by allowing banks to centralise processing, to develop joint domestic and cross-border products (such as automated electronic transfers for corporate clients), and to construct customer databases to facilitate the cross-selling of retail products. So far, the benefits of investment in technology and new products have been modest, in part because full implementation is in many cases not yet complete, and because its introduction has combined with a period of relatively slow growth in income in major countries. Moreover, over the long term, the benefits of new investment, particularly in retail products, may be hard-won: in some of the world's major economies, demographers point to a rising proportion of middle-aged households and thus higher savings; investment banks, money-market funds, and other non-bank financial institutions (such as insurance companies and unit trusts) are therefore investing in new technology and products in an attempt to attract new business.

(iv) Cost control

Over the last two years, banks in some of the major countries, such as France, the United Kingdom and the United States, which had seen some of the largest increases in staff and branches, have begun to reduce personnel and to close branches. These cutbacks have contributed to some improvement in earnings. At US banks for example, even in 1990 and 1991, when post-tax profits were squeezed by large loan loss provisions, operating profits (before taxes and bad debt charges) rose at many banks. This trend has continued in 1992 and contributed to an improvement in some US banks' credit ratings.

In addition to cutting staff and introducing new technology, banks have also attempted to contain costs by mergers and acquisitions, perhaps most noticeably in the United States where three major mergers were announced last year as well as a series of acquisitions by mid-size regional banks.[3] However, studies showing that earlier US mergers did not always fulfil their hoped-for cost savings illustrate that it is not easy to exploit putative economies of scale.[4]

Conclusion

The banking industry is less homogeneous now than ten years ago. Banks have taken opportunities offered by deregulation to pursue different strategies and to meet their customers' evolving needs in different ways. The diversity of banks' performance over the 1980s in part reflects banks' response, and exposure to, the economic cycle, but some

(1) Certain off-balance-sheet instruments such as contingent liabilities and note issuance facilities carry a 50% risk weight compared with 100% for on-balance-sheet corporate lending.
(2) Total income defined as the sum of net interest and non-interest earnings, pre-tax.
(3) The three major US mergers in 1991 were between: Chemical and Manufacturers Hanover, Security Pacific and BankAmerica, and C&S/Sovran and NCNB.
(4) See speech by Mr J P LaWare (a member of the Board of Governors of the US Federal Reserve System) to the Assemblies for Bank Directors in Scottsdale, Arizona, 24.1.92.

secular trends are apparent. In the United States and the United Kingdom for example (and latterly in some Nordic countries) where deregulation and competition from capital markets and non-banks emerged earliest, banks' performance has been quite volatile. In countries with traditionally more regulated and insulated financial sectors (such as Germany and Switzerland) banks appear to have performed more consistently (in part owing to accounting conventions), although asset quality concerns are emerging in these countries too. In Japan, deregulation began later, and is still not complete, but coincided with, and contributed to, a period of high loan growth and rapid asset price inflation, followed by asset price deflation and a deterioration in banks' asset quality. Experience suggests that moving from a regulated cartel-like environment to one in which lending capacity and competition are enhanced opens up more scope for banks' performance to vary according to the quality of management and individual strategies.

Banks' bad debt problems were the result of a combination of factors. Competition from securities markets and banks' own reduced credit ratings made borrowing from banks less attractive for the highest quality borrowers. The need for higher profits to strengthen capital may also have provided an incentive to pursue higher margin business, at a time when the lifting of credit controls increased banks' flexibility to meet credit demand. Misjudgements in the assessment and pricing of risk may have arisen in the course of adjusting to this new environment. At a broader level, the tightening of monetary policies towards the end of the 1980s and the subsequent readjustment of asset prices were also factors.

In attempting to combat pressures on their profitability, some banks have diversified their business while others have tended towards wholesale or retail niches, with some success in services such as insurance. Banks have also improved their capitalisation and, latterly, against a background of recession and Basle ratios, they have raised spreads and fees to improve return on equity. In addition, many banks now recognise, and have begun to tackle, high cost/income levels.