BANK POLICY INSTITUTE

# Vice Chair Barr's Unique View of the State of the U.S. Banking Industry

**BPI Staff | Oct. 13, 2023**

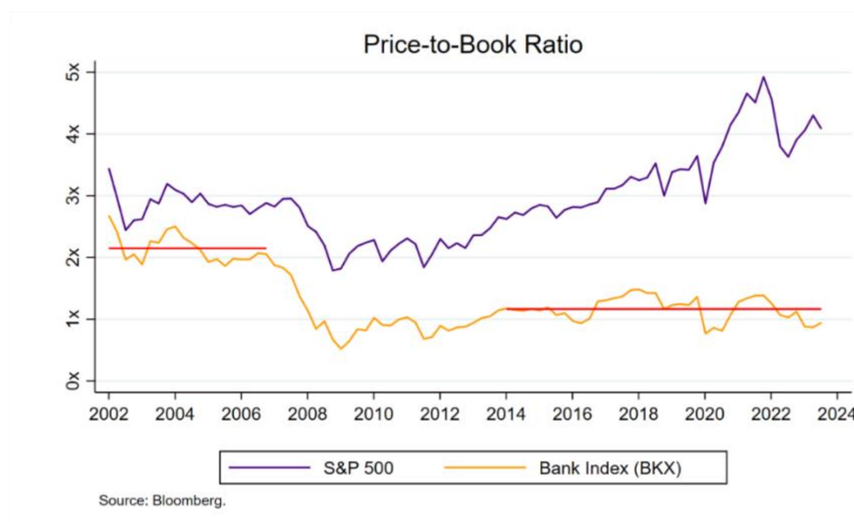
In Oct. 9 remarks championing the recent capital proposal from the federal banking agencies, Vice Chair for Supervision Michael Barr dismissed any concerns that higher capital requirements would damage the banking sector. As the basis for this assurance, he stated:

> Bank profitability measures—which dropped dramatically in the Global Financial Crisis—have mostly recovered and are close to historical averages. So as banks increased their capital cushions, their profitability grew, as did their market valuation.

This statement is inconsistent with numerous objective measures of the state of the banking industry. (He cites no measure in support of the statement.)

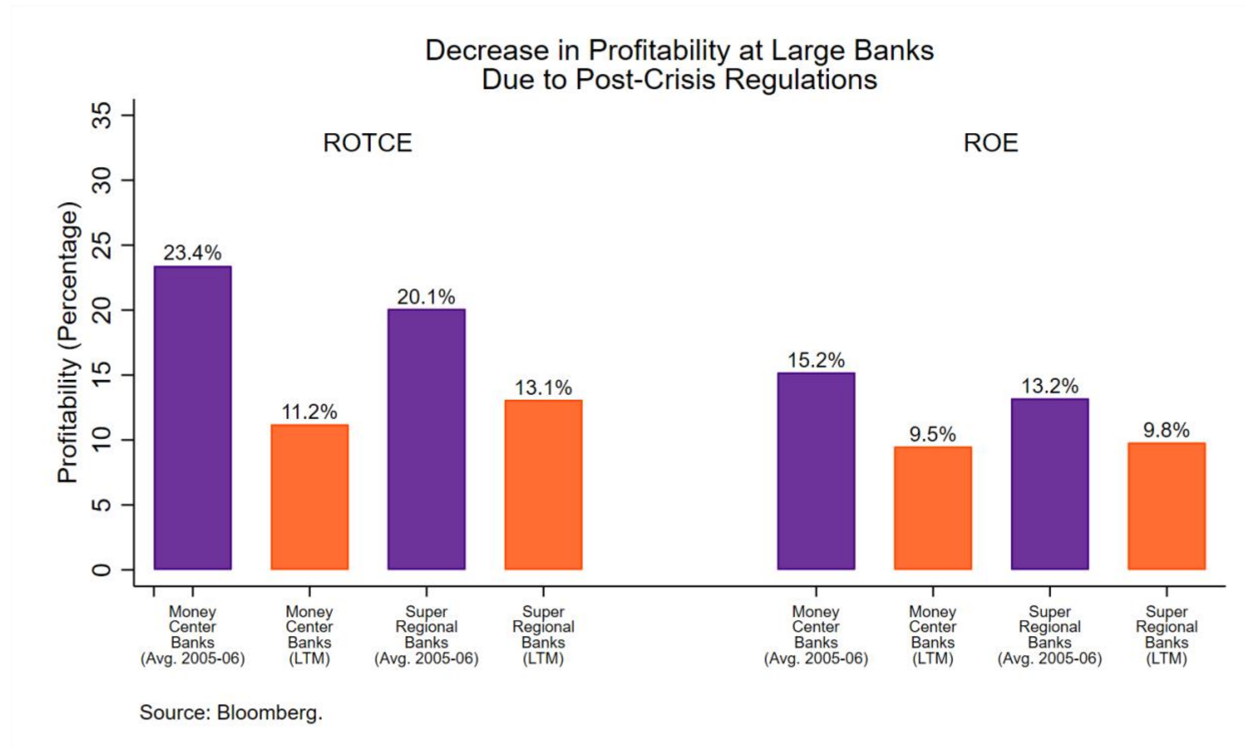
## FACTS

Consider first the banking industry's price-to-book ratio, where the industry is below historical norms and has diverged significantly from the broader corporate sector average. In the period between 2002 and 2007, banks were trading at approximately two times their book value. Currently, they are trading at book value, which is approximately the value that investors can expect to receive in a liquidation after a bankruptcy; in other words, the market is ascribing zero franchise value to the American banking industry.[1]



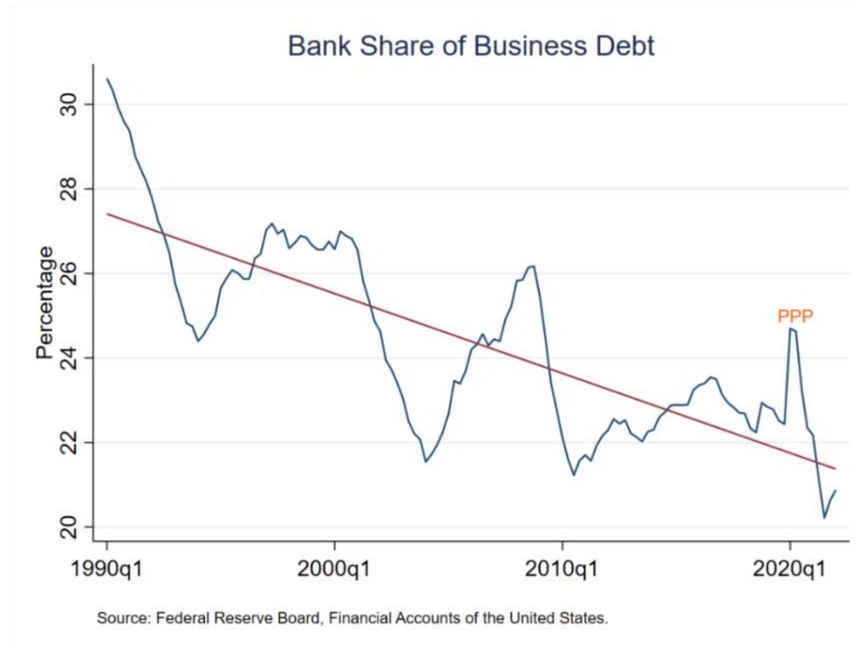

[1] A similar point was made in an academic paper by Natasha Sarin and Lawrence Summers, "Understanding Bank Risk through Market Measures," Brookings Papers on Economic Activity 2016(2):57-127 (link).

Industry returns help to explain the industry's valuation. The return on tangible common equity (ROTCE) for the six largest banks averaged 23.4 percent during 2005-2006 and was 11.2 percent over the last 12 months. For large regional banks, ROTCE was around 20.1 percent in the period leading up to the global financial crisis and has since fallen to 13 percent over the last twelve months. Results are similar for return on equity (ROE) as shown below. In a note we published in 2016, we demonstrated that the decline in profitability, particularly for the largest banks, resulted from regulatory changes implemented after the crisis.




## Poor bank earnings and valuations reflect business trends.

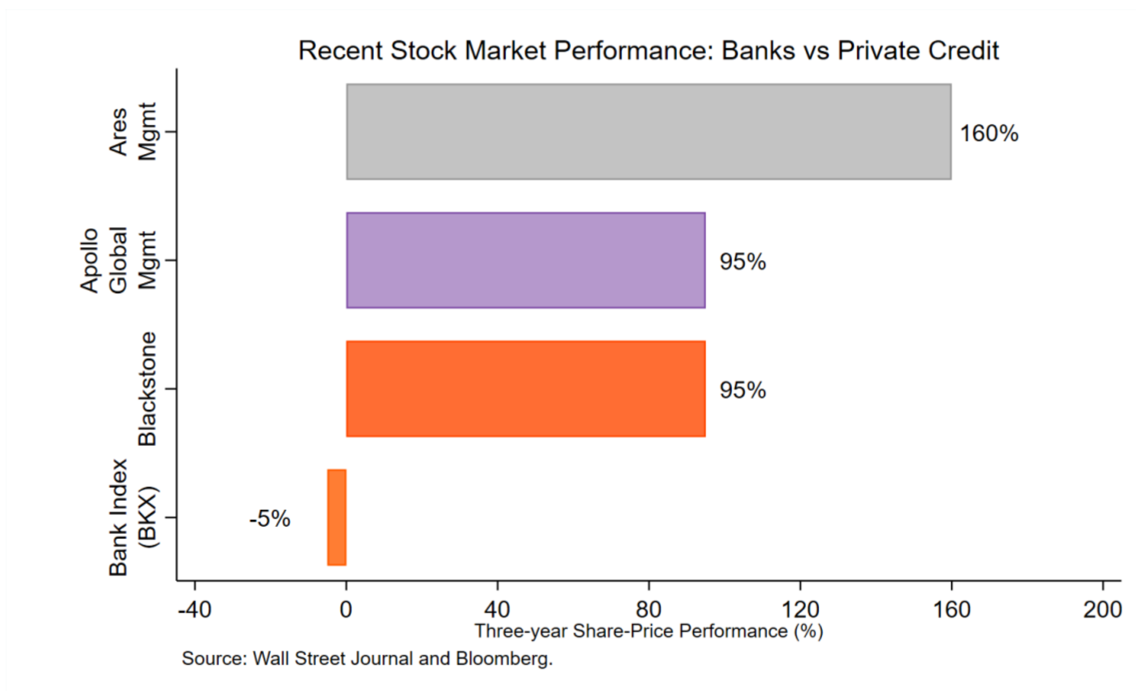
Banks hold a declining business debt share, as private capital markets — private equity, hedge funds, loan mutual funds, finance companies and business development companies — have dramatically increased their market share. For example, nonbank participation in syndicated loans increased from about 20 percent in 1993 to 70 percent in 2014. (A temporary uptick in bank market share in 2020 was attributable to banks' role in administering the Paycheck Protection Program.)



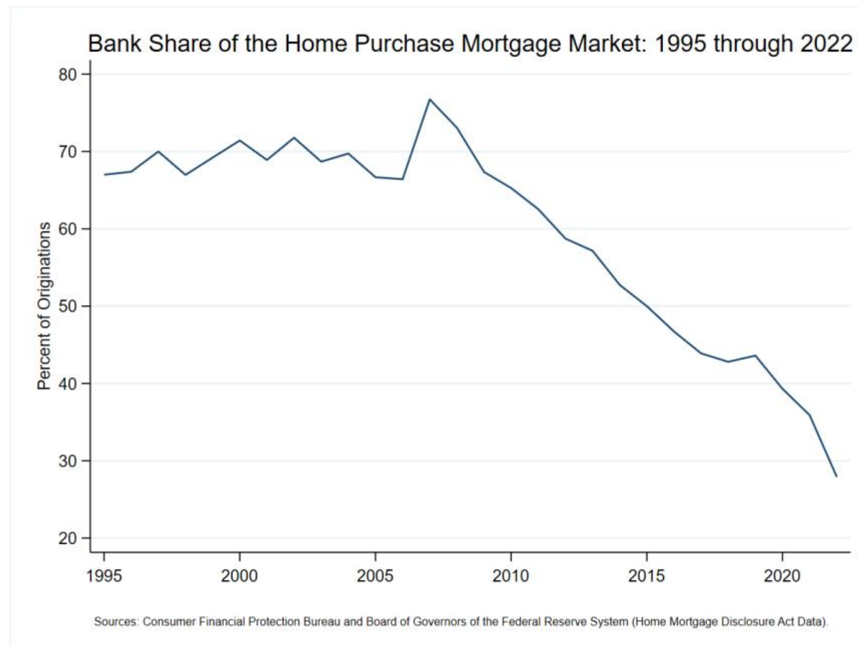

Indeed, on the same day that the Vice Chair spoke, the *Wall Street Journal* reported, in an article titled "The New Kings of Wall Street Aren't Banks. Private Funds Fuel Corporate America":

> Hedge funds, private-equity funds and other alternative-investment firms have been siphoning away money and talent from banks since a regulatory crackdown after the 2008-09 financial crisis. Lately, many on Wall Street say the balance of power—and risk—has hit a tipping point.

**Recent relative performance is illustrative.**



**Most people are familiar with the declining role of banks in the mortgage market:**




**Bank critics sometimes respond by saying that banks are earning "record profits." That is a tired canard.**

## RAMIFICATIONS

One can debate how large a role more stringent regulation of banks (and banks alone) post-2010 has played in the significant decline in absolute and relative bank returns. Most analyses ascribe a significant role. But what is worrisome is that by the Vice Chair's account, there is simply no reason to do that analysis, because it simply never happened.

Similarly, one might wish to study the economic growth and financial stability ramifications of moving so much of finance away from banks that are deposit-funded and therefore can lend at lower cost and more importantly can do so during economic downturns. It is also possible that the absence of prudential regulation for nonbank firms that are supplanting banks might worsen matters further. Many analysts and central bankers around the world are voicing concerns in this area. The capital rule proposed by the U.S. banking agencies does not engage this concern.

Lastly, there is an ongoing market and policy debate about the vitality of the regional banking model in the United States; that debate is a significant one because those banks account for more than half of small business loans originated in many of the 50 largest metropolitan areas. These are the banks for which Congress ordered the federal banking agencies to tailor regulation. The recent proposals from the federal banking agencies effectively repeal that statute. Because apparently everything is just fine.

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