Speeches

Prosperity or the Primrose Path: A Few Questions for Bankers

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Thank you for that kind introduction, and thanks to the Georgia Community Bankers Association for the hospitality you've shown me this weekend.

The health of the financial services industry and the health of the national economy have always largely mirrored each other, and, as the current expansion continues to grow into its ninth consecutive year, the financial services industry seems to find itself in just as enviable a position. Not coincidentally, the two major consumer confidence surveys continue to indicate a very high level of confidence toward the economy, and the American Banker's May consumer survey indicated a very high level of confidence toward the financial services industry.

So I'll start by observing that for bankers and central bankers alike, perhaps the most daunting legacy of the current period is what I've called the institutionalization of unrealistic expectations. What exactly does that mean?

For central bankers, it's the idea that three consecutive years of nearly 4 percent real GDP growth is no longer exceptional, but merely average. For investors, it's the conceit that anything less than 20 percent growth in the Dow Jones Industrial Average is unacceptable. And for bankers, it's the notion that there's no such thing as a bad loan.

These are indeed extraordinary days for the U.S. economy and for bankers. But when ordinary times return—when merely good times replace today's great times—bankers and central bankers alike will have to answer some very serious questions. I think that now is a good time to begin asking them. And while my colleagues and I on the FOMC have issues of our own to address, today I've got questions for you.

I'd like to begin, though, by arguing that the financial services industry is just now entering a period of unprecedented uncertainty. Now I realize that recent events in your industry seem to belie my thesis. In the first place, the industry is as well capitalized and as profitable as it ever has been. And in the second place, the banking industry has just completed two decades of changes that were supposed to shore it up for the 21st century. Things like deregulation, consolidation, nationwide branching, new products and services, nonbank competition and risk management tools like derivatives; you know them better than I do.

And on paper—in the banking journals and on the balance sheets—things do look as good as ever for this industry.

The problem is that, checks and currency notwithstanding, this is no longer a business that's conducted with paper. And I think if you reflect on some of the other changes we've seen over the last 20 years—if you consider how long they're likely to take on Internet time—the future is much more uncertain. Consider two obvious examples:

Twenty years ago, the average banking consumer had few choices and even less leverage. Small business loans, mortgages, car loans, you name it; the consumer took what was offered—and was glad to get it. Now the tables have turned completely. Financial products have become commodities, and bankers have become customer service providers.
Twenty years ago, with a captive geographic customer base, core deposit growth tended to keep pace with or exceed loan growth. Today, as consumers shift funds into alternative investment vehicles, deposit growth is slowing and banks increasingly find themselves relegated to the role of transaction processor, with pieces of paper that are enormously costly to handle and customers who will never be a source of profit, even on a marginal basis.

Ladies and gentlemen, as radical as these changes were, as profound as their consequences have been for your industry, they were only the beginning. To be sure, the thing that made them possible—deregulation—was essential: it allowed for the diversification of risk and product lines, along with competition. But compared to what's coming, the examples I just cited were part of an old, ancient order, and the even earlier days—the days when bankers had a lock on deposits and loans—are gone forever.

It also means, unfortunately, that many of the transitional steps taken over the last 20 years—the bold, strategic moves that were supposed to establish the industry on a much firmer competitive footing—were little more than the next logical progressions in the old fashioned banking model. On the marketing front, for example, expansion of the old bricks and mortar branch system is beginning to be foresworn by many of the banks that pursued it most aggressively in the past. And on the regulatory and legislative fronts, many of the changes we've witnessed have simply taken the industry back to the pre-Depression years, before commercial and investment banking were separate. With the benefit of hindsight, of course, it's easy to conclude that these might have been the wrong answers. What's perhaps more troubling is the possibility that we were asking the wrong questions all along.

I think that the next phase in the evolution of the financial services marketplace will be completely, utterly, profoundly different. That something on the order of the previous 20 years of changes in this industry will happen overnight—and again the next night. I think it could very well be a marketplace in which companies that don't yet exist offer products that haven't yet been invented over delivery vehicles that haven't yet been engineered. And while I don't consider myself an industry forecaster, I do have some questions, based on what I'm seeing in the financial services industry today, that may help bankers and policymakers consider what lies ahead.

1. Do you have the intellectual capital you need to compete?
The changes I cited earlier—the commoditization of financial products and the increasing competition for deposits—were brought about by two kinds of technologies: financial technology and delivery technology. Because these technologies have become so common, however—because no modern financial institution can hope to

operate with long-term success without both—an even more fundamental concern will be hiring and retaining the brainpower you need to keep them up and running.

Some financial technologies—I'm thinking of credit scoring in particular—come more or less prepackaged, and it's their proliferation that is helping to turn banking products into commodities. In the future, the products that will offer the most potential for adding value will be those that can be differentiated from other financial offerings. And those will be high-end products that require high-end skills: theoretical math skills for derivatives, for example. And, as I'll argue in a moment, even if all you want to do is continue writing plain vanilla business loans, you'll still need someone with financial skills to package them for the secondary markets. Suffice it to say, none of this will come cheap.

As for "delivery technology" I'll elaborate on what I think that means shortly, but I suspect that many of you already have experience with the kind of talent it requires: the designers, programmers and engineers who can already practically name their price.

In short, I think the intellectual capital it takes to run a bank will become as dear as financial capital. Maybe you *can* develop your financial and delivery talent internally. But you can expect your competitors to fight for your employees as fiercely as they fight for your customers. Still, you'll need them if you're going to be able to answer question number two.

2. Do you have a competitive delivery system?

It's no longer enough for a bank to tailor its delivery system to a customer's changing needs. Delivery systems must also increase output per worker while lowering costs for businesses and prices for consumers. And this, I should note, is a *minimum* standard; to fail to do this is to lose market share to a more efficient competitor. While banks have improved the productivity of their delivery systems by investing in ATM networks, credit scoring software and telephone systems, the industry now faces an entirely different delivery system improvement—the Internet.

I will concede that the Internet has heralded in a level of hype unlike any I've ever witnessed. Traditional models of business valuation seem to have been permanently cast aside for most dot-com stocks. Nevertheless, the recent mania gripping the Internet sector does not detract from its potential, especially as a delivery system in the financial services industry. Ignoring it will be fatal to your business.

A recent analysis by Lehman Brothers on Internet banking in Scandinavia demonstrates its inevitability. Internet penetration in the Scandinavian countries is among the highest in the world, and Lehman Brothers found that for customers there the Internet offers significantly improved convenience, lower prices and potentially higher deposit yields. For banks, it offers substantially lower costs and a far more efficient means for delivering a wide variety of product lines. As Lehman Brothers concluded, "The Internet offers such strong advantages for banks and customers that it will become the dominant form of everyday communication for retail and small business clients within a relatively short space of time."

Here in the United States, the most convincing example of Internet success in financial services is the retail brokerage business. Firms such as Charles Schwab, Ameritrade and E-Trade have transformed the industry to such an extent that even industry giants like Merrill-Lynch find themselves in the unusual position of reacting to, rather than leading, market change.

Which is not to say that banks have so far gone unscathed. Indeed, for banks the Internet threat is already here. It is just as easy—and maybe even easier—for customers to place their money in an online brokerage as in a bank. And as long as they keep their money in a conservative money market fund, it's just about as safe. Which brings me to question number three.

3. Where will your funding base come from?

While the Internet will only hasten the already frenzied competition for consumer savings, the truth is that deposit growth in banks began declining well before most of us ever knew what dot-com meant.

Like so many other business and public policy issues in the United States, the declining rate of growth in deposits is largely being driven by demographics. In the first place, there are simply fewer new customers coming into the banking fold, especially compared to the baby boom generation. Moreover, as policymakers realized that Social Security and other pay-as-you go programs must account for a declining base of workers, tax policies increasingly encouraged individuals to invest through IRAs, Keoghs and 401(k)s. This set off a huge shift in savings toward the mutual fund industry and away from banks and thrifts. In 20 years, mutual fund holdings have grown from $100 billion to nearly $6 trillion today. It is not a coincidence that $6 trillion is approximately the level of total assets in the U.S. banking system.

As for alternative sources of funds, they're available, but expensive. Institutions carrying investment grade ratings can supplement funding through local or euro-money markets. And noninvestment grade institutions can look to correspondent relationships or to secured financing through investment grade intermediaries like the Federal Home Loan Banks. But, wherever it comes from, funding will continue to be a major challenge for many banks. As will question number four.

4. How will you establish your loan pricing?

It's no secret that the United States is overbanked. It has been for many years. Still, it didn't much matter in the past because financial markets were divided by geography and industry, and banks had no reason or incentive to cut prices. Now, though, with deregulation and the Internet, not only are there too many banks chasing too few customers, there are a lot more ways to reach them. Geographical boundaries have become meaningless. And, of course, there are a lot more nonbanks in the lending-banking business too.

All of this has had the effect of increasing the aggregate supply of funds available for lending, and you'll recall from your high school economics class that when supply exceeds demand, prices fall. I think this is exactly what we're seeing now. Banks have become price takers, as lending seems to have little to do with profitability or the risk presented by an applicant, and everything to do with an excess supply of funds and holding onto customers. The result is that in many banks, plain vanilla lending looks increasingly like a commodity, a loss leader proposition, a ploy to keep customers in the bank and sell them something profitable. Well, that's a fine strategy—in a Wal-Mart. But unless banks can cut their supply costs the way a Wal-Mart can—and unless they've got a range of value-added products to offer in addition to the regular stable of financial commodities—well then it seems to me that the "everyday low prices" strategy is not a sensible way to price a loan.

The impact of the industry's funds surplus on loan pricing has been further compounded by falling demand for bank services among the largest and most creditworthy customers. It's a phenomenon we're observing throughout the industrial world: the banking industry's share of credit markets is falling as improved transparency allows large customers to satisfy working capital needs more efficiently in the commercial paper market. What that means for banks, though, is that they'll increasingly be left to slug it out at lower prices with their nonbank competitors in an effort to reach riskier customers further down the credit ladder. And while the banking industry's declining share of credit markets can only be seen as a good thing for the nation's economic health, it obviously does not portend any improvement in loan pricing.

Of course, for many of the biggest banks, loan pricing is practically irrelevant. They don't intend to keep the loan on their balance sheet in the first place. And while this fact doesn't stop competitors from matching their price, it does raise question number five.

5. Can you afford to keep the loans that you've got on your books?
As costs of funds increase and loan yields fall, it is becoming painfully obvious that banks can no longer afford to store loans on their balance sheets. Too many loans simply don't—or won't—make economic sense at the interest rates they carry. For this reason, we are beginning to witness in consumer and business lending the phenomenon of de-leveraging, whereby banks rid themselves of credit portfolios through asset securitization or loan syndication to intermediaries better able to profit from the activity, such as specialized investment and pension funds and life insurance companies. The profit for banks is thus not in carrying credit risk to maturity but in originating, packaging, selling and servicing that credit risk, for a fee, for third-party investors.

And this, of course, takes me back to the question I started with, "Do you have the intellectual capital you need to compete?" If you're going to erect and maintain the delivery systems you need to reach your customers, to make the loan, package it, sell it, and service it, your answer has to be yes.

But before you can answer that first question in the affirmative, you've got to recognize those forces that have converged to make traditional lending less and less profitable. To recognize that competition from mutual funds and online brokerage is only going to accelerate and that funds are only going to get more expensive. To realize that lending competition from banks and nonbanks is only going to get more intense and that prices—or at least margins—are only going to go down. And to understand that as radically different as all this may be, it's only just the beginning.

And that, ladies and gentlemen, brings me to my final question: Are you ready?

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