Banking Trends After Financial Modernization

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The Financial Modernization Act (Gramm-Leach-Bliley), which was passed last fall, is in the process of taking effect this year. Among other things, this act repealed the Glass-Steagall Act (which separated commercial banking and securities underwriting) and was yet another step in dismantling a regulatory structure put in place nearly seven decades ago. Ongoing deregulation of the banking and financial system along with rapid changes in technology has raised some questions about the ultimate outcomes of several trends in the banking industry.

Several key questions about these trends come to mind:

1. Will ongoing consolidation in the financial system and the ability of banks to expand into new product markets lead inevitably to financial supermarkets?
2. Will banking become primarily e-banking?
3. Will **relationships** between a small business and a bank, or between a consumer and a bank, go the way of the horse and buggy? To put it another way, will bank products primarily be bought and sold in the financial marketplace as commodities, or will personal service and personal contact still matter?

Past and current trends in the banking industry, along with the recent passage of Gramm-Leach-Bliley, may lead many people to respond in knee-jerk fashion and answer "yes" to all of these questions. Today I will make the case that there is more to the story.

Trends in the Financial Industry

1) Even though the Gramm-Leach-Bliley Act permits banks to perform a wide variety of activities, the question remains, will institutions take advantage of their new powers? And if so, will this, coupled with the ongoing consolidation we've seen in the financial services industry over the past few years, lead to financial institutions that look like financial supermarkets, offering all things to all people?

Over the past 10 years, the number of banks in the U.S. has fallen from over 12,000 to under 9000, a 30 percent decline. Consolidation has led to increased concentration in the banking industry, and to an increase in the average size of banks and bank holding companies.

Banks are getting bigger, but are they getting better? From the standpoint of profitability, the answer is yes. While the industry has been consolidating, bank performance, as measured by return on assets (ROA) and return on equity (ROE), has improved greatly. While merging banks appear to have experienced some increased costs, they have more than made up for this by increased revenues.

Consolidation and expansion into new activities can increase bank efficiency by allowing an institution to reach a scale or mix of output that is more profitable. And technological innovations have enabled the development of credit scoring and automated loan application processing, for example, which have spurred many banks to become larger to capture the scale economies embedded in these new technologies.

Recent research has documented that banks can benefit from increasing their scale of operations, but what about benefits to banks from expanding into new activities? Here the research results are more mixed. There is some evidence (not strong evidence) that risk might be lower when commercial banks expand their activities: for example, studies have simulated the performance of portfolios that include both permitted and previously nonpermitted banking activities, and usually, the variance of returns (a measure of risk) is smaller when nonpermitted activities are included.

To date, research has not conclusively shown that there are many cost or revenue synergies between different financial service offerings (although it is probably too early to tell, since banks have been restricted in the amounts of these other services that they could provide). The cross-selling opportunities, still to be worked out in light of the privacy rules now being written, suggest there may be gains to banks from expanding into new product markets.

However, it is not at all clear that one-stop shopping, which the modernization legislation now more easily permits, will be what consumers demand. At the same time that the law now permits commercial banks to offer insurance and other financial services, it is now easier for consumers to do comparison shopping and to switch accounts if it looks as if there's a better deal to be had elsewhere. Thus, the convenience of one-stop shopping might be overstated.

In fact, early attempts to develop financial supermarkets failed in the U.S. What's more, lessons from other industries suggest that the trend is **not always** toward greater product diversification. Among nonfinancial industries that have always had the ability to diversify across product lines, one finds that the desire to form big conglomerates ebbs and flows. Many nonfinancial firms still specialize in just one industry or in just one aspect of an industry.

Certainly, the more than 2000 new small banks that have entered the industry since 1985 think that they can make a go of it without being huge or without being all things to all people. What is likely to occur is that the average size of the financial firm will be larger, but there will still be community banks and niche players-institutions that focus on providing particular services to particular segments of the market. Indeed, one of the byproducts of technological innovations is that it has become easier to tailor products to individual customers' needs. Banks that wish to emphasize customer service might choose to remain small. While they would be less able to take advantage of some technologies, which require a larger size over which to spread the fixed costs of the technologies, they would be able to use other technologies to provide better service to their customers. For example, banks of all sizes have been expanding their presence on the Internet. Which brings us to our next question.

2) Will banking become primarily e-banking?

E-commerce seems to take up 50 percent of TV advertising, but so far it accounts for probably less than 5 percent of total retail sales. The advertising and hype lead one to think that e-commerce and e-banking are really big, but that is still some way off. Certainly electronic payments will become more important with time. But we can't count out paper-based payments just yet. Back in the 1960s, analysts predicted that by now we would have a checkless society because of the spread of electronic transfers, but checks are still with us. Indeed, between 65 and 70 billion checks are still written annually in the U.S.

Still, there is no doubt that electronic means are becoming a more important outlet for banking services. Various sources estimate that users of online banking currently number between 4 and 7 million, or 4 to 7 percent of households. And forecasts say the number of online banking users will double several times by 2003.

One development that makes predictions of double- or even triple-digit growth of PC banking more credible now than at any time in the past is the growth of the Internet. Internet banking, one form of PC banking, offers customers 24-hour access and the ability to bank from **multiple venues**, since proprietary software need not reside on each machine. Indeed, at the end of last year, over one-third of all banks reported having a web site and many more reported having plans to build one.

Some banks see the Internet as a way to deliver their products to customers; others see it as a separate line of business for the bank. Whereas some banks offer just information about their products on the web, others have transactional web sites at which their customers can do things like check their account balances, transfer funds between accounts, pay their bills, use financial planning software, apply for loans, stop payments, or trade online. And some banks exist **only** on the Internet. These banks save on the costs of brick and mortar, but need to spend more on advertising. So far, there are only a handful of these virtual banks, and many are finding it difficult to remain branchless. Seeing is believing, and that's as true in banking as in anything else.

Most banks are offering online banking now as a way to retain customers, rather than generate new business, although not always successfully (surveys suggest that many customers who have tried online banking have stopped using it-many thought it was too time consuming and some thought there was poor customer service). In this way, the online banking of today resembles the ATM of the 1970s. It took time for a large volume of customers to use ATMs. It seems reasonable to predict that online banking will eventually take its place alongside the other ways customers can interact with their banks, like branches, telephone centers, loan production offices, and ATMs. But it seems unlikely that all banking will become e-banking. Even in this technologically advanced age, the in-person visit remains the main way people interact with their banks, as they develop and maintain their relationship with the institution. But will this relationship change as banking becomes more electronic?

3) Will relationships between a consumer and a bank, or between a small business and a bank, go the way of the horse and buggy? To put it another way, will banking products primarily be bought and sold in the financial marketplace as commodities, or will personal service and personal contact still matter?

This question is related to both of the first two questions, concerning bank size and new technologies. Small-business lending and consumer lending used to be the purview of small banks, which devoted substantial resources to getting to know their customers and developing relationships with them. But this is changing. Today, large banks, which want to take advantage of the scale economies that come with size, are using credit scoring to make small-business loans and are processing applications using automated and centralized systems. These banks are able to generate large volumes of small-business loans at low cost even in areas where they do not have extensive branch networks.

But these loans differ from traditional small-business loans. These types of small-business loans are like credit card loans, which do not require much in the way of information-intensive credit evaluation beyond what is done in a credit scoring model. The scale economies in automation available to large banks allow them to produce these **transactions-type** small-business loans more cheaply than a small bank can. And such technology is also helping nonbanks become larger players in the small-business loan market.

Borrowers whose credit histories receive a passing grade from a credit scoring model may find it cheaper to obtain credit from larger banks. Small banks will still serve the small borrowers who prefer more individual treatment or whose financials do not fit credit scoring models, but who are still good risks. Small banks will continue to offer the traditional **relationship-driven** lending, which requires the bank to stay in contact with the borrower over time to gain information about the borrower and also requires the bank to be a specialist in evaluating the creditworthiness of borrowers for whom there is little public information. Such loans are what we often think of as "character" loans. The more complicated organizational structure of large banks generally puts them at a disadvantage in making these relationship-type loans. So small banks should retain their niche in relationship lending-although that niche may be smaller than it is today. Nevertheless, personal service and personal contact will still matter in bank lending.

The Fundamental Role of Public Confidence

Ultimately, the answers to the above questions will depend on whether trends in the financial industry reinforce or undermine the public's confidence in the financial system, since public confidence forms the essential underpinning of the financial system. If any of these trends pushes the envelope too far and begins to erode public confidence, it must be stopped. And it can be stopped in one of two ways: banks can take steps to stop it, or Congress or state legislatures will step in and stop it.

What is the foundation of the public's confidence in the financial system? Members of the public want their money to maintain its purchasing power; they don't want its value to be eaten away by inflation. They want banks and other financial institutions to be safe and sound. They want their financial transactions (whether involving loans or deposits or other services) to be executed in a timely and accurate manner. They want convenience, and they also want privacy and fairness.

Note that there is nothing new about any of these-no matter what form the banking system takes, these are the things the public will continue to care about.

Public confidence is essential: if consumers do not believe their money is in safe hands, they will exit the financial system. We saw this happen during the Great Depression and in later episodes of bank runs.

Most commercial bank buildings were constructed to convey the strength of the institutions and to instill public confidence -- the idea was that solid buildings with strong vaults would instill public confidence. Today, it is just as important for the public to have confidence in its financial system, but the means for ensuring this confidence is different in this age of technological innovation. It is important that the public be assured that banks will use the highest level of electronic security, not just imposing physical structures with strong vaults, to protect their money and the information that customers give to their banks. From the bank's viewpoint, this information can be as valuable as the money a customer places in the bank.

The trends in banking that we've been discussing cannot occur unless the public remains confident in the financial system as it undergoes transformation and unless the public sees a benefit in the changes taking place. For example, the trend is toward moving from a paper-based payments system to an electronic one, but how fast a payments instrument is adopted depends on how the risks, costs, and benefits of the new instrument are distributed among participants.

If consumers don't see much benefit from e-commerce or e-banking, or, even worse, if they are burned by fraudulent e-commerce or e-banking practices, then the trend toward electronic banking will slow down.

The issue of privacy is another example. Banks now have the reputation of treating customers' information in a secure manner, but this could be jeopardized in the move to e-banking, as some recent episodes suggest. Such episodes can make deep and lasting impressions on the minds of potential users of Internet financial services.

In the post-Gramm-Leach-Bliley era, where banks are less restricted in what they can do, both banks and regulators must be aware of the overriding public interest in maintaining confidence in the financial system.

Conclusion

In conclusion, overriding all of the changes in the banking system I have discussed is the public's need for confidence in the banking and financial system. A well-functioning financial system is the underpinning of a strong economy, and public confidence is the underpinning of a successful financial system.

My major point is that, while the financial system after passage of the Financial Modernization Act will be **vastly different** in terms of its structure and delivery systems, it will also be **fundamentally the same**: public confidence and trust will remain the basis of a sound financial system. All parties-big banks, community banks, nonbanks, regulators, legislators-share a responsibility to ensure public confidence. How this shared responsibility plays out will be a powerful influence shaping, and perhaps limiting, the trends we've discussed today.