Banking in the 1990s and Beyond: Adapting to a New Environment

Good afternoon. It's a pleasure to be here today. As I prepared for this talk, I considered several possible ways to describe the issues facing the banking system in the 1990s and beyond. Someone said: "Why not talk about the threats to the industry?" I thought about that, and decided that the real issues shouldn't be characterized as threats. Someone else said, "How about challenges to the banking industry?" Well, that's closer.

But I think the real issues are about evolution. The environment for banking has changed tremendously—both the economic environment and the competitive environment. That means that the real issue facing the banking industry today is about adapting—to survive and be profitable in the new environment.

So today I'm going to indulge in a little bit of "armchair Darwinism." I won't talk about threats or challenges. Instead I'll talk about environmental changes--and especially about the success with which banks are making innovative, aggressive moves to adapt to the changing environment and maintain their competitive strength.

Let me begin by taking a quick look at the economic environment and its effect on the condition of banks in the Twelfth District, and in Washington in particular.

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year, for example, those banks as a group were still losing money, even though the industry as a whole registered record earnings.

Fortunately for you, Washington's economic environment has been nearer the other end of the spectrum. During the national recession and recovery, Washington's employment continued to expand. During the past year, employment growth was about 1.7 percent, just below the national rate. As a result, the state has had a basically sound banking environment. And that's reflected in what you see on your own institution's bottom line. For example, ROA for the industry in Washington has been well over 1 percent each year since 1989. Last year, the figure was closer to 1.6 percent, and it was only a bit lower in the first part of this year.

Now I'd like to turn to changes in the competitive environment. Here the scope is much broader, and the changes are more relentless and on a global scale.

Two key trends are driving these changes. First is a fundamental revolution in the way we process information about risk. This includes improvements not only in hardware and software for computer and telecommunication technology; it also includes improvements in "brainware"-- that is, advances in the field of finance, like the theory of options.

These innovations have dramatically changed the way financial services are provided. They've reduced the cost of collecting and disseminating information related to financial risk, as well the cost of measuring, evaluating, and managing risk. And that has led to explosive growth in open capital markets and nonbank intermediation, and to the proliferation of securitization, derivatives, and so on.

The second key trend is deregulation. It began in earnest in the 1970s with the start
of deposit deregulation. Since then, we’ve seen a significant expansion in securities-related powers for banks under federal regulation, Glass-Steagall notwithstanding. We’ve also seen states take the initiative in deregulation. A key example is the removal of restrictions on interstate banking. This has had a larger impact on Washington than on many other states. Today, over 85 percent of the banking assets in the state are in institutions owned by holding companies headquartered elsewhere. By comparison, the average for the nation is closer to 20 percent.

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Now let me turn to adaptations financial markets have made to this changing environment. First, the heightened competition has meant that banks have been losing ground in their traditional activities, like deposit-taking and lending. For example, more open capital markets have contributed to the growth of nonbank competitors like pension funds and mutual funds. Debt held in mutual funds has grown from close to nothing in the early 1970s to over $1.2 trillion dollars; that’s on top of another $1 trillion in equity held by mutual funds. Nonbanks also are going head-to-head with banks. Finance companies have gained some market share at the expense of banks. Also, firms like Merrill Lynch now do more than just market mutual funds and underwrite securities -- they also make consumer and business loans. And securitization has dramatically changed the way single-family homes are financed. Federal-related mortgage pools equal over 40 percent of home mortgage debt outstanding.

How much ground have banks lost? In the 1970s, commercial banks’ share of total credit extended in the U.S. was over 30 percent. Today, it’s around 20 percent.
But do numbers like these mean that banking's on the decline? Not necessarily.

Banks have learned to adapt to the new environment. For one thing, although commercial banks have lost share in C&I loans and government financing, they've increased their share of both consumer and mortgage credit. Furthermore, banks have expanded fee-based, off-balance sheet products and services—like letters of credit, loan commitments, derivatives, and an array of investment-related activities.

In fact, there's some evidence that the rise in fee-based services and products at banks has offset a large part of the decline in their share of on-balance sheet financing. I'm referring to recent research presented last month at the annual bank structure conference at the Chicago Fed [Boyd and Gertler]. The study finds that adjusting for off-balance sheet activities makes up for something like one-half to two-thirds of the decline in banks' share of financial intermediation measured by on-balance sheet assets.

In addition to increased competition from outside the industry, there's some question about how the changing environment affects competition among banks. Are large banks favored, and are we headed toward a system dominated by a few "megabanks"?

It is true that only a few large banks--30 or so--are actively involved in off-balance sheet activities like securities underwriting, and only a dozen or so are market-makers in derivatives. Also, interstate banking has made nationwide banking feasible. Currently, every state except Hawaii allows some entry from out-of-state, and most allow nationwide access. And even in Hawaii, Bank of America managed to enter by acquiring a thrift.

As I see it, consolidation in banking will probably continue; the system still has a way to go in adjusting to the old artificial constraints on things like branching. But, considering
the course of consolidation so far, it doesn't look like we're evolving into a system of just a few nationwide "megabanks."

First, traditional banking services are still in demand by households and small businesses. The evidence suggests that scale economies are limited in these areas. So banks of all sizes can be expected to continue to engage in a sizable volume of traditional banking. Second, even small and medium-size banks have shared in the rise in noninterest income, though not as much as the largest banks. Third, the pattern of interstate banking suggests there are limits on bank consolidation. For example, interstate activity in the Twelfth District has been dominated by BHCs in the West. This suggests that the regional dimensions of banking could remain important enough to keep the industry from evolving into a system of few nationwide banks. Also, even in states like Washington, where interstate banks have a big share of bank assets, they're still competing with a large number of independent banks.

All in all, then, I think it's a mistake to say that the banking industry— as some commentators would have it— is "facing extinction." The industry so far has acted with a lot of initiative to adapt to the new environment. For the future, it will be just as important for policymakers and regulators to keep adapting, too, to provide you with the scope you need to compete. This means moving further toward integrating securities and insurance powers with banking. It also means not overreacting to burgeoning areas like derivatives, and being sensitive to the costs of regulation in general. If this happens, I'm confident the banks will continue to evolve— to be profitable, strong competitors— in the 1990s and beyond.

1The share of noninterest income accounted for by the top 1 percent (by assets) of banks has increased from 61.3 percent to 67.4 percent over the past 10 years.