Epilogue

The Future of U.S. Commercial Banking

As restrictions on scope and powers were eased in the 1980s and 1990s, banks have morphed into a new kind of financial services entity. The modern commercial bank is no longer a commercial bank, an investment bank, or a merchant bank. Its main activities involve managing and financing mergers, acquisitions, and divestitures; financing equipment leasing; financing the expansion of businesses, providing cash and transaction management services, and asset management for businesses, institutional investors, and individuals. For many of the top global firms an increasingly greater share of their income comes from trading for their own account as well as with each other and less from fees that clients pay for services. And many traditional client services are effectively subsidized by asset management services.

The effects of industry reforms are reflected in financial performance after 1992. Through the rest of the 1990s, banks reported improvements in asset growth, cost structures, profits, and capital adequacy, and the number of problem institutions declined. Robust stock prices and excess capital levels between 1996 and 1998 created favorable conditions for continued growth in merger and acquisition activity, resulting in further consolidation in the industry. Diversification reduced banks’ vulnerability to downturns in particular regions or in specialized business lines. In 1999, just prior to entering the recession, industry earnings increased at the rate of 16% year to year, delivering a record return on assets of 1.31%.

Despite record levels of profitability at the turn of the 20th century, in recent periods, higher loan loss provision expenses and narrowing net interest margins have created new pressures on bank profitability. While U.S. banks entered the recession in a strong position with better capital and reserve positions than they had in the 1980s and early 1990s, the recent downturn in the U.S. economy as well as the lending excesses of the 1990s will take their toll. In the first two years of the 21st century there has been a pronounced increase in non-performing assets, particularly at large banks, a rapid deterioration of credit quality in certain segments of bank portfolios - most notably within the corporate loan book - and meager growth in retail core deposits.

In combination, these developments create pressure on bank liquidity: benchmark ratios such as loans-to-deposits are at historic peaks. Results for year ending December 31, 2001 reflect these vulnerabilities. The FDIC reports that in the 4th quarter of 2001, net charge-offs for the 25 largest U.S. banks increased 64% over the prior year and non-performing assets increased 25%. As corporate scandals continue to unfold, it is clear that bankruptcies and debt defaults will be a continuing problem. Noting well the lessons of the 1970s and 1980s, the Chairman of the Federal Reserve has warned Congress that traditional measures of capital adequacy are less meaningful given the nature and complexity of risk undertaken by larger banking organizations in recent years.

Future Challenges

Have commercial banks survived the final decades of the 20th century only to disappear in the 21st century? It is too soon to answer this question but one thing is clear:
pressure for change will not dissipate and it will be up to a new generation of bank managers and regulators to meet the challenge. The same fundamental forces that drove change in U.S. financial services markets in the late 20th century will operate in the 21st century: population demographics, the nature of economic activity, and technology. Individuals, businesses, governments and other institutional investors who must finance the retirement of the aging baby boom population, will continue to exercise considerable impact on the supply of investment capital.

On the demand side, the economies of the “rust belt,” which have yet to fully restructure to reflect the changing terms of trade in industrial and manufacturing goods and services, will require significant capital investment to be competitive in the 21st century. Continued expansion of local and cross-border economic activity will stimulate demand for new financial products, new services, new organizational structures, and new regulation. Extracting economic value from new discoveries in the life and materials sciences, which is a strategic focus for most local economic development initiatives, will feed demand for capital and the supply of capital. Finally, the process of applying the research that forms the foundation of these discoveries will lead to new technological innovations, which will further stimulate the demand and supply of capital as well as influence conduct, structure, and performance in financial services markets.

One of the key lessons we can take from thirty years of change in the commercial banking industry is that the prosperity of the industry will depend upon the quality of industry leadership and the wisdom of regulators. The extensiveness and complexity of banking regulation is a favorite scapegoat for performance problems in the U.S. banking industry. Many experts contend that “politics” inhibit competitiveness and growth in the banking sector. They argue that it is difficult to summon the political will to change existing regulations or to agree to new regulations when economic conditions change. Yet as this study demonstrates, the evidence for this proposition is rather sparse. Instead, detailed analysis of the period 1960-2000 suggests that there is considerable latitude in the U.S. banking system for change but it is bank managers and regulators rather than legislators who must lead.

As economic change reconfigured the competitive landscape in the late 20th century, creative bank managers pushed the edges of the regulatory envelope to reformulate the banking business. While legislators facilitated discussion and debate about reform, change was initiated and implemented by pro-active firms and knowledgeable regulators. Many (but not all) banking firms and regulators took action before the legal framework for banking changed and before the direction of change was certain, despite the potential for failure or a disabling challenge. Following the industry’s lead, regulators relaxed restrictions for well capitalized banks and legislators reformed deeply entrenched rules that impaired macroeconomic economic competitiveness and growth.

In the years ahead, bank managers and regulators must lead new reform efforts because government cannot. Bank policy makers are constrained by the activities of other policy makers particularly in areas related to trade, antitrust, and macroeconomic policy. These other types of policy making activities are not controlled by U.S. bank regulators, the banking industry, or banking concerns: they emerge from the interactions of multiple, separate, and often conflicting political and economic interests and forces. In addition, the interactive effects of disparate but related policies are not always obvious to policy
makers. Even when these effects are apparent, policy makers cannot always coordinate effectively to reconcile conflicts. Both effects are exacerbated by innovation, which generates unpredictable consequences that are not only difficult to anticipate, but virtually impossible to regulate on a pre-emptive basis.

The increasingly international character of banking activities magnifies bank management and governance issues. Participation in the international financial system is not limited to global banks - the nature of modern economic life and hence modern banking dictates that every bank in the U.S. participates in the international financial system to some extent. International financial activity exposes U.S. banks to risks in every region of the world. Just as activities of individual banks within a domestic banking system have externalities, so too do the activities of individual banks within the international system. Difficult as it is to monitor risk in a domestic system, which has relatively familiar parameters, it is even more challenging to make this estimate for other country systems. Moreover, unlike the U.S. system, in which federal deposit guarantees act as a coordinating mechanism for large-scale change, no such mechanism currently exists in the international financial system.

Over the coming decades, bank managers and regulators will have to address the following challenges:

- Convergence among large, global banks will continue but banking systems will retain their distinctiveness at the country level. Nevertheless, banking systems in the advanced economies will continue to restructure. Hence global banks will have to become adept at operating in very different financial systems that are undergoing significant change. And domestic banks will have to anticipate and stay ahead of structural change in their own countries.
- More and more banking services are becoming commodities, hence banks will experience continuing pressure to reduce costs and focus on value-added products and services. These pressures will stimulate continued consolidation, a new focus on separating production and distribution activities, and innovations that electronically enable financial activity. It will be imperative that banks learn how to obtain value from mergers and acquisitions and to work effectively with strategic partners.
- Eventually there will be a face-off between insurance companies and banks based on their core competencies as financial intermediaries. Because insurance activities are regulated at the state level in the U.S., the process of change is likely to be similar to that of interstate banking reform.
- While U.S. banks now have the freedom to engage in universal banking, those that chose to do so will have to develop new business models that overcome the limitations of the traditional universal banking model.
- Banks will be forced to increase their innovative capacity. While some banks have demonstrated the ability to innovate in the areas of organizational design, process management, and financial engineering, banks lag other financial service providers in new product development. Moreover, there is much more that banks could do to improve profit and cost efficiency. However, success will require fundamental organizational transformation that is closely aligned to a clearly articulated business and technology strategy.
• Managing operational, systems, market, credit, regulatory, human resources, strategic, third party, and e-business risk will make or break a bank. Recent economic events are harbingers of the need to better anticipate and monitor domestic and overseas exposure and grapple with accounting transparency for off-balance sheet activities and investment concentrations in retirement plans. Capital adequacy will be an ongoing concern.

• Systemic risk arising from economic change, structural shifts in the banking and insurance industries, and the complex risk exposures created by financial innovations will be a continuing and worrisome threat to individual banks as well as domestic and global economic order. For example, the size of the inter-bank loan market for developed countries alone increased from $25 billion in 1999 to $662 billion in 2000, and the value of all cross border financial claims increased from $276 billion to over $1 trillion, yet banking experts and regulators do not fully understand the complex chain of financial flows and credit interdependencies in this market nor are they prepared to cope with a systemic crisis.

• Pressure to create an integrated international financial system that can work closely with domestic financial systems will intensify. This means that financial executives must work with domestic and international financial regulators on a pro-active basis in designing and implementing regulation that will protect the economic value of financial intermediation, assure the integrity and stability of financial markets, and maintain systemic stability.