Chapter 1

Fundamental Forces of Change in Banking

What were banks in the past?

Historically, commercial banks have been the most heavily regulated companies.

- Resulted in a banking system with a large number of smaller banks that was limited in the scope of products and services that could be offered and the geographic areas where individual banks could compete.

As a result, they were the safest and most conservative business.

- Although regulations limited opportunities and risks, they virtually guaranteed a profit.

Two areas of changes

Traditional role of banks as financial intermediaries declined

- New products such as cash management accounts, mutual funds, commercial paper, and junk bonds have become more prevalent.
- Banks have responded by accepting lower spreads, taking on more risk, and expanding their customer and product base.

Evolution of banking into nontraditional roles

Evolution of banking into nontraditional roles

- Expand into nontraditional areas and products to generate more fee income.
- Actively pursue the use of technology in the development and delivery of products.
- Gramm-Leach-Bliley Act eliminates most of the remaining restrictions that have separated commercial banking, investment banking, and insurance for over 70 years.

Deregulation and Competition

Many analysts attribute much of the change in the financial services industry to deregulation.

Deregulation was a natural response to increased competition rather than the catalyst of competition.

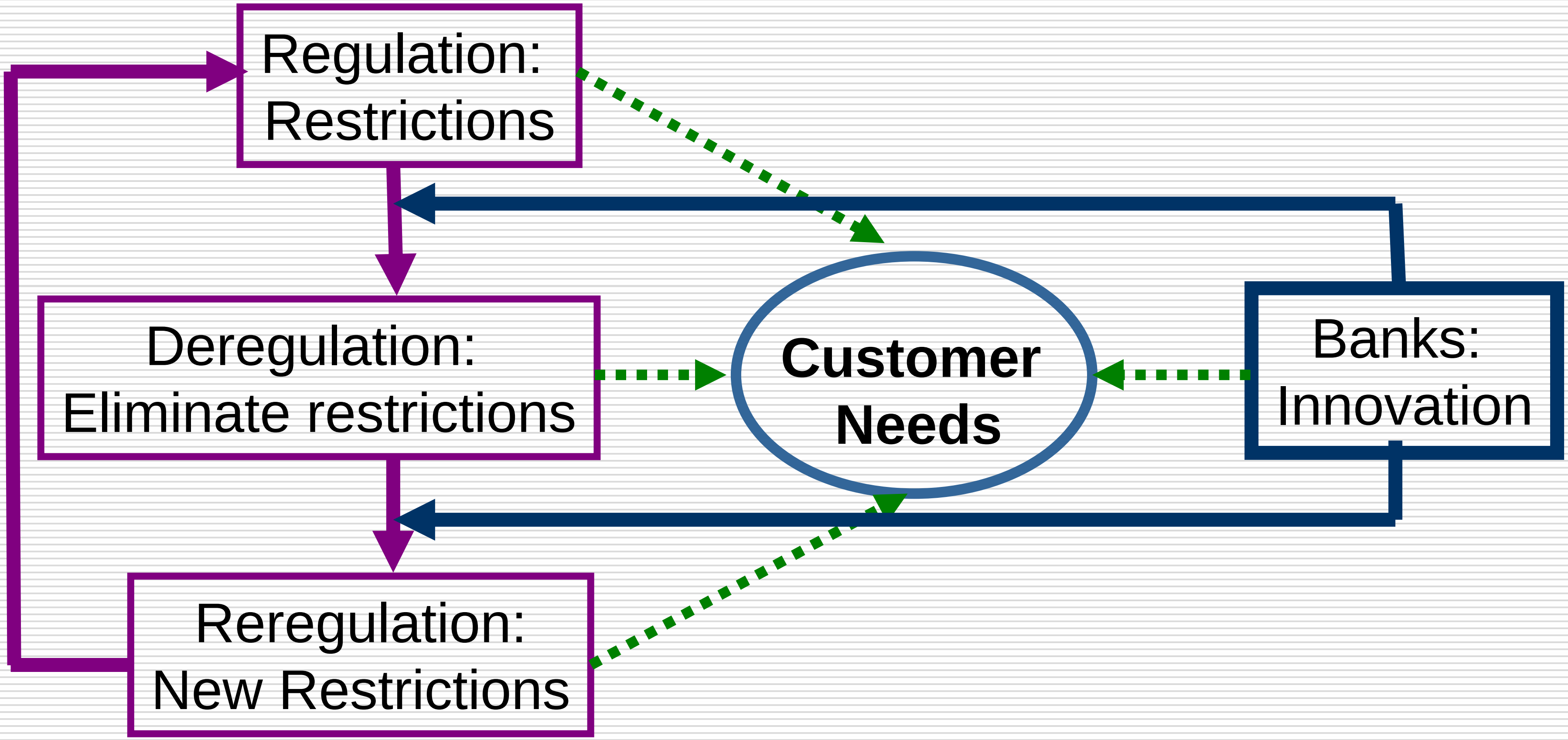
- competition between depository institutions and nondepository financial firms, and
- competition between the same type of competitors across world markets

Deregulation sped up the process, but did not necessarily start it.

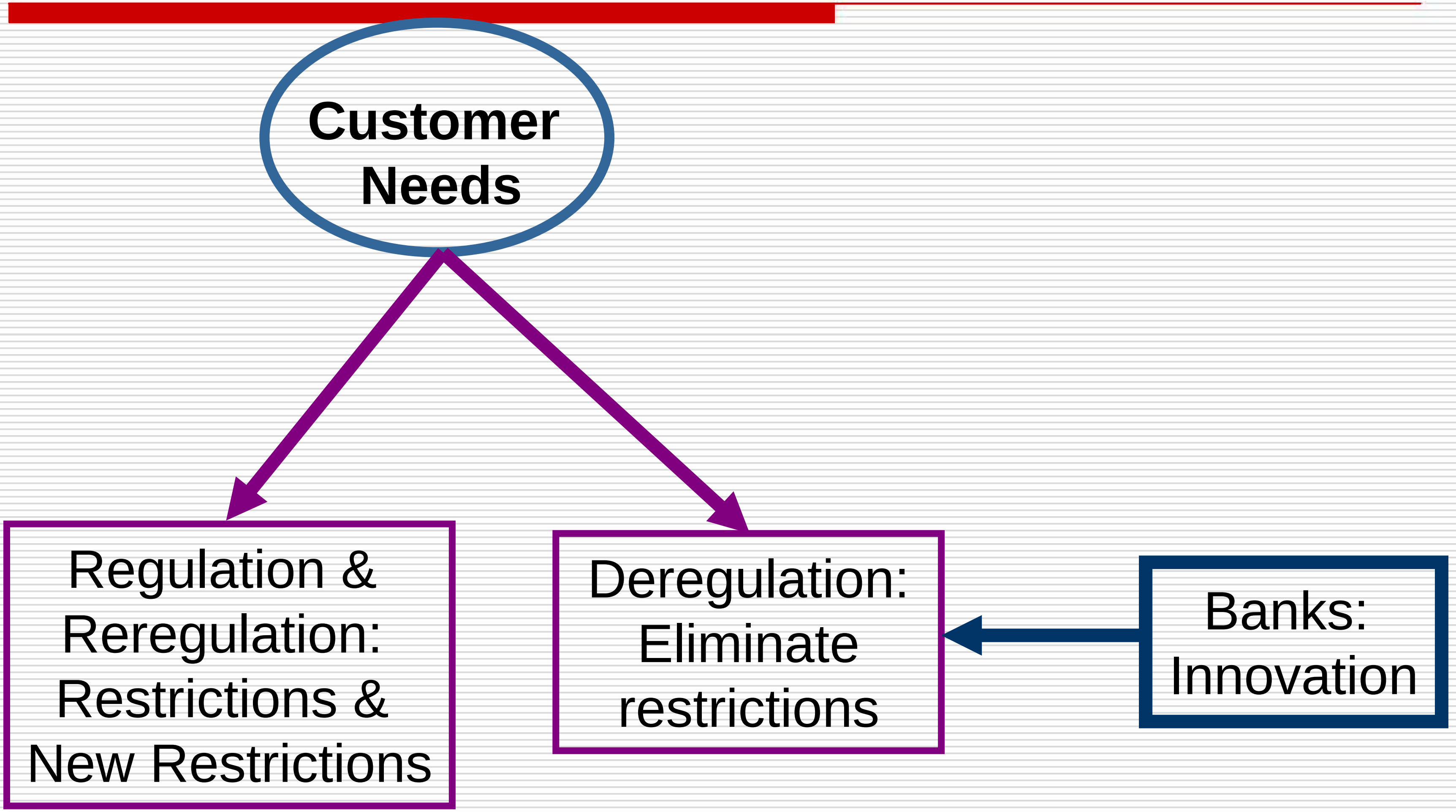
Regulatory Dialectic

Since World War II, banks and other market participants have consistently restructured their operations to circumvent regulation and meet perceived customer needs. In response, regulators or lawmakers would impose new restrictions, which market participants circumvented again.

Regulatory Dialectic



Regulatory Pendulum



What makes a bank 'special?'

The answer lies in our history; with the implementation of:

- The *Glass-Steagall Act* which created three separate industries: commercial banking, investment banking, and insurance.
- The *Bank Holding Act* determined activities closely related to banking and limited the scope of activities a company could engage in if it owned a bank.
- The *McFadden Act* limited the geographic market of banking by allowing individual states to determine the extent to which a bank could branch intra- or inter-state.

Consolidating and Diversifying Simultaneously

The traditional definition of a bank has been blurred by the introduction of new products and a wave of mergers, which have dramatically expanded the scope of activities that banks engage in and where products and services are offered.

What constitutes a bank, today is not as important as what products and services are offered and in what geographic markets the financial services company competes in.

Number of firms v.s Number of offices

- Consolidation, in turn, has increased the proportion of banking assets controlled by the largest banks.
- Not surprisingly, the same trends appear globally.
- The United States currently has several banks that operate in all 50 states and many locales outside the U.S.
- The largest foreign banks have significant operations in the U.S. and throughout the world.

Increased Competition

Competition also means geography no longer limits a financial institution's trade area or the markets in which it competes.

- Individuals can open a checking account at:
  - a traditional depository institution,
  - a brokerage firm, or
  - a nonbank firm, such as GE Capital, State Farm Insurance, and AT&T.

Regulatory restrictions

Product innovations and technological advances of the later half of the twentieth century allowed investment banking firms to circumvent the regulations restricting their banking activities.

- In the late 1970s Merrill Lynch effectively created an "interest bearing checking account," something banks had not been legally allowed to offer.

Banks were heavily regulated

Merrill Lynch was only regulated by the Securities and Exchange Commission.

- This allow investment companies to move into the banks market, circumventing Glass-Steagall and the Bank Holding Company Act

Not until the late 1980s and early 1990s did banks find ways around Glass-Steagall using a Section 20 affiliate which allowed them to offer a limited amount of investment banking products and services.

Branching restrictions

This created a system of many more but smaller banks as compared to other countries.

- By the late 1990s, all branching restrictions were removed from the banking system and the number of independent banks was reduced by almost half, the number of branches increased by almost 50 percent and the size of the largest U.S. banks increased dramatically.

Branching restrictions

These same branching restrictions, however, prevented banks from geographically diversify their product and credit risk and quite possibly contributed the loss of several large Texas banks during the late 1980s.

The removal of branching restrictions

Merrill Lynch and State Farm already operated branches across the nation and in comparison there were significantly fewer, but larger, investment and insurance companies.

In addition to relaxation of branching restrictions, technological advances allowed banks to open electronic branches, first by using the ATM network and later by using the Internet.

This structural change

In fact, deregulation was a natural response to increased competition between depository institutions and nondepository financial firms, and between the same type of competitors across world markets.

In fact, some regulations can be credited for the development of new products to avoid regulation—hence increased competition from firms not regulated like a bank; i.e., investment banks.

Five fundamental forces

Deregulation/re-regulation

Financial innovation

Securitization

Globalization

Advances in technology

Historically, most heavily regulated companies

Regulations took many forms including :

- maximum interest rates that could be paid on deposits or charged on loans,
- minimum capital-to-asset ratios,
- minimum legal reserve requirements,
- limited geographic markets for full-service banking,
- constraints on the type of investments permitted, and
- restrictions on the range of products and services offered.

Banks and other market participants

In response, regulators or lawmakers would impose new restrictions, which market participants circumvented again.

This process of regulation and market response (***financial innovation***) and imposition of new regulations (re-regulation) is the ***regulatory dialectic***.

Financial Services Modernization Act (Gramm-Leach-Bliley Act of 1999)

The Gramm-Leach-Bliley Act effectively eliminates the majority of the remaining restrictions that have separated commercial banking, investment banking and insurance industries for over 50 years.

The Glass-Steagall Act shaped the structure, products and business models of the banking industry for the later half of the 20th century.

Increased competition

The McFadden Act of 1927 and the Glass-Steagall Act of 1933 determined the framework within which financial institutions operated for the next 50 years.

- The McFadden Act saw to it that banks would be sheltered from competition with other banks by extending state restrictions on geographic expansion to national banks.

The fundamental forces of change… *increased competition*

Competition for deposits

Competition for loans

Competition for payment services

Competition for other financial services

Competition for deposits

- High inflation abruptly ended the guaranteed spread between asset yields and liability costs in the late 1970s.
- In 1973 several investment banks created money market mutual funds (MMMFs).
- Congress passed legislation enabling banks and thrifts to offer similar accounts.

Competition for loans

- Loan yields fell relative to borrowing costs, as lending institutions competed for a decreasing pool of quality credits.
- High loan growth also raises bank capital requirements.
- Junk bonds, commercial paper, auto finance companies, credit unions, and insurance companies compete directly for the same good quality customers.

Competition for loans (continued)

As bank funding costs rose, competition for loans put downward pressure on loan yields and interest spreads.

Prime corporate borrowers have always had the option to issue commercial paper or long-term bonds rather than borrow from banks.

Competition for loans (continued)

The competition for loans comes in many forms:

- Commercial paper
- Captive automobile finance companies
- Other finance companies

The development of the junk bond market extended loan competition to medium-sized companies representing lower-quality borrowers.

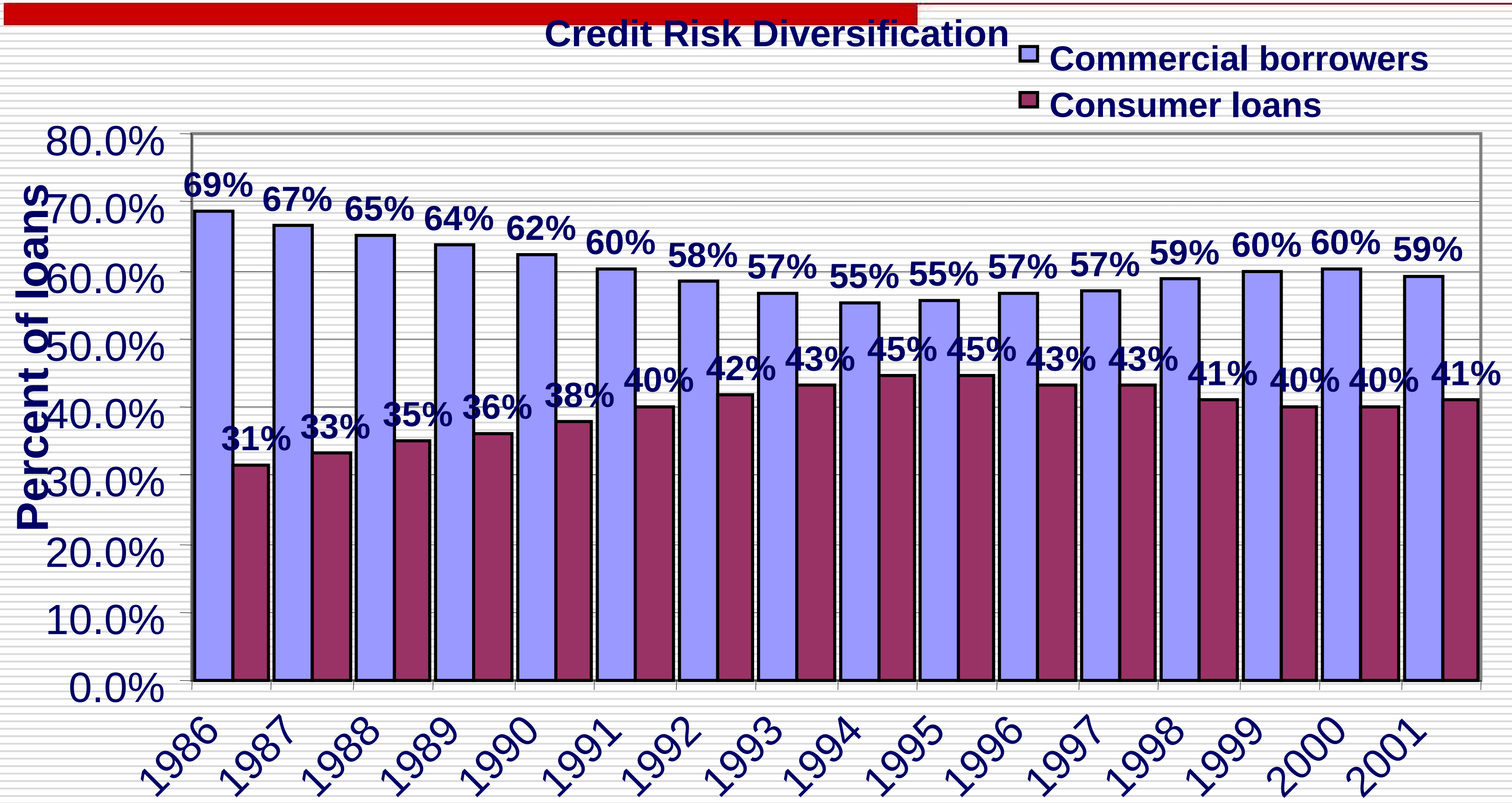
Different size banks generally pursue different strategies

Small- to medium-size banks continue to concentrate on loans but seek to strengthen the customer relationship by offering personal service.

These same banks have generally rediscovered the consumer loan.

The largest banks, in contrast, are looking to move assets off the balance sheet.

Loan concentrations: Consumer and commercial credits



Captive automobile finance companies

The three largest U.S. automobile manufacturers as well as most foreign automobile manufactures are aggressively expanding in the financial services industry as part of their long-term strategic plans.

Competition for payment services

In an American Banker article, Diogo Teixeira comment that:

GE Capital has almost $300 billion of financial assets. GMAC has $12 billion of financial services revenue, more than Microsoft's total corporate revenue.

Competition for payment services
…the impact of technology

Once the exclusive domain of banks and other depository institutions, the nations payment system has become highly competitive.

The real challenge for the Federal Reserve System and the banking industry is in the delivery of payment processing services.

It's not just electronic payment systems

Cash money can be acquired at any teller machine all over the country.

You can open a checking account, apply for a loan and receive the answer and funds electronically.

Direct deposit of paychecks, credit cards, electronic bill payment, and smart cards

The average payment size of cash is the smallest

	Volume of Transactions				Value of Transactions				
	2000	% Total 2000	% of Cashless Payments 2000	Growth: 1995-2000	1995	2000	% Total 2000	Growth: 1995-2000	Average Transaction Size 2000
Cash	550,000	82.3%	#N/A		#N/A	2,200,000	0.3%		$ 4.00
Cheques issued	69,000	10.3%	58.2%	1.8%	73,515,000	85,000,000	10.9%	2.9%	$ 1,231.88
Electronic Transactions:									
ACH	6,900	1.0%	5.8%	14.6%	12,231,500	20,300,000	2.6%	10.7%	$ 2,942.03
ATM	13,200	2.0%	11.1%	6.4%	656,600	800,000	0.1%	4.0%	$ 60.61
Credit Card	20,000	3.0%	16.9%	6.0%	879,000	1,400,000	0.2%	9.8%	$ 70.00
Debit Card	9,275	1.4%	7.8%	42.1%	59,100	400,000	0.1%	46.6%	$ 43.13
Total retail electronic	49,375	7.4%	41.7%	10.7%	13,826,200	22,900,000	2.9%	10.6%	$ 463.80
Chips	58	0.0%	0.0%	2.6%	310,021,200	292,147,000	37.4%	-1.2%	$5,037,017
Fed Wire	108	0.0%	0.1%	7.3%	222,954,100	379,756,000	48.6%	11.2%	$3,516,259
Total wholesale electronic	166	0.0%	0.1%	5.5%	532,975,300	671,903,000	85.9%	4.7%	$4,047,608
Total Electronic	49,541	7.4%	41.8%	10.7%	546,801,500	694,803,000	88.8%	4.9%	$ 14,025

Competition for other bank services

Banks and their affiliates offer many products and services in addition to deposits and loans.

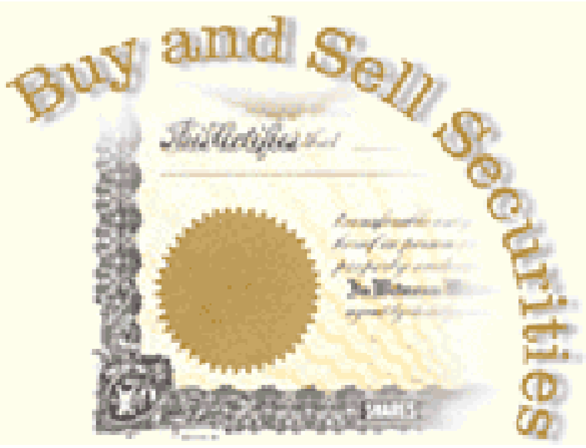
- **Trust services**
- **Brokerage**
- **Data processing**
- **Securities underwriting**
- **Real estate appraisal**
- **Credit life insurance**
- **Personal financial consulting**

"Non-bank" activities of banks
…the Gramm-Leach-Bliley Act.

Since the Glass-Steagall and Bank Holding Company acts, banks could not directly underwrite securities domestically.

Today, a bank can enter this line of business by forming a *financial holding company* through provisions of the Gramm-Leach-Bliley Act.

Investment banking



Commercial banks consider investment banking attractive because most investment banks:

- already offer many banking services to prime commercial customers and high net worth individuals and
- sell a wide range of products not available through banks.
- can compete in any geographic market without the heavy regulation of the FRS, FDIC, and OCC.

Investment banking

Investment banking encompasses three broad functions:

1. underwriting public offerings of new securities
2. trading existing securities
3. advising and financing mergers and acquisitions

Deregulation and re-regulation

Deregulation is the process of eliminating regulations, such as the elimination of Regulation Q (interest rate ceilings imposed on time and demand deposits offered by depository institutions.)

Efforts at deregulation and re-regulation generally address:

Pricing issues

- removing price controls on the maximum interest rates paid to depositors and the rate charged to borrowers (usury ceilings).

Allowable geographic market penetration

- The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 has eliminate branching restrictions.

New products and services

Financial innovation

Financial innovation is the catalyst behind the evolving financial services industry.

Innovations take the form of new securities and financial markets, new products and services, new organizational forms, and new delivery systems.

Financial innovation (continued)

Banks developed new vehicles to compete with Treasury bills, money market mutual funds, and cash management accounts.

Regulators typically responded by imposing marginal reserve requirements against the new instrument, raising the interest rate ceiling, and then authorizing a new deposit instrument.

Response of banks

- One competitive response to asset quality problems and earnings pressure has been to ***substitute fee income for interest income*** by offering more fee-based services.
- Banks also lower their capital requirements and reduce credit risk by selling assets and servicing the payments between borrower and lender rather than holding the same assets to earn interest.

Securitization

Securitization is the process of converting assets into marketable securities.

It enables banks to move assets off-balance sheet and increase fee income.

It increases competition for standardized products such as:

- mortgages and other credit-scored loans

The objectives behind securitization

- Free capital for other uses
- Improve ROE via servicing income
- Diversify credit risk
- Obtain new sources of liquidity
- Reduce interest rate risk

Off-balance sheet activities, asset sales and Enron

Enron engaged in questionable activities including not reporting losses from business activities that the firm inappropriately moved off-balance sheet.

- Enron was thus able to hide losses on the business activities and/or use its off-balance sheet activities to artificially inflate reported earnings.

Many banks also enter into agreements that do not have a balance sheet reporting impact until a transaction is effected.

From 1999-2001, PNC

Jan. '02. , PNC took a $615 million charge as it wrote down loans

Late Jan. '02, the FED and SEC questioned the special third-party structure used to shift assets off the balance sheet.

- PNC's shares dropped--the use of such off-balance sheet accounting was reminiscent of the Enron fiasco.

PNC reclassified its treatment of the problematic deals and lowered its reported income for 2001 several times.

- Earnings were restated due to new risks of special purpose vehicles.

Globalization

- The gradual evolution of markets and institutions so that geographic boundaries do not restrict financial transactions.
- Financial markets and institutions are becoming increasingly global in scope.
- Firms must recognize that businesses in other countries as well as their own are competitors, and that international events affect domestic operations.

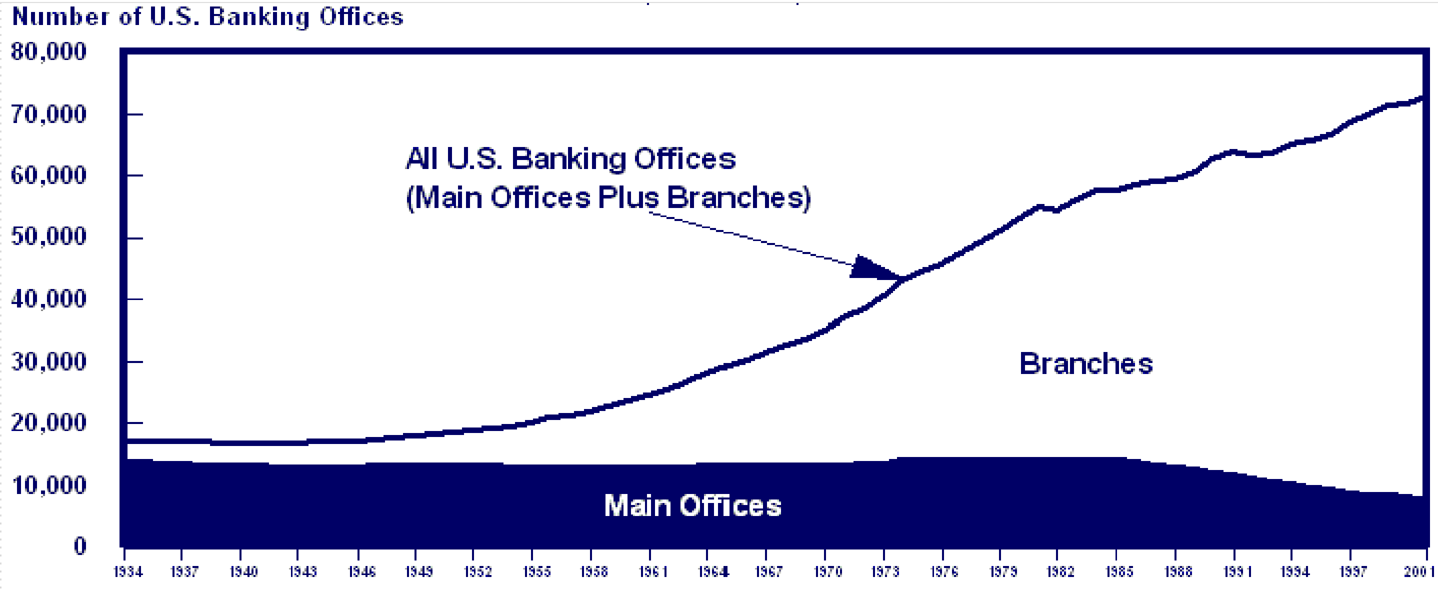
Increased consolidation

The dominant trend regarding the structure of financial institutions is that of consolidation.

With the asset quality problems of Texas banks in the 1980, regulators authorized acquisitions by out-of-state banks.

Increased consolidation

By 1998, effectively all interstate branching restrictions had been eliminated



The largest bank consolidations

Citicorp merges with Travelers

Chase Manhattan acquires Chemical Banking

Chase Manhattan acquires J.P. Morgan

Mellon Bank acquires Dreyfus

NationsBank acquires BankAmerica

Bank of New York acquires Irving Bank Corp

Fleet Financial Group acquires BankBoston

Bank One acquires First USA

Southern National acquires BB&T Financial

The removal of restrictive branching laws

The primary factor leading the reduction in the number of banks from a high of 14,364 in 1979 to about 8,000 at the beginning of 2002 can be attributed to the removal of branching restrictions provided by Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994


Thank You Very Much for
Your Kind Attention!