

# FINANCIAL INDUSTRY

FEDERAL RESERVE BANK OF DALLAS  
SECOND QUARTER 1997

# Issues

## Banking In a Changing World

*Whereas bankers in  
the past may have  
counted their change,  
bankers today must  
count on change.*

During this century, the world has witnessed unprecedented technological changes—from the horse and buggy to the space shuttle; from the slide rule to the laptop personal computer; from the pony express to E-mail. Technological progress has improved transportation and communications, enhanced information awareness and information processing, and set the stage for spectacular new products and innovations.

These changes have also permanently altered the face of banking. Traditional banking—accepting deposits to make loans and investments—was primarily concerned with managing the bank's balance sheet. Today, bankers must be concerned with much more. Whereas bankers in the past may have counted their change, bankers today must count on change.

The traditional banking model worked well in a predominantly agricultural and industrial society. But the shift toward a knowledge society and increased competition among financial services providers have forced banks to reevaluate how they do business. As we move into the 21st century, a number of forces are fundamentally changing the world in which banks compete. The widespread availability of information and the ability of firms to rapidly imitate profitable strategies will continue to put pressure on banks to stay competitive.

### How Are Banks Performing Today?

Despite the forces of change challenging the banking industry, the financial markets have reacted favorably to the recent performance of large banking organi-

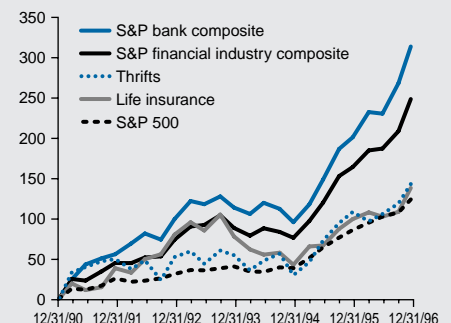
zations. As Chart 1 shows, banking organizations (represented by Standard & Poor's bank composite index<sup>1</sup>) have outperformed the S&P 500 by a substantial margin since the end of 1990. Other groups of financial organizations have also outperformed the market in the 1990s, although not as spectacularly as banks.

The banking industry's profitability, as measured by return on assets, also has improved through the years. Chart 2 shows insured commercial bank profitability over various time frames since the 1930s. Bank profitability reached unprecedented heights in the 1990s. Return on assets for the banking industry during 1995–96 averaged just over 1.2 percent.

Within the Eleventh Federal Reserve District,<sup>2</sup> bank profitability returned to

Chart 1  
Stock Price Performance

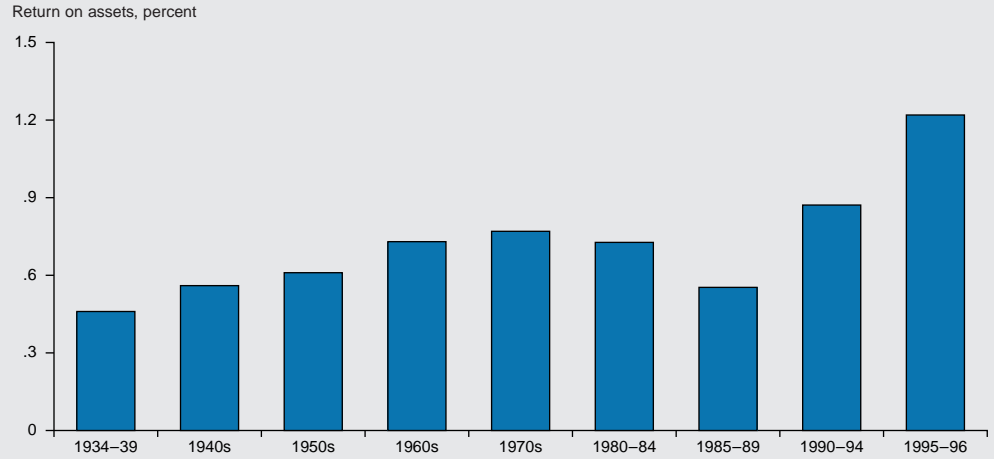
Cumulative growth, percent



DATA SOURCE: Bloomberg.

*Banking is moving more and more “beyond the balance sheet” and offering products and services not captured by conventional balance-sheet measures.*

**Chart 2**  
Insured Commercial Bank Profitability



DATA SOURCES: U.S. Department of the Treasury, *Modernizing the Financial System*, February 1991; Report of Condition and Income.

national levels during the 1990s (*Chart 3*). After a sharp downturn in net income during the late 1980s, regional bank profitability rebounded to match levels for banks in the rest of the United States.

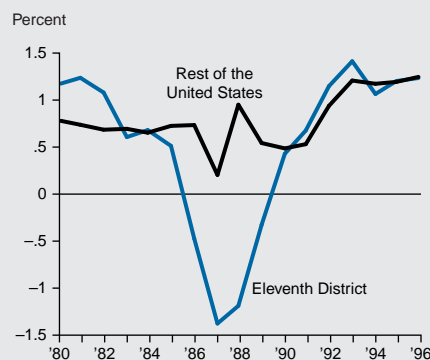
Bank statistics also indicate a shift toward higher levels of noninterest income as banks respond to changes in their environment. As *Chart 4* shows, noninterest income for Eleventh District banks rose from 0.72 percent of average assets in 1980 to 1.95 percent in 1996. For banks in the rest of the United States, noninterest income increased from 0.83 percent of average assets in 1980 to 2.23 percent in 1996.

The movement in banking toward off-balance-sheet activities has reinforced this shift to higher noninterest income levels. Many new lines of business have emerged

in banking in recent years, which have increased fee income. Banking is moving more and more “beyond the balance sheet” and offering products and services not captured by conventional balance-sheet measures. These nontraditional activities range from securitizations and backup lines of credit to complex financial derivatives products. *Chart 5* shows that total off-balance-sheet items have risen from \$8 trillion in 1990 to \$23 trillion in 1996, with financial derivatives accounting for most of this increase.

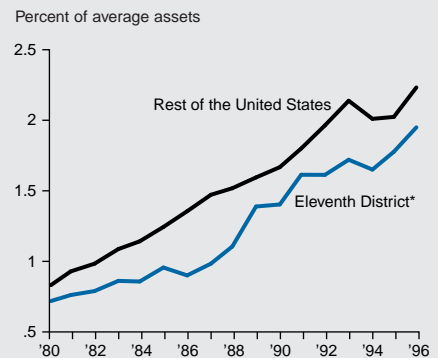
Banks also have improved asset quality, as the dramatic decline in troubled assets indicates (*Chart 6*). Troubled assets held by insured commercial banks in the United

**Chart 3**  
Return on Assets for Insured Commercial Banks



DATA SOURCE: Report of Condition and Income.

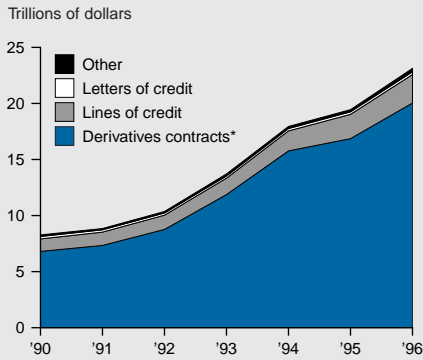
**Chart 4**  
Noninterest Income for Insured Commercial Banks



\* Figures for 1989 exclude Bank One—Texas. Including Bank One, the figure would be 2.04 percent.

DATA SOURCE: Report of Condition and Income.

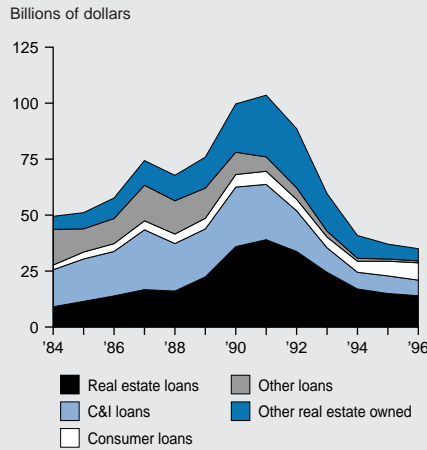
**Chart 5**  
Off-Balance-Sheet Activities of Insured Commercial Banks



\*Derivatives contracts are in notional value, which is the amount upon which interest and other payments are based. Notional principal typically does not change hands; it is simply a quantity used to calculate payments and does not give any indication of the underlying risk of the positions.

DATA SOURCE: Report of Condition and Income.

**Chart 6**  
Troubled Assets Held by Insured Commercial Banks



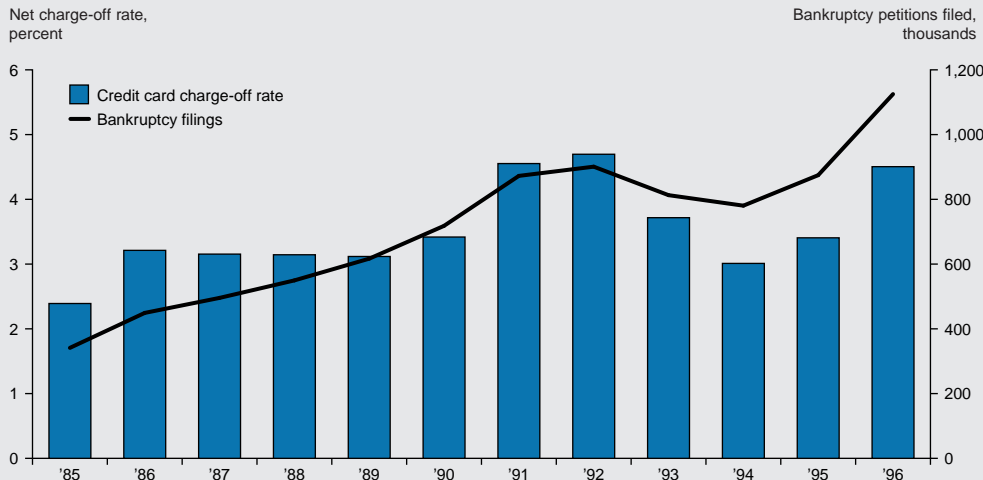
DATA SOURCE: Report of Condition and Income.

States dropped from \$104 billion in 1991 to \$35 billion in 1996. Despite recent increases in troubled consumer loans, total noncurrent loans also have fallen—from \$78 billion in 1991 to \$30 billion in 1996. The rise in past due consumer loans, however, is an area of increasing concern. Noncurrent consumer loans, which have been increasing since 1993, reached a peak level of \$7.8 billion as of year-end 1996. Accompanying this trend is the recent explosion in the number of personal bankruptcy filings and the current level of credit card charge-offs (*Chart 7*). Last year, the credit card charge-off rate reached 4.5 per-

cent, and personal bankruptcies hit an all-time high of more than 1.1 million filings.

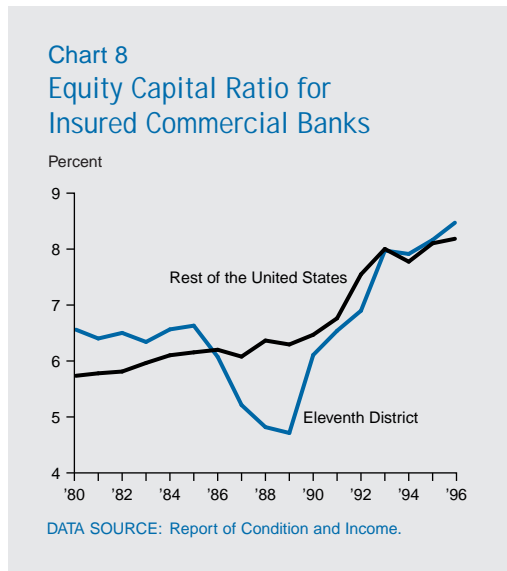
Despite growing consumer credit problems, bank loan loss reserves and capital levels remain high. Banks in the Eleventh District and elsewhere in the United States have maintained a ratio of loan loss reserves to noncurrent loans well over 100 percent since 1992. And, as *Chart 8* shows, capital levels generally have increased. At year-end 1996, Eleventh District banks reported an 8.5 percent capital-to-asset ratio and banks elsewhere in the U.S. reported 8.2 percent. In other words, banks appear able to absorb potential losses.

**Chart 7**  
Credit Card Loss Rate and Personal Bankruptcy Filings



DATA SOURCES: Report of Condition and Income; Administrative Office of the U.S. Courts.

*Much of the improvement in banking industry performance has likely resulted from the changes in industry structure.*

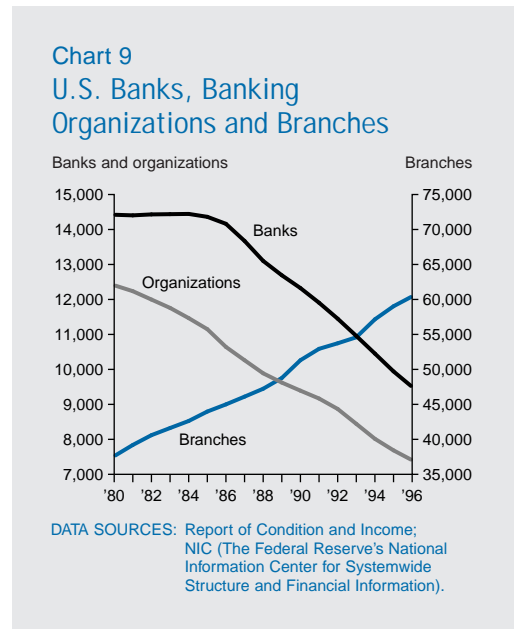


Bank measurement statistics indicate that the past few years have been good for banking. Profits are high partly because banks have found new sources for fee income. Despite recent increases in troubled consumer credit, overall asset quality measures remain favorable. In the event of a downturn, especially in the consumer credit area, banks have established fairly large cushions to absorb potential losses through high loan loss reserves and capital. Much of the improvement in banking industry performance has likely resulted from the changes in industry structure, as mergers have made many banks better able to compete within the changing environment in which they operate.

**How Has the Structure of the Banking Industry Changed?**

Massive consolidation among banks has occurred over the past several years. Chart 9 shows that the number of banks has declined from roughly 14,500 in 1984 to about 9,500 by the end of 1996. However, while the number of banks has declined sharply, the total number of branch offices has rapidly increased, which signifies greater efficiencies and broader customer outreach.

Mergers and acquisitions have contributed the most to bank consolidation, far outnumbering bank failures (Chart 10). Interestingly, new bank charters—which declined substantially from 1984 through 1994—have recently picked up steam. There were 142 new bank charters in 1996 and 100 in 1995, with 46 of the 50 states having at least one new charter each. The increasing number of new charters indicates there are plenty of opportunities for smaller



banks to compete in local markets.

Merger activity among the nation's largest banks has intensified in the last two years, with more than 20 billion-dollar deals announced since the beginning of 1995. High bank stock prices, intense competition, slow revenue growth and technology are helping fuel the recent merger frenzy. Through mergers, banks hope to increase their customer base, expand into new regions, extend their product offerings, cut overhead, exploit economies of scale and reduce overcapacity. An active merger and acquisition environment is expected to continue into the next several years.

The recent move to interstate branching will likely result in a continued decline in the number of banks. It is difficult to forecast the number of commercial banking

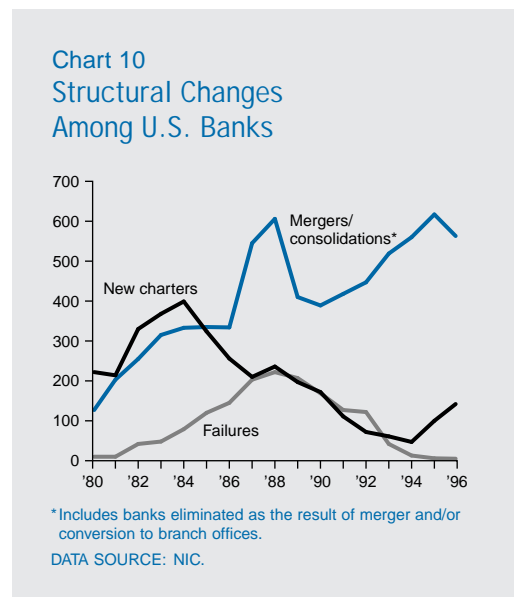
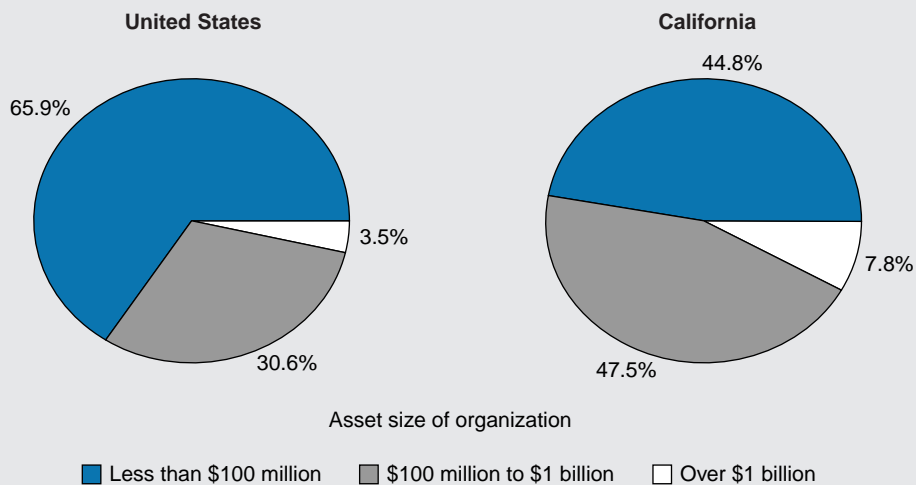


Chart 11  
Distribution of Banking Organizations  
December 31, 1996



DATA SOURCE: Report of Condition and Income.

*Congress is only beginning to address fundamental financial reform.*

organizations. However, because of California's longtime authorization of statewide branching and its diverse economy, the "California scenario" is often used as a model for predicting the number and distribution of U.S. banking organizations.

The California banking industry is characterized by a higher proportion of large banking organizations than in the United States as a whole. Assuming the same proportion of deposits per organization as California, the long-run projection for the total number of U.S. banking organizations would be roughly 3,300—down from 7,422 at the end of last year. Chart 11 shows the current banking organization distribution within three asset-size groups for both the United States and California. Nearly 66 percent of the banking organizations in the United States are small banks—those with less than \$100 million in total assets, compared with only 45 percent of

California's banking organizations. Assuming a distribution of U.S. banking organizations similar to that of California's would result in fewer banks overall, but particularly fewer small banks (*Table 1*).

While the structure of the U.S. banking industry has changed and will continue to change as the result of competitive pressures and technological advances, Congress is only beginning to address fundamental financial reform.

#### Should Financial Markets Be Reformed?

Banks and bank regulators have already taken steps, within statutory limitations, to expand the range of permissible bank activities. Banks have used products, such as derivatives, to gain access to a wider range of products and services. And regulators have effectively provided a limited avenue for financial reform by expanding the "laundry list" of activities

Table 1  
Number of U.S. Banking Organizations

	Actual 12/31/96	Projected	Percentage change
Less than \$100 million	4,891	1,492	-69.49
\$100 million to \$1 billion	2,274	1,581	-30.47
Over \$1 billion	257	258	.39
Total	7,422	3,331	-55.12

DATA SOURCE: Report of Condition and Income.

*The future of banking hinges on the industry's ability to embrace the changes inevitable in a transition to a knowledge-based society.*

permissible for bank holding companies, liberalizing Section 20 affiliate activities and allowing some banks to sell insurance and operate certain types of nonbank subsidiaries.

Although there appears to be general agreement on the need for more fundamental financial reform at the congressional level, the best method for accomplishing such reform is the critical question currently being debated. Allowing financial businesses to engage in the full range of financial activities—from traditional banking to securities activities to insurance—should provide the benefits of increased services and lower prices to customers, improved risk reduction and cost savings to financial institutions, and improved efficiency and stability of the U.S. financial system. These benefits result primarily from opportunities for diversification, cost reductions and effective cross-marketing arrangements through synergistic mergers.

The U.S. Treasury recently presented a financial modernization proposal aimed at overhauling the Depression-era laws that separate banking from other financial services activities. Under the proposal, bank holding companies that meet certain qualifications would be permitted, subject to certain safeguards, to engage in any financial activity. But while banks and the general public can expect to benefit from financial reform, legislative efforts to bring about financial modernization must not violate the tenets of good public policy. As Fed Chairman Alan Greenspan noted in a recent speech, "Any financial reform should be consistent with four basic objectives: (1) continuing the safety and soundness of the banking system; (2) limiting systemic risk; (3) contributing to macroeconomic stability; and (4) limiting the spread of both the moral hazard and the subsidy implicit in the federal safety net."<sup>3</sup>

#### What Will Banks Be Like in the Future?

The lines between banking and other financial services will become increasingly blurred. Banks of the future will be *financial services retailers* that provide products and services far beyond the traditional offerings of deposits and loans: insurance, investment options, tax and estate planning, and much more. As such, these financial services retailers will be keenly aware of changing customer demands. They will seek opportunities in the market, rather than trying to create opportunities from a developed infrastructure. They will initiate

dialogue with customers and draw direction from them, rather than sending out pre-packaged solutions in search of customers.

In addition, future "banks" will increasingly utilize cutting-edge technologies to bypass traditional delivery systems to meet customers where they want, when they want. The shift to electronic means for payments, communication and information processing will continue. Products and services such as smart cards, online banking and cybercash will become commonplace.

In this new environment, will small banks disappear? Certainly not. The large number of small banks in the United States goes hand in hand with the large number of small, entrepreneurial nonfinancial businesses. Small banks have traditionally been the major source of capital for these small businesses. And small businesses account for a major portion of our nation's new jobs and new ideas. As these new ideas develop, our economy is further strengthened. Well-managed, efficient small banks will still be able to provide this special niche in the financial marketplace.

#### Conclusion

The world of banking is indeed changing and will look different as banks evolve into financial services retailers. The future of banking hinges on the industry's ability to embrace the changes inevitable in a transition to a knowledge-based society where banks will continue to operate as information movers and risk managers. As long as there are information problems and risks to be managed, banks will be in demand. But we might not recognize them as the banks we know today. The banks of tomorrow will utilize technologically advanced delivery systems to offer an expanded selection of products and services customized to meet client needs.

— Thomas F. Siems  
Kelly Klemme

#### Notes

- <sup>1</sup> Standard & Poor's bank composite index is a capitalization-weighted index of all stocks in the S&P 500 involved in the business of banking.
- <sup>2</sup> The Eleventh Federal Reserve District comprises Texas, northern Louisiana and southern New Mexico.
- <sup>3</sup> See Alan Greenspan's May 3, 1997, speech at the annual meeting and conference of the Conference of State Bank Supervisors in San Diego.

# 11K Bank Notes

## Application Process Streamlined

The Board of Governors of the Federal Reserve System recently announced revisions to Regulation Y intended to improve the competitiveness of bank holding companies by eliminating unnecessary regulatory burden and operating restrictions, and simplifying the application and notice process. Effective April 21, 1997, the major revisions include the following:

- A streamlined, expedited review process for bank acquisition proposals from well-run bank holding companies
- Reorganizing and expanding the regulatory list of nonbanking activities and removing several restrictions on activities that are outmoded, have been superseded by Board order or do not apply to insured banks that conduct the same activity

For further information, contact the Banking Supervision Department's Applications Division at the Dallas Fed at (214) 922-6078, or visit our Web site at [www.dallasfed.org](http://www.dallasfed.org).

### Financial Industry Issues Federal Reserve Bank of Dallas

Robert D. McTeer, Jr.  
President and Chief Executive Officer

Helen E. Holcomb  
First Vice President and Chief Operating Officer

Robert D. Hankins  
Senior Vice President

Genie D. Short  
Vice President

Economists  
Jeffery W. Gunther, Robert R. Moore, Kenneth J. Robinson,  
Thomas F. Siems, Sujit "Bob" Chakravorti

Financial Analysts  
Robert V. Bubel, Karen M. Couch, Kelly Klemme,  
Susan P. Tetley, Edward C. Skelton

Research Programmer Analyst  
Olga N. Zograf

Graphic Designer  
Lydia L. Smith

Editors  
Anne L. Coursey, Monica Reeves

Financial Industry Issues Graphic Design  
Gene Autry, Laura J. Bell

*Financial Industry Issues* is published by the Federal Reserve Bank of Dallas. The views expressed are those of the authors and should not be attributed to the Federal Reserve Bank of Dallas or the Federal Reserve System.

Articles may be reprinted on the condition that the source is credited and a copy of the publication containing the reprinted article is provided to the Financial Industry Studies Department of the Federal Reserve Bank of Dallas.

*Financial Industry Issues* is available free of charge by writing the Public Affairs Department, Federal Reserve Bank of Dallas, P.O. Box 655906, Dallas, Texas 75265-5906, or by telephoning (214) 922-5254 or (800) 333-4460, ext. 5254.

# Want to Know More About Change?

The forthcoming issue of *Financial Industry Studies*, a semiannual Dallas Fed publication devoted to scholarly research into the forces shaping banking and finance, features a look at the effectiveness of capital requirements in banking supervision and ongoing payments system reforms in Mexico.

The first article, "Are Capital Requirements Effective? A Cautionary Tale from Pre-Depression Texas," by Jeffery W. Gunther, Linda M. Hooks and Kenneth J. Robinson, investigates data from Texas banks operating in the troubled 1920s. The authors find that capital requirements did not succeed mostly because of a reliance on book value capital measures that overstated the true financial condition of banks. Similar problems may exist today, they point out.

In the second article, "Mexican Payments System Reforms," Sujit "Bob" Chakravorti concludes that Banco de México has been largely successful in achieving Mexico's payments system reforms. But, like other central banks, it still faces the possibility that government guarantees may weaken market discipline in the payments system.

Subscriptions to *Studies* are free upon request by calling (800) 333-4460, ext. 5257, or (214) 922-5257. Or fax your name and address to (214) 922-5268.



FEDERAL RESERVE BANK OF DALLAS  
P.O. BOX 655906  
DALLAS, TEXAS 75265-5906

BULK RATE  
U.S. POSTAGE  
**PAID**  
DALLAS, TEXAS  
PERMIT NO. 151