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# Challenging issues for banking in the United States

by:

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President Esther George discusses the future of banking regulation and the challenges the industry faces.

Nearly a decade after the Great Recession, supervisors and regulators continue to work on repairs to the financial system. The implementation and ongoing refinement of reforms occupies the attention of both bankers and supervisors in order to assure the public that the system is safer. Considerable emphasis has been placed on developing better macroprudential frameworks, and in the United States, this remains a work in progress. This means supervisors must continue to carefully assess individual bank risks in today's challenging landscape influenced by monetary policy and other economic drivers as well as innovation.

With this as the backdrop, I see three key issues that confront the U.S. banking system today: a low interest rate environment; technological disruption; and ongoing implementation of regulatory changes and supervisory expectations. These views are mine and not necessarily those of others in the Federal Reserve System.

## Banking structure in the United States

The U.S. economy is characterized by businesses in a wide range of sizes that are spread across a large geography and require a variety of banking services. For most of the United States' history, our banking system mirrored this structure and, as a result, was a key source of strength for innovation and growth that helped create the world's largest and most dynamic economy. Historically, the vast majority of banks in the United States have been relatively small. These community banks provide the specialized services that small businesses need to prosper and grow, and serve households that need to save and invest. Large banks, meanwhile, provide the services that large businesses need to maintain a competitive advantage for operating nationally and internationally.

Over the past 30 years, however, the structural characteristics of the U.S. banking system have changed dramatically due to a variety of market and regulatory developments. While the number of U.S. banks is still quite large at more than 5,000 institutions, it is about one-third the number of banks that existed in the mid-1980s. The decline is due entirely to a drop in the number of banks with less than $1 billion in assets, while the number of large banks increased over this period. This consolidation continues today.

Much of the consolidation before the most recent financial crisis was the result of two factors:

• A large number of bank failures due to problems in agriculture, energy and commercial real estate in the early 1980s through the early 1990s; and

• The relaxation of geographic restrictions on branch banking and ownership within and across state lines in the mid-1990s that led to an increase in mergers.

One of the most significant developments of this period of consolidation has been the extraordinary rise in the dominance of the largest banks. In the 1980s and early 1990s, the shares across bank sizes were about the same, roughly in the range of 25 to 30 percent. Overall, this generally even distribution of bank sizes supported small rural businesses, to midsized commercial interests, to the country's largest domestic and global firms. By the mid-1990s, however, asset growth of banks larger than $50 billion in assets accelerated, leading to a three-fold increase in their market share to nearly 75 percent. Since 2008, the largest of these banks have had to refocus their efforts. They have pulled back their mergers and acquisition efforts, mortgage expansion programs and commercial real estate activities. Instead, they have had to focus on reducing excessive leverage, managing their operational and legal risks, and complying with the increased consumer protection, safety and soundness and financial stability regulations. As a result, their market share has stabilized as asset growth slowed to the same rate as smaller banks.[1]

Merger activity slowed through the financial crisis, but soon after resumed a healthy pace. Since 2010, the number of U.S. banks has fallen by 20 percent. Some of the decline initially resulted from failures, but since 2011, mergers have driven industry consolidation. There also has been a lack of new entry. Only three new banks have been chartered since 2010.

In any given industry, the lack of new entrants can signal trouble. Market saturation and economies of scale can create barriers to entry and discourage diversity and competition. In the case of the U.S. banking sector, a variety of reasons have been suggested for the lack of entry in recent years. I will focus on three challenges that may explain in part the lack of new entrants, but more generally are viewed as headwinds to the banking industry: a low-interest-rate environment, technological change and regulatory compliance.

## The challenge of low interest rates

Notwithstanding the objectives of monetary policy to support economic growth, the persistence of historically low interest rates since 2008 has negatively affected bank profitability. While the return on assets for U.S. banks has largely recovered from the crisis, it remains some 30 basis points lower in the current economic environment than what we saw prior to the crisis.[2] With relatively weak demand for loans and other services, Federal Reserve research finds the "low-for-long" interest rate environment hurts bank net interest margins and could well deter the formation of new banks.[3]

Net interest margins have fallen for both large and small banks. For large banks, margins are 40 basis points lower than the recession trough. For smaller banks, net interest margins remain near 30-year lows with a larger impact on earnings because smaller banks traditionally tend to be commercial lenders and depend almost exclusively on interest incomes as a source of revenue. In addition, these smaller banks face increased interest rate risk from this revenue source as they extend durations on their assets to improve yield. The current level of margins is supported by research at the Federal Reserve Bank of Kansas City, showing a stable relationship between short-term interest rates and margins over business cycles to the mid-1970s.[4]

I also have been particularly concerned that keeping rates too low can misallocate capital and create incentives to reach for yield, exposing lenders to higher risks when short-term rates do rise. More generally, as we have witnessed, interest-sensitive sectors can take on too much debt in response to low rates and grow quickly, then unwind in ways that are disruptive. We saw this during both the housing crisis and the current adjustments in the energy sector in the United States.

## The challenge of technological change

A second challenge facing the banking industry is a rapidly changing landscape for lending and payments mechanisms. Often referred to as disruptive technology, this change moves in the direction of improving productivity and efficiency across all sectors of the economy even as it alters existing business models. In the banking industry, technological change is challenging existing bank business models for lending and for how individuals and businesses make payments. New sources of competition have emerged from financial technology—or so-called fintech—firms. This competition can force banks to become more efficient within their own operations, and in some cases, banks are partnering with fintech firms to effectively respond to this changing marketplace.

The demand for online and mobile banking products, while an efficient and easy way for customers to access banking services, is costly for banks to implement, especially small banks or new entrants. Banks must have the personnel and infrastructure to provide these services while maintaining protections against unauthorized access of systems and confidential customer information.

In January 2015, the Federal Reserve released *Strategies for Improving the U.S. Payment System.* This is a multiyear plan focused on improving the speed, efficiency and safety of the U.S. payment system from end-to-end to meet the growing demands of American consumers and businesses as they continue to shift toward e-commerce and internet-enabled technologies in their daily transactions.

Central banks around the world have used government mandates to provide the control and direction needed to complete large-scale national initiatives such as payments system improvement. In the United States, the absence of a government mandate and recognition that significant investments in legacy systems were in place led the Federal Reserve to take a different approach.

Two task forces were created with some 500 members—one focused on faster payments and the other on the security of payments. Membership across these groups is broad-based and includes technology providers; small, medium and large financial institutions; payments networks; trade associations; business end-users and consumers; and a small number of government officials. In 2017, the Faster Payments Task Force will issue a public report assessing potential solutions.

Progress on bringing faster payments to the United States must keep in focus the fundamental responsibility to ensure the overall safety and integrity of the payment system. Today's dynamic, persistent and escalating security threats are challenging public confidence in the U.S. payments system. The growing scale, sophistication and global nature of cyberthreats along with the proliferation in points of vulnerability has made security a key priority for the banking industry and for central banks and regulators around the world. Real-time payments present some familiar and some new risks. Experiences around the world and here in our own systems prove that these risks can be effectively managed and real-time payments can be safely and securely provided.

These efforts all promise to produce valuable information, tools and insight for the industry. Driving widespread adoption of security improvements, however, remains a considerable challenge. Although U.S. payment system security is strong, keeping pace with the rapidly evolving and expanding risks that threaten the payments ecosystem is a key challenge. The Federal Reserve's priority in this important initiative has been to advance and support improvements that are in the public interest and will contribute to long-term financial stability and economic growth.

## Regulatory compliance challenges

The regulatory compliance challenges that banks face today are, of course, a reflection of the evolving nature of the industry. In the United States, changes over the past three decades produced a highly concentrated banking system with a small number of systemically important banks and thousands of smaller institutions. The stress of the financial crisis revealed the associated systemic risk to the broader economy and its taxpayers.

The international and U.S. response to the financial crisis was a host of new rules and regulations for capital, liquidity and resolution planning, to name a few. Now, with the associated increases in regulatory costs and lower profits, there are calls for halting or rolling back regulations. Thousands of small banks argue that regulatory burden threatens their long-term viability and ongoing business model as traditional lenders providing access to credit in small and rural communities. For bank regulators, questions remain as to the effectiveness of the new regulations to solve the too-big-to-fail problem and whether the cost of capital will constrain credit growth. Several legislative proposals have been brought forward to address these issues, but they often are based on ideological views of pulling back or expanding regulation as opposed to solving the problem at hand.

In the long run, my own view is that capital is the best regulator of risk because it is well-positioned to absorb losses by putting shareholders' money at risk. Putting owners' equity at risk also creates important incentives for allocating capital to its most productive use and for pricing risk appropriately. Indeed, enhanced capital regulations have significantly raised tangible common equity leverage ratios from the historically low pre-crisis levels for large banks. Yet, these ratios remain a full percentage point lower than for smaller banks.

Regulations work best when they appropriately align incentives and risk-taking. The current bank regulatory environment reflects the complexities of the banking system itself. Whether these regulations have been effectively calibrated to achieve their aim will be debated. Certainly, the largest banks should internalize both the private operating costs and social costs of the risk they pose to the financial system and economy.

## Looking ahead

U.S. banks, both large and small, face a challenging environment today in terms of low interest rates and a rapidly evolving technology delivery system for lending and making payments that is raising competitive pressures and posing new security risks. The industry also faces a challenging regulatory environment, one that is complicated by decades of major structural shifts. These changes have resulted in a handful of banks that pose systemic risk to the economy and the financial system, with thousands of smaller banks serving the credit needs of smaller communities and rural parts of the country.

Ultimately, our goal must be to provide an incentive-compatible policy framework that supports strong economic growth and financial stability. We are on the right path for providing a safe and efficient payment system to support economic growth. However, we have much more work to do in ensuring banks are not too big to fail, that we do not drive smaller banks that provide important public value out of the market, and that our interest rate policies do not create disruptive structural imbalances for which there are no tenable policy options.

## Editor's Note:

The text is from a speech George gave Oct. 19 at the Bank for International Settlements Eleventh High Level Meeting on Global Banking Standards and Supervisory Priorities in the Americas in Mexico City.

## Endnotes

[1] *From 1993 through 2008, the annual asset growth for the large banks was less than 10 percent in only two years. Their share of industry assets rose from 24 percent to 74 percent. Since 2009, the large-bank growth rate has slowed to 6.5 percent.*

[2] *Return on assets for large and small banks averaged about 1.3 percent pre-crisis and have been about 1.0 percent since 2012.*

[3] *"Low-for-long' Interest Rates and Net Interest Margins of Banks in Advanced Foreign Economies," Stijn Claessens, Nicholas S. Coleman and Michael Donnelly, Board of Governors of the Federal Reserve System, IFDP Notes, April 11, 2016.*

[4] *"What Explains Low Net Interest Income at Community Banks?" Charles S. Morris and Kristen Regehr, Federal Reserve Bank of Kansas City, Economic Review, Second Quarter, 2014.*

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