FYI: An Update on Emerging Issues in Banking

The Evolving Role of Commercial Banks in U.S. Credit Markets

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Note: This is the first of a series of papers comprising the FDIC's Future of Banking Study.

Banking is often thought of as among the most traditional of industries. Because of this conventional wisdom, innovation in financial services is sometimes thought to originate in areas other than commercial banks.[1] Long term financial sector trends would appear to support this view. As new technologies and new practices have expanded the volume of U.S. credit market debt relative to GDP since 1980, the share of that debt held by commercial banks has clearly declined. However, a careful analysis of U.S. financial sector data shows that banks' share of the financial services market has not shrunk to the extent that is commonly asserted. Moreover, banks have assumed leading roles in providing some of the newer types of financial services products, such as credit card securitizations and mortgage banking services. Today's issue of FYI summarizes an in-depth analysis of these trends that was published today under the FDIC's ongoing study of *The Future of Banking.*

Recent historical trends clearly show cross-currents in the importance of financial services in the economy and the share of that activity financed directly by banks. During the 1980s, the total indebtedness of U.S. households, government and nonfinancial businesses rose from just over 1.3 times annual GDP to nearly 1.9 times the size of the economy. Meanwhile, the share of these borrowings directly funded by commercial banks fell, from a peak of 30 percent in 1974 to a low of 20 percent in 1993 .

Banks' smaller share of the credit-market pie reflects a dramatic shift in the way loans to households and businesses are being financed. Specifically, asset securitization (the pooling of loans and their funding by the issue of securities) has allowed loans that used to be funded by traditional intermediaries, including banks, to be funded in securities markets.

Somewhat surprisingly, we find that commercial banks continue to play a significant role in directly funding loans to non-financial businesses. Indeed, the share of business-sector debt held directly on commercial bank balance sheets has remained relatively stable (at around 30 percent) for the past five decades. However, there has been a notable shift in *how* banks make commercial loans, moving away from shorter-term unsecured loans and towards loans secured by business real estate. This shift partly reflects increased competition from other sources of credit, including the commercial paper market, finance companies, and asset securitization. The shift also reflects the continuing comparative advantage of banks in commercial real estate lending, a form of lending that is, in some cases, less well-suited to the standardization necessary for asset-backed securitization.

With respect to the funding of household debt, commercial banks and, to a greater extent, savings institutions have lost market share to the securitization process for home mortgages and other forms of consumer credit. However, the increasing commoditization of consumer and mortgage lending—that is, the standardization, unbundling, and repackaging of payments and risks associated with credit flows—makes the actual holding of household debt a less accurate measure of the provision of financial services than it may previously have been. Commercial banks provide

significant services in originating, servicing, and enhancing the liquidity and quality of credit that is ultimately funded elsewhere. Hence, market-share measures based on balance-sheet data are likely to understate the importance of banks to a greater extent than even a decade ago.

A better measure of market share in the financial services sector may be the net income of banks versus other types of financial institutions. Focusing on income-based measures of market share, we find no evidence of a secular decline in the importance of commercial banking. Analysis of publicly-traded financial firms shows that commercial banks and savings institutions accounted for 44 percent of total financial sector earnings between 1992 and 2002, a level comparable to their share before the banking sector problems of the 1980s. A growing source of earnings for banks during the last two decades has been noninterest income, including fees from both traditional banking activities and new activities such as securities underwriting. Noninterest income rose from 18 percent of bank net operating revenue in 1980 to 42 percent in 2003, helping push total banking industry profits to record levels.

The bottom line of today's FDIC report on *The Future of Banking* is that, despite the challenges of measuring market share in an evolving financial services industry, common perceptions of the decline of the banking sector have tended to be somewhat exaggerated. While innovation has led to new and more efficient ways to provide credit market financing outside the banking balance sheet, banks remain integral not only in terms of funding these loans but also as active participants in the newer types of financial market activities.

[1] See, for example, "Banking Is Necessary -- Banks Are Not," *Fortune*, May 11, 1998. pp. 84-86.

About *FYI*

FYI is an electronic bulletin summarizing current information about the trends that are driving change in the banking industry, plus links to the wide array of other FDIC publications and data tools.

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