The Future of Banking:

by Stuart I. Greenbaum and Arnoud W.A. Boot

(Continued from page 1)

An ever-expanding array of financial instruments, institutions and markets provide increasingly sophisticated funding opportunities, risk management and payments services. The challenge of mastering the cascading opportunities has embarrassed more than a few non-financial corporations. Financial managers are asked to balance the benefits of bank relationships against the immediate savings of arms-length transactions with the more anonymous public capital markets, and this has proved to be a daunting challenge.

The following analysis explains the non-financial corporation's need for caution in exploiting competitive markets for financial services. Transaction-oriented deals will offer striking savings in the short run, but relationships with financial institutions protect liquidity in a volatile financial marketplace. Still other advantages of bank financing suggest a complementary relationship between banks and public capital markets. In the more competitive, fragmented and fragile financial services environment, conscious efforts are required to configure an optimal mix of relationship- and transaction-oriented financial opportunities.

We begin by sketching recent developments in the market for financial services. Although falling information costs will continue to stimulate competition and reshape financial markets, banks will continue to serve a crucial, if diminished, role in lending as well as risk management. Several suggestions are offered as to how banks should reposition themselves to exploit their inherent advantages vis-à-vis the public capital markets. Restructuring, reengineering and quality are increasingly commonplace in the banker's vocabulary as ambitious attacks on overhead expense are combined with enhanced customer sensitivity. Equally important are changes in the regulatory environment. The reconfiguration of the market for financial services will also test the adaptability of public regulators for they too will need to function in a more competitive environment. We will argue that without regulatory reform, commercial lending through banks will be impeded and credit crunches will subvert macroeconomic stabilization efforts.

We begin with a description of the banking environment. This is followed with a discussion of the emerging technology of securitization and its challenge to the competitive position of commercial banks. A discussion of the rising importance of banks' credit ratings and the evolving role of commercial banks as business financiers comes next. The lessons for Corporate America are addressed before the concluding section. ■

The Competitive Environment of Banking

For decades preceding the 1980s, banks operated in a symbiotic relationship with governmental regulators who restrained competition and supported the profitability of established institutions. Commercial banks were central among financial intermediaries; they safeguarded public savings, provided working capital and longer term credit to business, managed the payments system, and served as a conduit for the central bank's monetary policy initiatives. In return for their protected status, banks accepted regulatory scrutiny and restrictions on their activities.

However, a decade of stubborn inflation, lofty interest rates, and volatile capital markets trashed the banks' protected franchise. This was the legacy of the 1970s. Regulatory caps on deposit interest rates became too costly for bank and thrift depositors, prompting a massive diversion of savings to the largely unregulated money-market mutual funds that offered competitive interest rates. This shrank the banks' vast pool of cheap and stable funding, their so-called "core deposits," and forced them to borrow in the costlier public markets. In addition, the increased volatility of the banks' funding costs compelled a reallocation toward floating-rate credits. The inability of banks to offer low-cost fixed-rate credit drove their best customers to the public capital markets.

Worse, the clientele remaining became still riskier owing to the frequent repricing of their floating-rate loans. Higher and more volatile funding costs also coaxed banks into the business of writing off-balance sheet guarantees and trading all manner of financial derivatives. Collectively, these changes elevated banks' risks in virtually all aspects of their business.

Advances in information technology facilitated the circumvention of regulation and tilted the competitive advantage away from the "opaque" financial institutions, such as deposit takers and insurance companies, and towards more "transparent" intermediaries such as mutual funds and the public capital markets. The result has been a proliferation of specialized non-bank financial institutions. As shown in Figure 1 (see page 4), between 1980 and 1993 the market shares of commercial banks and savings institutions shrank whereas the anonymous "other" category more than doubled.[1] The winners included investment companies (mutual funds), finance companies, and pension funds.

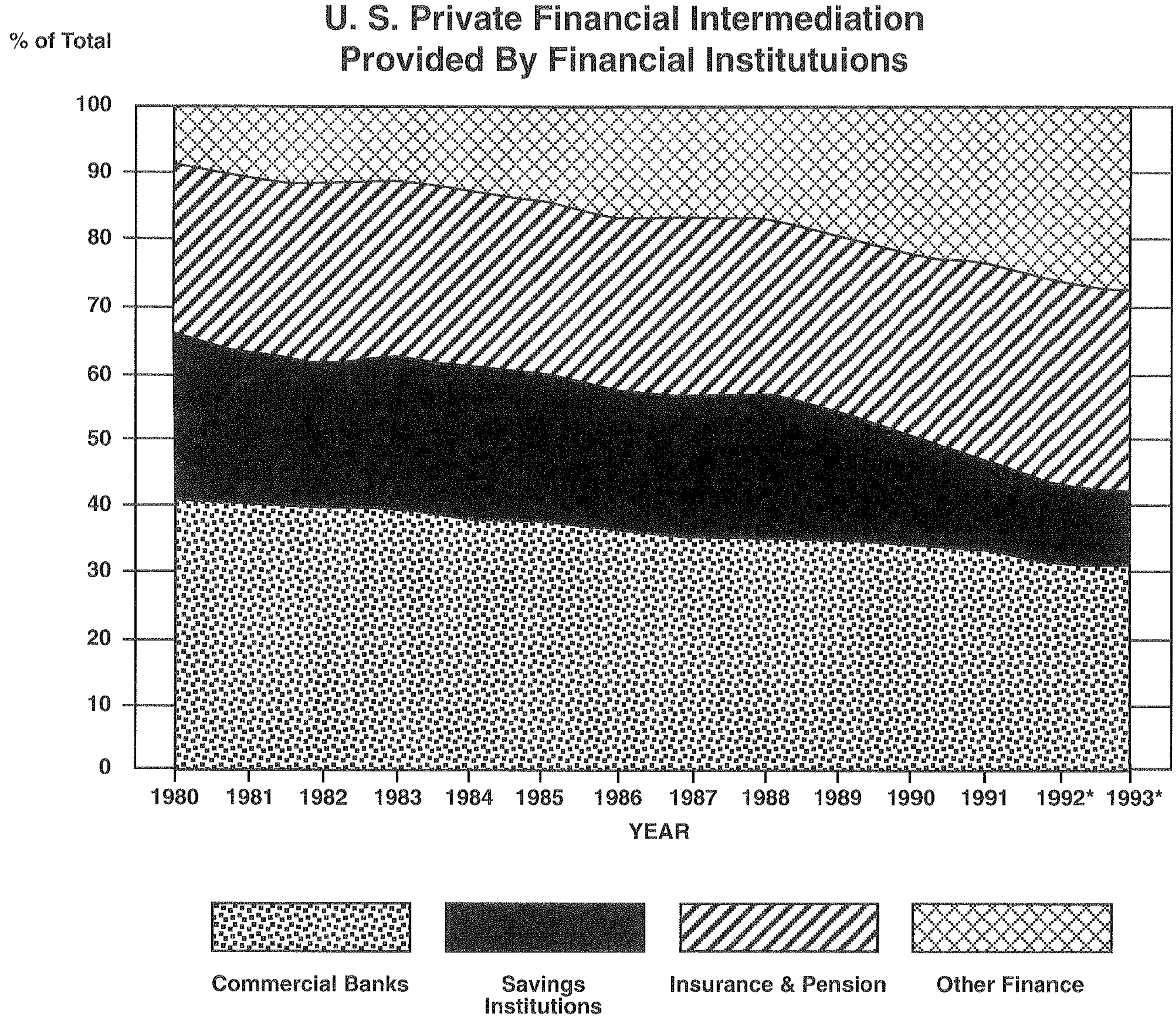
The banks' loss of market share is a manifestation of increased competition on both the asset and liability sides of their balance sheets. Finance companies, like GE Capital, have for decades grown their share of business and consumer lending. In addition, the commercial paper and bond markets have captured larger pieces of the business credit market. On the liability side, mutual funds have taken an ever-increasing share of the banks' low-cost funding. These bank losses, especially in their traditional funding function, seems structural and unlikely to be reversible. The recent spate of bank failures and consolidations reflects this competitive decline of banks.

With notable exceptions, such as the Scandinavian countries, other Western nations have been spared the banking turmoil visited upon the U.S. European banks are better diversified, both geographically and functionally. They typically operate nationwide, often with substantial cross-border operations, and engage in both commercial and investment banking activities. In addition, the greater concentration among European banks supports more discretionary pricing and other oligopolistic behaviors. Thus, Europe has not yet faced the unbridled competitive pressures of U.S. banking. Moreover, the most recent consolidation and despecialization among European banks —especially in Spain, Denmark, and the Netherlands — can be seen as a pre-emptive response to the threat of increased foreign competition. As a result, the market share of larger European banks has, in many instances, reached unprecedented levels.

However, focusing on the competitive and financial strength of existing institutions obscures the more fundamental changes in financial services markets. For a clearer understanding, it is necessary to address the basic services provided by financial intermediaries. After all, banks are what bankers do.

Most notable is the growth of banks' off-balance-sheet activities, including standby letters of credit, interest-rate and currency swaps, note issuance facilities, options, fixed- and variable-rate loan commitments, futures and forward contracts.[2] Most of these are financial guarantees, quite unlike the banks' simpler "money-in, money-out" activities. The newer off-balance-sheet activities reflect increased demand for insurance against interest rate, credit, currency and liquidity risks originating with clients who increasingly obtain credit from non-bank sources.

Off-balance-sheet activities are the consequence of a market-wide unbundling of financial ser-



Notes: Total private intermediation provided by financial institutions excludes corporate equities, but includes both direct and indirect holdings of credit market claims on the domestic nonfinancial sectors. Other Finance includes open-end investment companies (mutual funds), real estate investment trusts, money market mutual funds, security brokers and dealers and finance companies. A break in the data, denoted by *, occurs due to a change in the format of Table 1.60 of the Federal Reserve Bulletin.

Source: Board of Governors of the Federal Reserve System (1988, 1992, 1994).

Figure 1

vices. The banks' traditional lending function has been decomposed into more primal activities: origination, funding, servicing and risk processing. Origination subsumes screening prospective borrowers and the design and pricing of financial contracts. Funding relates to the provision of financial resources. Servicing involves the collection and remission of payments as well as the monitoring of credits. Risk processing alludes to hedging, diversification and absorption of credit, interest rate, liquidity and exchange rate exposures.

The bundling of origination, funding, servicing and risk processing that was traditional bank lending is being replaced. With the spread of securitization, illiquid assets are removed from banks' balance sheets. Asset-backed securities, rather than deposits, fund dedicated pools of bank-originated assets. Although the bank no longer funds the securitized assets, it continues to perform the other activities associated with lending. Thus, the loan origination, servicing and risk-processing activities remain with the banks.

Securitization highlights the growing importance of off-balance-sheet activities and the consequent reconfiguration of banking. The growth of off-balance-sheet banking also has elevated the competitive advantage attached to banks' credit ratings. Since financial guarantees from poorly-rated banks are of limited value, weaker institutions are disadvantaged in participating in such markets. ■

Securitization

Commercial banks traditionally financed their nonmarketable or illiquid assets with deposits. Little uncertainty is attached to the value or liquidity of these deposits which are often withdrawable on demand. The liquidity of bank deposits stands in striking contrast to that of their assets. By liquefying claims, banks facilitate the funding of projects that might otherwise be infeasible. In addition, the low risk, liquid deposit contract is valued for its transactions services and as a savings vehicle.

Banks' assets are illiquid largely because of their opaqueness or information sensitivity. In originating and pricing loans, banks develop proprietary information regarding borrowers and their projects and this proprietary information impedes the sale of these loans. Credit underwriting in advance of lending, as well as monitoring after the fact, generates a stream of private information that inhibits the tradeability of bank loans.

Securitization reorients the liquidity production process. According to McKinsey & Co's Lowell Bryan (1988):

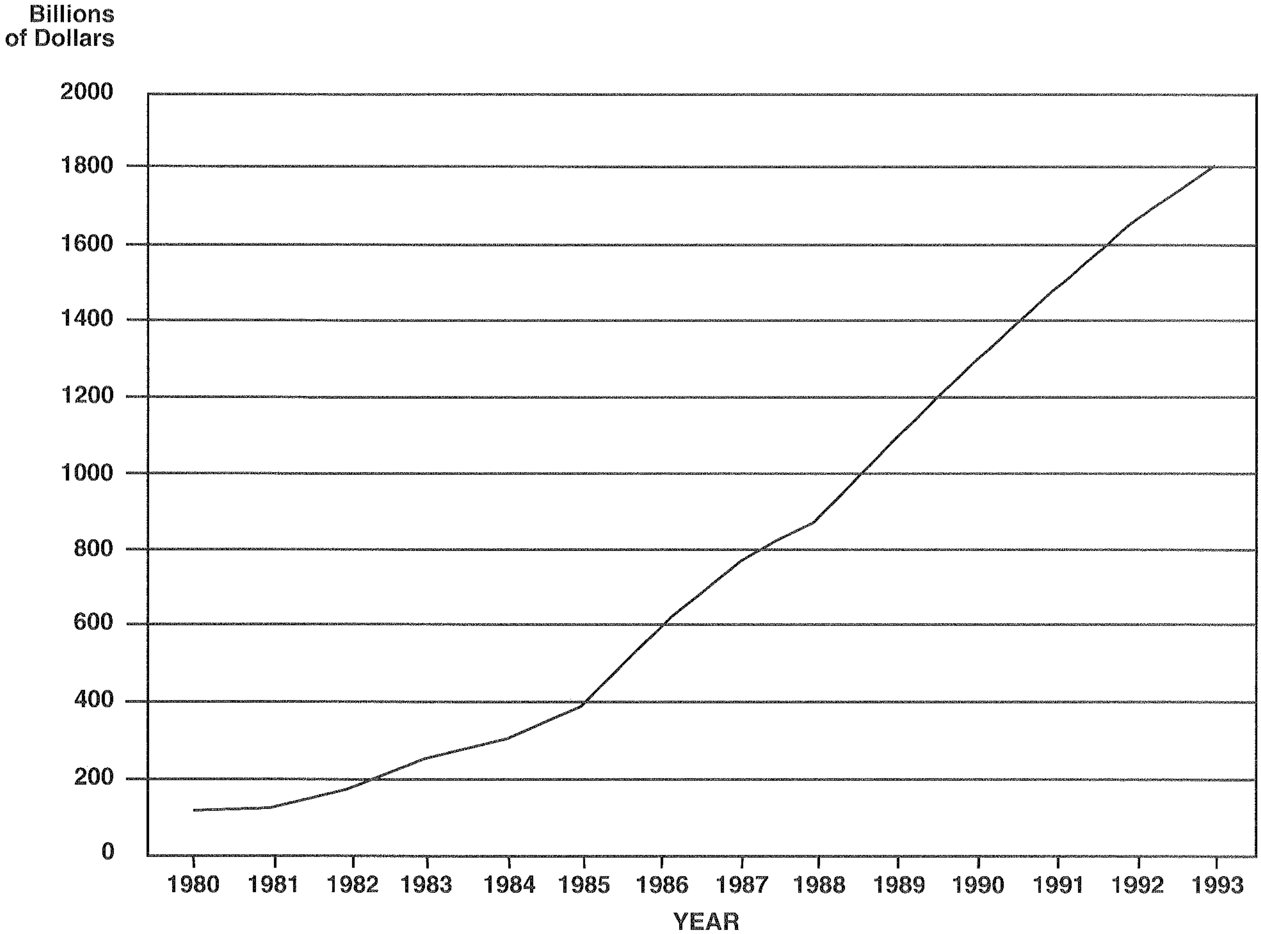
"Structured securitized credit is a new technology for lending that has been developed essentially by nonbankers. It is better on all counts than the traditional lending system. It is growing very rapidly precisely because it is a superior technology — one that, in fact, is rendering traditional banking obsolete."

Although securitization has spread rapidly in the last decade (see Figure 2 on page 6), mortgages, car loans, and credit-card receivables dominate.

The standardization and modest size of these credit contracts facilitate their pooling. Idiosyncratic risks are readily diversified, reducing the unpredictability of returns (see Box 1: The Basics of Securitization on pages 7 and 8). Private information distortions also are less severe for standardized credits. In contrast, larger, more customized and heterogeneous commercial loans tend to be more information sensitive. Their quality is therefore more dependent on the rigor of the initial screening and subsequent monitoring. Hence, the pooling of commercial loans does less to dissipate their information sensitivity, attenuating the benefits of securitization.

These considerations, however, do not preclude the securitization of business credits, they merely elevate the cost. For example, with more information-sensitive assets, the originating bank may need to retain a larger portion of the credit risk. In the jargon of the trade, greater "credit enhancement" will be required. Credit enhancement is typically achieved through the provision of "excess" collateral or with letters of credit. The enhancement reduces the riskiness of the asset-backed claims from the investor's perspective, but more importantly it addresses conflicts of interest rooted in the originating bank's proprietary information. With private information in possession of the originating bank, the market requires assurance

Outstanding Securitized Credit
Government and Private Issuers



Notes: Government issuers are government-sponsored enterprises such as Fannie Mae (mortgages), Freddie Mac (mortgages), and Sallie Mae (student loans).

Source: Board of Governors of the Federal Reserve System (1988, 1991, 1994).

Figure 2

that the bank will not exaggerate the quality of the assets it seeks to sell. As with a warranty in product markets, credit enhancement discourages misrepresentation by requiring the originator to absorb a portion of the losses owing to defaults. Similarly, credit enhancement signals the market that the originator will perform a thorough credit evaluation and an undiminished monitoring effort. Credit enhancement therefore reduces the information sensitivity of securitized claims by enhancing their marketability.

Securitization is a regulatory arbitrage, a method of shrinking banks' balance sheets in order to avoid regulatory taxes like cash-asset reserve and capital require-

The Basics of Securitization

Securitization is a technology for transforming illiquid bank loans into tradeable securities. It permits a bank that is capital-constrained and has exhausted its lending capacity to convert (sell) its loans into cash and thereby to resume its lending activities. Consider a bank with assets of $1000, distributed as follows:

Sno-Bank

Cash	$92	$920	Deposits
Loans	908	80	Capital

The bank just satisfies its 10 percent cash-asset reserve requirement and its 8 percent capital requirement and therefore has exhausted its capacity to lend.

In order to replenish its ability to lend, the bank sells its $908 of loans to a trust, a specially created legal entity designed to facilitate the securitization. The trust owns the $908 in loan assets and these would be funded by selling claims against the cash flows generated by the bank loans. Hence,

Securitization Trust

Loans	$908	$908	Claims

ments. However, capital and liquidity requirements are not the major culprits in the banks' competitive decline. Rather, the opaqueness of banks alluded to earlier more likely lies at the root of their diminished comparative advantage in funding. The private information inherent in bank loans affords bank management excessive discretion and their providers of capital too little control. Abundant cheap deposits and the paucity of competitive alternatives to bank loans held these problems in check, but with the dissipation of deposit rents the problems of opaqueness were brought to the fore. Securitization helps because it gives the market a direct claim to a specific group of assets that increases accountability and enhances transparency.

Since only a minuscule fraction of business loans has been securitized to date, many question whether information-sensitive assets are amenable to securitization. Traditional bank lending will undoubtedly continue to dominate when information sensitivity is severe. In such cases, credit enhancement, short of total recourse, may not overcome the private-information problem, in which case the advantage of securitization is largely lost. However, for an increasing array of moderately information-sensitive assets, securitization will become the preferred intermediation technology.

This further attrition of the funding role of banks need not imply their demise. Even if securitization eventually dominates the credit markets, an indispensable, if more attenuated role for banks will remain: they would originate and service assets, while also processing the attendant risk in order to sustain these activities. Banks would therefore continue to screen and monitor borrowers, design and price financial claims, and provide risk management services.

The monitoring and screening roles of banks point to the complementarity of bank and public capital market funding. In particular, the banks' role in overcoming information frictions may facilitate

The sale of the claims by the trust generates the cash that replaces the loans on Sno-Bank's balance sheet.

The claims sold to the public could be simply pro-rata shares in the loans' cash flows, but more typically there will be multiple classes of claims reflecting what is called "cash-flow stripping." For example, one class of claims might receive the early (short-term) cash flows and others would receive intermediate- and longer-dated cash flows. Sometimes the cash flows are stripped according to credit risk with a junior and a senior claim. In this case, all credit losses go to the junior security until it is exhausted, and only then are credit losses visited upon the senior claims. The stripping of cash flows is limited only by the imagination of the designer (financial engineer) and the opportunities provided by the marketplace.

In order to enhance the tradeability (liquidity) of the claims, almost all securitizations are "credit enhanced." This is done by either providing excess collateral (the $908 in bank loans might support only $850 in claims with the excess protecting claim owners against credit risk losses) or by providing guarantees such as standby letters of credit. The guarantees may be provided by the selling bank or by a third party — another bank or an insurance company. Credit enhancements typically elevate the claims to either double- or triple-A status, even though the underlying assets in the pool are unrated or below investment grade. The investment-grade status of the claims makes them readily tradeable. Hence the securitization of non-tradeable bank loans.

Box 1

arms-length funding in the public capital markets. For example, bond holders may free-ride on the monitoring done by bank lenders. Bank lending may thereby improve access to public capital markets.

Closely related to securitization has been the explosive growth of commercial and industrial loan syndications and sales. Prior to the LBO movement in the late 1980s, banks selectively sold loans of well-known companies to correspondents, but more recently riskier credits have been distributed to an ever-wider variety of buyers. In lieu of credit enhancement, selling banks typically retain a portion of the marketed loan in order to mitigate informational concerns.

Securitization and loan sales reflect an integration of banks and capital markets. Both call into question traditional institutional distinctions and attempts to preserve the legal separation of investment and commercial banking (see Box 2: The History of U.S. Bank Regulation on pages 9 and 10). ■

Bank Credit Ratings

According to Walter V. Shipley, CEO of Chemical Banking Corp.:

"With an improved credit rating we can finance ourselves more cheaply, and our customers as well." (*Business Week*, *11/4/91*)

Although a better-rated bank seems unlikely to accept a lower return on its assets, a better credit rating certainly affords a competitive advantage. For example, in international trade, transactions are often conditional on payment being guaranteed with a letter of credit from a highly rated bank. Over a wide and expanding range of activities, the credit ratings of banks define the quality of financial services being purveyed. Robert Merton (1993) distinguishes financial services from other investments on this basis.

The History of U.S. Bank Regulation

The idea that banks are special and therefore need to be regulated has deep historic roots. The First and Second Banks of the U.S., first chartered in 1791, played an active role in disciplining the note issuance of private banks. Indeed, their zeal earned the wrath of frontier interests that made recharter of the Second Bank an issue in the presidential election of 1832. Andrew Jackson, representing rural and frontier interests, hungry for cheap and abundant credit, prevailed and the recharter initiative failed. The Second Bank of the U.S. passed into history.

In 1829, safety concerns led the state of New York to create a short-lived deposit insurance fund. Concerns about the payment system prompted the National Banking Act of 1863/64 which established a national currency by taxing state-chartered bank notes out of existence while also establishing a system of national banks. This legislation led to the dual banking system with both state- and federal-chartered banks and accelerated the rise of deposit banking.

Further concerns about financial stability, especially as related to liquidity, led to the Federal Reserve Act of 1913 that established the Federal Reserve as clearing agent and lender of last resort. All national banks were required to join the Federal Reserve; for state-chartered banks membership was optional. Membership was desirable in that it provided access to Federal Reserve services, but it also imposed more stringent liquidity reserve requirements.

Much of the current regulation of U.S. banking dates from the Banking Act of 1933. Better known as the Glass-Steagall Act, the Banking Act of 1933 was a direct reaction to three debilitating banking panics that occurred after the Crash of 1929.

Crises are pandemic to banks that fund illiquid non-marketable assets with liquid deposit liabilities. They are periodically forced to incur large

When debt or equity of a non-financial enterprise is purchased, it is accepted that the value of the claims will vary with the fortunes of the firm. Indeed, the investor is routinely compensated for this risk. However, when guarantees are purchased from an insurer or deposits from a bank, hedging, liquidity or transactions services are sought. The purveyor's solvency is not something the purchaser seeks to speculate upon. Buyers are not investors and they need to believe the intermediary will perform if and when a claim eventuates. Hence, guarantees subject to solvency risk are steeply discounted.

There are at least two reasons to believe bank credit ratings have become more important in the market for financial services. The dramatic shift away from funding to off-balance-sheet activities offers one explanation. The point is especially compelling when bank liabilities are governmentally guaranteed, as with deposit insurance. Why would a bank's credit rating matter so long as the claim is a contingent liability of the U.S. government? But when the bank writes a letter of credit, an option, a swap contract or a loan commitment, the rating becomes overarching. Thus the shift toward securitization and off-balance-sheet services magnifies the importance of the bank's credit rating.

The second consideration is the widespread deterioration in banks' credit ratings (see Table 1 on page 12). The same is discernible among Japanese banks and larger U.S. insurance companies as well. This industry-wide decline expanded differences among individual banks and insurance companies giving rise to more pronounced quality distinctions among financial services. Earlier, when all were bunched around unexceptionable levels, there was little to distinguish the quality of the various services. With wider differences, the financial services producers were more

asset-liquidation costs when confronted with unexpectedly large deposit withdrawals. Indeed, even healthy banks can be pulled into insolvency. The Glass-Steagall Act, motivated by the Federal Reserve's failure to sustain the liquidity of the banking system, has three elements.

First, it created the Federal Deposit Insurance Corporation (FDIC). Participation in the FDIC's insurance was mandatory for all Federal Reserve member banks. Others, including state-chartered banks that chose not to join the Federal Reserve, could participate if approved by the FDIC.

Second, the Glass-Steagall Act restricted the operations of insured banks. The restrictions included limitations on deposit interest rates and a strict separation between investment and commercial banking that essentially prohibited commercial banks from originating, trading or holding securities other than those of the U.S. Government or general obligations (as opposed to revenue bonds) of state and local governments.

Third, together with the McFadden Act of 1927, Glass-Steagall erected entry barriers that limited competition among banks. Foremost it reinforced the individual states' authority to restrict interstate banking and limit bank holding companies and other avenues of expansion and concentration. Obtaining a bank charter became more difficult and expensive; the FDIC could refuse to insure a bank's deposits if capital was deemed inadequate, or if no community need was thought to be served.

Further restrictions were introduced with the Bank Holding Company (BHC) Act of 1956, which expanded Federal Reserve control over multi-bank holding companies. The 1970 Douglas Amendments to the BHC Act extended these controls to non-bank activities by bringing one-bank holding companies under regulatory control.

Box 2

clearly defined, and quality became the basis for sustainable competitive advantages.

Recent efforts of banks to augment capital may be an accommodation to *de jure* and *de facto* increases in capital requirements. However, at a deeper level, these efforts reflect the growing importance of ratings among increasingly disparate banks and off-balance-sheet banking services. Moreover, the banks' credit ratings should not be understood as ultimate ends, but rather as the most visible, albeit noisy, indicators of the banks' reputation, that intangible basis of trust. For financial service producers, reputation is a form of hidden capital, commensurable and even substitutable for financial capital (see Boot, Greenbaum and Thakor (1993)). Reputation warrants the price premia that elevate financial services from the realm of commodities.

J.P. Morgan, the best rated of the American money center banks, has been a paragon of profitability until very recently. Similarly, other U.S. money-center banks that have very recently managed to resurrect their ratings have experienced improved profitability. In contrast, the sullied Japanese banks have been forced out of markets for guarantees that they dominated only a few years ago. Clearly, when the stock-in-trade is promises, legally binding or not, and most especially in the latter case, it is the public's perception of the bank's trustworthiness that will determine the demand for its services.

Walter Bagehot spoke to this point more than a century ago:

Every banker knows that if he has to prove that he is worthy of credit, however good may be his arguments, in fact his credit is gone: but what we have requires no proof. The whole rests on an instinctive confidence generated by use and years.

Lombard Street, 1873

Banks as Financiers of Corporate America

If ever in doubt, the importance of banking was brought into focus during the economic stagnation of 1989-92. Bank lending to business had been declining for more than two years and the U.S. economy languished, failing to respond to expansive monetary policy stimuli (see Federal Reserve Bank of New York, 1994). Banks' holdings of government securities surpassed their loans to business, and for the first time in the U.S. banks' experience, American non-financial firms were found to have more relationships with foreign than with American banks. The Federal Reserve reported that, by value, almost half of all bank loans to U.S. businesses were by foreign banks.

The efficiency of the U.S. banking system needs to be assessed in a context broader than the profitability of U.S. banks. Banks are critically important to smaller corporations lacking access to the public capital markets. In past business cycles, the "small-cap" part of the corporate sector has led economic recovery. Smaller firms have been the primary engines of job creation, and these businesses are most reliant upon domestic banks for their financing. If they are to be adequately financed, it will require the active participation of domestic banks.

To be sure, the dependence of small-cap businesses on the banks will eventually wane if their credit needs are poorly served. The resurgence of the junk-bond market, the growing business lending of foreign banks, domestic finance and investment companies, and recent legislative initiatives aimed at encouraging business loan securitization, all suggest an institutional restructuring that could jeopardize the role of banks in the financing of smaller business.

Some argue that the weakness in bank business lending was demand driven; i.e., a paucity of attractive lending opportunities. However, this is a partial explanation, at best (see Federal Reserve Bank of New York (1994) and Bernanke and Lown (1991)). An equally compelling explanation points to the banks' capital paucity. The expansionary monetary policy was subverted by increased capital requirements and regulatory constraints. Aggressive monetary expansion depressed short-term interest rates to levels unseen for decades. Yet, banks failed to respond in time-honored fashion since many were capital constrained for the first time in modern experience.

The tighter constraint was reflected in higher capital requirements, greater penalties for non-compliance, and also greater certainty that penalties would be applied for non-compliance.[3] Instead of lending, banks deployed their augmented funds to government securities. Their profits rose smartly, but the business credit required to fuel an economic expansion was missing.

The lesson is that an impaired, capital constrained and over-regulated banking industry can impede economic recovery and prolong recessions. Perhaps for the first time since the Great Depression, the tension among sound banking, competitive banking and monetary policy was brought into acute relief.

An anemic recovery from recession deprived the community of needed jobs and income, absent the time-honored catalyst: inexpensive and readily available bank credit. Scandalized regulators and legislators were still reacting reflexively to the savings and loan debacle variously valued at a fourth to a third of a trillion dollars. Two hundred banks per year were failing and many billions of loan losses remained to be written off (see Figure 3 on page 14). In this environment, bankers were disinclined to accept credit risks, regulators were highly critical and punitive toward banks that were so inclined, and legislators elevated the amounts of unimpaired capital that banks were required to hold against risky assets. Bank examiners contributed to the ambience of fear and restraint by aggressively writing down loans, thereby forcing banks to record sometimes dubious losses.

The shortcomings of the prevailing approach to regulation, based on pervasive supervisory discretion, was exposed by the costly delay of economic recovery. Political incumbents certainly would have given bank reform greater priority had they understood the macro-economic entailments. As

Standard and Poor's Ratings of Senior Long-term Bank Debt

	1980	1981	1982	1983	1984	1985	1986
Banc One Corp.				AA	AA	AA	AA
BankAmerica Corp.	AAA	AAA	AA+	AA–	AA–	A–	BBB
Bankers Trust New York Corp.							AA+
Chase Manhattan Corp.			AAA	AAA	AA	AA	AA
Chemical Banking Corp.			AA+	AA+	AA	AA	AA
Citicorp	AAA	AA+	AA+	AA+	AA	AA	AA
First Chicago Corp.	AA	AA–			A	A	A
Manufacturers Hanover Corp.	AAA	AAA	AAA	AAA	AA–	AA–	A+
J.P. Morgan & Co.	AAA	AAA					AAA
Security Pacific Corp.	AA	AA+	AA+	AA+	AA+	AA+	AA

	1987[1]	1988	1989	1990	1991	1992	1993
Banc One Corp.	AA		AA–	AA–	A+	A+	A+
BankAmerica Corp.	BBB	BBB–	A	A	A	A	A–
Bankers Trust New York Corp.	AA+	AA+	AA+	AA	AA	AA–	AA–
Chase Manhattan Corp.	AA–	A	A	BBB+	BBB+	BBB+	BBB+
Chemical Banking Corp.	AA–	A	A–	BBB+	BBB+	A–	A–
Citicorp	AA	AA	AA	A+	A–	A–	A–
First Chicago Corp.	A	A	A+	A–	A–	A–	A–
Manufacturers Hanover Corp.	A	BBB	BBB	BBB+	BBB+	A–	
J.P. Morgan & Co.	AAA	AAA	AAA	AAA	AAA	AA+	AA+
Security Pacific Corp.	AA	AA	AA	AA–	A–	A	A–

Note: Blank spaces indicate either no senior long-term debt listed or that any senior long-term debt was not rated in the issue of the Standard and Poor's Bond Guide consulted. An issue was considered as long-term if it had a maturity date of at least 5 years from the year of the issue of the Bond Guide consulted.

Source: Standard and Poor's Corporation (1980–94).

Table 1

long as the small-cap sector of the economy remains dependent on domestic bank financing, the failure to forthrightly address the issue of banking reform will exacerbate the economic costs of the business cycle with all that entails. ■

Corporate America's Bank Relationships

Banks are the primary source of external funds for smaller corporations, but they serve larger institutions too. Even if securitization comes to dominate traditional bank lending, banks would continue to originate, service and guarantee loans. Given also the banks' underwriting and monitoring skills and proprietary information, they may well continue to prove indispensable in the provision of credit.

The costs of bank lending versus securitized borrowing depends on the information flow and trust between banks and their clients. Both grow out of relationships, but building relationships requires substantial investment that needs to be justified. The more competitive environment for financial services complicates this justification, explaining the proliferation of transaction- rather than relationship-oriented finance, whereby firms are pushed to the public capital markets.

While obviously not in the interest of banks, this migration need not be optimal for firms either. Close relationships with financial institutions preserve the flow of information between debtors and creditors as well as liquidity. But, how can firms benefit from more competitive pricing in the public capital markets without jeopardizing relationships with their financial services suppliers? This may be the most fundamental challenge of corporate finance: those corporations that best learn to balance the conflicting and sometimes subtle benefits of competitiveness and relationships will prevail.

The conflicting demands of competitiveness and relationship-building are highlighted by viewing banks as suppliers to the corporation. As with other inputs, quality dictates a mutual commitment between a firm and its suppliers. However, obtaining inputs at favorable prices requires exploiting competition. This tension must be managed in dealing with financial institutions.

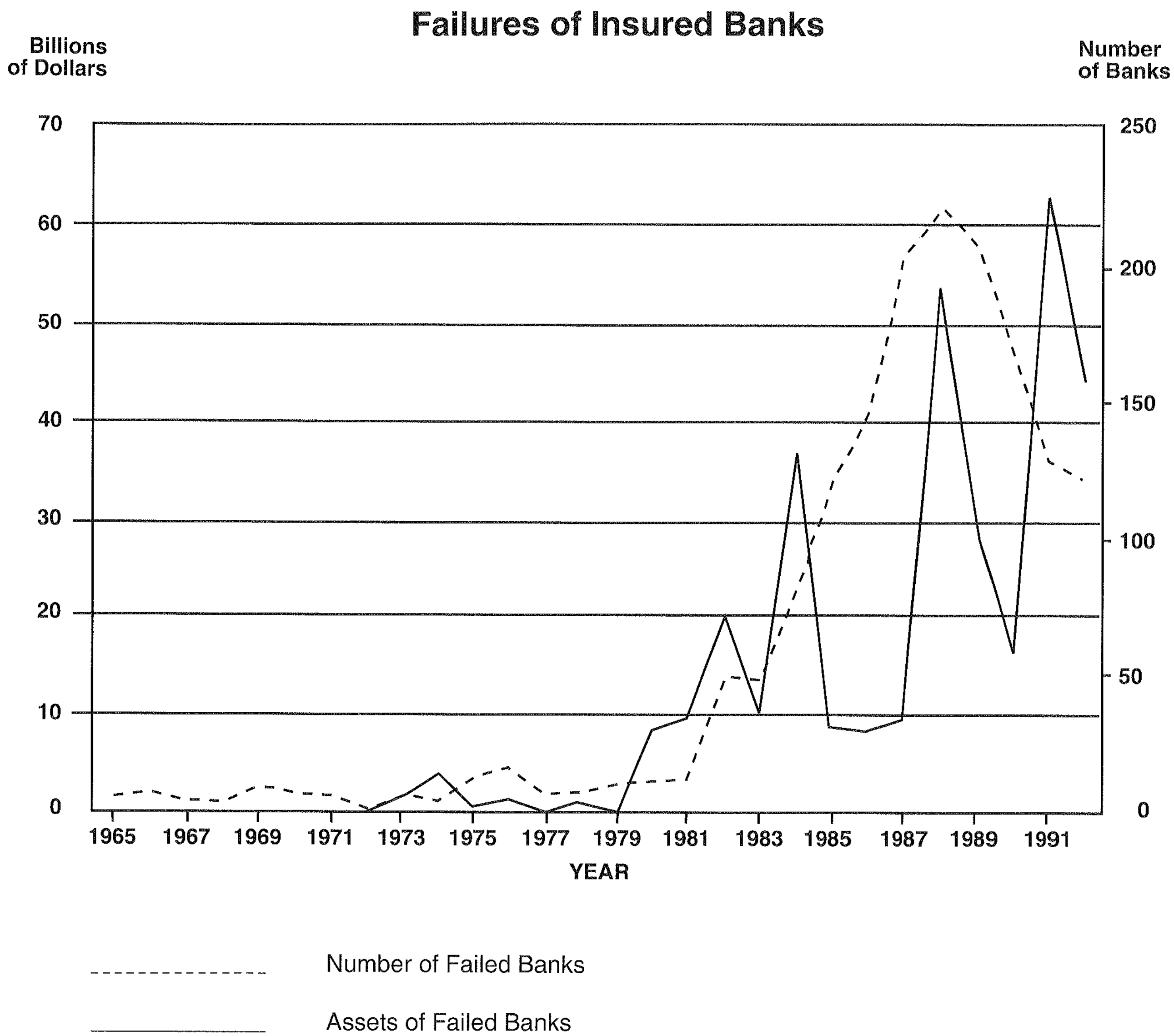
A corporation needs to promote candor and openness with its financial services suppliers. This will encourage banks to become client-driven rather than product-driven. Sophisticated users of financial services have an important role to play in this re-orientation. Increasingly competitive markets for financial services and the consequent unbundling of financial services will prod banks to customize more client-driven services. Reengineering, aggressive assaults on overhead and increasing attention to ISO standards and quality are symptomatic. ■

Summary

Securitization and off-balance-sheet activities have liquefied bank loans displacing them to the public capital markets. Banks and the capital markets have consequently converged toward seamlessness. The artificiality of separation between banks and financial markets is further highlighted by new financial instruments that blur the distinction between debt and equity. Swaps and options have made it possible to fashion securities with almost any desired combination of attributes. These developments weaken the special status of banks. No longer can bankers dominate their traditional clienteles. They now face relentless competition from public capital markets as well as from non-bank financial institutions, both domestic and foreign.

Competitiveness in banking is new; only rarely have Western countries consciously left their financial institutions unprotected. Entry into banking has been restricted from time immemorial. The challenge for corporate America is to have banks work for them. But this requires durable relationships. The challenge is to sustain such relationships without forfeiting the benefits of competitive pricing, and other forms of flexibility offered by the public capital markets.

The winners will learn to balance the need for liquidity and customized claims against the benefits of inexpensive, arm's-length transactions in the public capital markets. ■



Notes: Data includes open assistance transactions and is for insured banks only.

Source: Federal Deposit Insurance Corporation (1990–92) and United States Treasury (1991).

Figure 3

Endnotes and References

1 These data may overstate the decline of banks because off-balance-sheet banking, the most rapidly growing part of the business, is ignored (see Boyd and Gertler (1994)).

2 For a detailed discussion of financial derivatives, see Global Derivatives Study Group (1993).

3 The FDIC Improvement Act of 1991 addressed both penalties for non-compliance and the certitude with which penalties are enforced.

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Professor Greenbaum joined Northwestern University as Professor of Finance and Director of the Banking Research Center in 1976, twelve years after earning his Ph.D. in economics at The Johns Hopkins University. He was named the Strunk Distinguished Professor of Financial Institutions in 1983, five years after being designated the H.L. Stuart Professor of Banking and Finance. From 1988-92, he served as Kellogg's Associate Dean for Academic Affairs. At various times before joining Northwestern, Professor Greenbaum served as Chairman of the Economics Department at the University of Kentucky, and on the staffs of the Comptroller of the Currency and the Federal Reserve.

Professor Greenbaum has served on nine corporate boards. He was thrice appointed to the Federal Savings and Loan Advisory Council, and served on the Illinois Task Force on Financial Services in 1985-6. He has consulted for the American Bankers Association, the Bank Administration Institute, the Comptroller of the Currency, the Federal Reserve System and the Federal Home Loan Bank System, among others. He has on numerous occasions testified before Congressional committees, as well as other legislative bodies.

Professor Greenbaum has published more than 75 books and articles in academic journals and other professional media. He is the founding and managing editor of the Journal of Financial Intermediation and has served on the editorial boards of eight other academic journals.

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