Why Banking Isn't Declining

Banking has been described as a declining industry. Banks are not that important anymore, the story goes; modern capital markets and financial competitors are displacing them as suppliers of credit and transaction services. Superficial evidence of a decline is easily found. As Figure 1 shows, bank assets are a steadily smaller proportion of the total assets of the financial sector and the total number of banks in the United States has fallen dramatically. During the 1980s, bank failures hit levels not seen since the Depression.

Is banking dying? This Weekly Letter discusses evidence from several recent analyses of the health of banks and the banking industry. These studies approach the question from various angles, but their results support what may be a surprising conclusion: Banking is surviving, and by some measures becoming a larger part of the U.S. financial system.

Assets don't matter as much anymore

Banks' falling share of the total assets of the financial sector (as in Figure 1) is probably the most frequently cited evidence of the ill health of banking. However, the financial sector is growing steadily in importance in the economy. Even if banks are shrinking relative to their financial competitors, their slice of the expanding pie may be bigger. Banking assets are actually growing faster than the economy as a whole.

But asset trends are misleading, because assets are not a good signal of the volume of activity in financial services. An important and widely noted development in financial markets over the last decade has been the growth of lines of business that do not create assets in the traditional accounting balance-sheet sense. For example, if a bank provides a business customer with a standby letter of credit instead of a loan, nothing goes on the balance sheet. Bank involvement in derivative financial instruments generally adds little or nothing to booked assets. Yet these and other relatively new financial activities have become a major part of the business for which banks and other financial firms compete.

In recent research, Boyd and Gertler (1994) try two different approaches to adjusting bank assets for the importance of off-balance-sheet activities. For one, they use bank regulatory formulas to calculate “credit equivalents,” the amount of on-balance-sheet assets that would give the same credit risk exposure as the off-balance-sheet positions. This credit equivalent amount can then be added to the banks' total reported balance sheet assets. Their second, alternative adjustment is based on banks' ratio of noninterest to interest income. Roughly speaking, balance sheet assets produce interest income while off-balance-sheet items produce noninterest income; the mix has shifted noticeably toward the latter in recent years. Boyd and Gertler capitalize the noninterest portion, in effect calculating the quantity of assets that would produce the observed level of noninterest income. The capitalized value can be added to the on-balance-sheet total. Using either type of adjustment, they find that much of the decline in bank market share disappears. Thus, at least part of the downward trend in asset share...
(as in Figure 1) reflects a change in how banks do business, not how much business they do.

Boyd and Gertler also point out that the typical measure of bank assets does not include all of the banking assets active in U.S. financial markets. Specifically, many loans made by foreign banks to customers in the United States are booked outside the country. As a result, the official figures underestimate the amount of business being done by banks (foreign and domestic combined) in the United States. A shift in favor of offshore bookings causes reported banking assets to decline, even though U.S. banking activity could be as robust as ever. Total banking assets can be corrected for this undercounting using estimates of loans booked offshore. Boyd and Gertler find that combining this correction with the earlier adjustments for off-balance-sheet activities eliminates the apparent decline in banks’ share of financial assets.

Value added may be a better measure
The various asset adjustments of Boyd and Gertler are one way to address the problem that book assets are not a good measure of market share. However, there are other approaches to measuring the relative importance of various kinds of financial firms. One attractive candidate is “value added,” the difference between the value of output and the value of intermediate products used as inputs. Value added is a measure of how much a business has contributed to the production of valuable goods and services in the economy. If banks are creating relatively more value now than in the past, they are not declining in any meaningful sense.

Kaufman and Mote (1994) estimate value added for the banking industry, using information in corporate income tax returns. Specifically, they note that the difference between total receipts (which includes both interest and noninterest revenues) and interest paid should be a good approximation of value added in banking. The solid line in Figure 2 shows that this measure of banking value added has been increasing slightly relative to the financial sector as a whole. In addition, over this period the financial sector increased from 15.4 percent to 17.7 percent of gross domestic product (GDP). As a result, banking grew relative to the rest of the economy, accounting for the slight but noticeable upward slope of the dashed line in Figure 2, which compared banking to total GDP. Such growth in value added is not consistent with terminal decay.

Evidence from the stock market
Stock prices are another place to look for signs of banking’s health. In particular, investors in the shares of banks and other financial firms have strong incentives to make correct judgments about the health of banking firms, since they stand to lose real money if they are wrong. Because of the high stakes, sophisticated investors carefully analyze bank health and try to forecast the future profits of banks in which they invest. Their consensus beliefs are reflected in the prices of bank stocks; looking at those stock prices is like taking a survey of a group of experts. If those experts think banking is a declining industry, bank stock prices will be low to reflect the meager profits expected in the future.

I recently created a model linking the level, growth, and riskiness of a firm’s profits to its stock price, and evaluated a group of large, publicly traded banks that comprise the bulk of the industry (Levonian 1994). Investors’ consensus beliefs about these banks’ long-run profitability can be inferred from the stock-price model. There was no evidence that investors expect future bank profits to be subpar. On the contrary, the prices of the bank stocks seem to reflect a belief that competition in the industry will gradually drive profit rates to a level that is perfectly normal for the level of risk inherent in the banking business.
Why people think banking is declining

The research described above suggests that banking is viable. Yet a public perception of decline persists. Graphic evidence as in Figure 1 is compelling, showing the seemingly clear decline in "market share" and the disappearance of thousands of banks; failures of bank-type institutions were prominent during the 1980s. Adding to this evidence from another direction were the low industry profits during the late 1980s and early 1990s, when many banks lost money. Recent earnings have improved greatly, but the suspicion remains that the good times are not sustainable. It is tempting to view the earlier poor financial performance as a sign of decline, part of a larger trend, in much the same way that hot summers bring discussions of global warming and cold winters of the next ice age. If banks are so healthy, why have profits been so uneven?

Research on bank stock prices sheds light on the poor industry profitability of the recent past. The prices that investors are willing to pay for shares of stock incorporate estimates of core economic profitability, which may differ from the profits reported in any period. Estimates of core profitability are buried in stock prices, but can be unearthed with the help of the right model; if this fundamental underlying economic profitability is high, banks are basically healthy. The stock-price model in Levonian (1994) produces an estimate of the rate of return on bank equity that is most consistent with the prices investors are willing to pay for bank stocks. The solid line in Figure 3 shows these estimates of the underlying, or core, economic rate of return for large, publicly traded banks for the last few years; the dashed line shows the return on equity actually reported by those banks. Reported profits obviously sagged during much of the late 1980s, but the market viewed those low profits as aberrant and short-lived. True profitability, revealed by bank stock prices, remained consistently high. The market does not see the industry's poor recent profits as signs of longer-term decay.

Conclusion

Banks are not dinosaurs. Bank assets are growing faster than the rest of the economy, and after adjusting for off-balance-sheet activities and other accounting issues banks have lost little if any ground to other types of financial firms. Value added by banks has been growing fairly steadily. In support of this "market-share" evidence, bank stock price data also show that investors expect banking to remain profitable. Banks may be evolving away from their traditional role as lenders, but they remain central to other, equally vital forms of financial activity. Despite gloomy predictions and eye-catching headlines, banking is alive and well.

Mark E. Levonian
Research Officer

References

