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BANKING ACTIVITY'S FUNDAMENTAL FORCES OF CHANGE IN ECONOMIC ACTUAL CONDITIONS

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Abstract: Five fundamental forces have transformed the structure of financial markets and institutions and reflect the intense competition financial firms face today: deregulation/reregulation, financial innovation, securitization, globalization, and advances in technology. Market participants can choose from a larger number of suppliers which places a premium on customer service. To remain competitive, banks should identify the products with which they have a market advantage and provide personal service. The basic theme is that increased competition, brought about not only by continued deregulation but also as financial firms find ways around regulation, has encouraged banks to assume increased portfolio risks in order to earn acceptable returns.

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Key words: deregulation/reregulation, financial innovation, securitization, globalization, advances in technology

Introduction

Five fundamental forces have transformed the structure of financial markets and institutions and reflect the intense competition financial firms face today: deregulation/reregulation, financial innovation, securitization, globalization, and advances in technology. The latter factors actually represent responses to deregulation and reregulation. Thin combined forces have altered corporate balance-sheets by inducing firms to compete in new product and geographic markets and use new financial instruments to facilitate transactions and adjust their risk profile. Although consumers have benefited from these changes, the long term trend for financial institutions entails consolidation, realignment of corporate objectives, and diversifications of products offered as firms attempt to develop a market niche. Firms can expect regulators to closely monitor changes in risk and continually increase capital requirements, particularly against new lines of business.

Many analysts attribute much of the change in the financial services industry to deregulation. Actually, deregulation was a natural response to increased competition between depository institutions and non depository financial firms, and between the same type of competitors across world markets rather than the catalyst of competition. Deregulation sped up the process, but did not necessarily start. New regulations brought about the development of new products and increased competition with firms not regulated like banks, such as investment banks. Regulation also contributed to the

problems of savings and loans in the early 1980's as savings and loans portfolios were restricted to loan term mortgage securities financed by short term savings accounts. Today we consider this to be a very high interest rate risk position, enough to bring major regulatory sanctions!

The basic theme is that increased competition brought about not only by continued deregulation, but also as financial firms find ways around regulation, has encouraged banks to assume increased portfolios risks in order to earn acceptable returns. As bank regulators have tried to reduce overall risk by raising capital requirements, banks have moved assets off their balance sheet and tried to replace interest income with fee income. In these efforts, banks attempt to be more like insurance brokers, realtors, and investment bankers – competing with a broader range of firms in more product markets. As capital becomes increasingly costly or impossible to obtain, individual firms are forced to merge to continue operations.

The Role of Regulation

Historically, commercial banks have been one of the most heavily regulated companies in the United States – and thus among the safest and most conservative businesses around. Regulations took many forms, including maximum interest rates that could be paid on deposits or charged on loans, minimum capital-to-asset ratios, minimum legal reserve requirements, limited geographic markets for full-service banking, constraints on the type of investments permitted, and restrictions on the range of activities, products, and services offered. Although regulation limited opportunities and risks, the virtually guaranteed a profit if management did not perpetrate fraud.

Since World War II, banks and other market participants have consistently restructured their operations to circumvent regulation and meet perceived customer needs. In response, regulators and lawmakers imposed new restrictions, which market participants circumvented again. This process of regulation and market response (financial innovation) and imposition of new regulations is the regulatory dialectic. One aspect of regulatory response is financial innovation. Securitization, globalization, and new technologies are extensions of this response in the development of new products and international competition. The fear is that competitive forces have influenced financial markets and institutions so rapidly that the aggregate risk of the U.S. financial system has increased.

The changing nature of banking can be examined in two distinct areas: the traditional role of banks as financial intermediaries; and the evolution of banking into nontraditional roles as a result of changing regulation, technology, and financial innovation. Banks traditional role as intermediary has declined as new products such as cash management accounts, mutual funds, commercial paper, and junk bonds have become more prevalent. Banks have responded by accepting lower spreads, taking on more risk, and expanding their customer and product base. Banks have also expanded into nontraditional areas and products, especially investment banking activities, off-balance sheet activities, such as standby letters of credit, mortgage servicing, and credit enhancement products, to generate more fee income. Finally, the Gramm-Leach-Bliley Act effectively eliminates most of the remaining restrictions that have separated commercial banking, investment banking and insurance for more than 70 years. Banking organizations will continue to expand their operations by identifying specific products and services to offer and will subsequently compete against a broader array of firms.

Increased Competition

Following the enactment of the Glass-Steagall Act and through the early 1980s, the commercial banking industry was quite stable. Individuals who wanted to start a new bank found it difficult to get a charter from either federal or state regulators. The Federal Reserve System, in turn, limited interest rates that banks could pay depositors, effectively subsidizing banks by mandating low-cost sources of funds. Depositors had few substitutes for saving unless they held more than $100.000. As a result bank deposits grew systematically with economic conditions. Regulations also specified maximum rates that banks could charge on certain types of loans.

During this period, banks could not compete on price because the price of their inputs (deposits) was regulated and the price of their outputs (loans) was regulated. For all practical purposes, all banks had the same price and had to find other ways to compete. Today, banks are free to set the price for their services as well as the type of services they offer, as are other companies free to offer banking-type services at competitive prices. Bankers now compete directly on price, product offerings, and service.

Competition for Deposits

The free ride of a guaranteed spread between asset yields and liability costs abruptly ended during the late 1970's. The primary catalyst was high inflation due in part to foreign control of oil market and the doubling of oil costs. Although ceiling rates on bank deposits limited interest to 5,25 percent on savings accounts ant nothing on checking accounts, 8 to 12 percent of inflation rates guaranteed that consumers lost purchasing power. In 1973, several investment banks created money market mutual funds (MMMFs), which accepted deposits from individuals and invested the proceeds in Treasury bills, large certificates of deposits (CDs), and other securities that paid market yields. Not surprisingly, the attractiveness and growth of MMMFs tracked the spread between money market interest rates and Regulation Q ceilings. Without competing instruments, MMMFs increased from $10, 8 billion in 1978 to $2 trillion at the end of 2004. During this interval, three months Treasury bill rates exceeded the rate on bank savings accounts by as much as 9 percent.

In today environment, deposit competition takes many forms. First, institutions are virtually unconstrained in the terms they can offer. Thus, customers can negotiate any minimum denomination, market interest rate, and maturity. Firms cannot discriminate, so they make the same deposit available to all qualified customers. As such, the range of deposits and offer checking accounts. Almost every investment company that offers mutual funds also offers a cash management account for high-balance customers to use as part of their investment activity. Individuals can have proceeds from all financial transactions automatically invested at market rates until they make new investment decisions. Customers can transfer money from a core money market account to thousands of mutual funds with many investment companies. Finally, the combination of advances in technology and elimination of branching restrictions, most individuals were limited in choice to the local bank information about rates and prices that customers can quickly and easily obtain rate quotes from financial institutions all over the world. The elimination of branching restrictions means that just about any financial institutions can open a branch in any community. Not surprisingly, the competition for deposits is fierce.

Competition for Loans

As bank funding costs increased, competition for loans put downward pressure on loan yields and interest spreads over the cost of bank funds. High quality corporate borrowers have always had the option to issue commercial paper or long-term bonds rather than borrow from banks. Commercial paper is an unsecured ranging from 5 to 270 days. The growth in MMMFs accelerated the development and growth of the commercial paper market and improved investment banks relations with nonfinancial corporations. Investment banks continued to underwrite commercial paper and use money market funds to purchase paper. Because the Glass-Steagall Act prevented commercial banks from underwriting commercial paper, banks lost corporate barrowers who bypassed them by issuing commercial paper at lower cost. Today, commercial banks can underwrite and deal in securities.

The development of the junk market extended loan competition to medium-size companies representing lower-quality barrowers. Junk bonds are corporate securities that are unrated or rated Ba (BB) and lower and thus are not investment grade. Historically, firms with debt ratings below Baa (BBB) were precluded from issuing significant amounts of new debt and had to rely instead on bank loans. During the early 1980s, several investment banks convinced investors that many Ba and lower-rated bonds were sound investment and that historical default rates were so low that 3,5 to 5 percent yield premium offered on the bonds more than compensated for default risk. Investment banks were soon able to help companies that could not issue prime-grade commercial paper sell junk bonds in the new issue market. These bonds had several advantages over bank loans, including access to larger amounts of funds, longer-term financing, and fewer restrictions covenants. In many cases, the interest costs were well below loan rates quoted by a bank.

Today, the junk bond market is quite active. FED policymakers actually look at the interest spread between junk bond yields on low-default-risk Treasury securities as an indicator of the appropriate monetary policy. When the spread are extremely high, lower quality barrowers have more difficulty obtaining financing ant the Federal Reserve System often provides additional liquidity to the market.

These developments permanently altered the commercial banking industry. The growth in junk bond reduced the pool of good-quality loans and lowered risk adjusted yields spreads over bank barrowing costs. Banks generally responded by increasing the riskiness of their loan portfolios or trying to move into investment banking and other areas that generate fee income. Banks choosing the first path sacrificed long-term profitability and solvency for short-term gains. They maintained yield spreads temporarily, but increased default risk on the loans, which ultimately eroded earnings through higher loan charge-offs. Banks choosing the second path, generating greater fee income, had limited options. They would like to underwrite securities, sell new types to diversify their asset base and revenue stream and lower the risk of failure. Only recently have commercial banks been able to engage in many of these activities.

Today, different-sized bans pursue different strategies. Small to medium-size banks continue to concentrate on loans but seek to strengthen customer relationships by offering personal service. They now measure their costs better and price loans and deposits to cover their costs plus meet profit targets. The best evidence is that most banks now calculate their own costs of funds and price loans off this index rather than off a money center bank's prime rate. Many of these same banks have rediscovered the consumer loan. The proportion of consumer loans increased for some banks during the

1980s and early 1990s but slowed somewhat since 1995, due primarily to the rapid increase in default rates and personal bankruptcy rates. Rates charged on consumer loans generally far exceed their respective default rates and the cost of financing such that consumer deposits are much less rate sensitive than large certificates of deposit ant other barrowed funds. The biggest losers are low-balance depositors who have seen service charges increase to cover the banks costs of providing transactions services.

Off-balance Sheet Activities and Assets

The largest banks move assets off the balance sheet as part of their normal business because commercial and consumer loans are risky relative to the available returns. Regulatory capital requirements raise the cost of holding loans on balance sheets, and pricing pressures on new loans make owning loans too expensive and risky, given the available yield spreads. Thus some institutions consciously originate loans and securitize them, or issue securities using the loans as collateral, and effectively move the loans off the bank's balance sheet. Off balance sheet activity of the largest U.S. commercial banks has increased dramatically since 1980s. Meanwhile, noninterest income, as percentage of total operating income, has increased.

The trend is not without risk. Commitments and guaranties take the form of loan commitments, standby letters of credit, commitments related to interest to interest rate swaps, currency exchange, leases, insurance on securities, and third party guaranties, all of which generate excellent fee income and do not require large capital support. How-ever, because unfunded commitments and guaranties do not appear explicitly on published financial statements, banks continue to assume the risk that they might need to fund the commitments and make good on a defaulted obligation. This was dramatically demonstrated in late 2001 and 2002 with the bankruptcies of Enron and Kmart ant the problems of Tyco and other distressed firms. As these nonfinancial companies approached bankruptcy, the money and capital markets closed down to them so they drew down their credit lines at banks.

The Impact of Nonbank Competition

Competition for the bank's product line comes in many forms. Merrill Lynch began to offer its Cash Management Account (CMA) during the late 1970s in which smaller depositors could earn "market" rates. During this same time, banks were restricted from paying more than 5,25 percent on savings accounts and could not pay interest on checking accounts. It did not take long for Merrill Lynch's CMA was paying a short-term rate of almost 15 percent as compared with a bank's restricted 5,25 percent. It is no wonder the average investor began to look beyond the bank for a place to put investment dollars. In was not until the early 1980s that banks were allowed to offer interest on checking accounts and money market deposit accounts and money market deposit accounts to compete the CMA.

The 1980s and 1990s represented a period of intense competition where nonblank competitors aggressively entered traditional banking business line. Commercial banks competed fiercely with nonbank institutions, finance companies, captive automobile finance companies, high-growth thrifts and technology firms for loans and deposits. Once-loyal customers moved their business for better terms. Unfortunately, the increased competition coincided with many regulatory restrictions on the type of products banks could offer, as well as loan problems in energy, real

estate, and agriculture, which made it even more difficult to maintain quality assets and market share.

Much like other companies, the largest automobile manufacturers have aggressively expanded in the financial services as part of their long-term strategic plan. These companies provided a steady stream of financing for automobile buyers. They also provide dealer financing for inventories, capital improvements, and lease programs.

General-purpose finance companies cover the spectrum of lending activities. Most specialize in lending to individuals for durable goods purchases. They traditionally emphasize automobile loans, home improvement loans, and second mortgage loans, which are secured by real estate. Others specialize in lending business, either directly or through factoring a firm's accounts receivable, or equipment leasing.

Finance companies fund their investments by issuing commercial paper and long-term bonds and by barrowing directly from banks. Historically, their loans have been to relatively high credit risks. Even though their default experience exceeds that of banks, finance companies have generally earned greater returns because they price their loans at a premium, which compensates for the greater charge-offs. The returns to the largest finance companies have been as good as if not better than those of banks.

Competition for Payment Services

Once become the exclusive domain of banks and other depository institutions, the nation's payment system has become highly competitive. Even Fed`s role in processing and clearing checks could be replaced by new technology. This, of course, would not come without risks. Only the Fed can prevent default by one large institution from causing the system to collapse. The real challenge for the Fed and banks in the delivery of payment processing services is emerging electronic payment systems, such as smart and stored value cards, automatic bill payment, and bill presentment processing. Many private companies offer the products but the Fed still settles the accounts.

With recent electronic innovations, the role of paper check is diminishing. Finally, plastic is overtaking checks. A recent study concluded that credit cards and debit cards accounted for 52 percent of transactions in 2003, up from just 10 percent in 1995. Checks accounted for 15 percent in 2003 – one half its contribution in 1995 - while cash transactions represented 32 percent (down from 60 percent in 1995). In 2004, a new law enables banks to process checks faster by allowing electronic checks to meet check clearing requirements. A bank simply need to capture the front and back of a paper in picture form which is then transfers electronically.

Although cash remains the dominant form of payment, it has the smallest payment size, averaging about $4 per transactions. Large wholesale transactions, using Fed Wire and the Clearing House Interbank Payment System (CHIPS) are fewer in number but much larger in average transaction size. The Fed Wire is used to settle interbank transactions, while CHIPS is a private alternative operated by New York Clearing House Association and user principally to settle foreign exchange transactions.

Checks are the second most active payment method in the United States with just over 10 percent of transaction volume handled by check writing. Electronic check presentment, including point-of-sale (POS) check truncation, has been especially well received and 40 to 50 million paper checks are converted into electronic ACH (Automated Clearing House) debits each year at retail locations.

Credit cards remain the principal retail or small value electronic payment method. Ignoring cash, credit cards are used in almost 20 percent of the volume of transactions. Debit cards, on the other hand, are clearly the fastest growing payment method; more than a quarter of a million debit card are in circulation and more than 80 percent of banks offer debit cards. Similar to credit cards, debit cards are used for POS transactions but are not linked to credit. Instead, they are directly linked to the user's account. The growth in debit cards is also a result of electronic benefits transfer (EBT) programs. The vast majority of states and various governmental agencies offer EBT programs to deliver entitlement and food assistance benefits to those with or without a bank account. In these programs EBT cards can be used like debit or ATM cards.

Factors other than changes in electronic payments systems are also eroding banks traditional market. The growth and acceptance of electronic payment system means that there is less of a need to physically go to a bank or any other financial services company. Anyone with appropriate account can obtain cash at an ATM machine or make payment at the POS anywhere in the world, eliminating the need to go to the bank to obtain cash. Anyone can open a checking account, apply for a loan, make deposits, or receive a loan electronically. Direct deposit of paychecks, the use of credit cards, electronic bill payment, electronic check presentment, and smart cards all indicate that competition for the financial services goes well beyond the traditional mechanisms we think of from the recent past. Many analysts argue that the future delivery of banking services will not take place in the brick and mortar branches of a bank building but rather through smart cards.

Competition for Other Bank Services

Banks and their affiliates offer many products and services in addition to deposits and loans. A partial list includes trust services, brokerage, data processing, securities, underwriting, real estate appraisal, credit life insurance, and personal financial consulting. Although a bank cannot directly underwrite securities domestically, there are generally two methods by which banks can enter this line of business. One is to form a financial investment subsidiary. The investment subsidiary of a financial holding company is not restricted in the amount of investment underwriting engaged in. A second method is to form a subsidiary of a national bank using Glass-Steagall Act. Securities powers are basically unrestricted however, if underwriting is done through a financial holding company.

Another method of combining nonbanking companies and banking is to use exemptions in the Bank Holding Company Act, which allows a nonbank to own a certain types of banks or savings banks.

Investment Banking

Commercial banking consider investment banking attractive because most investment banks already offer many banking services to prime commercial customers and high net worth individuals and sell range of products not available through banks. They can operate in any geographic market without the heavy regulation of the FED, FDIC and OCC. They can earn extraordinarily high fees for certain types of transactions and can put their own capital at risk in selected investments. Of course, some risks are great such that there is the potential highly volatile profit.

The Securities and Exchange Commission, which regulates investment banks, classifies firms in terms of their primary trading activity and head office location. Two

categories of firms dominate the investment banking industry. National full-line firms offer a complete set of service, including and extensive network of branch offices located throughout the United States to handle the retail business. Large investment banking firms do not have extensive branch networks and instead focus on large-scale trading, underwriting, and mergers and acquisitions. Both types of firms generate earnings from fee-based services, trading, and brokerage services. One attractive source of fees is securities underwriting in which investment banks help firms issue new equity and debt. The top investment banking houses manage the bulk of new issues investment-grade securities and thus are referred to as special bracket firms. Even though fewer than 20 firms qualify as national full-line or large investment banks, they control more than one third of all assets held by investment banks. An underwriter typically buys the new securities from the issuer at an agreed-dealer in assuming the risk that it can resell the securities at higher prices. For this reason, an underwriter normally pre-sells the issue by obtaining commitments from investors. Underwriters may also act as agents and help issuers place new securities directly with the final investor. As such, they earn fees without taking ownership of the underlying securities. Because risk increases with issue size, investment banks frequently form underwriting syndicates, or groups of investment banks, to diversify the risk and increase the number of selling firms.

Investment banks also serve as brokers or dealers in secondary market transactions. Through trading departments, the make decisions in previously issued securities by executing trades for selected customers or for their own account. Many trades, especially those involving retail customers, are simply brokered; that is, the trader marches prospective buyers and sellers. The investment bank assumes no inventory risk and earns a straight commission on the exchange. Traders may also act as dealers, setting bid and ask prices for every security traded. Dealers incur inventory risk and adjust the size of the bid-ask spread to vary the size of their inventory. If necessary, a dealer may hedge inventory risk by trading futures, swaps, and options.

Investment banks also generate substantial fees from facilitating corporate mergers and acquisitions and asset management. In the first case, an investment bank helps in the valuation and offers advice ad assistance in negotiating deal terms. Corporate takeover specialists and junk bond financing spur this activity. Target companies are often those with stock market values far below the value of corporate assets. Acquiring firms issue large volumes of common stock or junk bond debt and use the proceeds to buy controlling interest in a target company's stock. After purchase, they sell some of the acquired firm's assets to refund the initial debt or generate cash flow that covers the service. Companies pursuing these leveraged buyouts often earn extraordinary profits when the market values of the firm's stocks later increase. In the second case, investment banks serve as agents and manage investment funds for clients earning a management fee. This generally represents a stable, low-risk source of revenue as long as the funds perform adequately.

Securities trading and brokerage represent the other sources of profit. The first involves either making a market in securities or trading for the firm's own account. When making a market, a bank serves as a ready buyer and/or seller of the underlying security or commodity. For example, in foreign exchange trading, a bank may operate as a dealer by posting bid and ask quotes for which it is willing to buy and sell specific currencies. It makes a profit from the difference between the asked and bit prices. Some investment banks allow employees to trade for the bank's own accounts. In this

situation, the trader takes speculative positions in an effort to buy the underlying asset at prices below the sale prices. Obviously, speculative trading embodies greater risk. In the brokerage business, investment banks serve as customer representatives helping individuals, pension funds, and business buy and sell securities. As agent, the bank makes the bulk of its profit from sales commissions.

1. Deregulation and Reregulation

Commercial bank regulatory agencies have always tried to control the individuals and activities associated with financial intermediation. Their fundamental purpose is to protect the public's resources and confidence in the financial system. Banking is a public trust that, if left to industry whims, might assume too much risk, ultimately leading to extensive losses and widespread lack of confidence in the soundness and integrity underlying financial intermediation. Deregulation is the process of eliminating existing regulations, such the elimination of Regulation Q interest rate ceilings imposed on time and demand deposits offered by depository institutions or the repeal of sections of the Glass-Steagall Act removing restrictions on investment banking activities. Deregulation is often confused with reregulation, witch is the process of implementing new restrictions or modifying existing controls on individuals and activities associated with banking. Reregulation arises in response to market participant's efforts to circumvent existing regulations.

An issue related to FED membership arose during 1970s and serve as an excellent example of the regulator-bank relationship. Banks that are members of the FED are required to hold reserves in the form of nonearning cash assets equal to percentage of qualifying liabilities. These reserves represent an implicit tax on banking operations because banks do not earn explicit interest on the assets. During the 1970s, this tax increased dramatically as short-term market interest rates increased. Banks that were not Fed members were required to hold fewer reserves and could typically hold interest-bearing securities to meet requirements. As such, their lost interest income was much smaller. To circumvent regulation, many member banks gave up Fed membership rather than absorb the loss. The FED and Congress, concerned about losing control of the money supply, passed the Depository Institutions Monetary Control Act in 1980, which allowed interest-bearing checking accounts but forced all financial institutions that offered them to hold reserves set by the Fed. This reregulation was an attempt to reimpose regulatory control over all depository institutions.

Efforts at deregulation and reregulation generally address pricing issues, allowable geographic market penetration, or the ability to offer new products and services. Recent pricing regulation have focused on removing price controls, such as the maximum interest rates paid to depositors and the rate charged to borrowers. Deregulation, addressing geographic markets, has expanded the locations where competing firms can conduct business. Finally, deregulation of the restrictions that separated commercial banking, investment banking, and insurance, brokerage service, and securities underwriting. These changes, combined with new technology, have expanded opportunities across geographic markets and produced a greater number of competitors offering banking services and intense price competition. Greater competition has, in turn, lowered aggregate returns as firms attempt to establish a permanent market presence.

2. Financial Innovation

Financial innovation is the catalyst behind the evolving financial services industry and the restructuring of financial markets. It represents the systematic process of change in instruments, institutions, and operating policies that determine the structure of our financial system. Innovations take the form of new securities and financial markets, new products and services, new organizational forms, and new delivery system. Financial institutions change the characteristics of financial instruments traded by the public and create new financial markets, which provide liquidity. Bank managers change the composition of their banks balance sheets by altering the mix of products or services offered and by competing in extended geographic markets. Financial institutions from holding companies and reserve holding companies, acquire subsidiaries, and merge with other entities. Finally, institutions may modify the means by which the offer products and services. Recent trends incorporate technological advances with the development of cash management accounts, including the use of ATMs, home banking via computer and Internet, and shared national and international electronic funds transfer systems.

Innovations have many causes. Firms may need to stop the loss of deposits, enter new geographic or product markets, deliver services with cheaper and better technology, increase their capital base, alter their tax position, reduce their risk profile, or cut operating costs. In virtually every case, the intent is to improve their competitive position. The external environment, evidenced by volatile economic conditions, new regulations, and technological developments, creates the opportunity for innovation.

More recent innovations with securities take the form of new futures, swaps, options, and options-on-futures contracts, or the development of markets for a wide range of securitized assets. Banks use financial futures to hedge interest rate and foreign exchange risk in their portfolios as well as offset mismatches in maturities of assets and liabilities or different amounts of assts and liabilities denominated in different currencies, to price fixed-rate loans to create synthetic deposits. Several large banks also earn fee income commissions by serving as futures merchants and advisers.

Of course, innovations are not restricted to banks. Major retailers acquired banks, savings and loans, insurance companies, and real estate companies, enabling them to offer banking products. These nonbank firms operate offices nationwide without regulatory interference. Investment banks have similarly linked up with consumer banks to provide a vehicle for offering credit card and transactions services nationally.

Innovation in delivery systems normally takes the form of new technological developments to facilitate funds transfers. During the 1980s, banks popularized ATMs and POS terminals in retail outlets. More recent innovations include the development of the smart cards, debit cards, home banking networks, and internet banking. Although customer acceptance has been slower than expected, these systems are growing at an increasing rate.

3. Securitization

Because loans offer the highest gross yields, many banks try to compensate for declining margins (a direct result of increased competition) by increasing loan-to-asset ratio. This fundamentally means that there is an increasing demand for a decreasing pool of quality credits. In many cases, this eventually leads to greater loan losses and long-term earnings problems. High loan growth also increases bank capital

requirements. Regulators consider most loans to be risky assets and require banks to add to their loan loss reserves and capital base, the more loans they put on the books. Higher provisions for loan loss reduced net income. Because equity capital is more expensive than debt, higher capital requirements, in turn, increase the marginal cost of financing operations.

One competitive response to asset-quality problems and earnings pressure has been to substitute fee income for interest income by offering more fee-based services. Banks also lower their capital requirements and reduce credit risk by selling assets and servicing their payments between barrower and lender, rather than holding the same asset to earn interest.

This process of converting assets into marketable securities is called securitization. A bank originates assets, typically loans, combines them in pools with similar features, and sells pass-through certificates, which are secured by the interest and principal payments on the original assets. Residential mortgages and mortgage-backed pass-through certificates served as prototype. The originating bank changes fees for making the loans. If it services the loans, it collects interest and principal payments on the loans, which it passes through to certificate holders minus a servicing fee. If the bank sells the certificates without recourse, regulators permit it to take the original assets of its books. The bank does not have to allocate loan-loss reserves against the assets, and its capital requirements decline proportionally. Securitization also eliminates interest rate risk associated with financing the underlying assets. In essence, the bank serves as an investment banker generating fee income from servicing the loans assuming additional credit risk.

4. Globalization

Financial markets and institutions are becoming increasingly international in scope. U.S. corporations, for example, can barrow from domestic or foreign institutions. They can issue securities denominated in U.S. dollars or foreign currencies issued in different countries as substitutes. Large firms thus participate in both domestic and foreign markets such that interest rates on domestic instruments closely track foreign interest rates.

Globalization is the gradual evolution of markets and institutions such that geographic boundaries do not restrict financial transactions. One country's economic policies affect the economies of other countries. Funds flow freely between countries because of efficient policies affect the economies of other countries. The establishment of the European Community (EC) in 1992 represents a prime example. Under the original formal agreement, 12 industrialized nations in Western Europe eliminated most trade restrictions, standardized basic product designs, reduced taxes and fees, and linked monetary control in order to facilitate trade. Today, there are now 16 countries in EC. The original intent was to have a common currency and fully integrated market that operates as one without borders. Monetary policy for the single currency is set by the European Central Bank. One presumed benefit of the euro is that it should sharply lower inflation rates and enhance opportunities for all member countries.

Although product innovation and the acquisition of domestic firms by foreign firms has led to a removal of the physical borders that separate firms internationally, technology has clearly had one of the most dramatic impacts on the globalization markets. Technological innovations, such as the commercialization of the internet, mean that the distance is no longer a limiting force. One can search for and purchase

products and services from anywhere in the world. Large, as well as small, companies now have global markets for their products and services. Consumers and business now search beyond their traditional local market in pursuit of price, quality, and availability.

5. Advances in Technology

It took more than 80 years until 50 percent of U.S. households owned an automobile. It only took about 70 years for the telephone, 50 years for the electricity, 35 years for the VCR, 27 years for television, and 15 years for the cell phone. But the internet reached 50 percent of U.S. households in only seven years. Clearly, the impact of technology on business over the past decade has been even greater than in other industries. Technology has had the biggest impact on efficiency and productivity. Technology allows one person to do more or handle more people and transactions, thereby dramatically reducing the cost of delivering products and services. In addition to gains in productivity, advances in technology – especially in areas of telecommunications – have expanded the banks marketplace from around the block to around the world. Banks can now offer banking services to anyone with a computer – but so can just about any other firm.

While advances in technology have dramatically increased the efficiency of banks providing services, they have also simultaneously increased competition. As an intermediary, banks add value in the economy by providing and processing soft information about those they provide services for. The internet makes obtaining information on smaller business customers less costly and easier to do, thereby increasing competition for the banks primary business of lending to small to medium-size business. Technology also makes it less costly to offer banking services and expands a company's market geographically with little cost. This all leads to increased competition for banking services. Technological advances allow firms to compete for customers electronically without branch facilities on every street corner.

Conclusions

Increased competition has arisen from financial innovation, deregulation, securitizations, globalization of financial institutions and markets and technological developments. Deregulation is the removal of regulations that limit financial institutions activities. Financial innovation is the continual development of new products and change in markets structure to circumvent regulation and meet customer needs. Securitization is the process of converting assets to marketable securities. Globalization involves the de facto elimination of geographic barriers to trade and financial market activity. Finally, technology has opened the door to competition from many more areas including the once sacred payments system.

Customers and business benefit from lower interest rates and increased capital availability. Market participants can choose from a larger number of suppliers which places a premium on customer service. To remain competitive, banks should identify the products with which they have a market advantage and provide personal service that distinguishes them from their competitors.

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