

# Viewpoint: Don't Suppress Innovation

*By Mary Beth Sullivan*

How important is innovation to the business of banking today? The government appears to believe that financial innovations are at least partly to blame for the recent economic crisis, and to some degree this is true. Were it not for powerful secondary markets and instruments like mortgage-backed securities and CDOs, we may well have avoided the real estate bubble in the first place, leaving nothing to burst.

However, innovation in financial services should remain a high priority in the U.S., particularly in light of the changing environment in which banks must now operate.

If the changes, in particular those in consumer behavior, technology and regulation, were incremental, not monumental, and happening on a manageable, predictable timetable, then small, incremental adjustments to strategy, products, and distribution capabilities would be sufficient.

Unfortunately, the changes impacting the banking industry are of such a large scale and moving at such a rapid pace that innovative solutions are badly needed to ensure a bright future for the U.S. banking industry.

Let's consider just one of the forces of change. Consumer behavior is shifting in ways that will redefine how people and businesses shop for, purchase and use financial products. Consumers have switched to a focus on savings and liquidity, away from the spending and investing mentality that drove product innovation in the past. These same consumers now need new approaches to rebuilding retirement savings and better managing personal finances. In addition, consumer mobility is driving the demand for real-time delivery of information and the disenfranchising of middlemen in the information equation (search engines being replaced by mobile apps, for example), yet very few banks in the U.S. offer any form of mobile banking. These and other shifts in consumer behavior are generating a very real need

for new services and new ways of reaching customers, which implies a need for banks to invest in new capabilities.

Enter the federal government.

The Senate Banking Committee has approved a financial reform bill intended in part to prevent future financial meltdowns, even though most banks had nothing to do with the recent crisis. This new regulatory world order will enable oversight of nonbanks that pose great risk to the overall U.S. financial system — and that's a good thing. However, it will also drive down industry profitability as compliance costs rise and revenues associated with consumer credit, NSF/OD fees, trading and other sources of historically significant revenue run dry. The timing of this assault on bank earnings couldn't be more troubling. Lower profitability levels aren't likely to encourage many banks to increase investment in the innovative solutions that are essential to be competitive down the road.

To those who lived through or studied the demise of the American automobile industry in the early 1980s, there are parallels to consider. The oil crisis of the late 1970s shrunk demand for domestic automobiles (akin to the recent rapid decline in the demand for consumer credit and investments). Auto manufacturing, like traditional banking, is a high-fixed-cost business, and when revenues dropped, earnings dropped in lock step.

The economic recession that followed made it difficult for the profit-challenged auto industry to afford the retooling needed in their plants to build cars with better gas mileage, stereo systems, cup holders and other features that consumers were demanding. Many auto manufacturers were in big trouble. In 1979 the administration stepped in to bail out

Chrysler with a \$1 billion infusion — then followed it with new, tougher regulations. By 1981, increased regulation of the U.S.

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auto industry had significantly increased the average prices of domestic cars. These events conspired to open the door for a new market entrant, the Japanese, to take share from U.S. automakers for the next 30 years.

In a paper released last month, Robert E. Litan, senior fellow at the Brookings Institution, argues persuasively that most financial innovations over the last 50 years have been good for the U.S. economy, contrary to the position now taken by the chairman of President Obama's Economic Recovery Board, Paul Volcker. Litan says regulatory policy should try to encourage innovation in financial services.

He's right, but this is not where the policymakers are headed. Who stands to gain from the U.S. banking industry's troubles isn't clear, but it won't be the thousands of banking companies that have played central roles in the lives of American consumers and who always played by the rules.

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