Structural Change and Slower Employment Growth in the Financial Services Sector

New York City's post-1978 economic revival has been largely due to rapid employment growth in the banking and securities industries. These industries account for 40 percent of the new jobs created in the city since the turnaround began. It is not the case that after 1978 New York became more attractive to these industries. In fact, New York City's share of total securities industry employment has continued to decline and the share of bank employment has remained stable (Chart 1). Instead, New York has benefited from a large, albeit constant or slowly declining, share of the rapid national employment growth of these industries.

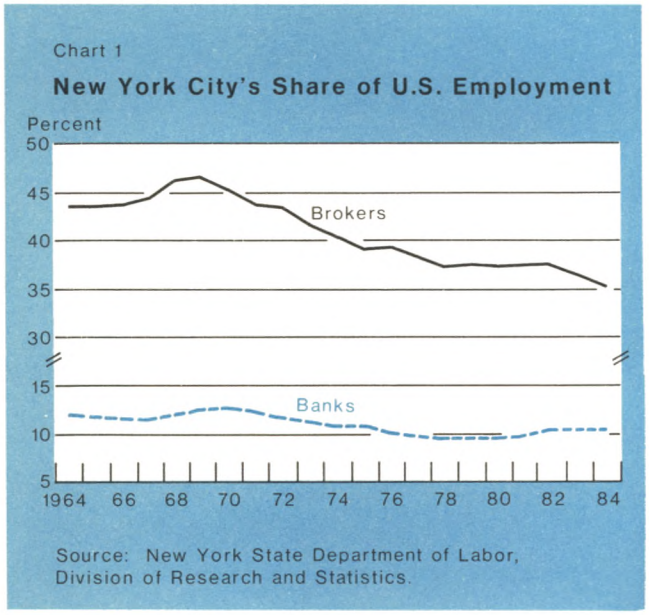
In the future, total U.S. employment in the banking and securities industries is likely to grow much more slowly than it has in the past, and some absolute declines in employment levels are possible. Employment in New York City's financial services sector may fare somewhat better than in the United States as a whole, but even local employment growth in these industries is likely to be slower than it has been since 1978.

For the last six quarters, for the first time since the early 1960s, U.S. bank employment has been essentially flat (Chart 2). There are three main reasons to believe that this slower growth in banking employment is the result of fundamental changes in the industry, and not the effect of a short-term squeeze on profits. First, the deregulation of interest payments on deposits has changed the incentives facing banks in ways that are likely to make the industry's retail operations less labor-intensive. Second, the automation of the United States payments system—the process by which checks, credit card slips, and electronic funds transfers are cleared—is continuing rapidly and even accelerating. Finally, the banking industry is facing new competition from other financial services industries, particularly the thrifts and brokerage houses.

Employment in some banking activities may continue to grow. And new legislation may grant banks the power to expand into fields previously reserved for insurance companies, securities firms, or investment banks. But the retail branch and payments functions of banks are their most labor-intensive activities. So, in spite of the expansion of other functions, it is likely that total employment growth will be slow or even negative.

Employment growth in the securities industry has been rapid since 1978, and some data sources report continued increases,[1] but during the second quarter of 1984 employment at New York Stock Exchange (NYSE) member firms declined for the first time since the fourth quarter of 1977. One quarter's reversal of a trend may not mean much, but there are a number of reasons to believe that this could be the beginning of a period of much slower growth. As with banks, the retail functions of securities firms are the most labor-intensive. However, through most of the postwar period, the individual investor has been withdrawing from the direct ownership of corporate securities, choosing instead to invest through pension systems and mutual funds.

[1]The United States Department of Labor reports a continued increase through June 1984.



Between 1978 and 1982 there was a rather sharp, temporary reversal of that trend. Now the trend toward withdrawal of the individual investor has resumed, and at an accelerated pace. The reduction of work forces at NYSE member firms this year probably represents the industry's initial adjustment to the resumption of the postwar trend.

As with the banks, again, there will probably continue to be employment growth in the "wholesale" activities of securities firms—investment banking, serving institutional clients, and so on. Also, the sale of bank-like services by securities firms—cash management accounts, mortgage lending, and the like—could also increase employment within the industry. But the most labor-intensive function of brokerage firms, servicing actively managed retail securities accounts, shows relatively less promise of rapid growth.

Banking employment: longstanding trends

Between the early 1960s and mid-1970s growth in bank employment was driven by four very powerful forces, beyond the general demographic and macroeconomic factors affecting all industries. First, the role of banks in the economy was expanding throughout the period[2] as bank assets grew faster (on average) than GNP. Accordingly, the number of officers and employees needed to manage the banks' balance sheets rose faster than total employment. Second, with the secular rise in nominal interest rates and the increased volatility of financial markets, more staff resources were devoted to cash float and portfolio management. Third, the volume of commercial transactions cleared through banks was growing rapidly. Through the 1970s the number of checks cleared in the United States grew at a rate of about 7 percent a year,[3] and the volume of credit card transactions increased even more rapidly.

Finally, as interest rates rose and Regulation Q limitations on deposit interest payments became binding, banks were induced to engage in a variety of "nonprice" competitive activities. In other words, because banks were not allowed to attract deposits by offering market interest rates, they were forced to find other ways to compete. One of the ways they tried to expand their market share was by establishing widespread, and labor-intensive, branch networks. Another way banks competed for market share was to set the fees charged for services to depositors below the cost of production. With charges for clearing or stopping checks held down, consumers had little incentive to economize on their use of these services. Heavy use of depositors' services, in turn, stimulated further employment growth.

The last two forces—the increased volume of transactions and the incentives created by Regulation Q—probably had the greatest effect on overall bank employment. This is because transactions clearance and retail services are the most labor-intensive bank activities. None of the available breakdowns of bank employment by function categorize activities in exactly the way we do here. But available data indicate that about 70 percent of bank employees are engaged in the demand deposit and other retail-related functions (Chart 3).

Furthermore, as the volume of transactions cleared through banks grew rapidly through the 1970s, the payments system was being automated extensively and quickly. The computerization of check and credit card receipt processing substantially dampened the job-creating effects of volume growth. Consequently, the most powerful and unambiguous force increasing bank employment through most of the past two decades was the incentives created by the regulation of deposit interest payments.

Recent shifts in the fundamental forces

There are three reasons to expect slower employment growth in the banking industry. First, the deregulation of interest payments on bank deposits has changed banks' incentives substantially and in ways which tend to reduce the labor intensiveness of bank operations. As banks have been freed to offer market rate interest

[2]Friedman, Benjamin M., "Postwar Changes in the American Financial Markets", Martin Feldstein, editor, *The American Economy in Transition*, National Bureau of Economic Research, 1980, page 4.

[3]*Checking Account Usage in the United States*, Bank Administration Institute, 1979.

payments on retail deposits, their incentive to maintain expensive branch networks has been reduced. In fact, the year after the passage of the Monetary Control Act, which authorized NOW accounts nationwide, saw an abrupt decrease in net creation of bank offices (Chart 4). Net office creation became positive in 1983, but at a much lower level than had been typical before interest rate deregulation, and a substantial proportion of the post-1982 branch creation probably involves the placement of automatic teller machines (ATMs) at locations away from established bank offices. So the strongest force behind bank employment growth through the past two decades was eliminated by interest rate deregulation.

As the deregulation of interest payments on deposits proceeded through the early 1980s, banks also began to raise service fees to cover the cost of production. To the extent that these fee increases induce depositors to make less use of services, this change, too, could reduce employment per dollar of deposits.

The second force retarding bank employment growth in the future will be the next phase of automation of the payments system. At present paperless electronic funds transfer is mostly confined to very large, wholesale transactions among financial institutions. Smaller business and consumer transactions are still largely handled by moving and processing paper checks and credit card receipts. Now, with the development and dissemination of automatic teller machines, point-of-sale terminals, and home banking, electronic transfer can begin to replace a larger share of paper transactions. As the potential of these technological innovations is exploited we can expect that employment in banks' payments function will contract, perhaps very sharply.

Finally, total bank asset growth, which had been consistently strong until the mid-1970s, has become much more erratic and slower on average since then.[4] Some of the financial service markets that have been traditionally reserved for commercial banks are now contested by other institutions. Thrift institutions offer checkable accounts and make commercial loans; securities firms offer cash management accounts and money market mutual funds; and investment houses offer commercial paper underwriting as an alternative to short-term bank loans. One example of the employment effects of this new competition: between the first quarter of 1981 and the second quarter of 1984 employment at S&Ls grew by 18 percent, compared with the banks' 5 percent.[5]

To be sure, employment in some bank functions is likely to increase, in some cases substantially in percentage terms. The trend toward more sophisticated

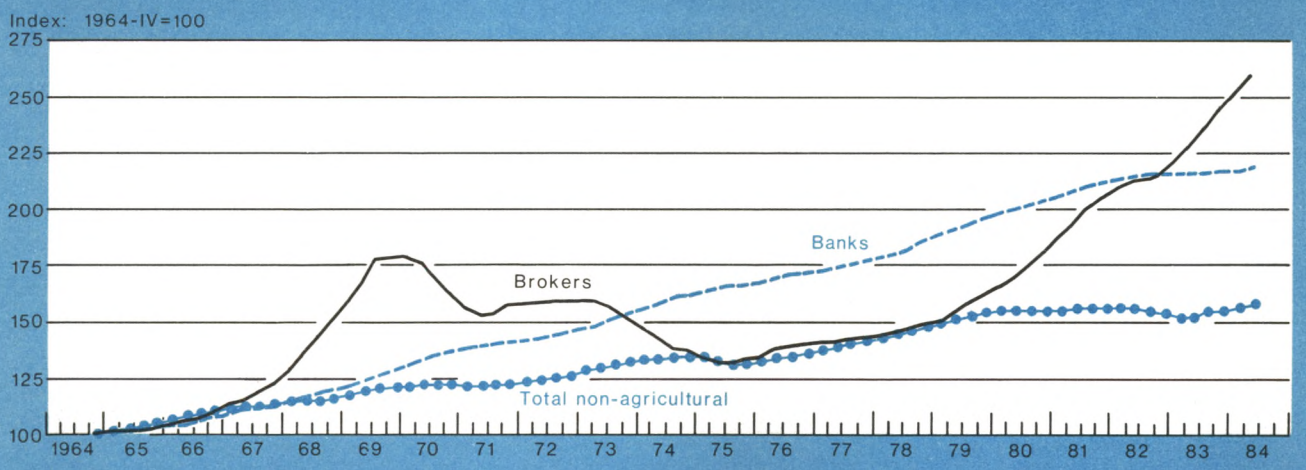
[4]Board of Governors of the Federal Reserve System, Division of Research and Statistics, Flow of Funds Table.

[5]United States Department of Labor, Bureau of Labor Statistics, *Employment and Earnings* (various issues). Employment at mutual savings banks is included in SIC 60. In this paper, therefore, no distinction is made between commercial banks and the much smaller mutual savings bank sector.

Chart 2

Employment Growth 1964-84

Four-quarter moving average



Sources: National Bureau of Economic Research; United States Department of Labor, Bureau of Labor Statistics.

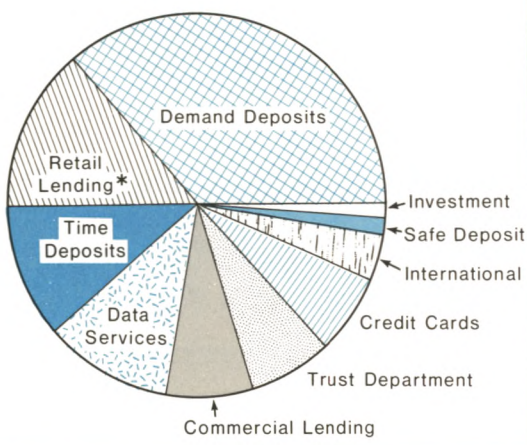
cash and float management, both on the banks' own account and as a fee-generating service to corporate customers, and the attendant growth in the staffing of this function will continue as long as interest rates remain high. Banks are also becoming more involved in off-balance sheet, fee-generating services: writing letters of credit, managing pension fund portfolios, originating loans for sale to third parties, and so on. And the larger banks are entering new lines of business such as insurance and securities brokerage. All these new functions will have to be staffed. Finally, the continuing movement toward interstate banking, especially through the establishment of "loan production offices" nationwide, could increase some categories of bank employment until regional market shares stabilize.

However, the sources of continued growth are all concentrated in the least labor-intensive banking functions. The forces for slower growth or contraction affect the functions that employ, by far, the most people. Therefore, the net effect of recent changes in the banking industry on employment growth will probably be negative. And it is possible that the contraction of branches (exclusive of unstaffed ATM locations) and the movement toward electronic funds transfer will result in substantial absolute employment reductions.

Chart 3

Bank Employment by Function

Banks with over $200 million in deposits, 1982



*Mortgage and installment.

Source: Federal Reserve Board, Functional Cost Analysis.

Securities industry revenues and employment

The securities industry is notorious for its patterns of "boom and bust".[6] In the late 1960s there was a sharp boom in industry employment followed by a marked bust in the early 1970s (Chart 1). Since 1978 the industry has been in another boom and the question naturally arises as to whether the most recent employment reduction is the beginning of another bust.

It is unlikely that the history of the late 1960s will simply repeat itself. The employment increases at that time were largely due to a serious but temporary paperwork crisis that followed some very large percentage increases in market volumes. Since then exchange procedures have been modernized, the securities industry has been computerized, and the share of total volume accounted for by large, institutional block trades has more than quadrupled.[7] All of these innovations made it possible for NYSE volume to increase almost ten times faster than securities industry employment over the past 20 years. Even though no simple repetition of the early 1970s "bust" in securities industry employment is likely, the period of most rapid growth is probably over for now.

Like banks, securities firms perform a number of related but different functions: retail brokerage, institutional brokerage, investment banking, securities trading, and so on. Retail brokerage is the most labor-intensive of these activities (Chart 5), but, over a long period of time, this segment of the securities industry has had a relatively poor record of growth.

The fundamental reason for slow average growth of the retail segment of the brokerage industry is that individual investors have been withdrawing from direct ownership of corporate securities through most of the postwar period (Chart 6). As the individual investor has withdrawn, the institutions have come to dominate securities markets and the securities industry has become, proportionally, much more of a "wholesale" operation. To be sure, the number of individual stock and bondholders has been increasing over the same period with general population growth and increasing real incomes. Furthermore, in the absence of data, we do not know whether individual investors have become much more active traders. However, the inflation-adjusted market value of directly-held household equity portfolios has been flat, on average, since 1975.

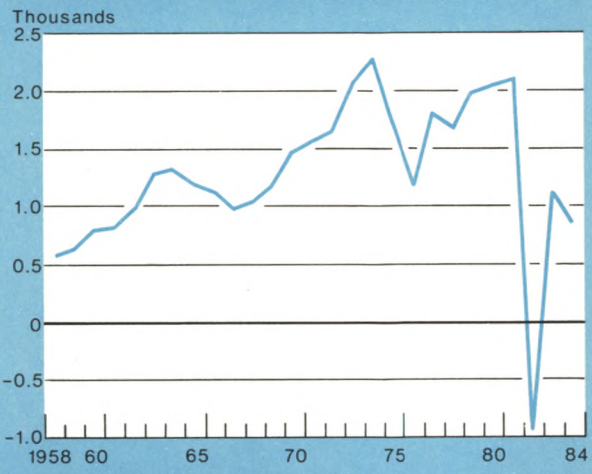
As the clientele of the most labor-intensive securities industry activity grew slowly, employment in the industry also grew slowly. Between 1964 and 1977, in spite of the marked boom of the late 1960s, industry employ-

[6]Most of the information in this section was gleaned from a review of *The Economist* over the past 20 years.

[7]*Fact Book 1984*, The New York Stock Exchange, 1984, page 74.

Chart 4

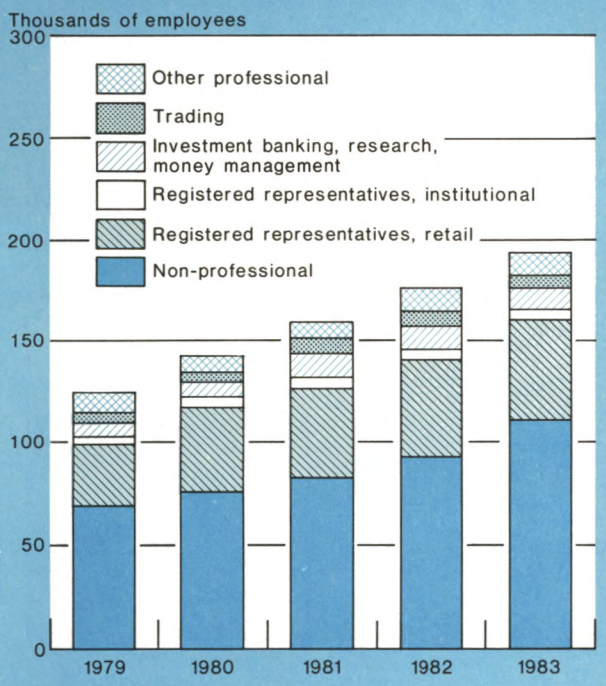
Changes in U.S. Bank Offices



Source: Federal Deposit Insurance Corporation.

Chart 5

Securities Industry Employment by Activity



Source: Securities Industry Association, Securities Industry Yearbook.

ment only grew as fast as total U.S. employment. Then, in 1978, individual investors began to return to the equities market in a rather substantial way.

For the securities industry the retail investor is a particularly lucrative customer. This has been especially true since 1969 when the institutional investors began winning major concessions on commissions from their brokers. Before the relatively recent growth of the retail discount segment of the industry, individuals had little choice but to pay full commissions. In addition, a large retail clientele offers distinct advantages when a firm begins marketing new financial services such as cash management accounts and money market funds. The securities industry may, therefore, have a tendency to over-react to any reappearance of the retail investor and to react slowly to a resumption of the household sector's withdrawal from direct ownership of equities.

This seems to be what has happened since 1978. Industry employment began growing rapidly at the same time as the individual investor began "returning", and, in terms of number of professionals, most of the increase has been in the retail segment (Chart 5).

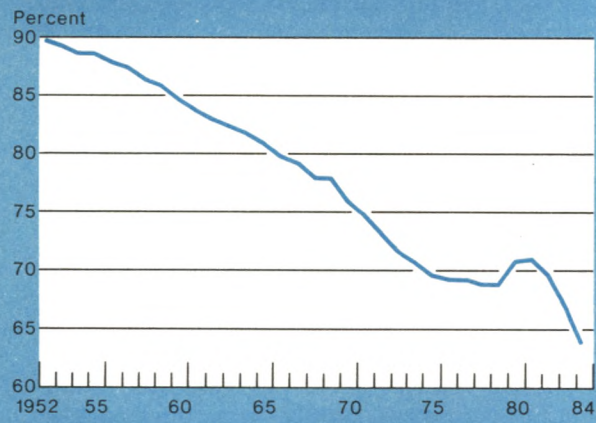
There are three reasons why this increase is probably not sustainable. First, the return of the individual investor proved to be only temporary. The share of corporate equities held directly by the household sector began falling again early in 1981 and the rate of decline has accelerated. Second, even if the brokerage firms wanted to maintain a large retail sales force in hopes of increasing market share, they would be under some immediate pressure not to. The total pretax net income of NYSE member firms peaked in the fourth quarter of 1982 and has been falling fairly steadily since then (Chart 7). Finally, even though total securities firm revenues have increased substantially since 1978, real commission revenues have been essentially flat. Most of the increase in operating incomes has come from the investment underwriting and "other securities-related" activities of the firms (Chart 8). The latter include, for example, the asset and money management and investment advisory functions. But this means that most of the revenue growth has been in the least labor-intensive functions of the securities industry.

Of course, there is a close connection between a firm's retail activities and the non-commission revenue. For example, a substantial portion of interest income is paid by retail clients borrowing on margin, and the mutual fund management fees a firm earns can depend on the success of its account executives in marketing those funds to retail clients. Nevertheless, servicing actively managed retail securities portfolios still pays the bulk of the salaries of the most numerous professional employees of securities firms, the retail registered representatives. Unless the household sector permanently

Chart 6

Household Share of U.S. Corporate Equity

Excluding mutual funds



Source: Board of Governors of the Federal Reserve System, Division of Research and Statistics.

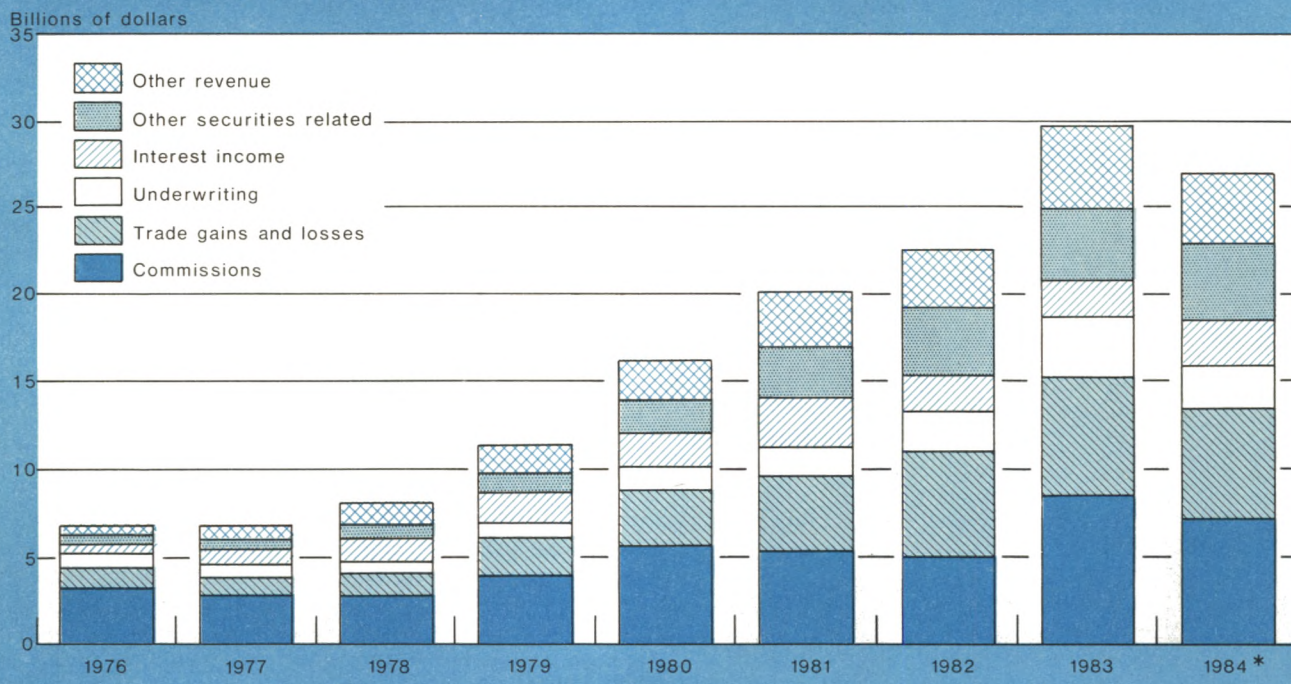
Chart 7

Securities Industry Pretax Net Income

Source: Securities Industry Association.

Chart 8

Securities Industry Revenues by Source



* 1984 data based on first two quarters annualized.

Source: Securities Industry Association.

reverses its long-standing withdrawal from direct participation in securities markets or those individuals who do hold securities increase their trading activity sharply, it will be hard to sustain rapid growth in total industry employment.

The securities industry could benefit from some current demographic trends. As the baby boom generation enters the peak earning and saving years of the life cycle the number of retail securities customers could increase. But it remains to be seen whether this generation will choose to build directly-held and actively managed portfolios.

New York City as a special case

Our analysis of the prospects for employment growth in these two industries nationwide requires some modification when applied to New York City. Most of the changes that are taking place in the banking and securities industries are likely to have a smaller negative impact, or even a positive effect, on employment in New York City. A theme running throughout the body of this paper is that employment in the "wholesale" or institutional segments of the banking and securities industries is likely to fare better than the retail segments. Indeed, there are many reasons to expect that wholesale employment will continue to grow fairly rapidly. New York, *the* national center for institutional financial services, is likely to benefit from continued growth of the "front office" work force.

New York is also the center for the international segments of the banking and securities industries. After several years of rapid growth, foreign bank employment in the United States—most of it concentrated in New York—decreased by 10 percent in 1983.[8] Nevertheless, there is a strong secular trend toward an increasing internationalization of capital markets, and as this trend continues employment in related activities will increase in New York.

[8] *The Banker*, February issues, 1980-84.

Also, the trend toward employment reductions in the retail end of the banking industry may be more advanced in New York than nationwide. NOW accounts were available in New York before they were authorized nationwide, and net bank office creation began to slow in this region before it did nationally. Hence, New York may have already experienced more of the total employment reduction brought about by deposit interest deregulation than the rest of the country.

Finally, the New York City and State governments have embarked on a number of efforts which could enhance the city's relative attractiveness to the banking and securities industries. Policies and programs aimed at rationalizing bank taxes, reducing the aggregate tax burden, lowering utility bills, etc., could, if they are successful, reduce some of the handicaps that have eroded the city's share of U.S. financial services employment.

For all of these reasons, the impact of the broad trends tending to reduce financial services employment could be smaller in New York than elsewhere. Nevertheless, there remain a number of threats to local employment in this sector. Other states have become more aggressive in competing to attract bank employment away from New York and some, notably Delaware and South Dakota, have been successful. For many years New York's suburbs have offered financial service firms attractive alternatives for location of back office operations.

A number of bank and to a lesser extent securities industry operations have moved out of New York City, but many still remain. How long they stay will depend on the operational linkages between the front office activities—which are tied to New York locations—and the relatively mobile back office functions. Predicting how financial services employment will develop in New York in the future requires an analysis of those linkages, as well as an assessment of the City's ability to attract a larger share of employment in two industries that will be growing more slowly.

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