The Federal Reserve Board

Remarks by Governor Roger W. Ferguson, Jr.

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Some Observations on the Future of the Financial Services Sector and Related Public Policy Issues

Let me first thank you for your invitation to speak today at this very topical conference. The future of the financial services sector holds great interest for industry participants as well as bank regulators, given the remarkable changes affecting the industry. Developments in this sector will affect all of us.

We are all acutely aware of the trend toward the blurring of lines that have separated the various parts of the financial sector, particularly commercial banking, investment banking, and insurance. Most recently, we are faced with the prospect of the formation of huge financial conglomerates, composed of amalgams of firms that have previously operated within the roughly defined boundaries of their respective industries. In addition, we have witnessed a substantial degree of consolidation through mergers in the commercial banking and other industries.

I will begin my remarks today by discussing historical experience with conglomeration in the U.S., and the underlying conditions necessary for conglomeration to be a successful business strategy. I will then offer some thoughts regarding what the financial services sector may look like in the future. Finally, I will address some of the issues that the Federal Reserve as a supervisor and regulator will need to consider.

There are several conclusions that I would like to highlight. The first is that the movement to financial conglomerate may prove to be transitory. Second, basic financial and risk management skills will likely remain the most important determinant of a company's viability and success. Third, even in a world of financial conglomerates there will be room for smaller, and more nimble, participants. Finally, the supervisory and regulatory structure will need to evolve to meet these new challenges, but regulatory authorities should remain vigilant to carry out our duties, particularly in enforcing the antitrust laws.

II. Will Financial Service Conglomerates be Successful?

The Historical Context of Conglomeration

The concept of the financial conglomerate is receiving a great deal of attention at this time because of the diminishing distinctions across financial industries. However, the success of such conglomerates is certainly not guaranteed, based on historical experience. For an illustration, one need only look back to the conglomerate merger movement in the industrial sector during the 1960s. Large conglomerate firms such as LTV, Gulf and Western, Textron, and Litton Industries became conglomerates through numerous mergers, heralded with great fanfare from the business press. By the 1970s, such proclamations sounded hollow, as many conglomerate firms' equities were pummeled as their corporate structure proved unsuccessful. This period was followed by a decade of spin-offs as the conglomerates sought to streamline their operations and return to their original areas of expertise - and this reversal of strategy was greeted with considerable enthusiasm by the business press.

Much closer to home, we should also recall that the retail financial sector went through a phase of conglomeration about 15 years ago, in the movement toward the "financial supermarket." The acquisitions of Coldwell Banker and Dean Witter by Sears, Shearson by American Express, Schwab by Bank of America, and Bache by Prudential come to mind. Despite the enthusiasm for the financial supermarket in the early 1980s, by the end of the decade the concept had stagnated, and the press instead reported the benefits of specialization and the provision of niche services.

I believe this past experience with business conglomerates in the U.S. should temper our views of the inevitability of today's financial conglomerates. There are clearly challenges to managing much larger, more diversified firms, as well as benefits. This business strategy is surely not for all financial services firms.

Business Conditions Necessary for Financial Conglomerates to Succeed

The difficulties associated with operating a financial conglomerate are suggested by the business conditions that are necessary for such a conglomerate to succeed. We have heard, of course, of the potential economies of scale and scope in managing information that may allow large firms to reduce the unit costs of doing business. We are also aware of the potential for cross marketing, where economies of scope on the supply side allow firms to sell multiple products to their customers, and on the demand side allow consumers to conveniently purchase bundles of services. Since a number of conglomerates of the past have been unable to improve upon separate delivery of services - including financial services - it is unclear whether technological or other changes have altered the nature of financial products or managerial capabilities sufficiently to result in significantly improved exploitation of scope economies.

The potential benefits of reducing risk through sectoral and geographic diversification are another motivation for conglomeration. I have little doubt that in many cases the potential for diversification gains exists. However, we have heard very little about the expertise needed to merge the risk management practices of previously separate financial firms. While merging risk management practices may be straightforward for firms consolidating within an industry, such a readjustment is likely far more complex for firms originating in different industries.

Furthermore, the challenges of managing a merger of diverse firms and the operation of the resulting conglomerate are substantial. The operation of a financial conglomerate requires the ability to integrate the financial activities, research and development investments, pricing decisions, compensation practices, cost containment activities, and cultures of an extremely large and diverse organization. Before any steps toward conglomeration are taken, each potential participant in such a merger must judge whether this extraordinary set of skills is to be found in any managerial team.

However, having raised the cautionary flags about the prospects for financial conglomerates, I should add that various considerations suggest that the financial conglomerate format in the future may be successful for at least some firms. From the management perspective, technological developments should help provide more detailed information for monitoring the various activities of the firm and allow the application of more sophisticated risk management models. Past experience with conglomeration may also provide new insights for managing product integration more effectively. On the demand side, retail customers may become more receptive to one-stop shopping as the range of services increases and as new opportunities for accessing these services become available.

III. How Might the Financial Services Sector Evolve?

The extraordinary changes occurring in the financial sector make projections about how the sector will evolve quite speculative. Nevertheless, it is useful to consider how the future might look as both industry participants and regulators plan to meet that future. I would like to offer some prognostications based both on systematic projections using historical experience and on analogies and informal observations of current trends.

Systematic Projections on Consolidation

The commercial banking industry, which is the largest single component of the financial sector, has experienced massive consolidation since 1980. For example, the number of banking organizations in the U.S. fell from around 12,300 in 1980 to just under 7,200 by the end of 1997. Not surprisingly, the percentage of banking assets held by the top 10 banking organizations rose from about 20 percent in 1980 to nearly 35 percent in 1997, while the share held by the top 25 increased from about 33 to 53 percent. Despite the large amount of consolidation and increase in banking concentration at the national level, banking concentration within local market areas (MSAs and non-MSA counties) has, on average, hardly changed over the past decade. For example, the average Herfindahl-Hirschman Index (HHI) in MSAs decreased from 1990 to 1949 between 1985 and 1997, while in non-MSA counties it decreased from 4357 to 4114 (thrifts excluded). The stability of average local market concentration is noteworthy because research suggests that competition for retail customers takes place substantially at the local market level, and concentration is a determinant of competition.

Based on these trends and the fact that tremendous new opportunities for bank mergers have been created by the removal of restrictions on interstate banking under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, I would expect more consolidation to occur in banking. Based on historical experience, some Fed economists have projected that in a decade or so about 3,000-to-4,000 banking organizations will remain. Importantly, most of these firms would be smaller organizations.

In addition to commercial banking, other financial service sectors have also experienced movements toward consolidation. Insurance companies and securities firms have all experienced merger waves in recent years, though not to the extent of commercial banking. This more moderate pace of consolidation in nonbank financial industries is likely due to the absence of preexisting restrictions on geographic expansion. Like banking, insurance underwriting is characterized by a broad size distribution of firms, from several large national insurers to much smaller local or technically specialized firms. Investment banking is more heavily concentrated, due to the greater geographic expanse of the markets for their services, and due to the considerable benefits of portfolio diversification. Extending current patterns into the future, we can only expect a continuation of the trend towards consolidation.

Informal Projections on Conglomeration

As I noted earlier, in addition to a continuing consolidation in banking and elsewhere in the financial sector, there is also a tendency toward increased conglomeration. Given the prospects for legislation expanding the product lines available to banks, I would not be surprised at a wave of cross-industry mergers within the financial sector, particularly among the largest firms, that results in the formation of financial conglomerates.

In order to consider the form of the financial sector in the future, I believe it is very important to distinguish between retail financial services (i.e., those for households and small businesses) and wholesale or large-scale corporate financial services. The customer bases of these two sectors differ dramatically, as do many of the products used.

Despite their differences, both the retail and wholesale sectors have moved to expand their product offerings. In retail financial services, the desire by banks to expand their product offerings is both a response to new products developed by other industries (for example, the emergence of annuities in the insurance industry), as well as a response to customers' substitution of other products (such as mutual funds) for traditional bank products (such as traditional savings accounts).

At wholesale firms, we have witnessed the push into securities underwriting and the establishment of offices throughout the world in an effort to respond to the financial needs of large corporate customers. Because of the very large scale required to serve a wholesale market consisting of a relatively small number of sizable customers, relatively few very large firms will likely remain active in the wholesale portion of the financial sector. Of course, the large wholesale institutions may operate in the retail portion as well, although the latter activity does not necessitate the extraordinary size of these firms. In addition, there are clearly boutique firms that achieve enviable results by serving just one need, say M&A advice, for large businesses.

The existence of both retail and wholesale institutions will have a direct bearing on the future of financial services. In contrast to wholesale institutions, retail financial institutions are able to operate profitably on a small scale. Given the continuing strong preference of many retail customers to deal with local offices, especially for many services of depository institutions, small retail financial institutions will likely be able to serve the needs of individuals and small businesses in local markets.

Such niche players would play an important role in a retail financial sector composed of perhaps several thousand relatively small retail financial institutions, and a much smaller number of large financial firms that offer wholesale products, or both wholesale and retail products. The large firms that offer retail services would likely operate offices throughout the country. This scenario would not be unlike that which we observe quite frequently in the nonfinancial retail sector. Restaurants, department stores, convenience stores and supermarkets are examples of locally based markets with a strong presence of large national or regional firms operating alongside a large number of small local sellers.

IV. What Do Conglomeration and Consolidation Mean for the Federal Reserve?

Now I would like to consider some of the issues that are raised by the evolution of the financial services sector for the Federal Reserve. Clearly the Federal Reserve must adapt along with the industry it supervises and regulates.

Reducing Moral Hazard through Increased Market Discipline

A key concern, which is a challenge internationally as well as in domestic supervision, is the well-known "moral-hazard" problem. Moral hazard occurs when a firm takes on greater risk than is prudent, because it does not bear the full cost of adopting that risk position. Instead, the cost of this risk is borne by the financial safety net, which in the U.S. banking system consists of access to federal deposit insurance, the Fed's discount window, and Federal Reserve payments system guarantees. While this safety net in my judgment will surely remain firmly in place, incentive-compatible policies should be developed and applied that shift more of the cost of risk-bearing onto the firms themselves. Such policies would seek to increase and improve the role of "market discipline" in constraining bank risk taking.

One widely discussed idea for increasing market discipline is to require a bank to issue a minimum amount of subordinated debt to non-related parties. The basic idea is to create a set of uninsured bank liability holders who will have risk preferences similar to those of bank supervisors, and who would thus discipline bank risk taking to a similar degree. In addition, changes in the price of a bank's subordinated debt might prove to be a useful signal of the market's evaluation of a bank's financial condition. Such signals could perhaps be used by supervisors as an aid in identifying problem banks. While a policy of "mandatory subordinated debt" is not without its problems and implementation difficulties, it is certainly worthy of serious discussion.

A second way that market discipline could be encouraged is through financial reporting and transparency guidelines, which provide the market with the information necessary to make informed transactions. This improved information is essential for market discipline to function. Greater transparency by itself will not alleviate the moral hazard problem inherent to insured deposits, since fully informed investors may be willing to make deposits in a bank with an overly risky portfolio, as long as their deposits are insured. However, transparency can reduce the need for some types of direct regulation in uninsured financial activities. If the holdings of financial institutions are apparent to the market, the institutions will adjust their risk positions optimally to maintain the ability to attract capital. Improved disclosure by domestic as well as international institutions would increase the information that allows investors to assess the risk they bear.

Communicating with Other Regulators

If the financial services sector moves further in the direction of conglomeration, the Federal Reserve will experience an ever greater need for communication with regulators of different financial industries. Regulators of the banking industry will need to coordinate with agencies governing the securities and insurance industries. Communication with insurance regulators will present a particular challenge, since in the U.S. insurance is regulated exclusively at the state level. Furthermore, international communication among central banks and other financial regulators is already essential. This need can only become greater as markets for many financial services continue to extend across national borders. Indeed, the need for crisis intervention could be reduced through preventive measures that include ongoing communication and coordinated improvements in supervisory methods.

Ensuring Competition

Also important is the role of encouraging competition through implementation of the Federal Reserve's bank merger policy. This role is particularly important at a time when banking and the financial sector in general are experiencing an unprecedented merger movement that is radically restructuring these industries. Before discussing newer analyses that we might be called upon to perform, let me emphasize that I think that we must continue to be extremely vigilant to protect local market competition. Applicants should remember that we measure impacts on local market structure considering both HHI and concentration ratios. Transactions satisfying one of those measures may not satisfy the other measure. Small increases in market share as measured by HHI may mask the high market share of the dominant competitor. In those cases, I would expect that mitigating factors, even for small increases in market share, must be extremely strong to gain approval.

The task of enforcing bank merger policy will become potentially more challenging if financial conglomeration occurs, since the analysis of competition relies on the correct definition of the relevant geographic and product markets. Thus, increasing numbers of financial conglomerates that sell traditional retail banking services along with insurance and securities will make the analysis of competitive effects of mergers more difficult. In addition, it will remain important to distinguish between markets for large-scale wholesale products and markets for household- and small-business-oriented retail banking products. We will also need to consider the effects that networks, such as ATM and point-of-sale networks, and other forms of electronic banking have on competition for financial services. Finally, as financial relationships become increasingly complex, we must work to reduce market inertia that could lessen competition by restricting customers' ability to choose freely among providers of financial services. Domestic competition is particularly important not only because it increases the welfare of our fellow citizens, but also because other reforms, such as those based on market discipline, probably work best in a competitive market. Also, domestic competition is one of the most powerful forces that gives rise to international competitiveness.

Reducing Systemic Risk through Improved Supervision

Finally, the Federal Reserve must continually improve the bank supervisory process in order to help manage risk that could be introduced into the financial system by the changes occurring in the financial sector. The effects of consolidation and conglomeration on systemic risk cannot be ignored. If risk is not managed properly within the consolidated firm, the repercussions could extend beyond a single institution and well into the financial sector. Even if the moral hazard problem could be largely solved, so that financial firms bear the individual costs of the risks they adopt, these firms may fail to internalize the costs borne by the entire financial system when their portfolio decisions result in bad financial outcomes. The risk of such damage can be held in check only by sound supervisory practices.

I do not have time to do more than quickly mention some of the important efforts that the Federal Reserve is pursuing in order to improve bank supervision. Much of our effort, along with that of other bank supervisors, is focused on improving our ability to monitor and supervise the risk management practices of banks and banking organizations. Closely related work is aimed at devising capital standards that more accurately reflect the realities of today's banking world. Through it all, I would emphasize that old-fashioned supervision, the core of which is the on-site examination, remains central to our supervisory strategy. Improved market discipline, increased communication with other supervisors, and enhanced stability through greater diversification are necessary. But improved supervision is also critical, and sometimes there is simply no substitute for a well-trained and highly motivated examiner "on the ground."

V. Conclusion

In closing, I would like to reemphasize the importance of the basic skills that remain centrally important in the financial services sector. Regardless of the extent and the nature of conglomeration, technological development, and new financial instruments, good fundamental business practices will remain essential: credit underwriting and risk management skills, cost control, and appropriate pricing practices. While technological improvements are an aid in nearly all these areas, only sound management practices will allow industry participants to take advantage of any advances in technology. At the same time, fundamental principles of supervision and regulation must be applied, including sound credit standards and on-site examinations, to ensure the safety and soundness of the financial sector. Finally, regulators should implement antitrust policy in a manner that will ensure competitive prices and services as the financial sector evolves and consolidates. Despite the importance of vigorous supervision and regulation, I and my colleagues on the Board are quite sensitive to the fact that it is not our role to judge the wisdom of management decisions and business strategies beyond ensuring that public policy standards regarding supervision and regulation are met. I look forward to observing and participating in this sector's evolution into the next century. I thank you once again for the opportunity to discuss these issues with you today.

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