

The Causes and Effects of Financial Modernization

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Well, Florida isn't New Jersey, but it will have to do. Thank you for your kind invitation to address you here today. I'd like to take this opportunity to give you my insights on the causes and effects of financial modernization and to talk about the role of the Federal Reserve in implementing the landmark Financial Modernization Act of 1999.

In reality, "financial modernization" is not an event or a law; it is the dominant theme of the past fifty years of American finance. It can best be described as the erosion of the arbitrary constraints dividing the financial marketplace from the time of the Great Depression. And so, describing the causes of financial modernization will require beginning at that time.

Financial Structure - Initiation and Evolution

The Glass-Steagall Act of 1933 was enacted to protect consumers and the greater economy from the conflict of interest that, conventional wisdom held, contributed to the Great Depression. By separating deposit-taking activity from the underwriting of securities, this and other directives created a highly regimented financial services landscape. Commercial banks were limited to lending and deposit gathering. Thrifts were mortgage lenders. Investment banks served as underwriters and brokers of both stocks and bonds. And insurance firms had a profitable niche of actuarial products. Additional constraints were geographic in nature. Congress left in place a framework that encouraged state prohibitions on bank branching, leaving county and state borders as geographical boundaries on the activities of banks.

If Congress did not anticipate deterioration of the neat pigeonholes to which it had relegated the financial industry, it should have. While useful in augmenting consumer confidence during the Depression, the boundaries became increasingly anachronistic in post-war America. Market pressure to expand product offerings, and consumers' desire to have financial needs better met, coupled with legal ingenuity and effective lobbying, were simply too powerful to allow such arbitrary market constraints to survive indefinitely. When supplemented with the capabilities of computers and telecommunication, the evolutionary pace of financial-sector convergence accelerated greatly. By the 1970s, the very nature of banking had been changed forever.

In corporate finance, large, stable firms like General Motors and General Electric had long been the banking industry's best customers. But by the 1970s many corporations found borrowing from banks to be less efficient than issuing direct capital market obligations. Bond traders, now better able to assess the merits of non-investment grade bonds with computer technology, saw their industry boom at the expense of bankers. Innovative non-financial firms also developed their own capacity to finance consumer debt by tapping the capital market directly - cutting banks out of the loop altogether.

At the same time, consumers no longer saw their traditional local bank as the only option for their savings balances. While they generally relied on a community bank or thrift for home mortgage loans, many consumers sought better returns for their deposits through more sophisticated instruments. What was formerly deposited in a checking or savings account was now likely to be invested in a money market mutual fund, a cash management account, or into securities directly. The money market mutual fund industry could not exist prior to computerization, but by the 1970s it held billions of dollars.

Traditional lenders, witnessing the drop in corporate and consumer deposits as well as loan demand from their balance sheets, were eager to offer new products and find new sources of revenue. Technology did empower commercial banks to offer some new products and conveniences to their customers, such as the expanded use of credit cards, ATMs, and phone banking. But government often blocked their ability to

compete within their traditional customer bases. Regulation Q, for example, forbade banks from offering competitive rates on checking accounts. Trying to stay competitive, many banks offered a completely new banking product - the toaster - as an incentive to open an account.

Such obstacles left bankers demanding relief through relaxed regulation, entry into new markets, and the ability to expand more freely across state borders. The government's response was to give them all three.

Action began at the state level when the state of Maine enacted legislation permitting out-of-state entry. At the national level, Congress allowed banks to offer more competitive interest rates on deposits in 1980, ending the ill-conceived era of toaster banking. The Garn-St. Germain Act of 1982 allowed banks to cross state boundaries to acquire troubled banks. The Federal Reserve permitted bank holding companies to acquire discount securities brokers in 1983. In 1987 the Fed blessed limited securities underwriting under the bank holding company umbrella - then expanded the limits in 1989 and again in 1996. The 1994 Riegle-Neal Banking and Branching Efficiency Act removed constraints on bank holding company acquisitions across state lines and also permitted banks to branch interstate if permitted by state law. Interstate and regional banking had begun in earnest.

By the mid-1990s the process of evolutionary convergence had transformed the financial services landscape. Commercial banks were brokering insurance and underwriting securities subject to percentage caps. Insurance companies, many of which had merged with investment banks, offered new risk-management products with all the characteristics of securities. Home mortgages were packaged into securities. Thrifts, credit unions, and commercial banks all offered similar consumer banking products to their members. The money market provided for more efficient transfers of capital. Major commercial firms had their own finance companies or even a thrift. And, with mergers and acquisitions, the size of financial conglomerates swelled to unprecedented new levels.

The accommodations that sanctioned these developments made economic sense. In many cases they were the only rational courses of action that could be taken by Congress, the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, or individual states. But these actions stretched the credibility of the rules. Often, the rulings of bank regulators seemed like unambiguous reversals of established policy - products offered by banks appeared to emerge despite regulatory prohibitions or regardless of precedent. The necessary regulatory contortionism taxed even the descriptive power of the English language, as terms such as "non-bank banks," and "the facilitation of commercial paper placement" entered the lexicon. And as complexity rose, smaller institutions found themselves at a competitive disadvantage. By the mid-1990s, large sections of federal banking law resembled the human appendix - vestiges of a bygone era.

The contrast between the inadequacy of existing legislation and the reality of a new financial services paradigm was made unmistakably clear in April of 1998, with the proposed \$70 billion merger of Citicorp and Travelers Group. The creation of Citigroup - America's largest financial conglomerate, with businesses ranging from banking to insurance to securities underwriting - demonstrated the inadequacy of the legislative and regulatory patches of the previous 20 years. Congress, which had long debated a wholesale update of our financial laws, knew that it had to respond. Within a year both the House and the Senate had passed legislation to bring our financial laws into the modern age. With President Clinton's signature in November of 1999, the Gramm-Leach-Bliley Financial Modernization Act became law.

Redefining American Financial Structures Through Regulation

Essentially, GLB provides a unified legal framework standardizing the process of financial convergence. As you know, its centerpiece is the creation of the entity called the financial holding company, or FHC. Once a financial organization obtains the FHC designation, it can house a complete family of financial activities through distinct affiliates. Each affiliate is still overseen by its traditional functional regulator. The Federal Reserve continues to oversee the FHC, much as it oversees all the bank holding companies, or BHCs, of both yesterday and today.

It should be clear that while GLB may have established a new legal framework for financial convergence, it did not change the underlying realities driving the marketplace. Technology, demographics, and customer needs - these are the forces that have determined and will continue to determine the structure of the financial services industry. But while GLB will not change the nature of the financial services industry, it will bring the financial services industry to convergence in a more expeditious and more orderly manner than if we had gone on without it.

A more expeditious and more orderly process perhaps, but one that still holds a few surprises. For example, before Gramm-Leach-Bliley was enacted, some had predicted that many banks and other financial services organizations would quickly seek FHC status and begin offering "one-stop-shopping" for financial services to their target customers. It has been just about one year now since organizations could apply to become FHCs. Thus far, things have not turned out as predicted.

As of the end of last year, fewer than 10 percent of all bank holding companies had converted to an FHC. The percentage of investment banks, brokerage houses, and insurance companies that converted is much smaller.

The largest multi-product institutions have led the way. This is no surprise. Presumably these large organizations were constrained from pursuing a "financial supermarket" strategy prior to GLB and acted swiftly to maximize that opportunity.

A number of relatively small banks and small bank holding companies also have found reason to obtain FHC status. Indeed, fully two-thirds of current FHCs have assets of less than \$500 million. These institutions appear to have sought this status not because they have immediate plans to expand their product offerings but because the designation presented a relatively low-cost option for future product expansion. In general, these local or regional BHCs have less complex corporate structures and are currently well capitalized. So, getting the designation proved relatively easy. In the event that a good opportunity presents itself, these institutions will be prepared.

Nonetheless, these institutions represent but a small percentage of the total number of firms many suspected would be eager to benefit from the new law. Why have so few financial firms elected to become FHCs? Why has the pace of cross-industry acquisition been so slow? Undoubtedly, there are many reasons why more financial institutions have not rushed to obtain a designation that allegedly allows them to be all things to all customers. However, one seems particularly relevant.

Perhaps I am too much of an economist, but I believe that many institutions have done a simple calculation. They have already adapted to the former, somewhat convoluted BHC structure. These firms have been successful in delivering financial services to their market area through a combination of bank and non-bank subsidiaries, coupled with the increasing use of strategic alliances and outsourcing. In spite of the legal and regulatory difficulties of establishing their existing operating structures, these are in place and have been effective.

By contrast, the process of converting to the FHC is not a costless or trivial task. I believe that many of these institutions see no immediate benefits to doing so and remain more than a bit uncertain as to the longer-term implications of FHC status.

Over time, the potential benefits of the FHC structure will be clarified by developments both in the marketplace and in regulatory pronouncements. Circumstances in the marketplace will illustrate whether the added flexibility afforded institutions operating under an FHC charter offers additional profit opportunities not available to other participants. Meanwhile, regulatory policies and procedures will reveal the parameters under which FHCs must operate.

A number of the detailed regulations necessary to implement Gramm-Leach-Bliley have yet to be offered for public comment by the Fed, and none of the provisions of law have undergone "trial by fire." Understandably, the rules that the Federal Reserve has offered for comment are being scrutinized for indications of the Fed's intent and its appreciation of industry conditions.

This was made abundantly clear by the reaction to last year's proposed rule that bank holding companies' merchant banking activity should be subject to a 50 percent capital charge. The comment period worked as intended - and the Federal Reserve substantially altered the rule - but the episode undoubtedly left some lingering apprehensions.

Looking ahead, the Fed's next steps to implement Gramm-Leach-Bliley will also attract considerable industry interest. This spring, the Federal Reserve will promulgate regulations to implement Sections 23A and B of the Federal Reserve Act. These regulations will begin to delineate permissible financial relationships between a bank and other FHC affiliates. Its primary goal will be to establish barriers protecting depository institutions from the problems of a failing affiliate. Even with the best of intentions, this regulation will prove difficult to codify and will be subject to close scrutiny.

Then, in the near future, the Federal Reserve will define both its regulatory relationship with non-bank dominated FHCs, and the borders between financial activity and commerce. The crafting of these regulations will make the earlier attempts look simple by comparison.

I also believe that the industry is interested in how the relationships among regulatory agencies will unfold in this new environment. The Federal Reserve's new role as umbrella supervisor of financial holding companies is similar to its role in supervising bank holding companies. However, our future success entails increased communication, cooperation, and coordination with the many supervisors of the more-diversified financial holding companies. As the Fed begins defining its working relationship with these traditional regulators, it will answer many of the questions of importance to securities and insurance-based firms.

As we move through this process of developing the rules and refining the regulators' roles in the financial holding company, I believe that FHCs will emerge as entities with the flexibility and the functionality to meet the demands of the marketplace without unnecessary or onerous regulatory burden. I expect the number of financial firms electing to establish financial holding companies will increase as this becomes clear.

Summary & Conclusion

Well, I began my remarks today by saying that "financial modernization" is not a single event or law, but rather a relentless process of eroding the constraints placed on the financial marketplace back in the time of the Great Depression. With the passage of the Financial Modernization Act of 1999 and the implementation of the FHC structure, that process took a big step forward.

What will the financial services industry look like in the future? It is hard to say, but there is some agreement - at least in broad strokes. There will almost surely be a handful of financial behemoths offering one-stop-shopping to businesses and consumers. Their outlines and their names are quickly emerging as we speak.

Beyond these few, which will attempt to be all things to all people, I believe a large number of institutions will remain. These may be described as niche players that will choose either a geographic area or a product set on which to concentrate. In their chosen market segment, they will remain credible, even fierce competitors. Large monolines will remain and frequently access customers through other institutions, as is currently the case in credit cards and mortgage servicing. Community banks will still be effective competitors, both in markets for small- business lending and personalized consumer service. Smaller firms, quick to see changes in customer needs and to adjust their services accordingly, will be able to compete effectively as well.

In short, the future holds more innovation for firms of all sizes. The needs of customers, whether they be individuals or organizations, will continue to evolve and financial service providers will adapt to meet their needs. Gramm-Leach-Bliley recognizes that this is the nature of the marketplace. Those who find ways to seize the opportunities this law offers will define the future financial marketplace ahead and they will be the first to reap the rewards.

Thank you.