The Evolving Structure of the American Financial System

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Economics and finance have a unique power to create lasting international relationships. In my three decades as a student, professor, and now as a Federal Reserve Bank president, I have seen first-hand how mutual interest in economic issues can bring people together. Sharing both different experiences and differing solutions can span borders and overcome differences in language, culture, and currency. During my tenure as a teacher and administrator at the University of Pennsylvania's Wharton School, I had the opportunity to consult with financial institutions and central banks, learning and working around the globe, from Sweden to South Africa, from Saudi Arabia to India. Each problem was different, each environment unique, but there were similarities and lessons that experiences elsewhere brought to the table. It is with these memories and for these reasons that I welcome the opportunity to address the issue of the evolution of the U.S. financial sector today.

I recognize that our two systems are different. Indeed, our two countries are separated by a common language, a common continent, and a common historical beginning. But the similarities of finance and banking across our border suggest that the U.S. experience may offer you some clues to the trends here in Canada. Given the lasting bonds of goodwill, respect, and friendship that the United States and Canada share, it is my pleasure to be here with you today to recount our story. My hope is that this presentation will provide additional understanding and further strengthen the bonds between our nations.

Before I provide a broad overview of the current state of the American financial system and relate my expectations for its future, let me first describe how we got to where we are today. It is only with the perspective of history that America's financial future can be understood. Indeed, most countries' futures are imbedded in their past.

Clearly, the Canadian and American financial sectors have very different political, economic, and financial histories. In the United States, the role of states' rights has been particularly important in the area of banking structure. Indeed, it was only with the advent of the last century that banks in the U.S. could obtain a federal charter. By contrast, the Canadian banking structure has long been nationwide and nationally focused. But beyond charters and allowable branching activity, in the U.S. the federal government has chosen to pass regulations that have oscillated between establishing and deconstructing barriers to competition along both functional and product lines.

The recent enactment of the Gramm-Leach-Bliley (GLB) Financial Modernization Act of 1999 is one of the most important steps in this history, but it is best understood as part of this historical continuum of regulatory change south of your border. This new law to modernize our financial system and the regulations that constrain it, to a large degree, will shape the future of American banking, insurance, and securities brokerage. But Gramm-Leach-Bliley must not be viewed in a vacuum.

In the U.S. political environment, regulations and legislation tend to be seen as a reaction to market developments. Once completed, they become a precursor of things to come, as they lead to further change and future developments. Indeed, any review of American financial history reveals that the regulation of finance, either financial markets or financial institutions, is a complicated interaction between the regulator's goal to effect change in the sector and their reaction to developments already occurring within the relevant marketplace.

A close examination of the past 50 years leads one to the conclusion that passage of legislation similar to GLB was virtually inevitable. This is true because the term "financial modernization" in the U.S. refers to more than just the recently passed reform. The term refers to a reaction to previous legislation and signifies the erosion of arbitrary legal constraints dividing the financial marketplace since the Great Depression. Fully understanding the impact of this legislation and anticipating how the American financial marketplace will develop over the coming years requires knowledge of the necessity for the act. So, I will begin with a brief history.

A Brief History of the American Financial Structure

My review of the American financial scene begins with the legislation passed in response to the financial crisis that began in 1929. The Glass-Steagall Act of 1933 was enacted to protect consumers and the economy from the conflicts of interest that, conventional wisdom held, contributed to the Great Depression.

By separating deposit-taking activity from the underwriting of securities, a highly regimented financial services landscape was created in the U.S. 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, while insurance firms had the profitable niche of actuarial products. In addition, the geographic constraints on branching and conducting business across state lines remained, a remnant of our frontier past and respect for states' rights. Accordingly, the Congress left in place a framework that encouraged state control of bank branching, with county and state borders often used as the geographic limits on bank expansion capability. And some states were more restrictive than others, with many restricting banking to a unit banking structure and only a few permitting statewide expansion.

Congress should have anticipated the deterioration of the neat pigeonholes to which the financial industry was relegated. Product-line and geographic restrictions on the industry were just too binding to last forever. While useful in augmenting consumer confidence during the Depression, the limitations became increasingly anachronistic soon after the conclusion of World War II. What followed was market pressure to expand product offerings and broaden the geographic availability of banking services, urged on by consumers' desires to better meet their financial needs. These forces, coupled with legal ingenuity and effective lobbying by the industry, were too powerful to allow market constraints to survive indefinitely. With the arrival of the capabilities of computers and telecommunication, the evolutionary pace of financial-sector convergence accelerated greatly. In short, it became revolutionary.

By the 1970s, the very nature of American banking had changed forever. Interestingly, however, these changes did not always accrue to the benefit of the banking sector.

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 used computer technology to assess the merits of non-investment grade bonds, and this industry boomed at the expense of bankers. Innovative non-financial firms developed their own capacity to finance consumer debt by tapping the capital market directly, effectively cutting banks out of the loop.

Simultaneously, consumers no longer saw their traditional local bank as the only option for their savings balances. While generally relying on a community bank or thrift for home mortgages, many consumers sought better deposit returns through more sophisticated instruments. Money 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 directly into securities. The U.S. money market mutual fund industry, which did not exist prior to computerization, held billions of dollars.

Traditional lenders, witnessing the drop in corporate and consumer deposits, as well as loan demand, were eager to offer new products and find new sources of revenue. Technology empowered 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. Interest rate ceilings, known by the title "Regulation Q," for example, forbade banks from offering competitive rates on both savings and checking accounts. Trying to stay competitive while still living within pertinent regulations, many banks offered incentives to open an account, such as toasters.

But free toasters were poor incentives compared to the higher rates of return available at the time outside traditional banks. Bankers quickly petitioned Congress for relief, requesting three remedies: (i) relaxation of the relevant regulations, (ii) permission to enter into new markets and, (iii) the ability to more freely expand their banks across state borders. The government responded by granting them all three of their wishes.

Action on geographic expansion began at the state level, with Maine enacting legislation permitting out of state banks to operate within its borders. Meanwhile, rate relief was attacked at the national level, with Congress allowing banks to offer more competitive interest rates on deposits in 1980. This ended the ill-conceived era of toaster banking. Next, the Garn-St. Germain Act of 1982 allowed banks to cross state boundaries to acquire troubled banks. Then in 1983, the Federal Reserve permitted bank holding companies to acquire discount securities brokers. 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 Interstate Banking and Branching Efficiency Act removed constraints on bank holding company acquisitions across state lines. It also permitted banks to branch interstate if permitted by state law. Interstate and multi-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 offered similar consumer products to their members. The money market provided more efficient transfers of capital. At the same time, 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.

Was Deregulation an Appropriate Response?

These developments made economic sense. In many cases Congress, the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and regulators from individual states took the only rational course of action available to them. But their actions stretched credibility. Reasons and rationales for legislation become ever more convoluted. Regulations were changed and reinterpreted with contradictory outcomes at times. Often, the rulings of bank regulators seemed like reversals of established policy, as bank products emerged despite regulatory prohibitions and regardless of precedent. Complexity increased, and confusing terminology such as "non-bank banks" and "the facilitation of commercial paper placement" was used to describe these new regulatory contortions. By the mid-1990s, large sections of federal banking law resembled relics of a bygone era.

The contrast between the inadequacy of existing legislation and the reality of a new financial services paradigm was clear in April of 1998 when Citicorp and Travelers Group proposed a $70 billion merger. 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 knew it had to stop debating and respond. Within a year both the House and Senate had passed legislation to bring our financial laws into the modern age. With President Clinton's signature in November 1999, the Gramm-Leach-Bliley Financial Modernization Act became law.

The Effect of Gramm-Leach-Bliley

Undoubtedly, you have heard much about Gramm-Leach-Bliley and its potential to dramatically remake the banking landscape. Broadly, GLB provides a unified legal framework that standardizes financial convergence. 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. However, each affiliate is still overseen by its traditional functional regulator. The Federal Reserve oversees the FHC, much as it oversees all bank holding companies.

As history shows, GLB was a reaction to what financial institutions were already doing as much as it was a piece of legislation that was designed to reshape the financial structure. In addition, while GLB established a new legal framework for financial convergence, it did not change the underlying realities driving the marketplace. Technology, demographics, and customer needs are the forces that have determined, and will continue to determine, the structure of the financial services industry. But, while GLB did not change the nature of the industry, it will bring the financial services industry to convergence in a more expeditious and orderly manner.

Yet, expeditious does not mean instantaneous. Before Gramm-Leach-Bliley was enacted, some predicted that many banks and other financial service organizations would quickly seek FHC status and begin offering, "one-stop-shopping" for financial services to their target customers. It is approaching the two-year mark since organizations could apply to become FHCs. Thus far, things have not turned out as predicted.

As of the end of August of this year, less than 20 percent of top-tier bank holding companies had converted to an FHC. The percentage of investment banks, brokerage houses, and insurance companies that converted is even smaller. Not surprisingly, the largest multi-product institutions have led the way. Before GLB, these large organizations were constrained from pursuing a "financial supermarket" strategy, so they 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 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 expansion. In general, these local or regional BHCs have less complex corporate structures and are well capitalized. Getting the designation proved relatively easy, and these institutions will be prepared for future opportunities.

So, the immediate impact of this law has not been a radical transformation of the U.S. financial system. Certainly there are a number of institutions that are jumping at the chance to expand product lines. But only a small percentage of the total number of firms many suspected would be eager to benefit from the new law have chosen to seek the FHC designation and begin the process of product expansion. Why have so few financial firms elected to become FHCs? Why has the pace of cross-industry acquisition been so slow?

Understanding the Industry's Slow Response to Gramm-Leach-Bliley

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. As an economist, however, I believe there is one important, simple answer. Many institutions considering obtaining the financial holding company designation have done a simple calculation. They have already adapted to the bank holding company structure and 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. Their existing operating structures are in place and have been effective.

By contrast, I believe that many of these institutions see no immediate benefits of converting to an FHC and remain uncertain as to the longer-term implications of FHC status. Over time, the potential benefits of the FHC structure will be clarified both by the marketplace and in regulatory pronouncements. So, it can be said that inertia is part of the rationale for keeping the current institutional structure in place.

But there is also another part to this story. One of the main concerns for many hesitant firms appears to be regulatory in nature. As FHCs are a completely new kind of financial entity, becoming one entails entering into a new, uncharted regulatory landscape.

As the primary regulator of financial holding companies, the Fed is issuing thousands of pages of new regulations, and other regulators are following suit. 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 law's provisions have undergone "trial by fire." Rather than jumping in with both feet, many institutions are scrutinizing the rules that the Federal Reserve has offered for comment for indications of the Fed's intent and its appreciation of industry conditions.

For those looking for reasons for caution, last year's proposed rule that financial holding companies' merchant banking activity should be subject to a 50 percent capital charge is a case in point. The comment period worked as intended - and the Federal Reserve substantially altered the rule - but the episode undoubtedly left some lingering apprehensions about the future direction of regulation and the regulator's intent.

Yet, we at the Fed continue to promulgate the regulations required to implement the legislation. Another important step toward implementing Gramm-Leach-Bliley was taken last spring when the Board of Governors announced the publication of the long-awaited proposed "Regulation W." This regulatory proposal seeks to implement Sections 23A and B of the Federal Reserve Act and define permissible transactions between a bank and its affiliates.

In the post financial modernization world, bank affiliations can and do extend to many kinds of institutions. Protecting insured deposits from improper transfer to an affiliate is vital to the safety and soundness of our national economy and a key function of this proposed regulation. Accordingly, Regulation W will be an important part of the regulatory landscape. The industry has been reviewing this regulatory proposal for further evidence of the Fed's agenda and sensitivity to market pressures. My reading of the comments suggests that the industry believes that we are on the right track, and this should reinforce our goal of overseeing an industry that is both competitive and sound.

I also believe the industry continues to track how relationships among regulatory agencies will unfold in our new environment. The Federal Reserve's new role as umbrella supervisor of financial holding companies is similar to our role in supervising bank holding companies. However, our future success entails increased communication, cooperation, and coordination with the many other supervisors, responsible for different portions of the more-diversified financial holding companies. As the Fed refines its working relationship with other regulators, it will answer many of the questions of importance to securities and insurance-based firms. Circumstances will illustrate the extent of the added flexibility afforded institutions operating under an FHC formal structure.

Where Is the American Financial Institution Structure Going?

In time, these kinds of regulatory concerns will be put to rest. Those seeking to expand via an FHC type corporate structure will find that the newly formed regulatory framework will be both a responsive and responsible structural design for firms that choose to offer the full array of financial products.

In fact, there are currently a number of firms prepared or planning to offer a broad array of financial services to their clients through this organizational form. These firms clearly believe that their franchises will support such a broad offering, and more than a few believe that they must prepare for a rapidly developing marketplace dominated by universal service providers. The data support this view of the emerging market for bank products and activities. Simply stated, large complex banking organizations have grown in relative importance in the U.S. banking market. This can be seen in any number of statistics currently available on the industry. Whether it is the fraction of total banking industry assets held in the largest institutions, or the expanded percentage of the retail market in top-tier banks, or the presence of these same names in League Tables in the institutional market, the story is the same.

But there are still a lot of banks in the U.S. - nearly 10,000 commercial banks and thrifts, and over 5000 holding companies. The vast majority of these institutions have examined data relevant to their enterprise and come to the conclusion that their niche, measured either by size or breadth of offerings, will allow them to maximize profit and revenue without reaching mammoth size.

Reasons for the Evolution in Structure

Nonetheless, in this changing economic landscape, consolidation continues to be rampant among U.S. financial institutions. There are several reasons why U.S. institutions have been moving to broaden their activity and have expanded their size. On the top of any executive's list of rationales for the current consolidation and convergence wave is the efficiency gains that are thought to flow from the expansion of bank size and scope. These are presumed to be the result of a move to universal firms delivering a broad array of financial services to their clients through multiple delivery channels. Most often this converts to increased operating cost efficiency, or what we in economics refer to as economies of scale and scope. Many American bankers and bank analysts believe that larger institutions are more efficient and that average cost decreases as scale increases. In addition, it is often argued that an expanded product array and the potential for cross selling will result in substantial revenue benefits from larger and deeper product offerings.

In fact, recent studies of U.S. banks suggest that such cost efficiencies may already be taking place at some banks with broad product offerings. However, the evidence is not unequivocal, and many researchers remain skeptical that these alleged cost economies actually materialize in the U.S. financial services industry. Yet, both academics and practitioners alike seem convinced that consolidated firms have substantial revenue enhancement capability.

Proponents of universal banks offer still other advantages to larger institutions. They argue that added stability has long been an argument favoring larger firms. The belief is that the universal banks will benefit from higher earnings diversification, increased operating earnings stability, and thus higher valuations. The perceived simple logic of these arguments has convinced many banks that they can maximize stability by increasing the scale and scope of their operations.

Taken at face value, the balance of costs and benefits associated with a broader product array do seem to favor the more universal U.S. financial franchise. Similar results have also been offered for banking institutions operating in Europe. This last observation is not completely obvious, because banking firms in most European countries operate within a somewhat different set of rules and regulations than their U.S. counterparts. Nonetheless, the benefits of scale and/or scope, the revenue enhancements, and the added stability favor increasing movement toward universal firms. This is the predominant view in the research community and in the financial industry itself, as evidenced by the increasing size of institutions in the U.S. and elsewhere.

The nature of these consolidations has changed dramatically, however, over the past two decades. In the 1980s, consolidations tended to materialize as stronger banks buying out weaker ones. In the 1990s, this changed - strong banks merged not only with somewhat smaller institutions, but more often they merged with other strong, solvent institutions. More importance was given to broad strategic objectives, as institutions sought economies of scale and scope, expanding market territories, and complementary synergies.

When Will the Consolidation Stop?

As American banks expand and mergers continue, one might assume that the future of the American financial marketplace will be dominated by the handful of mega-banks that result from endless mergers. But I think not. Countering the positive pressures toward universality are forces that have permitted more narrowly focused firms to survive and flourish even where universal banking has long been a reality.

It certainly is possible that the financial supermarkets will garner a majority of market share from the specialized firms. In many product lines this is already the case. But even if the universal firms gain the lion's share, there will always be specialized firms in the U.S. market. Small and nimble firms have a long history of being able to successfully compete for local customers across the United States. Gramm-Leach-Bliley will not change this.

Historically, America's small banks have been generators of innovation, and innovation is the key to successful competition in a healthy marketplace. Our recent experience with mono-line, single product firms reinforces this perception. Therefore, I believe small or very focused firms will continue to thrive alongside the giants.

Consider the nature of these nimble competitors. They generally focus on a small geographic or product area and are highly sensitive to the changing needs of their customer base. That's why these firms are often best able to meet the needs of particular communities or customer segments. There will always be a place for these more focused firms in the U.S. market, in part because there will always be niches that are best serviced by such firms.

Small-business lending provides a classic example. Recent studies suggest that large banks are less likely to lend to small businesses and are equally strict when dispersing capital to local governments. Experts have argued that this results from the underlying economics of the market for these loans. They add little scale to the balance sheet and require a good deal of community-based knowledge to be successfully evaluated. It is precisely in such circumstances that a firm that is either geographically focused or specialized in a particular market segment can be most effective.

The Regulatory Issues

Notwithstanding the fact that I do not expect mega-firms to be the only option for American consumers of financial products, the development of large universal banks does pose new issues for U.S. regulators. Just their sheer size presents a unique regulatory challenge. Because a catastrophic failure at a large financial institution could have adverse implications for the global economy, preventing such a scenario must be one of our highest priorities.

In addition, there is a real possibility that a bad outcome in any one affiliate of a large complex banking institution may have a magnified effect on all of its lines of business and the core franchise of the institution itself. So, permitting the association of divergent financial institutions may well be subjecting the lead financial firm to greater distress.

Some speculate this will result in an extension of the government safety net to other types of financial firms. I hope and trust that this will not be the outcome.

Others have expressed concern over the sheer size of these mega-firms and the implication this has for the whole economy. They worry that economic power in the financial markets may become too concentrated. The feared result is that large firms could manipulate, or at least affect, the whole financial sector to the detriment of the economy.

For believers in the efficiency of markets and the importance of market discipline, these concerns are merely additional reasons for the regulator to encourage open markets and ease of entry. For non-believers, the new financial structure may offer a world of less choice and market manipulation. I stand squarely in the camp favoring the potency of market discipline, and against over-regulation as a remedy for the emergence of large banking firms.

So, there are obviously many challenges for regulators. But the primary remedies to all of these concerns are effective oversight, sufficient competition to impose market discipline, and an increased emphasis on disclosure. Combined, these are potent tools to ensure the integrity of the market for financial services.

Ensuring the integrity of the financial marketplace is not a new mission for the Federal Reserve. Buttressed by the tools available in both Gramm-Leach-Bliley and the new Basel Capital proposal, healthy competition for financial products will continue to thrive under the Fed's watchful eye.

By the way, the Basel proposal's emphasis on more transparency clearly supports the regulator's attempts to ensure competition in the market. The differences between the old and new accords in this regard are profound. The most prominent new elements introduced by the Basel proposal that are relevant here are its reliance on market discipline and internal rating systems to accurately assess risk. In the U.S., the Federal Reserve and OCC are charged with establishing specific supervisory methods for domestically chartered banks. A top goal for the Federal Reserve is to develop detailed regulations to incorporate the promises of the Basel Accord, while meeting the needs of our myriad financial institutions.

Designing and monitoring regulatory firewalls to minimize the impact of any subsidiary financial weakness within the financial or bank holding company is another part of the Federal Reserve's tasks to ensure the stability of these large financial entities. This is why we have chosen to revise and update Sections 23A and 23B of the regulations with the proposed Regulation W discussed before.

Summary and Some Final Thoughts

On this note, let me end with a quick summary. Tonight, we have looked at the history of the American financial services industry and examined its likely future. Many of the challenges facing the American financial sector result from the fact that it is forever evolving and changing.

Regulation has a role in all this. The Federal Reserve has a responsibility to react to these changes and ensure a healthy marketplace. Technological and regulatory change will continue to have profound micro and macro effects on the financial sector. The goal of the Federal Reserve will continue to be finding a balance that maximizes the potentials for economic growth while encouraging competition.

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

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 surely be a handful of financial behemoths offering one-stop shopping to businesses and consumers. Their outlines and their names seem to be clearly emerging.

Beyond these few that will attempt to be all things to all people, a large number of institutions will remain. These institutions may be described as niche players, and they will choose to concentrate on either a geographic area or a product set. In their chosen market segment, they will remain credible, even fierce competitors. Single-product providers, such as credit card issuers or mortgage servicing companies, will remain. Community banks will still be effective competitors, both in markets for small-business lending and personalized consumer service. These smaller banks are quick to adjust to changes in customer needs and, therefore, fully able to compete effectively.

In short, the future of the U.S. financial structure holds more innovation for firms of all sizes. The needs of customers, be they individuals or organizations, will continue to evolve. Financial service providers will, as always, adapt to meet their needs.