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Financial Services in the New Century

Robert T. Parry

T. S. Eliot wrote "April is the cruelest month." But April 1998 stands out–at least to people interested in the financial services industry–as a month of stunning changes. At the beginning of April, Citigroup was a word few people had ever heard of, and BankAmerica's headquarters seemed like a permanent fixture in San Francisco. Since then, how things have changed! Citigroup could become the largest financial firm in the world, and BankAmerica Corp. could call Charlotte, North Carolina, home!

These striking and rapid-fire developments serve to demonstrate the tremendous momentum for change in the financial services industry as we move into the next century. And with this momentum, the need is more imperative than ever to bring the legal and regulatory framework that *governs* financial services up to speed. That means developing a *coherent* framework–one that addresses the tension between the market forces behind the momentum and the need for safety, soundness, and stability in the system.

This *Economic Letter* discusses these issues as the financial services industry faces the new century, and it does so by addressing three questions: What's creating the momentum? How is the momentum transforming the structure of the industry? Finally, how can and should policymakers respond?

What's creating the momentum?

The answer to this question can be put in terms of both demand and supply factors. On the demand side, the push for more financial services, as well as a changing mix, is coming from greater wealth, greater investor sophistication, and the globalization of economic activity.

But the supply side is, perhaps, even more important. Here I'm referring to advances in the so-called information age and to innovations in finance. The link to the information age is clear since the financial services industry is all about information–processing it, analyzing it, storing it, and transmitting it. The innovations in finance are thanks to the rocket scientists in academia and on Wall Street, whose work is reshaping the fundamentals of financial services with new ways to measure, assess, and manage risk.

Transforming the structure of the industry

How are these forces transforming the structure of the industry? There are two key dimensions of change: consolidation, as in BankAmerica Corp. and NationsBank, and convergence, as in Citicorp and Travelers.

While the momentum behind these structural changes is strong, there *are* some question marks. For example, in terms of consolidation, many might question whether you need to control assets of half a trillion dollars or more to realize the cost savings from size. Indeed, one could easily think of areas of operations where huge size would bring significant cost *dis*advantages. The move toward convergence also has its skeptics. Some point to examples of false starts in the past, as well as to the increased complexities of managing a diversified, mega-financial services institution. And others question whether customers really *want* “one-stop shopping” in financial services.

Still, major players in the market think the strategies of consolidation and convergence make sense in terms of cost and revenue. For example, through consolidation, institutions are looking to gain from combining back-office operations, leveraging electronic delivery systems, offering other products to a larger customer base, and, in many cases, achieving more geographic diversification.

Convergence also may make sense from a supply perspective–for several reasons. One is the potential for more efficiency in *producing* a mix of financial services. Take debt underwriting, for instance. Banks have been pretty successful at this–and that makes sense, since debt underwriting calls for the same kinds of expertise and information used in lending. Another potential is for more efficiency in joint *marketing* and *distribution*. “One-stop shopping” gives firms an opportunity to leverage information systems, sales forces, and distribution systems for cross-selling. Finally, convergence can be a good way to hedge against the uncertainty about the form and profitability of financial services in the future; one hedging strategy is to cover the bases by being diversified.

This reasoning, of course, doesn’t rule out the success of other strategies. Smaller banking institutions are operating profitably, and new banks are entering the market as well. Also, firms in similar lines of business are consolidating–just think of the proposed Household and Beneficial merger. Moreover, some institutions are relying on outsourcing to expand the line of products available to their customers. For example, here in California, some banks give their customers easy access to insurance products by having an insurance company do the underwriting, while another vendor puts licensed sales staff in the branches.

So, consolidation and convergence in the industry don’t necessarily spell the end of the smaller bank or the specialized institution. But, as the recent merger proposals show, the momentum for large, diversified national and global institutions is building–to a whole new level.

How should policymakers respond?

What do convergence and consolidation mean from a public policy perspective? They mean we need to develop a more *coherent* legal and regulatory framework that strikes a balance between the market forces pushing for consolidation and convergence and overall public policy regarding the federal safety net and the rationales for financial regulation. The safety net includes access to deposit insurance and access to Fed services like the discount window and the guarantees that come with being involved in the payments system.

In developing this framework, history tells us to proceed carefully. We don’t want to face again the problems created in the early 1980s, when deregulation proceeded without enough attention to its implications for the safety net. This time around, I am encouraged that prudence is being used in striking this balance in the framing of financial reform legislation like HR10. This is evident in the debate on two key aspects of this legislation–corporate structure and regulatory structure.

The debate about *corporate structure* is over the preferred way to allow broad affiliation while containing the scope of the safety net. The approach in the most recent public version of HR 10 would put most of the nonbank activities in holding company affiliates. The Fed has argued that this is preferable to using the op sub approach. I know that this issue smacks of being a "turf battle." But it's clear that the earnings of a bank sub–for better or worse–affect the earnings of the bank directly, while that's not the case for holding company affiliates. Of course, there *are* ways to mitigate the negative effects of losses in a bank sub, such as requiring a bank to deduct funds invested in a sub from the bank's regulatory capital. But the op sub probably still would be subject to the same degree of firewalls as an affiliate, which would limit any potential operational advantage. In the end, without taking sides on the issues of theory or turf, I think the new framework should start on the side of caution. And, the more prudent way to begin is to use the holding company affiliate as the primary vehicle for accommodating convergence.

In terms of the debate over *regulatory structure*, the most recent draft of HR 10 takes a quasi-functional approach. It attempts to ensure that we maintain safety and soundness standards for entities directly covered by the safety net while giving their affiliates more leeway.

But as a longer-term solution, this approach has its shortcomings. New instruments developed in the future–being neither fish nor fowl–won't fit neatly into today's notions of banking, insurance, and securities activities. And having some of the future disputes subject to judicial ruling would contribute to uncertainty. So it's probably almost impossible to adopt a regulatory structure that will be acceptable today *and* in the future. The quasi-functional regulation approach, coupled with umbrella supervisors, has to be seen for what it is–a workable interim compromise.

As for consolidation, it means that the number one financial regulation issue–how to deal with the problem of "too big to fail"–becomes even more intractable. As long as the markets see some institutions as "too big to be allowed to fail," the implicit government backstop breaks down market discipline and gives rise to a "moral hazard problem." FDICIA addresses this issue with a number of measures that are designed to put uninsured liability holders at risk in order to increase market discipline. And since FDICIA, there's evidence that uninsured liability holders *are* more at risk than in the past.

But the least-cost-resolution provision of the law contains an escape clause–it gives authorities discretion when systemic problems might arise, and that effectively leaves "too big to fail" an open issue. Now, in the current economic context–with today's remarkably strong economy–"too big to fail" may not seem like such a threatening problem. Financial firms are performing very well, and even if a big one threatened to fail, the economy probably is resilient enough to absorb that kind of shock. But these remarkably good times aren't going to last forever. And when times are tough, the potential failure of mega-institutions could mean a very serious threat in terms of creating systemic problems.

That's why it's important to take steps now to mitigate the problem. To begin with, we need to keep the main focus on the insured depositories and entities in an organization involved in the payments system. This would mean bolstering the legal punch behind corporate separateness, requiring these firms to have strong capital positions, improving the methods regulators use to monitor their risk by taking advantage of the advances in measuring and assessing risk, and establishing a credible policy that leaves the liability holders of the largest institutions at risk.

Second, steps can be taken to limit the potential for systemic risk. This would mean moving to greater transparency and disclosure, which would limit contagion based on the lack of information, improving monitoring of the financial links among financial institutions, improving international coordination of regulatory and supervisory standards as well as payments system policies, and continuing to improve the payments system through netting as well as tapping technology to reduce the lags in clearing and settlement, with the longer-term goal of effective gross real-time settlement systems.

Conclusion

These steps are straightforward to describe, but they're not all straightforward to implement. And finding the way to make them realities will be the biggest challenge for public policymakers as this century draws to a close and the new one dawns. With a more concentrated industry and intensified concerns about the potential for systemic problems, the Fed's independence will be an even more essential ingredient in the regulatory process–heightening the need for us to maintain an intimate knowledge of and ongoing contact with financial institutions, especially the largest institutions.

We at the Fed look forward to these challenges as financial services in the new century evolve. The growing demand for financial services, the improvements in efficiency, the development of new financial products, and a more competitive environment are all inevitable and desirable developments. They point not only to continued expansion in the financial services sector, but most important, to offering increased benefits to those the Fed ultimately serves, the consumers.

Robert T. Parry
President and Chief Executive Officer

This Economic Letter is adapted from remarks delivered by Robert T. Parry to the California Bankers Association Bank Counsel Seminar on April 25, 1998.

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