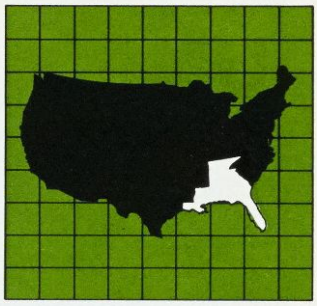
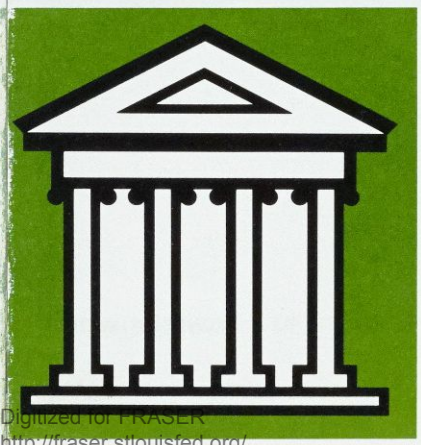
Economic Review



FEDERAL RESERVE BANK OF ATLANTA MAY 1984



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Special Issue: Bank Product Deregulation

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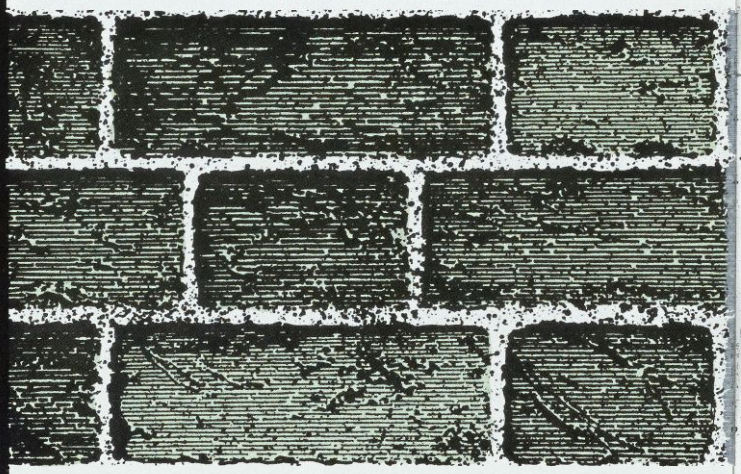

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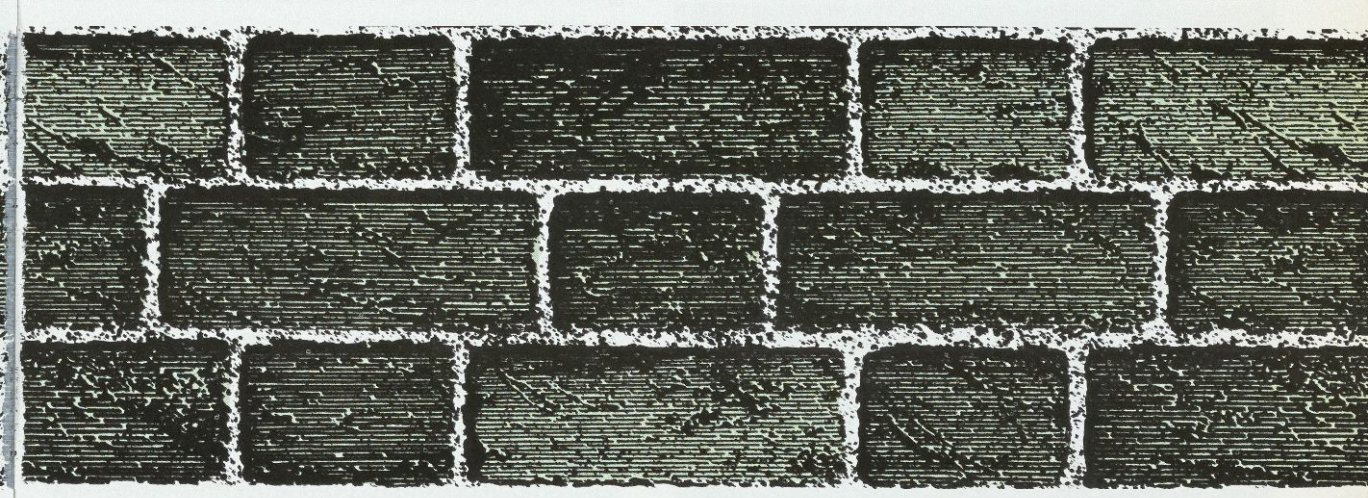
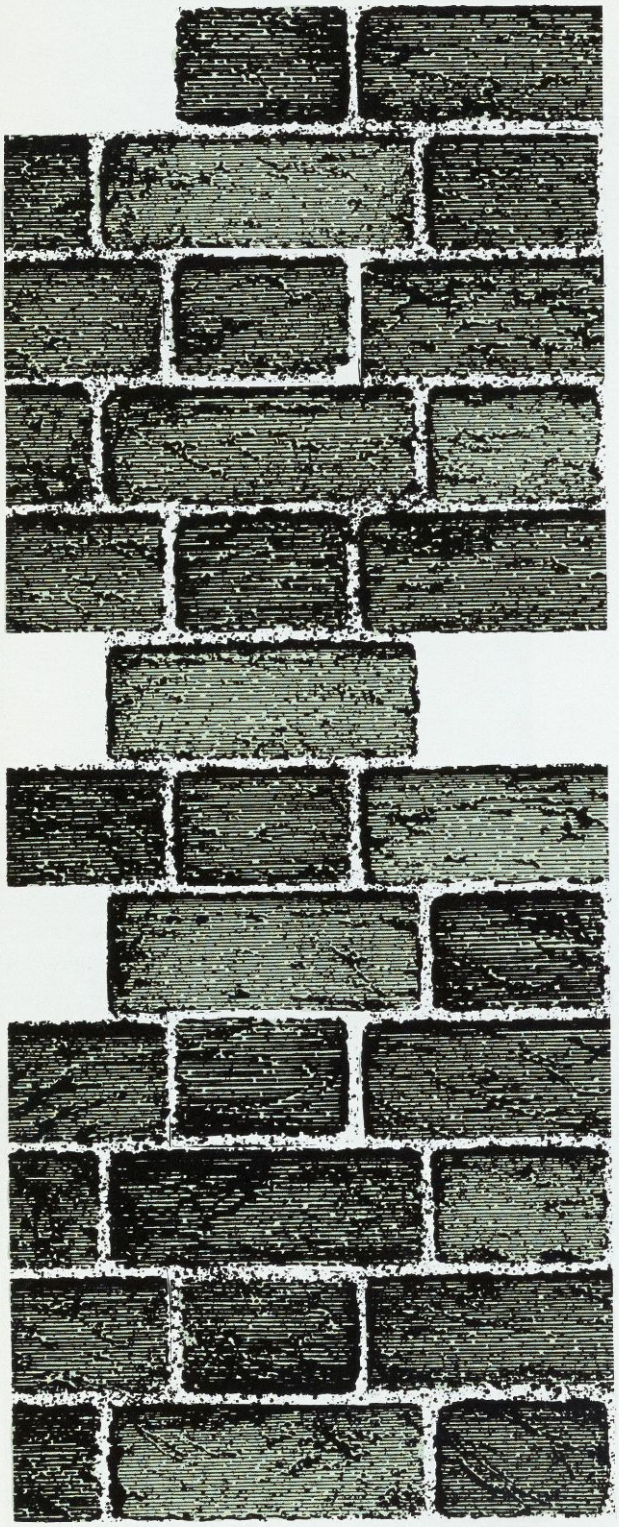


FEDERAL RESERVE BANK OF ATLANTA

Introduction



Legislative walls that have partitioned the American financial system into separate commercial banking, insurance, investment banking, savings and mortgage lending and nonfinancial segments have eroded during the past several years. They seem likely to continue to crumble as businesses try to diversify their financial offerings in the future. This issue of our **Economic Review** will survey the important issues bound up in the process of product deregulation now occupying financial markets, regulators and lawmakers. It parallels our analysis, published in this **Review** in May 1983, of the breakdown of geographic barriers to banking.

The regulatory limits to banks' activities arose from public concerns about the safety and soundness of banks and the financial system and about concentration of financial power. Present-day limits grew primarily from federal laws passed in reaction to economic problems of the 1930s. Chaotic conditions in the nation's financial system accompanied by the failure of one-third of the nation's banks induced far-reaching reforms. Congress introduced federal deposit insurance and improved the Federal Reserve's ability to provide bank reserves through the discount window and open-market operations in order to restore and maintain confidence in banks and the financial system.

In addition, the Congress sought to control banks' costs by limiting the interest that they could pay on deposits. It also sought both to control their risk and to limit concentration of financial power by limiting banks' activities in the securities business. This latter limitation, combined with earlier prohibitions against certain real estate and insurance activities, served to keep commercial banks specialized in the deposit-taking and lending business until activity restrictions began to fall in the early 1970s.

A third limit—barring interstate banking—had been passed earlier and was reaffirmed in the early 1930s. By prohibiting interstate banking by national banks, the McFadden Act of 1927 insulated banks from out-of-state competition and also limited their geographic diversification. State branching and bank holding company restrictions, the McFadden Act and, later, the Douglas Amendment to the Bank Holding Company Act, are largely responsible for the existence of approximately 14,000 commercial banks in the nation today.

Each of the limitations served to insulate various types of financial firms from price, geographic

or product competition. Since the payment of interest on deposits was limited, interest rate increases in other markets had limited effects in raising banks' cost of funds. The McFadden Act limited deposit and loan competition from out-of-state organizations, again holding down the cost of funds and possibly raising the return on loans. Activity limitations compartmentalized product offerings, restraining competition and insulating banks from whatever risk may have been associated with investment banking, insurance and real estate operations.

Market and legal conditions have changed since the 1930s. The Depository Institutions Deregulation Committee has removed interest-rate ceilings on all deposits but passbook savings and transactions accounts. Geographic restraints imposed by state laws, the McFadden Act and the Douglas Amendment are breaking down, largely because of bank holding companies' nonbank activities and states' reciprocal banking laws.

What's more, product restraints are being severely tested (witness the NOW accounts offered by thrifts, money market mutual funds, and the new financial services offered by nonbanks such as Merrill Lynch, Sears Roebuck, American Express and J. C. Penney). These changing market conditions certainly indicate the need for a reappraisal of the current product limitations. Technology has changed, and interest rates show greater variability today than has historically been true. Some states are now allowing banks to engage in nonbanking activities prohibited by federal banking laws. In addition, various proposals before Congress contemplate increased bank powers in securities, insurance and real estate activities. Adding to the confusion, large banks perform many domestically prohibited activities in foreign countries. Even the definition of what constitutes a bank is in question.

The product regulations imposed on commercial banks were designed to preserve the safety and soundness of the banking system and to prevent undue concentration of financial power. The former rationale revolves around a desire to guarantee the safety of deposited funds in order to maintain stability of the money supply and to ensure efficacy of the savings and investment cycle and the payments mechanism. In terms of product deregulation, fears are centered on the increased risk that some assume to be associated with banks' expanding product offerings. The fear of concentrated financial power seems to be based on concern that concentration of financial resources through banks' product diversification may lead to a misallocation of economic resources. In other words, as the division between banking and commerce erodes, banks may gain power to earn excess profits and to allocate credit on the basis of their own ownership interest rather than on an unbiased view of the investments undertaken.

The first section of this issue of our **Economic Review** will provide an assessment of the safety and soundness question. Robert A. Eisenbeis, Wachovia Professor of Banking at the University of North Carolina, and Larry Wall, a Federal Reserve Bank of Atlanta economist, will analyze the potential impacts on bank and financial system risk associated with product deregulation in the financial services industry. The second section, written by Elinor Solomon, professor of economics at George Washington University, will assess issues related to potential concentration of financial power resulting from financial product deregulation. Is this fear of concentrated financial resources really justified?

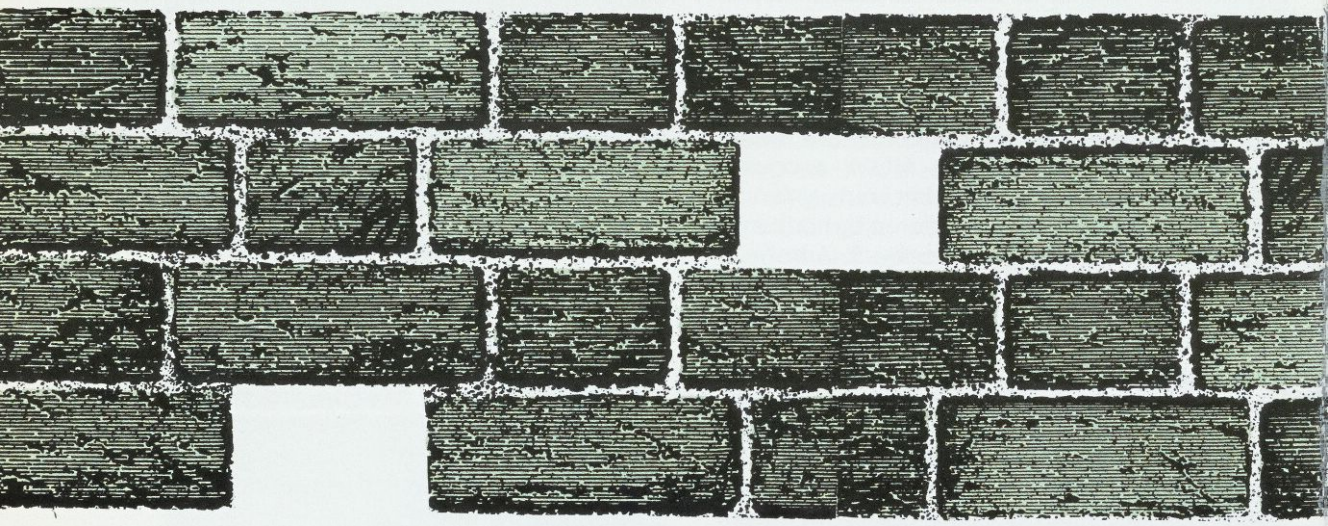
The third and fourth sections deal with potential benefits of deregulation to banks' customers. All financial institutions would like to believe they can provide all things to all customers, but market realities may not support this optimism. Veronica Bennett, a financial industry research specialist, will reveal the results of three attitude surveys that sought to determine how consumers prefer to receive their financial services. She reports on a special survey of consumer attitudes undertaken by the Atlanta Fed as well as evidence from proprietary studies.

Bernell Stone, Mills B. Lane Professor of Banking and Finance at Georgia Institute of Technology, will address the same question from corporate customers' perspective: What do corporate customers want and from whom do they want to receive these services? The fifth section deals with what we can learn about product deregulation in financial services through a case study of U.S. banks' experience in the securities industry. This section was written by Samuel L. Hayes III, Jacob Schiff Professor of Investment Banking at Harvard University. The concluding section will pull the evidence together and suggest policy implications. We hope you find this issue of our **Economic Review** interesting and informative.

—B. Frank King
David D. Whitehead

Risk Considerations in Deregulating Bank Activities

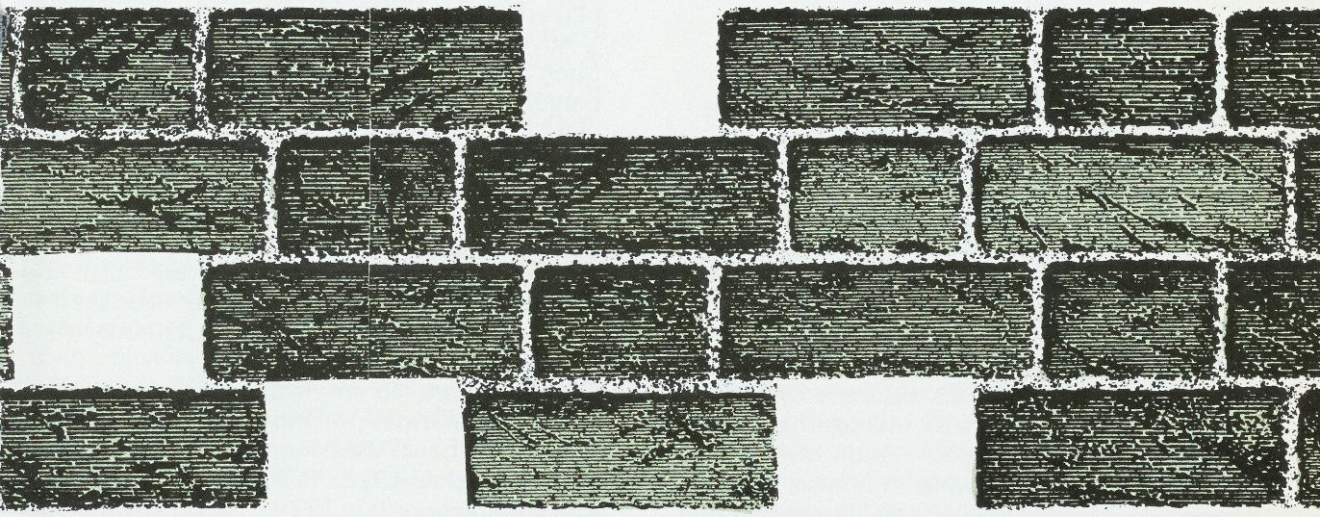
Easing restrictions on bank products may carry risks if an institution's activities are poorly managed, but perpetuating those limitations poses dangers as well. Here's a look at the arguments on both sides of the dilemma.



Bank activities have long been heavily regulated, not only because of concern over potential conflicts of interest, unfair competition, and undue concentration of resources, but more important, for safety and soundness reasons.[1] Safety and soundness regulations limit banking organizations' asset and liability portfolios, provide for examinations, provide deposit insurance and offer access to the discount window at the Federal Reserve.

Proponents of deregulation argue that continued regulation of activities adds nothing to the system protecting bank safety and soundness. They further contend that regulation places banks at a competitive disadvantage and will allow less-regulated nonbank competitors to assume banks' role in our financial system. Advocates of continued regulation argue that deregulation would strain the rest of the safety and soundness system and could even undermine the banking system.

We have reviewed the argument that continued regulation jeopardizes banks' competitive position and then considered the risks of allowing new activities. Our conclusion is that deregulation poses no threat to the stability of the financial system but that failure to deregulate does pose such a threat. The risks inherent in deregulation



arise because the deposit insurance agency and the discount window bear much of the costs of bank failure. We have examined three regulatory reforms suggested as substitutes for activity deregulation but found significant problems with each.

We then considered the effect on bank risk of allowing banks to expand into currently prohibited financial activities. Our findings suggest that, had banking organizations been passive owners of some prohibited activities, their earnings might have been less volatile during the 1970s. But their earnings might have been more volatile had they been passive owners of some other activities. We also found no evidence to indicate that the bond market anticipates significant changes in the riskiness of acquirers of various financial firms.

Risks of Continued Regulation

The system set up to maintain bank safety and soundness exists in large part because banks' deposit-taking activities play such an important role in the economy. Banks traditionally have dominated payments services, and we learned during the 1800s and early 1900s that protecting bank safety was critical to a smoothly

functioning economy. This dominance is being challenged, however, by competitors from outside the banking industry.[2] These competitors generally are not sheltered by the protective system covering banks. Thus, regulation that weakens banks' competitive position—even if it strengthens bank safety—can weaken the economy by increasing the growth rate of institutions that offer liabilities serving as money but that lack access to federal deposit insurance or the discount window.

Some proponents of deregulation, such as Charles S. Sanford, Jr. of Bankers Trust Company, argue that regulation threatens banks' competitive position. Sanford (1984) contends that commercial and investment banking are becoming indistinguishable. He also argues that current restrictions increase banks' riskiness by limiting their ability to employ risk-management techniques such as selling off credit risk. Other bankers point to the growing list of retail products offered by Merrill Lynch, Sears, Prudential and others as evidence that they need to expand into new activities to compete effectively.

"Our conclusion is that deregulation poses no threat to the stability of the financial system but that failure to deregulate does pose such a threat."

Given current regulation, the threat nonbank challengers pose to commercial banks' competitive position depends on consumer preferences and the ability of less regulated firms to generate synergies between different financial services. Evidence on individual and corporate preferences is reviewed elsewhere in this issue. Also in this issue, Samuel Hayes (1984) discusses the importance of synergies in various aspects of investment banking. Regardless of the conclusions drawn from available evidence, the risk of regulating commercial banks and unknowingly affecting the structure of the financial system must be considered. Maintaining the soundness of individual banks is only a means to an end; the ultimate goal is a safe and sound financial system.

The Risk Rationale for Activity Restrictions

Two major types of restrictions on the affiliation of commercial banks with other firms have been imposed at different times for different reasons. Specific restrictions barring commercial banks from affiliating with investment banking were adopted shortly after the banking crisis of 1933 and were in part a reaction to that crisis. The general restrictions on commercial bank affiliations with other banks and nonbanking firms are based on the 1956 Bank Holding Company Act and its 1970 amendments. These restrictions appear to have been justified primarily by a desire to prevent concentration of financial power and conflicts of interest. Risk considerations played a less significant role.

Advocates of continued activity regulation frequently argue that commercial and investment banking were separated by the Glass-Steagall Act in 1933 to protect commercial banks' safety. A review of the record suggests, however, that conflict of interest considerations played a larger role in the separation. During the late 1920s and early 1930s, commercial bank affiliates could engage in investment banking. During this period some investment banking affiliates engaged in operations that appeared unethical (though they were legal at that time).[3]

Furthermore, commercial banks were making loans for securities purchases, and some people believe the banks were feeding the "...speculative fever of the late 1920s."[4] The fever ended with a stock market crash in 1929. The early 1930s saw a wave of bank failures, culminating in a 1933 panic that struck both strong and weak banks. That panic forced President Roosevelt to declare a nationwide bank holiday shortly after he was inaugurated. Congress responded to the collapse by passing a series of banking laws, including the Glass-Steagall Act, which prohibits commercial banks and their affiliates from engaging in investment banking.

The 1930s collapse of the banking system was tragic, but it did not prove that the safety and soundness of the current banking system depends on activity regulation. Many contemporary analysts doubt that the 1933 collapse was due to banks' affiliation with securities firms.[5] Most banks that failed during the 1920s and early 1930s were small and had no large securities affiliates.[6] The prominent commercial banks whose

affiliates' unethical behavior had upset Congress remained in business.

Another reason for doubting a current safety-activity regulation connection is the development of deposit insurance and the more active role taken by the discount window since 1933. The 1933 banking crisis occurred because even sound banks became illiquid when the public lost confidence and withdrew deposits. The creation of deposit insurance reduced the incentives for people to withdraw money if they think a bank will fail. Furthermore, as a consequence of changes in Federal Reserve policies for administering the discount window, the Fed now provides sound banks with the resources they need to survive a liquidity crisis.

Federal deposit insurance and strengthening the Federal Reserve discount window have reduced the probability of a banking system collapse, but they have created new problems. As Edward Kane (1983 and 1984) points out, the government now bears much of the risk of bank failures. If banks are allowed to engage in new activities that increase bank risk, then the government will bear those risks.

One problem with the government's bearing the risk of bank failure is the effect on competition between firms. If the market believes that banking organizations' liabilities all have implicit government backing, then it will charge lower risk premiums on those liabilities. This will give banking organizations a competitive advantage over firms not associated with a commercial bank.[7]

Fear of concentration of power and conflicts of interest were far more responsible for the Bank Holding Company Act of 1956 and its 1970 amendments than was the financial risk of nonbanking activities.[8] Prior to 1956, BHCs could acquire banks outside their home state and commercial firms without obtaining permission from the state of the acquiring bank. Some BHCs were building interstate networks of banks and commercial firms. For example, William Upshaw (1968) notes that Transamerica held 38 percent of all commercial bank deposits in five western states in 1946. In 1956, following the Supreme Court's refusal to uphold the Federal Reserve's attempt to force a divestiture of Transamerica's interstate holdings, Congress turned its attention to BHC activities. It found some BHCs building a conglomeration of bank and nonbank firms that raised concerns about the concentration of financial power. A Senate Banking and Currency Committee report on the proposed act makes it clear that the primary rationale for restricting BHCs was a fear of concentrated power:

> "It is not the committee's contention that bank holding companies are evil of themselves. However, because of the importance of the banking system to the national economy, adequate safeguards should be provided against undue concentration of control of banking activities."

Further support for the concentration of power theory is given by the fact that the act covered only multi-bank holding companies. If the primary concern had been bank safety, one would expect the controls also would have been placed on one-bank holding companies, but no such restrictions were placed on them. The Senate report justified this by arguing that:

> "Your committee did not deem it necessary to include within the scope of this bill any company which manges or controls no more than a single bank. It is possible to conjure up visions of monopolistic control of banking in a given area through ownership of a single bank with many and widespread branches. However, in the opinion of your committee no present danger of such control through the bank holding company device threatens to a degree sufficient to warrant inclusion of such a company within the scope of this bill."

Starting in early 1968, many large banks began to form one-bank holding companies to exploit the potential diversification opportunities. This alarmed many observers, including then Federal Reserve Chairman William Martin, who argued in 1969 that: "...if we allow the line between banking and commerce to be eased, we run the risk of cartelizing our economy."[9] This concern dealt more with the potential for problems than the

"Federal deposit insurance and strengthening the Federal Reserve discount window have reduced the probability of a banking system collapse, but they have created new problems."

reality of any problems. As the Senate Banking Committee's report on the 1970 BHC act amendments notes:

> "In making this decision, the committee wishes to note its agreement with all of the government regulatory agencies who testified that there have been no major abuses effectuated through the one-bank holding company device. It is clearly understood that the legislation is to prevent possible future problems rather than to solve existing ones."

Essentially, the one-bank holding company movement exposed a major loophole in the 1956 restrictions and Congress wanted to extend the restrictions to prevent undue concentration of power. This interpretation of the 1970 amendments is further bolstered by the statement of the House managers in the conference committee report on the amendments. The report details its concerns with the concentration of economic resources and power, decreased or unfair competition, adverse competitive effects, and tie-ins. It then says that the Federal Reserve Board also should consider potential conflicts of interest and unsound banking practices when it authorizes a new activity. Congress was concerned about bank safety and soundness when it passed the 1970 amendments, but these appear to have been secondary concerns.

Thus safety and soundness considerations do not appear to have been the primary factor behind either the Glass-Steagall restrictions or the BHC act's activity restrictions. Furthermore, the development of deposit insurance and the revision of discount window administration minimized the risk of a banking system collapse. The real problem with removing activity restrictions is that it could shift risks to the government. Such a shift could strain the safety and soundness system and give banks a competitive advantage in their nonbanking endeavors.

The potential problem of allowing traditional banking organizations to enter into currently prohibited activities is not one-dimensional. Firms currently operating in activities prohibited to banks are acquiring savings and loans and nonbank banks.[10] These thrifts and nonbank institutions can provide most of the asset and liability services, such as transaction accounts and commercial loans, that have in the past made banks uniquely important in our financial system. Furthermore, nonbank institutions can be insured by the federal government and can gain access to the discount window, so their problems can also impose costs on the system designed to protect traditional banking organizations. These nonbank bank acquisitions raise the same fundamental questions posed by proposals to expand permissible bank activities. The conclusions drawn below, therefore, apply to acquirers of thrifts and nonbank banks.[11]

Other Methods of Maintaining Bank Safety

The above analysis argues that, given deposit insurance and the discount window, activity restraints are not necessary to protect the banking system from collapse—but they may have a role in limiting the risks borne by the government safety and soundness programs when insurance is not properly priced.[12] This suggests that reform of the safety and soundness system could substitute for activity regulation.[13] Possible reforms include proposals to deregulate the activities of BHC nonbank subsidiaries, proposals to reform deposit insurance so that banks are charged risk-based premiums, and proposals to increase the risk borne by private creditors of banks.

"The real problem with removing activity restrictions is that it could shift risks to the government (which could) strain the safety and soundness system and give banks a competitive advantage in their nonbanking endeavors."

One proposal to allow activity deregulation through expanding the permissible activities of BHC subsidiaries was made by the Treasury Department a couple of years ago.[14] It attempts to ensure safety and soundness by restricting transactions between bank and nonbank subsidiaries to insulate banks from the risks borne by their affiliates. It assumes that individual nonbank subsidiaries within a BHC could fail without affecting the health of the banking subsidiaries.

This proposal is attractive because it claims to eliminate the safety and soundness problems

associated with expanded BHC activity. Unfortunately, as Robert Eisenbeis (1983) points out, subsidiary banks' risk exposure can be independent of the exposure of its affiliates only if the BHC is run as a passive mutual fund. If the BHC controls or coordinates the activities of its subsidiaries to maximize joint (or consolidated) profit, then BHC affiliates' problems will inevitably affect the bank subsidiaries. Furthermore, existing evidence suggests that BHCs operate as integrated entities.[15]

An important problem is that BHCs have shown a tendency to draw on all of their resources to help troubled subsidiaries. For example, BHCs risked substantial losses in the 1970s to prevent the real estate investment trusts they sponsored from failing, even though the BHCs did not even have substantial ownership interest in those REITs. The primary stake to individual BHCs in an REIT failure was their reputation. BHCs logically would do at least as much for units they own, especially if those units generate important synergies with the BHCs' banking subsidiaries. The Treasury Department argues that regulations can be developed to prevent BHCs from using banks to help nonbank subsidiaries. Eisenbeis argues, however, that such regulation imposes costs on the BHC and will induce it to shift activities from subsidiary banks to nonbank affiliates. These shifts would increase bank dependence on nonbank affiliates for customer services and operational support. Thus, attempting to isolate banks from their subsidiaries could increase their dependence on subsidiaries.

"We imposed deposit insurance to prevent bank panics, but now are considering reimposing market discipline through the threat of runs to limit the risk exposure of the insurance system."

The risk borne by the government if a bank or an affiliate is allowed to engage in a new activity could be controlled by charging the bank a variable-rate insurance premium based on risk exposure. The government bears some of the cost of a failure because it fails to charge premiums based on the banking organization's risk. Thus, individual banks are in a position to take large gambles knowing that the bank can keep its earnings if the risk pays off and that the government will cover the losses if it fails. Furthermore, even banks not inclined to gamble have less of an incentive to control their risk exposure than they would if they were charged for the risks they take. As Mark Flannery (1982) notes: "...FDIC's fixed-rate premium structure is unusual and this constitutes the raison d'etre for other bank regulations."

Variable-rate insurance may work well in some theoretical models, but risk-based premiums would be difficult to implement. In its report to Congress, for example, the FDIC said that an "ideal system" with premiums closely tied to (commercial bank) risk "is simply not feasible." If relating insurance premiums to risk for banks is difficult, it must be even more difficult within a holding company framework.[16]

A third way of deregulating while limiting the risk exposure of government is to shift more of the risk exposure to the private sector. The FDIC recently began experimenting with this approach by limiting full payment on deposits to $100,000 per depositor for selected bank failures.[17] Other possible ways of transferring the risk to the private sector include substituting private for government insurance, and requiring banking organizations to use more equity and subordinated debt funding.

Before the government can shift more risk to the private sector, several problems must be addressed. One is that shifting risk to depositors and private deposit insurers means that uninsured depositors will be more likely to panic when bank solvency becomes a question.[18] As noted above, the banking collapse of 1933 was due in part to a loss of public confidence in the system. Deposit insurance was created in part to prevent bank runs, and it (along with the discount window) has prevented the reoccurrence of widespread runs. Thus, reducing deposit insurance coverage to limit bank risk would create an anomalous situation. We imposed deposit insurance to prevent such panics, but now are considering reimposing market discipline through the threat of runs to limit the risk exposure of the insurance system.[19]

A second problem with shifting risk is that in order to do so the government must be perceived

as willing, and must in fact be willing, to let troubled banking organizations fail.[20] The private sector will not control bank risk exposure effectively if it believes the government may not allow banks to fail.[21] The FDIC report notes that, at present, many large depositors doubt that multi-billion dollar institutions will be closed.[22] The public's view of large bank failures is represented in a recent article by Robert A. Bennett in the **New York Times**. Bennett states that "...big banks...are too important to be allowed to collapse. Public policy has for decades affirmed this doctrine by keeping banks from going far afield into other businesses and by propping them up when they get in trouble."

Each of the three methods of minimizing the government's exposure to potential losses from expanded banking activities would be desirable if they worked as intended. Unfortunately, each of the three has problems. The separate subsidiary approach can work only if BHCs operate as passive mutual funds or if regulations are imposed to force them to operate that way. The FDIC has difficulty measuring bank risk now, and these problems would be increased as banks expanded into new activities. Finally, greater reliance on the public sector may be possible, but the issues of bank runs and the closing of very large banks must be addressed first.

Analyzing The Riskiness of Prohibited Activities

There is reason, then, to be concerned about the riskiness of currently prohibited activities. Ideally, these concerns would be reduced by reforming the safety and soundness system. Unfortunately, no reform proposal appears both workable and easy to implement. Furthermore, the financial services industry is evolving too fast to allow us to take several years to reform the system. As an interim measure, we could permit banking organizations to engage in financial activities that seem unlikely to increase significantly the risk of failure. Limiting the range of permitted activities to financial acitivities would allow banks to compete with the aspiring financial supermarkets, while limiting the types of risks borne by the government. Prohibiting acquisition of activities likely to increase banking organizations' risk would further limit the government's exposure.

If risk is to be a criterion for activity reform, then some method of measurement is needed. A naive approach would be to compare each activity's variability of earnings and failure rate with those of banks. A more sophisticated approach is suggested by David Meinster and Rodney Johnson (1979). Their approach looks at the effect of diversification on banking organizations' cash flow. It is clearly superior to the naive approach because it recognizes that some "risky" activities can actually curtail risk by reducing the variability of a combined organization's cash flow. For example, a risky activity could produce most of its cash flow when bank cash flow is weak but produce little when the bank's cash flow is strong. The variations in flow from the risky activity would offset variations in the bank's flow and their combined cash flow would be less variable than either of their individual flows.

"Studies that examine earnings data often find that banking is one of the riskiest activities and that bank risk exposure would be reduced if they diversified."

While Meinster and Johnson's approach is an improvement, it still has some weaknesses. Their focus on liquidity rather than solvency is inappropriate for most larger banking organizations. These organizations rely on liability management for their liquidity rather than cash flows from operations. Another weakness is the authors' concern about the combined organization's capitalization. Bank regulators can offset any attempt to undercapitalize the new activities by imposing capital standards on the bank or BHC. Thus capitalization appears irrelevant in deciding whether to allow banking organizations to perform a particular activity.[23]

The Meinster and Johnson study's focus on the effects of diversification is an appropriate first step in reviewing the risks of allowing banks to expand into new activities. One way to analyze the diversification effects is to look at the level

and variance of earnings of banking and other activities, and then look at the correlation between those earnings. Nonbanking activities can reduce the riskiness of banking organizations if either (1) the earnings from a nonbank activity are less volatile than in banking, or (2) earnings from the nonbanking activity are negatively correlated with those in banking (that is, if nonbanking profitability is highest when bank profits are at their lowest and vice versa). A banking organization's risk could increase if it acquires financial activities that have more volatile earnings than banking and whose returns are highly correlated with banking.

Analysis of those diversification effects are important, but they are not the sole criteria on which a decision should be based. The way an activity is managed can also affect its risk significantly. Cautious managers can turn a risky activity into a safe one, while an aggressive or inept management can jeopardize a safe activity. Banks already can take huge, undiversified risks by speculating on interest rate and foreign exchange movements, but few banks have failed for these reasons. This suggests that regulators should scrutinize a bank's management when considering whether to let it expand into new activities. Some activities that may be too risky for banks in general could be acceptable for a bank that has a plan for maintaining reasonable risk levels. In other cases, a bank with weak management might not be permitted to perform an activity allowed to most other banks.[24]

Riskiness of New Activities: Prior Studies

Two types of studies may shed some light on the effect on bank risk of expanding permitted activities. One type uses accounting data to study the riskiness of selected activities by themselves and their riskiness in combination with a banking organization. These studies typically have assumed that the bank and its prospective nonbank affiliates were held by a passive holding company that did not interfere in their operations. The evidence from these studies suggests that allowing banks to engage in additional activities may reduce their riskiness. The other type of study examines stock market reactions to the changing activity restrictions and to mergers of bank and nonbank firms. Studies of stock market reactions are useful because of their prospective nature. The market evaluates a company's expected future earnings and risk, taking account of any anticipated operating changes. These studies have found evidence that stock returns increase when a BHC can undertake geographic diversification, but that stocks neither gain nor lose on product diversification.

One of the earliest studies comparing the risks of banking and nonbanking organizations was conducted by Arnold Heggestad (1975). Heggestad used industry data to examine a variety of activities that one-bank holding companies engaged in prior to 1970.[25] He noted that one weakness of using industry data is that it captures only cyclical variations in profitability and not firm specific variations in profits. Heggestad found that commercial banking is one of the most risky activities when risk is measured as the coefficient of variation in profits. He also found that the returns to some activities (including real estate agents, brokers and managers and insurance brokers and agents) are negatively correlated with banking. These findings suggest that banks could reduce their risk exposure by diversifying into new activities.

Johnson and Meinster (1974) also used industry data and reached conclusions similar to Heggestad's. They also simulated various portfolio combinations and found that BHCs that expand into nonbank activities can be less risky than BHCs that confine their activities to banking.

Peter Eisemann (1976) looked at a small sample of firms in different industry groupings and concluded that banking is one of the lowest risk activities based on profit variability. John Rose (1978b) reexamined Eisemann's results and concluded that banks were more risky taking into account both profit levels and variability (using coefficient of variation in profits). Interestingly, Eisemann's simulation found that insurance brokerage was in the simulated portfolio that gave the highest return for low and medium risk organizations.

Michael Jessee and Steven Seelig (1977) compared the coefficient of variation of profits for selected BHCs and independent banks to determine whether BHCs were less risky and whether differences in diversification across BHCs reduced risk. They found that risk is not lower in BHCs than independent banks nor is it lower in BHCs that have a greater share of nonbanking assets. Rose (1978b) argued, however, that Jessee and Seelig's results may reflect econometric problems with their model. Rose also argued that the

reduction in risk due to the BHC diversification may be offset by increased risk-taking by the bank and its nonbanking affiliates.

Roger Stover (1982) examined the effect on a BHC's value of establishing a portfolio of banks and assorted nonbank subsidiaries. He began by determining the debt capacity of a portfolio of bank and nonbank assets given a fixed probability of failure. He then assumed that an organization's value increases as its debt capacity increases. His results also have implications for the portfolio's risk. In his model, an increase in debt capacity would imply a decrease in the riskiness of the firm with leverage held constant. The model was estimated using both industry average data and data from specific firms. Stover found that BHC diversification outside of banking increased the organization's value. His analysis of companies found that fire and casualty insurance, investment banking, land development and savings and loan companies should be included in a portfolio along with banking organizations because they increase its debt capacity and, by implication, lower its risk given constant leverage.

John Boyd, Gerald Hanweck, and Pipat Pithyachariyakul (1980) point out an important problem with using industry data when analyzing risk. Their study uses data on existing BHC subsidiaries. They found that the risk is almost always underestimated when one uses industry data rather than data for individual companies. They also found that the correlations of returns can even change signs when one uses individual company data rather than industry data. Their results suggest that we should not read too much into analysis using industrywide data.

The effect of one-bank holding company formations (and the impact of the 1970 amendments to the Bank Holding Company Act) on bank stock returns is examined by Robert Eisenbeis, Robert Harris and Josef Lakonishok (1982). Prior to the 1970 amendments, a one-bank holding company could engage in any activity except investment banking. Thus, the stock market's reaction to holding company formation during the sample period would reflect the market's opinion of the value of diversification. The researchers found that the stock market valued the potential for one-bank holding companies to provide for geographic diversification, but they found little evidence that the stock market valued product diversification.

The effect on the stock price of nonbank organizations acquiring so-called "nonbank banks" is examined by Jeffery Born, Robert Eisenbeis and Robert Harris (1983). Presumably, if banking is less risky than nonbank activities, then acquiring nonbank banks should lower a nonbank organization's risk. That study found positive, but statistically insignificant, returns to the shares of nonbank organizations.

These studies of stock market returns provide some information on change in the firms' value. The results, however, are ambiguous concerning the perceived change in risk of an acquiring firm. Stock prices can increase even if the combined organization is more risky, provided the firm's expected returns also increase. Conversely, stock prices can fall for the acquirer even if the combined organization is less risky, provided the combined organization's expected returns are lower.

Studies that examine earnings data often find that banking is one of the riskiest activities and that banks' risk exposure would be reduced if they diversified. These studies use the best available data, but they must be interpreted with caution. Boyd, Hanweck and Pithyachariyakul demonstrate the problems with using industry data and the studies that used data from individual companies relied on small samples. Studies that looked at stock market returns have found no evidence to demonstrate that banks will become either more or less risky.

Evidence on Risk: Analysis of Earnings

Table 1 provides a detailed look at the variability of returns from the **Corporate Source Book of Income** similar to those examined by Heggestad.[26] Heggestad's data covered the 1953-1967 period, prior to passage of the 1970 amendments to the BHC Act. He examined the variability of both the ratio of average profits to capital and the ratio of net income to total assets. Given what has subsequently proved to be a significant difference in the capitalization of BHC subsidiaries compared to independent firms and the widespread use of double leverage by holding companies, only the variability of net income to assets from nonbanking activities is examined in Table 1.[27] The 1970-1980 data allow a comparison with those of Heggestad of any differences that may have occurred over a

Table 1. Coefficients of Variation and Determination for Selected Banking Activities (1970-1980)

	Coefficient Variation	Coefficient Determination
Banking	0.173503	0.622278
Mutual Savings Banks	0.296098	−0.43451
Banks and Trusts Except Mutual Savings Banks	0.211527	1
Credit Agencies Other than Banks	0.229455	−0.26771
Savings and Loans	0.337307	−0.20784
Personal Credit Agencies	0.326252	−0.49144
Business Credit Agencies	0.253581	0.586265
Other Credit Agencies and Finance Companies Not Allocable	0.146301	−0.05962
Security and Commodity Brokers, Dealers, etc.	0.350792	−0.16108
Security Brokers, Dealers, etc.	0.406553	−0.17821
Commodity Brokers, Dealers, etc.	0.213660	0.431596
Insurance	0.183474	0.167736
Life Insurance	0.100957	−0.163621
Mutual Insurance	0.487323	0.095143
Other Insurance Companies	0.427181	0.202264
Insurance Agents, Brokers, Service	0.118640	0.487375
Real Estate	0.216494	0.605346
Real Estate Operators, Lessors of Buildings	0.200242	0.645042
Lessors of Mining, Oil, etc.	0.434163	0.370005
Lessors of RR Property, Other Property Not Allocable	0.124316	−0.36543
Condominium Management, Co-op Housing Associations	0.542500	0.928662
Subdividers and Developers	0.306568	0.560607
Other Real Estate	0.184351	0.310724
Holding and Other Investment Companies	0.259857	0.792789
Regulated Investment Companies	0.247479	0.599360
Real Estate Investment Trusts	0.609843	0.421816
Small Business Investment Companies	0.627969	0.808927
Other Holding and Investment Companies Except BHCs	0.156598	0.686523
General Merchandise Stores	0.385963	−0.24442
Food Stores	0.106876	0.456074
Bank Holding Companies	0.198433	0.621591

The coefficient of variation is a measure of risk of the activity by itself. The coefficient of determination is a measure of the correlation of earnings of the firms with banking.

period of rapid change in the banking industry. These expanded tabulations also permit a preliminary examination of securities, insurance and related activities now being considered as possible permissible activities for bank holding companies.

Several observations are worth noting. First, if the coefficient of variation is used as a risk measure then we conclude that banking (whether looking only at banks or at bank holding companies) is neither the most nor least risky activity. Second, conclusions about risk are influenced by the period under investigation. For example, using these same measures, Heggestad found that "lessors of railroad property" were among the riskiest firms investigated, while the present results suggest they are among the least risky. Third, many of the

activities presently under consideration, such as securities, insurance, and certain real estate activities are more risky than banking. On the other hand, these activities appear somewhat less risky than other activities (such as consumer and commercial finance, operating small business investment corporations, and owning S&Ls), already permissible to banking organizations, which have not necessarily caused substantial problems. Examination of the coefficients of determination, however, reveals that several activities that appear more risky than banking (S&Ls, personal credit agencies, security brokerages and dealers, life insurance, and general merchandise) have returns that are negatively correlated with those of banking. This would suggest that such activities would be risk-reducing and imply the potential for beneficial diversification.

As Heggestad noted, we must exercise care in interpreting these data. They look only at cyclical variability of returns without weighing any synergies that may accrue; the fact that bank holding companies (not controlling for size) seem to have a smaller coefficient of variation than commercial banks alone suggests that such synergies may exist, possibly because certain risk-reducing activities have been authorized. Nor do the data imply anything about the riskiness of specific acquisitions. Finally, no attention is paid to cash flows. Rather, those data raise more questions than they answer concerning, for example, the stability of such measures over time. Also, the importance of negative correlation among banking and various nonbanking activities deserves further investigation.

Evidence on Risk: Bond Market Reactions

What about the return on bonds of firms that have recently acquired a financial services firm? Can it provide additional information on the riskiness of different financial services? The bond markets, in determining the price of a company's bonds, consider the factors that can influence its riskiness. Thus, the market will provide information on the expected effect of management on the riskiness of the new combination.[28] If the bond markets expect the new firm to be more risky, after considering all factors including management, then the price of the firm's bonds will fall. If the new firm is expected to be less risky, prices will rise.[29]

Unfortuanately most of the cases where one firm entered a new aspect of the financial services industry did not involve banking organization acquisitions. Therefore, most of the acquiring organizations we looked at are nonbank financial firms and nonfinancial firms. This analysis should shed some light on which combinations of services in the financial services industry are the most risky and whether the financial services industry is less risky than some nonfinancial industries.

For this study we used the monthly returns on the bonds of 11 companies.[30] We separated the sample into four groups based on the characteristics of the acquiring and acquired firms. The composition of the four groups and the merger dates are given in Table 2.

"The threat that activity deregulation will destabilize the financial system is minimal given the rest of the safety and soundness system, especially deposit insurance and discount-window access."

The returns on a company's bonds normally fluctuate, so we needed some method to distinguish abnormally large fluctuations due to a merger from random fluctuations. We utilized the comparison period returns approach that Stephen Brown and Jerold Warner (1980) used in analyzing changes in stock returns.[31] This method compares fluctuations in returns during a control period with their fluctuations at the time of acquisitions. If the fluctuations are significantly larger at the time of acquisition than during the comparison period, the acquisition is assumed to have had a significant effect on bond prices. The control period extends from six months prior to the acquisition to two months prior and from one month after to six months after. The abnormal returns are measured over the month before and month of the acquisition.

Some of the abnormal bond returns in Table 3 are quantitatively large, but all are statistically insignificant. Neither were the abnormal returns of the individual acquiring firms significant. The

Table 2. List of Firms in Bond Study by Characteristics of Acquired and Acquiring Company

Group	Acquiring Company	Acquired Company	Announcement Date	Bond Rating
Nonfinancial firms acquiring financial firms	American Can	Associated Madison Co.	1/8/82	Baa
	Sears, Roebuck & Co.	Dean Witter Reynolds	10/8/81	Aa
	Dana Corp.	General Ohio S&L Corp.	1/2/81	Aa
	Xerox	Crum & Foster	9/22/82	Aaa
Banks acquiring discount brokers	United Jersey Banks	Richard Blackman & Co.	9/29/82	N/A
	Bank America	Charles Schwab & Co.	11/25/81	Aaa
Financial firm acquiring another financial firm	American General	Credithrift Financial Inc.	9/21/81	A
Financial firms acquiring a nonbank bank	Household International	Valley National Bank	7/13/81	Aa
	Aetna Life & Casualty	Samuel Montagu & Co.	7/23/82	Aaa
	Walter E. Heller Intl. Corp.	American National Bank & Trust	7/14/72	N/A
	National Steel Corp.	United Financial Corp.	3/7/79	Aa

Table 3. Mean Abnormal Bond Returns of Firms Acquiring a New Financial Activity

Group	Annualized Return (t-statistic)
Nonfinancial firm acquiring a financial firm	−.00202 (−.104)
Banks acquiring a discount broker	−.19737 −.70289
Financial firm acquiring another financial firm	.25844 (.24117)
Financial firm acquiring a nonbank bank	−.19089 (−.48717)

large size of some of the abnormal returns appears to reflect volatility in long-term rates during this period. The insignificance of the abnormal returns suggests that bondholders did not perceive the acquisitions to have a significant effect on the acquiring firm's risk position.

Conclusion

Bank activity regulation is part of a larger system designed to protect the stability of the U.S. financial system. The threat that activity deregulation will destabilize the financial system is minimal given the rest of the safety and soundness system, especially deposit insurance and discount-window access. The problem with activity deregulation is that the government now bears much of the risk of bank failure. Thus, the government will bear additional risk to the extent that deregulation increases the riskiness of banks. We cannot avoid all risks, however, by maintaining existing activity regulation. Banks are regulated to protect the financial system. Regulation may

allow important bank functions to be assumed by institutions whose safety is less protected. If this happens, we would defeat the very purpose of regulating and protecting banks.

One alternative to regulating activities is to reform the safety and soundness system so that the private sector, and not the government, bears the risks of new ventures. Each of the three reforms under consideration have important problems that must be resolved. The first reform we considered would allow the new activities to be performed in BHC nonbank subsidiaries, and then use regulations to insulate the banking subsidiaries from their nonbank affiliates. Unfortunately, the health of the banking subsidiaries necessarily will depend on the health of their nonbank affiliates so long as the BHC uses its control over subsidiaries to maximize synergies and profits.

Another possible reform would charge risk-based premiums for government deposit insurance. The problem is that the FDIC says it cannot link premiums closely to risk for traditional banks, and the task is certain to be more difficult as the range of covered activities expands. A third possible reform would be to transfer more of the risk of bank failure to the private sector. This may have some merit, but first we must consider what to do about dealing with bank runs and about allowing very large banks to fail.

Since the decision to maintain existing regulations and the decision to reduce activity regulation both carry risks, one possible interim measure would be to allow banking organizations to offer additional financial services that are unlikely to increase their risk significantly. We explored this possibility by looking at the evidence on the effect of deregulation on risk. The evidence, based on historical earnings data, suggests that banking organizations' risk would have been lower in the 1970s had they been passive owners of some activities, but it would have increased for other activities.

This evidence is incomplete, however, because management can have a significant effect on risk. Cautious bank managers can make a risky activity relatively safe, but aggressive or inept managers can make a safe activity become risky. An analysis of bond market reactions to the acquisition of financial firms suggests that the bond market doubts that these acquisitions significantly change the risk exposure of the acquiring firm. This evidence also is incomplete, however, because examples of banks acquiring firms performing prohibited activities are, by definition, unavailable.

—Larry D. Wall
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NOTES

[1]See Rose (1984) for an overview of the rationale for bank activity regulation.

[2]For example, banks lost substantial consumer deposits to the money market funds when bank deposit rates were limited by Regulation Q.

[3]For example, an affiliate of National City Bank sold Peruvian bonds without notifying the public that its agents had reported that Peru was a bad credit risk. The value of these bonds fell from 96½ with a spread of 5.03 points when issued in 1927 to 7 in February 1933. See Kennedy (1973), especially Chapter 5, for a discussion of the unethical behavior.

[4]The Supreme Court commenting on the reasons for the passage of Glass-Steagall in I.C.I vs. Camp decision, 91 S. Ct. 1091 (1971).

[5]Benston (1982), for example, argues that the primary purpose behind the legislation was to restrict competition.

[6]Kennedy notes that the overwhelming majority of small banks were small, rural and located in unit banking states.

[7]Sanford argues that commercial banks are charged a lower risk premium than other firms because regulation reduces their risk.

[8]Some restrictions on bank holding company affiliates were passed in the 1933 Banking Act, but these restriction were weak. They only limited BHC affiliation with an investment banking firm and limited BHCs' ability to vote the shares of any Federal Reserve member banks.

[9]Senate Banking Committee's 1970 report.

[10]The Bank Holding Company Act of 1956, as amended, defines a bank as an institution that accepts demand deposits and makes commercial loans. A nonbank bank is an insured and regulated commercial bank, but it does not offer either demand deposits or commercial loans. It does not therefore, meet the legal definition of a bank for the purposes of the Bank Holding Company Act.

[11]See Eisenbeis (1984) for a further discussion of the issues raised by nonbank banks.

[12]See also Karekan and Wallace (1978).

[13]Ignoring for the moment the concentration of financial power and conflict of interest problems.

[14]Chase and Waage (1983) also argue that banking subsidiaries can be protected from the problems of their nonbank affiliates.

[15]See Walen (1982a, b), Rose (1978) and Murray (1978).

[16]See Wall (1984a) for a review of the FDIC report and Wall (1984b) for further discussion of the problems with a risk based insurance premium scheme run by the government.

[17]The first failure to be handled with the modified purchase and assumption method that exposes depositors to risk was the failure of Seminole State Bank. See Murray and Paltrow (1984).

[18]Private deposit insurance will not stop bank runs unless the solvency and liquidity of the private insurer are guaranteed by someone with unquestionable solvency and liquidity. See Leff and Park (1977) for discussion of the collapse of the Mississippi savings and loan insurance fund.

[19]Wall (1984b) discusses the potential for overcoming the problem by requiring banks to issue additional subordinated debt. Subordinated debt holders can redeem their claims only when the debt matures and they are therefore unable to participate in bank runs. He also points out, however, that the amount of subordinated debt that can be issued in the short run (and perhaps in the long run) will be limited due to practical problems.

[20]Mayer (1975) and Longstreth (1983) both discuss reasons why the government may not want to let large organizations fail.

[21]See Wall (1984b) for a further discussion of the issues involved in shifting the risk of loss to the private sector.

[22]Even if depositors, private insurers or other parties are nominally at risk, the government can prevent a bank from failing if it wishes. The Federal

Reserve can keep an illiquid bank open by providing loans to the bank, but this will result in a subsidy by the government to the extent the rates on the loans are below those the market would charge the bank.

[23]This concern is obviously relevant to the agencies, however, when they modify current standards.

[24]This suggestion would effectively extend current restrictions on BHC expansion to BHC expansion into new activities.

[25]The activities of one-bank holding companies were not restricted prior to the passage of the 1970 amendments to the Bank Holding Company Act except for the Glass-Steagall restrictions on investment banking.

[26]Source: Internal Revenue Service, various years 1970-1980.

[27]See for example, the studies reviewed in **The Bank Holding Company Movement to 1978: A Compendium**, A study by the staff of the Board of Governors of the Federal Reserve System, Washington, D. C., 1978.

[28]The effect of management on risk could also be examined by looking at the earnings of the combined firms after the acquisition. This is not done in this study because the mergers being analyzed have taken place since 1979, which is too recently to have produced enough information on earnings.

[29]The unambiguous effect of risk on bond prices contrasts with the ambiguous effect of risk on stock prices. If an increase in the risk of a stock is more than offset by an increase in expected return, then the price of a stock will go up, and vice versa for a decrease in risk. In contrast, the maximum return on bonds is fixed, so bondholders concentrate on risk and can ignore changes in expected returns.

[30]An initial list of companies was obtained from Rosenblum and Siegel, Information Access Corporation, Trade and Industry Index (DIALOG ONLINE FILE 148) and Born, Eisenbeis and Harris. The list was then pared down to those acquisitions involving a new entry or dramatic increase in current position of the acquiring firm in some aspect of the financial services industry. The firms actually used are those in the reduced sample with publicly traded bonds that were listed in Moody's Bond Guide.

[31]Masulis and Woolridge also use this method to examine bond returns.

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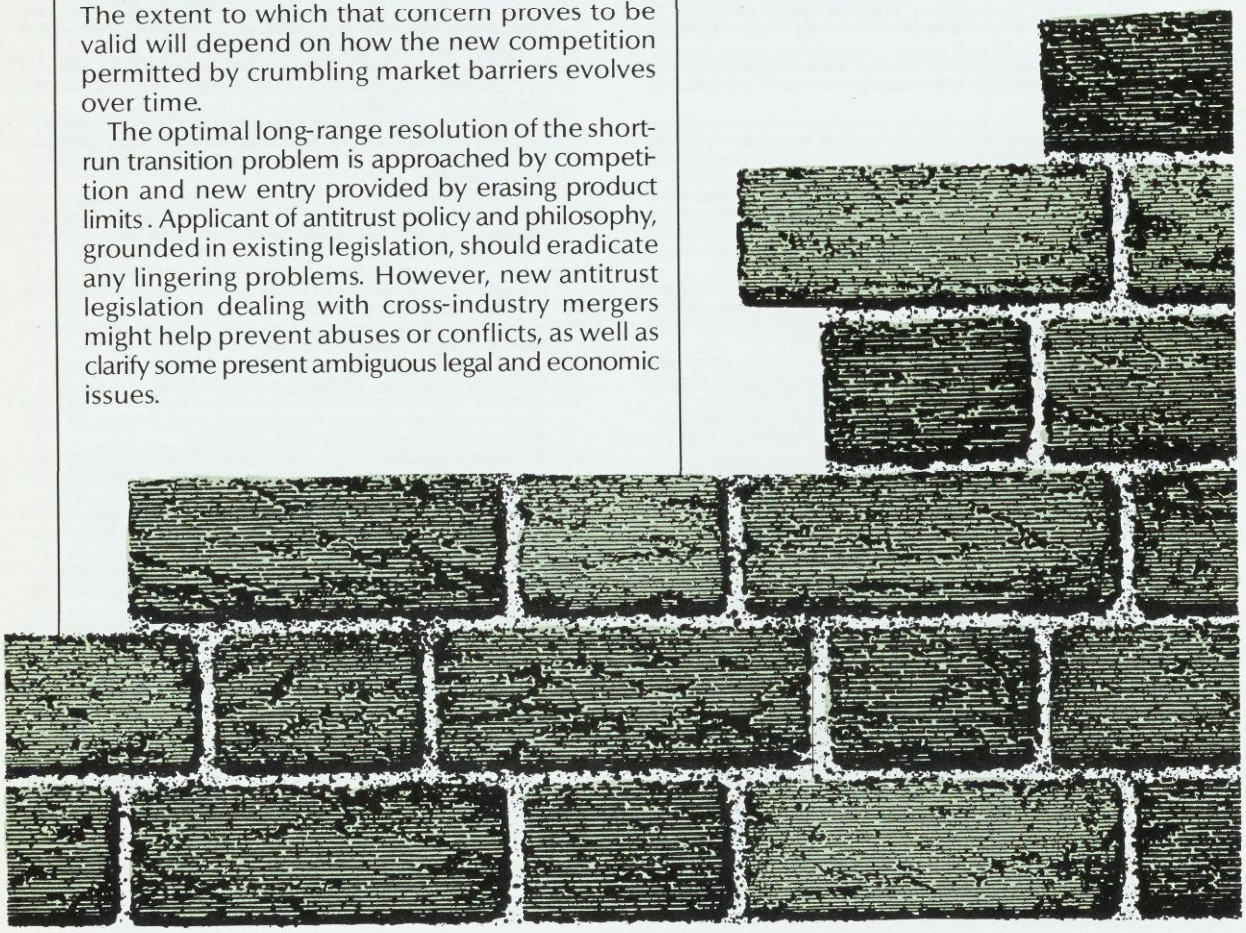
Bank Product Deregulation: Some Antitrust Tradeoffs

Financial-industry deregulation will stimulate greater competition that can benefit America's consumers, but for some critics it raises the spectre of concentrated economic power.

Beyond the deregulation that has already taken place in financial services are foreshadowings of continued market change and proposals for further legislative deregulation. Further moves of banks into insurance and securities activities at home and abroad and further incursions of nonbank firms into traditional preserves of depository institutions seem certain. There will be pressure to give these moves and other potential changes legal blessing.

Beyond the initial flush of success of interest rate deregulation, what problems may arise to haunt us in this new world? One of the principal concerns voiced by some important participants has been its impact on the public's access to competitive markets and to prices that reflect the economic value of the resources that they use. The extent to which that concern proves to be valid will depend on how the new competition permitted by crumbling market barriers evolves over time.

The optimal long-range resolution of the short-run transition problem is approached by competition and new entry provided by erasing product limits. Applicant of antitrust policy and philosophy, grounded in existing legislation, should eradicate any lingering problems. However, new antitrust legislation dealing with cross-industry mergers might help prevent abuses or conflicts, as well as clarify some present ambiguous legal and economic issues.



I. HYPOTHETICAL SCENARIOS OF MARKET EVOLUTION

Product deregulation could produce several alternative results:

A. The Fully Competitive Scenario. The ideal competitive solution would produce an environment where barriers to entry erode as Congress removes remaining Glass-Steagall constraints, and technology permits all businesses to take full advantage of new opportunities. More firms, bank and nonbank alike, compete with one another head-on in broadened product markets. Technology will reduce dramatically the cost of producing and delivering these new services. Consumers will benefit fully from the new technology through lower prices and higher quality financial service at retail. If small banks and thrifts lack the necessary capital and expertise to "go it alone," they can share in the new electronic systems or buy or rent essential components without restrictions. Since competition for small institutions' respondent accounts will be intense, the necessary technological and human inputs will be available to the country bank from big city firms or correspondents for the full cluster of new financial services.

Small or specialized institutions can compensate for any cost or pricing disadvantage through special consumer services gleaned from first-hand knowledge of the local market. Empirical studies indicate the small seller can flourish despite new competition from bank leaders.[1] Whether new rivalry comes from other banks or nonbanks, the theoretical implications for competition are similar. If competitors are numerous and varied in size and focus, sellers are unlikely to develop a collusive oligopoly. Other financial institutions will stand ready to take business away from would-be collusive oligopolists if prices get out of line. Market power will not persist permanently when attempts by would-be monopolists to raise price cause consumers to shift their business to existing competitors in the broadened product market. If that fails to keep market participants in line, then new entry from all the other kinds of financial institutions now able to compete with banks will surely do so.

Suppose that dominant commercial banks in a market are pricing short-term loans in a noncompetitive way. Customers will increasingly turn to the commercial paper markets to get short-term financing of equivalent maturity, price and quality.[2] A sufficient rise in the price of bank loans will induce these customers to shift their allegiance from bank to nonbank sellers of virtually identical loan services. At the same time, given Garn-St Germain, locally limited customers can go to a local savings and loan for business loans and the related business and transactions accounts services that they require. Hence, any noncompetitive supplier will find itself thwarted by customers who can easily switch in response to noncompetitive price increase.

In Diagram 1, we can visualize competition through markets at many stages of the financial "productive process" ranging from initial "seller" (the Federal Reserve Banks and Board) to ultimate consumer (the business and household user at retail several levels downstream).

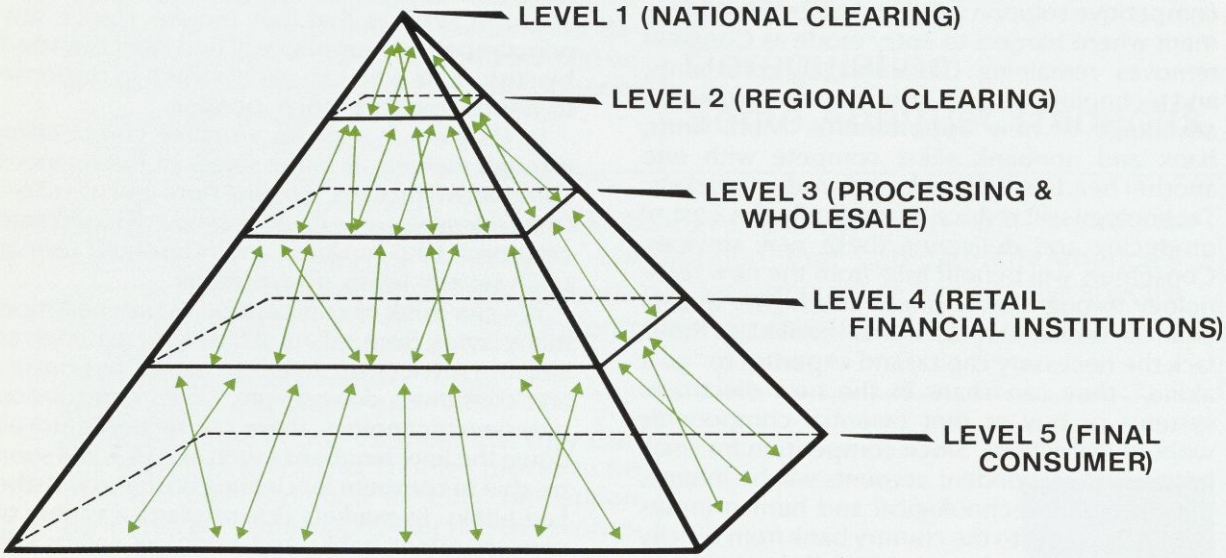
We can think of competition as proceeding in many layers, from sellers of basic raw materials or clearing services upstream to banks, businesses and consumers downstream. Given deregulation plus new technology, there can be new entry all down the line. Nonbanks such as AT&T, will soon be able to compete for clearing business with the Fed banks. In markets downstream, a variety of correspondent banks and nonbank sellers will compete for small bank business. Interaction of still greater numbers of sellers is possible at retail, all offering a cluster of financial services in regional or broader markets. Merrill Lynch, American Express and Sears compete with Citicorp.

The joint benefits of technology and bank and nonbank entry accrue to each user at each level of production, from wholesale (clearing) to interbank (correspondent services) to retail (consumer and business buyers). Because none of the profits gained from scale efficiencies of the new technology get trapped at any stage of the productive process through monopoly power, the final consumer at retail gleans fully the benefits of deregulation.[3] Market forces will have triumphed. There is little for antitrust to do given such a scenario, except perhaps to monitor development in an unobtrusive way.

B. The "Lingering Pockets of Monopoly" Scenario. Market solutions may take time. Not all thrift institutions can easily gear up to full competition for business loans (or deposits) where any lingering pockets of monopoly persist.[4] Deregulation may impact unevenly from the deposit side according to customer sophistication or knowledge of deposit options. Banks may more rapidly raise rates paid on deposits to larger depositors with large minimum balances and collateral business. Some,

Diagram 1.

Levels of Financial Services Competition



but not all, of the difference in treatment of deposit accounts may reflect the different administrative cost or services bartered in return for low-cost deposits. A lack of full information about customer pricing may result in noncompetitive pricing.[5] Not all prime-based bank business loan customers are aware of below-prime market-based loan pricing. If bank customers can be clearly and permanently segmented into groups over which the bank can exercise some degree of monopoly power, price discrimination would be possible and attractive where the groups display different elasticities of demand.[6] With imperfect markets, it may be important to identify the problem and seek a practical remedy.

C. The Concentration of Resources Scenario. Another alternative scenario suggests than the present wave of large bank and financial conglomerate mergers eventually may give rise to different, but potentially more significant, competitive difficulties. Beyond some critical "triggering point" in a merger wave, the efficiencies of large-scale production of banking services may be outweighed by possible market harm to groups of customers. At this critical point, the nature of competition is changed because a community of interest or common understanding develops between the remaining rivals.[7] The public fear of concentration of financial power is based in part upon the presumed economic clout wielded by the large and powerful.

The "deep-pockets" theory assumes that organizations with greater resources and staying power can intimidate rivals or develop anticompetitive strategies that can stick. Buyers may trust the greater reliability of a Schwab discount brokerage house allied with the Bank of America more than one standing alone, especially when the former is accompanied by extensive media hype or advertising. Or, buyers may think they stand a better chance of securing loans if they try to patronize other departments of the bank, whether or not such beliefs are well grounded.

Banks may erect a "Chinese wall" between different departments, and especially between

parent bank and affiliate. But skeptics may fear conflict of interest between trust officer and loan officer, or that bank loan officers may make lower interest rate loans to long-term customers of other bank departments. The Justice Department's early Minneapolis price fixing cases found agreement between banks to charge below-prime rates to certain respondent bank customers seeking bank acquisition financing.[8] Fears are stated also in terms of political power, and the power to influence legislation, yielding results that cannot always be measured in strictly economic terms.[9]

II. THE QUESTIONS

Based on how these scenarios evolve, we can pose the following questions:

A. Are fears of undue concentration following mergers between large financial institutions exaggerated or real? If the fears materialize, can antitrust actions solve the public policy problems, given the present legal and economic underpinnings for enforcement?

B. May conflicts of interest, or alternatively, tying of scarce bank to nonbank services by the financial "supermarket" present problems? Again, what can the Antitrust Division do to resolve conflicts?

C. May all customers expect to share equally—and promptly—the benefits of deregulation and product market mixing? Will operations people (now schooled in the MBA tradition to target customer groups selectively) segment market pricing according to the price-sensitivity of customer demand? After all, customers with the greatest clout, who buy most from the financial "super-market," can threaten most effectively to leave the bank for other financial institutions if prices get out of line. Given the fact that preferred treatment to such customers may be the proper strategy for maximizing profits, what steps might the antitrust authorities wish to take to remedy pricing or allocation inequities?

One problem is to determine how the issues should be identified in economic terms. The classical microeconomic approach is implicit in modern antitrust analysis, which seeks to optimize economic efficiency and overall welfare. As long as producers gain more from a particular practice than consumers lose, say from tying or price discrimination, the conditions for welfare maximization are satisfied. Any questions of income distribution, whose wealth is maximized, or whether producers gain at the expense of consumers, are left to macroeconomics, or for a political response, such as subsidies or direct grants.

III. POSSIBLE SOLUTIONS

A. Undue Concentration Questions. Market solutions are always to be preferred, particularly in a period of rapid technological change. To the extent that market failures occur, there may be no one best solution to any potential problem. Our first line of defense against undue concentration is the antitrust laws, and the starting point for analysis must be the new Department of Justice Merger Guidelines.[10] They give powerful weight to economic theory in deciding which cases to litigate and how to litigate them. Judges will decide cases on the basis of economic theory and evidence to a much greater degree than earlier. Masses of data developing information on nonbank as well as bank behavior will be brought into evidence. To gauge product markets, judges may have to evaluate surveys to determine whether consumers may switch their purchases, given any hypothetical future increase in price by would-be monopolists.

> The "deep-pockets" theory assumes that organizations with greater resources and staying power can intimidate rivals or develop anticompetitive strategies that can stick.

1. The Horizontal Product Merger. Under the best of circumstances, it is difficult for the Justice Department to win antitrust cases based on hypothetical consumer behavior. Empirical difficulties of designing a reliable market survey and developing data within a realistic time frame for trial purposes are great. Defendants may argue that consumers won't know whether they will switch or not until they find themselves face to face with the reality of monopoly power. Moreover, when the prospect becomes a switch to another institutional supplier, say from banks to thrifts,

or from both to money market mutuals, some consumers will be perplexed as to how to respond. They may be unfamiliar with the alternate supplier or the benefit it can offer until pushed to the wall by bad service or high prices.

Economists can unanimously welcome the introduction of more sophisticated economic criteria as represented by the new Merger Guidelines. But that recognition puts a special burden on the antitrust authorities and especially on economists within the Antitrust Division.[11] The new complexities of product market definition in post-Garn-St Germain markets increase the costs of effective antitrust enforcement. At the same time, economists may worry about the public policy effects of moving away from the banking "cluster of services" market definitions that simplify legal analysis.[12] These problems are compounded if the Antitrust Division is given sole responsibility for competitive analysis and enforcement as recommended by the Bush Task Force. Given broader markets through deregulation, however, the probabilities of competitive harm from all but the most significant mergers decrease.

The combination of more complex analysis and the economic gains brought by a broader market base should reduce the number of cases initiated, but the financial community would be ill advised to consider this as an indication that "anything goes." The Division's recent actions on the LTV-Republic merger makes clear that its continuing presence is real.[13]

2. Product Extension Mergers. A market extension merger is one in which a bank seeks to expand into geographic markets other than its own but often adjacent. A product extension merger is expansion into a product market often closely related to its own. Analysis is similar in both cases and can proceed in several ways.

Suppose Citicorp decides to buy Household Finance. The Antitrust Division can analyze the merger's effects by computing Herfindahl indices in all the markets in which the two firms may now directly compete. As in any horizontal case, economists may delineate the geographic and product markets according to consumer future buying intentions in the event that prices charged by the new merged company get out of line. The Division may seek to litigate in markets where substantial overlap occurs or to require spinoffs as part of a legal settlement.

Unfortunately, the reliability of good banking data, supplied in the past by a cooperative Federal Reserve, is not paralleled in the finance company sphere where spotty and often inconsistent data are collected by 50 state supervisory authorities. The market share data of other competing banks or finance companies and other suppliers of the same services must be secured from reluctant firms, made consistent, and factored into the market universe.

Another alternative is to go the potential competition route. Given the Department's record of Supreme Court losses in such cases, that alternative may not be appealing. With many more potential entrants in most markets, the likelihood of injury to the public on the basis of eliminating a potential competitor will decline significantly. Compared with earlier efforts, the Justice Department will have less need for and likelihood of winning.[14]

An exciting concept in the new world of interproduct competition is spatial analysis which attempts to look at many dimensions of competition simultaneously. This concept assumes that markets are not clearly separated, but that clusters of suppliers and customers compete at cluster borders where transactions costs of switching to new suppliers are lower than at the market center.[15] At the border, consumer transactions costs of purchase in alternative clusters become equalized. Suppliers must react and prices must respond competitively in both clusters, hence the "true" market expands. In this manner, just as service areas blend into broader local markets, so the local market may mesh into broader statewide, regional, or even national combined product-geographic markets. The new computer technology speeds this process by reducing transactions costs and disseminating product information.

"The reliability of good banking data, supplied in the past by a cooperative Federal Reserve, is not paralleled in the finance company sphere where spotty and often inconsistent data are collected by 50 state supervisory authorities."

While intellectually satisfying, this theory mathematically embraces the concept of product and geographic markets in intertwined multi-dimensional space. Hence, on a practical level it is unsuitable for easy empirical resolution or court use.[16]

A related and somewhat easier approach to product extension mergers would be the tentative measurement of markets as a group of concentric circle-like shapes. In a highly concentrated statewide branching state, say Oregon or Washington, the state represents an area in which banks can operate and transfer funds from within the branching organization. An EFT network may transfer funds or make short-term consumer loans for card holders over a broader multi-state region. The local market, constrained in size by convenience to depositors or small retail businesses, will represent another smaller market within the broader circumference. In product extension mergers it also may be appropriate to consider ringed areas of possible impact and to single out for analysis specific markets where damage to classes of consumers most likely will occur—bank and thrift, or bank and nonbank.

The Federal Reserve Board, in assesssing mergers of large financial organizations, has often measured both statewide and local market concentration. However, except perhaps in correspondent banking markets, the state often does not represent the market area.

"Multi-market linkages between the same organizations do not necessarily diminish competition in markets where rivalry already is intense."

In states of high concentration, and generally poor bank economic performance, the state was sometimes viewed as a cluster of interconnected local markets in which monopoly power was exercised. This theory too has a counterpart for product extension mergers where substitution possibilities are close. One advantage of the "linked oligopoly" theory was that attorneys wishing to preserve the broadest range of potential horizontal and market extension antitrust possibilities could have their cake and eat it too. Markets could either be local, hence, suited for the run-of-the-mill small bank horizontal market litigation. Or, they might be viewed as concentrated clusters of interlinked local (or product) markets.

However, multi-market linkages between the same organizations do not necessarily diminish competition in markets where rivalry already is intense, as proven empirically by David D. Whitehead and Jan Luytjes (1983). Indeed, multi-market meetings may enhance the initial interfirm rivalry.[17] Modern game theory may help us understand which mergers may strengthen competition in the new world of highly interlinked product as well as geographic markets, and which may reduce or alter competition and behaviorial relationships in complex and difficult to predict ways. In either case, present performance in a market must enter into analysis as a proxy for initial group interdependence.[18]

B. Tying and Conflict of Interest Questions. It seems unlikely that the present Antitrust Division will often litigate tying or conflict of interest questions. The Division has gone on record as believing there are few circumstances where tying (or other vertical restraints on trade) are likely to reduce economic efficiency.[19]

A "tie" means that a customer's purchase of one product is conditioned on the purchase of another product. A bank cannot tie such nonbank services as mortgage banking to banking services such as loans in the absence of some "leverage." The buyer will simply switch to another seller who does not attach strings to the purchase. Even in times of tight money, banks are unlikely to possess leverage over many bank loan customers who have other bank or nonbank financing options. But even if banks have leverage or market power over customers, independent competing suppliers of the "tied" products will not be hurt competitively unless "foreclosed" from the opportunity of selling the tied product. That implies both high concentration in the tied nonbank product and lack of easy entry—a lack of competition in both tied and tying markets. Since nonbank financial organizations such as finance companies, mortgage bankers and discount brokers tend to be less regulated than banks, with generally easier entry, the conditions conducive to a successful tie rarely exist. It is not surprising that the Justice Department has initiated few tying cases in financial markets over the years.

"Unfair advantage" questions often focus on financing opportunities, such as a bank's superior ability to attract low-cost funds in the form of price regulated deposits. But that opportunity, if it ever existed, is shrinking as deposit rates become deregulated. The important consideration for pricing purposes is the marginal cost of funds, such as the large denomination CDs that banks must sell at market rates. Under the Bank Holding Company Act, the holding company cannot lend more than a small percentage of its assets to affiliates. If the acquired nonbank firm itself enjoys a lower financing price as an affiliate of the new bank holding company parent, that reduction may reflect administrative or marketing efficiency, or lower actual or perceived investor risk.

Tying was an issue in the recent Bank of America/Schwab acquisition, in which the nation's second largest bank acquired the nation's largest discount brokerage house. The merger, approved by the Federal Reserve Board, has been appealed. The Supreme Court voted to consider the issues formally upon request of the Securities Industry Association. A Supreme Court decision will be welcome, for it may settle difficult issues of law, including Glass-Steagall Act interpretation. But because of easy entry into brokerage, careful analysis of the microeconomic issues reveals no real tying opportunity in that case.

Conflict-of-interest problems appear unlikely "since it is improbable that unsound loans will be made to discount brokerage customers to facilitate securities purchases."

Nor is "conflict of interest" a likely problem, since it is improbable that unsound loans will be made to discount brokerage customers to facilitate securities purchases. Bank trust departments will not accept unsound securities to help the brokerage subsidiary; Schwab will merely execute orders, not take market positions. The Bank of America may influence consumers' preferences through effective packaging of prestige associated with its many brand names and multiproduct offerings. But is that necessarily contrary to public interest? Consumers may benefit through extensive advertising of discount brokerage services, with the result that full line brokers have to lower prices or improve service quality.

C. User Group Equity Questions. It may well be that new competition will provide needed solutions in the world of interproduct competition and deregulation. Then we will not have to worry about esoteric measurements of equity welfare and consumer marginal utility. Even so, there is room for a continued antitrust role even if all it accomplishes is monitoring and deterrence. It is not enough simply to look at how many cases the Justice Department won vs. how many it lost in the period since 1961 when antitrust first began to be applied to financial markets. A better test would be the number of anticompetitive actions such as discrimination, price fixing or market division which did not take place because of antitrust deterrents. To that the response would be of course, how much damage the antitrust presence also did through unsolicited meddling, or dampening of normal profit and investment incentives. In either case, the problem to consider now is whether that deterrence function may in the future fail because of distorted private beliefs about the antitrust authorities' ability and readiness to do their legal job.

IV. CONGRESSIONAL AND REGULATORY SOLUTIONS

While all the economic and legal issues surrounding antitrust sort themselves out, other solutions come to mind. One would be to retain or even expand Federal Reserve authority to judge independently any major bank or nonbank acquisitions under its present bank holding company authority. Historically, the Federal Reserve Board has been more independent politically than many other branches of government. It also has a large staff of highly qualified financial economists, along with great data-gathering and econometric capabilities. To expect the Antitrust Division to understand and solve all financial competition matters in unitary isolation seems, in my view, to ask the impossible as well as to risk cyclical shifts in emphasis.

The Federal Reserve's help has been invaluable to banking antitrust enforcers, often to the distress of private parties involved. Any Board decisions are subject to Justice Department analysis and intervention through comments or active participation in regulatory proceedings, to assure a broader economic and legal frame of reference. Court review (up to and including the Supreme Court) will continue also in contested cases. The

latter, too, assures full public airing and consideration of all the issues, both legal and economic.

A final alternative is for Congress to tighten the antitrust laws and improve litigating speed. Former Assistant Attorney General John Shennefield (1979) advocated legislation designed to eliminate very large corporate mergers through acquisition of leading market positions.[22] More recently, an eminent scholar in this financial antitrust field, Stephen Rhoades, suggested legislation to limit large acquisitions. Rhoades discussed cogently the political and social as well as economic bases for accumulating and deploying power.[23] The Congress, in my view, would do well to consider these questions further for the social as well as economic payoff. Assuming the legislative route is desirable, the question is whether the Congress should act before or after relatively unencumbered free market forces have had the opportunity to sift themselves out fully. If our goal is to address the antitrust question without having to resort to divestiture, with all the potentially painful consequences of unscrambling, then Congress perhaps should look at these questions sooner rather than later.

—Elinor H. Solomon*

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NOTES

[1] See Alan S. McCall. "Economies of Scale, Operating Efficiencies and the Organizational Structure of Commercial Banks," **Journal of Bank Research**, (Summer 1980), pp. 95-100; Paul F. Metzker, "Future Payments System Technology: Can Small Financial Institutions Compete?" Federal Reserve Bank of Atlanta, **Economic Review** (November 1982), pp. 58-67.

[2] Evelyn M. Hurley. "The Commercial Paper Market Since the Mid-Seventies," **Federal Reserve Bulletin** (June 1982) pp. 327-334.

[3] Benefits may flow freely downstream if, for example, arrangements or joint ventures by sellers at one level who offer, say, processing or credit card services (#3), do not contain clauses which specify prices of services at retail (#5) or discriminate against any institutional buyers at the next level (#4).

[4] The New England experience is described by Constance Dunham, "Mutual Savings Banks: Are They Now or Will They Ever Be Commercial Banks?" **New England Economic Review**, (May/June 1982) pp. 51-68.

[5] Steven Salop. "The Noisy Monopolist: Imperfect Information, Price Dispersion and Price Discrimination," **Review of Economic Studies** XLIV (October 1977), pp. 393-406.

[6] Bernard Schull, "Commercial Banks as Multiple-Product, Price-Discriminating Firms," **Banking and Monetary Studies**, pp. 351-363, P. Carson, editor 1966. Michael A. Goldberg, "The Pricing of Prime Rate," **Journal of Banking and Finance** 6 (1982), pp. 277-96. Marcelle Arak, A. S. Englander, and E.M.P. Tang, "Credit Cycles and the Pricing of the Prime Rate," Federal Reserve Bank of New York, **Quarterly Review**, (Summer 1983), p. 8 and pp. 12-28.

[7] Donald Savage and Elinor Solomon, "Branch Banking: The Competitive Issues," **Journal of Bank Research**, 11 (Summer 1980), pp. 110-121.

[8] **United States** vs. **Northwestern National Bank of Minneapolis, et. al.**, 1964 Trade Cases #71,020 (D. Minn. 1964); **United States** vs. **The First National Bank of St. Paul, et. al.**, 1964 Trade Cases #71,021 (D. Minn. 1964) and **United States** vs. **The Duluth Clearinghouse Association, et. al.**, 1964 Trade Cases #71,022 (D. Minn. 1964) (consent decrees).

[9] Stephen A. Rhoades, **Power, Empire Building and Mergers** (Lexington Books: Lexington, Mass., 1983). Corwin Edwards, "Conglomerate Bigness as a Source of Power," in George Stigler (ed.) **Business Concentration and Price Policy** (Princeton: Princeton University Press, 1955), pp. 331-359. The Zaibatsu breakup experience in postwar Japan is instructive also. See Eleanor Hadley, **Antitrust in Japan** (Princeton, 1970).

[10] U. S. Department of Justice Merger Guidelines (June 14, 1982), reprinted in **Trade Regulation Report** (Commerce Clearing House) pp. 4500-05.

[11] One problem may be that mergers in small or isolated geographic markets, where nonbank entry is unattractive because of poor growth prospects, become the easiest to litigate and win. This prospect of lopsided emphasis poses a danger for effective antitrust enforcement across the board.

[12] For a statement of issues and tradeoffs see Robert A. Eisenbeis, "Regulatory Agencies' Approaches to the 'Line of Commerce,'" Federal Reserve Bank of Atlanta, **Economic Review** (April 1982), pp. 20-28.

[13] See **The Wall Street Journal**, February 16, 1984, 3. Assistant Attorney Paul McGrath said the more recent U. S. Steel Corp. bid for National Steel Corp. increased his concerns about the LTV-Republic merger, which would excessively increase concentration in three product lines.

[14] For example, **United States** vs. **Connecticut National Bank**, 418 U. S. 656 (1973). **United States** vs. **First National State Bancorporation**, 499 F. Supp. 793 (D. N. J. 1980).

[15] The literature is extensive. See, for example, B. Benson, "Spatial Microeconomics: Implications for the Relationship Between Concentration and Ownership in Bank Performance," in **Proceedings of a Conference on Bank Structure and Competition** (1980), Federal Reserve Bank of Chicago, pp. 60-85.

[16] However, Markovitz suggests that legal rules may be developed to handle specific situations in his "gravitational" spatial analysis. Richard S. Markovitz, "Predicting the Competitive Impact of Horizontal Mergers in a Monopolistically Competitive World: A Non-Market Oriented Proposal," 56 **Texas Law Review** (March 1978). "Shading" of market shares by the Antitrust Division to account for such close competition outside the primary market often reflected this view.

[17] See David D. Whitehead and Jan Luytjes, "Can Interstate Banking Increase Competitive Market Performance? An Empirical Test," **Economic Review**, Federal Reserve Bank of Atlanta, (January 1984), pp. 4-10.

[18] Likelihood of a "linked oligopoly" developing was enhanced in one court case by suggestions of close personal contracts between leading bankers, who enjoyed discussions of common banking strategies. Merger in that litigated case was viewed as a way of eliminating the maverick local banker who did not think and act in the way of the group, thus upsetting to achievement of common goals. Rivalry was not great to begin with, whether or not collusion in a strictly legal Sherman Act sense was present. The final twist to this story was that the maverick banker decided not to go through with the merger following the ultimate Supreme Court victory after three years of litigation, and has thrived well and independently ever since.

[19] For example, William F. Baxter, "Vertical Practices—Half Slave, Half Free," **Antitrust Law Journal, op, cit**, pp. 743-754. F. M. Scherer, however, points out the technical difficulties of the new theory and its imperfect state of development, at that same Antitrust Institute, pp. 687-707.

[20] John H. Shenefield, Testimony before the Senate Committee on the Judiciary Concerning Conglomerate Mergers, (March 1979).

[21] See Rhoades, *op, cit.*, footnote 10 above.

Consumer Demand for Product Deregulation

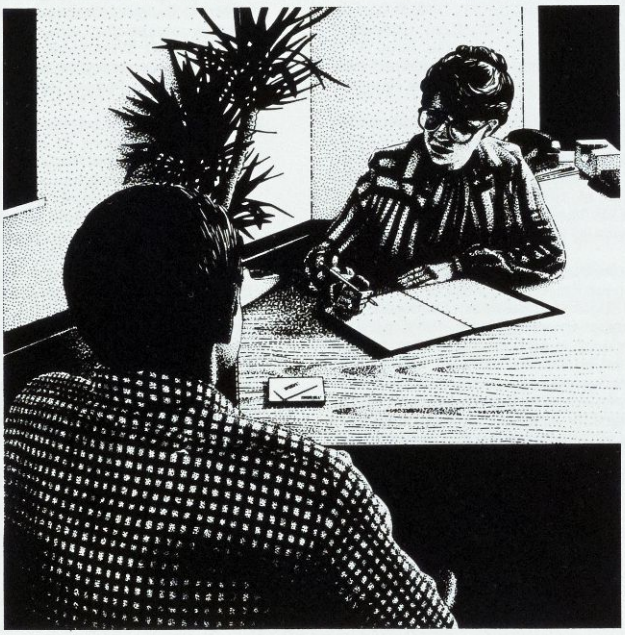
Changing consumer demand already has prompted considerable deregulation of the retail financial services industry. In the inflationary environment of the late 1970s and early 1980s, many consumers, demanding a better return on their money than depository institutions could legally pay, shifted their funds to newly created "checkable" money-market funds. It was this evidence of heightened consumer demand for transactionable high-interest-rate accounts that led ultimately to the deregulation of interest-rate ceilings for depository institutions.

Today, industry spokesmen claim that consumer demand is the driving force behind the movement toward product deregulation. Consumers demand one-stop financial service convenience, they say, and that demand cannot be denied.

What evidence exists to support these claims? This article will address that point. It is based on empirical data generated by consumer surveys conducted in 1982, 1983 and 1984. Some of the data have come from publicly available research reports. Some are based on proprietary studies conducted by private research firms. Some are new. After reviewing the empirical data that were available for public use, the Federal Reserve Bank of Atlanta commissioned a nationwide mail panel survey through National Family Opinion (NFO) to fill in the gaps. Of the 5,000 households surveyed, 3,410 usable surveys were returned. The sample represents a national distribution. The publicly available and proprietary data were assembled here with the Reserve Bank's new survey data in order to provide a comprehensive picture of consumers' reaction to broad financial product offerings.

All of the surveys indicate that many consumers favor the idea of one-stop financial service convenience. The evidence that consumer demand is the driving force behind product deregulation is less concrete. Just over a quarter of U.S. households want to secure most of their services from a single firm. Furthermore, affluent consumers, who use the greatest variety of financial services, generally are reluctant

Many consumers favor the concept of one-stop convenience in securing financial services, surveys indicate. Yet research has turned up less evidence that consumer demand is the force driving bank-product deregulation.



to consolidate their services. Because of customer loyalty and the desire to obtain a number of different investment perspectives, most U. S. households currently prefer to continue obtaining banking services from banks, insurance from insurance companies, and brokerage services from brokerage firms. Some, however, would like to have all these businesses located in a single place.

The Use of Multiple Financial Service Providers

A financial service provider may be a depository institution (commercial bank, savings bank, savings and loan association or credit union) or a nondepository financial service firm such as an insurance company or brokerage house. Most U.S. households today deal with two or more financial service providers.

A study conducted in 1982 by Electronic Banking Inc. (EBI) of Atlanta counted the number of financial service providers used by consumers and classified them as Bank Only, Bank +1 Bank +2 and Bank +3 or more. Under this classification scheme, "bank" is a generic term referring to any type of depository institution, while the +1, +2 and +3 designations refer to additional consumer/financial institution relationships, regardless of whether those relationships are with depository institutions or nondepository financial service firms.[1]

Data from the EBI study reveal that less than 2 percent of the responding households surveyed deal with only one financial institution. Thirty-nine percent deal with a "bank" and one other provider. Forty-two percent deal with a "bank" and two other providers. At the other extreme, only 17 percent dealt with three or more financial service providers in addition to a "bank".

The EBI data also indicate that the number of financial service providers a household uses is directly related to income. Households in the $10,000-$20,000 income range are one-and-one-half times as likely on average to deal with a "bank" and only one other firm. In contrast, the likelihood of high-income ($50,000 or over) households dealing with a "bank" and three other types of providers is twice the norm.[2]

A nationwide consumer survey conducted and published by Payment Systems Inc. (PSI) of Tampa in 1983, provides evidence that the use of multiple providers is a reflection of the financial services industry segmentation brought about by rate and product regulation.[3] Until NOW accounts were authorized nationwide in 1980, commercial banks were virtually the only institutions authorized to offer transaction accounts. Because of Regulation Q, savings and loan associations paid higher rates on savings than did commercial banks. Life insurance has been available primarily from life insurance companies. The average consumer historically has dealt with three different types of financial service providers to meet these three basic financial service needs and get the best possible return on their savings. Table 1 shows that most U.S. households have done this, and, despite recent interest rate deregulation, few have changed their ways.

Table 1. Percentage of U.S. Households Using Selected Types of Financial Service Providers

Provider	Percent Using
Commercial Banks	86.8
Life Insurance Companies	62.1
Savings & Loan Associations	50.3
Credit Unions	38.9
Brokerage Firms	15.0

Source: **Payment Systems, Perspectives '83: A Special Report,** Volume 2, Payment Systems Inc., Tampa, Fla.

Demand for One-Stop Convenience

At least half of the population, it seems, would like to do things differently. In a survey conducted in March of this year, the Federal Reserve Bank of Atlanta asked consumers, "How desirable would it be to get all financial services at one location?" Nearly 50 percent of the respondents indicated it would be somewhat or very desirable. Back in November 1982, Electronic Banking Inc. asked consumers, "If it were possible to obtain nearly all financial services such as checking, savings, loans, insurance, investments and tax planning from one provider, would you be inclined to consolidate your services?"[3] Nearly 50 percent of the

Table 2. Attitudes Toward Desirabiity of One-Place Financial Service Convenience and Willingness to Consolidate Services

Attitudes Toward Desirability	Percent	
Not at all desirable...	16	30
Somewhat undesirable...	14	
Neither desirable nor undesirable...	20	
Somewhat desirable...	26	50
Very desirable...	24	
Total number of respondents	2804	

Source: Federal Reserve Bank of Atlanta

Willing to Consolidate	Percent
No...	36
Don't know...	14
Yes	50
Total	1092

Source: Electronic Banking Inc.

respondents answered yes or said that they already do so. (Table 2 shows the responses to the two questions in greater detail.) In addition, Synergistics Research Corporation asked consumers last August, "If you could obtain most of your financial services from one financial services provider, would you consider this to be... an improvement?" Fifty-nine percent of the respondents to this survey said it would be very much or somewhat of an improvement. (See related articles.)

The sample selection critieria for the three surveys differed slightly. The questions were worded differently, and the surveys were conducted at three different times. Nevertheless, the responses to the three questions were not significantly different. About half of all U.S. households favor one-stop financial service convenience. Another 15 to 20 percent have no strong feelings for or against the idea. The remainder of households find consolidation undesirable for one reason or another.

Types of One-Stop Financial Service Convenience Preferred

Financial service providers are considering three general approaches to providing consumer financial services. One is the single firm approach—a financial services firm or institution offering all types of services under its own name. Many financial institutions urging product deregulation would like to be able to do this.

Second is the financial service center concept in which different financial services, like insurance, real estate, and brokerage, are available from different firms in one location. Sears is one organization taking this approach. Although all the providers in a Sears Financial Service Center are subsidiaries of the retailer, they retain their original names and may be thought of as separate entities by the consumer.

Finally, there is the financial services boutique. The boutique approach connotes specialization, by providing a limited number of products and services or by targeting a specific market segment, such as affluent consumers.

Among the 70 percent of all consumers who are not opposed to the concept of one-stop financial services, few seem to want financial service boutiques. Only 7 percent of those surveyed preferred this type of provider.

On the other hand, the sample is split fairly evenly between those who prefer to get most of their services from a single firm and those who prefer financial service centers or financial boutiques. (See Table 3.) Indeed, only 28 percent of all respondents to the Fed survey prefer dealing with just one firm. This preference seems to be strongest among individuals in the 50-64 age group. Younger individuals appear to respond more favorably to financial service centers.

Table 3. Type of One-Stop Provider Preferred
(respondents who do not find one-place services undesirable)

		Age Groups			
	%	34 and Under %	35-49 %	50-64 %	65 and Above %
Single firm	40	34	4	44	37
Financial Service Center	31	36	29	29	32
Financial Service Boutique	7	8	6	7	9
No Preference	23	22	25	20	23
Total	100	100	100	100	100
Total number of respondents	2398	518	654	770	456

Source: Federal Reserve Bank of Atlanta

Depository Institutions Preferred

Regardless of the preference for single-firm providers or financial service centers, depository institutions top the list of institutions preferred. Among the respondents who favor the single firm approach, 93 percent say they would like for that single firm to be a depository institution. This was virtually identical to the response to a similar question asked in the EBI study. Of those Fed survey respondents who say they prefer a single firm, 51 percent would like to get most or all of their financial services from a commercial bank, 26 percent prefer an S&L, and 16 percent prefer a credit union. (Table 4)

Depository institutions also are desired strongly by the 31 percent of respondents who prefer the financial service center approach. Seventy percent of the respondents prefering a financial service center want to find an S&L there, while 66 percent want to find a commercial bank. Forty-one percent say they would want a credit union represented in the center. These consumers may be more thrift institution-oriented than those who prefer a single firm.

The data do not suggest that deregulation to permit one-stop financial service convenience would change the relative competitive positions of the different types of depository institutions. An analysis of the preferences suggests that household market shares of the three major types of depository institutions' would decline if one-stop financial service convenience were available. However, one-stop convenience would have no substantial effect on the share of total relationships claimed by each type of institution.

Section One in Table 5 highlights the difference between the percentage of households

Table 4 Type of Institutions Preferred
(respondents preferring single financial institution)

	Percent
Commercial Bank	51
Savings & Loan Association	26
Credit Union	16
Full-Line Brokerage Firm	4
Discount Brokerage Firm	*
Insurance Company	*
Others	3
	100
Total number of respondents	924

* Less than 0.5 percent

Source: Federal Reserve Bank of Atlanta

Table 5. Depository Institution Market Shares

Section One: Current Distribution of Market

	Household Market Share %	Relationships Per 100 Households (number)	Relationship Market Share %
Commercial Bank	87	87	49
Savings & Loan	50	50	28
Credit Union	39	39	22
Totals	176*	176	100

*Multiple relationships possible. Total exceeds 100%

Section Two: Data Available From Consumer Research

	Group: Respondents			Distribution: % Using or Would Use		
	Number	%		Bank	S&L	C.U.
One-Stop Undesirable	1012	38		87	50	39
Prefer Single Firm	955	37		51	26	16
Prefer Fin. Svs. Center	734	28		67	70	41
Totals			2601	100		

Section Three: Calculation Results
cell percentages = group percent of total × distribution for group

	One-Stop Undesirable %	Single Firm Preferred %	Fin. Svs. Center Preferred %	Total %
Commercial Bank	34	19	19	71
Savings & Loan	19	10	20	49
Credit Union	15	6	12	33

Section Four: Estimated Distribution of Market Share in One-Stop Environment

	Market Share %	100 Households (number)	Market Share %
Commercial Bank	71	71	47
Savings & Loan	49	49	32
Credit	33	33	21
Totals	153*	153	100

*Multiple relationships possible. Total exceeds 100%

that use a depository institution and the percentage of each household's total number of depository institution relationships. It is based on data from PSI. This study found that 87 percent of all households that deal with a depository institution use one or more services at a commercial bank. However, as Section One of Table 5 shows, the data might also be interpreted to mean that, on average, each household has some kind of service relationship with 1.76 depository institutions. Thus, each 100 households have approximately 176 relationships and 87 of those relationships are with commercial banks. In short, commercial banks have an 87 percent market share when the market is expressed as the total number of households maintaining a financial relationship with a given type of financial institutions. Banks have a 49 percent share when the market is expressed as the number of financial relationships between households and depository institutions.

The next step in the analysis was to recalculate the percentages of consumers who would use the three types of depository institutions. This was necessary because some respondents to the Fed survey provided too little information about the type of institution they would use if one-stop convenience were available to estimate their behavior in such an environment. We disregarded these responses. Respondents who stated they consider one-stop convenience undesirable were not eliminated. Instead, we assumed that their behavior would not change, and they would continue to use the three types of depository institutions in the same proportions as reported by PSI. The recalculated percentages are shown in Section Two of Table 5.

Section Three of Table 5 shows the market share of households that each type of institution would control within each of the three user groups. The consumers' preference distributions for the depository institutions were multiplied by the percentage of households that each group represents to obtain these estimates of market share.

Section Four of Table 5 parallels Section One. It shows household shares and total relationship shares of each type of institution in a one-stop convenience environment. As noted above, household market share for each type of depository institution would be lower than the current market share because some consumers currently using multiple depository institutions would consolidate their financial services with one of the three types. The differences between the current and projected relationship market shares is small. Although some consumers would consolidate their financial services at one type of depository institution or another, their choice of institutions would vary and most consumers would continue to use multiple depository institutions. The consumer's tendency to stick with the tried and true is also a major theme in the related article contributed by SRI International.

The Relationship Between Income and Financial Service Usage

Thus far, we have focused on consumers as a single group; however, not all consumers have the same financial service needs. Affluent households generally are more active financially than those of more moderate means. Table 6 provides evidence of this. It shows, for example, that households with annual incomes in excess of $60,000 are twice as likely to use transactionable investment accounts and IRAs and three times as likely to use the services of full-line and discount brokerage firms.

The Atlanta Fed survey covered a larger number of financial services than the PSI study. In the Atlanta Fed survey, consumers who were not opposed to the concept of one-stop financial services and who specified a favored provider were asked what services they probably would obtain from a single firm, financial service center or financial service boutique. The responses confirmed the positive relationship between income and the use of large numbers of services. Of the 19 services studied (see Table 7), the likelihood of using one (passbook savings) decreases as income goes up. Obviously the reason is the lower return associated with these accounts. For five services—checking, life insurance, property and casualty insurance, real estate brokerage and tax preparation—income was not related to likelihood of use. The likelihood of a consumer's using the remaining 13 services was directly related to income.

The Relationship Between Income and Service Consolidation

The Fed survey found no statistically significant evidence that households earning $35,000

Table 6. Percentage of U.S. Households Using Selected Types of Financial Services

		Income (in thousands)			
	Total	Under $25	$25-$40	$40-$60	Over $60
Transaction Services					
Regular Checking Accounts	66.1%	71.2%	64.1%	61.7%	71.2%
Now Accounts	31.2	25.0	31.2	41.7*	–31.8
	(466)	(125)	(202)	(98)	(18)
Share Draft Accounts**	35.8	30.4	37.6	41.8	33.3
Transactionable Investment Services					
MMDA/SuperNOW Accounts	22.3	17.7	19.2	27.2	45.5*
Money Market Mutual Funds	16.2	10.4	14.8	22.3*	34.8*
Brokerage Services					
Full-Service Brokerage	12.7	5.9	10.6	23.8	31.8*
Discount Brokerage	3.5	1.4	2.3	8.3*	9.1*
Individual Life Insurance					
Term	31.4	25.0	30.8	45.1*	35.0
Whole Life	43.9	34.9	49.5	52.9	50.0
Universal Life	6.9	4.5	9.2	8.3	6.1
Individual Retirement Accounts (IRAs)	22.7	10.8	20.9	40.8*	54.5*
Total Number of respondents	1,199	424	426	206	66

*Percentage is significantly higher than the percentage shown for all U.S. households (Total) when tested at the 95% confidence level.
**Asked only of credit union members. Bases on which percentages are calculated are shown in ( )s.

Source: Payment Systems Perspectives '83: A Special Report, Vol. 2, Payment System, Inc., Tampa, Fla.

or more a year are less likely than the population as a whole to consider one-stop financial service convenience desirable. Two other studies, however, suggest that affluent consumers are less likely than middle or lower income consumers to consolidate with a single firm. In other words, affluent consumers prefer to obtain their financial services from a wide array of suppliers. EBI's report notes:

> Overall, while there is a large segment of the sample who would consider consolidating their financial services into one institution ... this segment of the population is heavily weighted with young, low to middle income consumers who are not currently using a diversified group of financial service providers. In short, the upscale segment ... is the least likely to be attracted by consolidation.[4]

In addition, PSI's Affluent Market Research Program, which surveyed over 1,500 households having annual incomes of $50,000 or more or net worths or $200,000 or above, found that "virtually none of the respondents indicated any tendency to consolidate their accounts."

Consumer Demand for Services from Non-Traditional Vendors

If those consumers whose financial lives are most active and most complex are unwilling or unlikely to consolidate their financial services, does consumer demand for product deregulation exist? Empirical evidence suggests it does. The extent of that demand appears to be limited, however.

One measure of consumers' demand for product deregulation is the degree to which they are willing to obtain financial services from nontraditional vendors. Evidence of this willingness is mixed. For example, when EBI asked consumers how likely they would be to purchase life, health or property insurance through a bank, approximately 47 percent said

Table 7. Types of Financial Services Likely to be Used at One-Stop Provider of Choice

		Income in Thousands				
	Total	Under $10	$10.0—$17.5	$17.5—$24.9	$25.0—$34.9	$35 & Above
Checking	87	80*	89	86	89	87
Passbook Savings	70	70	74	77	70	63
Certificates of Deposit	53	42*	48	52	57	64
Money Markety Funds/Accts.	44	27*	38	43	48	58
Credit Cards	60	39*	58	64	64	72
Lines of Credit	33	22*	28	34	35	42
Consumer Loans	33	20*	31	37	37	39
Mortgages	43	23*	39	46	52	52
Second Mortgages	14	7*	10	13	16	22
Life Insurance	28	27	28	34	27	26
P&C Insurance	36	30*	38	38	35	39
Real Estate Brokerage	18	13*	16	18	20	21
Tax Preparation Ser.	33	28*	35	35	32	37
Tax and Investment Planning and Advice	27	13*	19*	24	30	42
Stock & Bond Brokerage	24	8*	15*	19	27	43
Managed Investment Funds	17	8*	12*	10	22	30
IRA/Keogh Accounts	44	21*	34*	45	52	63
Estate Planning Settlement & Trusts	21	14*	16*	16	23	33
Asset Management Accts.	11	5*	7*	6	12	21
Total number of respondents	1,864	363	370	294	365	472

Source. Federal Reserve Bank of Atlanta Survey

they would be somewhat or very likely to do so.[5] However, when PSI asked commercial bank customers if they would purchase life insurance from any depository financial institution they dealt with, only 17 percent said they definitely or probably would.[6] That is a large variation, some of which may be accounted for by the different wording of the questions and the broader spectrum of insurance products covered in the question asked by EBI. The EBI report also notes that some of the respondents "qualified their positive reactions with such disclaimers as I'm willing to check into the service," "it depends on the service," or it depends on the price of the service."[7]

The two studies were more in concert on the question of purchasing brokerage services from a commercial bank. In both studies, over a third of the respondents indicated they would do this. However, both also provided caveats. EBI again noted that many of the positive responses were qualified by statements like, "I'm willing to check it out," or "when I have money available to invest"[8] PSI cautioned readers, saying, "These figures represent only the consumer's predisposition to use a service." Therefore, it should not be assumed that the potential for discount brokerage offered by depository institutions is currently anywhere near 35-40 percent of affluent households."[9]

In another approach to determining consumer demand for financial product deregulation, a factor analysis was performed using responses to the Atlanta Fed survey concerning services likely to be used at a one-stop financial service location. Factor analysis is a statistical technique used to reduce a large number of measurements—in this case, the likelihood of using each of 19 services—to a smaller set by determining which seem to go together and measure the same factor. The four factors produced by

Table 8. Factor Analysis Results

Factor	Services
Factor One	Stock & Bond Brokerage Asset Management Account Tax and Investment Planning/Advice Managed Investment Funds Money Market Funds/Accounts Estate Planning, Settlement & Trust IRA/Keogh Accounts Certificates of Deposit
Factor Two	Mortgage Loans Consumer Loans Second Mortgages Lines of Credit Credit Cards Real Estate Brokerage
Factor Three	Checking Passbook Savings Certificates of Deposit Money Market Funds/Accounts Credit Cards IRA/Keogh Account
Factor Four	Life Insurance Property & Casualty Insurance Tax Preparation Real Estate Brokerage Tax and Investment Planning/Advice

this analysis and the services they comprise are shown in Table 8.

Factor One is a set of services that would be used by a distinct segment of the population that can be described as package-oriented investors. The "package" orientation is suggested by the demand for asset management accounts, which generally combine transaction and investment services in a single account. All of the services that make up this factor may currently be obtained from a full-line brokerage firm. Many are also available from larger commercial banks. Under current regulations, however, banks cannot offer investment advice. Thus, existing regulations prevent any financial service provider from directly filling all the needs of these customers.

Factor Two is a combination of services that suggests a segment of the population best described as borrowers. In this combination, mortgages and second mortgages have high factor scores, suggesting that real estate investments are an important part of this segment's financial lives. Thus, it is not surprising to find that real estate brokerage services constitute one of this segment's financial service needs. Once again, however, regulations that restrict banks' real estate activities obstruct this segment from obtaining all the services it would like at one location.

The services that make up Factor Three can be met by full-service depository institutions today. Lacking a better term, these customers might be called traditionalists. They seemingly would be content with the status quo or would prefer not to secure "banking" and other financial services at the same place.

Factor Four is more difficult to interpret. This combination of services desired at a single location seems to reflect the needs of a security-conscious, help-seeking group of people. They seem to want the services of independent professionals as well as those of insurance and real estate firms. One can only speculate why real estate brokerage would be one of their important financial service needs. Perhaps they are high-equity homeowners, or individuals who pay cash for primary or secondary homes, making sizable downpayments to minimize their mortgage payments. It is reasonable to believe that people with such a conservative financial orientation would consider it important to get professional help and advice when buying or selling real estate.

Factor analysis provides no indication of the number of responses each factor represents. Thus, while the analysis may provide evidence of some consumer demand for deregulation, the extent of that demand cannot be determined.

CONCLUSION

Some, but far from all, consumers expect to gain from product deregulation. Fifty percent of those responding to the Atlanta Fed survey considered it desirable to obtain all their financial services at one location. Twenty-eight percent would like to obtain most of their services from one firm. Both of these facts appear to indicate considerable demand for product deregulation. Yet a factor analysis of the Fed's survey data suggests that some individuals in that 28 percent may define "most" as those services they can already obtain from full-service depository financial institutions. In short, the data are not conclusive but leave the impression that the

general population's current demand for additional product deregulation is not extremely strong. Educating consumers concerning these offerings and allowing them to become accustomed to obtaining these services from a single location might remove some resistance. But some firms may not believe the effort worthwhile in terms of training a staff and otherwise preparing to offer all these services.

This survey of empirical evidence also leads to the conclusion that consumer demand for product deregulation is unlike the demand for interest-rate deregulation. The demand to earn higher interest rates was a compelling enough force to make consumers redirect their funds to the new types of institutions offering money-market rates. With product deregulation, however, there is a gap between what consumers say they will do when broader product choices are offered and what they say they will do when they consider using non-traditional vendors. It is doubtful that convenience alone will cause large numbers of consumers to consolidate their services if financial products are deregulated in the future. More likely, financial service firms in a deregulated environment will have to prove their ability to provide services outside of their traditional purview effectively and at a competitive price before consumers will make a change.

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Affluent Consumers' Demand for Financial Products and Services

Affuent consumers (defined as those with annual incomes of $50,000 or more and/or with net worth of $200,000 or more) represent an attractive market to many financial service providers. A nationwide survey of affluent consumers conducted by Payment Systems Inc. (PSI) in 1983 revealed, however, that this market is not homogeneous in terms of product usage and that such customers in general show little propensity to change their present ways of handling financial affairs.

In making their financial decisions, affluent consumers appear to make conscious tradeoffs between costs and benefts, risks and returns. The majority say they shop for convenience rather than low cost for services such as checking. They also shop around to find the financial institution offering the highest return. All agree that quality financial planning and investment advice can be costly. Finally, while 53 percent prefer guaranteed returns on their savings, 82 percent prefer to put some of their assets into non-guaranteed investments to get a higher rate of return.

Affluent consumers say they want personal attention from their financial service providers. Seventy percent feel it is important that the officers of their financial institutions know them personally; 78 percent agree they would stay with a account executive with whom they had established a good working relationship, even if the account executive changes firms; and 60 percent prefer tellers to automated teller machines (ATMs) for routine financial transactions.

A majority of affluent consumers use eight financial and investment products or services. First, of course, is the checking account; 90 percent of the respondents use one or more such accounts. It should be noted, however, that the PSI survey definition of a "checking" account includes NOW and Super NOW accounts.

The second most widely used product is life insurance, with 87 percent holding one or more life insurance policies. Nevertheless, there appears to be little potential to sell new insurance products to this group. None of the respondents lacking life insurance coverage at the time of the survey indicated that they planned to obtain it in the next 12 months. Only 1 percent of the life insurance users intended to increase their use of this financial product. And 2 percent said they intended to discontinue policies. Affluent consumers who value insurance protection obviously have already met their needs, and some will probably get out of this investment vehicle gradually as they grow older and their life circumstances change.

The remaining six products and services used by a majority of affluent consumers are:

- Money market accounts or funds - used by 79 percent;
- Retirement accounts - used by 75 percent;
- Brokerage services - used by 70 percent;
- Passbook savings accounts - used by 65 percent;
- Tax preparation services - used by 60 percent; and
- Premium credit and travel and entertainment cards - used by 59 percent.

Knowing the percentage of affluent consumers who use each particular service provides no insight into specific combinations of services used by different groups. PSI performed a factor analysis of the survey data and found considerable diversity in the combinations of services used. The six clusters of services that the analysis identified are shown in the accompanying table. The names assigned to the clusters are PSI's interpretation of the kinds of affluent consumers that use each group.

The absence of a particular product or service from the lists of services used by each segment in the table does not imply that none of the individuals use that service. Some may and some may not; however, usage is not consistent enough to make the unlisted product or service useful in identifying the segment's financial affairs. For example, while one may reasonably assume that individuals in the Entrepeneur segment have transactions accounts, they do not gravitate toward any one type of transaction account. Some may use checking (including NOWs and Super NOWs); some may use asset management accounts; some may use checkable money market funds; and some may be cash oriented.

In light of the variety of services affluent consumers use, it is not surprising to find that they deal with a number of different financial firms. Six types of providers are used by a majority of the respondents:

- Commercial banks - used by 87 percent;
- National full-line brokerage firms - used by 74 percent
- Insurance companies - used by 73 percent
- Independent professionals (attorneys, CPAs, etc.) - used by 72 percent
- Savings and loans or savings banks - used by 68 percent; and
- Travel and entertainment card companies - used by 63 percent.

In addition, about a third of the affluent consumers deal with direct-mail investment firms and credit unions, while 20-27 percent deal with bank trust departments, major retail chains, specialized brokerage firms and discount brokerage firms.

With all their experience in dealing with different financial service providers, affluent consumers should be able to identify the type of provider they would prefer if they wanted one-place convenience and could get all types of financial services from a single firm. The survey, however, shows a dichotomy exists between what affluent consumers say they want and what they say they would do.

Two attitude questions tested the respondents' desire to consolidate their financial dealings with a single firm. On each question, 70 percent consistently agreed that they would like to consolidate. However, when asked to place themselves in a hypothetical situation where all providers could offer all services legally and to assume that the cost, quality and features were the same regardless of provider, virtually none of the respondents indicated any tendency to consolidate their accounts. Affluent consumers say that, in a deregulated environment, they will still obtain insurance from insurance companies; discount brokerage services from discount brokerage firms; credit cards from credit card companies or banks; tax, accounting and advisory services from independent professionals; transactions, savings retirement accounts and loans from commercial banks and savings institutions; and other investments from national full-line brokerage firms.

In short, while affluent consumers find the concept of product deregulation attractive, the availability of one-stop financial service convenience appears unlikely, by itself, to encourage them to change their patterns. They say it would be nice to be able to consolidate all their financial dealings; but, before they will make a change, affluent consumers will have to be shown that a single provider can meet all their needs effectively and provide some advantage to them.

Consumer Preferences in the New Financial Services Industry

It is clear to financial services vendors that the industry has changed because of deregulation, but the effect of deregulation on consumers is less clear. Research conducted by SRI International's Consumer Financial Decisions (CFD) Program indicated that deregulation has produced little change in the way many households handle their financial affairs. Two factors causing consumers' inertia are their fear of change and their unmet needs for information and advice.

As a result of deregulation, consumers are deluged with advertising by financial services vendors. The volume of advertising will likely increase dramatically over the next few years. Households are bombarded with descriptions of the new financial products and vendors available to them. One reaction to these new options is typified by the CFD focus group respondent who eagerly anticipated the day he could buy a few shares of stock as he walked through the checkout line at his neighborhood grocery store. A more common reaction, however, is for households to attempt to maintain the status quo, in fact to insist that nothing has changed. In a recent CFD survey, more than half of the U.S. households questioned stated that they are unlikely to try a new financial product unless someone they know recommends it. Thus, it is unsurprising that, in the face of change, consumers continue to prefer traditional financial relationships.

The logic behind their convictions is sometimes surprising. For example, although less than one-fifth of the households surveyed use a stockbroker regularly, half say they would be comfortable dealing with a stockbroker in a brokerage office. Most households use banks regularly, but less than one-third say they would be comfortable with a broker in a retail store. To consumers, brokers belong in brokerage offices, not in banks or department stores.

Clearly, consumers have not yet developed preferences for nontraditional vendors. As the table below indicates, more than three-fourths of those surveyed say that, if all vendors offered financial services at competitive prices, they would prefer to

use banks. Yet, households do accept the idea of nontraditional vendors in theory. For example, more than half of the households surveyed believe that insurance companies could offer both insurance and checking, and more than a third believe department stores could.

The gap between consumers' willingness to consider nontraditional vendors in theory and their willingness to use them may be largely due to their inability to get information and advice for decision-making. In the deregulated environment, households need information and advice. Half of those surveyed consider being able to obtain information and advice regarding financial decisions highly important. One-fourth consider it critical. Because they often are unwilling to pay for information or advice, however, most households fail to receive the assistance they need. One-third of the households surveyed say they do not know how to choose financial products and services. More than half say they never get information about differences in financial products, and two-thirds say they never get advice on which financial products are best for them.

The need for information and advice represents a clear strategic opportunity for new vendors, or those willing to change, since this need is one that is not being met by existing relationships. Although households tend to maintain traditional relationships because of their confusion, they appear willing to establish new relationships to get the information and advice they need. Half of the households surveyed, for example, say they would use a financial center (that is, a financial "supermarket") for information, and close to half would do so for advice. Because bundling information with all but the simplest of financial products increases a product's perceived value, vendors that regard information and advice as a marketing necessity (rather than a profit-generating product) in mass markets will be a step ahead in the new financial services industry.

As the boundaries between traditional financial industries continue to dissolve, vendors must also concern themselves with developing or maintaining distinct images. Consumers will continue to be attracted by particular institutional attributes, such as safety and competitive prices. But their willingness to trade off one against the other will vary with their psychographic profiles, financial needs, and current life stages. Image attributes such as competence and courtesy will be helpful in maintaining customer relationships—less so in establishing them. Still other attributes, such as vendor size, are often irrelevant to the consumer.

The ideal image is insufficient to motivate confused consumers to modify their behavior. Promoting institutional differences or product features to consumers who insist nothing has changed wastes scarce marketing resources. Vendors that choose instead to inform and direct the mass-market consumer will benefit now through cross-selling opportunities and in the future through households' increased ability to differentiate products and institutions.

Relationship Management: A Consumer Perspective

Consumer financial relationship management has emerged as the dominant retail financial strategy in the 1980s. Success or failure in relationship management will depend on a service provider's ability to integrate multiple services. To achieve integrated, mutiple-service relationships, financial service providers will offer a wide variety of deregulated products and services that establish an initial account with a customer, and then encourage a total relationship including checking, savings, investing, insuring, and financial planning.

One of the key pressures now acting on the environment of financial services is competition for the pool of household assets. The consumer financial market is highly fragmented in the distribution of these assets. Even though the average consumer is using about eight services, the average client relationship amounts to two services per client. Through effective use of relationship programs and multiple service offerings, providers can increase their business and decrease the cost of acquiring clients.

The attractiveness of relationship management programs from the provider standpoint is obvious. Synergistics Research Corporation (SRC) of Atlanta assessed consumer reactions to such programs last August by surveying 500 consumers across the country. The data can be projected to the 74 percent of U.S. households with incomes or liquid financial assets (excluding the primary home) of $15,000 or more.

Respondents were asked: "If you could obtain most of your financial services from one financial services provider, would you consider this to be very much of an improvement, somewhat of an improvement, not too much of an improvement, or no improvement at all?" Data suggest that, while consumers are less enamored of this concept than providers, it appeals at least somewhat to the majority of those surveyed, as shown below:

Very much of an improvement	20%
Somewhat of an improvement	39%
Unsure	6%
Not too much of an improvement	15%
Not at all an improvement	20%

Marketing to the affluent is one of the segmentation strategies most often cited by financial services providers. Many providers see relationship management as an approach to improving their affluent-market

position. Survey data, however, show that the single provider concept is not as appealing to income-affluent or asset-affluent consumers as to others. For example, only half the consumers with household incomes of $50,000 or more feel that the concept represents at least somewhat of an improvement, compared to 62 percent of those with household incomes below the $50,000 level. Similarly, the single provider concept appeals to 48 percent of households with $100,000 or more in liquid assets, versus 64 percent of those with lower assets.

Consumer financial relationships are now highly fragmented—especially within the upscale or affluent customer segment. While these consumers use more services, they also maintain relationships with more nonbank providers. Also, they tend to rely on specialists such as accountants and attorneys for financial information and advice. The net result is that it may be difficult for financial firms to encourage a consolidated relationship among members of this market segment. Relationship management, by definition, decreases or eliminates the number of specialists that consumers rely on for their financial needs. It also should reduce the amount of comparison shopping done for financial products or providers. Survey data confirm that relationship prospects are not oriented toward specialists or comparison shopping to the same extent as are non-prospects.

Nearly two-thirds (63 percent) of consumers who feel that the single provider concept represents a substantial improvement strongly agree with the statement, "I would rather deal with one generalist for all types of financial services than with several specialists." In comparison, only one-third of non-prospects strongly agree with the same statement. Relationship prospects are also more likely than non-prospects to agree that, "It takes too much time to comparison shop for financial services" (56 percent vs. 32 percent). Therefore, it appears that prospects are convenience-driven to some degree.

One strategy for promoting relationship management being highly touted is to offer some form of financial planning services as a key element in the total relationship. From a practical standpoint, however, many providers are skeptical about their ability to deliver financial planning in a cost-effective manner. Nevertheless, SRC's research shows that consumers' reactions to the single provider concept are highly correlated with their stated willingness to pay for financial advice on savings and investments.

Almost three-quarters (74 percent) of conumers who say they are "willing to pay a reasonable fee for good advice about savings and investments" are attracted to the single provider concept, compared to only 44 percent of those who say they are not willing to pay a reasonable fee. Of course, we must take care in intepreting the term "reasonable fee." "Reasonble" as defined by providers is rarely the same as "reasonable" as defined by consumers. According to SRC's research, only 2 percent of the consumers surveyed have paid even $500 for financial planning during the past two years.

Given the volatility of the current environment—with new products, new providers, and uncertainty about interest rates—it is not surprising that consumers want and need financial information and advice. Consumer demand for relationship programs seems to be real, as measured in this and several other SRC research studies. It may well be that financial planning of some form will provide the impetus and incentive around which a relationship program can be built. Consumers surely will need an incentive to overcome the inertia, complexity, or awkwardness involved in changing their financial relationships.

NOTES

[1]Telephone conversation with J. Brittain, Brittain Associates, Atlanta, Ga., April 8, 1984.

[2]Electronic Banking Inc., **Financial Service Usage and Product Strategies: A National Consumer Survey**, (Atlanta December, 1982) Appendix B., Table 1, Page 1.

[3]Payments Systems Inc., **Payments Systems Perspectives '83: A Special Report**, (Atlanta: July 1983).

[4]Electronic Banking Inc., Appendix A.

[5]Ibid., p. 25.

[6]Payment Systems Inc., **Payment Systems Perspectives '83: A Special Report**, Payment Systems Inc. (Atlanta, Ga.: July, 1983) Vol. 1, p. 68.

[7]Electronic Banking Inc. **Financial Service Usage and Product Strategies: A National Consumer Survey**, Electronic Banking Inc. (Atlanta, Ga.: December, 1982) p. 26.

[8]Ibid., p. 27.

[9]Payment Systems Inc., **Payment Systems Perspectives '83: A Special Report**, Payment Systems Inc. (Atlanta, Ga.: July, 1983) Vol. 1, p. 73.

How are corporate banking services likely to evolve if securities activities restrictions are removed? This article will utilize criteria that an expansion-minded bank (or other organization) would use in considering whether to enter currently prohibited businesses.

Banks' potential investment management and credit and financing services are significantly limited at present by the Glass-Steagall Act. Removal of that law's limits on managing comingled funds would allow banks to offer services that businesses desire. These services also would involve extensions of banks' present services and skills.

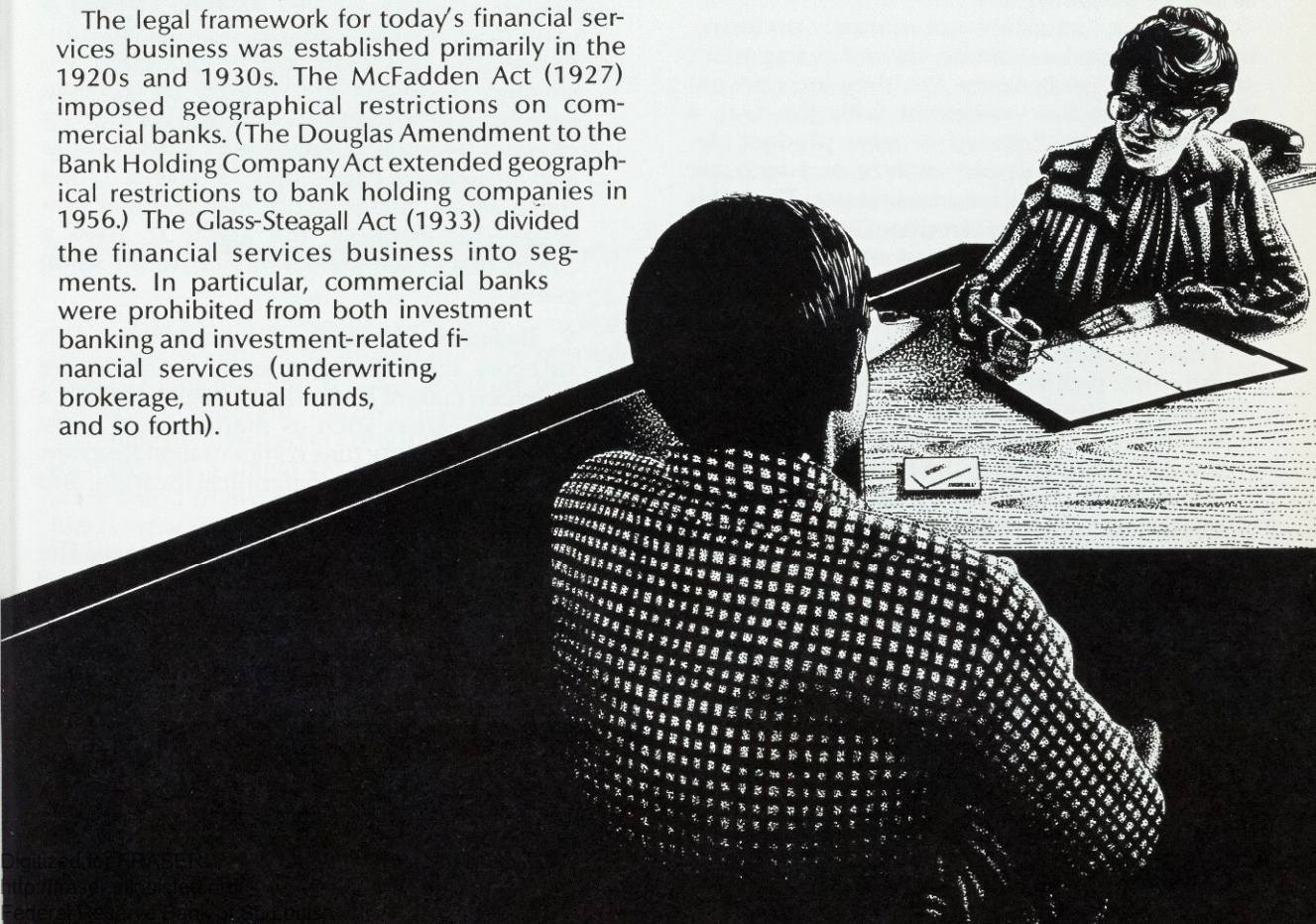
However, removing corporate underwriting restrictions would not significantly increase the benefits perceived by large corporations. They would most likely fear putting all financing eggs in one basket. Smaller corporations would be more likely to benefit from banks' entry. Banks now offering municipal underwriting and extensive government security trading almost certainly would expand to offer various types of debt placement and debt underwriting, but they are unlikely to enter into full-scale national debt and equity underwriting significantly.

Business and Bank Reactions to New Securities Powers

If Congress frees banks to compete in the securities business, the institutions will face hard decisions on what activities to undertake. Here's a look at the challenges expansion-minded banks might face in marketing these new services.

Background

The legal framework for today's financial services business was established primarily in the 1920s and 1930s. The McFadden Act (1927) imposed geographical restrictions on commercial banks. (The Douglas Amendment to the Bank Holding Company Act extended geographical restrictions to bank holding companies in 1956.) The Glass-Steagall Act (1933) divided the financial services business into segments. In particular, commercial banks were prohibited from both investment banking and investment-related financial services (underwriting, brokerage, mutual funds, and so forth).



While communications, transportation, computers, and other technology have changed greatly over the past 50 years, the line-of-business segmentation persists. However, the actual distinctions between commercial banks and other financial institutions have become blurred, especially over the last 15 years.

One reason for the blurring has been the creation of the bank holding company able to engage in a variety of financial services other than commercial banking. Thus, major banks now offer a variety of financial services under their holding company structure. Some do so on an interstate basis. Yet two corporate financial services remain clearly prohibited to banks today—securities underwriting and mutual fund management.

Economic Framework

In considering the corporate services that depository institutions would enter if the Glass-Steagall regulatory prohibitions were removed, five factors offer a systematic framework for evaluating the overall attractiveness of currently prohibited business lines: profitability, cross-product scale economies, synergy, competitive advantages or disadvantages, and business similarities or dissimilarities.

These five factors are not mutually exclusive. In fact, the last four can be viewed as important attributes of profitability. Yet they are relevant because they are congruent with the way a merger-acquisition group or new product development group would analyze and evaluate buying or developing new businesses. Thus, this analysis will attempt to simulate in capsule form banks' decision processes if legal-regulatory changes make such decisions possible.

1. **Profitability.** The ultimate reason for entering a new business is a belief that it offers attractive long-run profit opportunities. "Attractive" means a return on investment that more than compensates for the costs of investment and the risk borne. Hence, the basis for profitability decisions is attractive return-risk situations relative to other opportunities available to commercial banks and other depository institutions. The risk dimension is crucial since the financial service business is undergoing rapid change in products, structure, and competition, with the associated increase in business risk that accompanies such change.

2. **Scale Economies.** The design, development, production, and distribution of financial services are characterized by scale economies. Here "scale economies" refer to situations where fixed costs are substantial and variable costs are low, so that average cost per unit falls with increased volume. If scale economies are extensive, they can produce a market structure characterized by only a few large service providers, possibly only one. Securities underwriting is a clear example of a business with scale economies. Electronic distribution networks and computer-based processing are others that are pertinent to the emerging use of computer-communication technology to produce and distribute financial services.

In terms of new businesses that banks are likely to enter, the issue is not simply scale economies per se but rather cross-product scale economies. Cross-product scale economies represent a particular kind of synergy. Nevertheless, scale economies are so important in the emerging use of electronic-based financial services that this type of synergy merits special attention.

3. **Synergy.** The term synergy is overused in mergers to refer to situations where two businesses can be run more profitably together than as separate entities. **Product synergy** is used here to refer to cross-product interdependencies that allow cost savings when two or more products are offered by a single enterprise relative to the same level of product offerings by separate enterprises. These savings also are called economies of scope. Often these will be marketing or management synergies—for example, the ability to have a calling officer sell several services to the same client.

4. **Business Similarities/Dissimilarities.** This category covers similarities and differences between current businesses in which banks are engaged—areas such as management skills, organizational structure, compensation structure, skill requirements, geographical location, and technologies.

5. **Competitive Advantage/Disadvantage.** The terms competitive advantage and competitive disadvantage are used here to refer to anything that distinguishes banking from other financial service companies with which banks would have to compete.

Classification of Corporate Services

The financial services used by corporations can be placed in three broad categories—investment-management, credit-financing and cash management.

Investment management services include pension fund management and other trustee-based management for corporations or their beneficiaries. The central issue is the ability to expand current asset management services to include comingled funds or mutual funds.

Credit-financing involves provision of credit or financing.[1] Today, the only domestic business financing provided by banks is some form of lending. The central line-of-business issue is the expansion of financing services to include underwriting for corporate debt or equity and a variety of underwriting-related financing assistance.

Cash management is a catch-all term for the variety of transaction and information-based products provided corporations. Given the Federal Reserve's recent decision to allow Citicorp to offer a variety of computer-based services and even the incidental sale of computer hardware and time-sharing, there are few line-of-business restrictions covering cash management products and services. The only significant regulatory restrictions are geographical (McFadden and Douglas), namely, restrictions on the ability to establish deposit-taking offices across state lines.

Since line-of-business restrictions are insignificant for corporate cash management services, we will disregard these bank services except as they involve placement of commercial paper in the consideration of financing-underwriting.

Investment Management and Mutual Funds

In managing pension funds and other investment management services including personal trusts, banks cannot create and manage internal mutual funds into which client funds are placed. Moreover, different clients' funds cannot be comingled if invested in corporate securities, i.e., managed as a single set of funds with pro rata assignment of investment returns. Commingled funds are viewed as a de facto mutual fund and, thus, as the offering of a security by the bank.[2]

The inability to comingle funds or to achieve investment objectives via selection from a set of internal mutual funds is a significant competitive handicap. Commingled funds are less expensive in both administrative costs and transaction-trading costs, since roughly the same effort is required to manage one large pooled fund as to manage each company's separate fund. Thus, with deregulation, any bank offering pension fund management and other trustee-managed funds could offer comingled funds or internal mutual funds. Exhibit 1 summarizes the pros and cons of this product addition for the offering bank. It shows virtually all benefits and no disadvantages.

Since there are significant economies of scale in a well-automated commingled management service, there could be a net reduction in the number of service providers. Or, more likely, it could mean that a consortium of banks could form with centralized fund management and decentralized marketing and administration but with lower fees. Thus, the corporations seeking professional asset management also would be better off it these restrictions were removed. Asset management clearly would become more competitive.

Retail Synergy: Mutual Funds

Once mutual funds are created internally, it is logical in a deregulated environment to offer them also to the public. Therefore, it is reasonable to expect that banks now offering pension fund management and other trustee managed investments will enter mutual fund management, although many banks' offerings would logically be managed passively as index-type funds.

Once banks could offer mutual funds, these undoubtedly would be bundled into "cash management accounts" like that pioneered by Merrill Lynch (with the assistance of Bank One). These accounts could offer: (1) an automatic sweep into a mutual fund, especially an ordinary money-market fund or tax-exempt money-market fund, (2) automatic transfer between funds without any transaction cost, (3) the use of equity in mutual funds and other securities as collateral for an automatic loan, and possibly (4) a credit line. These accounts would be offered to consumers and businesses alike.

While only a few banks with large trust departments would enter the mutual fund management business, most would offer mutual funds as part of their cash management accounts or security brokerage business. They could serve as agents for the funds of either other banks or nonbanks. Thus, virtually all banks would be likely to offer mutual funds to their clients.

Exhibit 1. A Summary of the Pros and Cons Associated with Mutual-Fund-Like Services

CRITERION	STRENGTHS	WEAKNESSES
PROFITABILITY	It is much less costly to manage pooled funds as a single commingled account than to manage many separate accounts, especially for smaller companies.	Over time, banks offering lower service delivery costs could attract more business but not see revenue and income growth comparable to their growth in managed assets.
SYNERGY	Major banks are the primary source of back-office processing for most of the mutual fund management companies.	
	Funds are the best way to offer "passive assets management" designed to match security market indices. Hence, banks would become more competitive in one of the most rapidly growing areas of fund management, especially in extending this service to small accounts of smaller companies.	Fees (as well as costs) are much less for "passive asset management".
SCALE ECONOMIES	The crux of commingling is to obtain the benefits of aggregation and reduce the costs of many funds for n different companies to roughly 1/n-th the aggregate cost of n separate accounts.	
BUSINESS SIMILARITIES	1. Very similar to managing large pension funds and other trustee-oriented investment management services.	
	2. Banks already provide back-office processing, shareholder accounting and investment research to many mutual funds.	
COMPETITIVE ADVANTAGES AND DISADVANTAGES VERSUS NONBANK COMPETITORS	Major trust departments are much larger than most mutual fund management companies in terms of both assets managed and professional staff.	Some mutual fund management organizations may cease to use banks for support services if they are perceived as direct competition.

Financing Services and Securities Underwriting

At present, banks provide companies credit and short-term financing but not significant long-term debt or equity except in special situations. Thus, major companies issue commercial paper or borrow short-term from banks, and then rely primarily on other financial intermediaries to purchase or help them issue long-term debt and equity. Over time, a borrowing firm's underwriter not only will have provided underwriting of debt and equity; it also will have developed services sufficient to allow it to assume a preeminent role in advising on most aspects of corporate financing.

The Argument for Corporate Underwriting

The arguments for expanding bank credit-financing services include profitability, synergy with current financing, and the competitive advantage of offering a company "one-stop financing." Along with these advantages of corporate underwriting, Exhibit 2 lists the negatives, namely: (1) potential customer perception of conflict-of-interest between equity underwriting

Exhibit 2. A Summary of the Pros and Cons Associated with Underwriting

CRITERION	STRENGTHS	WEAKNESSES
PROFITABILITY	High sales margin, return on assets	Volatile, business-cycle and interest-rate dependent revenue; high systemic risk.
SYNERGY	Client base is same as for commercial loans and credit; contacts within businesses are senior financial officers; "relationship" natures of banking and underwriting are similar and involve similar knowledge-skill sets.	Many companies do not want to obtain long-term underwriting from the same firms that provide them credit and/or short-term financing.
SCALE ECONOMIES	There are cross-product cost sharing opportunities in image advertising, marketing and back-office operations.	Established firms with skilled personnel, investment in model technology, lack of securities marketing fuction are a significant entry barrier to new entrants.
BUSINESS SIMILARITIES	1. Both commercial lending and underwriting are financial services. 2. Knowledge of financing and financial markets is a key to both businesses.	1. Both commercial lending and underwriting involve business-cycle and interest-rate risk. 2. Employee compensation is primarily via direct salary and perquisite in banking rather than bonuses, commission, or profit sharing.
COMPETITIVE ADVANTAGES	There are many organizational, operational and technical similarities to municipal underwriting. Banks with large calling organizations are often the first source of financing for many companies.	Municipal underwriting is usually won on a competitive bid basis rather than the relationship-service-planning basis upon which most corporate underwriters are selected.
COMPETITIVE DISAVANTAGES	Banks are in regular contact with corporate financial officers. Banks could logically place commercial paper since they have information on companies with investable funds, and their balance reporting services are a natural communications link.	Banks lack the brokerage-based retail distribution required for large-scale national underwritings. Current bank market-making is limited to municipals and government securities rather than corporate debt and equity. Most banks lack the syndication and distribution structures of the investment banks and brokerage firms. Only the most senior officers in commercial banks receive compensation commensurate with that provided professionals in major investment banking firms; top salaries in most banks are for management rather than professional skills although some banks are now using commissions and other incentive structures in security trading, leasing, and consulting but this usually occurs in holding company units outside of the commercial lending area.

and being a provider of short-term credit, (2) competitive disadvantages involved in going up against a partnership-oriented organization with high compensation for the talent required to design and price underwritings, and (3) the need for a distribution capability that would require activities such as full-service brokerage and security market-making.

While underwriting is often viewed as a logical and attractive business, especially the apparent synergy from offering one-stop financing to companies, a close examination of the strengths and weaknesses raises questions about how eagerly banks would enter into corporate underwriting if they received complete securities powers.

The synergy of one-stop financing appears questionable. First, major companies already deal with many banks for credit so that the value of having one of several credit banks provide underwriting seems unlikely to increase administrative efficiency. Second, relying on the same organization for short-term credit and most long-term financing including its underwriting could be viewed as risky because of disadvantages of a company being dependent on a single vendor for two of its most critical needs—short-term credit and access to the capital markets. Third, and most important, most companies would be acutely aware of the conflict of interest between the role of credit granter and short-term lender and the role of underwriter of both equity and bonds.

Corporate financial officers clearly would worry that, in times of financial duress, a bank concerned with the safety of its short-term loans could force an equity offering or long-term debt offering at an inopportune time. Because companies use short-term financing as the primary means for controlling the timing of long-term financing, most would prefer to have one vendor for short-term debt and another for underwriting both long-term debt and equity, rather than relying on "one-stop financing."

Since major companies now deal with several banks and most would not want their major credit banks to be their equity underwriters, it seems that the common assumption regarding the marketing value of a bank's ability to offer one-step financing is dubious for the major companies that comprise most of the underwriting market.

The foregoing has focused on the issue of marketing synergy because some form of synergy is usually cited as the primary argument for bank entry. However, other reasons against significant bank entry into underwriting are also strong.

Profitability and Organizational Structure

Most investment bankers that act as major underwriters are organized as partnerships. The underwriting business is highly covariant with the business cycle and the level of interest rates. Hence, there is significant year-to-year variation in both revenue and income. For this reason, firms find it difficult to pay consistently high compensation even though the business requires talented professionals. A significant portion of pay is given as bonuses rather than base salary, with the bonus reflecting the year's revenue and income. Thus, compensation is variable and much of the firm's risk (uncertainly in revenue and income) is shifted to the professional employees—both partners and non-partner professionals. In addition, the partnership form means that, while the most senior professional employees receive compensation via their partnership shares, they also bear equity risk.

Banks, especially the major banks, cannot easily emulate either the high level of compensation or the employee risk-sharing inherent in bonus and partnership income. First, banker salaries are generally much lower than the averge compensation paid underwriting professionals. Moreover, most banks today pay high salaries only to senior management rather than non-manager personnel providing professional services. Second, if banks were to pay salaries comparable to the compensation in underwriting but without relying significantly on bonus and partnership income, the net effect would be a large salary base and, therefore, a volatile, highly seasonal profit contribution. Moreover, once higher employee compensation requirements are recognized, the actual profitability of underwriting to banks is likely to be much less than the apparent profitability.

In addition, compensation predominantly as salary would mean a high fixed cost that would make underwriting income risky and, thus, less attractive on a risk-adjusted basis than average income would suggest. Finally, banks have only limited ability to tolerate volatile, uncertain income streams because of their highly leveraged financial structure and narrow margins on lending. In sum, it seems quite doubtful that banks are

organizationally able to engage in broad-scale corporate underwriting on a significant scale.[3]

Besides the problems involved in assisting companies with planning long-term financing, other requirements of the business also could prove troublesome for banks. One is the need for a distribution network. Both market-making and full-service brokerage also involve high compensation and highly variable, business-cycle covariant income. Brokers, for instance, typically receive commissions as their primary source of income. Again, commission income is a device for shifting risk to employees in the presence of volatile revenue. But commission income is again a form of compensation alien to the rank-based salary ladders of most major banks.

Bank Underwriting: Synthesis

In summary, it seems clear that full-scale national underwriting is not an easy, synergistic business expansion for banks as they are currently organized. The usually assumed marketing synergy from being able to offer one-stop credit-financing would be of limited value to major companies and may even be rejected as risky and flawed by latent conflict-of-interest problems. Once the necessity of compensating skilled professionals generously is recognized, the apparently high average profitability becomes questionable. Moreover, the volatile, underwriting revenue pattern means that underwriting income is risky, especially if an organization cannot shift risk to employees by relying extensively on bonuses and partnership equity. Finally, the organizational structure of banks and the need to obtain or create market-making and security distribution capabilities constitute further obstacles to bank entry.

These obstacles are formidable. Thus, it seems that few major banks, probably at most five or six, could rationally hope to become full-scale national underwriters. Given the clear risks associated with trying and failing, few major banks would be likely even to attempt aggressive direct entry into full-scale national underwriting even if there were no line-of-business restrictions.

Rather than encouraging direct entry, complete securities line-of-business deregulation most likely would produce gradual expansion of major banks now engaged in municipal debt underwriting and U.S. and municipal-government securities trading into aspects of underwriting. Below are plausible types of underwriting activity for banks.

1. **Commercial Paper Placement.** More banks apparently would become commercial paper underwriters and dealers. A few banks (for example, Bankers Trust Company and Manufacturers Hanover Trust Company) already engage in this activity. In effect, major banks would seek to reestablish their role as short-term borrowing-lending intermediaries between major corporations, a business that has shifted to four investment bankers[4] as the primary intermediaries in dealer-placed commercial paper.
2. **Regional and Middle-Market Underwriting.** Banks now in municipal underwriting may expand into limited underwriting for regional and middle-market companies, especially those not listed on major exchanges. Much of this underwriting would be debt rather than equity and much would be privately placed rather than through public offerings. But the ability to engage in public underwritings would allow banks to fill out their line of services.
3. **Industry-Focused Underwriting.** Some banks may specialize by industry—for example, electric utilities and other regulated companies obligated to obtain competitive bids.
4. **Debt Underwriting.** Some banks might seek to expand their financing for major companies by expanding existing debt-underwriting skills into long-term debt placement and underwriting for high-quality companies, but avoiding equity underwriting.
5. **Underwriting Syndicate Participation.** Besides direct underwriting and debt placement, banks that expand into brokerage or acquire brokerage firms would participate in underwriting syndications. They would act not as a principal but as one of the many participating firms involved in the distribution network created for large underwritings.

Conclusions

Corporate banking services can be placed in three broad categories—investment management, credit-financing, and cash management. Aside from commercial paper placement (which some banks are now entering), corporate cash management services are not curtailed by line-of-business restrictions but only geographical restrictions. In contrast, investment management and credit-financing services are limited significantly by current line-of-business restrictions.

Internal mutual funds and other kinds of commingled fund management, currently prohibited to banks, represent a straightforward business extension of current pension fund and other corporate investment management services. Once banks offer internal mutual funds for their trustee-managed funds, it is also a straightforward business expansion for them to offer mutual funds to the public and to incorporate them in retail cash management accounts patterned on those pioneered by Merrill Lynch and now offered by other brokerage firms, banks and thrifts.

Bank entry into corporate underwriting involves much greater uncertainty in terms of both form and scope. Expanding into underwriting to provide more comprehensive credit-financing appears superficially to provide marketing synergy. But closer analysis suggests that major companies probably will want credit and short-term financing from a source other than their equity and long-term debt underwriters.

Virtually all other factors appear negative also. Thus, few if any banks are likely to become full-scale, full-service national underwriters. If all line-of-business restrictions were eliminated, bank entry into underwriting would be limited to banks already in municipal underwriting or government security market-making and would be focused on smaller regional companies and other specialized services. In addition, those few banks that choose to offer full-service retail brokerage seem more likely to participate as part of underwriting distribution systems rather than as the lead underwriter.

Conversely, investment banks specializing in corporate underwriting are unlikely to enter full-scale commercial banking in terms of direct credit and short-term financing for corporation although they would continue to place commercial paper.

—Bernell K. Stone*

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[1] **Credit** is used as a generic term for any agreement, both contractual and non-contractual, to loan funds up to a specified maximum level. The standard forms are **credit line** (non-contractual commitment to lend at a formula rate such as a prime for a term up to a year), **credit agreement** (contractual commitment to lend for a term up to a year), **revolving credit agreement** (contractual agreement to lend for periods in excess of a year under a variety of rate agreements and possibly with a time-varying upper limit).

[2] The issue of commingling trust assets has been the subject of litigation. The Investment Company Institute challenged Citibank's offering of a commingled fund service in 1969. The courts agreed that there was an implicit security offering and a violation of Glass-Steagall.

[3] An argument to counter the issues of salary form would be to create underwriting as a separate holding company unit so that it could emulate the organizational form of the major underwriting organizations. This device would clearly enable a different salary structure, salary level and organization. But, if it is operated as a separate holding company unit, the market synergy, cross-product cost savings and other arguments for bank underwriting are invalid.

[4] These are Goldman Sachs, A.G. Becker, First Boston and Merrill Lynch.

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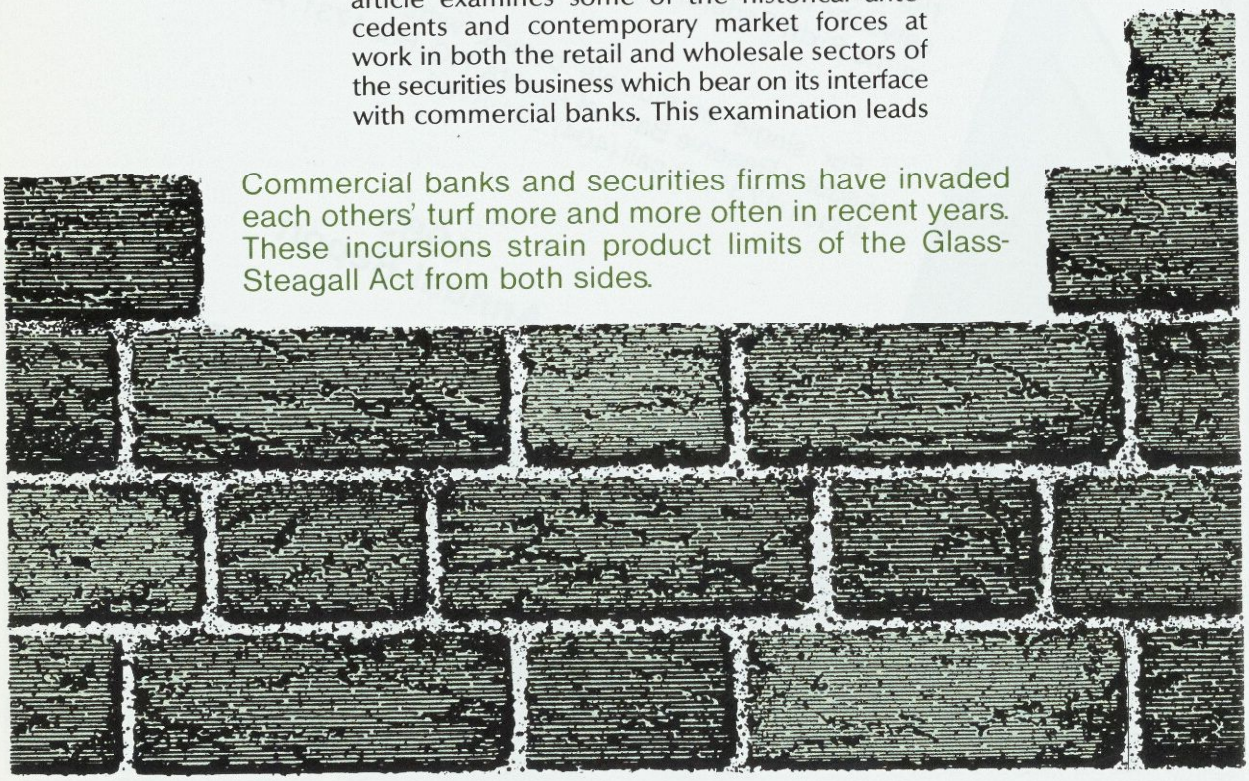
1983
Annual Report

Investment Banking: Commercial Banks' Inroads

The evolving competition between securities firms and commercial banks has come into increasingly sharp focus in recent years. This article examines some of the historical antecedents and contemporary market forces at work in both the retail and wholesale sectors of the securities business which bear on its interface with commercial banks. This examination leads

Commercial banks and securities firms have invaded each others' turf more and more often in recent years. These incursions strain product limits of the Glass-Steagall Act from both sides.



to some suggestions about possible direction and speed of future competitive change in these market sectors.

Historical Evolution

Since 1933, the traditional role of U.S. commercial banks has been reasonably clear; the niches occupied by various groups of securities firms during this period have been less well understood. Some observers see the securities business as a relatively homogeneous activity; others see it as a disparate series of independent, easy-entry "lines of commerce." Neither of these stereotypes mirrors reality. Instead, competitive factors have divided the business more practically into "retail" investor services and "wholesale" services to corporate, municipal and institutional customers.

Securities firms and deposit-taking commercial banks have undergone separate mutations in response to broader developments in financial services, but the historic routes and influences that have brought them to their current positions have much in common. The post-World War II U.S. commercial and investment banking structure grew out of legislation and regulatory interpretation in the 1930s. The Securities Act of 1933, the so-called Glass-Steagall Act, threw up a Chinese Wall between deposit-taking and securities-dealing firms and thus created an industry structure that is mirrored only in Japan, among industrialized countries.

This structural dichotomy survived for several post-war decades without major challenge, perhaps in part because the United States was enjoying an unprecedented era of secular growth accompanied by relatively high savings, nominal inflation and low interest rates. Each group of financial intermediaries was comfortable, protected, and able to prosper within its assigned niche in the industry structure.

The McFadden Act and the Douglas Amendment protected and nurtured local and regional banks and curbed the money center banks' market shares in domestic lending and deposit-seeking. But these large banks diversified and grew by following corporate customers into the largely unregulated international arena. Likewise, insurance companies were major beneficiaries of the post-war institutionalization of savings, and thrifts prospered by fueling the growth in home ownership with fixed-rate, long-term mortgages.

On the other side of Glass-Steagall's Chinese Wall, an ever-expanding base of individual stock ownership and overall market trading volume promoted growth and consolidation within the retail securities sector. Increasing corporate and municipal underwriting volume also yielded attractive profits to the wholesale investment banking sector. Growth in institutional investor demand, which first came into focus in the early 1960s, created yet another dimension for post-war securities industry growth. Over time, that dimension has come to be associated and identified more closely with the wholesale investment banking function.

Meanwhile, beginning in the 1960s, changes in the domestic and world economy conspired to upset the equilbrium in this financial services structure. Several important factors that particularly affected competition between commercial and investment banks were the rise of the Euro-markets, the increasing sophistication of both institutional investors and corporations, and the acceleration of inflation and interest rates in the 1970s, with a consequent realignment of securities values and investor preferences.

"The McFadden Act and the Douglas Amendment protected and nurtured local and regional banks and curbed the money center banks' market shares in domestic lending and deposit-seeking."

Originally minimized in the mid-1960s as a minor and temporary phenomenon, the Euro-markets' evolution into a large and permanent "supra-national" market has created an arena outside the jurisdiction of Glass-Steagall where participation is open to diverse financial institutions willing and able to assume the attendant risks. This market, abetted by the advances in—and application of—electronics technology, has spearheaded the rapid evolution toward a global market in money. Linkage of the various national capital markets with the Euro-markets and accompanying aggressive arbitrage on rates and terms have established money as a truly fungible commodity, whose movement across national and currency frontiers is increasingly difficult to control.[1] It has thus become more and more

compelling for U.S. financial service organizations to accommodate this global market.

In the United States, the inexorable institutionalization of savings had, by the beginning of the 1980s, raised the institutional sector share of the New York Stock Exchange equity wealth to 35.4 percent (from 17.2 percent in 1960) and its 1982 share of equity market trading to 83.8 percent (from 24.3 percent in 1960).[2] Money market funds have grown from nothing in the early 1970s to more than $175 billion at the end of 1983. This institutionalization has loosened the commercial banks' link to the individual saver and focused much of the securities industry's attention on the large portfolio manager.

Corporations also developed and expanded their internal financial engineering capabilities over this period. The growth of the commercial paper market to a mid-1983 annual rate of $123.7 billion (versus $4 billion in 1960)[3] reflects large companies' willingness to substitute these less expensive but potentially more volatile short-term funds for traditional commercial bank lines of credit. This development also has diminished an important, moderate-risk revenue stream for the commercial banks and forced them into other, often more risky funds deployments as well as more costly retail lending avenues. After the oil shocks of 1974 and 1979, this redeployment was evidenced by the much greater volumes of foreign, cross-border loans.

Of the forces that increased the pressure on the financial services industry status quo during the 1970s, accelerating inflation and rising interest rates were among the most pervasive. For many years, savings patterns had been fairly stable. Most individual savings were channeled to commercial banks, thrifts and insurance companies in exchange for a modest interest return.

Although earlier flare-ups in interest rates had failed to disrupt this deposit pattern seriously, inflation and interest rate jumps after the first oil price hike in 1973 appear to have precipitated a structural change in retail savings.

On one side of the Glass-Steagall wall, mandated rate differentials were causing commercial banks and other deposit-gathering institutions to lose deposits to money market funds and other intermediaries capable of adjusting more rapidly to changes in prevailing interest rates. Institutions such as thrifts, holding fixed rate instruments with greatly diminished value, suffered from badly mismatched maturity funding sources on the liability side of their balance sheets. As retail deposits deserted them for substantially better returns elsewhere, their options were to turn to the higher-cost wholesale markets for replacement funds or else sell their assets at substantial losses from their original value. Unlike the commercial banks, they had few alternative strategies for survival until passage of the Garn Act in 1982.

On the securities side of the Glass-Steagall wall, higher inflation and interest rates also created serious dislocations. The consequent downward revaluation in the market prices of securities created disaffection among retail and institutional investors and disrupted the markets for new issues of securities as well as for secondary market trading. Concurrently, inflation substantially increased securities firms' operating costs, especially since their overhead is heavily weighted with the "people" costs and electronics support systems deemed necessary to stay competitive.[4]

Break with the Status Quo. These developments have impelled various financial service institutions to seek out new—and hopefully more promising—business niches. On the deposit-accepting side, various legislative and regulatory changes initiated at the behest of industry lobbyists have facilitated this development. Deregulation of the interest payments permitted on deposits (Regulation Q), for instance, has helped spur an intensive competition for retail deposits. While these deposits are more expensive than they were prior to the deregulatory measures, they are seen as a stabilizing counterbalance to the banks' and thrifts' mismatched asset maturity structures.

"Of the forces that increased the pressure on the financial services industry status quo during the 1970s, accelerating inflation and rising interest rates were among the most pervasive."

To help attract those deposits and to spread the overhead of the infrastructure and marketing costs, banks and like institutions have sought both to broaden their retail product offerings and to explore alternatives for delivering them, including radically different electronic distribution

systems. There also has been a more concerted search, particularly by commercial banks, for additional products and services to strengthen relationships with traditional corporate customers.

In building new ties to both the retail saver and the corporate customer, commercial banks and a variety of other nonbank institutions have moved to break through the Glass-Steagall wall to get into new areas of the securities business. They have noted the growth in securities trading volume and the industry's greatly enhanced revenue stream.

Securities firms focusing on individual investors, however, have not themselves been comfortable with their own situation. They recognize that a large part of their profit derives from their role as banker for their customers and that their own historic "deposit base" (free credit balances), like that of the traditional deposit-taking institutions, has come under attack from the money market funds and other higher-yielding instruments. They have responded in part by creating their own in-house savings vehicles to hold those deposits and by creating an even wider variety of products and services both to retain customers and to spread their overhead across a wider base.

A consequence of that deposit-protecting and product diversification strategy has been for securities firms to emulate competing financial intermediaries on the deposit-taking side of the Glass-Steagall wall. They have initiated moves to break through that wall into the territory of the commercial banks, thrifts and insurance companies by offering de facto checking and savings accounts, consumer loans, home mortgages and various insurance products.

"In building new ties to both the retail saver and the corporate customer, commercial banks and a variety of nonbank institutions have moved to break through the Glass-Steagall wall to get into new areas of the securities business."

These retail brokerage firms also have sought to combat accelerating overhead and squeezed margins by attempting to integrate backward into the "manufacture" of their financial products. They have created special "think tank" groups to devise new marketable instruments such as unit trust, tax-advantaged investments and various "stripped" securities. It also has propelled them into a more active competition for leadership in new corporate underwritings, thus obtaining securities that are typically attractive products for their retail (and institutional) clientele and whose management and underwriting fees add incremental revenue to the selling commissions they traditionally have received.

Both retail securities firms and commercial banks have noted that wholesale investment firms were not hurt seriously by any of the major international or national money market developments in which their institutional and corporate customers were active during the 1970s and early 1980s.[5] To be sure, the banks often were prodded into making massive incremental investments of people and money to accommodate structural changes in their institutional and corporate markets. But they found ways to cushion their revenues even when the volume of underwritings declined cyclically.[6] The activities and employment within these firms increased dramatically during the 1970s,[7] and profitability held up much better than was true for the retail brokerage firms.[8] Notably, one of the wholesalers' diversifying moves was into the lucrative high-net-worth sector of the retail brokerage business—primarily because it was a profitable exploitation of their in-place research and trading activities rather than as a way of ensuring distribution for their underwritings.

These competitive "migratory" moves are noteworthy. Some of them appear to be in defiance of the spirit, if not the letter, of the 1933 act. Challenges to the long-held interpretation of the limits on business activity imposed by the act surfaced only as a result of economic and competitive forces in a more fragile and volatile environment. Industry competitors began to discover that, like the Wizard of Oz, the Glass-Steagall wall was much more formidable in appearance than in reality. Once tested by restive competitors with inventive legal counsel in an environment generally sympathetic to deregulation, gaps opened up that allowed competitors to cross through the wall in both directions.

It is still too early to predict with confidence the durability or success of many of these competitive moves. Nonetheless, we can learn something about their dynamics by looking at specific market segments. To do that, let us search for likely longer-term competitive patterns in two segments of the securities business.

Retail Discount Brokerage

An industrial organization view of the retail securities sector would depict a number of traditional, full-service brokers in the center, with individual savers on the one hand and the various capital users on the other. Primary and secondary transactions in traditional stocks and bonds have declined in importance as new products, many of them devised by the firms themselves, have grown in variety and volume.

A number of new firms have entered this business in recent years, including wholesale securities firms seeking to skim the cream through appeals to wealthy customers and discount brokers aiming at the price-sensitive, independent investor. Discount brokers emerged after securities commission rates were deregulated on May 1, 1975. In the immediate aftermath, rates on institution-sized transactions fell by almost 50 percent, whereas rates on trades under 200 share actually rose by almost 10 percent.[9] During the first couple of years of the negotiated commission era, the retail discounters made little progress, perhaps in part because of inertia on the part of individual investors. The discounters' market share began to grow materially after 1977, however, and by the beginning of 1984 fully 14 percent of the retail trades on the New York Stock Exchange were handled by discount brokers.[10]

Commercial banks and thrifts moved into discount brokerage beginning in 1982.[11] Many leading money center banks have acquired or affiliated with established discount brokerage operations.[12] Other banks have set up their own operations but clear the trades through a conventional securities firm.[13] In some instances, commercial banks and thrifts have even invited brokerage firms to set up booths on their banking floors, much as Dean Witter is doing within the retail stores of parent Sears, Roebuck.

The number of commercial banks and thrifts offering brokerage services has grown from virtually none in 1981 to an estimated 1,500 at the end of 1983.[14] One market observer has predicted that, with the growing participation of the commercial banks, discounters' share of the retail securities market could grow much larger within the next several years.[15]

With the effective neutralization of the Glass-Steagall legal barrier that had prevented banks from offering brokerage services, the question remains whether economies of scale or other barriers will inhibit the commercial banks, thrifts and others from maintaining a sustained presence in the retail brokerage business.[16] In an earlier study, Irwin Friend and Marshall Blume suggested that economies of scale are relatively modest in the brokerage business. Certainly these new bank entrants, whose overhead costs are largely covered by other service activities, appear to enjoy a current price advantage over full-service brokerage firms. That could change as the full-service brokers cut costs and spread their remaining overhead across an ever-broadening array of products and services. It could also be altered if commercial bank entrants move from discount transactions into a more full-service configuration. While trade reports indicate several banks have abandoned brokerage operations because of disappointing profits, the primary motivation for a number of others may be different. If this activity generates incremental retail deposits and other attractive retail "cross-selling" opportunities, it may become a permanent fixture in the banks' product line regardless of its profitability.

Wholesale Services

In contrast to the fluidity of the retail sector, the wholesale securities sector, catering as it does to corporate, municipal and institutional clienteles, is resisting intrusion more effectively. That appears to be the case from the viewpoint of either an aspiring retail securities firm trying to integrate backward into product "manufacture," or a non-traditional intermediary attempting to penetrate the wholesale business.

"The number of commercial banks and thrifts offering brokerage services has grown from virtually none in 1981 to an estimated 1,500 at the end of 1983."

Competitive patterns in the wholesale sector appear to differ materially from those in the retail sector. A variety of investment banking intermediaries are competing for the business of increasingly sophisticated capital-raising corporate clients on the one hand, and a group of "savers"

Table 1. Dollar Revenue Concentration: Combined Negotiated and Competitive Securities

(all $ figures are in millions)

	1970	1971	1972	1973	1974	1975	1976	1977	1980	1981	1982
Debt											
Top 4%	32	30	32	36	47	42	42	42	41	39	45
Top 8%	53	50	56	62	68	66	64	67	63	60	64
Top 15%	80	77	79	89	89	88	88	92	86	84	87
TOTAL UNIVERSE $	139	141	92	48	140	198	194	153	748	920	1,704
Equity											
Top 4%	44	31	29	30	49	41	39	46	44	41	43
Top 8%	67	51	51	53	72	65	62	67	68	65	67
Top 15%	97	75	77	80	93	89	89	92	88	87	90
TOTAL UNIVERSE $	109	268	263	134	86	211	181	159	346	350	289
Debt & Equity											
Top 4%	33	27	27	33	44	39	36	41	42	41	45
Top 8%	55	47	47	53	63	61	58	64	62	60	65
Top 15%	80	73	76	79	87	87	84	91	88	84	88
TOTAL UNIVERSE $	253	408	355	182	227	409	375	312	1,053	1,220	1,948

Source: Securities and Exchange Commission Data (1970-1977) released to author/Securities Industry Association (1980-1982) as provided by NYSE adjusted for "Universe" of top 25 firms. Data for 1978 and 1979 were not available from the NYSE.

heavily dominated by sophisticated institutions investors on the other hand. The growing competences of the traditional corporate clients and the heavily reinforced staffs of the wholesale securities firms[17] have accelerated the pace of "new product" and service innovation. Increasingly, the character of innovation has drawn on the secondary market intelligence generated by the wholesalers' trading floors. A number of firms have even moved part of their corporate finance groups down to those trading floors to provide better what their corporate clients identify (and pay for) as "value-added" services.

Some wholesalers entered the institutional markets seriously in the early 1970s as a defensive move to service their corporate clients better. Others that already had substantial positions in trading used this as a lever to obtain new corporate business. The institutional investors, for their part, have escalated the quid pro quo for their business, so that to be an investment banking participant in the institutional services (and therefore the corporate) sector requires a large commitment of capital and human resources. For some wholesalers the serious commitment to trading was originally a means to an end, but in some instances that activity has become so large that it rivals the firms' corporate finance activities.[18]

Retail securities firms' efforts to integrate backward into this wholesale sector have been modestly successful at best. The top eight wholesale firms' grip on various parts of the business has, if anything, grown stronger in recent years. This is true in the underwriting of corporate securities, whether one looks at a volume of corporate securities managed [19]or revenues from corporate underwriting activities (see attached exhibit). The same also holds true for municipal finance,[20] for perceived trading competence among institutional clients [21] and for the lucrative merger and acquisition counseling business.[22]

Several new or potential entrants to the securities market have emerged. They include foreign banks, with their merchant banking skills developed and refined in traditionally integrated

commercial and investment banking home market settings and in the Euro-markets.[23] They also include a variety of businesses that recently have purchased securities firms with some representation in the wholesale market. Among these are insurance companies (like Prudential), merchandising companies (like Sears), and financial services companies (like American Express). In addition, more and more money center and regional commercial banks have shown interest in parts of the wholesale market which they believe are not closed to them by the Glass-Steagall Act.[24]

These potential entrants believe they have the regulatory license to compete in a wide range of activities. For the commercial banks, some of the more important include Euro-market foreign exchange hedging, underwriting, lending and trading; U.S. government bond underwriting and trading; interest rate futures; general obligation, municipal underwriting and trading; mortgage-backed securities trading; real estate financing; taxable and nontaxable private placements; mergers and acquisitions; venture capital and leveraged buyouts; financial counseling; leasing and portfolio management.

Viewed from a national market perspective, the commercial banking group enjoys major positions in Euro-financing,[25] leasing,[26] and portfolio management.[27] Until now, they have been excluded from underwriting corporate securities[28] and severely restricted by Glass-Steagall's prohibition on revenue bond financing, which in recent years has constituted approximately three-quarters of municipal underwriting volume.[29]

In the areas of taxable private placements and mergers and acquisition counseling, no legal barriers prevent overt commercial bank competition with securities firms, and yet the results have been disappointing from banks' perspective. Their penetration in private placements has been quite modest, although growing,[30] and their share of mergers and acquisitions assistance at the national level thus far has been nominal.[31] In venture capital, neither commercial banks nor the cadre of leading securities firms have had much impact thus far, although commercial banks have been increasingly active in leveraged buyouts and both groups profess a major interest in venture capital for the future.[32]

Commercial banks have had a similar record at the regional level. Several regional banks have established "investment banking" or "corporate finance" departments,[33] usually well-separated from commercial lending activities. They offer a variety of services, including private placements, mergers and acquisitions, financial consulting, venture capital, leveraged buyouts, valuations and appraisals, various types of asset-based financing and international financing accommodations. Full-time personnel and revenues tend to be modest; these departments typically have had limited success in mobilizing the sponsoring banks' resources and momentum on behalf of these investment banking activities.

In sum, despite efforts to penetrate the wholesale securities markets, the commercial banks' overall record thus far has been unimpressive. In view of their professed interest in wholesale corporate finance, what are the prospects for the future?

Aside from the regulatory constraints discussed above, future progress for many commercial banks may hinge in part on their ability to sell corporate customers on the banks' professional capabilities in providing investment banking services.

It also will hinge on banks' ability to convince themselves that they have those capabilities.

"Corporate underwriting leadership increasingly depends on quick and deep access to institutional investors that can be assured only by a continuous presence in the secondary markets."

Two important aspects of the wholesale investment banking business seem clear: (1) activities within this sector tend to be interdependent and (2) the successful players in this market have made an important accommodation to the "culture" of investment banking, with its attendant risk and reward structure and high level of personal commitment.

The Interdependent Parts. Many of the key activities in wholesale investment banking are not isolated "lines of commerce" in the classic economic sense but rather "joint product" activities that are, to one degree or another, actually interdependent. A leadership position in the annual underwriting "league tables," for instance, is

treated by investment bankers as tangible evidence of their market presence and overall corporate finance skill, and is used as a selling tool to convince current and potential corporate clients of their acumen in such areas as financial counseling, private placements and, very lucratively, mergers and acquisitions.

Corporate underwriting leadership increasingly depends on quick and deep access to institutional investors, an access that can be assured only by a continuous presence in the secondary markets. That ongoing market activity, in turn, depends not only on the commitment of people and capital; it also depends on "product" that provides the excuse for securities salesmen to maintain daily contact with institutional portfolio traders and elicit a steady flow of transactions.

Wall Street's response to the introduction of Rule 415 "shelf" registrations demonstrates that investment bankers understand this interlocking system and act accordingly. When the Securities and Exchange Commission first began "shelf" registrations on a trial basis in March 1982, it expressed hope that the introduction of de facto competitive bidding on these offerings would not only yield savings to corporate issuers but also would boost competition by opening the market to a broader array of competing underwriters.[34]

"Despite efforts to penetrate the wholesale securities markets, the commercial banks' overall record thus far has been unimpressive."

While corporate issuers have realized significant savings,[35] the leading wholesale firms' responses have further concentrated, not broadened, the group of competing intermediaries.

These traditional underwriting leaders, as noted, have continued to consider high standings in the annual underwriting "league tables" important in soliciting business in other areas. In addition, because they are continually under pressure to generate adequate volumes of marketable products to feed their institutional trading and distribution networks, the "shelf" registrations, representing well-known credits, are often attractive acquisitions.

Perhaps most important, the traditional underwriting leaders have continued to hold onto their ties with certain corporate clients. They act as though the loss of a client's "shelf" offering to another investment bank could pose a threat to that relationship, with its prospects for other profitable pieces of business.

Thus, in most instances, these traditional leading wholesale investment banking firms have stepped in and aggressively (and often successfully) bid for their clients' 415 offerings. Having won the bid, these underwriting firms often have omitted or sharply curtailed the size of the distribution syndicates, thus further concentrating the new issue business. Investment banks' behavior in connection with "shelf" registrations helps clarify the interlocking nature of the corporate (wholesale) services business as well as the competitive response that leading securities firms could be expected to make to a new group attempting to enter this market.

Commercial banks, which in theory could be serious competitors in the corporate market, are blocked from a more effective challenge, in part because they lack access to some key components in the interlocking portfolio of products and services. They are legally barred not only from corporate underwriting and trading but also from the big volume industrial revenue bond business. This, in turn, has denied them access to other key components of the product and service "system." The commercial banks cannot aspire to the visibility and stature of a leadership position in corporate underwriting. They cannot benefit from the interaction with corporations that would follow from day-to-day trading in their securities. Absence from the corporate and revenue bond trading markets also can hamper them in providing the latest pricing intelligence to these corporations when new financing strategies are being formulated.

It is not surprising, therefore, that the investment banks have been tenaciously fighting any change in the prohibition on revenue bond underwriting by commercial banks. It probably is not fear of inroads into the profitable revenue bond market that galvanizes investment banks, but rather the spectre of commercial banks gaining greater momentum in secondary market trading and then arguing with credibility for authority to apply that acumen to the U.S. corporate securities markets.

competence that could wrest important fee-based corporate business from the current wholesale investment banking leaders.

The Bankers' Mindset. While some commercial bankers believe that the only thing standing between them and the wholesale investment banking business is Glass-Steagall, it is much less certain that commercial banks as a group could penetrate this market rapidly if these regulatory barriers fell. Even putting aside the massive counterattack that leading investment banks could be expected to launch, the traditional "mindset" of commercial banks' management could inhibit successful penetration of investment banking.

While the investment banks talk confidently of their ability to continue fielding the most competent resources in each of their business sectors, they may well fear the trading power that commercial banks might muster. From an initial strategy of "buying" leadership in high volume corporate underwritings such as "shelf" registrations, and by aggressive trading and principal positioning in the "commodity" end of the secondary markets with the help of their huge capitalizations, commercial banks (and certain other non-traditional entrants) subsequently could move into greater value-added products. Like Salomon Brothers, they might parlay that trading initiative into a credible, broad-based corporate finance

Field interviews suggest that commercial banks have found it difficult to link the competence and skills of their investment banking groups with their much larger core of lending officers. Some lending officers' reluctance to become familiar with investment banking product and service possibilities and to promote them to corporate customers may indicate a "mindset" that resists change and fears encroachment by investment banking specialists onto their traditional business "turf."

Envy and resentment at the elite status usually accorded a bank's investment banking personnel also may play a part in some lending officers' unenthusiastic response. These "corporate finance" professionals often are relatively young, deal in what is seen as a more glamorous mix of problems, and have access to the corporate customer group's highest management levels. Lending officers, by contrast, often interact with staff further down the organizational hierarchy. The investment banking staff members usually are paid substantially more than other bank officers, given comparable age, time-in-grade and experience. The managements of some leading money center banks believe they already have crossed the psychological barrier to sharply higher compensation levels for their corporate finance and securities trading professionals.[36] Yet at most banks there has been insufficient experience to predict how well mainstream personnel will react to compensation levels of a half million dollars or more for fast-track corporate finance professionals still in their 30s!

Similarly, commercial bank and other non-traditional entrants into investment banking must be prepared to absorb the vicissitudes of the securities block positioning and trading business. As mentioned earlier, a substantial presence in the institutional trading area has become a sine qua non among serious competitors for corporate service business. Inventory levels have risen dramatically in recent years[37] in the face of increasingly volatile securities markets. While hedging strategies have sought to dampen capital risks considerably, players must be prepared to absorb large, unexpected swings in securities inventory values.

On the positive side, commercial banks can point to gains in trading skills and the assimilation of a supportive culture through participation in several arenas, including the domestic market for U.S. government securities, the Euro-markets, the ongoing management of the banks' liability structure, and the emerging secondary markets for commercial, industrial and foreign loans.

"Changing economic and demographic patterns have broken the longstanding status quo that prevailed in the post-World War II financial services industry."

More than a dozen U.S. money center banks[38] are recognized dealers in government securities. These markets are so large and liquid that they often serve as the benchmark from which securities in other markets are priced, either directly or indirectly. Thus, banks actively participating in these markets have been able to hone their trading skills and related management systems in anticipation of later access to the corporate securities markets.

Euro-markets have offered commercial banks another arena in which to gain securities market experience, and some of the large U.S. multinational banks have become important participants there. While underwriting syndicates have been active in that market since the 1960s, secondary markets in Euro-securities are a relatively recent phenomenon. Nevertheless, several U.S. money center banks have already captured significant positions in these markets. Some U.S. commercial banks have developed impressive worldwide financial networks with which to exploit the evolving global market for money.

As commercial banks and other deposit-taking institutions have moved from primary dependency on savings and demand deposits toward greater reliance on the "wholesale" money markets, they have been propelled into an active trading mode. The constant money-raising efforts of banks' treasury operations and the increasing use of forward hedges and other sophisticated risk-management techniques to accommodate the gap between asset and liability maturities have fostered skills that find ready application in investment banking.

Similarly, on the asset side of their balance sheets, many commercial banks are moving toward a "transaction" as opposed to a "yield" management philosophy, in which each asset is priced as though it were a candidate for resale. As regulatory pressures have mounted on commercial banks to improve their capital bases relative to loans outstanding, one goal has been to increase the velocity of asset turnover through the temporary or permanent sale of their domestic loans [39] to correspondent bank, and institutional or foreign investors willing to take a slightly smaller spread. Thus, the selling bank is able to reduce its asset base, improve its loan-to-deposit ratio and enhance the return on those assets. It also can foster a transaction orientation among lending officers that supports the development of a trading culture.

Conclusions

Changing economic and demographic patterns have broken the longstanding status quo that prevailed in the post-World War II financial services industry. Each part of that industry has reacted differently to these changes, reflecting competitive dynamics specific to a particular niche. This pattern is mirrored in the intrusion of commercial banks into the securities business. Entry into discount brokerage has been quite rapid because there appear to be few barriers. Penetration of the wholesale investment banking business has been slower and more difficult. Regulatory barriers limit banks' ability to offer the trading and underwriting services necessary if an institution is to compete successfully in the wholesale securities business. The securities industry has recognized this and has moved in both the markets and the courts to limit banks' entry. Even removing regulatory barriers would not assure banks of rapid success, however. Despite the experience and success some banks have gained in permitted securities activities, they must learn to manage differences between commercial and investment banking cultures in order to penetrate the wholesale securities market.

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NOTES

[1] See, for instance, Theodore Leavitt, "The Globalization of Markets, **Harvard Business Review**, (May-June 1983), p. 92.

[2] **New York Stock Exchange Fact Book**-1969, p. 48.
New York Stock Exchange Fact Book-1983, p. 8.

[3] **Federal Reserve Bulletin**, (January 1961), p. 192. Federal Reserve Statistical Release dated December 30, 1983.

[4] See, for instance, **Staff Report on the Securities Industry in 1979**, published by the Securities and Exchange Commission.

[5] Ibid.

[6] Samuel L. Hayes, III, A. Michael Spence and David Van Praag **Marks. Competition in the Investment Banking Industry** Cambridge: Harvard University Press, 1983) p. 44.

[7] Samuel L. Hayes, III. "The Transformation of Investment Banking, **Harvard Business Review**, (January-February 1979) p. 153.

[8] See various staff reports of the Securities and Exchange Commission based upon "Focus" data supplied by the New York Stock Exchange.

[9] **Staff Report on the Securities Industry in 1979**, published by the Securities and Exchange Commission, p. 47.

[10] William B. Hummer. "Bankers March on Discount Brokerage," **Bankers Monthly Magazine** (January 15, 1984) p. 27.

[11] Chemical Bank made an earlier abortive attempt to enter the brokerage business in the 1970 s

[12] For instance in January 1983 Bank of America acquired Charles Schwab & Company and Chase Manhattan acquired Rose & Company.

[13] Pershing & Company, a division of Donaldson, Lufkin & Jenrette, provides trading and clearing services to banks as do a number of other securities firms.

[14]Hummer, in work cited, p. 26. Other estimates range considerably higher than this number.

[15]Hummer, in the work cited, p. 26.

[16]Irwin Friend and Marshall Blume. "Competitive Commissions on the New York Stock Exchange," **The Journal of Finance**, (September 1973), p. 795.

[17]Samuel L. Hayes, III. "The Transformation of Investment Banking, **Harvard Business Review**, (January-February 1979), p. 153.

[18]**New York Stock Exchange Fact Book**-1983.

[19]A. L. Adams, "Salomon's Number One, **Investment Dealers' Digest**, (January 17, 1984) p. 8

[20]**Municipal Securities Markets-1983**, published by the Public Securities Association, (February 29, 1984).

[21]See results of Greenwich Research surveys, as reported in various issues of the **Wall Street Letter** (published by **Institutions Investor).**

[22]"1983 Mergers and Acquisitions Tombstone Talley, **Corporate Financing Week**, (January 30, 1984), a publication of **Institutional Investor.**

[23]Dwight B. Crane and Samuel L. Hayes, III. "The New Competition in World Banking, **Harvard Business Review** (July-August 1982) pp. 88-94.

[24]Almost all of the money center banks have at least a corporate finance group. The **United States Commercial Bank Corporate Finance Directory-1983**, compiled by officials at Northwestern National Bank of Minneapolis, lists corporate finance groups for nine New York City banks, thirteen regional money center banks and eight other regional banks.

[25]"The International Sweepstakes," **Institutional Investor**, (September 1983), p. 213.

[26]The American Association of Equipment Lessors reports that, using either equipment cost of $32 billion or total receivables outstanding of $62 billion, commercial banks presently hold approximately 28% of the outstandings, compared to 34% for independent leasing companies and 13% for captive finance companies.

[27]Federal Deposit Insurance Corporation, "Trust Assets of Insured Commercial Banks-1977, Washington, D. C., **Forbes**, (April 17, 1978.)

[28]Bankers Trust, however, has recently engineered a "private placement of a Rule 415 "shelf registration securities and is being challenged in the courts by the Securities Industry Association for undertaking a de facto corporate underwriting.

[29]**Municipal Securities Markets-1983**, published by the Public Securities Association, (February 29, 1984).

[30]See, for instance, **Corporate Financing Week**, Vol. IX, No. 5 (February 7, 1983). In reporting on the top 15 leading intermediaries in private placements it notes that "Bank of America, the only bank on the 1981 list, didn't make it in 1982. No banks made it in the 1982 rankings, but Bankers Trust came the closest, finishing 16th.

[31]"1983 Mergers and Acquisitions Tombstone Tally, **Corporate Financing Week**, (January 30, 1984), a publication of **Institutional Investor.**

[32]See, for instance, M. Blumstein, "Morgan Stanley Fights for No. 1, **New York Times**, (April 1, 1984).

[33]**United States Commercial Bank Corporate Finance Directory-1983**, in the work cited.

[34]See, for instance, hearings, before the Securities and Exchange Commission on Rule 415, Jan 28-July 2, 1982.

[35]See, for instance, M. W. Marr and G. R. Thompson, "Shelf Registration and the Utility Industry," Virginia Polytechnic Institute and State University, Blacksburg, Virginia, (June 30, 1983).

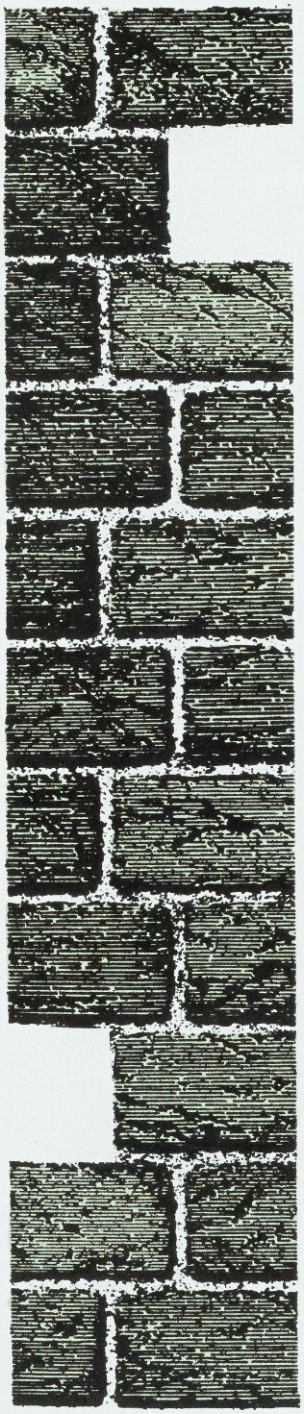
[36]G. Hector. "Bankers Trust Takes on Wall Street," **Fortune** 109 (January 9, 1984) pp. 105-107.

[37]See **Staff Report on the Securities Industry in 1979**, other years, Securities and Exchange Commission.

[38]The "Recognized Dealers" include: Bank of America, Bankers Trust, Chase Manhattan, Chemical, Citicorp, Continental Illinois, Crocker National, First Interstate, First Chicago, Harris Trust, Morgan Guaranty, Northern Trust, Manufacturers Hanover and Bank of Boston.

[39]There have also been reports of the creation of an informal secondary market for LDC loans, particularly in the case of Mexico. See Gary Hector, "The Banks' Latest Game: Loan Swapping," **Fortune**, (December 12, 1983), p. 111.

Conclusion

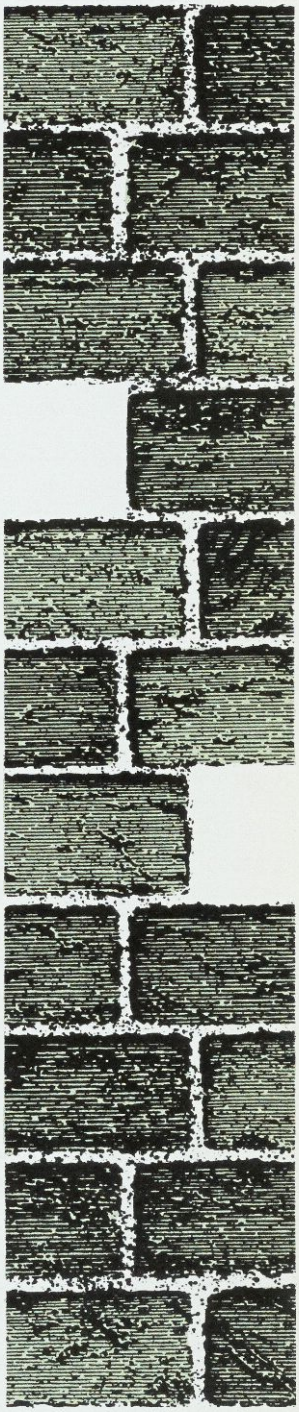


This **Review** has analyzed the consequences of expanding the array of financial products commercial banks may offer. The important questions are the impact of product deregulation on the safety and soundness of the banking system and on the concentration of financial power. The material here indicates there is little to fear from deregulating the financial products banks may offer. Indeed, there may be benefits for bank customers.

Safety and Soundness

This issue analyzed the potential risks to banks both of adding activities and of failing to add activities. The appropriate concern when considering the potential risk of allowing an additional activity is not the activity alone, but how the activity contributes to total risk exposure of the bank. A review of the relevant literature suggests that some new financial activities actually have the potential to decrease the risk exposure of banks. The literature also shows that acquisitions of financial firms do not necessarily change the acquiring firm's risk.

Management of the new activities determines whether potential risks become actual. Banks may already take substantial risks on their loans, securities, futures and options dealings, maturity matches and many other types of activities. U.S. banks engage abroad in many ventures forbidden at home. The evidence shows that U.S. banks have generally—not always—managed these risks competently. There is little reason to expect that managements will mismanage new domestic risks. New activities can be managed in a manner that will stabilize or even diminish risk to the individual bank and to the financial system. Providing incentives to limit risk is a crucial consideration. Today's deposit insurance and discount window arrangements actually provide incentives for risk by reducing the exposure of both depositors and shareholders. Adjusting these environmental factors to shift the risk on to the private sector would impose useful market discipline. These issues are already being widely discussed, so we have not focused on them here.



Failure to deregulate carries its own risk. Firms offering insurance, investment banking and real estate services are already invading the traditional financial service markets of banks, while banks are constrained from offering these traditional products. If less regulated firms are able to attract significant amounts of bank liabilities to less-regulated sectors, the financial system's safety and soundness will be reduced. Ensuring both intermediation and payments is important. Although nondepository contenders pose little threat to either of these systems in the short run, in the longer run, larger shifts of deposits and payments activity into less regulated sectors could weaken the safety of the financial and payments systems. Allowing banks to compete more broadly might delay or prevent that prospect.

Concentration and Competition

Proposals to broaden banks' permitted activities also have raised concerns about concentration of economic resources and competition. Overall, however, concentration, tie-in requirements and conflicts of interest apparently would be reduced, not encouraged,by the relaxation of product restraints on banks. Many competitors from several industries would be vying for financial services business. New entrances are generally more innovative and market-sensitive.This would increase the number of alternatives available, encouraging competition, and decreasing economic concentration.

Fears that cross-industry mergers will concentrate political and social power still trouble some regulators and economists. Policymakers lack hands-on experience with the potential structural changes resulting from broad financial deregulation and are not entirely sanguine about its ultimate effects on financial power. Laws limiting the size of cross-industry mergers would limit any natural tendencies toward concentration, if they exist. Size limits for merging firms would have to be considered carefully to ensure that they gave no advantages to firms that are already large and that they did not unduly limit firms' ability to increase efficiency by capturing economies of scale and scope.

Current laws, regulations and market factors serve to limit significant increases in concentration. The evidence suggests that concern about conflicts of interest and tie-ins are largely unwarranted. Users of financial services would be able to spurn financial organizations that demanded unreasonable tie-ins because deregulation should actually increase, not reduce, the number of alternative suppliers of financial services.

Customer Benefits

Surveys indicate that users of financial services desire broader product offerings from financial institutions. The public apparently believes it would benefit from some removal of activity limits. This expected benefit must be balanced against broader concerns about safety and concentration, of course. We surveyed household customers on their reactions to broader powers. Households generally responded positively. Those in the lower-and middle-income groups affirmed a stronger preference for making a wide array of product offerings available at single institutions. High-income consumers place a premium on receiving financial advice and information from a broader range of suppliers. Some households expressed strong preference for a commercial bank as their full-service provider. Asked what services they would like to see added to banks' present capacities, consumers indicated a preference for insurance, and stock and real estate brokerage services.

An analysis of probable business reactions to broader bank activities indicated that they would like to see an increased range of bank products, including management of comingled funds and, for some smaller firms, securities underwriting and retail distribution. Larger firms do not consider securities underwriting by banks to be particularly necessary. Judging from the evidence, current limits on banks' securities and underwriting business apparently have little impact on these businesses.

Lessons from the Securities Industry

Banks' current activities in the securities industry exemplify at least three things about product limitations: First, product limits may increase risk-taking as well as reduce it. Limits on banks' underwriting and trading activities, for example, may limit banks' ability to offer the narrow range of permitted securities services profitably. Second, product limitations may reduce banks' ability to serve customers. Securities

limitations apparently make it difficult for banks to provide the full services necessary to establish ongoing relationships with wholesale customers. Finally, removal of product limits need not mean that banks will increase substantially their share of new markets. For example, banks have fared poorly in securities activities for cultural reasons, in addition to regulatory restrictions.

Summing Up

Skeptics express concern that further deregulation could increase banks' and the financial systems' risk, spawn conflicts of interest or allow a dangerous concentration of financial power. This **Review**, however, has shown little threat that the banking system would be undermined by permitting banks to diversity into a broader range of activities. Most bankers have shown themselves to be competent and they will remain competent if regulatory prohibitions are relaxed. Capable managers can conduct potentially risky ventures safely, just as irresponsible ones can make "safe" activities hazardous. Reform of deposit insurance and the discount window,currently being debated, would help discourage bankers from taking inappropriate business gambles.

On balance, customers would benefit from an expansion of the products commercial banks are permitted to market. Customers for financial services would be likely to benefit from stimulated competition if banks were allowed to diversify into such areas as securities brokerage, insurance and real estate. Further, some customers expect to benefit from being able to buy more financial services from the same institution.

FINANCE

STATISTICAL SUPPLEMENT

$ millions	MAR 1984	FEB 1984	MAR 1983	ANN. % CHG.
UNITED STATES				
Commercial Bank Deposits	1,333,868	1,326,657	1,240,595	+ 8
Demand	302,556	299,371	291,377	+ 4
NOW	88,815	87,544	72,737	+22
Savings	356,733	352,739	304,431	+17
Time	622,999	619,272	603,360	+ 3
Credit Union Deposits	50,194	49,687	48,480	+ 4
Share Drafts	5,249	5,120	4,584	+15
Savings & Time	44,962	44,492	43,471	+ 3
SOUTHEAST				
Commercial Bank Deposits	153,046	151,756	138,502	+11
Demand	36,148	35,799	34,446	+ 5
NOW	11,645	11,416	9,685	+20
Savings	40,340	39,730	33,342	+21
Time	69,155	68,513	64,198	+ 8
Credit Union Deposits	5,816	5,749	5,058	+15
Share Drafts	515	494	372	+38
Savings & Time	5,200	5,137	4,303	+21
ALABAMA				
Commercial Bank Deposits	15,922	15,798	14,740	+ 8
Demand	3,770	3,741	3,516	+ 7
NOW	1,047	1,031	3,516	-70
Savings	3,264	3,222	2,816	+16
Time	8,416	8,305	7,986	+ 5
Credit Union Deposits	928	922	855	+ 9
Share Drafts	91	88	71	+28
Savings & Time	810	797	729	+11
FLORIDA				
Commercial Bank Deposits	54,443	53,777	47,796	+14
Demand	13,063	12,941	12,487	+ 5
NOW	4,850	4,764	4,116	+18
Savings	19,007	18,685	14,954	+27
Time	18,733	18,609	17,190	+ 9
Credit Union Deposits	2,525	2,498	2,285	+11
Share Drafts	238	248	198	+20
Savings & Time	2,144	2,121	1,804	+19
GEORGIA				
Commercial Bank Deposits	22,504	22,201	19,564	+15
Demand	6,940	6,739	6,178	+12
NOW	1,523	1,493	1,275	+19
Savings	5,090	4,964	4,304	+18
Time	10,168	10,044	8,714	+17
Credit Union Deposits	1,219	1,201	962	+27
Share Drafts	79	74	39	+103
Savings & Time	1,161	1,150	861	+35
LOUISIANA				
Commercial Bank Deposits	25,577	25,572	24,201	+ 6
Demand	5,706	5,777	5,835	- 2
NOW	1,530	1,499	1,295	+18
Savings	5,497	5,451	4,495	+22
Time	13,427	13,335	13,077	+ 3
Credit Union Deposits	206	203	163	+26
Share Drafts	24	23	13	+85
Savings & Time	199	197	154	+29
MISSISSIPPI				
Commercial Bank Deposits	12,012	11,923	11,147	+ 8
Demand	2,396	2,419	2,322	+ 3
NOW	843	841	757	+11
Savings	2,499	2,480	2,027	+23
Time	6,610	6,506	6,302	+ 5
Credit Union Deposits	*	*	*	
Share Drafts	*	*	*	
Savings & Time	*	*	*	
TENNESSEE				
Commercial Bank Deposits	22,588	22,485	21,049	+ 7
Demand	4,273	4,182	4,108	+ 4
NOW	4,273	4,182	4,108	+ 4
Savings	1,852	1,788	1,367	+35
Time	4,983	4,928	4,746	+ 5
Credit Union Deposits	11,801	11,714	10,929	+ 8
Share Drafts	63	61	51	+24
Savings & Time	886	872	755	+17

	MAR 1984	FEB 1984	MAR 1983	ANN. % CHG.
Savings & Loans**				
Total Deposits	643,174	637,308	579,199	+11
NOW	19,092	18,669	16,053	+19
Savings	174,626	173,594	174,957	- 0
Time	453,085	448,738	391,195	+16
	FEB	JAN	FEB	
Mortgages Outstanding	487,561	483,845	472,529	+ 3
Mortgage Commitments	29,513	27,524	17,512	+69
Savings & Loans				
Total Deposits	N.A.	N.A.	N.A.	
NOW	N.A.	N.A.	N.A.	
Savings	N.A.	N.A.	N.A.	
Time	N.A.	N.A	N.A.	
	FEB	JAN	FEB	
Mortgages Outstanding	68,776	68,616	67,477	+ 2
Mortgage Commitments	4,631	4,344	3,088	+50
Savings & Loans**				
Total Deposits	5,304	5,280	4,592	+16
NOW	154	150	136	+13
Savings	906	896	756	+20
Time	4,292	4,278	3,786	+13
	FEB	JAN	FEB	
Mortgages Outstanding	3,945	3,894	3,715	+ 6
Mortgage Commitments	235	253	78	+201
Savings & Loans**				
Total Deposits	55,140	54,615	51,160	+ 8
NOW	2,210	2,165	1,881	+17
Savings	15,102	14,974	15,416	- 2
Time	38,003	37,943	34,259	+11
	FEB	JAN	FEB	
Mortgages Outstanding	40,599	40,612	39,923	+ 2
Mortgage Commitments	3,098	2,917	2,307	+34
Savings & Loans				
Total Deposits	N.A.	N.A.	N.A.	
NOW	N.A.	N.A.	N.A.	
Savings	N.A.	N.A.	N.A.	
Time	N.A.	N.A.	N.A.	
	FEB	JAN	FEB	
Mortgages Outstanding	8,389	8,342	8,813	- 5
Mortgage Commitments	485	415	209	+132
Savings & Loans**				
Total Deposits	9,241	9,150	8,681	+ 6
NOW	211	210	179	+18
Savings	2,378	2,370	2,174	+ [illegible]
Time	6,758	6,669	6,402	+ [illegible]
	FEB	JAN	FEB	
Mortgages Outstanding	8,353	8,325	7,690	+ [illegible]
Mortgage Commitments	523	514	309	+69
Savings & Loans**				
Total Deposits	2,590	2,503	2,525	+ 3
NOW	106	101	69	+54
Savings	491	484	485	[illegible]
Time	1,938	1,964	1,999	- 3
	FEB	JAN	FEB	
Mortgages Outstanding	2,078	2,037	2,049	+ 1
Mortgage Commitments	63	62	32	+97
Savings & Loans**				
Total Deposits	6,878	6,817	6,858	+ 0
NOW	183	176	173	+ 6
Savings	1,351	1,337	1,511	-11
Time	5,392	5,350	5,200	+ 4
	FEB	JAN	FEB	
Mortgages Outstanding	5,412	5,406	5,287	+ 2
Mortgage Commitments	227	183	153	+48

Notes: All deposit data are extracted from the Federal Reserve Report of Transaction Accounts, other Deposits and Vault Cash (FR2900), and are reported for the average of the week ending the 1st Wednesday of the month. This data, reported by institutions with over $15 million in deposits as of December 31, 1979, represents 95% of deposits in the six state area. The major differences be this report and the "call report" are size, the treatment of interbank deposits, and the treatment of float. The data generated fr the Report of Transaction Accounts is for banks over $15 million in deposits as of December 31, 1979. The total deposit data ge from the Report of Transaction Accounts eliminates interbank deposits by reporting the net of deposits "due to" and "due from" o depository institutions. The Report of Transaction Accounts subtracts cash items in process of collection from demand deposits, w the call report does not. Savings and loan mortgage data are from the Federal Home Loan Bank Board Selected Balance Sheet D The Southeast data represent the total of the six states. Subcategories were chosen on a selective basis and do not add to total.

* = fewer than four institutions reporting.

** = S&L deposits subject to revisions due to reporting changes.

N.A. = not available at this time.

CONSTRUCTION

12-month Cumulative Rate	FEB 1984	JAN 1984	FEB 1983	ANN % CHG		FEB 1984	JAN 1984	FEB 1983	ANN % CHG
UNITED STATES									
Nonresidential Building Permits - $ Mil.					Residential Building Permits				
Total Nonresidential	53,121	52,264	44,869	+ 18	Value - $ Mil.	70,984	69,204	42,812	+ 66
Industrial Bldgs.	5,648	5,592	4,999	+ 13	Residential Permits - Thous.				
Offices	13,243	13,024	11,867	+ 12	Single-family units	918.1	900.7	584.3	+ 57
Stores	7,480	7,187	5,228	+ 43	Multi-family units	730.4	716.0	480.4	+ 52
Hospitals	2,099	2,065	1,580	+ 33	Total Building Permits				
Schools	848	857	781	+ 9	Value - $ Mil.	124,104	121,468	87,681	+ 42
SOUTHEAST									
Nonresidential Building Permits - $ Mil.					Residential Building Permits				
Total Nonresidential	8,343	8,271	6,487	+ 29	Value - $ Mil.	13,358	12,934	7,529	+ 77
Industrial Bldgs.	686	676	677	+ 1	Residential Permits - Thous.				
Offices	2,029	2,036	1,430	+ 42	Single-family units	188.8	184.7	121.6	+ 55
Stores	1,443	1,376	968	+ 49	Multi-family units	170.8	165.2	91.1	+ 87
Hospitals	469	470	345	+ 36	Total Building Permits				
Schools	162	152	105	+ 54	Value - $ Mil.	21,627	21,132	14,016	+ 54
ALABAMA									
Nonresidential Building Permits - $ Mil.					Residential Building Permits				
Total Nonresidential	562	543	371	+ 51	Value - $ Mil.	454	440	260	+ 75
Industrial Bldgs.	39	35	46	- 15	Residential Permits - Thous.				
Offices	66	62	72	- 8	Single-family units	8.1	8.0	5.5	+ 47
Stores	109	102	61	+ 79	Multi-family units	8.5	8.1	4.3	+ 98
Hospitals	5	5	30	- 83	Total Building Permits				
Schools	9	9	5	+ 80	Value - $ Mil.	1,015	983	631	+ 61
FLORIDA									
Nonresidential Building Permits - $ Mil.					Residential Building Permits				
Total Nonresidential	4,161	4,133	3,307	+ 26	Value - $ Mil.	7,766	7,578	4,350	+ 79
Industrial Bldgs.	363	360	380	- 4	Residential Permits - Thous.				
Offices	965	969	708	+ 36	Single-family units	101.7	99.8	62.6	+ 62
Stores	798	777	519	+ 54	Multi-family units	94.1	92.1	53.0	+ 78
Hospitals	290	297	178	+ 63	Total Building Permits				
Schools	63	57	21	+200	Value - $ Mil.	11,927	11,711	7,658	+ 56
GEORGIA									
Nonresidential Building Permits - $ Mil.					Residential Building Permits				
Total Nonresidential	1,396	1,384	980	+ 42	Value - $ Mil.	2,540	2,436	1,501	+ 69
Industrial Bldgs.	177	175	134	+ 32	Residential Permits - Thous.				
Offices	451	464	227	+ 99	Single-family units	43.1	41.9	29.0	+ 49
Stores	184	159	84	+119	Multi-family units	26.1	25.0	14.9	+ 75
Hospitals	36	35	25	+ 44	Total Building Permits				
Schools	31	28	13	+138	Value - $ Mil.	3,936	3,820	2,481	+ 59
LOUISIANA									
Nonresidential Building Permits - $ Mil.					Residential Building Permits				
Total Nonresidential	1,153	1,164	1,066	+ 8	Value - $ Mil.	1,157	1,098	708	+ 63
Industrial Bldgs.	33	33	63	- 48	Residential Permits - Thous.				
Offices	375	370	309	+ 21	Single-family units	16.9	16.6	12.1	+ 40
Stores	133	130	165	- 19	Multi-family units	18.3	17.1	9.5	+ 93
Hospitals	95	97	62	+ 53	Total Building Permits				
Schools	50	49	52	- 4	Value - $ Mil.	2,310	2,262	1,774	+ 30
MISSISSIPPI									
Nonresidential Building Permits - $ Mil.					Residential Building Permits				
Total Nonresidential	206	195	161	+ 28	Value - $ Mil.	328	317	193	+ 70
Industrial Bldgs.	10	10	13	- 23	Residential Permits - Thous.				
Offices	23	22	14	+ 64	Single-family units	4.9	4.7	3.8	+ 29
Stores	48	40	39	+ 23	Multi-family units	5.2	5.1	2.2	+136
Hospitals	19	19	6	+217	Total Building Permits				
Schools	4	4	5	- 20	Value - $ Mil.	534	511	354	+ 51
TENNESSEE									
Nonresidential Building Permits - $ Mil.					Residential Building Permits				
Total Nonresidential	865	852	602	+ 44	Value - $ Mil.	1,113	1,065	517	+115
Industrial Bldgs.	64	63	41	+ 56	Residential Permits - Thous.				
Offices	149	149	100	+ 49	Single-family units	14.1	13.7	8.6	+ 64
Stores	171	168	100	+ 71	Multi-family units	18.6	17.8	7.2	+158
Hospitals	24	17	44	- 45	Total Building Permits				
Schools	5	5	9	- 44	Value - $ Mil.	1,905	1,845	1,118	+ 70

NOTES:
Data supplied by the U. S. Bureau of the Census, Housing Units Authorized By Building Permits and Public Contracts, C-40. Nonresidential data excludes the cost of construction for publicly owned buildings. The southeast data represent the total of the six states. The annual percent change calculation is based on the most recent month over prior year. Publication of F. W. Dodge construction contracts has been discontinued.

GENERAL

	LATEST DATA	CURR. PERIOD	PREV. PERIOD	YEAR AGO	ANN. % CHG.
UNITED STATES					
Personal Income					
($bil. - SAAR)	3Q	2,775.1	2,709.1	2,584.7	+ 7
Taxable Sales - $bil.		N.A.	N.A.	N.A.	
Plane Pass. Arr. 000's		N.A.	N.A.	N.A.	
Petroleum Prod. (thous.)	MAR	8,509.7	8,675.5	8,665.0	- 2
Consumer Price Index					
1967=100	MAR	307.3	306.6	293.4	+ 5
Kilowatt Hours - mils.	JAN	206.5	185.4	178.7	+16
SOUTHEAST					
Personal Income					
($bil. - SAAR)	3Q	332.1	326.7	310.0	+ 7
Taxable Sales - $ bil.		N.A.	N.A.	N.A.	
Plane Pass. Arr. 000's	FEB	4,167.9	4,169.6	4,207.2	- 1
Petroleum Prod. (thous.)	MAR	1,428.0	1,404.0	1,380.0	+ 3
Consumer Price Index					
1967=100		N.A.	N.A.	N.A.	
Kilowatt Hours - mils.	JAN	32.7	27.8	28.0	+17
ALABAMA					
Personal Income					
($bil. - SAAR)	3Q	36.8	36.2	34.2	+ 8
Taxable Sales - $ bil.	DEC	30.2	29.6	28.4	+ 6
Plane Pass. Arr. 000's	FEB	103.2	99.9	90.6	+14
Petroleum Prod. (thous.)	MAR	51.0	49.0	52.0	- 2
Consumer Price Index					
1967=100		N.A.	N.A.	N.A.	
Kilowatt Hours - mils.	JAN	4.4	3.7	3.7	+19
FLORIDA					
Personal Income					
($bil. - SAAR)	3Q	124.9	121.9	115.1	+ 9
Taxable Sales - $ bil.	MAR	76.1	74.8	67.9	+12
Plane Pass. Arr. 000's	FEB	2,218.9	2,189.8	2,253.8	- 2
Petroleum Prod. (thous.)	MAR	49.0	49.0	62.0	-21
Consumer Price Index - Miami		**MAR**	**JAN**	**MAR**	
Nov. 1977 = 100		165.6	165.0	159.0	+ 4
Kilowatt Hours - mils.	JAN	8.8	7.3	7.5	+17
GEORGIA					
Personal Income					
($bil. - SAAR)	3Q	59.3	58.2	54.4	+ 9
Taxable Sales - $ bil.	4Q	43.2	41.1	40.6	+ 6
Plane Pass. Arr. 000's	FEB	1,443.1	1,469.0	1,455.8	- 1
Petroleum Prod. (thous.)		N.A.	N.A.	N.A.	
Consumer Price Index - Atlanta		**FEB**	**DEC**	**FEB**	
1967 = 100		309.3	307.3	295.1	+ 5
Kilowatt Hours - mils.	JAN	5.0	4.6	4.7	+ 6
LOUISIANA					
Personal Income					
($bil. - SAAR)	3Q	45.3	45.9	44.9	+ 1
Taxable Sales - $ bil.		N.A.	N.A.	N.A.	
Plane Pass. Arr. 000's	FEB	241.3	244.3	260.6	- 7
Petroleum Prod. (thous.)	MAR	1,240.0	1,220.0	1,180.0	+ 5
Consumer Price Index					
1967 = 100		N.A.	N.A.	N.A.	
Kilowatt Hours - mils.	JAN	4.9	4.2	4.4	+11
MISSISSIPPI					
Personal Income					
($bil. - SAAR)	3Q	21.1	20.8	19.8	+ 7
Taxable Sales - $ bil.		N.A.	N.A.	N.A.	
Plane Pass. Arr. 000's	FEB	29.3	30.0	25.2	+16
Petroleum Prod. (thous.)	MAR	88.0	86.0	86.0	+ 2
Consumer Price Index					
1967 = 100		N.A.	N.A.	N.A.	
Kilowatt Hours - mils.	JAN	2.2	1.9	1.8	+22
TENNESSEE					
Personal Income					
($bil. - SAAR)	3Q	44.7	43.7	41.6	+ 7
Taxable Sales - $ bil.	MAR	41.9	39.0	38.2	+ 9
Plane Pass. Arr. 000's	FEB	132.1	136.6	121.2	+ 9
Petroleum Prod. (thous.)	MAR	N.A.	N.A.	N.A.	
Consumer Price Index					
1967 = 100		N.A.	N.A.	N.A.	
Kilowatt Hours - mils.	JAN	7.4	6.1	5.9	+25

	MAR 1984	FEB (R) 1984	MAR 1983	ANN. % CHG.
UNITED STATES				
Agriculture				
Prices Rec'd by Farmers				
Index (1977=100)	146	144	134	+ 9
Broiler Placements (thous.)	84,498	80,879	84,834	- 0
Calf Prices ($ per cwt.)	65.00	63.90	68.40	- 5
Broiler Prices (¢ per lb.)	37.8	37.4	25.4	+49
Soybean Prices ($ per bu.)	7.65	7.29	5.82	+31
Broiler Feed Cost ($ per ton)	242	243	210	+15
SOUTHEAST				
Agriculture				
Prices Rec'd by Farmers				
Index (1977=100)	139	134	119	+17
Broiler Placements (thous.)	32,345	31,217	32,526	- 1
Calf Prices ($ per cwt.)	60.6	60.3	65.0	- 7
Broiler Prices (¢ per lb.)	36.9	36.7	24.8	+49
Soybean Prices ($ per bu.)	7.75	7.40	6.00	+29
Broiler Feed Cost ($ per ton)	228	235	200	+14
ALABAMA				
Agriculture				
Farm Cash Receipts - $ mil.				
(Dates: JAN, JAN)	144	-	148	- 3
Broiler Placements (thous.)	11,010	10,596	10,718	+ 3
Calf Prices ($ per cwt.)	60.3	59.0	63.6	- 5
Broiler Prices (¢ per lb.)	36.5	35.5	24.0	+52
Soybean Prices ($ per bu.)	7.75	7.47	5.99	+29
Broiler Feed Cost ($ per ton)	270	275	215	+26
FLORIDA				
Agriculture				
Farm Cash Receipts - $ mil.				
(Dates: JAN, JAN)	389	-	543	-28
Broiler Placements (thous.)	1,977	1,827	1,983	- 0
Calf Prices ($ per cwt.)	66.8	63.1	69.4	- 4
Broiler Prices (¢ per lb.)	37.0	36.0	24.0	+54
Soybean Prices ($ per bu.)	7.75	7.47	5.99	+29
Broiler Feed Cost ($ per ton)	255	260	215	+19
GEORGIA				
Agriculture				
Farm Cash Receipts - $ mil.				
(Dates: JAN, JAN)	218	-	216	+ 1
Broiler Placements (thous.)	12,912	12,694	13,223	- 2
Calf Prices ($ per cwt.)	58.4	57.1	61.5	- 5
Broiler Prices (¢ per lb.)	36.5	36.5	24.5	+49
Soybean Prices ($ per bu.)	7.81	7.61	5.90	+32
Broiler Feed Cost ($ per ton)	205	215	195	+ 5
LOUISIANA				
Agriculture				
Farm Cash Receipts - $ mil.				
(Dates: JAN, JAN)	194	-	191	+ 2
Broiler Placements (thous.)	N.A.	N.A.	N.A.	
Calf Prices ($ per cwt.)	60.5	62.2	65.9	- 8
Broiler Prices (¢ per lb.)	38.5	38.0	26.0	+48
Soybean Prices ($ per bu.)	7.83	7.44	6.18	+27
Broiler Feed Cost ($ per ton)	285	295	250	+14
MISSISSIPPI				
Agriculture				
Farm Cash Receipts - $ mil.				
(Dates: JAN, JAN)	176	-	251	-30
Broiler Placements (thous.)	6,446	6,101	6,603	- 2
Calf Prices ($ per cwt.)	59.0	61.7	65.5	-10
Broiler Prices (¢ per lb.)	38.8	39.0	26.5	+46
Soybean Prices ($ per bu.)	7.77	7.52	5.97	+30
Broiler Feed Cost ($ per ton)	187	191	169	+11
TENNESSEE				
Agriculture				
Farm Cash Receipts - $ mil.				
(Dates: JAN, JAN)	165	-	179	- 8
Broiler Placements (thous.)	N.A.	N.A.	N.A.	
Calf Prices ($ per cwt.)	58.1	58.6	63.4	- 8
Broiler Prices (¢ per lb.)	36.0	36.5	24.0	+50
Soybean Prices ($ per bu.)	7.56	6.95	5.91	+28
Broiler Feed Cost ($ per ton)	215	220	191	+13

Notes:
Personal Income data supplied by U. S. Department of Commerce. Taxable Sales are reported as a 12-month cumulative total. Plane Passenger Arrivals are collected from 26 airports. Petroleum Production data supplied by U. S. Bureau of Mines. Consumer Price Index data supplied by Bureau of Labor Statistics. Agriculture data supplied by U. S. Department of Agriculture. Farm Cash Receipts data are reported as cumulative for the calendar year through the month shown. Broiler placements are an average weekly rate. The Southeast data represent the total of the six states. N.A. = not available. The annual percent change calculation is based on most recent data over prior year. R = revised.

EMPLOYMENT

	FEB 1984	JAN 1984	FEB 1983	ANN. % CHG.		FEB 1984	JAN 1984	FEB 1983	ANN. % CHG.
UNITED STATES									
Civilian Labor Force - thous.	111,368	111,025	109,647	+ 2	Nonfarm Employment- thous.	91,033	90,572	87,613	+ 4
Total Employed - thous.	101,961	101,270	97,265	+ 5	Manufacturing	19,308	19,169	18,077	+ 7
Total Unemployed - thous.	9,407	9,755	12,382	-24	Construction	3,753	3,771	3,376	+11
Unemployment Rate - % SA	7.8	8.0	10.4		Trade	20,430	20,586	19,870	+ 3
Insured Unemployment - thous.	N.A.	N.A.	N.A.		Government	15,972	15,719	15,988	- 0
Insured Unempl. Rate - %	N.A.	N.A.	N.A.		Services	20,040	19,795	19,065	+ 5
Mfg. Avg. Wkly. Hours	41.7	40.5	38.8	+ 7	Fin., Ins., & Real Est.	5,518	5,514	5,340	+ 3
Mfg. Avg. Wkly. Earn. - $	370	368	340	+ 9	Trans. Com. & Pub. Util.	4,972	4,976	4,896	+ 2
SOUTHEAST									
Civilian Labor Force - thous.	14,535	14,507	14,068	+ 3	Nonfarm Employment- thous.	11,852	11,784	11,276	+ 5
Total Employed - thous.	13,314	13,167	12,436	+ 7	Manufacturing	2,232	2,225	2,096	+ 6
Total Unemployed - thous.	1,220	1,339	1,632	-25	Construction	684	676	595	+15
Unemployment Rate - % SA	7.9	8.6	11.0		Trade	2,860	2,861	2,676	+ 7
Insured Unemployment - thous.	N.A.	N.A.	N.A.		Government	2,187	2,162	2,179	+ 0
Insured Unempl. Rate - %	N.A.	N.A.	N.A.		Services	2,390	2,366	2,273	+ 5
Mfg. Avg. Wkly. Hours	41.1	40.8	39.7	+ 4	Fin., Ins., & Real Est.	684	683	646	+ 6
Mfg. Avg. Wkly. Earn. - $	325	324	300	+ 8	Trans. Com. & Pub. Util.	688	684	671	+ 3
ALABAMA									
Civilian Labor Force - thous.	1,756	1,755	1,742	+ 1	Nonfarm Employment- thous.	1,330	1,324	1,286	+ 3
Total Employed - thous.	1,531	1,516	1,454	+ 5	Manufacturing	345	345	327	+ 6
Total Unemployed - thous.	224	238	288	-22	Construction	60	60	53	+13
Unemployment Rate - % SA	12.2	12.8	16.0		Trade	274	274	261	+ 5
Insured Unemployment - thous.	N.A.	N.A.	N.A.		Government	287	286	291	- 1
Insured Unempl. Rate - %	N.A.	N.A.	N.A.		Services	218	216	214	+ 2
Mfg. Avg. Wkly. Hours	40.8	39.8	39.8	+ 3	Fin., Ins., & Real Est.	60	60	59	+ 2
Mfg. Avg. Wkly. Earn. - $	319	320	298	+ 7	Trans. Com. & Pub. Util.	72	70	69	+ 4
FLORIDA									
Civilian Labor Force - thous.	4,991	4,984	4,682	+ 7	Nonfarm Employment- thous.	4,084	4,059	3,816	+ 7
Total Employed - thous.	4,685	4,617	4,238	+11	Manufacturing	493	493	451	+ 9
Total Unemployed - thous.	306	367	444	-31	Construction	291	288	243	+20
Unemployment Rate - % SA	6.0	7.0	9.3		Trade	1,104	1,102	1,013	+ 9
Insured Unemployment - thous.	N.A.	N.A.	N.A.		Government	649	640	647	+ 0
Insured Unempl. Rate - %	N.A.	N.A.	N.A.		Services	1,006	995	947	+ 6
Mfg. Avg. Wkly. Hours	41.7	41.6	40.0	+ 4	Fin., Ins., & Real Est.	302	301	276	+ 9
Mfg. Avg. Wkly. Earn. - $	313	312	290	+ 8	Trans. Com. & Pub. Util.	229	229	230	- 0
GEORGIA									
Civilian Labor Force - thous.	2,683	2,657	2,637	+ 2	Nonfarm Employment- thous.	2,320	2,306	2,197	+ 6
Total Employed - thous.	2,507	2,481	2,406	+ 4	Manufacturing	522	520	493	+ 6
Total Unemployed - thous.	176	176	231	-24	Construction	116	111	97	+20
Unemployment Rate - % SA	5.9	6.2	8.4		Trade	558	557	518	+ 8
Insured Unemployment - thous.	N.A.	N.A.	N.A.		Government	440	438	440	0
Insured Unempl. Rate - %	N.A.	N.A.	N.A.		Services	403	400	378	+ 7
Mfg. Avg. Wkly. Hours	40.9	40.8	40.3	+ 1	Fin., Ins., & Real Est.	123	123	118	+ 4
Mfg. Avg. Wkly. Earn. - $	303	301	285	+ 6	Trans. Com. & Pub. Util.	150	150	145	+ 3
LOUISIANA									
Civilian Labor Force - thous.	1,890	1,888	1,833	+ 3	Nonfarm Employment- thous.	1,563	1,556	1,546	+ 1
Total Employed - thous.	1,705	1,688	1,610	+ 6	Manufacturing	176	175	180	- 2
Total Unemployed - thous.	185	200	223	-17	Construction	113	113	109	+ 4
Unemployment Rate - % SA	9.7	10.2	12.3		Trade	368	370	354	+ 4
Insured Unemployment - thous.	N.A.	N.A.	N.A.		Government	320	315	318	+ 1
Insured Unempl. Rate - %	N.A.	N.A.	N.A.		Services	309	307	301	+ 3
Mfg. Avg. Wkly. Hours	41.7	41.5	39.4	+ 6	Fin., Ins., & Real Est.	83	83	81	+ 2
Mfg. Avg. Wkly. Earn. - $	421	422	379	+11	Trans. Com. & Pub. Util.	114	114	109	+ 5
MISSISSIPPI									
Civilian Labor Force - thous.	1,021	1,023	1,056	- 3	Nonfarm Employment- thous.	796	793	769	+ 4
Total Employed - thous.	910	910	900	+ 1	Manufacturing	209	210	193	+ 8
Total Unemployed - thous.	111	113	156	-29	Construction	32	32	33	- 3
Unemployment Rate - % SA	9.9	10.2	13.6		Trade	164	164	158	+ 4
Insured Unemployment - thous.	N.A.	N.A.	N.A.		Government	184	181	183	+ 1
Insured Unempl. Rate - %	N.A.	N.A.	N.A.		Services	126	125	123	+ 2
Mfg. Avg. Wkly. Hours	40.7	40.5	39.1	+ 4	Fin., Ins., & Real Est.	34	34	33	+ 3
Mfg. Avg. Wkly. Earn. - $	281	280	258	+ 9	Trans. Com. & Pub. Util.	38	38	38	0
TENNESSEE									
Civilian Labor Force - thous.	2,194	2,200	2,118	+ 4	Nonfarm Employment- thous.	1,759	1,746	1,662	+ 6
Total Employed - thous.	1,976	1,955	1,828	+ 8	Manufacturing	487	482	452	+ 8
Total Unemployed - thous.	218	245	290	-25	Construction	72	60	60	+ 2
Unemployment Rate - % SA	8.7	9.7	12.6	-30	Trade	392	394	372	+ 5
Insured Unemployment - thous.	N.A.	N.A.	N.A.		Government	307	302	300	+ 2
Insured Unempl. Rate - %	N.A.	N.A.	N.A.		Services	328	323	310	+ 6
Mfg. Avg. Wkly. Hours	40.8	40.6	39.6	+ 3	Fin., Ins., & Real Est.	82	82	79	+ 4
Mfg. Avg. Wkly. Earn. - $	311	310	292	+ 6	Trans. Com. & Pub. Util.	85	83	80	+ 6

Notes: All labor force data are from Bureau of Labor Statistics reports supplied by state agencies.
Only the unemployment rate data are seasonally adjusted.
The Southeast data represent the total of the six states.
The annual percent change calculation is based on the most recent data over prior year.

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