Jamie B. Stewart, Jr.

Opening Remarks

I am pleased to welcome you to our conference, "Specialization, Diversification, and the Structure of the Financial System: The Impact of Technological Change and Regulatory Reform." The topic is extremely timely and interesting for all of us, and I am very impressed with the size and diversity of this audience. We have been fortunate to bring together speakers from a wide range of disciplines to share their wisdom and experience. I think it is going to be a very good program.

Our focus today is on the broad range of strategic issues facing financial institutions in light of the significant forces reshaping the financial services industry. I would like to begin by offering my view of why these strategic issues are important and by raising what I think are some vital questions about the incentives facing financial institutions in today's environment. I hope that by the end of our conference, we will have a better understanding of all of these questions.

The forces acting on the financial system today are truly profound. Technological change affecting the production and distribution of financial services, globalization resulting in markets that increasingly cross national borders, and regulatory reform removing long-standing restrictions on geographic expansion and business combinations have all come together to create new opportunities—and new risks—for financial institutions.

At the same time, we note the emergence of divergent corporate strategies among these institutions. Some financial firms, adopting the goal of greater *specialization*, are focusing their energies on providing a core set of services to a core customer base. Other firms—particularly very large institutions—are actively pursuing a strategy of *diversification* by offering a wide range of products and services to a wide range of customers.

The reasons for these conflicting responses will be the subject of much discussion today. For my part, I would like to set the stage for the discussion by raising some important questions about specialization and diversification. The most fundamental of these is, *how do the risks and rewards of specialization compare with those of diversification?*

We have all seen that financial analysts have pushed very hard for greater specialization among firms in the financial industry. I would contend that, for one thing, analysts find it easier to understand organizations with a narrow business focus. Firms, however, also see advantages to specialization: an organization that focuses on a restricted set of activities may be better able to attract top managers, gain a lead position in its chosen market, and enjoy the enhanced efficiency that comes from really knowing a business from top to bottom.

Yet those of us who have been line managers also know the benefits of having a diversified set of businesses. There is some comfort in knowing that if one business is not doing well—or if one market is reaching a stage in the business cycle when the risks are getting to be a bit too high—you have the advantage of being able to back away from that market or that business

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and to direct your attention instead to another market or another business where things seem to be working better.

My prediction is that at the end of the day we will come to the conclusion that there is no one correct response to the choice between specialization and diversification. Rather, success for any firm is going to involve settling upon one of these strategies and then properly executing it.

These strategic decisions will no doubt be shaped by the forces affecting the financial services industry—and especially, perhaps, by technological change. Thus, a second key question is, *how does technological innovation affect the incentives for firms to become more specialized or more diversified?*

Technology is an issue that we are all learning to deal with in the financial industry. One area of concern focuses on the extent to which technological innovation has increased the benefits of being "big." On the one hand, large firms have the advantage of being able to afford the newest and most advanced hardware. They can also build whatever software they want. On the other hand, some small institutions are finding that they can achieve some of the benefits of being big by purchasing very good software and outsourcing much of their operating hardware.

Overall, my sense is that the desire to be big plays a vital—but not completely understood—role in shaping firms' strategic decisions. This topic will surely be the focus of much discussion today.

The uncertainty attending investments in technology is another area of concern. Firms that invest heavily in huge computer systems may find that the systems do not meet their needs over time. The technology is advancing very rapidly, and the software and hardware purchased today may quickly become outmoded. In this regard, small firms that outsource some part of their computer operations may fare better than their larger counterparts.

Rapid technological innovation may also prompt some organizations to limit the number of businesses in which they must make risky technology investments. Becoming expert enough to make informed decisions about competing technologies in any one business is an expensive proposition, and some firms may choose to specialize so as to limit these costs. Exactly how big a role technological uncertainty plays in shaping financial firms' strategic choices is an issue worth exploring, and today's speakers will undoubtedly bring many insights to this topic.

A third question to be addressed by our conference participants is the role of regulatory reform. In particular, *what opportunities does regulatory reform present for financial institutions?* The headline event in this area, of course, is the recent enactment of the Gramm-Leach-Bliley (GLB) Act, which, as you all know, legalizes previously restricted combinations of banking, insurance, and securities activities. Clearly, the issues raised by GLB—what type of combinations we will actually see and at what speed they will occur—are of interest to everyone, and they have led to many strong opinions. I feel confident that our panelists today will not be shy about sharing their views.

Although regulatory reforms such as GLB may legalize institutions combining banking, insurance, and securities activities, it is the underlying economic fundamentals of these businesses that will determine the type of institutions that will actually be formed. This observation leads to my fourth key question, *what are the synergies among banking, insurance, and securities activities and how might they influence the structure of the financial system?*

This is probably the most interesting topic before us, and to my mind, one of the most controversial. Are there real synergies between banking, insurance, and securities activities? Will large firms that are trying to operate in three or four different industries in fact enjoy the efficiencies of being large or will they turn out to be very complex and somewhat unwieldy organizations? Will the risks of these different activities offset one another? Theoretically, diversification should lead to a less risky overall business portfolio, but in reality the outcome may be different. For example, a firm active in the insurance business and the commercial banking business may not realize the benefits of diversification if its investment portfolio and its loan portfolio in both businesses are tied to the same geographic area or to the same industry.

A related issue is whether consumers and businesses will necessarily want to buy more products from a company that has a broader range of services. Considerable time and money—and a lot of reputations—are being staked on the assumption that the answer to this question is yes. However, I am not altogether sure that consumers will want to buy all their financial services from one company, despite the obvious convenience of doing so. And I think it is very far from being proved that wholesale, or business, customers are willing to entrust to one organization all their needs for insurance, investment banking, and commercial banking services—once again, despite the obvious convenience of doing business with a company that knows them very well.

The final question I want to raise this morning concerns the implications of specialization and diversification for those attempting to assess or manage the risks facing financial institutions. In particular, *how do divergent corporate strategies toward specialization and diversification affect the work of supervisors and risk managers?* Not surprisingly, here at the New York Fed, we are particularly interested in considering how these industry trends will affect our supervisory role.

First, we will want to evaluate how the day-to-day risks facing financial institutions—such as credit, market, and operations risks—will change as a result of consolidation among institutions. We are also becoming aware that, given our umbrella supervisory role, we need to be concerned about the strategic and implementation risks that various companies are undertaking. In my view, significant implementation risks will arise for companies that are launching themselves as financial conglomerates with broad geographic and product reach—and particularly for those companies that have historically had a much narrower focus and, consequently, a very different management challenge.

Second, we will be reexamining our current risk management and supervision tools and evaluating how they will change as a result of these industry shifts. It is very important to consider how the adequacy and appropriateness of risk management and measurement systems may be affected by a firm's strategic focus and mixture of business lines.

I would like to conclude my remarks this morning by summing up our reasons for organizing this conference. Clearly, with the passage of Gramm-Leach-Bliley and the astounding technological innovations that we read about regularly, the questions I have just outlined are very much on the minds of all those concerned with the financial services industry. The unique perspective the participants in this conference can bring to these issues comes from the observation that the broad forces acting on the financial services industry do so in large part by shaping the actions of individual firms within the financial system. By focusing our discussion today on the incentives and choices facing individual firms, we can develop a better understanding of future trends in the structure of the financial system. Our hope is that this conference can help us to gain deeper insight into the risks and rewards that lie before financial institutions as they make the decisions that will influence the evolution of the financial system.