

The Determinants of Success in the New Financial Services Environment: Now That Firms Can Do Everything, What Should They Do and Why Should Regulators Care?

1. Introduction

The U.S. government enacted the Banking Act of 1933, commonly known as the Glass-Steagall Act, at least partially to calm fears stemming from bank failures during the Great Depression. While there has been recent debate concerning the historic realism of characterizing the banking industry structure as the cause of the financial crisis (Benston 1990), the perception of bank activities in the financial market as risky (Puri 1994), and the motivation of the legislators (Benston 1996), the historical outcome of this legislation is clear. Glass-Steagall placed a heavy regulatory burden on commercial banks by limiting their product array, the prices they could charge, and the types of firms with whom they could affiliate. In short, it restricted the activities in which banks may participate.

During the ensuing sixty-five years, this landmark piece of regulation has slowly become both outdated and untenable. Technological innovation, regulatory circumvention, and new delivery mechanisms all have conspired to make the restrictions of the act increasingly irrelevant. The first force of change—technology—permitted firms to create and recreate products and services in different ways than had been envisioned decades ago. The most obvious example is the

transformation of the local mortgage loan market into the global securities giant it is today. Yet, one could equally cite the explosive growth of both derivatives and trading activity as areas where technology has transformed the very core of financial services (Allen and Santomero 1997).

Because of regulation, however, individual financial firms were still limited as to the scope of activities that were permissible. Commercial banks could not offer the full range of security investment services, investment firms could not offer demand deposits, and insurance firms were limited in terms of offering services beyond their own “appropriate” products. Many firms responded by circumventing regulation, either explicitly or implicitly (Kane 1999 and Kaufman 1996). Some more aggressive members of the fraternity simply acted in a manner not allowed by regulation in the hopes of either an innovative interpretation of the law (for example, NOW accounts or money funds) or formal regulatory relief (for instance, Citigroup). The results were almost always regulatory accommodation or capitulation. These decisions at times made economic sense (for example, the decisions on private placement activity or advisory services), but at other times they stretched the credibility of the rules, if not the English language (for instance, nonbank banks, the facilitation of commercial

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paper placement, and mutual funds distribution). Yet, through this mechanism of regulatory evolution, the industry progressed. Banks were granted greater latitude in product mix, as well as permitted to form holding companies that expanded their operations further. At the same time, competition increased as the rules permitted new entrants that flourished in focused areas, such as GE Capital. Today, myriad financial services firms operating under different regulatory charters are competing in the broad financial marketplace.

The final force of change is the continual evolution of the delivery channels through which financial services are offered. This has occurred in many ways and in several stages. First, the use of postal services substituted for physical market presence; this was followed by increased use of telephones for both customer service and outbound marketing; and now personal computers and the Internet have altered the very balance of the financial industry. Throughout this period, the application of technology has disrupted the industry's delivery paradigms and the traditional channels of service distribution. The combined use of new technology, conduits of distribution, and financial innovation has broadened the product offerings of all firms beyond their historic core businesses.

Nonetheless, by law, financial services firms of specific types continued to be expressly limited in their activities. Finally, the Financial Modernization Act of 1999 (FMA)—introduced on January 6, 1999, in the House of Representatives as H.R.10—became law as the Gramm-Leach-Bliley Act. The bill's stated purpose was “to enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, and other financial service providers, and for other purposes.”

The potential ramifications of the FMA have been, and surely will be, continuously analyzed as the details of the enabling regulation emerge and the industry responds to its new perspective on firm structure and allowable activity (American Bankers Association 1999 and Stein and Perrino 2000). Yet, the proponents of the FMA have already heralded its passage and argued that the legislation will result in more competitive, stable, and efficient financial firms, as well as a better overall capital market (Greenspan 1997). Detractors, and there have been some, claim that the new law will result in unfair business practices and less stable capital markets (Berger and Udell 1996).

In this contribution to the debate, we attempt to consolidate many of the arguments for and against the financial conglomeration that will inevitably follow the passage of the new law. We offer our view on the effects of this new competitive landscape on affected financial firms, as well as on the behavior of the capital market itself. Our focus is on the

impact of the changing nature of both the market infrastructure and the regulatory regime on the behavior and likely span of activity conducted by large financial firms. In the words of our title, *now that firms can do everything, what should they do and why should regulators care?*

2. Public Policy versus Firm-Level Effects

We have decided to look at the implications of the changing financial environment from two perspectives: a firm level and a public policy level. This dichotomy seems appropriate for a number of reasons. First, different market participants generally are interested only in one of these perspectives, and discussions among interested parties are generally more clear if the distinct points of view are clarified. On the one hand, economists will tend to focus almost exclusively on the market effects of the new regulatory and technological environment, and the impact that the shift in both of these important features will have on society at large and the interests of important subgroups. They may care very little about the impact of both the environmental effects outlined above and the new regulatory structure on individual firms. On the other hand, representatives of such firms may view these market effects as amorphous and of little interest to them and their organizations in the everyday working world. Their interests quite naturally will focus on the impact of the changing structure on their own competitive positioning.

However, we argue here that both perspectives are essential. The effect of the confluence of technology and regulatory change will have profound micro and macro effects on the financial sector. Participants in this debate must understand both aspects of the alteration of the financial environment to appreciate the change that is occurring in the financial sector. At times, the effects will be complementary; at other times, there will be distinctly different effects for different levels of analysis. For example, if the new environment results in a more competitive financial services industry, the public certainly will be better off, with less expensive and more abundant financial services. While this may be good for society, it may at the same time make individual firms worse off. Both industry members and policymakers need to appreciate these two distinct effects on the financial sector.

To the policymaker who claims indifference to the impact of these changes on the institutions that deliver financial services, a word of caution is in order. The social value brought to the

real economy by the financial sector is delivered by the firms and institutions that make up the industry. The impact of change on these entities can be ignored only at the policy-maker's peril. If firms cannot function—indeed flourish—the industry will not deliver on its essential role in the real economy. We have learned this the hard way (Bernanke 1983).

Conversely, some changes may be less than salutary to the aggregate economy, even though they are beneficial to firms in the industry. In such cases, if the social cost of the changes taking place is of a sufficient magnitude, it may elicit—indeed require—a public policy response that could have severe consequences on the firms within the industry. We read the recent debate over the computer software industrial structure as just such a circumstance. While we take no sides in that dispute, its mere existence points to the need to analyze the effect of change on these two distinct levels.

3. Firm-Level Effects of Financial Modernization

Perhaps the best place to begin any discussion of the new financial landscape is with the impact of these changes on the operating scale of firms within the industry. In an industry that once thought that firms with \$5 billion or \$10 billion in assets were substantial, we are seeing the emergence of firms with trillion-dollar balance sheets. The obvious first question, then, appears to be the impact of size on various aspects of the business. Here, we consider five elements, or effects, of size, namely:

- What is the likely effect of size on bank operating costs, that is, the alleged benefit of economies of scale and scope?
- Can size of product offering affect revenues by permitting cross-selling, relationship pricing, and increased use of financial products in general?
- Will megafirms have a more competitive global position merely because some businesses require large balance sheets and large-scale commitments?
- Will firms be inherently more stable due to diversification and the sheer inertia of the core franchises?
- Will universal banks be susceptible to contagion effects, precisely because of their many operating businesses?

Turning to the first consideration, we note that several types of efficiency gains are thought to flow from the expansion of

bank size and scope. Of these, increased operating cost efficiency is most commonly mentioned. The emergence of broad financial firms enables costs to be lowered, if scale or scope economies are relevant *and* if the range of the expansion is within the band whereby they can be achieved. This is not said to confuse the matter, but to enlighten it. The cost efficiencies of bank expansion are not likely to be monotonic. Size is not always a virtue! Scale may help for some levels of operation, while it might disadvantage other size ranges. At the same time, some lines of business benefit from scale while others may be hampered by it. The crucial issue in efficiency is the “right sizing” of the total firm *and* the “right sizing” of individual businesses within the firm.

Nonetheless, if average cost is decreasing in scale over the relevant range, as some suggest (Berger, Hancock, and Humphrey 1993 and Hughes and Mester 1998), larger institutions may be more efficient. In such a case, productivity of facilities and personnel can be improved by adding them to a larger organization. Examples of areas of potential gains include the physical branch distribution network, infrastructure software, electronic distribution systems in which marginal costs are negligible, and some niche processing businesses in which scale is a dominant success factor.

Beyond this, expenses may be lowered if the bank can offer several products at a lower cost than separate competing institutions offering a subset of the full product array (Berger, Hunter, and Timme 1993). According to this view, the evolving financial structure may enable larger banks to offer more products and services, and scope economies may allow providers of multiple products and services to produce them at a lower cost than their specialized predecessors. This will lead the former to garner an increase in market share of targeted customer activity at the expense of the latter (Thakor 1998).

For this to be relevant, there must be some scaleable asset that leads to the efficiency gain. Prime candidates include data on customer behavior and needs or a broad, underutilized distribution channel. Both benefit disproportionately from the added volume (Pulley and Humphrey 1993). The first rationale explains why there has been such intense interest in customer information, information systems, and data mining software. The economies of scale and scope of information are particularly relevant here. Greater customer knowledge is likely to mean lower monitoring costs and better cross-selling, as many studies have illustrated (Mester, Nakamura, and Renault 1999).

However, the real gain may not be in production efficiencies but in customer service. In this case, the gain accrues not from technical efficiency of production, but from a kind of consumption economy. The result will be higher revenue and a better return from any customer segment, as consumers of financial services find it more advantageous to purchase

multiple products from the same provider (Herring and Santomero 1990 and Berger, Humphrey, and Pulley 1996).

Combining both of these aspects of scale broadly defined, economists often refer to the total effect as improved profit efficiency (Berger, Hancock, and Humphrey 1993). The latter term refers to the ability of profits to improve from any of the sources noted above: cost, scope, or consumption economies. In a sense, it captures the total efficiency gains from scale without specific reference to the separately titled efficiency improvement areas.

The key issue here, however, is whether or not any of these gains are both real and substantial. Any of these reasons for gains is sufficient to herald the benefits of scale, and different ones presumably are relevant in different circumstances. Whether any of these gains are obtained or at least observable from past experience is another matter. To address this issue, the banking literature has examined both the cost structures across bank asset size and the cost effects of bank mergers in a number of different, hopefully complementary, ways (Akhavein, Berger, and Humphrey 1997, Berger 1998, and Pilloff and Santomero 1998). Almost universally, the gains from strict cost efficiency are seen as illusory. Many reasons are offered for this lack of empirical evidence. The most compelling seems to be that product-specific cost efficiencies are offset by managerial or span-of-control issues. Many have argued that operating economies are likely to be lost as the organization grows too large and too complex. The classic reference here is Williamson (1985). In the context of the financial services industry, it is sometimes stated that when economies are found, they often arise in large *specialized* firms exploiting a single line of business, not in huge universal banks (Steinherr 1996).

The new environment will certainly allow U.S. banks to go into new lines of business. However, the commonly argued benefit of multiproduct distribution may not be enough to outweigh the costs, if most of these benefits accrue to more specialized firms. Gains in one line of business are often heralded, but the economic loss elsewhere in the firm causes cost savings to go unrealized in aggregate (Pulley, Berger, and Humphrey 1996 and Steinherr 1996).

By contrast, revenue gains appear real. The expanded product array and potential for cross-selling suggest that real revenue benefits result from larger size and depth of product offering. In fact, recent work suggests that this increased revenue potential accounts for a substantial portion of performance increases for U.S. banks (Berger and Mester 1999).

Beyond direct operating efficiency, it is often argued by bankers that larger universal banks will benefit from financial modernization because the new financial services firms will be more innovative and offer new solutions to broad customer needs. Steinherr (1996) discusses this process, as opposed to

product, innovation advantage that universal banks may enjoy. This comes from a desire and ability to reduce costs and to distribute products as efficiently as possible. However, Boot and Thakor (1996) argue against this alleged benefit of size. They note that financial systems that have always allowed universal banking have not traditionally had an advantage in product innovation. Rather, market-dominated systems, like the U.S. and British financial sectors, tend to be the leaders in product innovation. What is yet to be shown is whether systems that move from a market-dominated to a universal system can maintain their financial innovation.

Turning to the third advantage listed above, it seems reasonable to expect that the larger universal banks will become more competitive in some product markets where size matters. This increased competitive position could result from a number of the unique features of the wholesale banking market, where scale can be seen to enhance performance in two distinct ways. First, most large-scale financings require substantial book positions, which would be impossible in the absence of a large balance sheet. This is of increasing relevance today as the nonfinancial industrial structure consolidates globally. The latter trend has forced financial firms to increase the scale of their ownership positions in underwritings, syndications, and new issues. With the decline in the size of selling groups and increased pressure on comanagers (Smith 2000), balance-sheet size becomes a comparative advantage, as does distribution capability, which is related to operating scale. Competitively, these are increasingly relevant issues.

Historically, European institutions have operated with the benefit of a universal banking charter. With further consolidation in Europe, resulting in, alternatively, country champions and pan-European competitors, U.S. bankers are understandably concerned about their ability to compete. Thus, it seems that allowing universal banking in the United States would place U.S. banks on a level playing field with the European institutions, and this is often listed as a second reason for enhanced financial performance.

However, using anecdotal evidence from Germany, some have pointed out that few universal banks are universal outside of their home country (Steinherr 1996). That is, a universal bank in Germany is likely to have a specialized, or more narrowly focused, banking operation outside of Germany, and almost never operates as a universal bank outside of its home market. So, the net benefit of universal banking, with respect to global competitiveness, is still not clearly understood. Does the fact that the home country allows for universal banks give its national banks a global advantage, even though they may not operate a universal bank in a foreign country? This question has no obvious answer and lacks empirical evidence in either direction.

Next on our list of the benefits of scale, we have the issue of stability. It has long been a tenet of those who favor larger universal banks that such entities are, by definition, more diversified than their specialized counterparts. The argument is that the larger universal banks will benefit from higher earnings-source diversification (Denenis and Nurullah 2000), increased operating earnings stability (Santomero and Chung 1992), and higher valuations (Boyd and Graham 1988). Assuming that each business line or geographic area is independent, the argument is so direct as to follow from the simple law of large numbers.

In addition, proponents of the stability argument assert that such broad product capability may permit better performance for more technical reasons as well. They extend the scope-economies scenario above to reduced volatility by alleging that various synergies are involved in different but related businesses. Black (1975), for one, argues that the universal banks have better monitoring capacity, which will reduce the risk to the firm, an argument made by Fama as well (1980). Steinherr (1996) presents empirical evidence that universal banks "achieve a better risk-return tradeoff" and that universal banks have "reduc[ed] variability of income from lending activity." Thus, the universal banks should be safer and less susceptible to insolvency.

Together, such benefits from earnings diversification, due to either broadening the geographic reach of an institution or increasing the breadth of products and services offered, may increase firm value in several ways. First, reduced risk directly translates into reduced probability of incurring distress costs. This is because the probability of insolvency or even a credit rating downgrade is reduced due to the diversification of business units under one corporate umbrella (Stulz 1984 and Santomero 1995). This, in turn, reduces expected funding costs and directly affects reported earnings. Second, if firms face a tax schedule that is less than strictly proportional, then reduced volatility will lead to a decline in the expected tax burden, raising expected net after-tax income (Gennotte and Pyle 1991 and Santomero 1995). Third, earnings from lines of business in which customers value a bank's reputation for stability may be increased. Some areas of activity, such as standby letters of credit, require a premier rating and a conservative reputation to be a credible competitor. Finally, the firm may be able to increase the level of some risky, yet profitable, activities such as commercial lending without additional capital being necessary (Saunders and Walter 1994).

However, these arguments in favor of scale can be taken too far. In fact, there are at least three reasons to suggest that the broader franchise results in a *less* stable firm. The first argues that the consolidated entity has a franchise value and brand name that are intimately intertwined with all of its businesses.

Therefore, a bad outcome in any one may have a magnified effect on all the lines of business and the core franchise itself. If this is the case, then the association of the bank with any high variance line of business has a potentially detrimental effect on the entire franchise. In fact, conglomeration may increase instability, as the firm's name suffers when "even the least of your brethren" is subject to a shock.

Second, the usual discussion of activity expansion is presented under the assumption of relatively uncorrelated business units. In all likelihood, however, the correlations are apt to be highly positive. Activities are added to the firm because of a perception of management that the firm has a comparative advantage in producing the underlying product or assessing the underlying risk. Real estate lenders have gone into real estate development, at times with disastrous effects. Third-world lenders have become emerging market trading houses with little better luck. This should not be a surprise. Firms attempt to find their comparative advantage or value-added capabilities. So, as a direct result, affiliates are related businesses at some level, which may well result in high positive correlations in times of stress.

Finally, it is important to consider the regulatory environment that is likely to pervade new business ventures. Bankers and their regulators usually assume the supremacy of lead bank regulators over foreign country regulators or those in charge of other parts of the financial sector. However, in the event of a crisis, the local regulator—be it the state insurance commissioner or the Securities and Exchange Commission (SEC)—will not sit idly by and allow a retrenchment of bank funds and commitments of support. Furthermore, they are likely to be strident at exactly the time when the holding company and/or its lead bank is experiencing trouble. This line of reasoning does not support the diversification arguments made above. To the contrary, the new organizational form permitted by regulation may well be subjecting the financial firm to greater distress costs when any one of its operating subsidiaries has difficulty. It is quite possible that a financially distressed subsidiary will cripple the entire entity.

4. Does One Size Fit All?

Taken at face value, the balance of costs and benefits associated with a broader product array seems to favor the more universal financial franchise. The benefits of scale and/or scope, the revenue enhancements, the bigger playing field, the potential for greater innovation, and the added stability all favor the observed movement toward universal firms. The results,

however, are not unequivocal. There are real concerns over complexity, complacency, and fragility of franchise. Nonetheless, the observed trend toward broader firms seems to be supported by our analysis of the factors influencing change.

The Limits on Consolidation

This has led some to voice the concern that all financial firms will become huge universal banks. Will the financial services industry eventually become dominated by a small number of these behemoths? We think not. Countervailing the positive pressures toward universality are forces that have permitted more narrowly focused firms to survive and flourish even where universal banking has long been a reality.

Four key features of the universal firm place limits on the megabank and its ability to add market share indefinitely. These argue in favor of the ability of small firms to remain competitive. The issues of managing diverse firms in different markets and different geographies are not trivial. The innovation that has traditionally come from small firms is not lost here, notwithstanding the arguments in favor of the potential for innovation in larger organizations. In addition, incentive compatibility issues all speak in favor of the survival of small firms. Especially today, small firms seem quite capable of finding a niche as more focused competitors.

Finally, regulation may also support this argument. The advent of the Financial Services Holding Company contains considerable baggage. The oversight by the Federal Reserve, so-called “Fed Lite,” is unlikely to be lite. Existing regulators in other areas—including insurance regulators in the National Association of Insurance Commissioners, the SEC, and the foreign regulators—could create a situation in which many participants find it unprofitable to pursue universal product offerings. Some firms will find it too burdensome to become too big. The gains in efficiency, scope economies, and other areas may be swamped by the excessive regulatory cost.

If the burdens of oversight spring from legitimate public policy concerns (discussed below), this is the right outcome and it is socially optimal. However, if the burdens are the result of a lack of efficient oversight and regulatory turf wars, society as a whole loses as a result of the excessive burden of regulation.

Choosing a Method of Expansion: Acquisition or Entry?

Some firms will become large universal banking firms in spite of the regulatory burden. These firms will be able to exploit the

synergies between the operating units in such a way that the regulatory cost will be swamped by the aforementioned advantages. The next decision that such firms will face is the choice of methods to achieve product line expansion. There are two possible approaches we will focus on here: expansion through acquisition or new entry.

Every organization contemplating product line expansion must weigh the relative desirability of entry methods. It may enter by purchasing an existing firm or by establishing an entirely new firm or subsidiary. This decision will depend on several factors:

- the nature of the new business and its relationship to existing capabilities,
- the start-up costs involved, in terms of initial capital, technology platform, and unique infrastructure or distribution requirements,
- the nature of the brand name or franchise value required for market penetration.

The method used to extend product offerings into a new channel or to offer a greater product array will depend most importantly on the relationship of the new product area to the existing businesses of the firm. As a general matter, a closely related new activity favors new entry over entry through acquisition. For this reason, commercial banks traditionally have found it easier to enter directly into investment banking, where the synergies between a commercial and investment bank in terms of investment and credit analysis favored expansion over acquisition. However, the new emphasis on distribution and special product knowledge may be changing this perception as recent acquisitions suggest—for example, Fleming by Chase, and Bankers Trust by Deutsche Bank. The perceived need to acquire specific product knowledge is also the case for entering into the insurance industry. Actuarial science is a relatively new field for banking institutions. Thus, mergers between commercial banks and insurance companies appear more likely.

Purchasing an existing firm has several advantages. First, the start-up costs are lower. A target company has already made the necessary infrastructure investment, and technology is increasingly seen as a major barrier to entry. In addition, the purchased firm is a going concern, with a customer base that can be leveraged and cross-sold into other products—for example, the recent Citigroup and Schwab acquisitions. To the extent that this is specific capital, the purchase of an existing firm is preferred to assembling the capability piecemeal. Furthermore, to the extent that these benefits are somewhat unique to a single partner, the market price of the acquired firm will be less than its value to its new owner, with its

substantial synergy capabilities. However, taking over an existing firm requires adaptation and a particular set of management challenges. If the two cultures clash, the whole venture will suffer, and the specific know-how of the acquired firm will be dissipated by the acquisition process itself.

The third advantage of pursuing an acquisition strategy, as opposed to de novo entry, is the fact that the existing firm may have a valuable asset, such as brand recognition, beyond the acquirer's existing customers. The target company as a going concern is potentially already established in the industry, with known capability and an existing customer base. This is especially important when purchasing a firm far from the acquirer's existing product offering and reputation area. Purchasing a firm gives instant credibility and access.

By contrast, in closely allied product areas, the acquiring firm is already well established and the opportunities that come with another brand name are not as desirable. Thus, building a new subsidiary is not as difficult and the franchise value of the existing firms is not as valuable to the acquirer. It therefore appears more likely that a firm whose core business is similar to the target area will create its own operations through internal expansion.

Choosing a Method of Expansion: Alliances?

However, there is the middle ground of alliances, whereby firms can expand capability in a manner short of direct ownership. On the surface, this presents a viable alternative to either buying or building. In addition, this should substantially reduce the regulatory costs associated with extending the firm's range and reach.

Using alliances is seen as a fertile middle ground for industry product expansion (Dyer and Singh 1998). In fact, alliances have been an effective means of expansion in both the nonfinancial and financial sectors. However, as noted in the management literature, such arrangements achieve their desired outcome only when alliance partners truly commit to the partnership. Interested firms must combine or invest in idiosyncratic assets, knowledge, and/or capabilities to leverage complementary resource endowments. This creates a real governance challenge. To quote Parkhe (1993, p. 301), "strategic alliances are frequently subject to high instability, poor performance, and premature dissolution" as a result.

This has been the case in financial services, where, in most instances, alliances have proved rather temporary. The examples include the cash management account, private label proprietary mutual funds, and annuity distribution agreements. These experiences, among others, point to the

transitory nature of intraindustry alliances and joint distribution agreements. This may not be the case for alliances with vendor organizations, such as technology firms, where partnerships have proved more durable. Nonetheless, most see alliances as transitory agreements that lack permanence and forestall a long-run decision on entry.

The Resultant Industrial Structure?

The next logical question is whether or not any one of these models of firm structure is stable. Will the industrial structure be one of only huge universal banks? In time, will the niche players ultimately acquiesce and join larger organizations? Or, will the universal financial firm devolve, as the conglomerate industrial firm did in the 1960s (Bhagat, Schleifer, and Vishney 1990)? Will our children see the resurgence of the partnerships and small securities firms that populated Wall Street forty years ago? Will Main Street see the return of local banks and regional brokers?

It seems most likely that there will be a mix of specialized firms and universal firms. There appears to be no economic force majeure that will lead to a single firm type, and, by extension, it seems likely that there will always be room for specialized firms. However, history suggests that alliances have not been a stable industrial form. There is no reason to expect that this will change in the future.

At the same time, we do not expect to see the massive spin-off of divisions in the financial sector, which occurred as raiders spun off and broke up the industrial conglomerates of years past. To us, there is a clear distinction between the random collection of unrelated businesses that represented the industrial conglomerate and the emergence of the universal financial firm (Bhagat, Schleifer, and Vishney 1990). The latter is rooted in the belief that the firm has generic capabilities, including either financial asset management and/or unique customer knowledge. The target customer group may be defined by type (for example, wealthy individual or large corporate) or by distribution channel (for example, branches or the Internet). In any case, the strategy is not a simple diversification play, but an interest in capitalizing on specific capabilities across the financial industry.

It certainly is possible that the financial supermarkets can garner a majority of the market share from the specialized firms. This trend is already present in the data on ten- and twenty-firm concentration ratios in the banking, underwriting, asset management, and insurance industries (Santomero and Babbel 2000). However, if the universal firms gain a majority of the market share, there will always be specialized firms in the

industry. For the reasons outlined above, the niche player remains a credible competitor in all but the narrowest of product lines.

Conversely, the universal bank model can succeed only if it can adequately address the contagion concerns expressed above. Recall that the last restructuring of the financial sector was a direct result of systemic concerns. The perception that the franchise of the broad financial firm is intertwined with its operating units suggests that a failure or crisis in any one unit will drag the entire company down with it.

Regulators worry about this issue and have attempted to put in place sufficient firewalls to keep the operating units separate. However, this often results in a loss in efficiency, as such legal structures and regulations increase operating costs and raise the minimum price of services provided. In the limit, such restrictions reduce the market share of regulated firms and shift the activity to unregulated competitors or institutions from less regulated regions of the world who are vying for the same customer's business. And, such regulations and organizational restrictions may not even address the real problem. The issue of contagion is more than a matter of legal separation. It involves reputation and brand name, which suggests that adverse publicity associated with a major firm transcends the legal structure of the firm and goes directly to future revenue potential. For this reason, the market will not be assuaged by neat legal separation.

Little can be added to the discussion of the first point. If one believes that systemic risk is increased rather than decreased by the extended financial firms, this implies a stronger role for regulation in the sector. This has led to a call for the full array of regulatory oversight, prudential regulation, and careful separation of financial activities contained in the holding company. This is the very essence of the arguments in favor of standard regulation (Herring and Santomero forthcoming) and the Federal Reserve position in the debates on H.R.10. Conceding a role for regulation in the financial sector, the issue here is whether the emergence of the universal financial firm exacerbates the stability concerns of regulators.

It appears that it does. By virtue of the fact that the financial firm is engaged in many financial activities, there is an increase in the probability of some form of financial distress within the combined entity that would extend to the holding company and its subsidiaries. In short, something is likely to go wrong somewhere in the franchise, and this could be destabilizing to the firm, the entire sector, and the economy at large.

The counterargument is that the additional diversification present in these firms will dampen volatility, rather than exacerbate it. This is clearly true for small changes in economic performance from quarter to quarter. However, as the Asian crisis illustrated (Diebold and Santomero 1999), correlations tend to increase in crisis episodes. This renders standard diversification measures less useful in times of financial distress. For this reason, regulators have been legitimately concerned about the growth of large universal firms and their effect on macroeconomic stability. The solution, of course, is central bank intervention.

However, the expectation of central bank intervention has its own problems, as Karaken and Wallace (1978) pointed out some twenty years ago. Regulation leads to the expectation of government intervention, which permits the market to relegate risk control to the central bank. This, of course, leads to a problem of government-induced moral hazard. One need look no further than the savings and loan scandal in the 1980s to highlight the existence of government-induced moral hazard and to note that it is not an artifact of universal banking.

The advent of universal firms, however, exacerbates this problem in two ways. First, the increased size of the financial firm makes government intervention a virtual certainty, notwithstanding the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). No reasonable market participant could question the importance of one of these financial conglomerates. So in time of crisis, there is little question of support by the Federal Reserve. In addition, universal banking does present a new way in which

5. Implications for Public Policy

This is perhaps an appropriate place to introduce the public policy concerns. In fact, some have suggested that regulators and policymakers have a clear stake in large financial firms because universal banks are susceptible to contagion effects. Beyond this, however, other reasons are offered for regulatory oversight and intervention. The four major public policy concerns usually expressed include:

- the above-mentioned argument of systemic stability concerns,
- an opposite concern over an extension of the government safety net to these broad financial firms,
- the impact of consolidation and convergence on the concentration of power, in several manifestations, and
- the age-old concerns over conflicts of interest and predatory business practices.

government-induced moral hazard can manifest itself. Boyd explains how government-induced moral hazard manifests itself in the universal banking system and how it can be passed down to nonbank subsidiaries owned by universal banks.

This will create both the appearance and the reality of a double standard between big and small firms in the financial sector. Some would argue that such a standard already exists, with some firms viewed as "too big to fail" and others "too small to save" (Cole and Gunther 1994). The evolving financial institution structure will exacerbate this distinction. Some authors speculate that this will result in an extension of the government safety net to other types of financial firms. We hope and trust that this will not be the outcome. Nonetheless, the present situation represents an unlevel playing field, wherein some bank-owned subsidiaries may appear guaranteed by the federal government. Greenspan (1997) has recently argued that bank holding companies may be able to pass cheaper borrowed funds along to subsidiaries, to create an additional unfair competitive advantage.

In the end, this may all lead to a large taxpayer bill, as these huge firms become too big to fail. These firms may become financially troubled and require an expensive government bailout that could eventually cost taxpayers money. At the very least, the Treasury Department has entered into the derivatives business by writing a large number of "puts" on the financial conglomerates operating within its jurisdiction.

A somewhat different concern relates to the sheer size of these megafirms and the implication that this might have for the economy as a whole. As these new financial firms emerge, some policy experts worry that economic power in the financial markets may become so concentrated that such firms could manipulate or at least affect the whole financial sector, to the detriment of the economy as a whole. Even unwittingly, they may unilaterally affect the flow of capital in particular directions that could have a substantial impact on specific segments of the economy.

These concerns have several concrete manifestations. As large firms begin to be the major providers of all financial products, consumer advocates have expressed concern about credit availability and equal access to all members of the economy. Consolidated products, limited access to credit for low-income groups, and predatory lending are all seen as part of the process of consolidation (Benston 1994 and Berger and Udell 1996).

There has been particular concern over credit availability for small firms. Small businesses are crucial to the economy—especially local economies—and if their access to capital is diminished by the emergence of these large financial firms, the public will suffer. The amount of credit available to small

businesses is viewed as so important to the political process that FDICIA mandated regular reporting to Congress of the amount of credit available to small businesses.

Recently, some criticism has been directed against large commercial banks for their reduced lending to small businesses and for being equally strict when dispersing capital to local governments (Berger and Udell 1992). This issue has also received attention because the recent empirical studies suggest that the concern is real and verifiable. Berger and Udell investigate this issue and find that "as banks become larger and more complex, they may become less inclined to supply credit services to small businesses."

The only real answer to these concerns is competition, brought about by free entry in open markets. Inasmuch as various members of the financial community are expanding their product array and increasingly using the Internet as a financial product distribution channel, one should expect that industry participants will seek profit opportunities no matter where they are. As long as access to the consumer and small business markets is open, there appears to be little reason for concern. Beyond this, one must remember the unique financial structure of the U.S. market. Banking institutions play a relatively small role in the sector, unlike their dominant role in Germany and Japan (Allen and Santomero forthcoming). Therefore, as long as competitors from any part of the financial sector have access to the market, there is little reason to expect that resources will not find their way to fertile profit opportunities.

Finally, there is the concern that conglomerates may use unfair business practices to the detriment of the consumer. By this theory, mergers may be motivated, in part, by attempts to increase market power (Amel and Rhoades 1989). Proponents of this view point out that deals among financial firms with substantial geographic overlap reduce the number of firms in markets in which both organizations compete. A related effect of in-market mergers is that the market share of the surviving organization increases. These changes in market structure make the affected markets more vulnerable to reduced competition. The increased market power of the surviving organization may enable it to earn higher profits by raising loan rates and lowering deposit rates. The bank regulation literature offers ample evidence of the relationship between structure and performance (Wolken and Rose 1991). To the extent that a local market can be exploited by a merger, that literature suggests that the potential gain could be substantial.

It should be noted that antitrust policies of the Federal Reserve and the Department of Justice are designed to prohibit mergers with substantially anticompetitive effects (Berger and Humphrey 1992). Nonetheless, free entry remains the

preferred solution to such competitive concerns in local markets. This has become increasingly true as the relevant market definition for most financial products has become increasingly national, if not global, due to the new technology of delivery. In fact, it is best to think of all financial product markets as global, rather than local.

Additionally, concerned parties offer a list of predatory practices and nefarious acts that *may* arise from consolidation. Walter (1997) points out six such conflicts that have been suggested as potential conflicts of interest in universal banking:

- 1) salesman's stake,
- 2) stuffing fiduciary accounts,
- 3) bankruptcy-risk transfer,
- 4) third-party loans,
- 5) tie-ins,
- 6) information transfer.

The first of these occurs when a broker gives inappropriate advice when selling products offered by affiliates. The second occurs when an underwriting institution places investments into an affiliate that it is unable to sell in the open market. The third occurs when a bank has private information on the bankruptcy risk of a debtor and encourages the distressed firm to issue other securities to pay off affiliate debt. The fourth and fifth conflicts occur when the firm inappropriately packages products with cross-subsidies. Such tie-ins are said to be a result of a firm using its power in one market to "encourage" the client to purchase a second product from an affiliate. The final source of these conflicts is said to occur when one division or line of a business can relay private information on the financial situation of a client to another division in an effort to gain competitive advantage and unique price-setting power.

Many of these alleged abuses are the direct outgrowth of the synergies available from a universal bank, which can use the information gathered to serve its clients better. It is a manifestation of the economies of scope discussed above available to such firms. It is not at all clear that forbidding such information sharing and cross-subsidies is detrimental to the consumer and to overall credit availability.

Yet many opponents of financial modernization are convinced that financial conglomerates will use their size and power to take advantage of the consumer, using one or more of these mechanisms. To alleviate these potential problems, universal banks will almost certainly have to be exposed to further oversight in these matters.

However, as noted above, the real solution to these concerns is the assurance of full disclosure and sufficient competition from other service providers to impose market discipline. If the

customer has options, then the potential of informed suppliers looking at all of the customer's financial needs need not be very worrisome.

6. Conclusion

In this paper, we have consolidated many of the arguments for and against the financial conglomeration that is occurring in the U.S. financial market. We offered our view of the effect of this new competitive landscape on affected financial firms, as well as on the behavior of the capital market itself. Our focus was on the impact of the changing nature of both the market infrastructure and the regulatory regime on the behavior and likely span of activity conducted by large financial firms.

We looked at the implications of the changing financial environment from two perspectives: a firm level and a public policy level. After a review of the firm-level issues, we concluded that the balance of costs and benefits associated with a broader product array seems to favor the more universal financial firm franchise. The benefits of scale and/or scope, the revenue enhancements, the bigger playing field, the potential for greater innovation, and the added stability all favor the observed movement toward universal firms. The results, however, are not unequivocal. There are real concerns over complexity, complacency, and fragility of franchise.

This does not, however, imply that all firms will be universal or that all niche firms are in trouble. It seems most likely that there will be a mix of specialized firms and universal firms. Nevertheless, we know that alliances have not been of a stable form, and there is no reason to expect that this will change going forward.

The advent of universal firms, however, exacerbates the regulatory challenges. First, their increased size makes government intervention virtually certain. This may well create both the appearance and the reality of a double standard between big and small firms in the financial sector.

The only real answer to these concerns is competition, and the increased competition that free entry and open markets bring. Inasmuch as various members of the financial community are expanding their product array, one should expect that these new entrants will seek profit opportunities no matter where they are. Therefore, as long as competitors from any part of the financial sector have access to the market, there is little reason to expect that resources will not find their way to fertile profit opportunities. As long as the consumer and small business markets are open, there appears to be little reason for concern.

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