

# Banks and nonbanks: The horse race continues

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Financial services have been provided by individuals and commercial enterprises at least since Biblical times. During the last few centuries, some business firms began to specialize by providing only financial services. Until recently, the specialization tended to be very narrow; some firms provided insurance, others home mortgage lending, and still others consumer lending. Even commercial banks, which now serve a wide range of commercial, household, and government customers by intermeditating across a wide range of financial products, for many years restricted themselves to commercial lending.

During the last decade, several trends have reshaped the financial services industry. Many specialized financial firms have sought to diversify themselves and have begun to offer a wider range of financial products than they had offered previously. For example, S&Ls and mutual savings banks now offer commercial and consumer credit in addition to their more traditional product, home mortgages, and credit unions have begun to offer home mortgages in addition to their traditional product, consumer credit. Further, all three of these depository institutions have begun to offer a wider range of deposit instruments, particularly transaction accounts, that they had not offered previously. In addition to depository institutions, many other financial firms have sought to increase the breadth of their product array. For example, insurance companies have acquired securities companies, consumer finance companies, and banks.

Also over the last decade, firms whose primary orientation has been nonfinancial have become much more heavily involved in financial services, both related and unrelated to their primary product lines. Not only have these firms been making inroads into the market share of banks with some of the products they offer, but the pace of these new competitive thrusts seems to have accelerated during the last five years (see Table 1).

The list of bank competitors now includes not only depository institutions—commercial banks, savings and loan associations, mutual savings banks, and credit unions—but well-

known nondeposit-based competitors such as American Express, Merrill Lynch, and Sears as well as lesser-known nonbank competitors such as National Steel, J. C. Penney, and Westinghouse. Some of these nonbank firms have been more successful than others in providing financial services. Some firms are retrenching, while others are integrating and regrouping, after recently acquiring or establishing financial services operations.

This article examines competition in financial services over the past few years and analyzes how the financial services operations of nondeposit-based firms have fared relative to banking firms and relative to each other. The article is the third annual review of this subject by the authors and differs from the previous studies in that it is able to distinguish a few emerging trends that were not available in the prior "snap-shot," cross-sectional analyses. In addition, the use of 1983 and some 1984 data allows us to speculate on deregulation's impact upon the ability of commercial banks to deal with the nondeposit-based rivals. The financial services activities of 30 nonbank companies, classified into four groups—retailers, industrial-based companies, diversified financial firms, and insurance-based companies—are examined along with publicly available accounting data for the 30 firms, the 15 largest bank holding companies, and all insured, domestic commercial banks. (For a list of the nonbank companies in each group and the 15 largest bank holding companies, see Table 2.)

Most of the data are for the years 1981, the first year for which information on the individual companies was gathered, and 1983, the last year for which annual report information was readily available. When available, however, 1984 data are used. Unless stated otherwise, total consumer lending includes consumer installment and one-to-four family residential mortgages; commercial lending includes commercial and industrial (C&I) loans

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**Table 1**  
**Financial services offered by selected nonfinancial companies**

	General Motors	Ford	ITT	General Electric	Control Data	Borg- Warner	Westing- house	Sears	Marcor	J. C. Penney
Commercial finance:										
Commercial lending	1944	1960	1954-5	1965	1968	*	1961		1966	
Factoring					1968					
A/R and inventory finance	1919	1959	1971	1932	1968	1950	1954			
Venture capital				1970	1971					
Consumer finance:										
Sales finance	1919	1959	1964	1964	1968	1953	1959	1911	1917	1958
Personal finance		1966	1964	1965	1968	1969		1962	1966	1970
Credit card			1983		1983			*	1957	1958
Real estate:										
Mortgage banking			1983	1981	1982	1982		1972		1970
Residential first mortgages				1981	1982	1982		1961		1981
Residential second mortgages			1972	1965	1979		1969	1961	1966	
Real estate development		1969	1970	1960	1972	1969	1969	1960	1970	1970
Real estate sales & management				1983	1981			1960	1970	1970
Commercial real estate & finance		1960	1980	1963			1969	1961	1966	1970
Insurance:										
Credit life insurance	1975	1962	1964	1973	1968	1970		1960	1966	1970
Regular life insurance		1974	1964	1973	1968			1957	1966	1970
Property & casualty insurance	1925	1959	1964	1970	1968	1970		1931		1970
Accident & health insurance			1964	1973	1968			1958	1968	1967
Leasing:										
Equipment and personal property	1981	1966	1968	1963	1968	1968	1968			
Real property leasing								1960	1970	1970
Lease brokerage		1982	1982					1981		
Investment services:										
Investment management			1966					1969		
Mutual fund sales		1982	1966					1969		1970
Corporate trust & agency										
Custodial services										
Business and personal services:										
Travel services		1978						1961	1971	
Cash management services								1981		
Tax preparation services									1966-70	1969
Financial data processing services			1965			1968	1970			1982
Credit card management services				1965			1969			

\*Entry date unavailable.

SOURCE: Cleveland A. Christophe, *Competition in Financial Services* (New York, First National City Corporation, 1974), Company Annual Reports, and phone conversations with company spokesmen.

and commercial mortgages; and total finance receivables include consumer loans, commercial loans, and lease finance receivables.

### Overview and background

In 1972, at least ten nonfinancial firms had significant financial services earnings,<sup>1</sup> and by 1981 this list had grown over three-fold.<sup>2</sup> Further, in 1981, these nonbank companies posed a competitive threat to banks and other depository institutions in a number of their traditional product lines.

In the area of consumer lending, nonbank firms seemed to have dominated in 1981. Of the 15 largest consumer installment lenders, ten

were nonbank firms, and General Motors topped the list with over \$31 billion in consumer finance receivables. These ten firms accounted for 24 percent of all consumer installment credit outstanding.<sup>3</sup> This is quite impressive since the remaining 76 percent was accounted for by over 15,000 commercial banks, 3,100 savings and loan associations, 400 mutual savings banks, 3,100 credit unions, as well as numerous other nondeposit-based companies, primarily finance companies. Nevertheless, market shares in consumer installment lending are quite fluid: the new business volume accounted for by any supplier changes drastically with changes in the economy.

By 1981, nonbank firms had also encroached on commercial banks' prime turf—business lending—although commercial banks were, and still are, the dominant commercial lenders. At year-end 1981, the top 15 bank holding companies had nearly \$300 billion in C&I loans outstanding worldwide, while the selected 30 nonbank companies had less than one-third of that total. However, 14 selected industrial-based firms did outweigh the bank holding companies in lease financing, and a mere five insurance-based firms bested the bank holding companies in commercial mortgage lending.

Throughout 1982, nonbank competitors continued to make inroads in the financial services industry. Sears, for example, opened its first in-store financial service center, and several securities-based firms and a furniture store acquired "nonbank banks." Nevertheless, commercial banks were beginning to regain some of the market share that they had lost, mostly in consumer lending, over the previous four or five years. By 1983, the entire banking industry was reacting vigorously to the competitive threats posed by the nonbanks, aided in part by the virtual demise of Regulation Q and the creation (in December 1982) of the Money Market Deposit Account. Banks of all sizes and locations began to offer new services such as discount brokerage and to find other ways to compete more effectively in a new and changing environment.<sup>4</sup>

During 1983, the nonbanks continued to increase their financial services earnings (Table 3). The profits from financial activities of 30 selected nonbank companies increased 19 percent between 1981 and 1983, exceeding the earnings growth of the 15 largest bank holding companies and all domestic, insured commercial banks. At year-end 1983, the 30 nonbank firms' profits from financial activities were \$8 billion, more than half of the combined profits of the nation's 15,000 commercial banks.

Over the 1981-83 period, the nonbanks increased their total finance receivables as well. The combined finance receivables of the 30 nonbank firms increased 16 percent from 1981 to 1983, slightly faster than the top 15 bank holding companies, but slower than all commercial banks.<sup>5</sup>

All nonbank firms are clearly not alike in providing financial services. They do not offer all of the same financial products and services,

**Table 2**  
**List of 30 nonbank firms and**  
**15 largest BHCs ranked by assets**

NONBANKS:

Retailers:	Diversified Financials:
Sears	American Express
J.C. Penney	Merrill Lynch
Montgomery Ward	E.F. Hutton
	Household International
Industrials:	Beneficial Corp.
General Motors	Avco Corp.
Ford Motor	Loews Corp.
Chrysler	Transamerica
IBM	
General Electric	Insurance companies:
Westinghouse	Prudential
Borg-Warner	Equitable Life Assurance
Gulf & Western	Aetna Life & Casualty
Control Data	American General Corp.
Greyhound	The Travelers
Dana Corp.	
Armco Corp.	
National Intergroup	
ITT Corp.	

BANK HOLDING COMPANIES

Citicorp
BankAmerica Corp.
Chase Manhattan Corp.
Manufacturers Hanover Corp.
Continental Illinois Corp.
Chemical New York Corp.
J.P. Morgan & Co.
First Interstate Bancorp
Security Pacific Corp.
Bankers Trust New York Corp.
First Chicago Corp.
Wells Fargo & Co.
Crocker National Corp.
Marine Midland Banks, Inc.
Mellon National Corp.

and they do not target the same markets. Some nonbank firms primarily target consumers, while some do not provide financial services to consumers at all. Also, some nonbank firms have outperformed other nonbanks as well as banks, whereas others have struggled to earn a profit.

To gain more insight into these nonbank competitors and, therefore, competition in the financial services industry, it is helpful to classify the nonbanks into groups based on each firm's primary line of business and then analyze each group in relation to traditional suppliers of financial services—banks and bank holding companies—before examining them in relation to one another.

**Table 3**  
**Financial services at a glance: 1981-83**  
(\$ billions)

	Total finance receivables		Consumer loans		Commercial loans		Lease financing		Financial services earnings	
	1983	% change 1981-83	1982	% change 1981-83	1983	% change 1981-83	1983	% change 1981-83	1983	% change 1981-83
3 retailers	26.4	38	26.4	38	—	—	—	—	0.9	50
14 industrial-based firms	133.3	16	72.0	14	43.8	17	17.5	22	2.2	57
8 diversified financial firms	38.7	8	29.7	9	7.4	14	1.6	26	1.6	18
5 insurance-based firms	<u>63.3</u>	13	<u>14.4</u>	18	<u>48.3</u>	13	<u>0.6</u>	-33	<u>3.3</u>	3
Total, 30 nonbanks	262.3	16	142.5	17	99.5	15	19.7	18	8.0	19
Top 15 bank holding companies (domestic)	295.5	14	104.4	26	175.1	8	16.0	12	3.6	0
All domestic, insured commercial banks	1,136.5	21	383.8	13	563.7	24	14.2	8	15.7	6

SOURCE: Company annual reports and *Federal Reserve Bulletin*, various issues.

## Retailers

Retailers compete with banks and other financial services providers primarily in consumer-oriented product lines. Retailers' concentration in consumer-oriented financial services should not be surprising because many of them entered the financial services industry by offering credit in conjunction with retail purchases. Sears, perhaps the most famous and aggressive of the retailers that provide financial services, began offering retail credit in 1910. Similarly, J. C. Penney and Montgomery Ward became involved in financial services by financing their retail sales.

Retailers, however, offer many financial products and services besides retail credit. Some offer many of the same financial products and services to consumers that banks do. In addition, they offer insurance products and maintain offices across state lines.

One explanation for the retailers' foray into financial services can be found in the retail trade. Retailing has undergone several changes over the last few years. Such retailers as Sears, J.C. Penney, and Montgomery Ward have been faced with stiff competition from the new discount stores and the specialty stores. Furthermore, according to *Moody's Industry Outlook*, only moderate growth in retailing is expected over the next five years, and the

retailers that will "show some growth are off-price retail[ers] and some companies in the upscale discounting and specialty fields."<sup>6</sup>

Such an environment has sent retailers like Sears searching for ways to capitalize on their extensive distribution networks, large customer bases, and solid reputations. Together these three retailers operate over 2,600 stores nationwide, giving them the underlying basis for a retail branching network that banks, at least for the time being, are prohibited from duplicating. In addition, Sears, Penney, and Wards combined have 50 million credit customers, many of whom utilize these stores on a regular basis.

Given their experience in credit operations and, for some, their experience in providing insurance, retailers seem particularly well-suited to expand their activities in financial services. In addition, these retailers are getting closer and closer to providing one-stop financial shopping. A consumer can obtain many of his financial services at some Sears or Penney stores, and shop for clothes, furniture, or hardware at the same location.

**Business volume.** Some retailers have been very aggressive in providing financial services, including installment credit, to consumers.<sup>7</sup> In 1981, the three retailers had combined consumer installment receivables of \$16 billion.

By 1983, the three retailers increased their total consumer installment credit almost 40 percent to \$23 billion. Sears alone in 1981 held nearly \$10 billion in consumer installment credit, and by 1983 had increased its holdings of such debt 45 percent to \$14 billion.

In comparison, over the same two years, all insured, domestic commercial banks increased their installment credit by 17 percent, but the 15 largest bank holding companies' installment credit outstanding jumped 35 percent. Citicorp, perhaps the most aggressive of the top 15 bank holding companies in consumer financial services, increased its consumer installment credit 61 percent over the 1981-83 period.

Although there are banks like Citibank, which are aggressively pursuing the consumer market, the commercial banking industry as a whole has neither gained nor lost market share in consumer installment lending. Commercial banks held about 44 percent of consumer installment debt in 1981 and in 1983. And even though a few retailers are very actively offering financial services to consumers, retailers have not increased their share of consumer credit outstanding, holding about 9 percent of all consumer installment credit since 1978. The 15 largest bank holding companies, however, increased their share of consumer installment credit outstanding nearly 2 percentage points from 13.0 percent to 14.9 percent over the 1981-83 period, while Sears, Wards, and Penney increased their combined share from 5.4 percent to 5.8 percent.

**Credit cards.** Retailers' consumer finance receivables are mostly credit card receivables. In this narrow area of consumer lending, the retailers seem to be more successful than the banks, although banks have come a long way since 1972. Since that year, the number of bank cards outstanding has more than doubled, and annual customer charge volume has grown nearly eightfold.

In credit card operations, however, the retailers still have the edge. At year-end 1983, all retailers had over \$46 billion in credit card receivables, while banks held \$38 billion in Visa and MasterCard credit card receivables. No individual bank had more customer account balances outstanding at that time than Sears, and on the basis of customer charge volume and cards issued, no individual bank came

close to Sears in 1983. In fact, Sears had more customer charge volume than the two largest issuers of bank cards (Bank of America and Citibank) combined.<sup>8</sup>

The Sears credit card, of course, is only accepted in Sears stores, but has achieved widespread acceptance and usage in spite of this disadvantage largely because of the size of Sears relative to other retailers. Visa, Mastercard, and American Express cards are, at least to their users, reasonably good substitutes for money in conducting many day-to-day transactions. Because of its drastically more limited acceptance (it can be used in only about 800 locations), the Sears card is almost useless as a money substitute. In order to overcome this disadvantage Sears announced plans in February 1985 to introduce a universal credit card that would compete directly with Visa, MasterCard, and American Express.

**Profitability.** The financial services operations of the retailers mentioned above are profitable. In 1981, Sears, Wards, and Penney had combined financial services earnings of nearly \$600 million, and in 1983, the financial earnings of these three retailers had increased more than 50 percent to \$927 million. This is about equal to the total 1983 earnings of Bank-America, Chemical New York, and Manufacturers Hanover, the fourth, fifth, and sixth largest bank holding companies ranked by earnings. Also, by 1983, the three retailers had a combined ROE of 12 percent from financial services activities, higher than their combined ROE from retailing and higher than the ROE for all commercial banks.

Furthermore, in 1981 and 1983, financial services earnings represented a significant portion of total earnings for these retailers. For Sears, financial services account for more than half of its total profits. And were it not for its finance subsidiary, Wards would have shown a net loss in 1983, as it did for 1981.

**Long-run impact.** It is probably too soon to conclusively assess the impact that the retailers have, or could have, on the competitive position of commercial banks and other depository institutions. So far only a few retailers have significant financial services operations, and only recently has Sears, the predominant financial services provider among the retailers, committed to becoming a major supplier of fi-

financial services. Penney and Wards are still "experimenting" with financial services. Yet the retailers are making money from their financial businesses; they are increasing their financial receivables; they are expanding their financial operations; and the number of retailers that offer financial services in their stores is increasing. Kmart and Kroger are offering various financial products and services in their retail outlets in conjunction with depository institutions and insurance companies. It appears, therefore, that the financial businesses of retailers have met with success—so far.

The success of a few retailers, however, does not imply the demise of over 15,000 commercial banks as providers of financial services to consumers. In October 1982, *ABA Banking Journal* asked bankers in the eight cities where Sears had launched its financial network whether the in-store centers posed a threat.<sup>9</sup> At that time, none of the bankers thought Sears threatened their competitive positions. One year later, *ABA Banking Journal* repeated its survey and found:

In general, community bankers in cities where in-store centers have opened can't imagine ever feeling seriously threatened by Sears—no matter how numerous nor generally accepted such centers might become.<sup>10</sup>

### **Industrial-based firms**

Industrial-based firms provide a variety of financial services through subsidiaries. At least 14 industrial firms have significant financial services operations (see Table 2). Four of these are captive finance subsidiaries of their manufacturer-parents (General Motors Acceptance Corp., Ford Motor Credit Co., Chrysler Financial Corp., and IBM Credit Corp.), and three were captive subsidiaries but have become independent providers of financial services (General Electric Credit, Westinghouse Credit, and Borg-Warner Acceptance Corp.). The other seven have always been independent of their parents.

The captive finance subsidiaries of the auto companies were originally formed to bolster the sales of their parents' products, especially when demand is weak or other lenders such as banks and independent finance companies are decreasing their auto lending. Thus, in a period, such as the 1978-82 period, which was characterized by a decrease in domestic car

sales, liberalized bankruptcy laws, soaring costs of funds, and interest rate volatility, the captive finance companies of the U.S. auto-makers offered below-market-rate financing to support the sale of their parents' automobiles. During this period, the auto captive finance companies increased their share of auto loans outstanding and greatly increased their share of new auto lending volume (see Figure 1).<sup>11</sup>

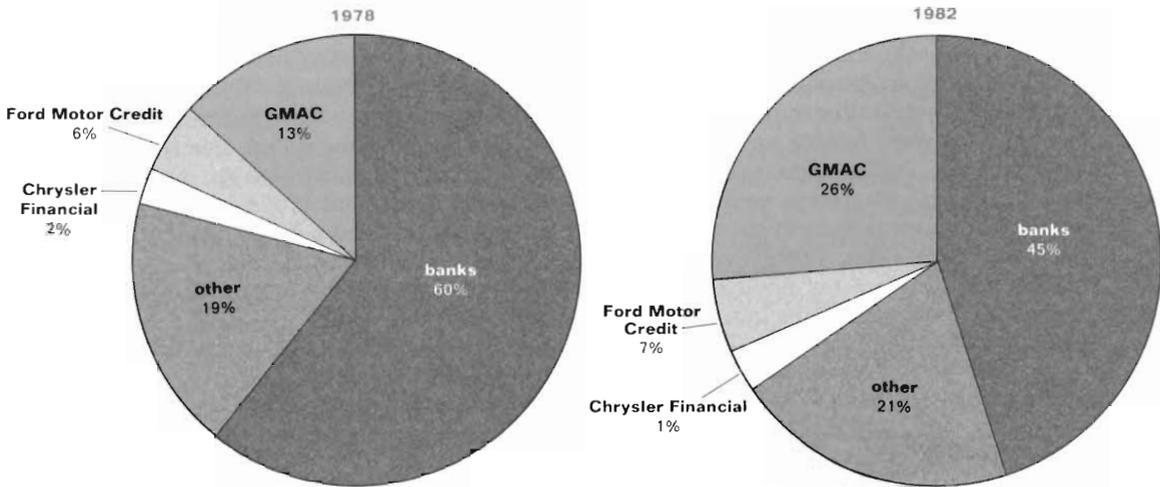
Even though their primary mission remains to support the sale of their parents' products, some of these captives are expanding into other areas of financial services. For example, in March 1985 General Motors announced plans to purchase two mortgage banking subsidiaries. Also, Chrysler is considering expanding its financing operations to include nonautomobile financing.

Some captive finance companies have become independent providers of financial services. These finance companies have the advantage of once having been under their parents' wings. Borg-Warner Acceptance Corporation, for example, gained experience and customers by offering inventory financing to dealers of Borg-Warner products. Today, BWAC provides this service for some of the same customers, but it finances the inventories of products from other manufacturers.

One disadvantage, however, that the finance subsidiaries of industrial-based firms have is that financial services is very different from their parents' traditional lines of business. To some extent this has been overcome by the captives and the once-captives, as financial services activities developed as a complement to their parents' manufacturing operations. For at least one of the independents, this disadvantage could not be overcome. As a result of its huge losses in financial services, Armco sold its insurance operations in 1983. As stated in the 1983 *Armco Annual Report*, "This change in strategic direction reflects a renewed emphasis on the businesses and market niches we know best."<sup>12</sup>

**Business volume.** The industrial-based firms, as a group, provide financial services to consumers as well as to businesses. Ten of the 14 industrial firms provide consumer financing; these ten companies held over \$72 billion in consumer credit outstanding at year-end 1983, nearly all of which was consumer installment credit (Table 3). These 10 industrial firms held

Figure 1  
Shares of auto loans outstanding



NOTE: The shares for 1983 were as follows: Banks, 47%; GMAC, 26%; Ford Motor Credit, 8%; Chrysler Financial, 1%; and other, 18%.  
SOURCE: Federal Reserve Bulletin and company annual reports.

nearly 16 percent of all consumer installment credit outstanding, while the top 15 bank holding companies held 15 percent. Further, in 1983, GMAC alone held over \$40 billion, more than the combined consumer installment credit held at the four largest bank holding companies.

Consumer finance receivables held by the ten industrial firms grew by 14 percent over the 1981-83 period, yet they did not keep pace with the bank holding companies. Similarly, in consumer installment lending the ten industrial companies increased their outstandings 19 percent over the two-year period, but again they did not keep pace with the top 15 bank holding companies.

Each of the 14 selected industrial firms offers commercial financing or lease financing. At year-end 1983, these 14 industrial firms held nearly \$44 billion in commercial loans (C&I loans and commercial mortgages); C&I loans account for nearly all of this amount. Nevertheless, the 14 industrial firms accounted for about 8 percent of all C&I loans outstanding at the end of 1983, while the top 15 bank holding companies accounted for 31 percent. GMAC, however, held \$11.4 billion in C&I loans, roughly equal to the domestic C&I loans

of Chase Manhattan Corp., the third largest bank holding company.

The industrial-based companies increased their C&I loans 14 percent between 1981 and 1983, outpacing the bank holding companies but not all commercial banks, which increased their C&I loans by 25 percent. Borg-Warner and Commercial Credit Corp. led the industrial firms, increasing their C&I loans 43 percent each.<sup>13</sup>

The 14 industrial firms increased their commercial mortgage receivables 74 percent from 1981 to 1983, much faster than the top 15 bank holding companies and all insured domestic commercial banks. The industrial firms, however, have only \$3.4 billion in commercial mortgages, less than one percent of all commercial mortgages outstanding in 1983, and only six of the 14 industrials make commercial real estate loans.

Lease financing is the area in which the industrial companies shine. At year-end 1983, they had a combined \$17.5 billion in lease receivables, more than the 15 largest bank holding companies and more than all domestic, commercial banks. Further, the industrial firms increased their lease receivables 22 percent over the 1981-83 period. Bank holding

companies increased their lease receivables only 12 percent, and banks, 8 percent during this period.

One reason for the industrial firms' success in leasing is that companies such as GECC and Westinghouse, which have parents with large and growing profit bases, gain a competitive advantage by exploiting an opportunity in the tax laws. In their leasing activities, the finance subsidiaries retain ownership of the equipment they lease; therefore, their parents get to apply the depreciation, investment tax credits, and, in some cases, energy credits to their taxable income (since the finance subsidiaries are consolidated with the parent and other subsidiaries for tax purposes). These tax savings can then be passed on to the finance subsidiaries' customers in the form of lower leasing rates, thus allowing the finance subsidiaries to undercut the competition. Banks and bank holding companies have the same opportunity to use leasing to shelter income from taxes. But from 1981-83 the net income of banks and bank holding companies grew very slowly, providing comparatively little incentive to banks to expand their leasing operations.

Only five of the 14 industrial-based firms take deposits, and each of these four owns depository institutions. As of year-end 1983, these firms—Dana, National Steel, ITT, Control Data—had \$8.4 billion in deposits, 3 percent of the deposits of the five largest bank holding company based on deposits.

**Profitability.** Financial services have been profitable for most of the selected 14 industrial-based firms. The combined financial services earnings of the 14 companies was \$2.2 billion in 1983, nearly two-thirds as much as the earnings of the top 15 bank holding companies. GMAC was by far the biggest moneymaker among the finance subsidiaries of the industrial-based firms, with 1983 earnings over \$1 billion. All other finance subsidiaries earned less than half as much as GMAC, and only one financial services subsidiary posted a net loss for 1983.

The industrial-based firms' financial services earnings grew rapidly (57 percent) over the 1981-83 period, while the total earnings of the top 15 bank holding companies were virtually unchanged over this same period. On an individual basis, however, earnings growth among the manufacturers was mixed. For five

industrial companies, financial services earnings fell, while financial services earnings more than doubled for four others.

Returns on equity (ROEs) for the industrial firms' financial operations exceeded those of their nonfinancial operations in 1981, but the reverse was true in 1983. In 1983 their nonfinancial operations returned 20 percent on equity, outperforming their financial operations by nearly 5 percentage points. Nonetheless, the financial operations of the manufacturers, as a group, experienced a higher ROE in 1983 than did the top 15 bank holding companies or all domestic commercial banks. To some extent, these differences reflect cyclical behavior. The earnings of retailers and manufacturers tend to be coincident with the business cycle; 1981 and 1982 were recession years while 1983 was a year of strong economic rebound. Bank performance tends to lag behind the general economy. Clearly, several more years of profitability data are necessary before conclusions can be drawn regarding the changing comparative profitability of banks and nonbanks.

**Long-run impact.** In some business lines, these industrial companies are formidable competitors of commercial banks. Furthermore, if changing technology provides any basis for economies of scale in offering consumer lending, some of these industrial companies may be even more formidable competitors in the future.

Prior to 1985 none of the industrial firms seem to have posed a competitive threat to banks in commercial or consumer mortgage lending. However, a few, such as General Electric and Borg-Warner, have made aggressive moves into mortgage banking.<sup>14</sup> And as mentioned earlier, General Motors has proposed to acquire two mortgage banking firms. If there are economies of scope in mortgage banking or, more importantly, if these industrial firms *perceive* that there are economies of scope, then certain industrial firms do pose some competitive threat to banks, particularly since Regulation Q no longer confers a cost-of-funds advantage to banks.<sup>15</sup>

In areas in which banks and the industrial firms do compete, the industrial firms' results have been mixed. Some industrial companies have increased their finance receivables in the various lending categories faster than banking organizations, while others have actually de-

creased their receivables over the 1981-83 period. Of course, some firms in the latter group, such as General Electric and Westinghouse, have intentionally decreased their holdings of certain receivables to devote their attention and resources to other financial services areas. Also, some industrial firms have maintained highly profitable financial services operations, but the financial earnings of other firms' plummeted over the 1981-83 period.

### **Diversified Financials**

Eight diversified financial firms have been identified as having a significant presence in the financial services industry (see Table 2). American Express, Merrill Lynch, and E.F. Hutton are large national distribution companies; they have many offices throughout the country and the world, and they offer a wide array of financial services to both consumers and commercial customers. Beneficial and Household are primarily consumer finance companies, and the remaining three firms are truly diversified, having financial as well as nonfinancial operations.

These diversified financial firms compete with banking firms, and it seems that some, but not all, may pose competitive threats to banking firms in providing financial services to consumers as well as business customers. These eight firms compete with banks in most product areas, and they offer a few services that banks are prohibited from offering, such as life and property-casualty insurance.

The diversified financials have extensive distribution networks. These networks give them a nationwide presence, allow them to deliver their services to millions of customers, and enable them to experiment with new products and services at a lower cost than would be possible without their existing distribution networks. These networks, however, may be laden with a history, culture, and tradition that preclude these firms from fully exploiting their advantages.

For example, while Merrill Lynch's delivery network is one of its major strengths, it is also one of its major weaknesses. Indeed, Merrill Lynch's extensive nationwide branch network of over 400 branches employing nearly 9,000 brokers is the primary reason that it generates huge sales volume. But because its

brokers get a cut of all they sell and are motivated primarily by commission income incentives, this approach has tended to be a high-cost distribution system. Furthermore, this type of product delivery system has an inherent inflexibility that makes Merrill Lynch vulnerable at a time when discount brokering and other low-cost distribution methods are gaining market share.<sup>16</sup> The fact that Merrill Lynch operates essentially as a brokerage house also stymies its innovations. At first, Merrill Lynch's Cash Management Account met with much opposition from the brokers because it pays no commission.<sup>17</sup>

Like Merrill Lynch, other diversified financials have found the need to change as more and more financial services concerns are moving toward becoming financial conglomerates; these diversified financial firms are finding change difficult but necessary. American Express, for instance, was until 1981 essentially a travel services company. In 1981, American Express began an acquisition campaign in order to become a major diversified financial services competitor. These acquisitions did allow American Express to enter new markets, including securities brokerage (Shearson), middle market investment products distribution (Investors Diversified Services) and investment banking (Lehman Brothers), and target new customer bases, but the company is now faced with the delicate task of integrating and managing its recently acquired financial businesses. And the success of American Express in these endeavors is not a foregone conclusion; in the early 1970s, American Express entered the brokerage business by acquiring a 25 percent interest in Donaldson, Lufkin, Jenrette, but divested it a few years later.

A characteristic among the diversified financials, which some (especially bankers who want to enter the industry) view as an advantage, is their ability to underwrite and market insurance. Whether insurance products really confer an advantage, however, is open to serious question because the property-casualty insurance industry has suffered losses recently, losing money every year since 1978, and 1983 was the worst year ever.<sup>18</sup> Income from investments, which saved the industry from losses in the past, did not keep pace with underwriting losses. Also, fierce price competition in this industry has contributed to the problem.

**Business volume.** The eight diversified financial firms engage in both consumer and commercial lending. At year-end 1983, they had about \$30 billion of consumer finance receivables outstanding, of which over three quarters was installment credit (see Table 3). In fact, almost all of the mortgage loans of the diversified financials are second mortgages and could, therefore, be classified as installment lending as well. This \$30 billion represented a 9 percent increase over 1981, but a smaller increase than those of all commercial banks and the top 15 bank holding companies.

The range of growth in consumer receivables among the diversified financial firms is quite large. Loews' consumer finance receivables fell 58 percent, while E.F. Hutton's consumer receivables grew 37 percent over the two-year period. Loews' drop in consumer loans reflects the sale of its consumer finance subsidiary in 1983, and Hutton's growth reflects more margin lending. American Express and Merrill Lynch also increased their margin account lending quite rapidly over this period because of the bull market that began in late 1982 and ran through much of 1983. Since bull markets come and go, this high rate of consumer credit expansion is probably not sustainable.

All eight diversified financial firms engage in some form of commercial lending. Over the 1981-83 period, the eight diversified financials increased their holdings of commercial loans faster than the top 15 bank holding companies but slower than the growth rate for all commercial banks. As with the growth of consumer loans, however, the range of commercial loan growth among the eight firms was quite wide. Merrill Lynch increased its outstandings 152 percent, while Household *decreased* its outstandings 44 percent. Furthermore, the absolute size of the combined commercial loan portfolio of the eight diversified financial firms is small—only \$7.4 billion, 1 percent of all C&I loans outstanding at year-end 1983. In contrast, the eight largest bank holding companies accounted for over 20 percent of all C&I loans at that time.

The diversified financial firms are weak, relative to the banking firms, in C&I lending but are somewhat stronger in lease financing and commercial mortgage lending. At year-end 1983, the eight diversified financials held only 3 percent of the C&I loans held by the top

15 bank holding companies, but they held 11 percent of the lease receivables and 16 percent of the commercial mortgage loans of the bank holding companies.

**Deposit substitutes.** The diversified financial firms offer products that compete with bank deposits as well as the lending products just reviewed. Four of the diversified financial firms managed money market funds. At year-end 1984, these four had money fund assets of about \$67 billion. Merrill Lynch alone managed more than \$39 billion, which is roughly equivalent to the deposits of Chemical New York Corp., the sixth largest bank holding company. In addition, six of the eight diversified financial firms own depository institutions, which combined had over \$15 billion in deposits at year-end 1983.

The ownership of money market funds by the diversified financials and others may have represented a competitive threat to banks in the past, but the threat in the current environment seems minimal because money market funds (MMFs) have become a less attractive substitute for money or bank deposits. The Garn-St Germain Act of 1982 granted banks and thrifts the right to offer a money market deposit account (MMDA) that is directly competitive with MMFs. MMDAs were an instant success, growing from zero to more than \$350 billion in just a few months. Over this same period, MMF balances declined by more than 20 percent. By year-end 1984, MMF balances had grown to \$236 billion, about the same level as they were when MMDAs were first introduced. Nonetheless, general purpose MMFs declined from 9.2 percent of M2 (the Federal Reserve's broadly defined money supply) in December 1982 to 7.1 percent in December 1984.

There are several reasons for this decline: 1) MMDAs are covered by federal deposit insurance while MMFs are not; 2) MMDAs can pay the same market rates as MMFs; and 3) MMDAs allow a depositor to maintain an account directly competitive with MMFs at the same depository institution where he conducts the rest of his deposit business, thus affording the convenience of one-stop shopping.

MMFs, however, do have some advantages over MMDAs. MMFs generally allow a greater number of checks to be written than MMDAs, although they usually impose a high

minimum denomination on each check. Also, many MMFs are part of a “family” of mutual funds and allow convenient shifting among members of the mutual fund family, a service that banks cannot match.

Nevertheless, banks can apparently compete very well against their less regulated competitors—such as those diversified financial firms that offer MMFs—when regulatory barriers are relaxed sufficiently for them to compete on a roughly equal footing.

**Profitability.** Financial services seem to be quite profitable for the diversified financial firms. In 1983, the combined eight firms earned more than \$1.6 billion from financial operations, 18 percent more than they earned two years earlier. In comparison, the 15 largest bank holding companies earned \$41 million less than they earned in 1981; however, the top eight bank holding companies earned 16 percent more than they earned in 1981 and twice as much as the eight diversified financial firms. American Express earned \$515 million, the highest 1983 net earnings of the diversified financials and more than any bank holding company except Citicorp (the largest).

All of the diversified financial firms’ product lines are not necessarily profitable. Five of the selected eight diversified financial firms have been hurt recently by problems that have plagued the property-casualty insurance industry. Also, some of these firms have recently exited certain financial businesses. Further, two diversified financial companies, Baldwin-United and Walter E. Heller International, which were included in the Chicago Fed’s two previous studies, have fallen on bad times and were removed from the sample.

**Long-run impact.** The financial services operations of the diversified financial firms seem to be in a state of flux, so whether or not, as a group, they are a significant threat to traditional suppliers is uncertain.

In consumer finance, the combination of the eight diversified financial firms did not do as well as the 15 largest bank holding companies. None of the diversified financials pose any kind of threat in making residential first mortgage loans: almost all of the diversified financial firms’ residential mortgages are second mortgages. Only four of the diversified financials “take deposits” through money market

funds, but six own nonbank banks or have savings and loan subsidiaries.

Some diversified financial firms are expanding their offerings of financial products and services to businesses. Yet even those diversified financial firms that have growing commercial operations accounted at the end of 1983 for too small of a share of total commercial lending and deposit-taking to pose a serious threat to commercial banking firms in these product areas in the near future.

### **Insurance-based companies**

Insurance companies compete with commercial banks and other depository institutions primarily through their investment portfolios. Some insurance companies also compete in the financial services industry through other means. Five of these insurance-based firms are Prudential, Equitable Life Assurance, Aetna Life & Casualty, American General, and Travelers. Among the noninsurance activities of these five firms are mutual funds, brokerage, cash management, mortgage banking, leasing, and consumer finance.

**Business volume.** At year-end 1983, life insurance companies held \$69.5 billion in consumer loans, over three-fourths of which was consumer installment credit (policy loans). The five insurance-based companies mentioned above held \$12.3 billion, or about 3 percent, of all consumer installment loans outstanding. But installment credit held at the 15 largest bank holding companies grew almost three times as fast over the 1981-83 period as installment credit at these five insurance companies. This is what would be expected as interest rates decline, since the demand for policy loans increases when interest rates rise.

In consumer mortgage lending, insurance companies are dwarfed by commercial banks. At year-end 1983, life insurance companies held less than one-tenth of the consumer mortgages held by all commercial banks. Moreover, only two of the selected five insurance-based firms had consumer mortgages on their books in 1983; however, one (Equitable) increased its holdings 24 percent, faster than all commercial banks and faster than the top 15 bank holding companies.

In commercial lending, insurance-based firms are only significant in mortgage lending.

In 1983, the five insurance companies held 8 percent of all commercial mortgage loans outstanding—more than the top 15 bank holding companies and about one-third that of all insured commercial banks. Commercial mortgages, however, grew at a faster pace over the 1981-83 period at commercial banks than they did at insurance companies.

**Profitability.** Total earnings for the five insurance-based firms exceeded \$3.3 billion, nearly as much as the worldwide earnings of the top 15 bank holding companies. Over the 1981-83 period, however, the combined earnings of the five insurance firms increased only 3 percent, and for three of the firms, earnings fell.

**Long-run impact.** Insurance companies do not seem to be a threat to banking firms. In fact, banks have certain attributes that would contribute to their success in offering insurance. These include their image as providers of financial services, their existing customer base, and their existing distribution networks. Consequently, the insurance industry has expressed more concern about banks invading the turf of insurance companies than vice versa.

### **How they all stack up**

All nonbank firms do not compete with all banking firms or with each other. The retailers offer financial products and services, almost exclusively, to consumers, while many of the industrial-based companies devote a greater proportion of their financial services activities to commercial customers than to consumers. Also, of those firms that provide financial services to consumers, not all target the same ones. Some, like Merrill Lynch and American Express, target the "upscale" customer, while others, especially the retailers, target "middle America."

Also, as would be expected, each group of nonbank competitors has not been as successful as other groups in providing financial services, and within the groups, some companies have not done as well as others. Furthermore, banks and bank holding companies have been more successful than the nonbanks in some areas.

In 1983, the nonbank firms held about \$262 billion in finance receivables, almost as

much as that held by the top 15 bank holding companies. The industrial firms accounted for over half of this amount; however, the retailers led the nonbanks in receivables growth over the 1981-83 period, while the diversified financial firms brought up the rear.

In the consumer finance area, the 30 nonbank firms accounted for over 30 percent of all consumer installment credit outstanding in 1983. At that time, seven nondeposit-based firms each held over 1 percent of all consumer installment credit (see Table 4). An industrial firm, General Motors, held over 10 percent, and a retailer, Sears, held 3.5 percent. In contrast, Citicorp, the largest consumer installment lender among the bank holding companies, held about 4 percent.

In commercial financing, the only relevant nonbank groups (so far) are the industrial firms and the insurance companies. The retailers do not engage in commercial financing, and the eight diversified financials held less than one percent of all commercial loans in 1983.

The insurance-based firms and the industrial-based firms each had about a 4 percent share of all commercial receivables at year-end 1983, with \$48.3 billion and \$43.8 billion, respectively. General Motors and IBM had the largest shares of C&I loans among the nonbanks with 2.3 percent and 1.5 percent, respectively. In contrast, BankAmerica, the largest C&I lender among the bank holding companies had a 4.1 percent share. In commercial mortgage lending, Prudential and Equitable had the largest shares, each with about 2 percent. Citicorp held less than 1 percent of all commercial mortgage loans outstanding in 1983.

In lease financing, the only significant group of nonbank firms is the industrial-based companies. They held almost 90 percent of the lease receivables held by the 30 nonbank firms in 1983. Over the 1981-83 period, however, the diversified financial firms increased their lease financing receivables 26 percent, a faster pace than the industrial firms' 22 percent increase. The industrial firms that dominate this lending category are General Electric, General Motors, Ford, Greyhound, and Control Data. Each held over \$1 billion in lease receivables at year-end 1983.

The 30 nonbank firms reported \$8 billion in earnings from financial services in 1983. The

**Table 4**  
**Top 10 consumer installment**  
**lenders: 1983**

	1983		1981	
	\$ bil	Market* share	\$ bil	Market* share
General Motors	\$40.2	10.2%	\$31.1	9.3%
Citicorp	15.4	3.9	9.6	2.9
Sears	13.8	3.5	9.5	2.8
Ford Motor	11.9	3.0	11.9	3.5
BankAmerica Corp	11.4	2.9	9.7	2.9
American Express	7.7	1.9	5.0	1.5
Prudential	6.7	1.7	5.1	1.5
Merrill Lynch	6.1	1.5	4.7	1.4
J.C. Penney	5.5	1.4	4.4	1.3
Security Pacific	5.5	1.4	3.8	1.1
	124.2	31.4	94.8	28.2

\*Market shares for the nonbank firms are slightly understated because second mortgages are excluded from consumer installment credit for these companies.

SOURCE: Company annual reports and *Flow of Funds Accounts, Assets and Liabilities Outstanding 1960-83*, Board of Governors of the Federal Reserve System.

five insurance companies accounted for the largest share of these earnings. The insurance companies, however, although appearing strong in absolute earnings, lag the other nonbank firms in earnings growth. Over the 1981-83 period, the 14 industrial-based firms increased their financial services earnings 57 percent, while the earnings of the insurance companies grew only 3 percent. Five nonbank firms had both high financial services earnings in 1983 and high earnings growth over the 1981-83 period. Three are industrial-based firms—General Motors, Ford, and General Electric. The other two are Sears and American General. No diversified financial firm made this list.

## Conclusions

When attention began to be focused on nonbank competitors—such as Sears, American Express, General Motors, Prudential, and Merrill Lynch—early in the 1980s, their new competitive thrusts seemed to represent a real and immediate danger to the banking industry. With the benefit of hindsight and the research discussed in this and our previous studies, we conclude those fears are unwarranted, although

some nonbank firms have gained substantial market shares in some product lines and are increasing their presence at a very fast pace.

The environment at the beginning of the 1980s must be kept in mind. The banking industry was still reeling from three unanticipated forces: 1) deregulation brought on by the Depository Institutions Deregulation and Monetary Control Act passed in March 1980, which opened up a new era in price competition by phasing out Regulation Q ceilings; 2) prolonged downward sloping yield curves containing record level interest rates all along the maturity spectrum; and 3) record high volatility, or lack of predictability of interest rates. If this were not enough, these events were followed by the steepest recession of the post-World War II period; an international debt crisis; a period of disinflation that undermined the value of tangible assets such as real estate and commodities; and an oil glut. To sort out the separate impact of each of these simultaneous events on the performance of banks would be nearly impossible. To evaluate the impact on bank performance resulting from increased nonbank competition during a period when banks were being buffeted by these other events is even more difficult, if not impossible. Despite these caveats and the fact that only three or four years of data have been analyzed extensively, we offer a few tentative conclusions on financial industry competition.

By far the safest observation that can be made from our analysis is that the banking industry has shown an amazing degree of resiliency in the face of these changes. Small banks gained market share in commercial lending relative to large banks and nonbanks. Large banks gained market share in consumer lending relative to small banks and all nonbanks except retailers. In this hostile macroeconomic environment, bank profitability suffered relative to nonbanks. Yet, in those areas where banks were deregulated in recent years, they have fared quite well against their nonbank competitors. The MMDA vs MMF battle is a case in point.

Prior to 1980, banks were subject to price regulation (Regulation Q and usury ceilings), product restrictions, and geographic restrictions. To be sure, banks do have federal deposit insurance while nonbank competitors do not, but nonbank competitors were subject only to usury ceilings. Since 1980, the driving

force behind the contentiousness of banks and nonbanks has shifted to issues such as the Glass-Steagall Act, and the McFadden Act and the Douglas Amendment to the Bank Holding Company Act.

The nonbanks increased their emphasis on the financial services and products offered by banks because they saw profitable opportunities to be exploited in going against competitors like banks that were not free to adjust their price, product, and geographical mix. Many of these nonbank competitors at the time were not doing particularly well in their own primary product lines where they faced competition that had equal price, product, and geographical freedom.

They also recognized some synergies between their primary lines of business and financial services. For the retailers, financial services allows them to take advantage of their extensive distribution networks, large customer bases, and years of credit experience. Similarly, industrial firms can capitalize on their captive financing experience and, in some cases, their distribution systems. Diversified financials and insurance companies also have extensive distribution systems, and are recognized as suppliers of financial services.

This is not to say that all nonbanks will do well in financial services. Some will do well, others will not. Our research to date does not indicate any particular nonbank firm or group of firms that seems destined to outperform their banking and nonbank competitors. By the same token, no particular bank or group of banks seems destined for success or extinction. However, the limited evidence we have reviewed suggests that banks will improve their chances of competing successfully against their nonbank competitors as geographic and product restrictions are relaxed. That is, many of the regulations designed to protect banks from one another have hurt them by limiting their ability to formulate strategies and actions to deal effectively with their nonbank competitors.

<sup>1</sup> Cleveland A. Christophe. *Competition in Financial Services*, (New York: First National City Corporation, 1974).

<sup>2</sup> Harvey Rosenblum and Diane Siegel. *Competition in Financial Services: The Impact of Nonbank Entry*, Staff Study 83-1, Federal Reserve Bank of Chicago, May 1983; and Harvey Rosenblum and Christine

Pavel, *Financial Services in Transition: The Effects of Nonbank Competitors*, Staff Memo 84-1, Federal Reserve Bank of Chicago, 1984.

<sup>3</sup> Consumer installment credit for the nonbank firms is slightly understated because it excludes second mortgages, which, for the nonbanks, were grouped with consumer first mortgages.

<sup>4</sup> Harvey Rosenblum and Christine Pavel, "1983: The Year in Review," *Commercial West*, 165 (December 31, 1983) pp. 10-11.

<sup>5</sup> Bank assets expanded at a fast rate during the 1981-83 period partly because of a vigorous economic expansion, accompanied by an easier monetary policy beginning in July 1982.

<sup>6</sup> *Moody's Industry Outlook Retail Industry*, (New York: Moody's Investors Service, Inc.) August 24, 1984, p. 4.

<sup>7</sup> Mortgage loans are excluded here because only Sears makes mortgage loans, through Sears Savings Bank in California.

<sup>8</sup> *Nilson Report*, no. 337 (August 1984), p.4 and no. 338 (August 1984), p. 3.

<sup>9</sup> "The only thing we have to fear is Sears itself," *ABA Banking Journal* (October 1983) pp. 58-60.

<sup>10</sup> *Ibid.*, p. 58.

<sup>11</sup> For a variety of reasons, this increased market share was purchased through vigorous price-cutting. For detailed discussion see Harvey Rosenblum and Christine Pavel, "Banking Services in Transition," *Handbook for Banking Strategy*, 1984, pp. 219-26, and Donna Vandenbrink, "Did usury ceilings hold down auto sales?" *Economic Perspectives*, September/October 1984, pp. 24-30.

<sup>12</sup> *Armco Annual Report, 1983*, p. 102.

<sup>13</sup> While it is difficult to provide a definitive interpretation, these findings are consistent with recent trends that show the larger banks emphasizing middle market lending and noncredit services because of the shrinking profitability of lending to large companies that have access to national or global money and credit markets. Smaller and medium-size banks have always confined their commercial lending to small and medium-size customers which, because of their limited access to the national money markets, are forced to maintain their credit relationships with banks and suppliers of trade credit. These data suggest that the larger banks and bank holding companies have a long way to go in luring so-called middle market customers away from their relationships with local and regional banks, trade credit suppliers, and commercial finance companies. When combined with the evidence on consumer lending, these data suggest a significant change in the perceived relative opportunities and profitability of commercial vs. consumer lending.

<sup>14</sup> Since 1981, GECC has engaged in mortgage banking through two subsidiaries, General Electric Mortgage Corp. and General Electric Mortgage Securities Corp. Control Data has engaged in mortgage banking since 1982 through a subsidiary of Commercial Credit Corp.

<sup>15</sup> Economies of scope result when there is a cost advantage to producing two products simultaneously rather than each separately.

<sup>16</sup> "Merrill Lynch's Big Dilemma," *Business Week*, January 16, 1984, pp. 63-67.

<sup>17</sup> In 1984, Merrill Lynch responded to this apparent disadvantage by adopting a reorganization plan designed to transform the company from a sales-oriented firm into a marketing one.

<sup>18</sup> "Insurers' Mounting Troubles," *New York Times*, 14 February 1984, sec. D, pp. 1, 17.