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Changing financial industry structure and regulation

On May 3–5, 2000, the Federal Reserve Bank of Chicago held its 36th annual Conference on Bank Structure and Competition, focusing on the changing financial industry structure and regulation. As barriers to geographic expansion have been removed, there has been a significant increase in the number and size of bank mergers in the U.S. Between 1990 and 1999, bank mergers and acquisitions averaged about 550 per year compared with 345 per year in 1980–89. As a result, the number of banks operating in the U.S. has declined about 30% since 1990.

Beginning in the 1980s, market, legal, and regulatory developments allowed commercial banking organizations limited entry to products and services that were previously offered exclusively by other segments of the financial industry. With the passage of the Financial Services Modernization (Gramm-Leach-Bliley) Act of 1999, which allowed the operation of commercial banking, investment banking, and insurance underwriting in the same holding company, consolidation in financial services is expected to continue.

What opportunities does the recent trend present for the financial services industry and what changes will be required of regulators? How will the industry structure be affected by the development of Internet banking? Will these developments curtail the role of the smaller community bank or might they actually enhance it? How might the "unbanked" sector of the population be affected by these developments? Alan Greenspan, chairman of the Federal Reserve System, addressed these questions in his keynote speech. To further explore the conference theme, a special session was held, featuring James M. McCormick, First Manhattan Consulting Group; J. Robert Kramer II, U.S. Department of Justice; James Chessen, American Bankers Association; Malcolm Bush, Woodstock Institute; and Thomas K. Brown, Second Curve Capital.[1] In his keynote address, Greenspan observed that the "most dramatic change in the financial landscape that the Gramm-Leach-Bliley Act may have induced is not the combination of banking, securities underwriting, and insurance, but rather the generalized merchant banking powers for financial holding companies." These powers give banking organizations the authority to make equity investments in nonfinancial firms and will have a significant impact on the structure and effectiveness of the industry. Greenspan's comments underscored the necessity for regulators to monitor and control the risks of these activities and to ensure they are managed in ways that do not undermine the viability of the banking and federal deposit insurance systems.

New opportunities for financial service providers

In the theme panel discussion, Chessen described the banking environment as "constant whitewater," with deregulation and technological innovations providing important strategic opportunities. The Gramm-Leach-Bliley Act allows banks to offer one-stop financial services to their customers. McCormick and Brown argued that banks' success will depend on their ability to adapt and operate efficiently in this new environment. Since economists often examine efficiency by concentrating on cost advantages from increases in a firm's scale of operation, scale could be used to spread the fixed cost of the new technology over a larger customer base and improve the organization's overall efficiency.

The most typical conclusion from studies of scale economies among U.S. banking firms is that potential gains from scale economies via internal growth or merger are relatively limited. Brown argued that "scale has never been important in banking." Brown and McCormick criticized the consolidation trend in banking, citing it as one of the causes of the poor performance of bank stocks. According to Brown, there are no substitutes for good management with a thorough knowledge of the demands of the customer base. He outlined six steps that banking organizations need to take to be successful in this new environment: 1) recognize the need for dramatic changes in the way they do business; 2) sharpen the focus of the company; 3) become totally customer centric; 4) build and maintain an innovation engine; 5) improve the speed of the company; and 6) have the right personnel to deliver high-quality services. Brown said that "how focused a banking organization's strategy is in this new environment is more important than scale." He stressed that a winning strategy will be one that increases the focus of the company on specific markets or products. McCormick then pointed out that a critical competency in this new environment will be market segmentation. "Banks must dramatically improve their competency in marketing and segmentation to warrant higher stock prices," he said. Customers have no reservations about using multiple service providers. McCormick argued that the most successful financial firms will be those that best use information technology to carve out well-defined market niches.

Bush expressed concern about the potential abuse of market segmentation of low-income individuals and neighborhoods. He reported on a recent study by the Woodstock Institute that indicated that, "subprime mortgage companies dominate minority home refinance markets, while prime companies are dominant in white markets." The Woodstock Institute is most concerned about the increasing activity of high-cost, high-fee retail and mortgage lenders. According to Bush, these fringe firms have an increasingly commanding presence in low-income areas, partly because of the comparative absence of mainstream companies. In the current environment, funding sources extend well beyond depository institutions. As a result, it was argued, fair lending regulations directed only at depository institutions will lead to a gradual shrinkage in the scope of such regulations, affecting, most importantly, the Community Reinvestment Act (CRA). This could lead to decreased competition for servicing lower income groups and a proliferation of predatory mortgage lenders and payday loan stores.

Antitrust work in the changing financial environment

According to Kramer, the Justice Department's Antitrust Division encourages the evolution of an efficient banking structure and tries to protect consumers from anticompetitive effects of bank consolidation. To this end, the department evaluates the effects of each merger on local market concentration and the ability of banks in the localized market, either through unilateral or coordinated actions, to influence the pricing of products. "Antitrust policy has focused … on localized competition, because individuals and small- and medium-sized businesses have traditionally relied on local banks for credit and other banking services while large businesses have typically had a wider array of choices," said Kramer. Today, however, the development of the Internet and e-commence is allowing financial services firms to offer banking products to retail and business customers without establishing a physical presence in the local market. Kramer argued that localized competition, despite developments such as electronic banking and advances in credit scoring, is still critical and that most retail consumers and small- to medium-sized businesses are still tied to local banking. Kramer suggested that the Antitrust Division's approach to mergers is sufficiently flexible and robust to account for any change in market dynamics. One change is the type of merger allowed by Gramm-Leach-Bliley, whereby a financial holding company can combine banking, securities underwriting, and insurance. Kramer said that the nonbanking portion of financial holding company mergers will require firms to report information about the proposed transactions to the Federal Trade Commission (FTC) and the Department of Justice, while the banking portion will require firms to file with a banking agency. According to Kramer, "product expansion" mergers are not seen as potential antitrust problems. If anything, this expansion will be procompetitive, leading to greater efficiency and smaller underwriter spreads. The challenge for businesses will be determining whether these deals can create consumer and shareholder value.

New financial delivery systems

As the financial services industry evolves, we also see significant changes in the delivery of services. One of the major forces influencing these changes has been technology: particularly the Internet and innovations in electronic commerce. A special conference session discussed Internet banking, recent efforts within the Treasury and the Federal Reserve System to encourage and enhance the delivery of financial services, and potential barriers to greater use of new financial delivery systems (particularly privacy issues). The panel was moderated by William Conrad, first vice president of the Federal Reserve Bank of Chicago, and included Roger Ferguson, Board of Governors of the Federal Reserve System; Stephen Baine, formerly of Wingspan Investment Services; David Medine, FTC; and Gary Gensler, U.S. Treasury Department.

Ferguson argued that there are three major factors influencing the pace and direction of delivery system development: convenience, confidence, and complexity. Convenience refers to the resources needed to conduct a financial transaction, confidence to the trust parties have in aspects of the transaction that generate risk for the consumer, and complexity to the degree of difficulty involved in standardizing and automating key features of the transaction. For most transaction methods, there are tradeoffs involved with the three influences. For example, increased convenience from electronic transactions during nontraditional hours may result in privacy and security concerns and partially impair consumer confidence in the delivery system. Evolution to new delivery systems occurs as a result of improvements in these tradeoffs. These may owe to technological progress or improvements in the payments infrastructure (such as advances in legal certainty or payment system standards). Advances in encryption systems, public key infrastructure, and case law concerning electronic transactions are all making e-commerce more economically viable.

Given this framework, the transition from a paper-based system toward a more electronic-based payments system will occur as the tradeoffs change. The private sector will play the pivotal role in most innovations as businesses develop efficient value-added products demanded by consumers. The role of government, particularly the Federal Reserve, is to work with the private sector and, when appropriate, address the infrastructure issues and other barriers to innovation. Toward this goal, in 1999 the Board of Governors announced the formation of the Payment Systems Development Committee to address longer-term policy issues involving retail payments. What barriers exist? How should they be addressed? What legal or regulatory refinements are necessary? Currently, the committee is concentrating on these and other issues affecting the development of retail and low-value commercial payments. The committee aims to bring together industry experts from both the public and private sectors to determine how best to address obstacles to payment innovation.

The product development process laid out by Ferguson provided a good framework for describing the evolution of Internet financing. Next, Baine described his experience with the new delivery system and emphasized that the major force driving Internet banking was improved convenience versus traditional brick and mortar, or legacy systems. The technology currently exists to allow 24-hour access at very low marginal cost. The markets apparently saw Internet banking as the future of finance—the value of Internet banks and related suppliers surged more than fifteenfold over the 1997–99 period. Along with other Internet stocks, however, many Internet financial services stocks have declined dramatically (some by as much as 90%) over the past year.

Baine discussed his experience with developing an Internet bank. In 1998, he joined a group that was evaluating the e-commerce initiatives of Bank One Corp. This ultimately led to the founding of WingspanBank.com as one of the first nationally branded Internet-only banks. The objective was to allow customers to access an array of financial services in a single integrated application (e.g., banking, brokerage, credit card, and transfer services). In a relatively short time, Wingspan became one of the top 25 most recognized names on the Internet.

While Baine believes the prospects for Internet banking are quite significant, he also emphasized the barriers to realizing these prospects in the near future. He described Internet-only banking as a "generational play that will require patience and innovations to meet the lofty expectations" of the industry. While the potential is huge, the current market is estimated at less than 5% of the total banking market, with that being heavily skewed toward the younger population (which has limited financial resources). Baine also emphasized the need for improving the means to open and transfer accounts into Internet-only institutions. Additionally, he argued that the start-up costs of such enterprises could be significant and few of the front-end expenses could be capitalized. The software, PC, and promotional expenses (which can be substantial) must be expensed immediately, which, of course, adversely affects the bottom line during the early stages of development.

Baine also discussed the advantages of starting a new stand-alone Internet-bank instead of adding Internet capacity within an existing organization. He argued that development of a new organization was preferred because it could be much more nimble. Bank One, for example, already had rather large, complex computer systems in place and the cost to change that would have been substantial. There are also numerous integration issues to be overcome if Internet services are introduced within the existing organization. WingspanBank.com went from the conceptual stage to up-and-running in six months, which could not have occurred, Baine said, if it had been housed within the existing bank.

An important issue relating to Internet banking and e-commerce is consumer protection. In his role at the FTC, Medine is responsible for enforcing federal statues aimed at protecting consumers engaging in financial transactions and the privacy of sensitive financial information. He emphasized that while new financial delivery systems provide consumers with tremendous opportunities, they also raise a number of new concerns. These concerns include the breadth of service access, health of the service provider, and consumer privacy. Concerning consumer access, unlike brick and mortar banks that may not provide services in all communities, Internet and electronic services are obviously not geographically based. As such, they can be accessed by nearly anyone using an array of media (such as telephone or ATM). Yet, the services can only be made widely available if consumers are aware of their options. Thus, similar to the concerns that led to the introduction of the CRA, there are concerns that these new services may overlook certain segments of the economy. The single most important aspect of wide consumer access is consumer education about the range of new products and services. Another concern involves the financial condition of the service provider. Recently many of the new financial innovations have been provided by uninsured depository institutions (e.g., stored value cards and bill paying services). While there are means to address these problems, such as bonding the stored value card provider, there is concern that the failure of a service provider could disrupt the market and have a significant adverse impact on the market for such services.

The most common consumer protection concern is about privacy—both about financial information and financial practices. During the earlier theme panel discussion, it was argued that addressing these issues would go a long way toward establishing Internet banking as a viable alternative to traditional banking services. Chessen said that "perhaps the biggest issue today, and one that will define the industry in the future, is privacy and keeping information confidential in an electronic world." Medine claimed that many of the potential privacy problems could be avoided if companies followed fair information practices. He listed four standard information practices: notice, choice, access, and security. *Notice* involves informing the consumer what information is being collected and how the company intends to use the information. *Choice* provides the consumer with some control over the information; and *access* provides the consumer with the ability to check the information for accuracy. *Security* deals with protecting customers' right to privacy. Consumer information will not be made available to those that have no right to access it. The FTC is currently actively involved in studying the access and security issues, with a goal of developing a number of options for the type of access websites should be providing to consumers and the measures websites should take to protect

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the security of that information. The FTC is also surveying websites to evaluate whether they are posting privacy policies. The results will be reported to Congress to help determine whether additional consumer protection legislation may be necessary.

Gensler also stressed the importance of consumer privacy and the efforts of the current Administration in this regard. In spring 1999, President Clinton introduced a comprehensive plan for consumer privacy in the twenty-first century. The financial aspects of the plan were included in Gramm-Leach-Bliley. In addition, in May 2000, the President introduced the Consumer Financial Privacy Act. Gensler argued that consumer choice was at the core of the President's proposal. Consumers should have the right to choose whether to permit companies to share their financial information. As President Clinton said, "… in this informational age, we can't let new opportunities erode fundamental rights. We can't let breakthroughs in technology break down the wall of privacy." It was also argued that there should be rather strict limits on "particularly sensitive data" such as medical information. Accessing this information should require prior permission from the consumer. Gensler emphasized that limits on the sharing of information in other industries are relatively common and generally accepted. For example, individuals have a federally mandated right to opt out of having their telephone number listed. Additionally, telephone companies cannot share calling records or patterns with other companies. Gensler argued that privacy protections are good business practices, as they improve customer relations and increase consumer confidence.

Gensler also stressed the phenomenal potential for electronic payment services, and reiterated Ferguson's position on the importance of developing the infrastructure and standards for electronic retail payments. The potential benefits to the Treasury of moving toward greater use of electronic payments are thought to be substantial. While nearly three-quarters of all government benefit payments are currently transacted electronically, as are over 60% of vendor payments by the Treasury, over 99% of tax payments received in April 2000 were in the form of paper checks. That is 99% of over $190 billion in receipts! Clearly, much can be done to move these transactions toward electronic payment methods and to enhance the general movement toward electronic payments. One such effort currently underway at the Treasury is to increase the use of smart cards for retail transactions. Currently, the Treasury is the world's largest issuer of smart cards, which are used primarily on military bases. Another effort is directed at bringing the "unbanked" into the financial mainstream. Under one such program over 500 banks have agreed to offer low-cost electronic accounts to recipients of federal benefits. Additionally, the Treasury and the Federal Reserve Bank of Chicago are evaluating alternative means of providing benefit payments to individuals without formal financial account relationships.

Conclusion

The 2000 Bank Structure Conference provided an opportunity for scholars and practitioners to evaluate issues concerning financial industry structure and competition in a rapidly changing environment. Planning for the 2001 Bank Structure Conference, scheduled for May 9–11, 2001, is currently underway.[2]

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[1]A conference proceedings volume will be available in fall 2000. For information, contact the Public Information Department at 312-322-5111.

[2]For information on the 2001 conference, visit the Federal Reserve Bank of Chicago's website at www.frbchi.org, or contact Portia Jackson at (312)322-5775 or portia.jackson@chi.frb.org.

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