

# The Causes and Effects of Financial Modernization

Based on a speech given by President Santomero to the Pennsylvania Bankers Association, Charleston, SC, May 7, 2001

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**P**assage of the Gramm-Leach-Bliley (GLB) Act, also known as the Financial Services Modernization Act, is just the latest step in the “relentless process of eroding the constraints placed on the financial marketplace during the Great Depression.” So says President Santomero in this issue’s *Third Dimension*. In addition, President Santomero sketches the history of financial services law since the 1930s. He then looks at the impact that GLB — especially its creation of financial holding companies — has had and will continue to have on the financial services industry.

In reality, “financial modernization” is not an event or a law; it is the dominant theme of the past 50 years of American finance. It signifies the erosion of arbitrary constraints that have divided the financial marketplace since the Great Depression. Therefore, describing the causes of financial modernization requires beginning then.

The Glass-Steagall Act of 1933 was enacted to protect consumers and the economy from the conflict of interest that, conventional wisdom held, contributed to the Great Depression. By separating deposit-taking activity from the underwriting of securities, the Glass-Steagall Act created a highly regimented financial services landscape. Commercial banks were limited to lending and deposit gathering. Thrifts were mortgage lenders. Investment banks served as underwriters and

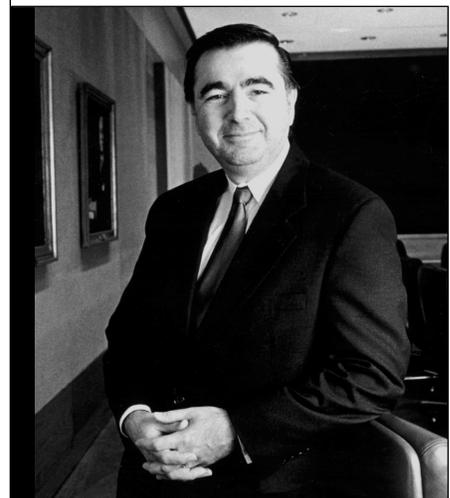
brokers of both stocks and bonds. And insurance firms had the profitable niche of actuarial products. Additional constraints were geographic in nature. Congress left in place a framework that encouraged state prohibitions on bank branching, leaving county and state borders as geographical boundaries on banks.

Congress should have anticipated the deterioration of the neat pigeonholes to which the financial industry was relegated. While useful in augmenting consumer confidence during the Depression, the boundaries became increasingly anachronistic in post-war America. Market pressure to expand product offerings and consumer desire to better meet financial needs, coupled with legal ingenuity and effective lobbying, were too powerful to allow these market constraints to survive

indefinitely. Supplemented with the capabilities of computers and telecommunication, the evolutionary pace of financial-sector convergence accelerated greatly. By the 1970s, the very nature of banking had been changed forever.

In corporate finance, large, stable firms like General Motors and General Electric had long been the banking industry’s best customers. But by the 1970s, many corporations found borrowing from banks to be less efficient than issuing direct capital market obligations. Bond traders could use computer technology to assess the merits of noninvestment-grade bonds, and they saw their industry boom at the expense of bankers. Innovative nonfinancial firms developed their own capacity to finance consumer debt by directly tapping the capital market, and they cut banks out of the loop.

At the same time, consumers no longer saw their traditional local bank as the only option for their savings



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balances. While they generally relied on a community bank or thrift for home mortgage loans, many consumers sought better returns for deposits through more sophisticated instruments. What was formerly deposited in a checking or savings account was now likely to be invested in a money market mutual fund or a cash management account or directly into securities. The money market mutual fund industry, which could not exist prior to computerization, held billions of dollars by the 1970s.

Traditional lenders, witnessing the drop in corporate and consumer deposits as well as loan demand, were eager to offer new products and find new sources of revenue. Technology did empower commercial banks to offer some new products and conveniences to their customers, such as the expanded use of credit cards, ATMs, and phone banking. But government often blocked their ability to compete within their traditional customer bases. Regulation Q, for example, forbade banks from offering competitive rates on checking accounts. Trying to stay competitive, many banks offered a completely new banking product — the toaster — as an incentive to open an account.

Such obstacles left bankers demanding relief through relaxed regulation, entry into new markets, and the ability to expand more freely across state borders. The government's response was to give them all three.

Action began at the state level when Maine enacted legislation permitting out-of-state entry. At the national level, Congress allowed banks to offer more competitive interest rates on deposits in 1980, ending the ill-conceived era of toaster banking. The Garn-St. Germain Act of 1982 allowed banks to cross state boundaries to acquire troubled banks. The Federal Reserve permitted bank holding companies to acquire discount securities brokers in 1983. In 1987, the Fed blessed limited securities underwriting under

the bank holding company umbrella — then expanded the limits in 1989 and again in 1996. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 removed constraints on bank holding company acquisitions across state lines and also permitted banks to branch interstate if

despite regulatory prohibitions or regardless of precedent. Now terms such as “nonbank banks” and “the facilitation of commercial paper placement” entered the lexicon. And as complexity rose, smaller institutions found themselves at a competitive disadvantage. By the mid-1990s, large

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permitted by state law. Interstate and regional banking had begun in earnest.

By the mid-1990s, the process of evolutionary convergence had transformed the financial services landscape. Commercial banks were brokering insurance and underwriting securities subject to percentage caps. Insurance companies, many of which had merged with investment banks, offered new risk-management products with all the characteristics of securities. Home mortgages were packaged into securities. Thrifts, credit unions, and commercial banks offered similar consumer products to their members. The money market provided more efficient transfers of capital. Major commercial firms had their own finance companies or even a thrift. And with mergers and acquisitions, the size of financial conglomerates swelled to unprecedented new levels.

These developments made economic sense. In many cases they were the only rational courses of action that could be taken by Congress, the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, or individual states. But these actions stretched the credibility of the rules. Often, the rulings of bank regulators seemed like reversals of established policy, because bank products emerged

sections of federal banking law resembled relics of a bygone era.

The contrast between the inadequacy of existing legislation and the reality of a new financial services paradigm was made clear in April 1998 when Citicorp and Travelers Group proposed a \$70 billion merger. The creation of Citigroup — America's largest financial conglomerate, with businesses ranging from banking to insurance to securities underwriting — demonstrated the inadequacy of the legislative and regulatory patches of the previous 20 years. Congress knew it had to stop debating financial laws and respond. Within a year, both the House and the Senate had passed legislation to bring our financial laws into the modern age. With President Clinton's signature in November 1999, the Gramm-Leach-Bliley (GLB) Act, also known as the Financial Services Modernization Act, became law.

GLB provides a unified legal framework that standardizes financial convergence. Its centerpiece is the creation of an entity called a financial holding company, or FHC. Once a financial organization obtains the FHC designation, it can house a complete family of financial activities through distinct affiliates. Each affiliate is still overseen by its traditional functional regulator. The Federal Reserve

continues to oversee the FHC, much as it oversees all the bank holding companies, or BHCs, of both yesterday and today.

However, while GLB established a new legal framework for financial convergence, it did not change the underlying realities driving the marketplace. Technology, demographics, and customer needs are the forces that have determined and will continue to determine the structure of the financial services industry.

But while GLB will not change the nature of the industry, it will bring the financial services industry to convergence in a more expeditious and orderly manner — but one that still holds a few surprises. For example, before GLB was enacted, some predicted that many banks and other financial service organizations would quickly seek FHC status and begin offering “one-stop shopping” for financial services to their target customers. It’s been about 18 months since organizations could apply to become FHCs. Thus far, things have not turned out as predicted.

As of August of this year, less than 20 percent of top-tier bank holding companies had converted to an FHC. The percentage of investment banks, brokerage houses, and insurance companies that converted is much smaller.

Not surprisingly, the largest multi-product institutions have led the way. Before GLB, these large organizations were constrained from pursuing a “financial supermarket” strategy, so they acted swiftly to maximize that opportunity.

A number of relatively small banks and small bank holding companies also have found reason to obtain FHC status. Indeed, fully two-thirds of current FHCs have assets of less than \$500 million. These institutions sought this status not because they have immediate plans to expand their product

offerings, but because the designation presented a relatively low-cost option for future expansion. In general, these local or regional BHCs have less complex corporate structures and are well-capitalized. So, getting the

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designation proved relatively easy, and these institutions will be prepared for good future opportunities.

Nonetheless, only a small percentage of the total number of firms many suspected would be eager to benefit from the new law have chosen to seek the designation. Why have so few financial firms elected to become FHCs? Why has the pace of cross-industry acquisition been so slow? Undoubtedly, there are many reasons why more financial institutions have not rushed to obtain a designation that allegedly allows them to be all things to all customers. However, one seems particularly relevant.

Perhaps I am too much of an economist, but I believe that many institutions have done a simple calculation. They have already adapted to BHC structure. They have been successful in delivering financial services to their market area through a combination of bank and

nonbank subsidiaries, coupled with the increasing use of strategic alliances and outsourcing. Their operating structures are in place and have been effective.

By contrast, I believe that many of these institutions see no immediate benefits of converting to an FHC and remain uncertain as to the longer term implications of FHC status.

Over time, the potential benefits of the FHC structure will be clarified by developments both in the marketplace and in regulatory pronouncements. Circumstances will illustrate whether the added flexibility afforded institutions operating under an FHC charter offers additional, exclusive profit opportunities. Meanwhile, regulatory policies and procedures will reveal the parameters under which FHCs must operate.

A number of the detailed regulations necessary to implement Gramm-Leach-Bliley have yet to be offered for public comment by the Fed, and none of the law’s provisions have undergone “trial by fire.” Under-



standably, the rules that the Federal Reserve has offered for comment are being scrutinized for indications of the Fed's intent and its appreciation of industry conditions.

This was made abundantly clear by the reaction to the proposed rule that bank holding companies' merchant banking activity should be subject to a 50 percent capital charge. The comment period worked as intended — and the Federal Reserve substantially altered the rule — but the

proposed in recent years. Comments were due August 15, and the input of affected organizations will be constructive and useful in determining the final form of this landmark regulation.

I also believe that the industry is interested in how relationships among regulatory agencies will unfold in this new environment. The Federal Reserve's new role as umbrella supervisor of financial holding companies is similar to its role in supervising bank holding

marketplace during the Great Depression. With the passage of the Financial Modernization Act of 1999 and the implementation of the FHC structure, that process took a big step forward.

What will the financial services industry look like in the future? It is hard to say, but there is some agreement — at least in broad strokes. There will surely be a handful of financial behemoths offering one-stop shopping to businesses and consumers. Their outlines and their names seem to be emerging daily.

Beyond these few that will attempt to be all things to all people, a large number of institutions will remain. These may be described as niche players, which will choose to concentrate on either a geographic area or a product set. In their chosen market segment, they will remain credible, even fierce competitors. Single-product providers, such as credit card and mortgage servicing companies, will remain. Community banks will still be effective competitors, both in markets for small-business lending and personalized consumer service. These smaller banks are quick to adjust to changes in customer needs, and they will be able to compete effectively as well.

In short, the future holds more innovation for firms of all sizes. The needs of customers, be they individuals or organizations, will continue to evolve, and financial service providers will, as always, adapt to meet their needs. Gramm-Leach-Bliley recognizes that this is the nature of the marketplace. Those who find ways to seize the opportunities this law offers will benefit in the financial marketplace of the future and will be the first to reap the rewards. ☛

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episode undoubtedly left some lingering apprehension.

Another important step toward implementing Gramm-Leach-Bliley was taken in early May when the Board of Governors announced that it was seeking comment on the long-awaited Regulation W. This proposed rule seeks to implement section 23 A and B of the Federal Reserve Act and to define permissible transactions between a bank and its affiliates. In the post financial modernization world, bank affiliations can and do extend to many kinds of institutions. Protecting insured deposits from improper transfer to an affiliate is vital to the safety and soundness of our national economy and one of the key functions of this regulation.

Following enactment of Gramm-Leach-Bliley, implementing regulations for section 23 A and B became more possible and more necessary. But despite a basis in precedent, Regulation W is as complex and detailed as any federal regulation

companies. However, the Fed's future success entails increased communication, cooperation, and coordination with the many supervisors of the more-diversified financial holding companies. As the Fed begins redefining its working relationship with other regulators, it will answer many of the questions of importance to securities and insurance-based firms.

As we develop the rules and refine the regulators' roles in the financial holding company, I believe that FHCs will emerge as entities with the flexibility and functionality to meet the demands of the marketplace without unnecessary or onerous regulatory burden. As this becomes clear, I expect the number of financial firms electing to establish financial holding companies will increase.

At the start of this article, I said that financial modernization is not a single event or law, but rather a relentless process of eroding the constraints placed on the financial