

*This article is an edited version of the Hutchinson Lecture, delivered at the University of Delaware on April 18, 2000, by Edward G. Boehne. On May 31, 2000, Ed Boehne retired from the Federal Reserve Bank of Philadelphia after 32 years of service, the last 19 of them as president. Closing his career with the publication of an article in the Business Review seems fitting, since writing a Business Review article was one of his first tasks when he joined the Philadelphia Fed as an economist in 1968. Ed thanks Loretta Mester for her assistance in preparing the Hutchinson Lecture.*

## Financial Modernization: Vastly Different or Fundamentally the Same?

*Edward G. Boehne*

**T**he Financial Modernization Act (Gramm-Leach-Bliley), which was passed last fall, is in the process of taking effect this year. Among other things, this act repealed the Glass-Steagall Act (which separated commercial banking and securities underwriting) and was yet another step in dismantling a regulatory structure put in place nearly seven decades ago. Ongoing deregulation of the banking and financial system along

with rapid changes in technology has raised some questions about the ultimate outcomes of several trends in the banking industry.

Five key questions come to mind:

1. Will ongoing consolidation in the financial system and the ability of banks to expand into new product markets lead inevitably to financial supermarkets?
2. Will banking become primarily e-banking?

3. Will *relationships* between a small business and a bank, or between a consumer and a bank, go the way of the horse and buggy? To put it another way, will bank products primarily be bought and sold in the financial marketplace as commodities, or will personal service and personal contact still matter?
4. Will the major focus of the business of banking become the collection of fee income instead of the margins on loans?
5. Will bank regulators eventually rely primarily on market discipline instead of on more traditional bank examinations to determine the health of banks?

Past and current trends in the banking industry, along with the recent passage of Gramm-Leach-Bliley, may lead many people to respond in knee-jerk fashion and answer "yes" to all of these questions. I will make the case that there is more to the story: the financial system, to be sure, is going to be *vastly different* in terms of the structure of the industry and the delivery systems used by banks to provide services to their customers. Nevertheless, I will also argue that the financial system will be *fundamentally the same*; that is, the fundamental underpinning of a stable and successful financial system will remain as it has always been, *public confidence*. This fact will help shape, and perhaps limit, the ways some of these banking trends unfold.

#### SUMMARY OF THE FINANCIAL MODERNIZATION ACT

At least for the foreseeable future, financial institutions in the U.S. will operate under the new financial landscape established late last year. The Gramm-Leach-Bliley Act of 1999, also called the Financial Modernization Act, became law on November 12, 1999, and the remnants of the separation between commercial banking and investment banking were finally carted away. I say remnants, since the Glass-Steagall Act, which established the separation in 1933, had been whittled away by market forces, court rul-

ings, and regulatory actions.

For example, banks were able to affiliate with securities underwriters, but there were limits on the types and amount of debt and equity underwriting in which the security affiliate could engage. With passage of Gramm-Leach-Bliley, this is no longer the case. The act sets up a two-tier system for expanding activities. A new entity, called a financial holding company, can have commercial bank subsidiaries along with other subsidiaries that engage in activities considered "financial in nature," "incidental" to financial activities (as determined by the Fed and the Office of the Comptroller of the Currency), or "complementary" to financial activities (as determined by the Fed). These activities include insurance underwriting, real estate development, merchant banking, and securities underwriting. In addition, subsidiaries of commercial banks (called financial subsidiaries) will be able to engage in some expanded activities, including insurance agency and brokerage activities (but not underwriting), and securities underwriting. These bank subs will not be allowed to participate in real estate development or merchant banking, at least for now, or in activities considered "complementary" to financial activities. Those activities can be done in affiliates of a bank within a financial holding company structure, but not in subsidiaries of the bank itself.

Limiting some of the activities of banking subs but allowing these activities in bank affiliates is intended to allow banks to engage in new activities, but in such a way that their risks can be limited. The act contains other provisions intended to limit the risks of new activities. To qualify as a financial holding company, the institution's bank subsidiaries must be well capitalized and well managed. They also must have CRA ratings of satisfactory or higher. As of early April 2000, the Federal Reserve Board has approved 144 applications from bank holding companies wishing to become financial holding companies. Mellon Financial Corporation, First Union Corporation, PNC, Chase, and Citigroup

are a few familiar names that have been approved. Similarly, for a bank to qualify for having a financial subsidiary, the bank and its depository affiliates must be well capitalized and well managed and must have CRA ratings of satisfactory or higher. Also, if a bank is one of the 50 largest insured banks in the United States, it must have at least one issue of unsecured long-term debt that is rated in one of the three highest categories by a nationally recognized rating agency like Moody's or Standard & Poor's. This brings the discipline of the market down on banks that wish to engage in expanded activities.

These criteria are intended to protect the FDIC's bank insurance funds and prevent extension of the discount window safety net to nonbanking firms. In addition to these criteria, the Gramm-Leach-Bliley Act uses the provisions of Sections 23A and 23B of the Federal Reserve Act to limit credit extensions and require arm's-length activity between a bank and its subsidiaries and between a bank and other financial holding company subsidiaries. As further protection, Gramm-Leach-Bliley does not permit the mixing of banking and commerce, and it closed the unitary thrift holding company loophole, whereby commercial firms could enter the banking industry by buying a single thrift institution.

Now that institutions can engage in a wider array of activities, the regulatory structure will change to one of functional regulation. That is, instead of a bank regulator having primary responsibility for supervising all aspects of an institution, each of the institution's functions will be supervised by the appropriate regulator. For example, the insurance agency activities of a commercial bank subsidiary will be subject to state insurance regulations, and securities affiliates will be regulated by the Securities and Exchange Commission and National Association

of Securities Dealers. In addition, the Federal Reserve will act as an umbrella supervisor over financial holding companies, similar to the role it plays today with respect to bank holding companies. Here the Fed will have oversight of the entire organization, with a focus on consolidated risk management.

#### TRENDS IN THE FINANCIAL INDUSTRY

Now, let's go back to the five questions raised earlier. Even though the Gramm-Leach-Bliley Act permits banks to perform a wide variety of activities, the question remains: *will institutions take advantage of their new powers? And if so, will this, coupled with the ongoing consolidation we've seen in the financial services industry over the past few years, lead to financial institutions that look like financial supermarkets, offering all things to all people?*

Over the past 10 years, the number of banks in the United States has fallen from over 12,000 to under 9000, a 30 percent decline. Much of the consolidation was driven by mergers and acquisitions among existing banks and bank holding companies. In fact, several hundred mergers and acquisitions occurred each year. We have seen some of the largest bank mergers and acquisitions ever in the past few years, including several between institutions with assets over \$100 billion each.

Consolidation has led to increased concentration in the banking industry, which can be illustrated by a few simple comparisons:

- Over the last 10 years, the share of domestic banking assets held by the 10 largest banking organizations in the country doubled, from about 20 percent to about 40 percent.
- Over the last 15 years, the share of industry assets in very large banks has risen substantially. Now, over 60 percent of indus-

## Will banks become financial supermarkets?

try assets are in banks with more than \$10 billion in assets, compared with 40 percent in 1985. In inflation-adjusted dollars, the average asset size of U.S. banks has *doubled* since 1985 and is currently about \$550 million.

- Consolidation is even more striking at the holding company level. The share of assets in bank holding companies with over \$100 billion in assets has tripled since 1985; these institutions now hold over 40 percent of industry assets.

Banks are getting bigger, but are they getting better? From the standpoint of profitability, the answer is yes. While the industry has been consolidating, bank performance, as measured by return on assets (ROA) and return on equity (ROE), has improved greatly. Is this just a coincidence? Much of the improvement in performance reflects the favorable macroeconomic environment in which banks have been operating. The banking industry is similar to other cyclically sensitive industries in this respect, although banking is probably more sensitive to the interest rate cycle than other industries. But recent evidence also suggests that consolidation may have played an important role in the dramatic changes in bank performance. Indeed, while merging banks appear to have experienced some increased costs, they have more than made up for this by increased revenues.

In a changing marketplace, banks must reinvent themselves to stay competitive. And regulators must allow this to happen while ensuring that the safety and soundness of the industry remains intact as the transformation occurs. Banks now compete with money market mutual funds and stock and bond funds on the deposit side. Data from the Federal Reserve's Flow of Funds Accounts show that 25 years ago, nearly one-quarter of households' assets were in deposits and less than 2 percent were in mutual and money market funds combined. Today, the deposit share has fallen to under 13 percent, while the share in mutual and money market

funds has risen to almost 10 percent. And this does not even include households' pension fund assets, which have seen tremendous growth.

On the loan side, the growth of the commercial paper market and the entry of nonbank firms into the market for middle market borrowers and now even for small business loans have changed the face of commercial lending. Technological innovations have enabled the development of credit scoring and automated loan application processing, for example, which can be used by bankers and nonbankers alike. In addition, these technological changes have spurred banks to become larger to capture the scale economies embedded in these new technologies.

Consolidation and expansion into new activities can increase bank efficiency by allowing an institution to reach a scale or mix of output that is more profitable. Gains might come from lower costs but also from higher revenues as banks provide better quality services or additional services valued by their customers. Restructuring can also mean a change in managerial behavior that improves the efficient use of resources or that improves the tradeoff between the bank's risk and its expected returns, by allowing the bank to expand into broader geographic areas or into different product areas with different return characteristics.

Recent research has documented the benefits from banks' increasing their scale of operations, but what about banks' expanding into new activities? Here the research results are more mixed. There is some evidence (not strong evidence) that risk might be lower when commercial banks expand their activities: for example, studies have simulated the performance of portfolios that include both permitted and previously nonpermitted banking activities, and usually, the variance of returns (a measure of risk) is smaller when nonpermitted activities are included.

To date, research has not conclusively shown that there are many cost or revenue synergies between different financial service offerings (al-

though it is probably too early to tell, since banks have been restricted in the amounts of these other services that they could provide). The cross-selling opportunities, still to be worked out in light of the privacy rules now being written, suggest there may be gains to banks from expanding into new product markets.

However, it is not at all clear that one-stop shopping, which the modernization legislation now more easily permits, will be what consumers demand. At the same time that the law now permits commercial banks to offer insurance and other financial services, it is now easier for consumers to do comparison shopping and to switch accounts if it looks as if there's a better deal to be had elsewhere. Thus, the convenience of one-stop shopping might be overstated.

In fact, early attempts to develop financial supermarkets failed in the U.S. What's more, lessons from other industries suggest that the trend is *not always* toward greater product diversification. Among nonfinancial industries that have always had the ability to diversify across product lines, one finds that the desire to form big conglomerates ebbs and flows. And many nonfinancial firms still specialize in just one industry or in just one aspect of an industry.

Certainly, the more than 2000 small banks that have entered the industry since 1985 think that they can make a go of it without being huge or without being all things to all people. What is likely to occur is that the average size of the financial firm will be larger, but there will still be niche players—institutions that focus on providing particular services to particular segments of the market. Indeed, one of the byproducts of technological innovations is that it has become easier to tailor products to individual customers' needs. Banks that wish to emphasize customer service might choose to remain small. While they would be less able to take advantage

of some technologies, which require a larger size over which to spread the fixed costs of the technologies, they would be able to use other technologies to provide better service to their customers. For example, banks of all sizes have been expanding their presence on the Internet. Which brings us to our next question: *Will banking become primarily e-banking?*

E-commerce seems to take up 50 percent of TV advertising, but so far it accounts for probably less than 5 percent of total retail sales. The advertising and hype lead one to think that e-commerce and e-banking are really big, but that

day is still some way off. Certainly electronic payments will become more important with time. But we can't count out paper-based payments just yet. Back in the 1960s, analysts predicted that by now we would have a checkless society because of the spread of electronic transfers,

but checks are still with us. Indeed, between 65 and 70 billion checks are written annually in the U.S.

Still, there is no doubt that electronic means are becoming a more important outlet for banking services. Banks began offering PC banking in the 1980s via proprietary computer systems. But these systems were so slow that consumers were turned off, and it was very difficult to get them to try PC banking again once the technology improved. Various sources estimate that users of online banking currently number between 4 and 7 million, or 4 to 7 percent of households. And forecasts say the number of online banking users will double several times by 2003.

One development that makes predictions of double- or even triple-digit growth of PC banking more credible now than at any time in the past is the growth of the Internet. Internet banking, one form of PC banking, offers customers 24-hour access and the ability to bank from *multiple venues*, since proprietary software need not

## Will banking become primarily e-banking?

reside on each machine. According to estimates, 30 to 40 percent of all households access the Internet now, and this number has been growing quickly. According to the Graphics, Visualization, and Usability (GVU) Center's 1998 survey, over 90 percent of the Internet users surveyed are making purchases online and about 60 percent are also paying for the items over the Internet most or all of the time. This indicates that these buyers have some confidence in the security of the Internet for financial transactions. Indeed, at the end of last year, over one-third of all banks indicated on their Reports of Condition and Income (Call Reports) that they had a web site and many more reported plans to build one.

Some banks see the Internet as a way to deliver their products to customers; others see it as a separate line of business for the bank. Whereas some banks just offer information about their products on the web, others have transactional web sites at which their customers can do things like check their account balances, transfer funds between accounts, pay their bills, use financial planning software, apply for loans, stop payments, or trade online. And some banks exist *only* on the Internet. They have no physical presence — no branches at all! These banks save on the costs of brick and mortar, but need to spend more on advertising. So far, there are only a handful of these virtual banks, and many are finding it difficult to remain branchless. Seeing is believing, and that's as true in banking as in anything else. A special problem that virtual banks have to solve is how to deliver cash to their customers and how to accept deposits. Some are allowing customers to access ATMs without cost. Direct deposit can sometimes be used, but in other

cases, deposits have to be mailed to the bank. So much for the electronic age!

Most banks are offering online banking now as a way to retain customers, rather than generate new business, although not always successfully (surveys suggest that many customers who have tried online banking have stopped using it—many thought it was too time consuming and some thought there was poor customer service). In this way, the online banking of today resembles the ATM of the 1970s. It took time for a large volume of customers to use ATMs. While

the cost savings to the bank were substantial, trying to coerce customers to use ATMs instead of tellers wasn't successful. Youth, high income, and a college degree are associated with a higher incidence of computer banking. It seems reasonable to predict that online banking will eventually take its place alongside the other ways customers can interact with their banks: branches, telephone centers, loan production offices, and ATMs. But it seems unlikely that all banking will become e-banking. Even in

this technologically advanced age, the in-person visit remains the main way people interact with their banks, as they develop and maintain their relationship with the institution.

But will this relationship change as banking becomes more electronic? *Will relationships between a consumer and a bank, or between a small business and a bank, go the way of the horse and buggy?* To put it another way: *will banking products primarily be bought and sold in the financial marketplace as commodities, or will personal service and personal contact still matter?*

This question is related to both of the first two questions, concerning bank size and new technologies. Small-business lending and consumer

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lending used to be the purview of small banks, which devoted substantial resources to getting to know their customers and developing relationships with them. But this is changing. Today, large banks, which want to take advantage of the scale economies that come with size, are using credit scoring to make small-business loans and are processing applications using automated and centralized systems. These banks are able to generate large volumes of small-business loans at low cost even in areas where they do not have extensive branch networks. Applications are being accepted over the phone, and some banks are soliciting customers via direct mail, as credit card lenders do. Technology is also helping nonbanks become larger players in the small-business loan market. For example, American Express is one of the top granters of credit lines to small businesses in the Philadelphia Federal Reserve District, especially lines with face values under \$100,000.

The smallest loans are the most likely to benefit from new technologies, and data indicate that those are the types of loans where the larger banks are increasing their small-business lending. But these loans differ from traditional small-business loans. Recently, economists Rebel Cole, Lawrence Goldberg, and Lawrence White studied more than 1200 loan applications made by small businesses. Their results indicate that large and small banks do differ in the way they handle applications from small businesses: large banks rely more on easily verified, interpreted, and quantifiable financial data while smaller banks use more subjective criteria indicative of “character,” or relationship-type, lending. Some types of small-business loans are like credit card loans, which do not require much in the way of information-intensive credit evaluation beyond what is done in a credit scoring model. The scale economies in automation available to large banks allow them to produce these transactions-type small-business loans more cheaply than a small bank can. Credit scoring will tend to standardize these loans and make default risk more

predictable. These steps should make it more feasible to securitize the loans. This ability to securitize would bring a new set of investors into the small-business loan market, a positive effect.

Borrowers who have credit histories good enough to receive a passing grade from a credit scoring model will find it cheaper to obtain credit from larger banks. Small banks will still serve the small borrowers who may not have the financials to qualify for a passing credit score, but who, upon further credit evaluation, are good risks. Small banks will continue to offer the traditional relationship-driven lending, which requires the bank to stay in contact with borrowers over time to gain information about them. It also requires the bank to be a specialist in evaluating the creditworthiness of borrowers for whom there is little public information. The more complicated organizational structure of large banks may put them at a disadvantage in making these relationship-type loans. So small banks should retain their niche in relationship lending — but that niche is likely to be smaller than it is today.

It’s important for small businesses to realize they are making a choice between different kinds of credit when they choose their type of lender. (I’m not sure they do realize this — new small businesses have not experienced a recession in which their financials quickly deteriorate, thereby making it difficult to pass a credit scoring model.) It is also important for borrowers to understand the pricing of relationship vs. commodity-type loans. With a relationship loan, a bank can offer better terms to a firm facing temporary problems, then make up for these concessionary rates when the firm turns around. But, of course, the firm should expect to pay something for this kind of insurance. With commodity-type lending, the bank charges its break-even price period by period. The borrower should not expect to get a concessionary rate in bad times. Thus, technology will impact not only the type of loans being offered but also their price-

ing. Technology can also affect pricing in a less direct way, which brings us to our next question: *Will the major focus of the business of banking become the collection of fee income instead of the margins on loans?*

The answer is yes, because it is happening already. As new technologies have come into the banking industry, new players have entered too. Commercial banks' share of loans to businesses and households has declined significantly over the past two decades. The increased competition banks are facing from insurance companies, mortgage banks, and the commercial paper market has driven commercial banks to seek more stable sources of income. These fee-based services include mortgage servicing, cash management, data processing, and investment services. Income from these sources is less sensitive to the business cycle. FDIC data indicate that in 1984, noninterest income was about 25 percent of operating revenue, and in 1999, it had risen to over 40 percent. Both large and small banks are increasing their percentage of fee-based income, although there has been a stronger rise at the larger banks because they operate at a sufficient size to capture the scale economies inherent in many of the technologies used to provide these fee-based services.

The push toward fee income goes hand in hand with the expansion of banking into new product areas and the commoditization of traditional bank products. Technology allows the unbundling of banking products so that fees can be assessed for each component of the product. Note that there's an interaction between the pricing of new products and their acceptance by the consumer. For example, until recently, consumers didn't explicitly pay for the costs of using

checks; they implicitly paid for check services by receiving lower rates on deposits or paying higher rates on loans, but the costs were not apparent to consumers. The fact that they now see the cost of using paper checks may spur them to explore new, more efficient electronic forms of payment.

There is no doubt that the changing nature of banking will necessitate changes in the way banks are supervised and regulated. Which brings up our final question: *Will bank regulators eventually rely primarily on market discipline instead of more traditional bank examinations to determine the health of banks?*

Already, the trend is toward relying more on the market's assessment of the health of larger, more complex banking institutions than had been possible in the past. As banks become larger, they are more likely to have stocks and bonds that are actively traded. The market's view of the institution is embedded in the prices of these securities. Indeed, under the Gramm-Leach-Bliley Act, if a bank is one of the 50 largest insured

banks in the U.S., it can have a financial subsidiary that engages in expanded activities only if it has at least one issue of unsecured long-term debt that is rated in one of the three highest categories by a nationally recognized rating agency (such as Moody's or Standard & Poor's). The act also calls for a study by the Fed and the OCC to determine the feasibility of requiring large banks and financial holding companies to hold some of their regulatory capital in the form of subordinated debt. The idea is that subordinated debtholders are sophisticated investors, but unlike equityholders, they would not share in any upside gains from risky actions that happened to pay off. Thus, these investors have lower pref-

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erence for risk than do equityholders.

The Financial Modernization Act allows for a more complicated banking organization. These complicated institutions will be more difficult to monitor using only examinations. And research has shown that information in bank exams gets stale fairly quickly — in about six months. Thus, it is important to set up rules to give institutions better incentives to better align their interests with those of society. One can view reliance on market discipline in this way: if the market has information about the institution, it will exact a risk premium from those institutions considered to be especially risky. The bank's having to pay more for taking on risk works to control the bank's risk-taking. However, it is important that the market have access to information about the institution in order to make its evaluation. Hence, disclosure becomes much more important. Indeed, disclosure is one of the key factors in helping to ensure public confidence in the financial system.

### **THE FUNDAMENTAL ROLE OF PUBLIC CONFIDENCE**

Ultimately, the answers to the above questions will depend on whether trends in the financial industry reinforce or undermine the public's confidence in the financial system, since public confidence forms the essential underpinning of the financial system. If any of these trends pushes the envelope too far and begins to erode public confidence, it must be stopped. And it can be stopped in one of two ways: banks can take steps to stop it, or Congress or state legislatures will step in and stop it.

What is the foundation of the public's confidence in the financial system? Members of the public want their money to maintain its purchasing power; they don't want its value eaten away by inflation. They want banks and other finan-

cial institutions to be safe and sound. They want their financial transactions (whether involving loans or deposits or other services) to be executed in a timely and accurate manner. They want convenience, and they also want privacy and fairness.

Note that there is nothing new about any of these — no matter what form the banking system takes, these are the things the public will continue to care about.

Public confidence is essential: if consumers do not believe their money is in safe hands, they will exit the financial system. We saw this happen during the Great Depression and in later episodes of bank runs.

Just a few blocks from the Federal Reserve Bank of Philadelphia are the First and Second Banks of the United States. These banks, established in 1791 and 1816, respectively, are still standing today and remain quite impressive buildings. The strength of the structures was meant to convey the strength of the institutions

and to instill public confidence. Most commercial bank buildings were constructed with the same idea in mind: solid buildings with strong vaults that would instill public confidence.

Today, it is just as important for the public to have confidence in its financial system, but the means for ensuring this confidence is different in this age of technological innovation. It is important that the public be assured that banks will use the highest level of electronic security, not just imposing physical structures with strong vaults, to protect their money and the information that customers give to their banks. From the bank's viewpoint, this information can be as valuable as the money a customer places in the bank.

The trends in banking that we've been discussing cannot occur unless the public remains

*Will bank regulators eventually rely primarily on market discipline?*

confident in the financial system as it undergoes transformation and unless the public sees a benefit in the changes taking place. For example, the trend is toward moving from a paper-based payments system to an electronic one, but how fast a payments instrument is adopted depends on how the risks, costs, and benefits of the new instrument are distributed among participants. Why have smart cards done so poorly in trials in the U.S.? Because consumers and merchants could not see much benefit in using the cards instead of using cash for small purchases.

Similarly with e-commerce and e-banking. If consumers don't see much benefit or, even worse, if they are burned by fraudulent e-commerce or e-banking practices, the trend toward electronic banking will slow down. When banks offered their own proprietary PC banking systems in the 1980s, these systems were so slow that consumers were turned off. It was difficult to get consumers to take another look once the technologies improved.

The issue of privacy is another example. Banks now have the reputation of treating customers' information in a secure manner, but this could be jeopardized in the move to e-banking, as some recent episodes suggest.

Consider DoubleClick. This company has built a database of consumer profiles by using "cookies" planted on computers when users visit any of the 11,000 web sites operated by the company's 1500 clients. Until recently, DoubleClick said it would not collect or share information that could identify individuals. But, in January, DoubleClick announced it would begin doing so to facilitate targeted advertising. Unfortunately for DoubleClick, there was an immediate backlash. Two states plan to sue the

company for violating their consumer protection laws, and the FTC is investigating whether DoubleClick uses unfair and deceptive trade practices in failing to properly disclose what information it collects and how it is used. Faced with mounting criticism, DoubleClick has retreated and again says it will not provide consumer-profile data to advertisers. Other firms also are being sued for breaching states' privacy laws.

In addition to these types of intentional disclosures involving targeted advertising, there have also been a number of highly publicized unintentional disclosures of customer information. For example, Intuit's policy states that Intuit will not willfully disclose customer data without a customer's permission. However, a programming bug in Quicken relayed to DoubleClick some customer data, including income, assets, and debts. Similarly, H&R Block inadvertently exposed some customers' tax data to other customers. Episodes like these can make deep and lasting impressions on the minds of potential users of Internet financial services.

Both banks and regulators must be aware of the overriding public interest in maintaining confidence in the financial system. Banks are now allowed to expand into new product markets, and they now have more avenues at their disposal by which to provide these products to their customers. The general approach being taken is one of allowing banks and other providers of financial services to determine which services to provide and in what manner, within broad guidelines. This is consistent with the current supervisory framework, where bank management is responsible for risk management and control, and bank supervisors are respon-

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sible for ensuring that bank management has an effective system to manage risk. There has been a recognition on the part of regulators that market forces are difficult, if not impossible, to thwart. Regulation needs to accommodate changes in the financial system. Thus, rather than regulate through proscriptions, the goal is to establish the proper incentives, so that it is in a financial service firm's interest to act in a prudent and responsible manner.

This approach has the potential of yielding a more efficient, flexible, and innovative financial system (all attributes that can bolster confidence in the system). Banks, however, must share the responsibility for maintaining public confidence in the financial system. Banks must understand that if they fail to take appropriate actions or find themselves unable to maintain the public's confidence, regulators and legislators will be forced to take action.

Unfortunately, political interventions can sometimes be inefficient in the long run. In light of the Gramm-Leach-Bliley Act, a prime example of this comes to mind. The Glass-Steagall Act that separated commercial banking from securities underwriting was passed in the backlash of the Depression. About 10,000 banks failed between 1929 and 1933. In response to the banking crises, some 20 laws were passed between 1932 and 1935. These laws limited competition and restricted bank activities in an attempt to secure bank safety. In retrospect, the majority of bank failures during the 1930s was likely *not* due to excessive risk-taking on the part of banks, but rather to some bad policy-making. Thus, it appears that the Glass-Steagall Act was not really necessary, yet we lived with it for almost 70 years.

This is not to say regulations and legislation are always uncalled for. It is well to remember that public confidence is a public good, and sometimes the market may fail to ensure sufficient provision of this public good. In these cases, measured intervention can be a help.

For example, regulators are currently writing

rules regarding financial institutions' handling of customers' personal data. Until recently, the general approach to privacy on the Internet was one of self-regulation, where industry providers would take care to establish privacy standards and stick with them. From a competitive viewpoint it makes perfect sense that banks should be at the forefront, establishing policies to safeguard their customers' privacy. Why wouldn't banks want to build on the reputation they already have and one that their nonbank competitors have yet to establish? But breaches of privacy standards have pushed privacy onto the radar screens of legislators and regulators. And rules are now being written to implement privacy provisions of the Gramm-Leach-Bliley Act. These types of rules enable further development of electronic financial services by assuring consumers that information about them on such electronic systems is safe.

Regulators can also work to encourage financial market participants to communicate with one another as financial innovations develop. They can help to clarify some of the legal issues surrounding financial innovations, which would help facilitate their growth. For example, it is not yet clear what the potential liabilities, rights, and responsibilities of issuers, merchants, and consumers are with regard to some of the new electronic payments instruments. If an issuer were to become bankrupt or insolvent, what would be the status of the claim represented by a balance on a smart card? Clarifying such legal ambiguities also helps to ensure public confidence.

In the post-Gramm-Leach-Bliley era, where banks are less restricted in what they can do, the task for regulators is to determine how banks can enter new businesses in ways that maintain the public's confidence in the financial system.

## CONCLUSION

Overriding all of the changes in the banking system I have discussed is the public's need for confidence in the banking and financial system.

A well-functioning financial system is the underpinning of a strong economy, and public confidence is the underpinning of a successful financial system.

My major point is that while the financial system after passage of the Financial Modernization Act will be *vastly different* in terms of its structure and delivery systems, it will also be

*fundamentally the same*: public confidence will remain the basis of a sound financial system. All parties — banks, nonbanks, regulators, legislators — share a responsibility to ensure public confidence. How this shared responsibility plays out will be a powerful influence shaping, and perhaps limiting, the trends we've discussed here.