

# *Editors' Summary*

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**I**N 1999, AFTER NEARLY TWENTY YEARS of debate, the United States finally enacted legislation permitting bank affiliations with all sorts of other financial enterprises and vice versa. In taking this step, the United States joined many other countries—especially in Europe and, more recently, Japan—in allowing the operation of financial conglomerates.

But are financial conglomerates the wave of the future in finance? And if so, how are they to be regulated? These were the two central questions addressed in the sixth annual conference on financial services, held in October 2002 at the Dumbarton House in Washington, D.C. We were joined in sponsoring this conference by the government of the Netherlands, with the benefit of financial support from financial institutions on both sides of the Atlantic.<sup>1</sup>

In this introduction, we briefly outline the main conclusions of the papers presented at the conference. To preview the answers to the questions just posed, the papers suggest that although the future may see more financial conglomerate activity than in the past, there still will be a role for specialist, or “monoline,” financial companies. As for regulation,

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there is no settled model: some nations will pursue consolidated supervision, with authority over entire conglomerates vested in a single authority (often the central bank), while others will continue to regulate the pieces of diversified financial enterprises along structural lines.

INGO WALTER ADDRESSES the threshold question about the future landscape of the financial industry, in the United States and abroad, by surveying what we know and don't know about the success of various business strategies in the financial services sector. In particular, are economies of scale and scope so compelling that the future must inevitably belong to the largest financial conglomerates?

Walter concludes that the answer to this conclusion is no. The available evidence, in his survey, suggests that firm performance in financial services is essentially unrelated to size and that the evidence of economies or diseconomies of scope is inconclusive. Instead, the key to explaining differences in firm performance seems to be variations in management effectiveness, or "X-efficiency." Much of the gain from mergers may derive from the extension of successful management of the acquiring firm to the acquired entity, not from an increase in scale or scope. So-called "revenue efficiencies" from cross-selling products and services across a conglomerate, meanwhile, appear to be firm-specific and cannot be generalized to all financial services firms. Walter cautions, however, that most studies investigating the effects of economies of scope were conducted during a period when many financial firms were incurring large, but transitory, set-up costs, which create a bias against finding such economies.

In principle, firms operating with market power should be able to charge higher prices and earn greater profits than firms operating in a competitive environment. Although Walter finds that banks doing business in concentrated markets do tend to charge higher rates for loans and provide lower rates for deposits, higher expenses appear to absorb the excess revenue generated by the larger spreads, so that banks in such markets do not systematically earn supranormal profits.

Again, in principle, an increase in the size and scope of a financial conglomerate should lower its risk and thereby lead to a higher stock price. The empirical evidence supports this view with respect to combinations of commercial banking and insurance, but not with respect to commercial banking and securities activities.

One key downside of the movement toward financial conglomerates, in Walter's view, is the increased opportunity for conflicts of interest. As the activities of conglomerates become more complex and varied, so do the number and nature of their conflicts. Correspondingly, it becomes more difficult for regulators to monitor and police them effectively.

Significantly, investors do not necessarily welcome financial firms' drive to be conglomerates or financial supermarkets. Walter reports that stock prices of (nonfinancial) multiproduct firms generally sell at some discount relative to firms with more narrowly drawn product or service lines. A major reason: conglomerates tend to use capital less efficiently than more focused firms. Walter suggests that the same tendency is true among financial services firms.

In sum, despite much of the hype surrounding the supposed inevitability of financial conglomerates taking increasing shares of the financial services market, the evidence, so far at least, does not appear to support this view. There is still a role to be played by firms of all sizes and specialties.

GIVEN THE PARTICIPATION by European experts and financial market actors at the conference, it was appropriate that one of the papers examine financial consolidation and strategy in Europe. This is the focus of the paper by Arnoud Boot.

Boot echoes the view expressed by Walter that neither scope nor scale economies are driving consolidation in the financial services sector, which Boot characterizes as "breathtaking" in both the United States and Europe. Instead, Boot believes that firms are moving toward the conglomerate model for various strategic reasons, notably, the desire for first-mover advantages and the quest for market power and thus supra-normal profits. In addition, uncertainty about the source of future profits may lead firms to diversify their activities—as a way of hedging all bets. Deregulation and rapid technological change clearly contribute to this uncertainty. For this reason, Boot believes that much consolidation may be more defensive than offensive in nature.

Yet despite the growing consolidation across traditional industry lines, Boot finds that competitive pressures in financial services are growing, not receding. Margins are therefore eroding, threatening the viability of costly scope-expanding strategies.

These tendencies are especially apparent in banking, according to Boot. Running against the conventional wisdom that capital market

financing will drive out bank lending, Boot finds that loans serve as a check against excessive risk-taking from borrowing firms, thereby lowering their overall cost of capital. Although securitization will continue, banking will restructure rather than disappear. Banks still offer valuable information as well as processing and credit enhancement services, even if they do not provide the bulk of financing.

Boot also claims that the widely reported demise of relationship banking is overblown. Precisely because cutting prices in response to eroding margins cannot be a recipe for success, banks can only survive by focusing more on clients and by customizing their services to client needs.

As for the lack of empirical evidence of scale and scope economies in banking, Boot notes that most of the studies reaching this conclusion rely on data that now look somewhat stale—from the 1980s and earlier. At the same time, various technological, regulatory, managerial, and political barriers may continue to prevent larger firms from realizing these economies. In principle, diversified firms may nonetheless be able to realize scope economies through information technology (which can be used to reduce costs for a broad range of services and products), reputational benefits, financial innovation, and risk diversification. Still, the jury is out on whether these sources of possible gains will justify the move toward financial conglomerates and “universal banking.”

If Boot is right, then the recent move toward financial conglomerates may be temporary or at least about to peak. In a more competitive environment, narrowly focused business strategies may trump the financial supermarket model. Banks, in particular, may rely more heavily on alliances, which are inherently more flexible and can be changed more easily, as an alternative to outright consolidation.

THE INTEREST IN financial conglomerates is not confined to developed economies. Financial conglomerates are an important feature of the financial landscape in emerging markets as well, as Stijn Claessens reports in his paper.

Historically, banks have been regulated because of their inherent fragility—they are highly leveraged with highly liquid liabilities and illiquid assets—and because of their importance to the real economy. However, as banks’ relative importance has waned, while the lines between bank and nonbank services have become blurred, new financial regulatory challenges have arisen.

Claessens reviews the financial landscape around the world and finds a broad and growing international consensus in favor of allowing banks to affiliate with other types of financial enterprises. Of the countries surveyed, only China still narrowly circumscribes the activities of banks and their affiliates (an attitude that may reflect the policy of the United States in this respect, at least until recently).

Claessens assesses both the benefits and costs of allowing integrated financial services (IFS) firms. On the benefit side, he too finds minimal evidence of economies of scope. In principle, however, diversified firms should be less risky because revenues from different lines of business may be uncorrelated or negatively correlated with each other.

On the cost side of allowing IFS firms—again, in principle—most prominent are the potential conflicts of interest, the difficulty of monitoring complex institutions, and the potential changes in the balance of competition and political power. From the extensive empirical literature applicable to developed economies, Claessens finds that universal banks have been largely successful in avoiding conflicts of interest, while little evidence exists of anticompetitive behavior by these diversified institutions. In developing countries, IFS firms may pose greater dangers of conflicts of interest, but there may also be greater opportunities to realize the benefits of diversification in those environments.

Claessens also reviews the cross-country studies that bear on the benefits and costs of IFS firms. He finds that countries that impose greater restrictions on the mingling of banking and securities activities have been substantially more likely to suffer banking crises than countries that allow these two activities to be pursued by a single entity. There is also some evidence that allowing IFS firms to operate improves financial sector efficiency, although it may also add to market concentration.

A key challenge for regulators in emerging markets is to ensure that their financial systems are open and contestable and to strictly enforce measures designed to prevent leakage from any publicly provided safety net to support the nonbanking activities of IFS firms.

WHETHER OR NOT they prove to be the most efficient form of financial institution, are financial conglomerates less or more risky than narrowly focused financial firms? In principle, risk should fall as firms diversify their services. If so, then financial conglomerates may need less capital than financial firms engaged in only one or a few lines of financial business.

This is among several questions that Andrew Kurtizkes, Til Schuermann, and Scott Weiner address in their paper. They also examine whether the typical regulatory approach toward financial conglomerates—attention to the individual lines of business within the firm rather than to the overall conglomerate or holding company—is appropriate. And using what they believe to be reasonable parameters, the authors estimate what combinations of financial business are likely to achieve the greatest reduction in risk.

Taking the last question first, the authors find that the most effective risk-reducing financial strategy is to combine banking with property and casualty insurance. As for the effects of size, the most risk reduction occurs among combinations of equal-size firms.

Meanwhile, the authors are critical of the so-called “silo” approach to regulation, which among other things, fails to take account of risk concentrations or diversification across different operating subsidiaries. In addition, when different regulators oversee different financial lines of business within the same diversified financial firm, the same or similar activities may be inconsistently treated depending on the line of business where they are located. Realizing this, opportunistic managers may be tempted to take advantage of or “game” the differences in regulation by booking business in subsidiaries or even shell companies facing the lightest regulation. Finally, the silo approach ignores capital at unlicensed subsidiaries and the parent holding company.

To address these problems, the authors propose that regulators supplement existing supervision of regulated financial subsidiaries with oversight and capital requirements enforced at the holding-company level. The authors also urge regulators to validate internal capital models, paying specific attention to “economic capital,” which should take account of risks at each of the subsidiaries, as well as the correlations between the various lines of business that may increase, or more commonly reduce, the need for capital in the overall enterprise. The authors would like regulators to learn more from market judgments about the appropriate level of capital at the holding-company level, but these judgments can be relied on only with more disclosure of the risk and financial structure of financial conglomerates, which they advocate.

FINANCIAL REGULATORS ARE already grappling with how to supervise the risk of financial conglomerates in other countries. The following two

papers—by Iman van Lelyveld and Arnold Schilder, and by Jeroen Kremers, Dirk Schoenmaker, and Peter Wierds—look to the Netherlands and use it as a case study in recommending how regulators around the world should address this challenge.

Financial conglomerates have become an important part of the financial system in the Netherlands, increasing significantly in scale over the past decade. In the authors' view, consolidation has been driven by the search for additional revenues and cost savings, all the while encouraged by improvements in information technology.

Regulators have a role to play in the financial services arena, not because of the size of the firms involved, but because of the need to protect the public against systemic risk and potentially unscrupulous activity. Both sets of authors argue that these objectives are applicable to the regulation of both banks and insurers.

In the Netherlands, financial regulation is both functional—aimed at supervising the individual components of a diversified entity—and consolidated (although as Kremers and his team point out, it was not always this way, with regulators before 1999 supervising along functional or sectoral lines only). The Board of Financial Supervisors now coordinates the responsibilities of each of the individual functional regulators (banking, insurance, and securities), with special attention paid to financial conglomerates.

A main aim of regulating financial conglomerates is to prevent “double leveraging”—the issuance of debt by a parent company to provide equity to its subsidiaries. In addition, regulators remain concerned about the potential reputational impacts of a failure of one part of a financial conglomerate on the rest of the enterprise.

As diversified financial institutions became more important features of the Dutch financial landscape, regulators responded by adopting new institutional arrangements that facilitated consolidated supervision. The Board of Financial Supervisors is the main such response. Its formation signals that the financial diversification in the marketplace had made the old, purely sectoral-based regulatory system obsolete. As both sets of authors recognize, other nations, too, are now grappling with this fact and, as in the Netherlands, are having to refine their approach toward supervising the large and growing financial conglomerates that make up their respective financial systems.

NOT ALL REGULATION of financial institutions is effected through government agencies. The market also regulates, or more accurately “disciplines,” financial institutions by raising their cost of capital if they take on too much risk relative to the potential rewards.

Market discipline, in turn, can only work effectively if relevant information about institutions is made available on a timely basis. Although all firms have market-based reasons for providing disclosure, events in the past in the United States and elsewhere have underscored how unscrupulous managers, often with stock-based performance incentives, can withhold or distort necessary disclosures. Accordingly, if there were ever any doubts about the need for mandated disclosure for firms, the corporate accounting scandals of 2002 clearly have removed them.

Banks have long been under special obligations to disclose their financial status, although more so to regulators than to the public. In his paper, Lawrence White examines the adequacy of mandated bank disclosures and future directions for policy in this area, with special focus on the disclosure requirements for financial conglomerates under the latest proposed version of the revisions to the Basel Capital Accord.

As it is now, banks are required to release their balance sheet and income statements, both to the public and to regulators. As for other public corporations in the United States, U.S. bank financial disclosures are based on U.S. generally accepted accounting principles (GAAP). Yet GAAP, according to White, does not quickly reflect changes to a bank’s *economic capital*, as measured by the market values of the assets and liabilities in its portfolio. For this reason, White strongly advocates the replacement of GAAP with market value accounting, wherever and whenever feasible. White would allow banks to use historical costs only where market values or estimates are not available.

Furthermore, since timeliness is critical for bank regulation—it being essential to know as soon as possible when a bank’s economic capital has been significantly impaired so as to threaten the institution’s solvency—White supports bank financial reporting on a weekly, if not daily, basis (rather than quarterly, as is the practice now). Since banks (and other financial institutions) already close their books daily, White believes that more frequent public and regulatory reporting would be feasible and minimally burdensome.

Regulators also must supervise the risk assumed by banks and deal with it by demanding that banks maintain sufficient capital to absorb

these risks, while proscribing activities by banks that are not easily susceptible to examination. To ensure that bank risk is properly supervised, White recommends that banks make available to regulators information relating to covariances between their assets as well as results from “stress tests” of how the bank performs under various, unwelcome scenarios. White also advocates that banks back a certain portion of their assets with long-term tradable subordinated debt, so that banks are subject to market discipline as well as regulatory oversight. The price of this debt in the marketplace would provide a key signal of the bank’s financial well-being, while holders of the debt would be most concerned about bank solvency, the primary objective of bank regulators.

This is not the general approach taken so far in the proposed revisions to the Basel accord, however. The Basel committee has been resistant to both market value accounting and more frequent financial reporting. Instead, the revisions have adopted three approaches to risk. The “standardized” approach, based largely on the risk weights developed in the initial standards, explicitly eschews the use of stress tests, covariances, or market value accounting. The second approach, which relies on a bank’s self-estimate of the likelihood of default, is more sophisticated than the first approach, but it too avoids the tools White advocates. The third “advanced internal-ratings” approach permits banks to make estimates of more risks than the second approach, but it is subject to the same criticisms, in White’s view. Furthermore, none of the three approaches would mandate the use of subordinated debt to enhance market discipline. For all these reasons, White is highly critical of the Basel committee’s latest approach to controlling bank risk and encouraging appropriate disclosure.

Finally, White argues that what is appropriate disclosure for a financial conglomerate should resemble the standard for any other public company, with two variations: the requirement that banks back a certain percentage of their assets with subordinated debt and a provision requiring securities affiliates to report the connections among their underwriting activities, analysts’ recommendations, and bank lending to their clients.

ONE OF THE MORE controversial policy issues posed by the recent wave of financial consolidation relates to the use by diversified institutions of information about their customers. Specifically, how and under what circumstances should financial firms be able to use customer information to

attract their business in other lines of activity, whether or not engaged in by affiliates of the same firm?

Peter Swire addresses this important topic in the final paper in this volume. Countering what he claims is the belief by many economists that the need for perfect information trumps the preference for privacy, Swire argues that maintaining the privacy of financial information is more efficient than economists generally suppose.

The resistance among some economists to the need for privacy, in Swire's view, stems from the perception or belief that perfect information is required for markets to operate efficiently. However, by definition, protecting privacy entails some limits on the sharing of information. The fact that in financial services privacy has been the norm for decades therefore seemingly runs counter to the economic intuition that limits on information can be a cause of market failure.

Swire surveys confidentiality in other areas to substantiate his position that limits on information flow to protect privacy can be efficient. The maxim "don't hand out the keys to the safe" is one example where everyone would agree that confidentiality is essential and efficient. The same logic applies to electronic passwords for bank and e-mail accounts: release of such information would entail very high costs and little social benefit (if not outright harm). In short, if parties cannot be secure in the secrecy of sensitive information, economic activity can be disrupted, not facilitated.

Despite consistent polling data showing the public's strong preference for privacy, economists seemingly discredit this evidence by noting that, in fact, customers generally do reveal sensitive information about themselves when asked. Swire responds to this view in several ways. First, he believes that economists often underestimate the value many individuals attach to privacy and ignore the fact that individuals place different values on privacy in the short and long runs. Second, market failures may exist due to individuals' inability to express their preferences in monetary terms. In particular, lack of privacy for sensitive information could have a chilling effect on some kinds of economic activity in the long run.

Swire supports his argument from recent polling data suggesting that consumers do in fact demonstrate strong preferences for privacy. The study indicates a strong correlation between the intensity of use of online banking and a bank's rating on privacy protection, as perceived by the

public. Swire concludes by outlining a template for assessing the efficiency of confidentiality in a wide variety of contexts.

TAKEN AS A WHOLE, this collection of papers reflects the current understanding of why financial conglomerates are being formed, whether they are likely to dominate the financial landscape, and the policy issues that they present. Because this is a comparatively recent phenomenon in many countries, many of the empirical judgments must be tentative. It is simply too soon to rule out the importance of scale and scope economies definitively. But the early evidence certainly warrants a substantial measure of skepticism.

Similarly, the formation of consolidated regulators to deal with financial conglomerates is a very recent event. Fortunately, this approach to regulation has not yet been forced to withstand the test of a major financial crisis. But for the moment, it appears that the consolidated approach to regulation and supervision will stand alongside traditional functional approaches, which may complicate future attempts to harmonize financial regulation internationally.

