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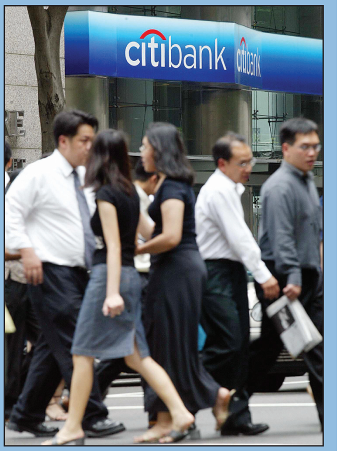
Financial Conglomerates: The Future of Finance?



RICHARD J. HERRING AND ROBERT E. LITAN

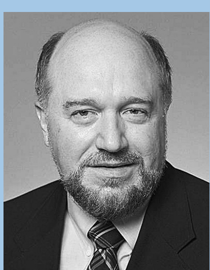
In 1999, after nearly twenty years of debate, the U.S. Congress finally passed legislation permitting bank affiliations with all sorts of other financial enterprises, and vice versa. In this step, the United States joined many other countries—especially in Europe and, more recently, Japan—in allowing 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 fifth annual conference of the *Brookings-Wharton Papers on Financial Services*, an annual volume published by the Brookings Institution Press. The conference, held in October 2002 in Washington, D.C., convened financial services experts from around the world.

The papers presented at the conference suggest, generally, that while the future may see more financial conglomerate activity than it has in the past, there still will be a role for specialist, or "monoline" financial companies. As for regulation, 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 still regulate the pieces of diversified financial enterprises along structural lines.

Ingo Walter of New York University addresses the threshold question about the future landscape of the financial industry, in the United States and abroad, by surveying what we know and do not 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 evidence relating to economies or diseconomies of scope is inconclusive. Instead, the key to explaining differences in firm performance seems to lie in variations in management effectiveness. Much of the gain from mergers may derive from the extension of



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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 financial firms may have been 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. While Walter finds that banks doing business in concentrated markets tend to charge higher rates for loans and provide lower rates for deposits, the excess revenue generated by the larger spreads appears to be absorbed by higher expenses, so that banks in such markets are not systematically earning unusually high profits.

Again, in principle, an increase in 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 conglomerates' activities 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 (non-financial) multi-product 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 service firms.

THE VIEW FROM EUROPE

In his paper on examine financial consolidation and strategy in Europe, Arnoud Boot echoes the view expressed by Walter that neither scope nor scale economies are driving consolidation in the financial services sector—which in both the United States and Europe Boot characterizes as "breathtaking." 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 supranormal profits. In addition, uncertainty about where future profits may come from may lead firms to diversify their activities—as a way of hedging their bets. Deregulation and rapid technological change clearly contribute to this uncertainty. For this reason, Boot believes that consolidation may be largely more defensive rather 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 markets 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. While securitization will continue, banking will restructure rather than disappear. Banks still offer valuable information 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 price-cutting in response to eroding margins cannot be a recipe for success, banks can only survive by being more client-focused 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 that reach this conclusion have relied on data that now look somewhat stale—from the 1980s and earlier. At the same time, there may continue to be various technological, regulatory, managerial, and political barriers preventing larger firms from realizing these economies.

In principle, diversified firms may nonetheless be able to realize scope economies through information technology, benefits of reputation, financial innovation, and risk diversification. The jury is still 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 moves 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 more easily be changed—as an alternative to outright consolidation.

FINANCIAL CONGLOMERATES AND EMERGING MARKETS

The interest in financial conglomerates is not confined to developed economies. Financial conglomerates are important features of the financial landscape in emerging markets as well, as Stijn Claessens of the University of Amsterdam reported 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 non-bank 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

In addition to sponsorship by Brookings and the University of Pennsylvania's Wharton School, this year's *Brookings-Wharton Papers on Financial Services* conference was co-sponsored by the Government of the Netherlands, with financial support from the following U.S. and European financial institutions: AEGON, ABN AMRO, USAA, Citigroup, Fortis, First Data Corporation, GE Finance, ING, Morgan Stanley, Rabobank International, and UBS.

The findings from papers delivered at this conference will appear in the 2003 edition of the *Brookings-Wharton Papers on Financial Services*, co-edited by the authors of this conference report. The journal is due out in May 2003 from the Brookings Institution Press.

> *"Are economies of scale and scope so compelling that the future must inevitably belong to the largest financial conglomerates?"*

narrowly circumscribes the activities of banks and their affiliates (an attitude that may reflect U.S. policy in this respect, at least until recently).

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

In principle, the cost incurred by allowing IFS firms 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 of anti-competitive behavior by these diversified institutions exists. In developing countries, IFS firms may pose greater dangers of conflicts of interest, but there may also be greater opportunities for 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 where these two activities are allowed 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 supporting the non-banking activities of IFS firms.

"Despite the growing consolidation across traditional industry lines, Boot finds that competitive pressures in financial services are growing, not receding."

THE RISK FACTOR

Whether or not they prove to be the most efficient kind 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 it does, then financial conglomerates may need less capital than financial firms engaged in one or a few lines of financial business.

This is among several questions that Andrew Kuritzkes, Til Schuermann, and Scott M. Weiner address in their paper, which also examines 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. The authors also estimate what combinations of financial business are likely to achieve the greatest reduction in risk.

The authors find that the most effective risk-reducing financial strategy is to combine banking with property-casualty insurance, with the most risk reduction occurring among combinations of equal-sized firms.

Meanwhile, the authors are critical of regulating financial institutions by the nature of their activities, 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 treated inconsistently depending on their line of business. Realizing this, opportunistic managers may be tempted to take advantage of the differences in regulation by booking business in subsidiaries or even shell companies facing the lightest regulation. Finally, the so-called "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 say regulators should learn more from market judgments about the appropriate level of capital at the holding company level, but these can be relied upon only with more disclosure of the risk and financial structure of financial conglomerates, which they advocate.

RISK AND FINANCIAL CONGLOMERATES

Financial regulators are already grappling with how to supervise risk of financial conglomerates in other countries. In their paper, Iman van Lelyveld and Arnold Schilder of the Netherlands Central Bank use the Netherlands as a model for 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 in order to protect the public against systemic risk and potentially unscrupulous activity. The 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. A main aim of regulating financial conglomerates is to prevent "double leveraging," or the issuance of debt by a parent company to provide equity to its subsidiaries. In addition, regulators remain concerned about the potential 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.

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In the mid-1990s, they adopted a formal means of coordinating separate supervision and by the end of the decade had formed a council of supervisors. The regulatory authorities continue to refine their approach toward supervising the large and growing financial conglomerates that make up the Dutch financial system.

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 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 it.

DISCLOSURE REQUIREMENTS

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 of New York University 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 (initially adopted by twelve industrialized countries in 1989).

Banks are currently required to release publicly their balance sheet and income statements quarterly, both to the public and 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 (MVA), wherever and whenever feasible. White would allow banks to use historical costs only where market values or estimates are unavailable.

Furthermore, since timeliness is critical for bank regulation, White supports bank financial reporting on a weekly, if not daily, basis. Since banks (and other financial institutions) already close their books daily, White does believes more frequent public and regulatory reporting would be feasible and minimally burdensome.

Regulators also must supervise the risk assumed by banks, and demand 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 various "stress tests" of how the bank performs under various, unwelcome scenarios. White furthermore 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.

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 MVA 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 MVA. The second approach, which relies on a bank's estimate of the likeliness of its own 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. 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 that securities affiliates report their connections between their underwriting activities, analysts' recommendations, and bank lending to their clients.

CONGLOMERATES AND CONSUMER PRIVACY

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 affiliates of the same firm engage in it?

Peter Swire addresses this important topic in the final paper in this volume. Countering what he says is the belief by many economists that the need for 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 complete information about price and quality is required for markets to operate efficiently. However, by definition, protecting privacy entails some limits on information-sharing. The fact that in financial services privacy has been the norm for decades, then, seems to contradict 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 same logic applies to electronic passwords for bank and email 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.

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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 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, there may exist market failures 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 the 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.

CONCLUSION

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 function approaches, which may complicate future attempts to harmonize financial regulation internationally.

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