Deregulation and Its Effects
On the Financial Services Industry

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Until a few years ago, financial markets in this country were ruled by laws and regulations from the 1930's. These rules were imposed to protect investors from another devastating loss like those they incurred during the depression of the late 1920's. The regulations were relevant for their time, but changes in all areas of the economy and market had produced a need for deregulation and new legislation. "The specialized structure of regulation led to further specialization of institutions. Lawmakers gave separate roles and regulators to banking, thrift, securities, and insurance industries, and competition was expected to take place within these industries, not between them. With few exceptions, the regulator for one industry had no authority over firms in another. Federally chartered savings associations have one deposit insurer; banks have a different one; and securities firms another kind of protection altogether. This plan was adequate as long as each firm was content with its assigned niche. For many years, the regulators could keep pace with the few aggressive entrepreneurs who sometimes attempted to break out of this rigid structure."!

To understand the purpose of deregulation, one must first understand the reason for regulation and the events
leading up to it. In the 1860's banks began to be nationally chartered and by the early 1900's had become the largest financial institutions ever formed. A committee was formed to investigate the concentration of money (both deposits and investments) among these banks. The committee decided that the two areas of banking should be separate, so they produced the Federal Reserve Act of 1913. This Act made it illegal for depository institutions to underwrite corporate securities. The banks found that they could bypass this legislation by owning affiliates which were either investment companies or trust companies. The depression and stock market crash of the 1920's caused thousands of banks to fail, due to the conflict of interest between depository institutions and securities firms.

Glass-Steagall Act

These failures caused pressure on the government to do something to protect the people. This pressure brought about the Banking Act of 1933, also known in part as the Glass-Steagall Act, which established the Federal Deposit Insurance Corporation. The FDIC was started with funds from the U.S. Treasury which were later replaced by premiums from the member banks. Nearly every bank joined the FDIC since it gave them the security that their depositors demanded. The formation of the FDIC helped the government to start regulating the banks, due to the need to examine records for insurance purposes. The main provision of the Glass-
Steagall Act, however, is the separation of commercial and investment banking. The Act prohibited national and state chartered banks from purchasing equity securities for their own account. Treasury securities were allowed since they are low risk instruments. A 1935 amendment to the Act allowed banks to purchase and sell securities, for the customers' accounts. Section twenty of the Act prohibited member banks from owning or being affiliated with any and all investment banking firms. Securities firms were prohibited from accepting demand deposits. One other provision of the Act prohibited interest payments on demand deposits. The reason for this was to curb competition among banks since this type of competition was one of the major factors of bank failures during the depression.

Financial Institutions Regulatory Act

Another Act in which Congress regulated finances was the Financial Institutions Regulatory Act of 1978. The House of Representatives Committee on Banking stated the reasons for the legislation as being "Financial institutions provide the lifeblood for communities...the public's need for laws to assure a safe, sound, and responsive financial system is obvious. When these bank services are lost or diminished...the impact on the community can be severe."

The first provision of this Act is to limit insider transactions. According to an FDIC bank failure study almost
sixty percent of the bank failures during the years 1960-1975 were principally caused by insider loans. This new provision limited all executive officers and stockholders, with ten percent of more of the outstanding stock, to total loans of no more than ten percent of the bank's capital accounts. All insured banks were also prohibited from paying overdrafts on accounts belonging to insiders. The payment of overdrafts is considered an extension of credit and was disallowed. They did allow the banks to make transfers of funds in the case of an overdraft, but only if there had been written preauthorization from the insider. In an attempt to further regulate insider transaction it was required that all loans to insiders that exceeded $25,000 must gain approval by the board of directors during a time in which the insider is absent from the meeting.

The only problem with all the regulation was that there was no way to enforce it. The committee then set up four supervisory powers to keep the laws enforced. A civil monetary penalty could be imposed for minor violations or first offenses. The assessment of such a penalty would take into account the severity of the infraction and the ability of the violator to pay. A cease-and-desist order may be issued against the institution or the officer(s) of the institution who broke the regulation. The third alternative is the removal or suspension of insiders who have evidenced personal dishonesty or demonstrated a willful and continuing
disregard for the safety and soundness of the institution. The fourth power is a preventive measure rather than a punishment. This required that any person or concert of people, who would be attempting to acquire the power to vote 25 percent or more of the stock, must apply to the appropriate agency sixty days prior to the purchase or transfer of the stock. The agency may approve or deny the acquisition request if it would be a threat to the institution or its depositors.

The next section of FIRA improved the regulatory agencies that control financial institutions. The four areas dealt with were conflicts of interest, financial institutions examination council, improving agency relations, and NCUA restructuring. The conflicts of interest section prohibited employment in a regulated institution for a period of two years for and person who did not complete a term for which he was appointed in a regulatory agency. This would include members of the board of the FDIC, governors of the Federal Reserve System, members of the Federal Home Loan Bank Board, and members of the National Credit Union Association board. A former official of these agencies may not appear before the agency for which he worked, on behalf of any agency or person. Next, the Financial Institutions Examinations Council was created to prescribe principles and standards for examination of federally chartered institutions. The
improvement of agency regulations required each banking agency to review their regulations to insure that the need and purpose for each was clear. The NCUA was restructured to have three members on the board rather than one.

The changes of authority for financial institutions provided new regulations for holding companies with regard to insurance. Until 1970 bank holding companies were allowed to sell all types of property and liability insurance. An amendment in 1970 changed this to read that a bank holding company could sell only those types of insurance directly related to the banking business. FIRA changed the regulation even further, to state that it would not be permissible for a BHC to provide insurance as a principle, agent, or broker except for the five categories of exemption. These exemptions include credit life, credit disability and mortgage redemption; a BHC in a community of less than five thousand residents; grandfathered BHC which can continue the activities which were legal for them at the time of the new legislation; and BHC with aggregate assets of less than $50 million.

DIDMCA of 1980

These two Acts have been regulatory legislations and all banking acts up to this point were of the same type. The first attempt at deregulation was the Depository Institutions Deregulation and Monetary Control Act of 1980.
The monetary control portion of this Act requires all depository institutions to keep reserves at the Federal Reserve, even if the institution is not a member of the Federal Reserve System. The reserves are to be figures as three percent of the total of all transaction accounts up to $25,000,000. Any amount of the total of these accounts exceeding $25,000,000 shall be reserved at twelve percent. All institutions will be entitled to the same discount and borrowing privileges as member banks. Fees charged for services such as check clearing and wire transfers will be the same for member as well as nonmember banks. This monetary control essentially gives no extra privileges or rights to members of the system.

Title II of the Act is deregulation. Section 202 states that "limitations on the interest rates which are payable on deposits and accounts discourage persons from saving money...and have not achieved their purpose of providing an even flow of funds for home mortgage lending; and all depositors, and in particular those with modest savings, are entitled to receive a market rate of return on their savings." For this reason, the Congress has provided for an orderly phase-out and elimination of limitations on the maximum rates which can be paid on deposits. This phase-out will occur over a six year period. Title II also calls for the assessment of whether the removal of the differential in rates between banks and thrifts will
adversely affect the viability of the thrift industry.

Title III is the Consumer Checking Account Equity Act, which allows for the withdrawal of funds to be made automatically from a savings account to a payment to the bank itself or to a demand deposit account as long as there is written authorization from the depositor. This title also allows for banks to have Negotiable Order of Withdrawal accounts in which the institution is entitled to pay interest or dividends on the money in the account. One other section in this title is the amendment of the FDIC to protect depositors for $100,000 instead of the previous limit of $40,000.

Powers of Thrift Institutions is Title IV. Section 401 lists and describes all the types of loans and investments that can be dealt by thrifts. Credit card issuance and extension of credit in connection with credit cards is allowed by section 402 of this title.

Truth in Lending simplification is the main purpose of Title V. The first section deals with the disclosure of fees, rates, and other charges used in computing the payments on loans. An amendment to the Truth in Lending Act allows sixty days for errors to be discovered. During this time adjustments may be made to the appropriate account to assure that the person will not be required to pay an amount in excess of the charges actually disclosed, whichever is lower. Section 617 amends the liability of a credit card
holder for unauthorized use. If a credit card is used by an unauthorized person, the cardholder will be liable for up to, but not exceeding fifty dollars as long as the card issuer has been notified that the card has been lost or stolen. The card issuer is liable to inform the cardholder of the action to be taken in the case of a stolen or lost card. Section 621 amends the treatment of credit balances in excess of one dollar. Any time there is such a balance it is the creditor's responsibility to credit the customer's account and to offer to refund the amount of the credit to the customer. If the amount stays as a credit for six months or longer it is the creditor's responsibility to make a good faith effort to refund the amount by tracing the customer through his last known address and/or telephone number. Oral inquiries as to the cost of credit shall be disclosed as to the amendments in Section 623. This section states that all such inquiries shall be answered in terms of annual percentage rate, no matter how the rates are figured. The only exception to this is open ended accounts which may be answered in terms of periodic rates as long as the annual percentage rate is also disclosed.

Garn-St. Germain

The next deregulation act is the Garn-St. Germain Depository Institutions Act of 1982. This Act did much to deregulate the financial world. Title I is Depository
Insurance Flexibility which expanded the forms of financial assistance that could be provided by the insurance agencies and broadens the circumstances under which such assistance can be granted. The new provision provides specific procedures for the agencies to follow for acquisitions or mergers of failing and failed institutions. This shall be done only with written permission from the state supervisor through the extraordinary acquisitions authority. This permission must be given at least forty-eight hours prior to the start of any such action. The mergers shall be given priority in the following order:

1. between institutions of the same type within the same state,
2. between institutions of the same type in different states,
3. between institutions of different types within the same state,
4. between institutions of different types in different states.

These guidelines shall be followed in the case of any absorption or merger of failed or failing depository institutions.

Title II concerns net worth certificates. These are a new type of certificates which will be used to provide capital assistance to depository institutions which have suffered capital losses as a result of their mortgage lending activities. These certificates may be purchased, with promissory notes, by institutions with a net worth of
up to three percent of total assets. To qualify for assistance the net worth must be equal to or greater than one-half of one percent of the assets after the issuance of the certificates. Federal insurance agencies can not require merger resolutions from institutions receiving this assistance as long as the said institution is projected to have a positive net worth for at least six months. Management changes can not be required if the projected net worth is positive for at least nine months. The amount of assistance shall be figured according to the percentage of net worth. An institution with three percent net worth will receive up to fifty percent of the lost amount, whereas one with one percent net worth will receive up to seventy percent of the lost amount. During the time that an institution has net worth certificates outstanding it is prohibited from paying dividends on common stock. In the event of a liquidation, the certificates will be of a higher priority than common stock.

The thrift restructuring of Title III provides for increased investment powers of federal thrift institutions. The purpose of this is to widen the range of services thrifts can provide to generate earnings. Thrifts have been granted the power to offer stock rather than mutual shares. They are also allowed to accept demand deposits from commercial and corporate customers. This Act also directs the Depository Institutions Deregulation Committee to
establish a bill for establishment of accounts which are directly equivalent to and competitive with money market mutual funds. These accounts shall allow three automatic transfers and three third party transfers per month. The legal minimum balance requirement shall be no higher than $5,000.

Title V outlines provisions relating to national and member banks. Lending limits were raised from ten to fifteen percent of the banks unimpaired capital and surplus. The title also provides an exemption from reserve requirements for those institutions with total demand deposits of two million dollars or less. Also, under this title the statutory limitations on loans to insiders was eliminated.

Other provisions of the Garn-St. Germain Act allow for NOW accounts to be offered to state and local governments. Banks are limited to loans to one affiliate to be no more than ten percent of capital stock and surplus and loans to all affiliates shall be no more than twenty percent.

Competitive Equality Banking Act

One of the most recent Acts in finance is the Competitive Equality Banking Act of 1987. The purpose of this legislation, according to the Senate report, is to halt the aggressive exploitation of loopholes in the banking laws and to recapitalize the Federal Savings and Loan
Insurance Corporation. The nonbank bank was formed through the exploitation of loopholes. This was accomplished when the definition of a bank was changed. In the 1956 Bank Holding Company Act a bank was defined as any entity chartered as a bank under the national bank act. A 1966 amendment changed this to include any institution that accepts deposits. In 1970 it was changed to any institution which accepts demand deposits and makes commercial loans. This definition was supposed to differentiate banks from trust companies. Some institutions found a way around the Bank Holding Company Act by either giving up demand deposits or commercial loans so that they would no longer be classified as a bank. By doing this, the nonbank bank did not have to follow interstate branching regulations and was exempt from the requirement that the activities of a bank holding company must be closely related to banking. Thus, by becoming a nonbank bank the institution could be owned by a parent in any industry. In order to close the loophole, Congress changed the definition of a bank to be any bank whose deposits are insured by the FDIC as well as those who accept demand deposits or any deposits in which the depositor may withdraw payments to third parties and engage in the business of making commercial loans. This bill excludes from the definition any foreign bank with no branches in the U.S.; any FSLIC thrift institution; trust companies that act solely as fiduciaries; credit unions;
credit card banks; industrial loan companies; and Edge Act companies. Any nonbank bank formed before March 5, 1987 will be grandfathered from compliance with the Bank Holding Company Act as long as it follows the new legislation set forth in this Competitive Equality Act. This legislation prohibits a parent company of a nonbank from obtaining control of additional banks or thrifts and from acquiring more than five percent of the shares or assets of a bank or thrift. No new activities may be allowed and no new joint marketing will be allowed. The parent company must control the nonbank so that its assets do not increase by more than seven percent per year.

The second part of this legislation imposes a moratorium on certain nonbanking activities. The Banking Act of 1933 prohibits banks from being affiliated with any institution principally engaged in issuing, underwriting, or distributing securities. Several bank holding companies, however, have applied to the Federal Reserve for the authority to underwrite and sell securities in a nonbank subsidiary by claiming that the sale of securities will not be the principal engagement of the subsidiaries. To give the Federal Reserve and Congress enough time to look into the legality of this matter, a moratorium has been set for one year beginning March 6, 1987. During this time there shall be no approval of any such applications. The bill also bars Federal banking agencies from issuing any rules to
increase the insurance powers of banks during the moratorium period. This was done to give Congress time to consider the issue of whether a national bank in a community of 5000 residents or less can sell insurance nationwide or only locally in the place in which it is located.

The next part of the Act is FSLIC recapitalization. This is important because of the substantial amount of losses in thrifts in 1986. The regulations in this title give guidelines for borrowing to help resolve the $20-$25 billion problems in thrifts. The framework considers a plan made by the Federal Home Loan Bank Board and the Treasury. It requires that the FSLIC provides to Congress a variety of reports to explain its financial position and its resolutions. It also requires that the FHLBB must not permit any accounting that is not consistent with the generally accepted accounting principles and it must not be more strict than the GAAP when writing down reserves against problem assets. The use of stringency in the past has been one of the causes of thrift failure.

Title IV concerns emergency acquisitions and mergers. The Act contends that if acquisitions are made during the failing stages rather than waiting until the actual failure occurs, that chances of finding a buyer will be improved. Bridge banks, those operated by the FDIC for three years, should be established only if it less expensive than liquidation or in the public's best interests.
Federal Credit Union Act Amendments are the topic of Title V. The clarification of the NCUA's authority to remove credit union employees from the office is explored here. This authority is extended to any person formally or informally associated with the credit union, who is in a position to do harm to it. If the said person is removed from conducting the affairs of an insured credit union, he will also be suspended from dealing with all federally insured credit unions, depository institutions, bank holding companies, and institutions chartered by the Farm Credit Administration unless he is allowed back in by the appropriate federal regulatory agency. This title also deals with the NCUAs discretion to allow home improvement loans and second mortgages for periods of longer than fifteen years. This will permit credit unions to be competitive with other financial institutions.

The final provision of this Act is the Fair Deposit Availability Act. The first part requires depository institutions to disclose their policy on delaying depositor's funds. The Federal Reserve is instructed to adopt an interim regulation based on improving the check clearing system. This shall have a tiered schedule with an outside limit of six days for fund availability on out-of-town checks. Also, within the next thirty-six months a final regulation must be adopted which will have the same tiered schedule, but with an outside limit of four days on
out-of-town checks. It shall also provide one day availability for U.S., state, and local government checks.

The five legislations and laws discussed thus far give the basis of financial regulation and deregulation in the United States. There has been much controversy over the main provisions of these laws. Financial institutions want to have the authority to sell securities and insurance, while insurance companies do not want competition from banks, yet want to sell securities. The securities industry does not want others to sell securities, however, it would like to possess some of the powers of banks. The regulations to keep these industries separate were made with key aspects of competition in mind. The industries do not feel as though they are being treated fairly. Each industry must be looked at individually to see what it has, what it wants, and how it has changed.

The Insurance Industry

The insurance industry has been affected in two ways; what products are sold and who can sell them. Insurance companies are offering many products that could only be offered by banks or securities firms in the past. Some of these include consumer financing, mutual funds, brokerage services, cash management, and commercial mortgages. The commercial mortgage is very important, in that insurance companies now hold a larger portion of them than do bank holding companies. One of the other big areas is
investment banking. Insurance firms are acquiring brokerage firms and using cross-selling between them to generate millions of dollars in investment capital. One such combination is Prudential-Bache. The next major area is personal financial planning. Life insurance companies as well as banks and securities firms are entering this business at a surprising rate. One thing insurance companies must remember when selling this service is to keep the sales function of insurance separate from the advising function of financial planning. If this is not done, the customer will be driven away, sue to his belief that personal financial planning is just one more way to sell insurance.

Since the Deficit Reduction Act of 1984, the products of insurance companies have become important as investment vehicles. The Act redefined insurance to be insurance company money that is payable to a beneficiary upon the death of an insured. This means that the insurance company owns the money until it is paid out. If a policyholder keeps a policy in force until his death he will not have had to pay income tax on the additional investment income because it was not his money. When the beneficiary receives the money upon the death of the insured it still will not be taxed as income. In this way, insurance as an investment has a distinct advantage over other investment vehicles.

Universal life policies also have advantages for the
investor, but they are advantageous to the insurance company too. In this policy the insurance company guarantees a rate of income for one year. This rate is usually higher than market rates. After the one year period the rate is no longer guaranteed, but the investor will generally leave his money invested anyway. This allows the insurance company to invest the money for longer than one year, thus earning a higher rate of return. This helps reduce the disintermediation that has affected insurance companies in the past. This is not the only benefit universal life policies offer, they also allow for movement of funds. This movement is generally among different policy accounts with differing rates of return.

Another type of investment insurance policy is the whole life policy. This policy provides income in two ways, one is a guaranteed cash value and the other is dividends. These dividends are not taxed because they are labeled as a reimbursement of excess premiums that have been paid in.

The change in who is allowed to offer insurance has not been as big as the change in products offered. All states require a person to be licensed to sell insurance products. In fifteen states, bank employees are prohibited from selling insurance even with a license. Banks are beginning to have some of their employees licensed in order to capitalize on annuity income. Annuities provide banks with significant fees income, protection from losing customers
upon maturity of CDs, and add greater appeal for new customers.

Banks offer two types of insurance policies; individual and group. Individual policies are between the insurance company and the insured individual. Group policies are between the insurance company and the financial institution, which, in return, issues certificates to the individual insured. Coverages and benefits are comparable except for cancellation. Products offered include mortgage life insurance, mortgage disability insurance, accidental disability insurance, accidental death insurance, and credit life insurance. 

New competition in the insurance industry will only intensify the efforts of the companies to hold onto their market shares. This will not be difficult because these companies have strong networks of agents who have built up relationships with customers. The new competition may well result only in better services and coverages for the consumers.

Banking and Securities

The effect competition has on services is not limited to the insurance industry. Banking and securities firms are also affected by competition. These two industries are becoming intertwined and hard to separate so they will be discussed together. The competition facing these two industries is highly regulated. Banks are regulated to
benefit the depositors and assure that their deposits are protected. This protection helps in case of a liquidation to ensure that depositors fare well. The shareholders and officers, however, usually tend to lose out. In Harmsen vs. Smith it was decided that banks are examined to help out with regulation. The examination may provide incidental benefit to the bank but it was not done solely for that purpose. The examination does not create an actionable duty to the bank. Franklin vs. U.S. government adds to this by finding that the government does not guarantee bank solvency and can not be held liable in the case of an insolvency. This means that the government is not liable to the bank, however, the FDIC (a government agency) is liable to the depositors.11

Hans Angermuller of Citicorp has a different reason as to why the industry is regulated. He says that the function of regulation is to facilitate the flow of funds from sources through intermediaries to users in a manner that protects them from loss. Mr. Angermuller has a set of four techniques to help accomplish this. First, avoid excessive competition through limits placed on interest rates paid, nature and scope of activities, geographic operating area, and entry into the business. The second technique is to limit the type and nature of portfolios. Next, insure against the misconduct of insiders by prohibiting certain activities and penalizing any deviation. The last step is
to provide government financial support. If these steps are followed regulation would be efficient and helpful to the industries and the public.

Regulation of these industries has caused the players to want deregulation. This deregulation focuses on three areas; deposit interest rate control, geographic expansion, and the separation of investment and commercial banking. These have come a long way since the initial lobby but have not been completely and freely deregulated. Actually the separation of commercial and investment banking has been more regulated since the industries have started to combine products.

Although Congress has called their actions deregulation, the bills they pass have more regulation in them than they take out. For example the Deregulation Act of 1979 deregulated a few areas but also had six areas in which it either tightened existing control or added new ones. These include:

1. Kept the prohibition of interest payments on demand deposits.
2. Authorized the revocation of national bank and trust powers by order of the Comptroller of the Currency.
3. Kept the requirement of bank directors to own qualifying shares of stock.
4. Restricted bank holding companies abilities to own trust subsidiaries in different states.
5. Authorized the Comptroller of the Currency to issue new regulations on those practices he believed to be unsafe or unsound.
6. Imposed a moratorium on United States banks being acquired by foreigners.

These are not exactly what the industries were looking for
when they lobbied for deregulation and reform.

Another example is the Competitive Equality Banking Act of 1987. This Act caused dramatic changes in the thrift industry but did little to help commercial banks. It closed the nonbank bank loophole, but that was not of much concern to the competitive forces pressuring commercial banks. The moratorium on new insurance, real estate, and security powers works against the banks goals of achieving a full role in the financial services market place. Congress said that they will try not to extend the moratorium past its expiration date, but they will probably have to. It will be impossible for them to pass a comprehensive banking legislation during an election year. The reason for this is that comprehensive banking involves bank securities, insurance, and real estate powers as well as fixing the overlapping regulatory structures of each of these industries.¹⁴

These regulations both help and hurt competition no matter which viewpoint one uses. The banks feel like they are being helped when competition is limited, but they also want to enter into new fields which will increase their competition. The public wants more competition so that the prices will decrease and service, as well as quality, will increase.

Eric Compton of the Chase Manhattan Bank clarifies three type of bank competition in his newest book. These
types are credit unions, nonbank banks, and nonbank companies. Credit unions are owned by members who purchase shares through depositing money in share draft accounts or savings accounts. These members must be of a common bond such as having the same employer or profession, having the same religion, living in the same geographic area or belonging to the same social or fraternal group. Credit unions offer a broad range of financial services, pay higher rates on deposits and charge lower rates on loans than do commercial banks. They are exempt from federal income tax on their net earnings. Despite all these advantages, they do not pose much of a threat to commercial banks because they are mainly local entities and are not open to the public. The next type of competition, the nonbank bank, was discussed earlier on pages 12 and 13. These entities are no longer legal, except under the grandfather clause of the Competitive Equality Banking Act of 1987.

The final type of competition is the strongest and poses a major threat for commercial banks. Nonbank companies are divided into five subcategories: financial conglomerates, industrial companies with financial services, brokerage firms, insurance companies, and retailers.¹⁵ These subcategories are slightly different from one another and many firms are hard to place in just one area. To find out how this is possible each subcategory must be studied.

Financial conglomerates are conglomerates which
specialize in the financial services industry, American Express, Shearson Lehman Brothers, Beneficial Corporation, and Household Finance Corporation are a few examples of this type of firm. The companies do not accept demand deposits but do provide credit facilities. They offer money transfers, credit cards, insurance coverages, mutual funds, CDs, mortgage loans, IRAs, or college savings programs. 16

Some financial conglomerates could be classified as industrial companies with financial services or vice versa. An industrial company is a company that also has some financial services. Examples include Ford, General Motors, Gulf and Western, and IBM. These firms offer consumer product financing such as GMAC offering auto loans. They also have commercial lending; credit insurance; auto and disability insurance; home improvement, personal, and home equity loans; as well as mortgage lending services. Most have at least one financial subsidiary such as Puritan Insurance Company, Mortgage Insurance Company, or Kidder, Peabody and Company (a brokerage firm). 17

Kidder, Peabody fits in industrial companies because it is a subsidiary, however it could fit just as well in the broker category. The removal of fixed rate commissions in 1975 made brokers look elsewhere for a money making strategy. This brought about the hybrid that most brokers are today. These hybrid brokers combine groups of financial services and market them nationally. Two examples are
Merrill Lynch and the Dreyfus Corporation. Merrill Lynch offers brokerage services, real estate, insurance, mortgage, Eurobond, securities underwriting, money management and commercial paper services, as well as a cash management account which will be discussed later. The Dreyfus Corporation was the first brokerage firm to actually enter banking. They acquired the Lincoln State Bank and divested its commercial loan portfolio so they would no longer be considered a bank holding company.  

The final competition facing banks today is retailers. Retailers entered the financial services industry in two ways. The first is through placing ATMs or minibranches of local banks in their stores. Two retailers who did this were K-Mart and Kroger. The other way retailers enter financial services was by offering consumers product financing and credit cards. J C Penney has subsidiaries including J C Penney Financial Services, J C Penney Realty, and First National Bank. It offers consumer product financing, credit cards, personal, mortgage, and auto loans. Sears is trying to become the largest retailer in the financial services industry. It has its own bank card as well as a proprietary card, check cashing services, cash advances, Allstate insurance, Dean Witter investment banking, and Coldwell Banker realty.

All of the competitors in each type of industry described have advantages over the commercial bank. Most of
these advantages came about through regulation. Eric Compton described five distinct advantages he believes these firms possess.

1. They can operate across state lines and branch within states. They are not subject to the McFadden Act which restricts banks from doing this.

2. They do not have to keep deposits at the Federal Reserve and can use this extra money however they wish.

3. They are not regulated as banks, thus are limited only to whatever financial services they can create or resource with their available funds.

4. They are not tied to long term, low-yield loans to other countries which require them to hold loan loss reserves.

5. They have an advantage from their start due to files on their existing retail or industrial customers, these can be used for cross-selling.  

Because of these advantages and the ever increasing competition, all firms in the financial services industry must continually create new products. These products are consumer based rather than commercial based. The reason for this is that consumers have more liquid assets than they have ever had before. They are looking for places to invest this money, such as money market funds, and demand deposits. They also have more debt than ever before, due to the deregulation of debt to income ratios. Banks have started charging more for their services and products such as monthly fees for checking and required minimum balances in customer's accounts. Thrifts have started offering variable rate mortgages which allow them to change the rate
of interest on the loan. This helps them to keep up with changes in the money market rates, which gives them flexibility. Thrifts have also started offering their owners stocks rather than mutual shares. The securities industry has come up with some new products too. The Intermarket Trading System allows orders to be placed in any exchange and them matched with the best available price in any other exchange that trades that same security.

Other new security products are combinations of financial units. The Individual Retirement Account can be invested in at commercial banks, thrifts, insurance companies, and brokerage firms. To keep ahead of the competition, banks offer self-directed IRAs in which the investor is allowed to move money to and from money market funds, mutual funds, money market mutual funds, CDs, stocks, and bonds. The transfer of funds from one instrument to another gives the bank a fees income and gives the investor interest rate options. Next, is the cash management account, started by Merrill Lynch. This account is a basic securities account that adds the right to borrow against the value of the securities, a checking account with overdraft privileges, the overnight investment of funds at market rates of interest, and a Visa credit card.

Financial service professionals have started to offer financial planning services. This moves the focus from capital driven strategies to consumer driven ones. They
combine depository institutions, insurance, accounting, and securities into one big service. There is an increase in the amount of competition in this business. There is also an increase in the number of people looking for this type of service, so if the advice is given so it benefits the company rather than the consumer, the investor will leave and look for another planner.\textsuperscript{22}

The last new concept is relationship planning. New accounts for existing customers are only one-third as expensive as new accounts for new customers. To help cut these costs, cross-selling is used. Files are created, for existing customers, which list the accounts that individual already has and his goals for the future. These files are then used to target new opportunities for existing customers.\textsuperscript{23}

Banks have never been allowed to engage in all of the services that the financial services industry offers today. This does not mean the services will not be offered by others, because if one institution is forbidden to offer a service all other types of institutions will vie for the right to gain the market. Banks are currently searching for an entry into the securities industry, while securities firms are trying to enter the banking industry. Senator John Chafee believes that allowing banks to deal in securities activities should help small investors by offering services that were once available only to wealthier
individuals. 24 Henry Gonzales, a U.S. Representative, believes that all of the mergers and acquisitions going on in the financial services industry will result in a few giant financial conglomerates. These conglomerates will reduce the diversity and increase the concentration of finances in the country. 25

Currently the activities that make up securities firms involve underwriting, dealing, and brokerage services. Underwriting is the purchase of new securities and the distribution of these to clients. Dealers purchase and sell securities for their own account. Brokers purchase and sell securities only on the order of a customer. Banks can act in all these capacities under limited circumstances.

To help banks gain entry into the securities industry, the FDIC has proposed a bill that would allow state nonmember banks to engage in securities activities. The proposal would require the bank to keep its records and personnel separate from those of the securities subsidiary. The subsidiary could sell, underwrite, and distribute only top rated debt securities on a best-effort basis and mutual funds that invest only in money market instruments. The bank would be restricted from purchasing any securities as a fiduciary; transacting trust department business through the subsidiary; extending credit to issuers whose securities are underwritten by the subsidiary; making loans to people for the acquisition of these securities; accepting collateral
consisting of these securities; and extending credit to the subsidiary.²⁶

Opponents believe the proposal is unfair because the public has more trust in banks than they do in securities firms. This is because banks are insured and some people will believe that the bank subsidiary is safer than others securities firms because of this. Banks can get funding capital at lower rates than securities firms by using the Federal Reserve discount window. Also, banks have almost half the tax rate of brokers and banks are allowed deductions for interest and carrying costs. These tax breaks are not offered to securities firms. Also banks can improve the credit rating of a bond by issuing a letter of credit, whereas securities firms are stuck with the credit rating that the firm has.

Proponents on the other hand, say this will increase the efficiency of banks and securities firms. There will be a reduction in risk and reduction in transaction costs. The newly fostered competition will help break up the high concentration of the securities industry. Existing securities firms would still handle all securities underwriting that is not done on the best-effort basis. They are currently competing with other nondepository institutions such as Sears, American Express and Prudential.²⁷

The securities industry believes that depository
institution intervention will drive the small, regional broker-dealers out of business and concentrate the entire financial services industry into a few large companies. Currently exchanges must report to member firms, listed companies, and the public. Sometimes the member firms have a hard time financing their expansion. Banks have the capital capacity to support this growth, but member firms do not want to be driven out of business by the banks. The listed companies are fast growing, highly innovative firms that have longstanding relationships with the securities industry. The firms do not want to breakup these relationships by using banks for private placement. If the private placement does not work out, the securities dealers would begrudge taking the company back. The public may not be protected if a bank got into financial difficulty over a securities subsidiary. These are all reasons why the securities industry does not want to open its doors to banking, however, banks feel differently.

Banks and others think that securities affiliates of banks would enhance the degree of competition in finance. The entry of securities firms into banking would do the same. The more competition the better the efficiency and equity of the industry. The securities industry is broken into groups and the most direct competition is within these groups, although there is some competition between the groups. The most competition in the securities industry is
the entrance of insurance companies and banks into the industry. Utilities are become a form of competition too, with their direct placement of securities to stockholder through dividend reinvestment plans. The securities industry is upset about the money being taken away from them by these competitors, but the banking industry say brokers took millions of dollars away from them by selling money market funds.29

Banks have entered the securities market little-by-little and still want more freedom. They are not doing as well as they had planned. The reason for this is attitudes. Banks have traditionally been of the attitude that conservative, low-risk taking practices are best. Securities firms believe that high-risk is the way to generate high profit. These attitudes must come together somewhere or the two industries will never mesh.30

Throughout this paper the regulation, deregulation, competition and products of the three major areas of financial services have been discussed. Banking, securities and insurance have crossed each others paths and must decide what will happen next. The best advice for them seems to be that the results of deregulation must be permitted to work themselves out. If this is done the result will be a far more efficient national financial system. Excess profits will disappear, transaction costs will be minimal, and information will be more readily available. "Perhaps even
more important, the new American financial system will improve availability of resources to new and emerging industries, strip away resources from declining and uncompetitive sectors and firms sooner, quite possibly enhance the underlying incentives to save and to invest, accelerate technological change, bolster the ability to shift risk, absorb economic and financial shocks with less social damage, and generally support the process of sustainable economic growth."

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END NOTES


3. Ibid. p.230.


5. Baldwin, Ben G. The Life Insurance Investment Advisor. p.11.

6. Ibid. p.15.

7. Ibid. p.60.

8. Ibid. p.31.


17. Ibid, p. 223.


22. Seglin, p.46.
24. AEI, p.31.
26. Ibid, p.34.
27. Ibid, p.45.
29. Sametz, p.143.
30. Conner, Daryl and Byron Fiman. Making the Cultural Transition to Investment Banking. p.32.
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