

## The Emerging Financial Services Industry: Challenge and Innovation

Innovation can help lead a banking institution into a new corporate culture according to the Federal Reserve Bank of Atlanta's director of research. Despite the risks, he says, banks must experiment to remain competitive in today's marketplace.



In the financial services industry, institutions' functions have significantly broadened over the past two decades, and product and geographic markets have become much more integrated. Institutions that once looked quite different from each other now offer similar products and offer them in much broader geographic markets. Though we tend to think of this as a process of nondepository institutions intruding onto the turf of banks and thrifts, a close look at the changes shows that banks and thrifts also have hurried to diversify.

### Barriers Have Fallen

Commercial banks and their holding companies have moved into credit cards, discount brokerage, leasing, operating finance companies and many other activities. They have greatly increased the proportion of their assets held in mortgages. Thrift institutions, though slow to diversify until the 1980s, have received broad new powers from the Monetary Control Act of 1980 and the more recent Garn-St Germain Act. They may now offer a wide range of products to consumers and businesses where before they were limited to individual savings and mortgage markets. Considerable evidence from financial reports and advertisements indicates that an important segment of the thrift industry is using its new powers. I have heard several bankers complain recently that thrifts were competing with them not only for customers but also for imaginative managers and competent lending and operations people.

On what was once called the nondepository side of the fence, firms of all sorts have been crossing institutional boundaries with abandon (Chart 1). Insurance companies have pushed diversification into securities, consumer finance



**Chart 1. Financial Services  
1960 and 1984**

	Banks		Savings & Loans		Insurance Companies		Retailers		Security Dealers	
	1960	1984	1960	1984	1960	1984	1960	1984	1960	1984
Checking	★	★		★		★		★		★
Saving	★	★	★	★		★		★		★
Time Deposits	★	★	★	★		★		★		★
Installment Loans	★	★		★		★		★		★
Business Loans	★	★	★	★		★		★		★
Mortgage Loans	★	★	★	★		★		★		★
Credit Cards		★		★		★	★	★		★
Insurance					★	★		★		★
Stocks, Bonds, Brokerage		★		★		★		★		★
Underwriting									★	★
Mutual Funds						★		★	★	★
Real Estate				★		★		★		★
Interstate Facilities		★		★		★		★		★

and even banking and thrift industries. Prudential is probably the best known of these firms with its acquisition of Bache, its money fund and its nonbank bank—a chartered and insured bank that, because it is owned by a nonbank company, is not subject to the restrictions of the Bank Holding Company Act. American General, with money market funds, more traditional mutual funds and its billion-dollar finance company, may have gone further in decreasing its concentration on insurance alone. Travelers has embarked on an entirely different strategy of expanding into a broader variety of businesses, providing financial services at the wholesale level to financial firms of all types. (Travelers also has a nonbank bank.)

Among securities firms, Merrill Lynch is the quintessential diversified financial corporation, but others have accomplished much the same sort of diversification. Merrill's CMA account has clones and semi-clones coming from several sources. In all, at least \$93 billion has been channeled into more than 1.1 million accounts of this type.

But CMAs represent only the leading edge of securities firms' spread into nontraditional product lines. They are venturing into insurance underwriting and sales, commercial lending and nonbank banks. Some offer brokered bank and thrift CDs (large certificates of deposits that have been broken into \$100,000 units to

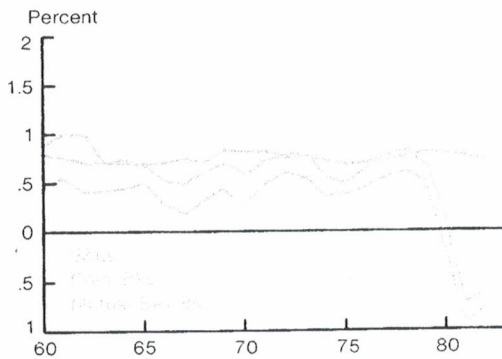
qualify for federal insurance), second mortgages and financial planning.

Firms that were once consumer finance companies have gotten into the diversification act too. Household International does not fit the image of the finance company of yesteryear. It owns a nonbank bank, a group of thrifts and a life insurance company. A competitor, Beneficial Corporation, also has a nonbank bank and insurance companies and has expanded into commercial finance, leasing and sales finance. Household is engaged in pilot programs that make insurance, ATMs, equity lines of credit and safe deposit boxes available at its consumer finance offices. Such offices could become the one-stop financial center for a substantial portion of our population.

The once-solid barrier separating these formerly nondepository industries and banking has shown cracks, which CMAs and money funds have penetrated in the past. Since 1980, the nonbank bank concept has threatened to burst the barrier. The nonbank bank is a strange word and a strange concept growing out of the Bank Holding Company Act's definition of a bank. The Act says that, to be considered and regulated as a bank holding company, a company must own an institution that offers both demand deposits and commercial loans. Nonbank firms have been acquiring bank charters and using them to operate insured depository institutions



**Chart 2. ROAA Depository Financial Institution**



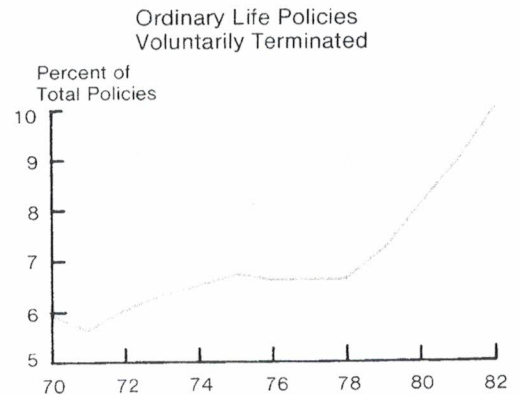
without demand deposits or without commercial loans in order to avoid the limits of the Holding Company Act.

Through that approach, they have been able to continue offering most bank services, particularly accepting insured deposits. Although the Federal Reserve has interpreted the bank definition broadly, the inventiveness of owners of nonbank banks and a recent court setback raise questions about whether the Fed has, by its new interpretation of the bank definition, sealed off the nonbank bank passage between depository and nondepository institutions<sup>1</sup>. If not, nondepository institutions will have additional opportunities to continue their move into traditional bank products, including insured deposits.

### Fruits of Diversification

The diversification of other institutions into banking functions has been motivated by a pull from the market for bank products and a push from the markets in which the other institutions operated. Banks have been, in many ways, the most diversified segment of the financial services industry. Their diversification and the markets in which they are diversified have provided them with good, steady earnings growth and, just as important, excellent earnings stability. Through the financial turmoil of the last 25

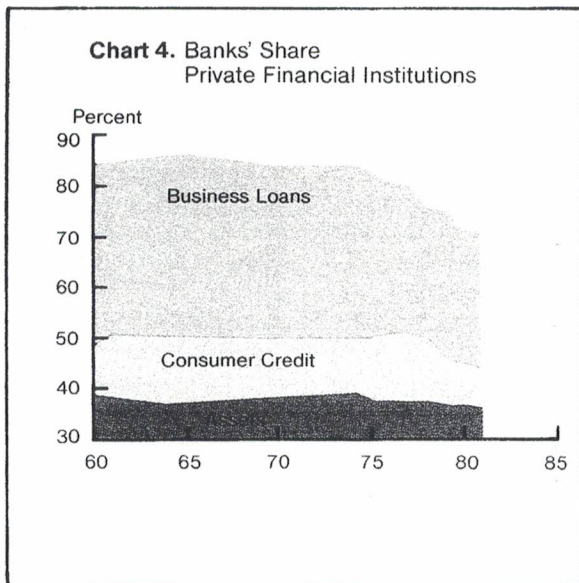
**Chart 3. Life Insurance Companies**



years, banks in the aggregate have suffered just one year of earnings decline—1959. Their compound earnings growth rate over that period has been 9.1 percent—well above the inflation rate for the period. In addition, bank earnings have been quite stable, around 0.75 percent return on assets (Chart 2).

Other segments of the industry have not fared so well. Thrift industry problems of the past several years are well known. Even before this debacle, their earnings were quite cyclical, showing much greater year-to-year variation than those of commercial banks. Security dealers suffered a shake-out during the back office problems and commission deregulation of the early and mid 1970s. Their health has improved but their earnings remain quite volatile. Life insurance companies have found themselves in the position of selling financial buggy whips. Many customers have allowed their ordinary life policies to lapse, demonstrating the inroads of competition by group insurance (Chart 3). Many new types of savings instruments have helped drive these insurance firms to reassess their positions and products. A look at retail growth and margins shows dramatically why Sears, Penney's, Kroger, K Mart and other retailers have sought balmier climes with consistent financial earnings performers in their portfolios.

But the banks' financial performances, reflecting the value of their markets, have created



problems for them by attracting a multitude of competitors. Commercial banks' share of the financial assets held by all private financial institutions dropped sharply after 1975, as did their share of consumer credit (Chart 4). The banks' share of business credit began declining earlier, in the 1960s, and has declined further in recent years.

Banks have lost market share not only because their managements have failed to keep pace with those diversifying into their markets. Regulatory limitations of several types have kept banks in their protected hothouse, unable to meet many challenges with proper pricing, product or geographic strategies. As it became obvious how much impact these limits were having on commercial banks' market shares and thrifts' earnings during the high-interest period of the early 1980s, some of the restrictions were lifted by the government.

Interest rate limits have been removed gradually to engender unlimited competition for funds. Soon only demand deposits will be controlled. These changes already have bought banks and thrifts a resurgent share of time and savings deposits. They also have transformed the major part of banks' and thrifts' liability markets into commodity markets with heavy price competition and similar service offerings. The activities allowed to banks and thrifts have been increased. While questioning some changes, the Federal Reserve has added credit insurance

underwriting and sales, finance and mortgage company operations, leasing, discount brokerages, financial advice and several other businesses to the activities permitted bank holding companies. It proposes to add more. At the same time, Congress and the Federal Home Loan Bank Board have greatly extended permissible activities for thrifts.

Geographic barriers also have been removed by many states and by federal regulators responding to emergencies. Seventeen states already have passed some kind of limited interstate banking legislation and several more are considering such laws. Savings and loans have been acquired in interstate emergency mergers. The latest approval for such acquisitions was granted to Citicorp by the Federal Reserve.

### New Meanings for Old Terms

The continuing elimination of barriers in the industry alters old ideas about winners and losers among the firms providing financial services. First of all, it is becoming much less meaningful to talk about subindustries such as banks, thrifts, insurance, finance and securities companies. Firms in all these industries can offer products that substantially overlap those of each other. So far the strong trend is for product capabilities to keep on increasing. It makes little sense to talk of long-term regulatory advantages any more.

Integration of product and geographic markets means there are few protected markets left. Protective limits are gone; entering new markets is relatively easy. Economies of scale are of minor importance in the production of many services, so many potential entrants are moving into most markets. Where economies of scale exist, service corporations that can exploit them can wholesale their advantage to many small institutions acting as agents. In such situations, products tend to become commodities. Differentiation is more difficult when most products can be copied and produced easily and when price is an important dimension.

### Challenges for Management

A situation is developing in which the financial industry is becoming like most others. There is no clear protection; getting into banking does not guarantee a business that is somewhat



proprietary, that provides a monopolistic right. With this easier entry, sharp profit squeezes are likely in the future and more and more bank products are going to be commodities rather than unique services. A major skill required of future senior management will be to design products that are unique or at least a bit different from those offered by the competition.

Success in providing financial services is going to be similar to succeeding in any other business. The major focus will be on finding out what customers want and really working to supply those needs. A recent detailed survey by a large Florida bank disclosed that its customer base really did not want additional services such as discount brokerage. The customers' whole emphasis was on high quality of existing products and on consistent service. All sellers of financial services will increase their focus on quality as we go through the 1980s and into the early 1990s.

Attention to customer needs will be the most crucial factor in financial institutions' success over the next decade. This may seem obvious, but the failure of many technologically feasible systems to gain customer acceptance indicates that many managers have failed to grasp the idea. A product's feasibility is not sufficient to assure success.

Closely related to the need to satisfy the customer is a growing desire by bank customers for quality service. Quality will offer a way to differentiate products successfully, at least for a while. Continued emphasis on quality gives promise of generating a wave of differentiated products over time.

One way to approach customer satisfaction with new technology is to put the computer to work saving the customer time and trouble and providing him or her with information. Computers can be a major offensive weapon if they are used to work for customers rather than for engineers. So long as they can save time and overcome disadvantages of distance and location, computer-based banking products will have a chance to succeed. But they must offer advantages over systems already in use. Electronic home banking, for example, has received a lot of attention lately. Whether any of the pilot projects now running will succeed depends on whether they can develop advantages over our present home banking system—the one that uses the Post Office instead of a

computer as its delivery system. Whether people will receive their bills by mail and then run to their computer terminals to pay them remains to be seen. I would feel more secure about home banking by computer if the bills were delivered by computer also.

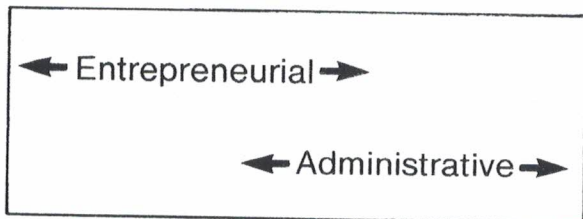
The premier providers of financial services also will realize that their assets with the highest return are those that go home every night. A six-month study that we conducted of high-performance companies in the Southeast (detailed in this issue of our **Review**) showed a whole set of exciting ways of increasing employee productivity and encouraging creativity.

This study of 21 varied companies—including four outstanding banking organizations in the Southeast—finds certain themes recurring over and over again. The successful firms, for instance, generally had a lean staff of workers, with small divisions or plants, and small work groups. They weren't monolithic behemoths with thousands and thousands of workers under the same direction, and they offered opportunities for promotion from within. These corporations also emphasized careful selection of employees, frequent feedback in both directions, continued recognition of what is good and what is bad about what employees and managers do, and aggressive employee participation in ownership of the firm.

Other shared characteristics include few executive privileges; relatively few management layers, so the level from the CEO to the bottom line person is not nine or ten levels but maybe two or three; a dedicated commitment to employee training in all forms—not just internal programs but external programs where people are developed and encouraged to recognize their potential fully over time. One Florida bank, for instance, surveyed its employees and found out that some were saying, "Sure, this is a great place to work, but I never get promoted." Management decided to change and came up with a university system in its own institution. They bring employees in, give them training or course skills, send them back out and also move them around the system. A branch manager of a small bank can earn more than he or she could if the employee were just thought of as an assistant cashier.

Finally, of course, these shared characteristics imply that the most important thing is always to

Chart 5. Management Skills



encourage a high degree of controlled experimentation in a banking organization. As financial institutions break their parochial barriers, they will place greater emphasis on managers' entrepreneurial skills and less on their administrative abilities (Chart 5). The balance between the administrator and the entrepreneur will shift

decisively toward the entrepreneur. Despite the risks inherent in attempting something new, a firm must innovate in planning its strategies. If one firm fails to innovate, some bright young turk elsewhere is going to figure out an operations or marketing approach that works and works well. Innovation may change the entire culture and make an institution more dynamic, more sensitive to the marketplace and more entrepreneurial. Success in financial services, as in any other industry, requires a high degree of energy, focus, sensitivity and, above all, creativity—the creativity to encourage excellence and the willingness to permit the entrepreneur the freedom to succeed.

—Donald L. Koch\*

*\*This article is based on a speech presented to a national conference on financial services sponsored by the Atlanta Society of Financial Analysts, Feb. 23, 1984.*

*'Since this speech was presented, the Federal Reserve Board has approved acquisition of a nonbank bank in Florida for U. S. Trust Corp. of New York, a registered bank holding company, stating "...although the Board believes that approval of this proposal presents a serious potential for undermining the policies of the (Bank Holding Company) Act, the Board is constrained by the definition of bank in the BHC Act to approve the application.' U. S. Trust agreed not to engage in the business of making commercial loans in Florida. Federal Reserve System, "U. S. Trust Corporation, New York, N. Y." Press Release, Mar. 23, 1984.*