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Financial Services

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ABSTRACT:

The US financial services industry is an important contributor to the economic power of the nation. The industry is in excellent health -- well capitalized, dynamic, and innovative. Recent legislative changes have altered the structure of the industry by allowing banks, insurance companies, and securities dealers to consolidate into large "financial holding companies" that cut across industry sectors. US financial services firms are also positioning to compete here and abroad with international firms. Advances in information technology continue to provide opportunities for firms to increase business and customer service, but also create an industry risk in the form of cyber crime. The industry will continue to be competitive, but profitable, and will remain well positioned to support continued US leadership in the global economy.

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PLACES VISITED

Domestic:

Bank of America, New York, NY

Cantor Fitzgerald, New York, NY

Citigroup, New York, NY

Chicago Board of Options Exchange, Chicago, IL
Chicago Board of Trade, Chicago, IL
Chicago Mercantile Exchange, Chicago, IL
Credit Suisse First Boston, New York, NY
Export - Import Bank, Washington, DC
Federal Reserve Bank of New York, New York, NY
Federal Reserve Board of Governors, Washington, DC
New York Stock Exchange, New York, NY
New York Mercantile Exchange, New York, NY
TIAA-CREF, New York, NY
Wall Street Journal, New York, NY

International:

Bank of England, London, England
Bechtel Corporation, London, England
Clearstream International, Luxembourg
Deutsche Bank, Frankfurt, Germany
Deutsche Borse, Frankfurt, Germany
European Bank for Reconstruction and Development, London, England
European Central Bank, Frankfurt, Germany
European Investment Bank, Luxembourg
Financial Times, London, England
Hesse Landeszentralbank, Frankfurt, Germany
Luxembourg Banker's Association, Luxembourg
Morgan Stanley, Frankfurt, Germany

INTRODUCTION

Financial services account for more than 7% of US gross domestic product (GDP), making it one of the largest single industries studied in the ICAF curriculum. The industry's role in fostering economic growth, increasing investment efficiency, and distributing financial risk helps ensure that the United States can pursue robust and effective national security policies. In addition, the strong presence of US banks, insurance companies, and securities brokers around the world provide the country with important, if indirect, leverage over global economic events. These factors, combined with the commanding influence the United States has at institutions like the International Monetary Fund (IMF) and the World Bank, serve to make financial reach a pillar of US power and influence. US financial institutions are healthy and grow more competitive each year, suggesting the industry will remain an important element of US power for the foreseeable future.

A veritable revolution is taking place within the financial services industry. Globalization, information technology and continuing deregulation have accelerated the pace and scope of change within the industry. As a result, the industry is coming to be dominated at one end by large, consolidated companies with global presence and sophisticated technological infrastructure, and at the other end by small niche firms offering personalized service in specialized markets. In the medium term, consolidation is certain to continue as markets themselves consolidate. Barriers between banking, insurance and other financial services are rapidly breaking down. Barriers separating financial markets in the United States, Europe and Asia are crumbling. Analysts at terminals in Hong Kong know the price of grain futures just seconds after they are posted in Chicago. Markets for nearly every financial instrument - stocks, bank deposits, mutual funds, futures, and options - are essentially global. US consumers have also participated in this revolution, becoming increasingly sophisticated as the Internet has enabled them to make daily financial decisions from their home computers. US financial services firms have not only adapted to revolutionary change, they are leading it. Still undecided is what role governments should play in this new environment, in terms of both domestic regulation and global supervision through agencies such as the IMF and World Bank.

The global market for financial services is becoming increasingly competitive as markets integrate. Fortunately, US firms have made the necessary investments in management and technology to compete well with their counterparts in Europe and Japan. Revolutionary change will continue in both the United States and abroad, but despite the uncertainties it will bring, the US financial

services industry is likely to remain the strongest and most adaptable in the world.

FINANCIAL SERVICES INDUSTRY DEFINED

The financial services industry engages in and facilitates transactions involving the creation, liquidation, or change in ownership of financial assets by:

- 1) Providing financial intermediation by taking deposits and issuing securities and, in the process, incurring liabilities;
- 2) Pooling risk by underwriting insurance and annuities; and
- 3) Providing specialized services facilitating or supporting financial intermediation, insurance, and employee benefit programs.

The concentration of the financial services industry is classified as an effective competition. There are over 395,000 finance and insurance branch offices in the United States, though the number of parent organizations has declined in recent years. The financial services industry comprises enterprises from banks to brokers to leasing companies. The largest sectors are banking (40% of the industry), insurance underwriting (22%), and securities and commodities (20%).

Within the banking sector, slightly more than 8,900 commercial banks in the United States control financial assets of approximately \$6 trillion. The sector employs more than 1.69 million people. Other depository institutions include savings and loan associations and credit unions.

The United States is the world's largest insurance market, with a 34% share of global premiums. The US insurance sector is comprised of over 5,000 companies that provide life, accident, health, property, and casualty insurance to consumers. Total assets exceed \$3.9 trillion.

The US securities sector is the world's largest in terms of market capitalization, listings, volume, and number of investors participating. The United States leads the world in the use of equities for financing economic activity. The New York Stock Exchange (NYSE) is four to five times larger than its nearest rival, the Tokyo Stock Exchange. US companies control nearly half of the mutual fund assets around the globe. Additionally, US exchanges still generate almost half of the world's futures and options trading. US commodity markets are gradually losing ground to overseas exchanges, particularly in Europe, but five of the world's ten largest commodity exchanges are in the United States.

The US financial services industry also includes government agencies such as the Export-Import Bank, Fannie Mae, Freddie Mac, and numerous regulatory agencies. The most important is the Federal Reserve (Fed), considered the most effective central bank in the world. The Fed's independence from undue political influence is its greatest strength. This has helped ensure a stable foundation for the US financial system.

CURRENT CONDITION OF THE INDUSTRY

The robust growth of financial services during the 1990s is evident throughout the economy. Nine of the top 20 companies in the United States are engaged in financial services, according to Forbes Magazine's composite rating, which takes into account assets, sales, profits, and market capitalization. (See Figure 1). The industry now has the largest capitalization of any on the NYSE. With a growing number of Americans favoring securities over bank deposits, the industry has moved toward greater reliance on fees and services rather than loan activity for profits. In the 1980s, 30% of bank revenue was from non-interest-related operations; by 2000, the figure was 40%.

1. Citigroup 11. SBC Communications
2. General Electric 12. Philip Morris
3. Exxon Mobil 13. Ford Motor
4. JP Morgan Chase 14. Fannie Mae
5. Verizon Communications 15. General Motors
6. Bank of America 16. Morgan Stanley
7. American International Group 17. Berkshire Hathaway

8. AT&T 18. Intel
9. IBM 19. Merrill Lynch
10. Wal-Mart 20. Wells Fargo

Figure 1: Forbes Magazine Top 20 US Companies (financial services firms in bold)

The financial services industry continues to experience significant consolidation. Legislative changes in the 1980s permitted banks to operate across state lines, a change that accelerated mergers within the banking sector. Banks and other financial institutions also entered into greater international competition. Even as mergers were accelerating within financial sectors, pressure was building to remove restrictions put in place by the Glass-Steagall Act in 1933. These developments challenged the basic principles upon which the regulatory framework was built and led to passage of the Financial Services Modernization Act of 1999, also known as the Gramm-Leach-Bliley Bill (GLB).

The purpose of GLB is to "enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, and other financial service providers, and for other purposes." The law:

- Permitted commercial banks, securities firms, and insurance companies to merge with one another and engage in each other's business;
- Created a new financial structure, the "financial holding company," that allows companies to engage in specific financial activities, including banking, underwriting, and selling insurance, and securities; and
- Established the Federal Reserve Board as the primary regulator over financial holding companies, expanding the Fed's regulatory authority.

GLB left in place restrictions on financial institutions acquiring non-financial enterprises. A bank, for example, can now merge with an insurance company but not with a chain of department stores.

Since the 1980s, several hundred banking mergers and acquisitions occurred each year, producing increasing concentration in the sector. For example, the 25 largest banking organizations accounted for 29.6% of deposits in 1986 and 51.2% in 1998. Since passage of GLB, the Fed has approved the establishment of more than 500 financial holding companies that provide a wide range of financial services. For example, the Citicorp-Travelers merger created a financial institution that provides commercial banking, securities underwriting, and insurance services. Merger activity continues within banking as well. In 1980, there were 190 bank mergers with \$10.2 billion in acquired assets. The five largest mergers in 1998 involved total assets over \$500 billion. Between 1980 and 1997, there have been thousands of bank failures, mergers, openings, and closings. The net result is that the number of banking companies in the United States has declined significantly, but the number of branch offices continues to increase. Consolidation has not led to a reduction in offices serving the public but there is continued concern that consolidation may have negative implications for quality and price of customer services.

The insurance sector is experiencing an overall decline in total policies. With the exception of variable annuities, the number of policies continues to decline as consumers show preference for other investments. The property and casualty segment are relatively weak due to poor pricing standards, intense competition and mounting losses. The medical and health care insurance segment is facing significant changes such as rising medical costs, medical breakthroughs, an aging population, and increased life expectancies. In an effort to increase returns, the industry has moved from traditional investment vehicles such as treasury securities, bonds, and blue chip stocks to more aggressive investing in all market sectors. Additionally, insurers are increasingly allowing greater choice by allowing consumers to structure their own policies.

The expansion of stock ownership is one of the most important developments in the financial industry in recent years, and has proven extremely profitable for US brokerages. Today, nearly 50% of all Americans own stocks, up from 13% in 1980. In the past decade, investment in equities and mutual funds rose from 33% to 61% of US investors' liquid financial assets. Consequently, market fluctuations now have a substantial impact on the actual and perceived wealth of individual investors. Stock market gains of the late 1990s were at least partly responsible for increased consumer spending, which helped fuel increases in GDP.

Market trading volume has grown tremendously. In 1985, the daily average number of shares traded on the NYSE was 109.2 million. By December 2000, trading volume rose to 1208.8 million, an increase of over 1000%. Over the same period, the average daily value traded rose from \$3.9 billion to \$45.5 billion on the NYSE and from \$0.9 billion to \$71.1 billion on NASDAQ.

Volatility in financial markets has also increased, making securities investments less stable than they were previously and spurring growth in derivative instruments as hedges against this volatility.

The integration of US and international financial markets has led to greater competition for all sectors of the US financial services industry. More than \$2.5 trillion in US savings is invested overseas through various financial instruments. The share of US public debt held by foreigners has doubled in the last 20 years. All sectors of the US financial industry -- brokerages, mutual funds companies, commercial banks, investment banks, insurance firms, and futures exchanges -- are heavily involved in foreign currency transactions. Ten percent of all bank profits derive from overseas operations, and in the case of large US banks, the figure approaches 45%.

Europe's reluctance to consolidate its securities markets has left the United States unchallenged. The Paris market combined with Amsterdam and Brussels, but an attempt to combine Frankfurt and London, Europe's two largest securities exchanges, fell apart in 2000 and the European system remains fragmented. The introduction of the Euro currency in 2002 may spur further efforts to consolidate these markets. Meanwhile, NASDAQ has launched several initiatives aimed at leveraging the global marketplace, such as NASDAQ-Japan, as well as linkages in Europe, Hong Kong, and Canada. The NYSE has announced similar plans. Additionally, considerable cross-border integration is taking place in which financial institutions are establishing physical presence in other nations.

Technology has also revolutionized the financial services industry in recent years, allowing banks and other financial enterprises to reach new customers with new products. Only 6% of banks operated Web pages in 1998; by 2002, the figure is expected to reach 80%. An increasing number of Americans trade stocks online. Technology has made traditional banking operations less costly and more profitable. For example, automated credit scaling and loan processing allow banks to reduce transaction time and expense considerably. Technology has also brought new risks in the form of cyber-attacks, hacking, and electronic theft. While cyber theft is growing, there has yet to be a successful attack on the Fed's crucial FedWire (which transfers funds between member banks) or on any major stock or commodity exchange.

CHALLENGES

Major challenges facing the financial services industry include, reaping the benefits from increased merger and acquisition (M&A) activity, protecting the industry's infrastructure from cyber attack, and effectively competing in an increasingly global market.

Mergers & Acquisitions

Realizing synergy in an environment of increased M&A activity is a continuing challenge for the industry. A Wall Street executive of a well-known financial services company said, "There is no such thing as mergers and acquisitions, only acquisitions." He was describing the recent acquisition of Chase Manhattan Bank by J. P. Morgan and the culture clash of the two organizations. Although merging with other financial service providers may yield significant savings, reconciling cultural differences between different, but related businesses has become a significant challenge. For example, from a business perspective, banks are service-oriented and insurance companies are sales-oriented. Additionally, incompatible IT structures among financial institutions and the difficulties integrating them may lessen anticipated gains. There is no research that conclusively shows significant cost or revenue synergies between different financial service sectors...although it is too early to tell. To be successful, M&A in the industry must enhance profits while preventing dilution in services. This is the only way newly created financial supermarkets will continue to attract customers.

Industry Infrastructure Protection

The financial services industry rests on a highly advanced technological infrastructure that must be protected. Industry vulnerabilities will continue to increase as use of the Internet, e-commerce, and e-banking become standard practice within the United States and internationally. Given the level of capital involved, the financial industry will always attract attention from those with criminal intent. The challenge is to recognize vulnerabilities, identify the various entities that seek to exploit them, and to develop counters. Security efforts must focus on risk management while realizing that unidentified vulnerabilities and unidentified threats will always exist.

Another challenge is to establish coordination between government and industry to achieve and maintain effective protective

measures. The Federal government must be cautious not to over-mandate and industry must demonstrate capability to develop adequate protective measures voluntarily. The industry must embrace business practices that promote information sharing among firms regarding vulnerabilities, threats, and protection. As world economies continue to integrate, protection of the US financial services industry infrastructure may ultimately require a global security program.

Globalization

The most far-reaching trend in financial services is globalization, which is now being accelerated by the Internet. The spread of more open political systems and market economies throughout the world and closer links among these markets has created greater opportunities for financial services companies, especially for those with an established global presence. Increasing interdependence can also cause chaotic behavior that is difficult to predict and manage. A market crisis or downturn in one region may have a significant impact on other regions. The Asian market crisis in 1998 threatened worldwide markets and affected US financial services companies with an Asian presence. The challenge is to increase market stability through the proper mix of market and governmental controls. The industry and multinational financial institutions such as the IMF and World Bank must develop adequate systems to provide sufficient warning of impending regional or worldwide economic crises so that measures can be taken to mitigate their effects.

OUTLOOK

The outlook for the financial services industry is strong. The industry set repeated record profits throughout the 1990s and is stronger and more competitive than a decade ago. Worldwide M&A volume, debt issuance, pension assets, US mutual fund assets, stock market trading volumes, and credit card receivables have all grown considerably. Financial firms will continue to expand geographically and enter other sectors of the industry through mergers and acquisitions. Industry firms will continue efforts to establish operations in international markets and effectively compete with established international firms. The industry will experience some growing pains due to the new regulatory structure put in place by GLB. An economic slowdown could cause an upsurge in non-performing debt and erode bank profits, but continued expansion in the industry is likely. The long-term trends are clearly in favor of continued profitability in financial services, despite short-term cycles. The forces of technological change, deregulation, and greater demands by customers are driving this growth.

Consolidation among the banking, insurance, and investment sectors will continue. All sectors are competing for the same investor dollars and asset retention has become a high priority as global competition intensifies. This will increase the demand for new products and services and require new approaches to attract customers. For example, there is an increased presence of banks (US and international) in the competition to acquire insurance agencies. A bank's wealth of customer information and frequent interaction with customers may provide a more efficient means to obtain prospective customers than the traditional cold calling practice used by insurers.

With the passage of GLB, the banking sector will continue to evolve at a rapid pace. Although the sector continues to restructure through regional and national mergers and acquisitions, strategies will shift toward concentration on internal efficiencies to eliminate excess infrastructure and reduce costs. This involves the consolidation of back office functions and branch closings in existing regions. To remain competitive with non-bank providers of financial services, many banks will diversify away from traditional products and services, enter new business areas, and eventually develop into one-stop shopping centers for all financial services. Others may adopt an approach that provides more specialized services designed to meet specific market needs. Both the one-stop shopping and the specialized service models will be necessary to meet the differing demands and preferences of the consumer base. Although consolidations have caused a decline in the number of banks, the number of branch offices available to the public has continued to increase. On-line banking services will continue to expand, as Internet use becomes more common. Small community banks will fill voids left behind by bank consolidations.

These trends may or may not enhance stability within the industry. As firms consolidate and attempt to achieve synergy between different, but related businesses, overall performance and stability could become an issue. One view is that consolidation provides greater diversification in the market for remaining firms and thus reduces the potential for volatility and risk. It can also be argued that too much consolidation increases risk, thereby creating a less stable environment. As individual businesses interlink under one corporate umbrella, a problem in one sector could affect the entire holding company. A crisis or failure of one large, consolidated financial service firm could have detrimental effects on both consumers and the US economy.

The US financial services industry will continue to expand internationally. Mergers, acquisitions, and strategic alliances will reshape the industry, expanding US involvement in global financial markets. Growth potential exists in both developing and developed countries. For example, insurance premiums as a percentage of GDP are much lower in developing countries than in developed countries (2% in many instances vs. 6% to 8% in most developed markets). In addition, the percentage of people who own stock is far less in Europe than in the United States, creating potential for further expansion by large US firms. Developed countries around the world also face pension crises due to demographic changes, and sophisticated US firms could play a significant role in addressing them. These facts, combined with projections for higher economic growth in some developing countries over the next several years, may provide significant opportunities for appropriately positioned financial services firms.

Involvement in developed countries is likely to intensify, especially in Europe, where US firms will be competing aggressively with established European counterparts. European firms have experience operating enterprises that sell both insurance and banking products to consumers, something many US firms lack. European firms also have experience with large acquisitions, balancing local autonomy with global competence, and operating in many languages and currencies. For example, nine of the world's twenty largest insurers are European, up from just four in 1987.

US firms also have to contend with environments that restrict foreign competition. The mutual fund segment in Europe currently manages assets of over \$3.5 trillion. Tax, regulatory, and cultural barriers have frustrated US firms' efforts to expand into this market. For example, Germany passed legislation that would tax all dividends generated by non-domestic funds while only taxing half of the dividends generated by German funds. On the other hand, Hungary has freely opened its market to foreign investment funds. Future growth in Europe may continue to be slow, at least until the European Union agrees on conditions for unified European financial services markets.

The outlook for the insurance sector is mixed. The sector is expected to grow at a moderate pace over the next 5 to 10 years. An aging population will boost demand for retirement and health products but without serious business reform, property and casualty profitability will limit overall sector growth. Mergers and alliances between insurers and banks is becoming a matter of survival in the sector. Firms that succeed will blend innovation, integration, and infrastructure to create organizations responsive to changing consumer needs. Insurance firms must make an effort to transition from a sales-oriented business model to one centered on customer service. Image, financial strength, protection, and security are keys to satisfying consumer needs.

The outlook for the securities sector is strong. Trading in stocks, bonds, and other securities occurs in an environment that is substantially free of corruption and other crime. Americans seem increasingly willing to accept market risk in search of greater returns offered by securities over deposits. Despite recent equity market perturbations, this trend is likely to continue. In addition, a large portion of the world's commodities and derivatives trading takes place in the United States. In all cases, effective price discovery helps maintain the efficiency of the markets, which in turn helps keep public confidence high.

Shifts in the demographic profile of the investor base and in investor behavior are reshaping the markets and raising the level of demand for securities. Individual investors are increasingly active in the market, in part because of the rising popularity of individual retirement accounts and 401k plans. The advent of low cost on-line trading and advances in information technology resulted in lower brokerage commissions, easier access to brokerage services, and more information on investment choices.

GOVERNMENT ROLES AND GOALS

Federal and state governments have long been involved in the regulation of financial services. This regulatory history stems largely from the aftermath of the Great Depression when widespread bank failures wiped out the life savings of many Americans. More recently, Congress has significantly liberalized regulations to permit greater flexibility in industry operations, culminating with the passage of GLB in 1999. A critical role of US government agencies will be to ensure a proper balance between regulation and market forces to maintain stability and growth in this industry.

Several US government institutions share regulatory responsibilities over a complex financial system. At the federal level, the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation (FDIC) and the Office of Thrift Supervision supervise the overall banking sector. The Securities and Exchange Commission and Commodities Future Trading Commission have oversight over organized exchanges and financial markets. State agencies are responsible for supervising banks, insurance companies, and other financial institutions chartered in their own states. The Federal Reserve and Justice Department's Anti-Trust Division closely regulate mergers and acquisitions in the industry.

A key question is whether the United States should continue with this fragmented arrangement or create a single agency to supervise all financial institutions, as the United Kingdom has done with the creation of its Financial Services Authority. One option is to streamline the agencies into a single regulating authority to oversee and manage the entire financial services industry. Alternatively, agencies could work to strengthen inter-agency cooperation and coordination, given their defined oversight roles under GLB. In this case, industry leaders will face the challenge of dealing with several regulatory agencies with different missions. To be successful, a diversified financial holding company from one particular segment of the industry must understand, appreciate, and integrate the different regulatory requirements of its subsidiaries.

Another issue to be addressed by government is the impact of consolidation on small businesses and small depositors. That is, will bigger banks continue to provide an acceptable level of service to the smallest consumers after the latest round of consolidations? This poses an interesting challenge for government regulators. It will be their mission to ensure that consolidation does not cause an unacceptable reduction of services offered to small customers. Increased competition should be an adequate safeguard, but regulators will need to ensure banks continue to meet the credit needs of small and low-income communities as required by the Community Reinvestment Act. In addition, regulatory agencies should ensure that financial services firms make clear and understandable disclosures so customers know which products are FDIC insured and which are not.

Safeguarding private consumer information is another challenge that has drawn attention from regulatory agencies. With passage of GLB, financial institutions now have an obligation to respect the privacy of their customers by protecting the security and confidentiality of nonpublic personal information. Consumers have the right to "opt out," to limit disclosure of personal information sold or passed to others. Establishing consumer protection rules and monitoring compliance will be a significant future role for government and industry.

The US government will also need to take further measures to protect the infrastructure of the financial services industry and to encourage international cooperation in this process. To date, the government has opted for self-regulation, and refrained from establishing specific protection standards that industry must meet. Whether done voluntarily or required by regulation, effective protective measures need to be implemented to guard against the entire gambit of possible illegal actors: thrill seeking hackers, lone criminals, organized crime (US and international), non-State actors, and subversive foreign governments. The US government role should continue to be that of encouraging industry leadership and cooperation through established forums, such as the financial services Information Sharing and Analysis Center.

Recent and projected budget surpluses have afforded the United States the opportunity to consider reducing or even eventually eliminating the national debt. Although most economists agree that reducing our national debt would be a positive step, a complete retirement of the debt would force changes in Federal Reserve monetary policy execution. Today, Fed open market activities primarily involve buying and selling government bonds. These bonds will become scarcer as the debt declines. Although Fed officials maintain they can execute monetary policy by other means, this issue bears careful consideration for the future, especially given the huge private sector market for US government securities.

The US government has been working primarily through the World Trade Organization (WTO) to open global financial services markets. After three years of negotiations, the United States and 70 other WTO members concluded the WTO Financial Services Agreement to improve foreign access to each of their markets. By March 1999, 60 of these countries had completed domestic ratification procedures and committed legally to accept their agreement commitments. The WTO Financial Services Agreement represents a broad package of commitments that cover an overwhelming share of global trade in both the developed and developing world. It extends to the most important financial services markets, encompassing \$38 trillion in global domestic bank lending, \$19.5 trillion in global securities trading, and \$2.1 trillion in worldwide insurance premiums. It opens world financial services markets to an unprecedented degree. This agreement is particularly important to the United States because financial services is one of the fastest growing areas of the world economy and one of our most competitive industries worldwide. Finally, the agreement is intended as a means of further opening up global financial services markets, in particular, at the ongoing negotiations associated with the General Agreement on Trade in Services, which started in 2000. The US government should continue these efforts to ensure that international opportunities for US financial services firms are available.

ESSAYS ON MAJOR ISSUES

A WALL STREET PERSPECTIVE OF THE DEFENSE INDUSTRY

Many people did not notice, but on Wall Street, the \$125 billion defense industry was on a roll in 2000. Fueled by the outlays for defense in fiscal year 2000, the first major increase in military spending since the mid-1980s, the Standard & Poor's aerospace/defense index soared 57 percent. Part of these gains may have come from the meltdown in technology stocks, which made other industries, including defense, relatively attractive. Nevertheless, the expected future stream of earnings of defense industry companies will determine the value of their stocks. How is the financial health of the industry, and how does Wall Street view the long-term investment opportunities in the defense industry? This paper will address the financial health of the defense industry and explore strategies for government and the industry to improve financial outlooks.

Analysis of the Defense Industry

The good news is that Department of Defense (DOD) spending on research and development and procurement is recovering modestly from the significant drop between 1987 and 1999. Continued stability or growth in the defense budget is expected in the next five years. Worldwide, the United States retains its technological lead in almost all areas of defense platforms and sub-systems. However, there are indications that the financial health of the defense industry has deteriorated.

Faced with declining DOD spending in recent years, the defense industry consolidated down to five major contractors: Boeing, Raytheon, Lockheed Martin, Northrop-Grumman, and General Dynamics. Consequently, many defense companies are carrying heavy debt loads and their credit ratings are barely investment grade. Industry balance sheets are under stress and ability to service debt is challenging for some companies. Wall Street views some defense contractors as working for the banks, not their shareholders.

This highly leveraged strategy can be successful if companies are earning a high return on assets. Unfortunately, this has not been true for the defense industry in recent years. Return on Assets (ROA) for the industry in 1999 was 5.1% and 4.9% over the past five years. Overall, industry ROA is less than half of what it was in the 1980s. These returns have not exceeded the cost of capital. Simply put, the defense industry earns insufficient profits to justify the level of risk involved.

What proactive steps can the defense industry and the DOD take to improve the financial health of the industry and create a path to a long-term sustainable industrial base? The answer to this question requires addressing strategies for defense contractors and for the government.

Defense Industry Strategies

Defense contractors that avoided high leverage strategies have performed well, but companies that took on a heavy debt burden have lost money for shareholders. General Dynamics, which used very little debt financing, experienced stock appreciation of 75% from 1997 to 2000. Lockheed Martin, one of the most highly leveraged defense contractors, saw its stock depreciate by over 40% during this same period.

Encouraging innovation and efficiency in the defense industry can have significant financial performance impact. The defense industry generates revenues of \$230,000 per employee while an average S&P 500 company generates \$712,000 per employee. Net income per employee in the defense industry is \$12,800, versus \$103,000 for the average S&P 500 company. The average employee for an S&P 500 company produces over eight times the net income as an employee of a defense contractor! During most of the 1990s, defense companies tended to spend more on acquisition of other companies than on capital improvements. This trend has since subsided, but the industry is less well positioned to efficiently compete than it would have been if expenditures had been more balanced.

Although there was tremendous consolidation in the industry, the synergies expected have not materialized. Most major defense contractors are operating at less than 50% capacity utilization, and some segments such as shipbuilding are operating as low as 20%. Tackling excess capacity and making capital investments for innovative changes will dramatically improve ROA and sales per employee.

The Government Role

The Government also has a major role to play in maintaining an environment favorable to a strong defense industry. As the sole

customer for many defense systems, the US Government shapes the industrial base. Several strategies are available to ensure a healthy and productive defense industrial base exists for the 21st century.

The deteriorating financial health of the industry mandates a closer partnership between the government and the defense industry. During the consolidation period, the government reformed its acquisition rules and processes, creating some tension and growing pains as both government and industry reacted to a new environment. Continued cooperation between both sides is required to ensure government requirements and industry financial health can be maintained into the future.

Funding instability has been detrimental to the defense industry. Programs are restructured every year because Congress changes funding levels or the military changes its demands, driving up program costs. The government should begin awarding multi-year contracts for weapons programs. Funding stabilization will directly translate into less risk for the industry and less expensive products for the government.

Much of the acquisition reform of the past two decades was needed, however, it is time to review the results and make adjustments. The DOD has become so restrictive in allowing companies to make a profit that they have trouble raising capital and are discouraged from making investments in new technologies. The government should also give prime contractors the freedom to deal with subcontractors on their own, rather than overseeing the purchase of weapons systems components.

A Base Realignment and Closure (BRAC) is needed to free up funds for modernization. Since the first of the four closure rounds began in 1988, 387 military facilities, 97 of them major bases, have been closed, or realigned. Savings from the closures will total \$14 billion in 2000, and \$5.6 billion for every year hereafter. Even with so many closures, the DOD estimates there is still 23% over-capacity at the 259 remaining major bases.

The government can provide growth opportunities for the industry by streamlining export control processes. The government should take a broader look at export controls under the Arms Export Control Act given current world business and security relationships. Once the government forms a consensus on the appropriate balance between technology protection and industrial competitiveness, review of the license review process will be possible.

Conclusion

Financial outlooks are improving for many defense firms. Wall Street analysts are currently bullish on the sector, especially when compared with the rest of the economy. Northrop-Grumman, Boeing, General Dynamics, and Alliant Techsystems have received favorable ratings from analysts in recent weeks. Strong earnings and growth will continue to be required to attract such positive ratings. A healthy industry will be able to attract investment/shareholders, lowering cost of capital, enabling it to invest more in R & D and attract talent. A financially healthy industry is also critical to preserving the world's preeminent defense industry and maintaining national security.

CDR Robert Bronson

THE SOCIAL SECURITY DEBATE

Social Security (SS) has a significant role in our society today. Although it is not technically classified within the financial services industry, the SS program is an important economic influence that will affect the industry whether or not it is privatized. SS is our largest and most comprehensive public program and provides Old Age, Survivors, and Disability Insurance (OASDI) benefits for about one of every six residents (over 44 million people in 1999). Over 90% of Americans over age 65 receive SS benefits. Twenty-nine percent of them rely on SS for over 90% of total income and 40% are kept out of poverty by SS.

Despite the success of SS, US population aging will seriously stress the program in the future. The population over 65 is expected to double, to over 70 million, by 2030 and will comprise about 20% of the population. By 2030, social insurance programs could constitute approximately 55% of the federal budget and about 12% of GDP. The ratio of current workers to current retirees has shrunk from 16.5 to 1 in 1950, to 3.4:1 today, and will fall to 2:1 by 2030. These dramatic demographic changes make the SS "pay as you go" system unsustainable in the future.

How do we pay for Social Security?

The Social Security program receives income from the Federal Insurance Contribution Act (FICA) payroll tax of current workers. Current workers pay 6.2% tax on earnings that is matched by employers for an aggregate 12.4% tax contributed to the system. SS taxes are collected by the Treasury, which then uses this income to pay benefits directly to SS recipients in the year collected. This is called a "pay as you go" system in which current workers pay for benefits received by current recipients. Examining the process from a "flow of money" perspective gives a more pragmatic view. In the year 2000, current workers, employers, and retirees paid \$504.5B in payroll and benefit taxes to the Treasury. The Treasury paid OASDI beneficiaries \$407.6M, paid the Railroad Retirement Program \$3.7M and paid \$3.8B in administrative expenses for the Social Security Administration (SSA). This left a surplus of \$89.7M that remains in the Treasury. The Treasury "sells" \$89.7M in S-bonds to the Social Security Trust Funds. These bonds are special Treasury securities issued only to the SSA and are the invested assets of the trust fund. Following this transaction, the SS surplus remains in the Treasury where it is spent on other government programs or used to pay down federal debt.

The Social Security Trust Fund

The trust fund is probably the most misunderstood element of the SS program. The government uses surplus SS taxes to purchase S-bonds guaranteed by the federal government for future payment. The federal government is, in actuality, spending the excess taxes received for SS, and then giving itself a loan to pay back the SSA, with interest, creating debt on actual tax payments received. These S-bonds are actually IOU's or real government debt, that will be resolved when the SSA needs the money.

The OASI and DI Trust Funds held \$896.1B in S-bond assets at the end of 1999. In 2000, the Treasury issued \$89.7B in S-bonds to the trust fund for surplus taxes collected. The Treasury also paid \$64.5B in interest on S-bonds debt in the year 2000 to the trust funds with more S-bonds. This raised trust fund assets to \$1,049.4B at the end of 2000. In the year 2000, the government spent the excess taxes collected--\$89.7B, loaned itself the money on paper through S-bonds, and then paid interest to itself--\$64.5B, by lending itself more money that it doesn't have. Therefore, since the surplus taxes are spent real time and no longer exist, the \$1049.4B of reserve "assets" in the trust funds are actually \$1049.4B of debt accumulated by the Treasury in S-bonds. The SS reserve and trust funds exist only on paper but imply a government commitment to fund the program when outlays exceed income to the system and the SS "reserves" are required.

The "pay as you go" system works fine as long as incoming tax payments are greater than outlays. However, when expenditures exceed income and the real money flow is in deficit, the SSA will need to sell back S-bonds to the Treasury. According to the projections from the 2001 OASDI Trustees Report, the annual cost of Social Security will exceed SS tax income starting in 2016 and the DI and OASI Trust Funds will be exhausted in 2026 and 2040, respectively. The Treasury will need to generate extra money for SS payments to cover the shortfall. To do this the Treasury can sell Treasury Bonds on the market, thereby increasing real federal debt, use surplus tax money from outside FICA or by a tax increase.

Fixing Social Security

The alternatives for fixing SS fall into two categories, programmatic reform of the system or keeping the "pay as you go" system and instituting measures to fix the shortfall using mechanisms currently available. While opposing sides of the debate disagree on the objectives of the system, future projections, financial and social costs among other issues, there is agreement that the benefits of those nearing retirement must be protected and the sooner reform or adjustments are made, the less impact these changes will have on the economy, federal budget, workers and beneficiaries.

The most popular reform proposal-privatization, involves establishing private investment accounts for beneficiaries during their working careers. The advantages of this system would be higher returns, better retirement benefits through accumulated wealth, which may be passed to heirs, choice and control over retirement assets and freedom from the political risk and influence over the current system. The disadvantages are market risk and the difficulty in implementing an equitable transition. Our current market conditions provide an excellent example. A worker planning to retire in 2001 with assets invested in the market could have conceivably lost 30-50% of his portfolio value in the market downturn. This would have a significant affect on retirement income. If this worker was planning to buy an annuity for a constant retirement income stream, he now has a much smaller annuity. Likewise buying this annuity in this market is inferior as the return on fixed annuities goes down with interest rates.

Privatization is a long-term solution and cannot be implemented for workers nearing retirement. There is not enough time for many baby boomers to build adequate private accounts in time for retirement so their impact on the present system remains a problem. Making the transition between the current system and a private system will be a long, tenuous process.

Maintaining the solvency of the current system rests simply on having income at least equal to outlays. The bottom line is that around 2016, when SS needs the "trust fund assets" the treasury needs to produce income through borrowing or taxing for the trust fund reimbursements. The OASDI Trustees Report concludes that an increase in payroll tax from 12.4% to 14.26%, a 13% reduction in benefits or a lesser combination of the two is required to make the trust fund solvent for 75 years. Existing payroll taxes alone will finance 72-75% of the projected SS benefits and adjustments in taxes and benefits will address the shortfall, particularly if we experience good growth. The likely way to solvency lies in a combination of reduced benefits and increased income through other methods. Lifting the \$76,200 cap on payroll taxes affects a small part of the population but is projected to ease 75% of the shortfall through 2075. Benefits could be reduced through a combination of increasing the age for full benefits, percentage reductions in benefits or cost of living adjustments.

Conclusion

The future of Social Security is a critical issue for our nation. How we deal with it will affect our economy, federal budget, and its ability to provide services, the well being of our aging population and our national psyche. It will take serious national debate and political will to successfully navigate this issue. Several facts are clear. The SS system trust fund is implicit debt and will not go away in any reform scenario; we still have to pay this bill. A large portion of our population depends on Social Security benefits as a large portion of their retirement income, this will hold true for quite a while. The sooner we act the easier it will be to change.

Some questions to consider when deciding which side of the debate is more favorable are: Are the social and ideological aspects of Social Security more important than getting your money's worth? Will the social aspects become more important to our society as our demographics shift to an older population? Is social security supposed to provide full retirement benefits or should it be a supplement to savings, pensions, 401k's etc?

There are compelling aspects of both sides of the debate. We should try to capture the beneficial aspects of both by making the system smaller, solvent and providing better alternatives to social security. Fine-tuning the system using an increase in the cap on payroll taxes will increase income to the system. We should continue aggressive efforts to pay down the national debt so that borrowing to finance shortfall debt, if needed, has less impact on the federal budget. Further reductions in benefits and an effort to get people out of the system could be achieved by temporary adjustments to the cost of living adjustments during projected shortfalls, or means testing to reduce benefits for high-income workers. To reduce beneficiaries in the system we could examine offering "buyouts" to high income, means tested workers using existing real surpluses to pay one time, lump sum, tax free benefits in return for no claim to benefits upon retirement. Adjustments would be made in order to reduce the payroll tax over time and reduce future expected benefits in kind. Rather than privatize accounts, government expansion of IRA limits based on SS tax reductions would promote the same benefits of privatization without the burden of government management or regulation. This does not however guarantee that people will save, but knowing they have less guaranteed benefits in the future should provide incentive to save. Over time, the system can be evaluated or phased so that more may opt out of the existing system and use a larger portion of their payroll tax to finance their own retirement.

CDR Barry Dagnall

AN INDEPENDENT FEDERAL RESERVE IS CRITICAL TO NATIONAL SECURITY

The Federal Reserve is the backbone of the nation's financial system and among the most respected central banks in the world. Its key responsibilities include monitoring and maintaining the health of the nation's banking system and setting monetary policy that keeps inflation at levels that support long-term sustainable economic growth. More recently, the Fed was given responsibility under GLB for supervising new financial holding companies like Citigroup that combine banking, insurance, and securities brokers. The Fed also plays a key role clearing billions of checks Americans write each year and replacing worn currency with new bills. All knowledgeable observers agree that the key to the Fed's success has been its relative independence from both the Executive Branch and Congress. It is far more immune from political influence, for example, than its counterpart European Central Bank and similar institutions in the developed world. The Fed's continued success will depend in large measure on its maintaining this independence.

The Federal Reserve Structure

The Fed was created in 1913 to establish more effective supervision of banking in the United States, to set monetary policy and to afford a means of rediscounting commercial paper. It is composed of a Chairman, Board of Governors, twelve regional banks, Federal Open Market Committee, member banks, and advisory committees. The President appoints the Chairman and Vice Chairman to the Board of Governors. The Board of Governors and presidents of five Federal Reserve Banks form the Federal Open Market Committee that manages market operations and establishes monetary policy. Various advisory committees share information with the Board of Governors directly or with the Federal Reserve Bank. The committees consist of representatives from the banking, financial, academic, legal, savings and loan, and credit union industry. All national banks and many state chartered banks are members of the Federal Reserve and are required to meet Fed standards on reserve requirements, capital ratios and similar measures and open their books to the Fed's inspection.

The Fed has been an important institution since its inception, but it has become a household word in recent years due largely to the success of Chairman Alan Greenspan's policies, which played a key role in fostering the high-growth, low-inflation economy that marked the 1990s. Many important changes in the financial services industry; the rapid growth in stock ownership by average Americans, for example, took place during this same period and can be attributed in some measure to Greenspan's policies, which created confidence and a climate conducive to long-term investment.

Setting Monetary Policy

The Federal Reserve uses monetary policy to keep the economy in balance, raising interest rates when rapid economic growth threatens to increase inflation, and lowering rates when economic growth is sluggish and the nation is producing below capacity. The Fed implements monetary policy through open market operations and by setting reserve requirements and the federal funds rate. In open market operations, it buys and sells government securities to influence the level of reserves in the depository system. In setting reserve requirements, the Fed defines what proportion of assets commercial banks and must hold in reserve against deposits. The federal funds rate establishes the interest rate charged banks and institutions when they borrow reserves from a regional federal reserve bank. The Greenspan Fed has been active: from 1990-1999, the Federal Reserve adjusted the federal funds target rate 31 times.

Keeping the Fed Independent

Several essential features of the Federal Reserve promote its independence. First, it is the final authority on setting interest rates and monetary policy. Its actions are not subject to veto by the executive or legislative branches. Second, the governors are appointed for long overlapping terms, limiting the number of appointments that any one presidential administration can make. Finally, it covers its own expenses from the earnings of its portfolio of government securities, thus freeing it from the Congressional budget and appropriations process.

The appointment process provides the Executive and Congress with their primary influence over the Fed. The President appoints the chairman and vice chairman to four-year terms and governors to fourteen-year terms. All appointments require Senate confirmation. If a governor resigns before his or her term is complete, the President appoints a successor for the remainder of the term. At the end of that term, the President can appoint that governor to a full term. Once a full term is served, a governor cannot be reappointed.

Should the President have greater control over the Federal Reserve? If the President controlled the Federal Reserve, he would control monetary policy. He would then be in a position to support his political agenda and fiscal policy that might not be in the best interest of the economy. The Chairmen of the Council of Economic Advisers consistently have argued that a Federal Reserve standing independent of the administration has helped provide stability at times of economic uncertainty. Research by Andrew Brimmer, a former Federal Reserve governor, indicates that 12 of the 14 Presidents from Woodrow Wilson to George W. Bush had some type of public debate, conflict, or criticism of Federal Reserve policy. Brimmer wrote that "Presidents resented the delegation of monetary policy by the Congress to an independent Federal Reserve and sought ways to bring monetary policy under their influence, often by exerting direct political pressure on the Federal Reserve, but principally through the appointment process." Brimmer documents three cases where he believes a president exerted political pressure by appointing a new Fed chair. Thomas M. Havrilesky, in a 1992 book, asserted that the Kennedy, Johnson, and Nixon administrations exerted political pressure on the Federal Reserve measured by the number of comments made by the administration on monetary policy.

Congress has oversight of the Federal Reserve. The Federal Reserve provides Congress two monetary reports each year on February 20 and July 20. Congress cannot fulfill its oversight responsibilities without actively engaging the Federal Reserve in a dialogue

about the conduct of monetary policy. The Chairman testifies on the status of the economy to Congress before the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Banking, Finance and Urban Affairs. In 1995, the Chairman testified twenty-five times with only seven hearings relating directly to monetary policy and the governors testified for a one-year record of twenty-two times.

Congressional influence over the Fed is also limited though Congress has used a variety of approaches to influence monetary policy, including recommending specific goals and holding up individual board member nominations. Congress is most likely to try influencing the Federal Reserve when the economy is performing poorly or interest rates are high. Congress passed Concurrent Resolution 133 in 1975 and introduced a resolution in 1982 with specific monetary directives about lowering interest rates, but the final language included a qualification that left the execution of monetary policy to the Federal Reserve. Congressional representatives do write letters to the Fed to convey a concern about the economy, most often, about high interest rates.

Federal Reserve Governor Laurence H. Meyer explains the relationship this way: "Congress keeps its part of the bargain by leaving the core of our operations alone, so long as things go right, and intervening only around the edges to show they remain alert to their oversight responsibilities and reflect the concerns of their constituents." Meyer believes that Congress has three expectations of the Federal Reserve: to do a good job of promoting objectives established by Congress, accept part of the grumbling for decisions that impose short-term costs, and be prepared to accept part of the blame for bad results.

Summary

The Federal Reserve structure allows the Board of Governors to evaluate economic conditions and determine appropriate monetary policy to generate economic activity or maintain economic stability. The term length for the governors, overlapping appointments of governors, independence from the Congressional budget process, and the power to set interest rates without veto from the Executive Branch and Congress are essential to maintaining an independent Federal Reserve. The Federal Reserve conducts monetary policy by influencing conditions to achieve full employment and stable prices, supervise and regulate banking institutions, maintain the stability of the financial system and contain systemic risks that may arise in financial markets. Given that its decisions have a great impact not only on the health of the economy but on the health of the nation's entire financial system, it is essential that the Fed remain independent and not be subject to political pressures from elected officials.

LTC George Washington

CONCLUSION

The US financial services industry continues to provide strong and stable support for our economic power. The industry easily accomplishes its main tasks of providing markets, supporting the availability and movement of capital, providing investment opportunities, and providing risk mitigation and reduction tools. The implications and consequences of GLB continue to be widely analyzed as the industry responds to new business opportunities, resulting structural changes, and the new roles and methods of government regulation. With banks, insurance companies and securities firms crossing sector boundaries, government regulators will need to ensure that all financial services areas that deserve regulatory scrutiny are appropriately but not excessively regulated. US financial service firms will continue to grow and should compete favorably with foreign companies for markets made available by continued globalization of world markets. The strength of the Federal Reserve will continue as a pillar of worldwide stability. US markets will continue to attract international investment due to this stability and to the tremendous opportunity for economic growth in the United States. In terms of direct national security needs, the US financial system makes it possible for nearly any private company to obtain the financing necessary to expand production during times of crisis. The industry is well positioned to implement surge production or undertake a broader industrial mobilization. Americans should feel confident that the financial services industry will continue to be the backbone of the United States economy.

Endnotes: