INDUSTRY STUDIES 2000

Financial Services

ABSTRACT

The financial services industry of the United States is in excellent health. It is well capitalized, structurally sound, dynamic, and innovative. The industry faces challenges on both the domestic and international fronts. Recent legislation has repealed Depression Era restrictions on the industry, opening the door to increased domestic competition, consolidation, and restructuring of financial firms. Globalization of the financial system increases competition, principally among the three dominant economic powers: the United States, the European Union, and Japan. The U.S. industry will be able to maintain global leadership if it continues its historical trend of innovation and customer service.

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PLACES VISITED

Domestic

American Stock Exchange

Chase Manhattan Bank, New York, NY

Deutsche Bank, New York, NY

Export-Import Bank, Washington, DC

Federal Reserve Bank of New York, New York, NY

Federal Reserve Board of Governors, Washington, DC

International Monetary Fund, Washington, DC

Morgan Stanley Dean Witter, Alexandria, VA

National Association of Securities Dealers and Quotations (NASDAQ), Washington, DC

New York Board of Trade, New York, NY

New York Mercantile Exchange, New York, NY

New York Stock Exchange, New York, NY

TIAA-CREF, New York, NY

The Wall Street Journal, New York, NY

International

Athens Stock Exchange, Athens, Greece

Bank of Greece, Athens, Greece

Banque de France, Paris, France

Bocconi University, Milan, Italy

Borsa Italiana (Italian Stock Exchange), Milan, Italy

Council of Economic Advisors, Athens, Greece

Deutsche Bank, Frankfurt, Germany

Deutsche Bourse (Frankfurt Stock Exchange), Frankfurt, Germany

EUROBANK, Athens, Greece

European Central Bank, Frankfurt, Germany

Hellenic Bank Association, Athens, Greece

Hellenic Capital Market Commission, Athens, Greece

Hesse Landescentral Bank, Frankfurt, Germany

Merrill Lynch Italia, Milan, Italy

Paris Bourse (Paris Stock Exchange), Paris, France

Societe Generale (SG Asset Management), Paris, France

INTRODUCTION

The financial services industry contributes to national security by promoting the development of a strong economy, which creates prosperity and promotes national well-being. The economy is a critical center of gravity for the United States. It provides the resources needed for a robust national defense and for domestic social programs that are important for promoting societal good and for assisting those who have not benefited from the overall rise in prosperity.

The financial services industry promotes a strong economy by making capital available to individuals, businesses, and government to finance economic activity and by facilitating payments for financial transactions. The industry is strong and well capitalized. It has benefited from a regulatory structure that protects consumers without restricting ingenuity. Until recently, the industry had been encumbered by post–Depression Era laws that limited the business of a financial firm to its own sector (banking, securities, or insurance). In spite of this, the industry strengthened, becoming the largest in the world. Passage of recent legislation eliminating the post–Depression Era laws creates the opportunity for the industry to grow stronger and play an even more dominant role in fueling economic activity, both within the United States and in other countries.

THE FINANCIAL SERVICES INDUSTRY DEFINED

The financial services industry is comprised of three sectors: banks and other deposit institutions, insurance companies, and securities trading and underwriting firms. The three sectors developed as a result of laws passed in the 1930s to prevent a recurrence of the Great Depression. Congress' intent was to prevent the speculation of firms in financial activities outside their business area and the concentration of power in large holding companies. The laws created inefficiencies that hampered the growth and effectiveness of the industry, however.

In the early 1990s, several minor legislative actions were taken toward reform. Simultaneously, the industry moved toward a broader reform through several significant mergers of financial firms. In 1999, Congress passed sweeping legislation in the form of the Financial Services Modernization Act (also known as the Gramm-Leach-Bliley law for its sponsors). The new law eliminates the walls that had divided the industry into sectors. Future Industry Study reports may address the financial services industry without mention of discrete sectors. But for this, the first report since passage of the Gramm-Leach-Bliley law, it is instructive to analyze by sector because of the distinct differences between them: specifically, their financial condition, their business strategies, and their readiness for the changes that lie ahead.

CURRENT CONDITION

The financial services industry of the United States is the world's strongest. A variety of statistics can be used to support this assessment, including the total capitalization, the number and vitality of financial firms and institutions, the degree to which individuals actively participate in the industry, and the industry's global reach. High total capitalization, structural soundness, an appropriate degree of regulation, and the strength of innovation combine to give the industry its success. The financial services industry has proved so successful as a driver of economic activity that it has fueled growth in the gross domestic product (GDP) at a rate that is deemed unsustainable by the U.S. Federal Reserve.

There is every reason to expect that the industry will remain strong and competitive in the years to come. It possesses an edge over foreign competitors in the application of information technology to business practices. By integrating advances in information technology, the industry is able to develop innovative products, make them available to an expanding clientele within the United States and overseas, and provide better customer service. Technology also facilitates the free flow of financial information that provides transparency, and transparency further strengthens the industry by bolstering confidence.

Financial firms are presently adapting to the opportunities and challenges created by the recent passage of the Financial Services Modernization Act. The strongest firms are expanding business into other sectors, taking advantage of new opportunities to increase their product diversity, market share, and profitability. Those that are less prepared for the increased competition are developing alternate strategies for survival.

Banking

The U.S. banking industry is highly competitive, well structured, and capitalized. Competition among banks has driven the current pace of consolidation as banks seek to achieve economies of scale. Strategic mergers and acquisitions (M&A) are enabling banks to increase market share and lower operating costs, thereby enhancing profits. Banks are marketing their services aggressively and offering an increasing number of ways for customers to use their services "anywhere, anytime, anyhow." Adding to their system of branch offices, banks have opened minibranches in grocery stores and shopping malls, and have greatly expanded their network of automated teller machines (ATMs). Banks are now offering home banking via the Internet, telephone tellers, and wireless banking. Many banks are taking advantage of new legislation to sell products across the barriers that formerly divided the financial industry into discrete sectors.

Information and telecommunication technologies are proving critical to profitability, productivity, and customer service in banking. Transactions conducted electronically carry a fraction of the cost of a branch office visit and give total control to the customer. Investment banks of the United States dominate the international market for M&A, privatization of government-controlled firms, and initial public offerings (IPOs) of stock. Foreign banks are consolidating to improve their competitiveness in this area of banking, but U.S. banks maintain a significant edge.

Insurance

With more than $600 billion in premiums, the U.S. insurance industry is second only to Japan's in size.[i] The U.S. industry's financial condition is good, overall, but it is not prepared for the competitive environment introduced by passage of the Financial Services Modernization Act. The insurance industry has long relied on a network of agents to offer personal service to customers and has been relatively slow to adapt its business model to the Information Age. Its investment in technology has been only half that of banks and securities firms in the last 5 years.[ii] Although some insurers have introduced call centers, interactive Web sites, and other technology-based methods for reaching their customers, many more continue to follow the old way. Profitability is a concern, particularly for property/casualty (P/C) insurers that have endured an increasing variety of large-scale natural catastrophes. In spite of bold moves to lower operating costs by reducing employment, many P/C insurers have been able to show profit only through gains in their investment portfolios. Insurers are also facing barriers to entry into several of the most lucrative overseas markets, as foreign governments are protecting firms of their own nation.

Securities

By every standard of measure, the U.S. securities industry is the world's largest. It is the biggest in total capitalization (49 percent of world equities),[iii] total listings, total volume, and number of investors participating. The United States leads the globe in the use of equities for financing economic activity. Other nations have begun to develop and expand their equities sector, but are still more reliant on banks to finance capital investment. Explosive growth in the number of individual investors has resulted from lower brokerage commissions, easy on-line access to brokerage services, and an abundance of information for guiding investment choices, enabled by bold advances in information technology. A sharp increase in market volume and volatility has accompanied the rising number of individual investors and short-term traders. The competitive forces that have driven down brokerage fees have also lowered profit margins, causing exchanges and investment firms to pursue M&A in order to improve profits through economies of scale and provide better market liquidity.

CHALLENGES

The U.S. financial services industry has the capability to continue as the world leader, but in order to do so it must recognize and respond to several key challenges that are developing. Three principal challenges are noteworthy.

Financial Tripolarity of the International System

Three primary financial and economic power bases have developed: the United States, the European Union (EU), and Japan. There is considerable economic and financial activity outside of these three spheres, but it does not affect the world financial system as do these three powerhouses. The United States is currently the strongest of the three power bases, but developments in Europe and Japan are increasingly challenging U.S. leadership.

Contrary to the predictions of skeptics, the European Monetary Union (EMU) has been a great success. United under a single entity to guide monetary policy and guided by EU regulations for trade and commerce, the national economies of Europe can improve their performance through regional coordination of efforts. The success of the EU and the EMU creates the potential for Europe to act as a single economic entity larger than the United States. Despite justifiable optimism, challenges to European integration remain. Concerns for national sovereignty and the protection of domestic firms from competition continue, and one of the region’s largest players, the United Kingdom, has yet to join the EMU.

Despite its sluggish economy, Japan remains the strongest economic power in Asia. Political differences notwithstanding, there is a potential for Asian economies to draw closer together and act as one. Of note, several East Asian governments are attempting to develop a structure like the International Monetary Fund (IMF) for meeting regional needs for short-term liquidity in the future rather than turning to the IMF.

Increased Competition

Every U.S. financial firm will feel the strain of increased competition, both from domestic firms and foreign firms. Now that the passage of the Financial Services Modernization Act has increased domestic competition by permitting cross-sales of the products of other sectors, firms that had come to rely upon old regulations to maintain their market share and profitability are likely to become vulnerable to takeover by firms that are better prepared and more competitive. Increased foreign competition is the inevitable result of the forces of globalization, the interconnecting of economic activity across national borders and stretching around the globe. The introduction of information technology and the ongoing efforts to promote world trade combine to speed the pace of globalization and increase the pressure on U.S. firms. Foreign companies are experiencing even greater pressure from U.S. firms because of the relative size of the U.S. economy. Increased competition is a perpetual invitation to protectionism. As U.S financial firms pursue profit in lucrative overseas markets, these firms face the prospect of protective strictures.

Interconnection of the World Economies via the Financial System

Several key trends in world equities markets show the effects of globalization and financial integration. These trends include the significant growth in equity and bond capitalization; moves to integrate EU stock exchanges; the enormous size of the EU bond market; the shift to a common currency, the euro, for the denomination of assets; expanded trading hours; and the decimalization of the U.S. stock markets. Increased globalization facilitates the transmission of financial shocks around the world. The amount of capital and speed of its flow into and out of capital markets can magnify a shock's effect. Trouble in one region can cause economies elsewhere in the world to tumble. In spite of ongoing international efforts to reform weak financial structures, the potential for financial turmoil remains.

OUTLOOK

The passage of the Financial Services Modernization Act and the accelerating trend of financial globalization create a new landscape for the financial services industry. The future will involve greater competition among all financial firms, both domestic and international. No firm will be able to rest comfortably on past achievements or current market share. Doing so will hazard the sudden loss of clientele and profitability to a competitor offering a better product and/or better customer service. The Internet, which makes geography virtually irrelevant, will compound this situation. In the networked world, it will be just as easy for a foreign firm as for a domestic firm to reach the U.S. consumer. Because increased competition will shave profit margins to razor-thin proportions, profitability will require that firms lower their costs and increase their market share.

The successful financial firms will pursue information technology–based solutions for all business processes. These firms will develop innovative ways of serving their customers, using the array of emerging information technology systems (e.g., Internet, wireless telephones, call centers). The companies will use these innovations to achieve per-transaction cost savings and better customer service. Firms will also integrate technology into all internal functions of the business to improve labor productivity (significant cost savings can be achieved by reducing the number of employees needed to carry out routine administrative tasks). Greater productivity can be generated through the electronic cataloguing and management of documents, making them available instantaneously to multiple users in any location.

The current trend of consolidation can be expected to continue and even expand. Firms will pursue M&A opportunities and develop strategic partnerships with other firms to improve their access to new, undeveloped markets or to draw in customers of other firms. Mergers and acquisitions will occur among domestic firms and among domestic and foreign firms. Partnerships, domestic and foreign, have a great potential to increase market share. Consolidation will also enable firms to lower their operating costs through economies of scale.

Increased competition naturally produces better service, lower prices for the consumer, and greater innovation in new product development. Consolidation can support these objectives by creating strong companies that are able to develop new products and bring them to market, but it can also work against the consumer by reducing competition.

As firms attempt to expand into overseas markets, resistance is likely to appear among firms threatened by new entrants. Foreign governments can be expected to erect any number and type of barriers to entry in the form of regulations, taxes or tariffs, or complex registration requirements. Within the United States, financial firms that previously enjoyed protection from competition by regulatory strictures now face new challenges. These companies can be expected to pursue federal and state regulations to restore the former structure that divided the industry into discrete sectors.

Banking

It can be expected that U.S. banks will continue current trends toward consolidation, application of technology to business practices, and customer outreach by providing "anywhere, anytime, anyhow" service via an expanding number of methods. Banks will take advantage of the explosive growth of wireless communication devices to offer the full range of services now available on-line and in branch offices via wireless telephone, also known as "m-banking" (i.e., multiple banking). At the same time, the introduction of smart cards will enable consumers to conduct cash- and check-free transactions. Where enhanced profits are foreseen, banks will develop business in areas formerly restricted by legislation. Banks will cross-sell insurance and equity products either by developing their own business or by merging with or acquiring a firm that specializes in that business. Mergers and acquisitions with foreign banks can also be anticipated, especially among large banks seeking to become global banks. Occasionally, the dominant bank will be foreign, as in the acquisition of Banker's Trust by Deutsche Bank.

Insurance

The most successful insurance firms will grow stronger and expand business into other sectors, either through M&A or through the independent development of new services. Some insurers are already offering brokerage services and banking. Insurers could also increase the size of their insurance operation by acquiring one or more of the insurers that are not well prepared for the more competitive environment. Some insurance firms are good targets for takeover by larger firms in the banking, securities, or equities sectors. Firms with a good client base, technical expertise, low debt, and low stock price are particularly appealing for takeover by a bank or securities firm. The insurance industry will continue to pursue new business in lucrative overseas markets, including China and India, and will appeal to the federal government for support in the World Trade Organization (WTO) or other forums addressing free trade. Finally, insurers can be expected to lobby Congress and state legislatures as regulations are modified to comply with the provisions of the Financial Services Modernization Act. Insurers will seek to influence regulations to preserve at least some of the protections that they formerly enjoyed.

Securities

Capitalization, listings, volume, and participation in world equities markets will increase as foreign countries move toward the greater use of equity financing. Stock exchanges that are not yet operating as publicly owned entities will shift in that direction and become full for-profit businesses. Stock exchanges can be expected to continue expanding current efforts at international mergers to widen investment opportunities, enhance liquidity, and improve profitability. International exchange mergers will continue to be complex because of differences in exchange format (e.g., trading floor vs. computer), electronic trading platforms, currencies (e.g., sterling vs. euro), and clearing systems. For the equities sector to fulfill the vision of “around-the-world, around-the-clock trading,” it will be necessary to resolve these and other complexities. The growth of the equities markets portends increasing volume and higher volatility. The transition of U.S. exchanges to stock price decimalization will place further demands on existing capacity as a result of expected increases in options quote traffic, requiring exchanges to make major upgrades in information systems.

GOVERNMENT GOALS AND ROLE

It is in the interest of the U.S. government that the financial services industry remains strong and capable of meeting the capital needs of a robust U.S. economy. The federal government has an important role to play in making it a reality.

Market Forces

The government should allow market forces to shape the financial services industry while monitoring developments to ensure the following:

A level playing field for all financial services firms. The government must resist efforts by firms in any sector to gain advantage over other firms by regulation rather than by competition. When there is a need for government support for a particular problem affecting a sector or group of firms, the action should be well focused, short-term, and coordinated with foreign governments to avoid the imposition of barriers to U.S. firms.

The protection of consumer interests. The government should permit financial firms to consolidate as necessary to achieve improved profits and market share, but antitrust regulators should ensure that competition is preserved. Competition has required the industry to offer innovative ways of financing economic activity at low cost to the consumer. The impressive growth of the U.S. economy is attributable to a large degree to that blend of innovation and low cost. Therefore, the government should intervene where necessary to ensure that consolidation does not pose a hazard to these critical requirements of the financial services industry.

Preservation of the public trust in the competence of the government to supervise financial activities. A critical strength of the U.S. economy and financial system is the high confidence in the U.S. government held worldwide by private citizens, organizations, firms, markets, and other governments. The wisdom and constancy of the U.S. government and its organizations (e.g., the Federal Reserve Bank) anchor the world financial system. The federal government should continue to hold that trust in high regard and act in a manner that promotes financial stability.

Stability

The U.S. government should promote stability within the international financial system through good governance, transparency, and early coordinated actions to isolate financial failures and prevent the spread of financial contagion. The benefits of globalization come with the risk of global impact when financial crises strike a particular area of the globe. There is abundant proof of the importance of good governance and transparency for a stable financial system. Market forces are capable of assessing and adjusting to the risks of the financial systems of emerging economies, but accurate information voluntarily disclosed by governments is crucial for stability in the international system. The federal government should use its influence to lead emerging economies in the direction of transparency and good governance as two pillars of a strong economy and a requirement for full participation in international capital markets. Where short-term liquidity problems occur, early and decisive action in coordination with the IMF and foreign governments should be taken to preclude an outbreak of contagion. If problems are the result of serious structural and governance problems, assistance from the IMF and the World Bank should be contingent on the willingness of the foreign government to adopt a balanced and reasonable package of reform measures that will lead the country to stability and further protect the international financial system.

Foreign Market Access

The federal government should promote the free and unhindered access of U.S. financial firms to overseas markets. Despite the mutual benefit to be derived by the full participation of U.S. firms in overseas markets, other governments have established protective strictures that are likely to increase. The federal government should use the WTO and other vehicles for opening foreign markets to U.S. firms. At the same time, the federal government should take the necessary actions to ensure that the U.S. market is kept open to foreign competitors as they open their markets to the United States. One issue of increasing concern is the difference between the privacy laws of the United States and those of the EU. In order to ensure that U.S. firms are not precluded from participating fully in Europe, the United States should adopt on-line privacy standards that are comparable and compatible with those of Europe.

CONCLUSION

The financial services industry of the United States has been able to provide the capital necessary to meet the increasing demands of the world's largest economy. Record growth of the U.S. economy has created prosperity and promoted the welfare of the citizenry. The success of the industry can be attributed to the stability of the nation's economic and political systems, the lack of government control over the industry and the economy, and the development of innovative ways of generating capital.

The primary challenge facing the industry is the growing tripolarity of the international financial system and the threat of increased competition that it poses. Globalization of the financial system makes it possible for firms of the different power centers (i.e., the United States, the EU, and Asia, the latter centered on Japan) to compete directly with one another. Companies in Europe and Asia are restructuring and emerging stronger and more competitive, posing a direct threat to U.S. leadership in market share. In 1999, Congress passed the Financial Services Modernization Act, removing a series of Depression Era laws that restricted banks, securities firms, and insurers from activities outside their business sector. Although intended to provide stability, those laws undermined competitiveness. Unencumbered by the former strictures, the financial services industry will undergo a process of restructuring that will produce fewer, but stronger firms able to compete against those of Europe and Asia.

It is in the interest of the U.S. government that the financial services industry continues as the world leader, always able to provide unrestricted access to capital. The method for achieving such access is for the government to allow market forces to shape the industry while monitoring developments. The government should take necessary action to (1) preserve an open and competitive market for U.S. firms, both domestically and overseas; (2) ensure that the U.S. consumer receives the best possible service; (3) provide for the continued high confidence in the U.S. government and its economic system; and (4) promote the stability of the international financial system.

ESSAYS ON MAJOR ISSUES

FINANCIAL GLOBALIZATION AND INTERNATIONAL STABILITY

Stephen J. Hadley and Clifford B. Bussard

The globalization of international finance is creating interdependence among nations in trade, services, information, and ideas. There is a rising trend in cross-border financial flows and cross-border M&A among financial institutions. The rapid advance of information technology is a critical enabler for making financial information widely available around the world, increasing the efficiency and speed of international transactions, and lowering the costs of these transactions. Furthermore, the benefits to the United States of financial globalization are significant. It enables individuals and institutions to invest funds wherever the potential for return is greatest. It creates a means for foreign capital to flow into the U.S. economy. A recent analysis illustrates this trend in global integration:[iv] the share of U.S. pension funds invested abroad has doubled since 1990; more than $2.5 trillion of U.S. savings is now in portfolio investments overseas; U.S. cross-border transactions in bonds and securities, as a share of the GDP, are 20 times their 1970 level; and almost 45 percent of the profits of the five largest U.S. banks derive from foreign operations. There are vulnerabilities that come with globalization, however. Interdependence increases U.S. exposure to financial instability abroad.

Challenges

Global integration of financial markets increases the risk that financial instability and crisis in one economy or region can be rapidly transmitted to others. The frequency and severity of financial crises and shocks are at an all-time high. They peaked with the "Asian contagion" crisis of 1997–1998, but have been almost continuous for the past two decades. The majority have originated in developing market economies—Latin America in the 1970s, for example, and Mexico, Asia, Russia, and Brazil in the 1990s. Developing countries have suffered an especially large number of banking/financial failures. From 1976 to 1996, there were 59 banking crises in developing countries; they cost an average of 9 percent of the countries' GDP, not including the Asian crises, for which cost estimates range 20–55 percent of the GDP.[v]

The crisis countries themselves have generally borne the costs of instability in international markets, although there has been some impact on the United States. Exports from the United States to Latin America and Asia dropped 40 percent in the worst years of those crises. The United States paid the largest share of Mexico's $50 billion bailout, and U.S. investors lost at least $30 billion in the worst 6 months of the Asian crisis. Unfortunately, the surprisingly rapid recovery of most Asian economies after 1997–1998, the (narrow) avoidance of a subsequent crisis in Brazil, and the spectacular technology-driven performance of the U.S. securities market in 1998–1999 drew attention away from these problems.

Measures to address global financial instability in a systemic way are proceeding, nevertheless, along two tracks. First, in the wake of the Asian crisis, there is an ongoing international effort to prevent financial crises by improving standards of accountability, transparency, and governance in the financial markets of crisis-prone emerging and developing country economies. A number of international standards have been developed or improved during the last 2 years. There has been a concerted effort by the IMF to provide better information. Its goal is to inform the public and the financial community of the extent to which emerging market institutions are applying these standards in such activities as bank and corporate accounting, determination of bank capital adequacy, loan risk evaluation, corporate governance, and foreign reserves reporting, among others.

The second track is an attempt to reduce "moral hazard" risk in the area of international financial transactions. Until recently, the financial system has sometimes unwittingly encouraged speculative and/or risky lending to emerging market economies by bailing out (repaying) lending institutions for loans made to economies in financial crisis. The objective of reform is to reduce bad lending by requiring lenders to bear a greater share of the risk of default. The possibility of "bail-ins" by private sector lenders, as opposed to bailouts by lenders of last resort, is under active exploration. Transactions of this sort have yet to be made, but the role of the IMF in international bailouts has evolved over the past 2 years in ways that should discourage attacks on currencies. Actions of the IMF include establishing several new contingency lines of credit to deter speculation and reducing the size and abruptness of their bailout packages. Accordingly, the risk of speculative bubbles is declining.

The efforts that have been made should reduce global financial instability by making financial markets work better, principally by improving the quality and availability of market information to enable lenders and investors to make better decisions and reduce risk. The emerging role of the IMF is to help member countries increase the quality of information available by adopting and reporting improved standards, and to offer a smaller target to speculators through a more gradual and lower profile for bailouts.

Outlook

There has been considerable progress in preparing standards for financial markets and in refocusing the IMF. Improved governance in developing country financial markets will likely take years, however, and will probably proceed in stages, willing countries first. Several other steps are critical. First, the private banking and investment community must be engaged quickly on the question of instituting "bail-in" procedures, which can work only with that community's full cooperation and commitment. Second, the stability of emerging financial markets will be increased if financial flows to them are diversified to include equity investments, as well as bank loans.

Conclusion

Global economic interdependence is a reality. Significant benefits can result if the vulnerabilities that it creates are effectively managed. The leadership of the United States is essential in this critical area. Thus, U.S. policy should

- Support the continuing evolution of the role of the IMF toward crisis prevention rather than crisis relief
- Facilitate dialogue with financial market leaders (private sector) to assume greater risk in international lending, thus shifting more risk from lenders of last resort
- Assist and support organizations that are improving financial market standards
- Continue to support long-term efforts by the World Bank and bilateral assistance agencies to build institutions and a corporate culture for greater transparency and governance in emerging financial markets

These actions will facilitate global financial stability and protect U.S. financial assets, and they should aid the United States in retaining a world leadership role in the provision of financial services.

WINDOW OF OPPORTUNITY FOR U.S. INVESTMENT BANKS

Ernie H. Haendschke

Because of their dominance in corporate banking, U.S. investment banks are well positioned to take advantage of the new wave of overseas mergers, acquisitions, and privatizations. They possess the latest U.S.–developed financing techniques and excel in capitalization, global reach, equity distribution capability, and M&A expertise; therefore, they are the natural choice for foreign firms undergoing restructuring and interested in a merger.

Liberalized Regulation

Domestic. By the 1990s, it had become clear that the restrictions of the 1933 Glass-Steagall Act were having a profound negative impact on U.S. leadership in the world banking industry and the broader financial services sector. Passage of the Financial Services Modernization Act in November 1999 repealed the Depression Era law and dramatically altered the financial services landscape. The U.S. banks are now better positioned to compete against their foreign counterparts, which have long operated without restrictions on the type of services that they could provide. Competition is increasing through the entry of previously segmented companies into the full range of financial transactions, including securities, insurance, and banking. Investment banks are providing vital corporate banking services, including stock underwriting, financing, M&A advice, and asset management. Liberalization permits banks to restructure to take full advantage of both economies of scale and scope, thus creating a stronger U.S. banking industry. This domestic deregulation is occurring simultaneously with two trans-Atlantic policy developments that also affect the U.S. global investment banking industry.

International. Two policy developments in Europe are sparking a new round of corporate restructuring and creating new opportunities for U.S. investment banks. First, the adoption of a common currency by the 11 countries in the EMU has simplified financial transactions within Europe by creating a single capital market. The elimination of currency exchange risk greatly enhances cross-border trade and investment. Second, the liberalization of corporate tax structures in several EMU nations is likely to stem the continual movement of jobs and investments overseas to more lucrative markets.[vi] Additionally, corporations will be free to sell cross-holdings in various companies without incurring costly capital gains taxes. An explosion of corporate restructuring is expected to result and, with it, a new demand for investment banking services.

The total U.S. and European equity issuance volume and initial public offerings soared in 1999. As the M&A market growth rate slowed in the United States, the European market sizzled with a 26 percent increase in volume and a doubling in value. Europe is now the largest growth area for M&A, with expectations that volume will grow by another 50 percent in 2000. In this regard, estimates predict that Korea, Japan, and other Pacific Rim countries are only 3 years behind Europe. The U.S. investment banks are likely to benefit from these developments.

Financing Innovations Developed by the United States

One of the reasons that U.S. investment banks are desirable as advisors for restructuring is the innovative financing techniques that they have developed to remain competitive. These include securitization, the transformation of individual assets into marketable securities,[vii] and derivatives, financial instruments that derive their value from the prices of one or more other assets (e.g., equity or fixed-income securities, foreign currencies, or commodities).[viii] Investment banks have also used junk bonds and other leveraged finance techniques (e.g., high-yield bonds, leveraged loans, bridge loans) used in the United States for the last 10 years. A new technique in frequent use is the stock-based transaction, "the new economy currency" for M&A.[ix] The recent AOL–Time Warner deal is the biggest stock-based deal to date, providing further proof of the acceptance and legitimacy of such deals throughout the financial community.

These U.S.–developed innovations are in use around the world today, particularly in Europe and Asia, for financing mergers, both friendly and hostile.[x] Few foreign investment banks have the level of experience in using them that U.S. banks have, however. Their experience gives U.S. global investment banks a distinct competitive advantage.

Globalization

Globalization is facilitating the move toward direct foreign investment as the primary source of development capital rather than traditional government and international institutions. This creates growth opportunities in all of the fee-generating businesses of investment banks: underwriting and selling securities (shares and bonds); engaging in M&A, restructuring, and giving financial advice to corporations; serving as global custodians of defined pensions; and managing assets.

Chief executive officers (CEOs) desire that investment banks be proficient in the latest financing mechanisms and large enough to handle global capital financing requirements, including self-financing, if necessary.[xi] They also want banks to retain real estate authorities, securitization specialists, equity pros, and high-yield experts—which may be needed in the future. This one-stop shopping for the corporation becomes a customized package deal.[xii] In addition, CEOs want investment banks to be capable of placing their company's securities around the world. Most important, CEOs require a bank that is strong in the United States, the biggest and most sophisticated capital market of the world. These requirements leave foreign investment banks at a distinct disadvantage, since few have strong positions in the United States.

Once an investment bank gains strength in its domestic market, it will expand to offer services anywhere by purchasing and partnering with local banks to blanket the market. These global enterprises require local infrastructure and local value added in multiple countries or regions. Many cross-border consolidations are occurring in investment banking to strengthen or fill these geographical requirements. This process of country networking acquisitions or localization will be the defining growth trend of the investment banking industry. Banks sometimes expand to strengthen particular areas of functional expertise (e.g., M&A, bonds, real estate, securitization). These types of consolidations are occurring more frequently as banks rush to find appropriate "partners" with the expertise that they themselves lack.[xiii]

According to a Morgan Stanley Dean Witter report, of the current 20 global investment bank players today, only a half dozen will still exist in a matter of a few years. The U.S. investment banks can be the global survivors and continue their leadership role if they make the right moves in the next few years.

Conclusion

The investment banking industry is undergoing consolidation, both geographically and functionally, to enable banks to compete more efficiently and maximize their growth opportunities. Global investment banks based in the United States are in a favorable position to retain their leadership role and profit from the new wave of foreign consolidation. The factors influencing and favoring U.S. banks are deregulation, financing experience, all-encompassing investment banking expertise, and securities distribution capability. The U.S. investment banks can retain their leadership position, provided that they seize the window of opportunity for growth in front of them.

NEW MEASURES FOR THE KNOWLEDGE ECONOMY

Brenda L. Schworm

A new process is underlying the business cycle: the process of discovery and innovation. It is possible to develop more accurate market indexes that reflect the diversity and dynamics of the stock market. New economy stock valuations are a concern. More intrinsic values, or at the very least relative valuations, could be applied. Fundamental changes are occurring as this knowledge-based economy begins, and it will be necessary to develop new indicators that measure innovative performance and related outputs. Leaders will have to be thoughtful and careful about how these measurements are factored into policy.

Indexes

The various stock market indexes provide a good overview of what is happening in the stock markets. The Dow Jones Industrial Average contains only 30 large-company stocks that represent less than 30 percent of the value of the U.S. equity market. Although Dow stocks tend to represent a cross-section of industries, there are no specific guidelines on market capitalization, sector weightings, or any other standard measures; the Dow is very subjective. Nearly all the other major indexes are market capitalization–weighted. Each stock's weight is based on its price. The Dow is widely watched because it affects market psychology and investor behavior,[xiv] but to base other market activity on it may be misleading. Thus, it is often held out as a relic.[xv]

Standard & Poor's (S&P's) Index has 500 large-capitalization stocks that account for about 80 percent of the total value of the U.S. stock market. Most money managers think of the S&P 500 Index as a proxy for the market. The S&P's market capitalization weighting accurately reflects the flow of investor dollars into the market and, therefore, the growth of wealth in the U.S. stock market. The outsize weighting of the biggest stocks does mean that the index return will not tell how the bulk of the stocks in the index performed, however.[xvi]

The NASDAQ Combined Composite technically is not an index. It is a market capitalization weighting of all the stocks listed on the NASDAQ market of more than 4,800 issues. It has a large weighting in technology listings of approximately 70 percent versus 28 percent for the S&P and so is a decent benchmark on how the large technology stocks are doing.[xvii] The Wilshire 5,000 Index covers the entire U.S. stock market and contains more than 7,000 stocks. It tends to track the S&P pretty closely, and it is the best gauge for measuring the ebb and flow of stock market wealth in the United State.[xviii]

Other indexes may reflect the markets more accurately. Taken together, the *Fortune* 500 Index and *Fortune* e-50 Index represent the size, strength, and inventiveness of U.S. business. The capitalization-weighted *Fortune* 500 Index, based on *Fortune*'s 45-year-old list of the 500 biggest companies in the United States, is ranked by revenues rather than by more volatile factors such as market value or earnings. The new *Fortune* e-50 Index is based on the list of the 50 companies that *Fortune* thinks best capture the scope of the Internet revolution. To make the e-50 truly reflect the new economy, *Fortune* puts the percentage of revenue each company derives from the Internet into one of four proportional revenue buckets, termed modified capitalization. Finally, no stock is allowed to have a weight of more than 10 percent in the Index, providing an accurate and diversified reflection of the Internet sector.[xix]

Wired Magazine's Wired Index attempts to do for the Information Age what the Dow did for the Industrial Age: track the growth of the companies that are establishing the new economy. The companies chosen demonstrate one or more of the qualities that are transforming the economy, not just intelligent use of technology, but also more abstract notions, such as globalism, innovation, and strategic vision. This subjective index uses 40 stocks, but adds market capitalization weighting. One of the ironies of the Information Age is the difficulty of measuring new economic aggregates. New metrics are needed for computing service industry productivity and valuing these intangible assets.[xx]

Valuations

One difficulty in the knowledge economy is deciding what yardstick to use in valuing stocks. By focusing only on whether earnings exceed estimates, Wall Street ignores what really matters: whether the prospect of growth in a company's earnings justifies the price that the stock market has applied to the company's shares.[xxi] In the knowledge economy, however, many now believe that the old limitations on growth no longer apply. Companies are harnessing new technologies and showing unprecedented improvements in efficiency. The mean level of stock prices may be moving higher largely because of technology and globalism. The main beneficiaries of this movement are companies that get to their markets first and stake out a dominant position: the "network effect."[xxii]

In an attempt to understand inflated stock valuations, there are various possible approaches. Some argue that the sector's projected 5-year growth rate, the PEG rate, which is the price-to-earnings ratio divided by the growth rate, justifies the high price-to-earnings (P/E) ratio.[xxiii] Many recognize the potential of the Internet, but simply cannot value its stocks. It is well-known that P/E ratios are worthless without an *E*. Unseasoned companies in new fields of activity often provide no sound basis for the determination of intrinsic value. Thus, it is important to identify the companies as highly speculative and not attempt to value them. Investing in this way can produce rich rewards, but they are an odds-setting process, not a valuation process. A relative valuation may be determined to obtain a value per customer metric. This valuation method compares only the knowledge economy universe of stocks that may be valid at the early portions of the business cycle.[xxiv]

Intangibles in knowledge economy stocks are becoming core drivers of value at the early stage of companies. It is possible to evaluate the market potential of any new idea; for example, how hard will it be to generate cash flow behind the idea and to ignite the company's stock price? Other, softer criteria may be, does someone need what the company is doing, does it have sustainable advantage, is there a business model that will lead to profitability, is the management good? Still other questions allude to intrinsic value: where is the talent, what are the relationships, how fast are the processes, where are the intellectual assets? These qualitative measures focus less on past performance and more on a company's ability to create wealth in the future.[xxv]

Impact of the Knowledge-Based Economy

The Internet represents a fundamental shift in the way that business will operate, creating enormous opportunities in hardware, software, and other technology. Powerful forces are converging that could set the stage for a long sustained economic boom in the next few decades—the transition to a knowledge-based society. The change taking place in information technology markets and the development of interactive applications is based on three factors that are rapidly occurring:

convergence, globalization, and universal network access. Unlike other technological changes, the rapid development and diffusion of these technologies have the potential to affect all economic sectors, organizational and work structures, public services, and cultural and social activities. The driving force behind economic growth and development in such a networked economy will be based on information. The term *knowledge-based economy* stems from a fuller recognition of the place of information in modern economies.[xxvi]

The investment in intangibles is important in a knowledge-based economy. It may be necessary to modify selected indicators of economic performance or to create new ones in order to accurately measure innovative performance and related outputs of a knowledge-based economy. Government may then incorporate these measures into their monthly or quarterly reports to help gauge the economy's performance. Thought and care will be essential in factoring these measurements into policy.

[i] U.S. Department of Commerce, *U.S. Industry and Trade Outlook 1998: Financial Services*, 47–9.

[ii] Tracy Longo, "Insurance-An Uncertain Trail Ahead: Insurers Have Their Work Cut Out for Them If They Hope to Compete in the 21st Century," *Financial Planning* (1 January 2000).

[iii] Mark Hulbert, "A Plan to Overcome Investor's Home Bias," *The New York Times*, 23 January 2000.

[iv] Council on Foreign Relations, *Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture Report of Independent Task Force*, Fall 1999, www.foreignrelations.org.

[v] G. Caprio and P. Honohan, "Restoring Banking Stability: Beyond Supervised Capital Requirements," *Journal of Economic Perspectives* 13, no. 4 (Fall 1999): 44.

[vi] In Germany, the punitive capital gains taxes—as much as 60 percent on profits when one company sells another—are being removed. (4: p.56) The hope is that this will spur restructuring by the traditional German corporation that owns stakes in many different companies.

[vii] Commercial and investment banks use securitization to package many different loans into large bundles of assets held in trust. Securities are issued and sold to investors representing indivisible interests in the trust (13: p.58).

[viii] Derivatives are not new or unique to the United States. What is new, is the way that U.S. investment banks increased the variety and complexity of derivative contracts and the growth in the amount of derivative transactions. (13: p.59)**.**

[ix] A variation of this type of financing was also used in the pending MCI/Sprint merger. MCI used a "mirror" tracking stock and a premium to acquire the existing tracking stock, thereby

providing a method for a new economy company and old economy company to merge. (2: p.16).

[x] In 1994, U.S. investment banks first started pushing junk bonds and other U.S.-styled leverage finance techniques in Europe. (17: p.1).

[xi] Morgan Stanley Dean Witter recently extended Germany's Kirch Group an $820 million loan after withdrawing an unsuccessful high-yield offering (15: p.7).

[xii] A customized package deal could include M&A advice, financing capital through a high-yield bond offering, followed later by an equity offering all under a specialized reduced fee structure.

[xiii] The following examples are just some of the recent ones. In January 2000, Salomon Smith Barney (SSB), part of Citigroup, bought Schroders—the largest British investment bank at the time—giving them a strong foothold in England. In 1998, Deutsche Bank bought U.S. Bankers—giving them a presence in the United States and expertise in investment banking, specifically the M&A area. In 1999, Merrill Lynch purchased British fund manager Mercury Asset Management for their expertise and their global reach—now Merrill truly has a global reach with ready access to the European and Japanese markets. These are just some examples how investment banks are consolidating based on geographical and functional expertise considerations to take advantage of economies of scale and scope.

[xiv] Walter Updegrave, "Ins and Outs of Indexes," *Money* (February 2000), 56.

[xv] Carol Vinzant, "The Dow Is Still a Relic," *Fortune* (22 November 1999), 1.

[xvi] Updegrave, "Ins and Outs," 58–60.

[xvii] Updegrave, "Ins and Outs," 60.

[xviii] Updegrave, "Ins and Outs," 60.

[xix] "Introducing the Fortune Stock Indexes," *Fortune* (6 March 2000), 130–131.

[xx] Kevin Kelly, "The Roaring Zeros," *Wired* (September 1999), 1–4.

[xxi] Joseph Nocera, "Requiem for the Bull," *Fortune* (28 September 1998), 3–4.

[xxii] Anne Harrington, "Has the Market Gone Mad?" *Fortune* (24 January 2000), 1–2.

[xxiii] Michael C. Perkins, "The Economy's New Clothes," *Red Herring* (December 1999), 374.

[xxiv] Nocera, "Requiem for the Bull," 6–9.

[xxv] Bill Birchard, "Intangible Assets + Hard Numbers = Soft Finance," *Fast Company* (October 1999), 328–330.

[xxvi] Global Information Infrastructures—Global Information Society (GII-GIS). *OECD* (1999): 4.

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