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FINANCIAL MODERNIZATION: WHAT'S IN IT FOR COMMUNITIES?

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INTRODUCTION

"Financial modernization" is often used as a pair of code words for the Gramm-Leach-Bliley ("GLB") Act, which was signed into law on November 12, 1999. Though the GLB Act will hasten the processes of financial consolidation and modernization modestly, those processes have been going on for the past few decades and surely would have continued even in the absence of GLB. Thus, GLB is only a part of the full sweep of financial modernization.

In this essay I will offer some thoughts about the consequences of financial modernization, both broadly considered and specifically in the guise of the GLB Act, for communities and their residents. Section I will review briefly the relative magnitudes of important components of the financial services sector, and some recent and longer-term trends. Section II will discuss the reasons for these trends. Section III will address the consequences for communities. Section IV will specifically address the Community Reinvestment Act ("CRA"). And then, I will offer a brief conclusion.

I. THE COMPONENTS OF THE FINANCIAL SERVICES SECTOR: SIZES, NUMBERS, AND TRENDS

Table 1 presents data on the asset sizes,[1] in billions of dollars, of the major components or sub-sectors of the financial services sector, as of the end of the calendar year 1999, which approximates

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[1] For comparison purposes, the 1999 value of the U.S. GDP — a flow — is placed a the bottom of the table.

the date of the passage of the GLB Act. Table 2 presents data on the numbers of enterprises in many of these sub-sectors. Table 3 portrays some important recent trends. The data are drawn from an amalgam of sources: government regulatory agencies, government statistical agencies, and trade associations.

As Table 1 indicates, the dollar magnitudes of these components are large.[2] The commercial banks, on which a considerable amount of public attention and regulatory effort is focused, accounted for almost five and a half trillion dollars at year-end 1999. But commercial banks were not the only sizable financial sub-sector. Other notable sectors included: savings institutions and credit unions, with over one and a half billion dollars in assets; insurance companies, with over four billion dollars in assets; mutual funds, with almost seven billion dollars; and pension funds, with over eight billion dollars. Finance companies and trade credit, often under-appreciated as sources of financing, totaled almost three billion dollars in assets. And the stock market, which attracted a considerable amount of attention in the 1990s, had an aggregate value of almost nineteen billion dollars.

Turning to Table 2, we see that there were tens of thousands of enterprises offering various financial services. The number of separately chartered commercial banks alone numbered 8,580, although the existence of bank holding companies reduced the number of bank organizations to about 6,600. In addition, there were over 12,600 savings institutions and credit unions, about 3,600 insurance companies, over 400 mutual fund companies that offered almost 8,000 funds, and about 7,700 securities firms. Despite the widespread attention given to the stock market, it is worth noting that only about 10,000 enterprises (out of about 22 million enterprises in the U.S.) were listed and traded.

Finally in Table 3 we see some important trends for banking. The financial services sector has been growing in relative importance; banks have been becoming fewer, larger, and healthier; banking has become more global; there has been reduced regulation and increased competition; there is more electronic banking, especially at the bank-

[2] The asset figures of Table 1 include some double counting; for example, the assets of banks include bond securities and mortgage backed securities; the assets of pension funds include mutual funds; the assets of mutual funds include stocks and bonds; etc.

to-bank "wholesale" level; but electronic banking has been slow to penetrate retail banking, as evidenced by the large number of checks that continue to be written every year (which contrasts with the rapid rise of the Internet for securities trading); and there has been a long-term decline in the relative importance of commercial banks within the financial sector.

We now turn to some explanations for these trends.

II. EXPLAINING THE TRENDS

A. Some History

A larger historical background on the financial services sector will provide a useful context for how and why the trends of the past few decades came to be.[3]

Traditionally, the U.S. financial services sector tended to be compartmentalized: banks did banking (i.e., accepted deposits and made loans); insurance companies underwrote and sold insurance; securities firms underwrote, sold, and made markets in securities; etc. Though there were exceptions — e.g., some large urban banks did both banking and securities activities — this general pattern prevailed. This pattern was inherited from the British financial services sector, and was sometimes reinforced by state and/or federal regulation.

Further, in eras when telecommunications were wholly absent or relatively primitive, much of financial dealings tended to be local in nature. Proximity of the parties involved in financial transactions followed from two essential features of finance: (a) the unavoidable delay between the act of lending (or investing or making an insurance commitment) and the act of repayment; and (b) the asymmetry of

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[3] A longer discussion of the historical sweep can be found in Bernard Shull, The Origins of Antitrust Banking: An Historical Perspective, 41 Antitrust Bull. 255, 258 1996).

information between borrower and lender as to the former's pre-loan repayment probabilities and post-loan (but pre-repayment) behaviors. With proximity, the lender could "size up" and reassure itself as to the creditworthiness of a potential borrower and then monitor the borrower's activities during the term of the loan; similarly, the potential borrower could present its best case to the lender. With the large geographic size and scattered population of the U.S., proximity implied that there would be large numbers of relatively small enterprises offering financial services of many kinds. State and federal regulation often reinforced this tendency.

Populist sentiments, with fears of the economic/social/political powers of financial institutions and their owners, favored keeping financial institutions small, dispersed, and locally focused. For example, most states restricted or entirely prohibited bank branching; in "unit banking" states such as Illinois and Texas, the prohibition on branching meant a proliferation of small single-location states spread throughout the state.[4] And all states prohibited branching across state lines. Thus, the U.S. in the late nineteenth century was a country that had tens of thousands financial services firms of various kinds scattered across the landscape.

After the turn of the century the processes of financial consolidation began. The improved telecommunications of the telephone and the telegraph meant that financial services firms could do more things over wider areas and longer distances. The most notable beneficiary was the securities industry. Relatively unencumbered by regulation at any level, securities exchanges centered on a few large cities, with New York clearly pre-eminent. The major stock brokerage "wire houses" spread their networks of retail distribution branch office broadly across the country. Banking also showed some signs of consolidation: the number of commercial banks peaked at 30,456 in 1920 and then fell to 24,970 by 1929.

The stock market crash of 1929 and the severe decline in economic activity that followed from 1929–1933, produced a wave of

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[4] By contrast, there were some states, such as California, that permitted unlimited branching within their borders. And there were others, such as New York, that permitted a limited amount of branching, but confined the branching to defined geographic areas within the state.

federal legislation that extended the federal government's regulatory powers in many directions; the financial services sector was prominent. Heightened federal regulation of banks and savings institutions encompassed stringent safety-and-soundness regulation, restrictions on entry, and ceilings on the interest rates that banks could pay to their depositors. The securities industry (and the publicly traded companies that issued them) was blanketed with extensive disclosure and investor safety requirements. Due to concerns that the securities activities of commercial banks had somehow contributed to the stock market crash and the wave of bank failures that followed, the Glass-Steagall Act of 1933 prohibited commercial banks from engaging in most securities activities. The Act also prohibited securities firms from owning commercial banks, thus strengthening the functional compartmentalization of American finance.

Further compartmentalization was imposed by the Bank Holding Company Acts of 1956 and 1970. Commercial banks were generally restricted to activities that were closely related to traditional banking. As such, the banks were prohibited from owning insurance companies and non-financial enterprises.[5]

The last major piece of regulatory legislation of this type was the Community Reinvestment Act of 1977. The CRA was a response to beliefs that some banks and savings institutions were "red lining" some low income communities and simply not lending to any borrowers in such communities. The Act imposed an obligation on banks and savings institutions "to meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions."[6]

[5] As the names of these acts imply, these restrictions also applied to the bank holding companies that were becoming an increasingly common ownership structure for banks.

[6] *See* Community Reinvestment Act of 1977, 12 U.S.C. § 2901 (1977) ("CRA").

B. The Reasons for the Trends.

We are now in a position to discuss the reasons underlying the trends described in Table 3. At base, the most important reasons are the dramatic and continuing improvements in data processing and telecommunications technologies, which are the core technologies for the provision of financial services. These improvements permit financial services to be offered over longer distances and in larger combinations. Simultaneously, there has been a deregulation movement that, since the early 1970s, has meant a loosening of governmental regulation in a number of industries,[7] including financial services. The dramatic technological improvements and the deregulation efforts have been symbiotic, at least for banks. Many bank managements wanted to take advantage of the wider capabilities that the improved technologies gave them; the reductions in regulatory barriers provided them with wider opportunities to take advantage of the expanded capabilities. But, the improved technologies and looser restrictions have also increasingly permitted non-banks to encroach on the services that were the preserve of banks in earlier decades.

The deregulation of financial services began in the early 1970s with the end of government-blessed fixed commission rates for stock brokerage transactions; this culminated in the "May Day" (July 1, 1975) freeing-up of all commission rates. Also in the 1970s some states eased their restrictions on intra-state bank branching, and by the late 1970s some states had begun negotiating and entering mutual compacts that permitted reciprocal bank entry across state lines. These efforts continued through the 1980s, and finally culminated in 1994 federal legislation (the Riegle-Neal Interstate Banking and Branching Efficiency Act) that explicitly permitted interstate branching.

Beginning in the mid 1970s, sharp-eyed lawyers began finding "loop-holes" in the Glass-Steagall Act's prohibitions, and banks began slowly moving into the securities business, starting first with discount brokerage. Also, interest rate controls on most deposits were

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[7] These include airlines, railroads, trucking, telecommunications, natural gas, and petroleum.

eliminated in the early 1980s, allowing market forces to determine rates. In the late 1980s banks began limited entry into securities underwriting and expanded those efforts in the 1990s. Federal regulators were generally sympathetic to banks' desires to expand into securities activities and indeed were broadly sympathetic to banks' desires to expand the general scope of their activities — over the opposition of other financial services providers, such as securities firms and insurance companies. Finally, after over two decades of trying to pass legislation that would formally rescind the Glass-Steagall barriers, but finding itself deadlocked by conflicting interest groups, the Congress succeeded in passing the GLB Act in late 1999.[8]

III. THE IMPACT ON COMMUNITIES

The impacts of financial modernization — both the longer trends and the GLB Act itself — are straightforward. Consolidation clearly means that there will be fewer locally based financial institutions. Localism will be reduced, especially in rural areas and small towns. But the improved technologies will mean that for many financial services most consumers will have wider choices. Telephones, automated teller machines (ATMs), and most recently the Internet will allow financial services firms, that are headquartered elsewhere, to have local branch offices or to conduct their transactions through the mail, the telephone, or the Internet. These methods are now standard for many financial services transactions.[9]

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[8] This overall sweep of deregulation has not been uniform. In the late 1980s and early 1990s, in response to the debacle of the insolvency and failure of thousands of savings institutions and banks, Congress passed legislation that considerably tightened the safety-and-soundness regulatory procedures that applied to depository institutions. See Lawrence J. White, The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation (1991); see also Lawrence J. White, Bank Regulation in the United States: Understanding the Lessons of the 1980s and 1990s, in Japan And The World Economy (forthcoming 2001).

[9] Examples include securities transactions, mutual fund transactions, loan applications, and deposit and withdrawal activities.

Another potential trend, though still nascent, will be a tendency for financial services firms to offer bundles of services. How extensive the bundles will be, and how receptive consumers will be to the bundles, are still open questions. The Citigroup "experiment" — the bundling of a commercial bank, a securities firm, and an insurance company; all under one corporate roof; and all providing products and services that can be "cross-sold" to customers — is just that. If successful, this bundling will mean that users of financial services will be able to do more "one stop shopping." However, though the GLB Act has legitimized this experiment, there have been few other banks that have proceeded much beyond the inclusion of a securities firm and the offering of mutual funds as part of their packages of services.[10]

As was discussed in the previous section, these tendencies toward consolidation had been present well before the passage of the GLB Act. The forces of technological change, accompanied by the rolling back of earlier regulatory restraints, have been potent. These trends surely would have continued even in the absence of GLB. But, GLB will provide a public policy nudge that is likely to accelerate them modestly.

As a consequence, though users of financial services may have physical or personal contact with fewer locally headquartered providers, they will surely have access to a far larger array of financial services that are offered by a larger number of electronically[11] accessible firms. Though those firms will be fewer and larger than was true even a decade ago, there will still be thousands of them. However, where a local presence seems to be important for competitive reasons — for example, in the provision of bank deposits, and in the provision of loans to small and medium size enterprises — vigilant antitrust enforcement will be necessary to ensure that mergers do not create positions of local market power.[12]

[10] And it is worth noting that efforts in the past to provide a broad array of financial services under one corporate roof, notably by American Express and by Sears, were not successful.

[11] Or by mail or telephone.

[12] For example, for bank mergers that involve overlapping branch structures

Also, the public purposes served by the safety-and-soundness regulatory restraints on banks and other depositories, on insurance companies, and on defined-benefit pension plans remain as valid in the new world of financial modernization as they have in the past. The more complicated nature of modern financial services firms may make these regulatory tasks somewhat more complicated. But modern regulators should be capable of handling these burdens.

In sum, the overall effects of financial consolidation — so long as antitrust enforcement and safety-and-soundness regulation remain vigorous — will generally be positive for the users of financial services.

IV. WHAT ABOUT THE COMMUNITY REINVESTMENT ACT?

The GLB Act contained a few provisions that, arguably, weakened the CRA. The regulatory examinations for smaller banks and savings institutions (with assets under $250 million) will occur less often for institutions whose last examination ratings were deemed "outstanding" or "satisfactory". The smaller institutions' argument was that they are community-oriented anyway and therefore the examinations have been largely a waste of time, effort, and money, especially for institutions that have performed well in the past. Also, agreements between financial institutions and community groups in connection with fulfillment of CRA obligations must be revealed, and there are annual reporting requirements on groups in connection with funds received in connection with such agreements. The proponents of this provision argued that some community groups were extracting "ransom" from banks, especially at the times of mergers (when CRA performance is especially scrutinized), and that "sunshine" should be applied to these arrangements.

Unfortunately, the entire CRA effort — though well

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in communities where bank branches are few, the U.S. Department of Justice's Antitrust Division routinely requires that the merging banks spin or sell off sufficient branches in the communities so as to maintain adequate local competition.

intentioned — is a misguided one.[13] It is a throwback to the simpler era of localized banks and savings institutions. The CRA also assumes that banks are, in essence, local public utilities that have monopoly power and earn monopoly rents and that some of these rents can be forced back into the community. It is a localist anachronism in the wider and more competitive financial world of the twenty-first century.

The flaw of the CRA can be simply stated: Banks earn their profits by making loans and providing other financial services to their customers in the best way that they can. If a loan or a service is perceived to be profitable, the bank will try to provide it; if not, then not. In this light, either the CRA is redundant (the bank will make the loans and provide the services anyway); or it is a requirement that the bank should make loans that it does not find profitable and somehow cover those losses — to cross-subsidize — with excess profits from other activities.

Perhaps, in earlier decades the local public utility model for banking was closer to reality. And perhaps in this protected and comfortable world some banks were passing up potentially profitable opportunities; and perhaps the CRA at that time could have spurred banks to take actions that they were overlooking. But those days have long since passed.

Instead, in the increasingly competitive world of financial services, excess profits are less likely to appear, and the opportunities for cross-subsidization diminish accordingly. Further, the localist orientation of the CRA is truly anachronistic in an era when the physical location of the provider of financial services is decreasing in importance. And the CRA may well have unintended negative consequences: Banks may be reluctant to establish a local presence in an area to provide any financial services if they believe that they may subsequently be obligated to provided services that they see as unprofitable.

The informal system of implicit pressures that the CRA places

[13] For an extended version of my views, see Lawrence J. White, The Community Reinvestment Act: Good Intentions Headed in the Wrong Direction, 20 FORDAM URB. L.J. 281 (1993).

on banks should be replaced with a formal system that relies on public subsidies for the financing of projects that cannot be financed through normal commercial channels, but serve an appropriate public purpose. Projects that can be justified to serve public purposes should properly be supported through the public fisc.

Further, to the extent that racial or other types of *personal* discrimination in lending is perceived to be the problem, more vigorous enforcement of anti-discrimination laws — notably, the Equal Opportunity Credit Act of 1975 — is a better way to proceed. This approach has the double advantage of being more direct in addressing the problem and of covering all lenders of all kinds, not just banks and savings institutions that are covered by the CRA.

CONCLUSION

Financial modernization — both in its broad interpretation and in the guise of the GLB Act — will generally be beneficial for communities and their residents. The Act ought to be welcomed as part of the process by which the forces of technological change and improve the efficiency and productivity of the U.S. economy.

TABLE 1: THE SECTORS, AND THEIR SIZES
($billions, assets year-end 1999)

Commercial banks	$5,735
Savings institutions	$1,149
Credit unions	$425
Life insurance companies	$3,150
Other insurance companies (property/casualty)	$891
Mutual funds	$6,846
Equity & bond funds	$5,233
Money market funds	$1,613
Securities brokers & dealers	$999
Finance companies	$956
Pension funds:	
Private	$4,998
State & local governments	$3,047
Government sponsored enterprises (GSEs)	$1,720
Government sponsored MBS	$2,292
Trade credit	$1,928
Market value, equity shares	$18,877
U.S. GDP	$9,255

TABLE 2: NUMBERS OF FIRMS
(1999, approximate)

Commercial banks	8,580
Commercial bank organizations	6,600
Savings institutions	1,640
Credit unions	11,016
Insurance companies	3,600
Insurance organizations	1,600
Mutual funds:	
Number of funds	7,791
Equity & bond	6,746
Money market	1,045
Number of companies	434
Finance companies	n.a.
Securities firms	7,700
Number of listed companies (publicly traded)	10,000
Number of enterprises in the U.S.	22,000,000

TABLE 3: RECENT TRENDS, AND SOME LONGER-TERM TRENDS

Relative growth of financial sector:	
% of GDP, 1970	4.0%
% of GDP, 1998	7.7%
Consolidation:	
# of commercial banks, 1985	14,423
# of commercial banks with assets > $10B, 1985	27
% of all bank assets in banks with assets > $10B, 1985	34.7%
# of commercial banks, 1999	8,580
# of commercial banks with assets > $10B, 1999	76
% of all bank assets in banks with assets > $10B, 1999	66.6%
Recent health of U.S. banks:	
# of banks closed, 1989	207 (loss = $6.2B)
# of banks closed, 1999	7 (loss = $0.8B)
Globalization:	
% of U.S. bank assets held by non-U.S. banks, 1973	3.8%
% of U.S. bank assets held by non-U.S. banks, 1999	19.0%
Reduced regulation	
More competition	
More electronic banking:	
Daily Fedwire transfers, 1989	$727B
Daily Fedwire transfers, 1999	$1,363B
But slow retail growth; 65 billion checks written in 1999!	
Rapid rise in the use of the Internet for stock trading	
Long-term decline in the relative importance of banks	