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HEADLINE: Reinventing the Bank; With Depression-Era Law About to Be Rewritten, the Future Remains Unclear

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BODY:

Twenty minutes after arriving in Washington from a whirlwind trip to China last week, Treasury Secretary Lawrence H. Summers strode into the Treasury's elegant diplomatic reception room on pressing business.

Through jet-lagged eyes, he faced several dozen lobbyists representing the titans of American finance--companies such as Citigroup, Merrill Lynch & Co., J.P. Morgan & Co., Chase Manhattan Corp. and Goldman Sachs Group Inc.--to deliver a message: Take nothing for granted, even if an industry-backed bill to overhaul decades-old bank law seems a sure bet to pass Congress.

Lobbyists had to continue to sell the bill's benefits to lawmakers, he said, by underscoring White House and industry predictions that it would create jobs, increase competition and, most important, help consumers. "He said it would be very unfortunate if any financial institution were to . . . suggest that they do not see the broad public purpose of the legislation," said a lobbyist who asked that his name not be used.

Many lobbyists interpreted Summers's words as a White House counterattack on criticism from consumer groups and some bankers, who say the legislation greatly enriches big business while providing few privacy or other protections for individuals or much benefit to small and medium-size companies.

The bill, which congressional leaders expect to pass the House and Senate this week and be signed into law by President Clinton, would make it easier for banks, insurers and securities firms to enter one another's turf. Analysts say it's likely to set off a spate of mergers over the next few years--combinations like last year's mega-merger of banking giant Citicorp with insurance and securities company Travelers Group Inc. to create Citigroup--and will cause consolidation of much of the industry into a handful of financial conglomerates.

Consumer groups and executives at some small banks argue that such financial concentration has never been good for consumers. A recent Federal Reserve report, for example, showed that bigger banks tended to charge higher fees for use of automated teller machines and other services. But industry executives say customers will see lower prices and more convenient services, such as consolidated financial statements and one-stop financial shopping. Treasury officials estimate the legislation would bring efficiencies that save the industry $ 15 billion a year.

Consumer groups turn their nose up at such estimates. "I question if that savings will ever be passed on to consumers," said Frank Torres of Consumers Union, which publishes Consumer Reports magazine.

While the long-term impact of the bill may be unclear, banking analysts and historians say a change in the law was inevitable, the result of decades of economic change that has made old rules outdated. And it's finally happening now, after 20 years of being pushed by banks, because of a new-found unity among bankers, insurers and brokers. Just four years ago, all sides were battling to keep one another at bay.

Corporations and individuals, aided by accelerating advances in computer technology, have changed their borrowing and investing habits drastically in recent decades, forcing banks and eventually other financial companies to change, too, by expanding into one another's products.

"There's a little game of catch-up by Congress going on to what's already happening in the marketplace," said Tom Theurkauf at the New York financial services research firm Keefe, Bruyette & Woods Inc.

The nation's biggest companies, for example, for years have bypassed banks altogether and gone directly to the securities markets for loans at cheaper rates, forcing banks to eye insurance and securities to make up the lost profit. And consumers have come to think of themselves as investors, not just savers. That has made consumers sensitive to even slight fluctuations in investment rates with a focus unthinkable 25 years ago, industry executives and government regulators say.

This has led to dramatic shifts in where money is kept. Commercial banks held 37 percent of all financial assets in 1980 but only 24 percent in 1998, according to the Federal Reserve Board. Mutual funds and pension funds, which held 21 percent of the nation's financial assets in 1980, held 49 percent last year.

To understand the genesis of the pending banking legislation is to understand how banks have fought to follow that flow of money, starting in the 1960s but more intensely in the 1970s and more keenly still in the 1980s and 1990s.

For more than a decade, the official strategy of the American Bankers Association, the largest bank lobby group, has been to poke as many holes in bank law as possible by persuading regulators to reinterpret existing law more liberally and fighting legal challenges to those new interpretations. The ultimate aim was legislation to repeal the Banking Act of 1933, better known as Glass-Steagall, and other laws that have separated commercial banking from investment banking and insurance.

Congress passed Glass-Steagall believing that the stock market crash of 1929 had been caused by banks that sold the public securities in shaky companies so the companies could repay loans to the bank--a cozy exchange of money that left investors holding the bag.

The law also barred banks from offering competitive interest rates on savings deposits. The theory was that such competition caused banks to offer ever-higher rates to lure cash into their doors, which then required them to make riskier--but potentially higher-yielding--investments to pay the higher rates. It was a vicious circle that would eventually sour the quality of loans on the banks' books, lawmakers thought.

Eventually economists came to believe that neither of these practices caused the 1929 crash or the Great Depression, but it has taken years for the law to reflect that historical revision.

Banks lived fairly happily through the 1940s and 1950s, but in the 1960s the Vietnam War sparked inflation, prompting banks to make a few attempts to circumvent the law and venture beyond their traditional activities of taking deposits and making commercial loans. Then interest rates soared in the 1970s after the oil price shock, with the prime lending rate reaching 21 percent in 1981, a high for the century.

Suddenly banks saw depositors withdraw their money in favor of higher-yielding instruments, such as money-market accounts, offered by innovators in the securities industry, such as Merrill Lynch. Congress responded in 1980 by voting to lift deposit rate caps over six years, freeing banks to compete for deposits.

It wasn't enough and bankers began to push for a complete overhaul of bank law. But bankers bet Congress wouldn't act until many of the changes had already taken place in the market and lawmakers saw they didn't hurt consumers or the U.S. financial system.

The securities and insurance industries, by contrast, are relative newcomers to the fight to change banking law. With the exception of a few companies, securities firms and insurers didn't embrace the cause and lobby alongside bankers until 1996.

When they did, they weren't motivated by wanting to change the law. Rather, they simply realized that bankers were already changing it. They reasoned it was better to help craft a new law in their own advantage than allow bankers to continue to dictate the shape of the financial landscape.

"We saw change was going to happen whether we participated in the discussion or not, and we realized we needed a seat at the table," said Jack Dolan, spokesman for the American Council of Life Insurance, a lobbying group for 500 companies that represents 80 percent of that industry's assets.

A key catalyst for changing the securities industry's mind was the Federal Reserve, which in the late 1980s began reinterpreting law to allow banks to engage in limited securities activities. Through the 1990s it gradually loosened those limits.

Securities firms, too, were pushing into banking. Merrill Lynch, for example, sent the banking industry crying foul and running to court in 1977 when it introduced its cash-management account, a way for consumers facing rising interest rates to earn market rates on checking-account deposits. Ten years later, in 1987, Merrill Lynch bought a savings and loan through which it could provide many bank products.

And the biggest securities firms, including Merrill Lynch, Goldman Sachs and Morgan Stanley Dean Witter, were establishing themselves as global financial companies. Many foreign countries already allow financial firms to both underwrite securities and make commercial loans, and U.S. securities firms wanted to expand into banking in those overseas markets.

But because securities firms aren't regulated by a U.S. bank regulator, many foreign governments have felt uncomfortable allowing them to offer bank products.

Under the pending bill, all financial conglomerates would be regulated by the Fed, which in addition to regulating banks is the nation's central bank. As such, it's the U.S. regulator foreign governments know and trust best. Merrill Lynch and others realized a change in bank law was needed for them to come under the Fed umbrella for foreign expansion.

Finally, in the spring of 1996 at a meeting in Boca Raton, Fla., the Securities Industry Association, the major industry lobby group, voted to join bankers in the fight to repeal old bank laws.

The catalyst for insurers was a 1996 Supreme Court case in which insurers lost their fight to use state regulators to limit bank entry into insurance. They, too, realized that banks were winning the war, so they were better off joining the enemy.

Some realized it years earlier. The board of the American Council of Life Insurance, for example, ordered its lobbyists as early as 1981 to stall any bank bill for at least five years, until insurers would become better prepared to sell bank products.

Once securities and insurance executives openly converted to bank allies in the fight to change the law, many began to see it as not only a defensive move against banks but also an offensive one that would keep them current with consumer demand.

It was a realization that some securities firms, notably Merrill Lynch, the largest retail brokerage company, had come to as early as the 1980s. "If you are only in stocks and bonds, you are really not in the broader wealth-management business," said Jerome Kenney, head of corporate strategy for the firm.

As consumers came to think of themselves as investors, they wanted a broader array of investment products, including money-market funds, insurance annuities, mutual funds and interest-bearing checking accounts. The idea of cross-selling a range of products to each customer put dollar signs in the eyes of many financial services executives.

"To some extent the prospect of linking arms with banks was a bitter pill, but the cross-selling was a big sweetener," Dolan said. Once arms were linked, marriage was natural next step.

"Any time you have groups that are effectively competing with each other and are selling the same product, there has to be a desire to merge to generate efficiencies," said John Mingo, founder and president of Mingo & Co., a financial services consulting firm in Bethesda.

And financial executives realized that loopholes in the law, no matter how big, weren't big enough. Banks were still limited in how big their securities business could be. Securities firms were still limited in how big their banking operations could be. And restrictions added costs.

After 1996 there was just one last group to come round: the independent insurance agents. Most joined the industry alliance late last year, albeit bitterly, for two reasons. One was that their key champion--House Speaker Newt Gingrich (R-Ga.)--left Congress, and another was that they realized momentum was building for a bill, with or without their support.

"We have fought comprehensive financial service reform for decades because we thought that insurance and banking should be kept separate," said Robert A. Rusbuldt, chief lobbyist for Independent Insurance Agents of America, the lobbying group for 300,000 insurance agents in all 50 states.

He said his group worries about potential conflicts of interest that could lead to consumer fraud or abuse. For example, he said, surveys show that many consumers believe any product purchased from a bank is federally insured, even though only deposits are insured, and only up to $ 100,000.

But now that Congress is about to allow banking and insurance to fully mix, he said, he supports the bill because it "contains enough consumer safeguards."

"It's by no means a perfect bill," he said, "but we can't let the perfect be the enemy of the good."

The silver lining, he says, is that independent insurance agents are going to diversify by offering products such as mutual funds and that "banks and investment banks will be looking to our distribution system to distribute their products."

Talk like this convinced lawmakers this year that industry had sufficiently ended its bickering, clearing the way for the creation of the bill likely to become law this week.

Once the bill passes, the industry will be under scrutiny by consumers and regulators alike to see if predicted cost savings result and if self-policying on consumer privacy issues works.

In addition to mega-mergers that create companies offering one-stop financial shopping, analysts predict the bill will speed the creation of big firms that specialize in one product, a phenomenon already seen today in such companies as Countrywide Home Loans in California or credit-card giant MBNA in Delaware.

These specialists and full-line companies will create an opening for smaller firms offering more personal service, analysts say. And the Internet will provide additional help in keeping consumers adept at comparison shopping, which should keep prices sharply competitive, said Undersecretary of the Treasury Gary Gensler.

Most industry analysts predict that even after the legislation is passed, banks will continue to be the biggest buyers in the merger game, with most securities and insurance firms being the acquired firms and disappearing under bank names.

Theurkauf at Keefe, Bruyette & Woods says that's because banking still dwarfs other financial industries. U.S. banks' market capitalization--the value of shares of stock multiplied by the number of shares outstanding--is $ 1 trillion, he said, compared with $ 175 billion for securities firms and $ 95 billion for life insurance companies.

In 1998, acquisitions of financial services companies totaled $ 573 billion worldwide, up sharply from under $ 100 million a year before 1995. Most of the acquisitions were in the United States. Banks were buyers in more than 70 percent of the mergers, while insurance companies were buyers 20 percent of the time.

"We are in an accelerated phase of the most dramatic structural change in the history of the financial industry," said Merrill Lynch's Kenney, who stresses that Merrill Lynch intends to be among the handful of financial giants that it predicts will be left standing when the merger dust settles in five to 10 years.

Change in Assets

The assets of major financial institutions have shifted dramatically over the past decade, with commercial banks accounting for a much smaller share of the market now.

Percentage of total assets 1998 1980

Pension funds 28% 17%

Commercial banks 24% 37%

Mutual funds 21% 4%

Insurance 16% 16%

Other depositories 6% 21%

Finance companies 4% 5%

SOURCE: Federal Reserve

GRAPHIC: Chart, The Washington Post

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