# Financial Services
# A Report on the Industry

June 2004


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# Report Documentation Page

*Form Approved*
*OMB No. 0704-0188*

Public reporting burden for the collection of information is estimated to average 1 hour per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Washington Headquarters Services, Directorate for Information Operations and Reports, 1215 Jefferson Davis Highway, Suite 1204, Arlington VA 22202-4302. Respondents should be aware that notwithstanding any other provision of law, no person shall be subject to a penalty for failing to comply with a collection of information if it does not display a currently valid OMB control number.

| 1. REPORT DATE | 2. REPORT TYPE | 3. DATES COVERED |
|---|---|---|
| **2004** | **N/A** | **-** |

4. TITLE AND SUBTITLE
**Financial Services A Report on the Industry 2004**

5a. CONTRACT NUMBER
5b. GRANT NUMBER
5c. PROGRAM ELEMENT NUMBER

6. AUTHOR(S)

5d. PROJECT NUMBER
5e. TASK NUMBER
5f. WORK UNIT NUMBER

7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES)
**The Industrial College of the Armed Forces National Defense University Fort McNair Washington, DC 20319-5062**

8. PERFORMING ORGANIZATION REPORT NUMBER

9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES)

10. SPONSOR/MONITOR'S ACRONYM(S)

11. SPONSOR/MONITOR'S REPORT NUMBER(S)

12. DISTRIBUTION/AVAILABILITY STATEMENT
**Approved for public release, distribution unlimited**

13. SUPPLEMENTARY NOTES

14. ABSTRACT

15. SUBJECT TERMS

| 16. SECURITY CLASSIFICATION OF: | | | 17. LIMITATION OF ABSTRACT | 18. NUMBER OF PAGES | 19a. NAME OF RESPONSIBLE PERSON |
|---|---|---|---|---|---|
| a. REPORT | b. ABSTRACT | c. THIS PAGE | | | |
| **unclassified** | **unclassified** | **unclassified** | **UU** | **28** | |

**Standard Form 298 (Rev. 8-98)**
Prescribed by ANSI Std Z39-18

# FINANCIAL SERVICES INDUSTRY STUDY REPORT - 2004


**ABSTRACT**

The financial services industry directly impacts America's ability to achieve its national security goals. It is the lifeblood of the economy. The financial services industry's infrastructure is designated critical by Presidential Directive – it accounts directly for nine percent of our Gross Domestic Product; more importantly, it supports virtually the entire economy by providing capital and liquidity for investment and operations.

The financial services portion of the United States' industrial base is generally strong. U.S. companies in this sector have transformed their business strategies to improve competitive advantages. The U.S. Government must also change by streamlining regulations and organizations to help assure continued success relative to global competition and to minimize the potential for the profit motive based to result in moral hazard behavior. A positive finding of the study is that significant security upgrades were implemented in the aftermath of 9/11. Finally, concrete steps must be made to reform Government Sponsored Enterprises that have become "too big to fail."

There is a need to improve Defense Department financial policies and procedures. A better understanding of the behavior of capital markets by lawmakers, policy-makers and planners/programmers would result in more effective and efficient use of taxpayer dollars in funding defense procurement and operations. The cost of capital dynamics that impact our suppliers are, to a great extent, underappreciated by government officials.


## Participants


Mr. Jay Aragon, Department of the Air Force
Col Milan Celko, Slovakia Air Force
CDR Brian Drapp, USN
CDR Moises Del Toro, USN
Ms. Sandy Goodman, U.S. Southern Command
LTC Dave Griffith, USA
Lt Col Ed Keegan, USAF
CDR Dave Kiel, USN
Lt Col Mark Lane, USAF
LTC Gary Langston, USA
Lt Col Dave Miller, USAF
CDR Ingrid Phillips, USN
Mr. Lou Torchia, Defense Contract Management Agency
Mr. Michael Walsh, U.S. Agency for International Development

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**Speakers at ICAF**

United States Bankruptcy Court for the District of Maryland
Office of the Comptroller, United States Air Force
American Bankers Association
Hong Kong Economic and Trade Office
Center for Strategic and International Studies
The Heritage Foundation

**Local Visits/Briefs:**

Federal Reserve Bank, Washington, DC
Bank of America Greater Washington, Washington, DC
Securities and Exchange Commission, Washington, DC
Pentagon Federal Credit Union, Alexandria, VA
Financial Crimes Enforcement Network (FinCen), Tysons Corner, VA
Commodity Futures Trading Commission, Washington, DC
European Commission Delegation, Washington, DC
World Bank, Washington, DC
United States Export-Import Bank, Washington, DC
National Association of Securities Dealers, Rockville, MD

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Chicago Board of Options Exchange, Chicago, IL
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Citibank Private Bank, New York, NY
Citibank/Salomon Smith Barney, New York, NY
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HSBC, London
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Japanese Banker's Association, Tokyo
Financial Times, Tokyo Bureau, Tokyo
Bank of Japan, Tokyo
National Diet of Japan, Tokyo
Morgan Stanley Japan, Tokyo
Mr. Milton Isa (formerly of State Street Bank Japan), Tokyo
Shinsei Bank, Tokyo
Tokyo Stock Exchange, Tokyo

**ACKNOWLEDGEMENTS**

We would like to offer our heartfelt thanks to our speakers – from subject matter experts to Chairmen and Chief Executive Officers, who found time in their busy schedules to candidly offer their views, and answer our questions, on the industry in general, and the business strategies of their companies or the role of their government agencies. We were granted extraordinary access to leaders in private industry – for which we are very grateful.

We also offer a special thanks to the staffs of our speakers who coordinated our visits and helped us immeasurably with outstanding support.

Finally, our visit to Tokyo was exceptionally successful in large part due to the efforts of numerous personnel in the American Embassy. We cannot thank them enough.

Over 80(!) speakers and briefers are listed below (in chronological order):

| Name | Company/Organization | Date | Location |
|---|---|---|---|
| Hon. Duncan W. Keir | U.S. Federal Bankruptcy Court | 28-Jan-04 | Ft McNair |
| Mr. Patrick Mulloy | (Former General Counsel of) Senate Banking Committee | 28-Jan-04 | Ft McNair |
| Mr. Frank Pollack, CEO | Pentagon Federal Credit Union | 6-Feb-04 | Alexandria, VA |
| Mr. William Baity | Financial Crimes Enforcement Network | 6-Feb-04 | Tysons Corner, VA |
| Mr. Keith Leggett | American Bankers Association | 11-Feb-04 | Ft McNair |
| Mr. James B. Bittman | Chicago Board of Options Exchange | 4-Mar-04 | Chicago |
| Mr. Peter Howland | Chicago Board of Trade (CBOT) | 4-Mar-04 | Chicago |
| Mr. Tim Malishenko | The Boeing Company | 4-Mar-04 | Chicago |
| Mr. Todd Adams | The Boeing Company | 4-Mar-04 | Chicago |
| Mr. Ruud Roggekamp | The Boeing Company | 4-Mar-04 | Chicago |

| Name | Company/Organization | Date | Location |
|---|---|---|---|
| Ms. Bavan Hollaway | The Boeing Company | 4-Mar-04 | Chicago |
| Mr. John E. Scully | LaSalle Bank Corporation | 5-Mar-04 | Chicago |
| Mr. Brian T. Sullivan | The Sullivan Companies, Inc. | 5-Mar-04 | Chicago |
| Mr. William Couper, President | Bank of America Greater Washington | 11-Mar-04 | Washington |
| Mr. William Wood | Bank of America Greater Washington | 11-Mar-04 | Washington |
| Ms. Cheryl P. Taylor | Board of Governors, Federal Reserve | 11-Mar-04 | Washington |
| Mr. Pierre A. Chao | Center for Strategic & International Studies | 18-Mar-04 | Ft McNair |
| Mr. Moreno Bertoldi | European Commission Delegation | 18-Mar-04 | Washington |
| Ms. Amy H. Medearis | European Commission Delegation | 18-Mar-04 | Washington |
| Mr. David C. Chavern | Export-Import Bank of the United States | 19-Mar-04 | Washington |
| Maj Gen George Miller, USAF (ret) | Secretary Air Force/FM Ofc of Comptroller | Multiple dates | Ft McNair and New York |
| Mr. William Earner | Navy Federal Credit Union | 25-Mar-04 | Ft McNair |
| Mr. Andrew Wilson | Center for International Private Enterprise | 26-Mar-04 | Ft McNair |
| Mr. John J. Tkacik, Jr. | The Heritage Foundation Asian Studies Center | 2-Apr-04 | Ft McNair |
| Mr. Homi Kharas | World Bank | 2-Apr-04 | Washington |
| Ms. Maya Brahmam | World Bank | 2-Apr-04 | Washington |
| Mr. Joe C.C. Wong | Hong Kong Economic & Trade Office | 7-Apr-04 | Ft McNair |
| Mr. Scott J. Budde | TIAA-CREF Investment Managing | 12-Apr-04 | New York |
| Mr. Joel Allegretti | American Institute of Certified Public Accountants | 13-Apr-04 | New York |
| Mr. Alan Anderson | American Institute of Certified Public Accountants | 13-Apr-04 | New York |
| Mr. John Morrow | American Institute of Certified Public Accountants | 13-Apr-04 | New York |
| Mr. A. George Gero | Legg Mason Wood Walker, Incorporated | 13-Apr-04 | New York |
| Mr. James Buehler | Legg Mason Wood Walker, Incorporated | 13-Apr-04 | New York |
| Mr. Horace Lowman | Legg Mason Wood Walker, Incorporated | 13-Apr-04 | New York |
| Mr. Joseph J. Grano, Jr., Chairman and CEO | UBS Financial Services, Inc. and Chairman, Homeland Security Advisory Council | 13-Apr-04 | New York |
| Mr. Seth Waugh, CEO | Deutsche Bank Americas | 14-Apr-04 | New York |
| Mr. John Dudzik | Deutsche Bank Americas | 14-Apr-04 | New York |
| Ms. Perry Trimble | Deutsche Bank Americas | 14-Apr-04 | New York |
| Mr. Hossein Amir-Aslani | J.P. Morgan Securities, Inc. | 14-Apr-04 | New York |
| Mr. Robert Osieski | J.P. Morgan Securities, Inc. | 14-Apr-04 | New York |
| Mr. Matthew Massie | J.P. Morgan Securities, Inc. | 14-Apr-04 | New York |
| Ms. Goksu Yolac | J.P. Morgan Securities, Inc. | 14-Apr-04 | New York |
| Mr. Louis Bremer | J.P. Morgan Securities, Inc. | 14-Apr-04 | New York |
| Dr. Steven Malin, Senior Economist | New York Federal Reserve Bank | 14-Apr-04 | New York |
| Mr. Peter Quick, President | American Stock Exchange | 15-Apr-04 | New York |
| Mr. Patrick Campbell | American Stock Exchange | 15-Apr-04 | New York |
| Ms. Kristen Winter | American Stock Exchange | 15-Apr-04 | New York |
| Ms. Crystal Carrafiello | Moody's Investors Service | 15-Apr-04 | New York |

| Name | Company/Organization | Date | Location |
|---|---|---|---|
| Mr. David Berge | Moody's Investors Service | 15-Apr-04 | New York |
| Mr. Peter M. Dawkins, Vice Chairman | The Citigroup Private Bank | 15-Apr-04 | New York |
| Mr. Wm. Stuart Shepetin | TIAA-CREF Investment Managing | 15-Apr-04 | New York |
| Ms. Elizabeth Eodice | TIAA-CREF Investment Managing | 15-Apr-04 | New York |
| Mr. Abraham Gulkowitz | Brookville Capital Management | 16-Apr-04 | New York |
| Mr. Phillip Winiecki | Citibank/Salomon Smith Barney | 16-Apr-04 | New York |
| Mr. Kenneth Shidler | Citibank/Salomon Smith Barney | 16-Apr-04 | New York |
| Mr. Ish McLaughlin | Citibank/Salomon Smith Barney | 16-Apr-04 | New York |
| Mr. Stephen Edelman | Citibank/Salomon Smith Barney | 16-Apr-04 | New York |
| Mr. John Slowik | Citibank/Salomon Smith Barney | 16-Apr-04 | New York |
| Mr. Eric H. Hertting | Lockheed Martin Corporation | 16-Apr-04 | New York |
| Mr. Daniel B. Matthews | Northwest Airlines, Inc. | 16-Apr-04 | New York |
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| Ms. Tanya Roper | Bank of America (U.K. Operations) | 4-May-04 | Bromley, U.K. |
| Ms. Colette Tobin | Bank of America (U.K. Operations) | 4-May-04 | Bromley, U.K. |
| Ms. Gail Bishop | Bank of England | 4-May-04 | London |
| Amb. Mark Sullivan | European Bank for Reconstruction and Development (EBRD) | 4-May-04 | London |
| Mr. Philip Brown | Citibank | 5-May-04 | London |
| Mr. Eirik Winter | Citibank | 5-May-04 | London |
| Mr. Graham Bishop | Citibank | 5-May-04 | London |
| Mr. Kenneth Borton | Citibank | 5-May-04 | London |
| Mr. Simon McGeary | Citibank | 5-May-04 | London |
| Mr. Darrel Uden | Citibank | 5-May-04 | London |
| Mr. Tim O'Brien | HSBC | 5-May-04 | London |
| Mr. Robin Osmond | HSBC | 5-May-04 | London |
| Mr. Patrick Butler | HSBC | 5-May-04 | London |
| Mr. Ian Godfrey-Davies | HSBC | 5-May-04 | London |
| Mr. Martin Leach | Lloyd's of London | 6-May-04 | London |
| Mr. Kindaichi, Hiroo | Bank of Japan | 10-May-04 | Tokyo |
| Mr. Robert Kaplan | Department of Treasury (U.S. Embassy Japan) | 10-May-04 | Tokyo |
| Mr. David Pilling | Financial Times | 10-May-04 | Tokyo |
| Ms. Hosaka, Asako | Japanese Bankers Association (JBA) | 10-May-04 | Tokyo |
| Hon. Shiozaki, Yasuhisa | National Diet of Japan, Member, House of Representatives | 10-May-04 | Tokyo |
| Mr. Milton Isa | (Formerly of) State Street Bank | 11-May-04 | Tokyo |
| Mr. Robert Alan Feldman | Morgan Stanley Japan | 11-May-04 | Tokyo |
| Mr. Thierry Porte', Vice Chairman | Shinsei Bank | 11-May-04 | Tokyo |
| Mr. Akamine, Shin | Tokyo Stock Exchange | 12-May-04 | Tokyo |

***3-6-3 Rule***

- ***Borrow money from your depositors at 3 percent***
- ***Lend it to others at 6 percent,***
- ***Be on the golf course by 3***

- Old Banker's Business Model

Introduction

Capital is the fuel for the economic engines of the world's strongest economies. Without ready access to capital, industry cannot operate efficiently – or, in some cases, cannot operate at all. Without the free flow of capital, the economy will sputter to a halt, undermining our national power as well as our way of life. Much of America's strength is derived directly from the entrepreneurial character of our people and from our free market economy. Both are dependent on the free flow of capital. The financial services industry is a large and diverse industry. It moves capital to where it is needed to fuel growth, lower investment risk, and promote the economic well being of our people, which provides America her power. To achieve these goals efficiently and fairly, transparency is essential in the industry.

Strong national power is not possible in the 21st century without a healthy and stable economy supported by a growing financial services sector. We cite two recent examples as evidence. First, consider the Soviet Union of the late 20th century that built an unsustainable military capability relative to its economic capacity. Second, the situation in Japan since 1989 illustrates how the inefficient use of capital ultimately led to more than a decade of negative growth and deflation.

The financial services industry has remained strong despite the downturn in the overall economy following the burst of the stock market bubble in 1999-2000. Globalized capital markets have a direct impact on America's long-range national security goals. There are many challenges to be discussed with respect to promoting international growth and stability through the financial services industry. We will focus on areas requiring attention by senior government/industry leaders.

We observed that the "3-6-3" rule is dead, killed by competitive market forces which consolidated the industry and reduced margins as the market searched for more efficient use of capital. Here's the 'Rest of the Story'…

The "Old Banker" is now out-of-business. As he played golf, the New Banker grew his own bank into a world-class financial institution paying better rates, offering more services, and successfully competing in a new global environment. The New Bank acquired the Old Bank and eliminated outdated processes (i.e., the Old Banker).

Financial Services Industry Defined

The financial services industry is a vast complex system of interrelated activities. Businesses and individuals seek to increase their assets through savings and investments. They borrow funds to purchase assets or finance business opportunities. The financial services industry manages these activities by bringing savers, investors, and borrowers together. Banks act as intermediaries. They take deposits and lend funds to those who need credit. Securities firms facilitate the process of buying and selling corporate debt and equity to investors. Insurance companies safeguard the assets of its policyholders by investing premiums it collects in corporate and government securities. Finance companies provide credit to both individuals and businesses by issuing bonds, commercial paper, and asset-backed securities. Private/government pensions, government lending enterprises, and federally-related mortgage pools, as well as government and corporate regulators round out membership of the financial services industry. With assets totaling over $37 trillion, the financial services industry accounts for $905 billion (or nearly 9%) of the U.S. Gross Domestic Product,[i] a percentage that has remained steady for the past several years.

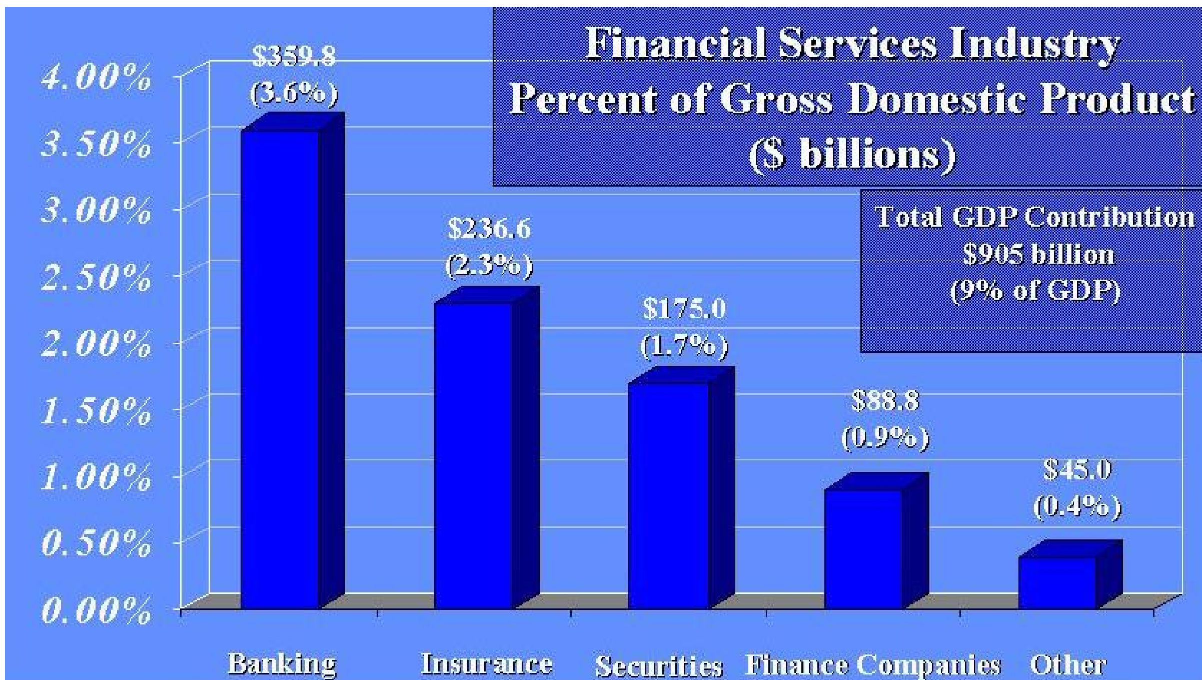


**Figure 1 – Percent of Gross Domestic Product from Financial Services in U.S.**
(Source: U.S. Department of Commerce, 2003: 2001 Results[ii])

**Banking.** Banking is the largest sector within the financial services industry and includes all depository institutions, from commercial banks and thrifts (e.g., savings and loan associations and savings banks) to credit unions and community banks. Banks use the funds they receive from depositors to make loans to individuals and businesses, seeking to earn more on their lending activities than it costs them to pay depositors and fund their operations. In doing so, they manage many risk factors, including interest rates, which can result in a mismatch of assets and

liabilities.[iii] Consumers rely on banking institutions to maintain their savings for retirement and emergencies. Businesses, especially small and medium-sized companies, use bank loans as a primary source of capital to fund their investments and operations.

The U.S. central bank is the Federal Reserve (the "Fed"), established by Congress in 1913 to regulate the money supply according to the needs of the U.S. economy. The Fed attempts to do this by changing reserve requirements and the discount rate that banks pay for loans from the Federal Reserve System. They also control the money supply by increasing or decreasing their open-market operations through the buying and selling of federal securities. When the Fed buys Treasury bills, reserves in the federal banking system and the overall money supply rise. When it sells T-Bills, reserves in the system shrink, which tends to push up interest rates and, therefore, the cost of credit. Fed policy has a major impact on the banking sector, since bank margins are very sensitive to interest rates.[iv]

**Securities.** The securities industry consists of brokers and dealers, investment banks and advisers, stock exchanges and their associated regulators. These entities facilitate the flow of funds from investors to companies and institutions seeking to finance expansions or other projects. Firms that make up the securities sector may specialize in one segment of the business or engage in a wide range of activities that includes brokerage, asset management, advisory services and investment banking.[v]

Investment banks underwrite new debt securities (bonds) and equity securities (stocks) issued by private or government entities to finance projects and operations. They buy new issues and act as wholesalers in selling them primarily to institutional investors such as banks, mutual funds, and pension funds. Investment bankers may also be called securities dealers or broker/dealers, because many participate in the financial market as retailers selling to individual investors.[vi]

Exchanges are markets where sales of securities are transacted. Most stock exchanges are auction markets where stocks are traded through competitive bidding in a central location. The oldest exchanges in the United States are the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX). The National Association of Securities Dealers operates a national electronic stock market, the NASDAQ, for over-the-counter (OTC) securities. Securities traded in the OTC markets are generally those not listed by major exchanges. Seven regional exchanges and others specialize in commodities and derivatives. The Chicago Mercantile Exchange and the Chicago Board of Trade, for example, are markets where both futures and options on financial and agricultural products are traded. Technology improvements have enabled exchanges to meet the demands of growing investor participation.[vii]

The Securities and Exchange Commission (SEC), established by Congress in 1934 to minimize the risk of stock market crashes and other irregularities regulates these securities markets. Its mission is to protect investors and maintain the integrity of the markets by enacting new regulations and interpreting and enforcing existing laws, with a special focus on protecting small (and naive) investors. A component of the Securities Act of 1933 is the requirement that publicly held companies disclose their financial information, ensuring that potential investors have the key information needed for investment decisions.[viii] In 2002, Congress passed the

Sarbanes-Oxley Act, designed to restore shareholder confidence in publicly traded securities following a series of highly publicized corporate scandals. Its goals are to provide greater transparency in corporate accounting and reporting by making board members and executives personally responsible for financial statements.[ix]

**Insurance.** The insurance industry safeguards the assets of its policyholders, ensuring that they or their families can reestablish normalcy in their lives and continue to contribute to the economy after a disaster. Insurance companies invest the premiums they collect for providing this service to pay claims as they arise. The insurance industry is divided into two groups, life/health and property/casualty. Many large insurers offer both life/health and property/casualty insurance, and a number are expanding into other financial services sectors, including banking and mutual funds. All types of insurance are regulated by the states, with each state having its own set of statutes and rules. State insurance departments oversee insurer solvency and market conduct. The National Association of Insurance Commissioners develops model rules and regulations for the industry; however, state legislatures must approve them before they can be implemented.[x]

**Finance Companies.** Finance companies, mortgage bankers and brokers are often categorized as non-depository institutions, because they make loans to businesses and individuals without taking in deposits. They acquire funds to make these loans largely by issuing commercial paper and bonds. Finance companies compete directly with banks, savings institutions, and credit unions; and they serve a variety of consumers. Captive finance companies are affiliated with car and appliance manufacturers, and finance dealer inventories and consumer purchases of their products -- sometimes at below-market rates. Consumer finance companies make loans to consumers who want to finance purchases of large household items or refinance small debts. Business finance companies offer commercial credit, making loans secured by the assets of the business, to wholesalers, manufacturers, and purchasing accounts receivable at a discount.[xi]

**Regulators.** All aspects of this industry are regulated through government established agencies such as the Federal Reserve System, State Banking and Insurance Commissioners, and the Securities and Exchange Commission as well as “self-regulation” such as the National Association of Securities Dealers (NASD) for stocks and credit rating agencies such as Moody’s or Standard and Poor’s for bonds.

## Overview of Current Conditions

Gross Domestic Product (GDP) is predicted to rise modestly in the short and long-terms.[xii] GDP growth is important in the general sense since a strong economy fosters more successful businesses and a healthy financial services industry. Interest rates hit a low point in 2004. Indications are that while interest rates will begin to rise, and the financial services industry will remain highly competitive.

Between 2003 and 2004, the net operating income for FDIC commercial banks is forecasted to increase from $90.5 billion to $98.4 billion, or roughly 8.7%.[xiii] Mergers and acquisitions are expected to continue in the U.S. at a reduced but steady pace to improve market

share, diversify services, reduce operating costs, and improve business "synergies." Providing corporate loans, banking services to commercial businesses, and acquiring new business are the mainstays of revenues and income, especially in the banking industry. Non-interest incomes continue to be a growing part of bank portfolios. Diversification, minimization of risk, and preparing for the increase in interest rates are all strategies being employed in today's market. Yet, with the increase in size and complexity, credibility and reputation remain key parts of a financial service business strategy. Not only must a business remain credible to attract good business; it must also select reputable corporate clients to minimize its risk. Increasing technical sophistication combined with interpersonal relationships will continue to be as valuable now as they were at the dawn of the financial services industry in the 19th Century. The following provide additional details regarding these trends.

**Regulation.** Despite a general tendency towards government deregulation, financial services are more subject to regulation than ever before in response to recent corporate scandals. The consolidation of the banking, securities and insurance industries has led to increased overlap among regulatory agencies. The Federal Reserve, SEC and Commodity Futures Trading Commissions may each pay visits to mega-banks that provide a range of financial services. Firms that break the law or regulation risk sanctions from these regulators, prosecution from the Department of Justice or the State Attorneys General, suspension from the Exchanges, fines from NASD and negative findings by internal auditors. Under the recently passed Sarbanes-Oxley Act, CEOs and members of the board may be held personally liable for these transgressions. Clearly, the industry is highly regulated. At risk is the market's credibility and viability, important components of the nation's economic power.

**Reputational Risk.** With recent scandals in accounting firms, big corporations, and mutual funds, reputation has become increasingly important to financial services firms. Among banks and Wall Street financiers, this is termed reputational risk.[xiv]

Reputation, or character, is again becoming important to the financial services industry. As in the past, described by Nelson Aldrich in his witty book, *Old Money*, the great banker, J. P. Morgan, Jr., was quoted to have replied when asked by Congress:

> "Is not commercial credit based primarily upon money or property?"
> 'No, sir,' said Morgan; 'the first thing is character.'"[xv]

**Non-interest Income.** Given the pressures on profit margins in the financial industry, many of the banks are more aggressively seeking income other than interest on loans. Because of the Gramm-Leach-Bliley Financial Services Modernization Act of 1999 (that overturned the Depression-era Glass-Steagall Act), banks are allowed to underwrite corporate debt securities, offer stocks, and to provide a panoply of consumer investment services. Initially banks were allowed to earn up to 5% of their revenues from securities; that percentage has increased to 25% in 2003.[xvi]

Fees charged by banks have also become more sophisticated. With a greater reliance on Internet banking to pay bills, the way money flows in the retail markets has become more

complex. Fees for checking accounts and other services add to the consumer and commercial banking revenue. Consumer credit card and debit card usage generates fees paid by merchandisers. ATM fees have also become significant consideration in income strategies of banks.

**Mergers and acquisitions,** (M&As) in the financial services industry have proceeded unimpeded without significant government interference. In fact, the Citicorp-Travelers merger precipitated the 1999 overturn of Glass-Steagall by the Congress. Now, Citigroup has over 100 million customers in 100 countries, with 150,000 employees, and over $700 billion in assets.[xvii] While M&As have slowed in 2003, this trend will continue into the near future.

**More Efficient Operations.** Efficient operations are becoming more important to the financial services industry as profits are squeezed. Banks have sought to improve their "efficiency ratios" (non-interest expenses divided by net operating revenues). They now target efficiency ratios in the low-middle 50% range. Controlling expenses has led banks to better efficiency ratios, which had been in the lower 60% range during the 1990s.[xviii]

Another way of minimizing the cost of operations is outsourcing (domestic and international). With the advent of worldwide communications and readily available information, workers in other parts of the world are being recruited more than before to make U.S. financial services' labor more efficient.

**International Presence for U.S. Financial Services Corporations.** Access to geographic regions within and outside the U.S. will continue to be a major strategy of the U.S. financial services industry. Overseas expansion will continue, despite the threat of terrorism. Reasons to expand overseas include serving U.S. corporate clients or working to acquire market share in a less competitive area.

Despite the long established presence of U.S. corporations overseas, the banking industry has been slow to move into foreign territory. The changes came from within the banking industry itself and primarily through changes to the regulatory environment. Further access to international markets was granted in 1981, when the Federal Reserve approved the formation of "international banking facilities" (IBFs), which opened up this area of opportunity.[xix] Chase Manhattan Bank was one of the first to internationalize its operations during the 1970s. The push to change the Chase "culture" is fittingly presented in David Rockefeller's autobiography.[xx]

Risk, both from a government and commercial standpoint, remains a valid impediment to overseas moves. For example, after the Russian economic crisis of 1998, big U.S. commercial banks have been reluctant to return. The Asia crisis of the late-90s had a dampening effect as well.[xxi] Once stability and reforms have been adopted, banks will again return, though usually following U.S. businesses or institutions.

**Interest Rates and Mortgages.** Most analysts, as well as Federal Reserve Chairman, Alan Greenspan,[xxii] agree that interest rates have reached a low and will rise sometime in the near future. The strategy for rising interest rates is more favorable to banks that are asset-sensitive.

An asset-sensitive bank is one that has more assets that will mature than liabilities, or a *positive gap*. For falling interest rates, the reverse is true, strategy favors the liability sensitive banks, and thus they have a *negative gap*.[xxiii]

Mortgage volume remains steady but shows signs of a decline as the refinance boom slows. For financial service companies whose strategies deal heavily with consumer lending, market share could decline. According to Standards & Poor's, "…banks that focus on consumer lending, those with relatively diversified loan portfolios, full consumer product lines, and strong sales cultures are better positioned to compete in a post-mortgage-boom environment."[xxiv]

Global/International Trends

The world economy is doing well, benefiting from a healthier U.S. economy, low interest rates and decline of the US dollar. The financial services industry worldwide faces a number of challenges:

(1) Inefficiencies due to protectionist regulations that burden economies with unproductive industries;
(2) Pegged exchange rates that do not respond to trade fluctuations;
(3) Instantaneous movement of capital around the world put at risk by inadequate information on condition of entities seeking financing in international financial markets; and
(4) Inadequate rule of law and supporting institutions to effectively harness private property for collateral in financing small and medium enterprises in developing countries.

An overview of some of the trends currently influencing the financial services industry worldwide follows.

**Europe:** The economies of Western Europe are starting to revive from flat growth. However, Europe is burdened with an aging population, inflexible labor policies, looming pension costs and an already high public debt ratio. Over-regulation and protectionism further hamper its banking sector.

United Kingdom (U.K.): The U.K., in contrast to continental Europe, has made dramatic economic improvements in the past 25 years through privatization of industry and allowing market forces to drive the economy. Per capita GDP is the strongest in Europe, surpassing France and Germany, while maintaining low government debt. With a strong Pound, the U.K. is doing quite well. The jury is still out on whether they will adopt the Euro.

**Asia:** The Japanese economy is also showing signs that its deflationary problems may be ending. GDP has grown in Japan during six of the last seven quarters; however, forecasters differ on whether this is merely a cyclical upturn or a return to long-term growth.[xxv] Similar to Europe, Japan is burdened with an aging population and employment practices that impact productivity. Some changes are underway – lifetime employment is no longer deemed a societal

right and recent banking reforms have resulted in the institution of a deposit insurance system. (Previously, the government of Japan fully backed all deposits with the full faith and credit of the government – with no limits on losses to be covered.) The biggest factors hampering Japan's financial services industry is the magnitude of unresolved, non-performing loans and the misallocation of capital to "zombie" companies.

**China** warrants special mention. Its economy has been growing at a tremendous rate, but is severely threatened by demographics (an aging population and the consequences of the one child policy). Sustaining this high economic growth rate is jeopardized by a banking sector with huge non-performing loans, the threat of inflation, and a fixed exchange rate.

**Emerging Markets** (including South and Central America, Central and Eastern Europe, Middle East and Africa). Developing countries would benefit from strengthened rule of law, especially property laws and land reform, coupled with supporting institutions, to harness collateralization of private property for development of small and medium enterprises (SMEs).

Outlook

The United States financial system's perseverance, technology, and flexibility post September 11, 2001 are testaments to our decentralized and diversified economic structure. Emerging from the effects of 9/11 and on the heels of the largest stimulus package in U.S. history, reaching over $375 billion, discretionary spending grew more than 12 percent in fiscal year 2003. Consequently, all indications are that the recession that started March 2001, plagued with stubbornly high unemployment and lower industrial production, has given way to growth. Supported by positive first quarter 2004 reports; the U.S. economy appears to have turned the corner. The unemployment rate is down, industrial production is trending upward while wholesale and retail sales are climbing. In addition, market developments, regulatory relief, and legislative reform have ensured that banks, insurance companies, securities firms, finance companies, and a host of other participants, including pension funds, hedge funds, trusts, and mutual funds, are all conducting sound and customer supported business.

We believe the three biggest factors affecting the industry are: the economy, competition, and changes in the regulatory environment. In determining the outlook of the financial industry, our group considered these three factors while analyzing current market developments. Despite their perceived conservatism, financial strategies have become resilient and flexible as competition increases, the economy changes, and profit margins tighten. It has been one of the industries least affected by the recent economic recession. However, not unlike other profit-oriented industries, the financial services industry, in an effort to attract and/or maintain a strong customer base while pursuing profits, is constantly seeking to gain a competitive advantage. As a result, financial institutions are continually leveraging and managing risks. We believe this trend will intensify as the market place becomes more competitive. Unfortunately, the intense competitive nature of the industry has led to pockets of unscrupulous behavior.

To counter potential criminal or unethical practices, both government and industry will continue to establish laws and regulations designed to protect the customer while maintaining the integrity and security of the industry. The Sarbanes-Oxley Act, for example, is designed to

tighten regulation regarding corporate governance, sets new rules for the audit committees of corporate boards of directors and toughens penalties for violations. Unfortunately, after 70 years of SEC oversight, mis-governance within the industry continues to surface. New York Attorney General Eliot Spitzer and Massachusetts Secretary of State William Galvin have uncovered a stream of industry frauds that have led to additional corrective actions. The industry is increasingly being burdened with stringent regulatory oversight as well as self-imposed compliance procedures — forcing down the bottom line through additional cost of staffing, reporting, and monitoring requirements.

Although many financial companies have taken the lead to ensure fair and equitable practices within their firms, technology has increased the sophistication of illegal transgressions taking place, thus making oversight increasingly difficult. Today the industry is more Internet dependent; consequently, regulators must adjust existing regulations to better govern this new capability. However, we warn against unnecessary regulation … what is needed is a fine-tuning of existing regulations that are practical and enforceable by both the government and the financial services industry as well as the consolidation of oversight/regulatory organizations. We believe this regulatory trend will continue, leveling the market for consumers but at a cost to profit margins within the industry.

In an effort to maintain competitive advantage, technology within the financial industry will continue to advance—most recently witnessed in electronic banking and exchange trading. Payment services, application processing, investing, etc., will continue to migrate towards the Internet. Consequently, many face-to-face relationships between financial institutions and their customers will increasingly be eclipsed by convenience and cost-savings initiatives. As a result, the previous dominance in the U.S. by local banking institutions will continue to shift from community service branches to big commercial bank conglomerates with local points of presence. Mergers and acquisitions will continue at a reduced but steady pace to improve market share, diversify services, reduce operating costs, and improve business "synergies." Big commercial banks will continue to squeeze efficiencies out of existing resources and diversify their revenue sources.[xxvi]

Globalization and outsourcing within the industry is expected to continue. Despite the long established presence of U.S. corporations overseas, the financial industry has been slower to move into foreign territory. We believe access to geographic regions within and outside the U.S. will continue to be a major strategy of the industry. Overseas expansion will continue, despite the threat of terrorism.

The financial industry provides a critical value to the financial structure of this country; however, modifications are required to ensure the future vitality of the industry. Changes are necessary that accommodate technology and keep pace with the enormous scope of today's financial industry and increased physical and cybersecurity threats.

Diversification, minimization of risk and preparing for the increases in interest rates are all strategies being employed in today's market. Yet, with the increase in size and complexity, credibility and reputation remain key parts of the industry's strategy. Not only must financial institutions remain credible to attract good business, but they must also select reputable corporate

clients to minimize risk. Increasing technical sophistication combined with interpersonal relationships will continue to be as valuable now as they were at the dawn of the big commercial banking industry in the 19th Century. We believe the health of the financial services industry is and will remain strong.

Short Term (1-3 Years)

The short-term outlook for the American financial services industry remains strong as it rides on and supports the strengthening wave of the US economy.

Financial institutions have posted record earnings buoyed by the large number of homeowners who refinanced their mortgages due to low interest rates. However, experts expect rates to rise beginning this summer. Although refinancing will decrease, this lost revenue will be offset by an increase in commercial lending as companies re-invest due to the favorable U.S. economic environment. Additionally, banks will continue their strategic investments in information and information technology, thereby increasing efficiencies and creating new revenue-generating capabilities and services.

Two other specific areas of growth within the financial services industry include internet banking and branch banking. Internet banking will greatly expand as more consumers get on-line and become familiar and confident with its use. However, there will also be a renewed emphasis in retail and branch banking because consumers still want in-person service and because banks can use their branches to cross-market other services.

The growth and consolidation within the industry will continue as financial institutions fill in the last pieces needed to have a presence in all major financial areas. However, because many of the big mergers and acquisitions (M&A) have already taken place, we see a dramatic slowing of large M&A activity.

The importance of trust and confidence within the industry only grows stronger. Corporate governance and leadership must lead the way. Financial institutions will continue their efforts to implement Sarbanes-Oxley, and will gradually move up the learning curve. In addition, through their experience and lessons learned, we expect Congress to pass a Sarbanes-Oxley II that can be tailored to fit very different sizes and types of companies. In addition to mere compliance, consumers will expect the highest standards of conduct, and those financial institutions that provide them will be most successful.

Finally, along with trusting the actions of the industry, the U.S. and consumers must also trust the reliability and survivability of the industry in case of a terrorist attack or a natural disaster. Critical infrastructure protection of financial services is vital to national security. Because 80% of the financial services infrastructure is privately owned, the Department of Homeland Security has chartered public-private forums to cooperate and share information. If this approach does not show progress soon, Congress will seriously consider mandating specific actions.

Long-Term (4-15 Years)

We expect the U.S. financial services industry to remain strong in the long-term. It must – the health of the U.S. economy and the security of the nation depend on it. However, there are several trends that are noteworthy.

First, the financial services industry will move more operations offshore. Thus far, this industry has not been as aggressive in off-shoring as some industries due to the time-sensitivity of financial operations as well as privacy and security issues. However, as these issues are overcome with technology and other process safeguards, financial institutions will take advantage of cost savings achieved by moving work to foreign countries that have lower personnel costs.

Second, after the dust settles from consolidation, there will be a concentration of large institutions that will try to dominate the industry. However, they will realize that being big is not the only criteria for success. Consumers will demand superior service, and thus we expect institutions to focus on key business areas. Quality of service and attention to detail will become even more important.

Third, information technology will continue to raise standards for efficiency and performance in the financial services industry. This industry is already known as a big user of proven technology, and that dependence will continue to grow. One major area finally succumbing to technology is the trading floor. It may take several more years, but in the long run, the trading pits like those in the Chicago Board of Trade and New York stock exchange will be replaced with all-electronic trading. Tokyo made the transition in the late 1990s. The Tokyo Stock Exchange was once an arena of madly gesturing people, but is now simply a large scoreboard of rapidly changing stock prices. It is a quiet monument to electronic trading that, incongruously, still includes a break from trading at the lunch hour. Ultimately, electronic floor trading will allow for longer trading hours, faster and more transactions, and an eventual reduction in the number of exchanges since physical location becomes irrelevant[xxvii]. The need for investment in technology is a factor driving mergers and acquisitions, for two reasons. First, small and medium enterprises often cannot afford to continuously upgrade their information technology systems, and so must join with larger firms to remain competitive. Second, in an interconnected and mobile society, economies of scale favor the larger firms.

Fourth, critical infrastructure protection remains vital. The industry has made great strides in securing the assets and process, but will always be a strong potential for terrorist attack. The industry can never let down its guard.

And, finally, because the financial services industry is big money, it will be rocked by more scandals in the future. However, the key to the industry is to minimize the occurrences and decisively act when a problem arises to preclude government over regulation. One speaker in Japan referred to the financial services industry (including lawmakers and regulators) as a "self-correcting system" noting that when issues have arisen, the U.S. has been comparatively quick to respond with updated laws, regulations, and business practices.

Roles and Goals of Government

The role of the federal government has been the regulation of the financial services industry to prevent Enron-like collapses that occur when different parties in a financial contract have asymmetric information. Asymmetric information describes the condition that exists when one party to a transaction has insufficient information about the other party with which to make a sound decision. Asymmetry can result in overly risky lending and lead to moral hazard behavior. A moral hazard exists when the lender believes that the federal government will provide a safety net if risky loans go bad. The federal government provides a safety net for consumers by restricting bank asset holdings and capital requirements to prevent bank failures, chartering and bank examination, disclosure requirements, consumer protection, restrictions on competition, and the separation of the banking and securities industries.

The establishment of the Federal Deposit Insurance Corporation was the government's first safety net to prevent runs on banks that occurred during the Depression Era. The Federal Savings and Loan Insurance Corporation (FSLIC) insured Savings and Loans until their debacle of the 1980's. In more recent times, the federal government casts its safety net through the passage of such laws like Riegle-Neal Interstate Banking and Branching and Efficiency Act of 1994 and the Gramm-Leach-Bliley Financial Services Modernization Act of 1999 that repealed Depression-era separation of lenders from brokers and removed the last barrier to competition between the nation's banks and brokerage companies.

The question for the future is: Is the industry over regulated? While the banks and institutions visited by the Financial Services Seminar almost all complained that the passage of the Patriot Act and Sarbanes-Oxley Act of 2002 have placed greater and costly burdens on the firms, Enron-like collapses and insider trading the likes of Martha Stewart still occur and shake the foundation of the industry. The industry must do a better job of self-policing and restoring credibility before a lessening of federal regulations can occur.

The federal government's role in regulating the global financial market is not yet clear. While the United States is certainly financially hegemonic, the global financial market is key to the United States economic security. The Basel II Accord, for implementation in 2006, is being hammered out now to determine how much money international banks will need to set aside to cover the risk of problems in their loan portfolios and other banking operations. U.S. regulators believe that only the 20 or so largest financial institutions should be required to adopt accord standards, but smaller banks, who are not required to meet the standards, feel they may be seen as more risky and, therefore, pay more to raise money in financial markets.

Implications for National Security

**Critical Infrastructure.** In 1998, Presidential Decision Directive-63 (since superseded by Homeland Security Presidential Directive (HSPD) – 7[xxviii] after the Bush Administration established the Homeland Security Council) identified the financial services industry as a critical industry. Because 80% of the Financial Services infrastructure is privately owned, the government and financial services organizations established a public/private partnership to

coordinate protection efforts. The sector has been proactive in implementing defensive measures, both physical and cyber, which mitigate the risk of "cascading failure." Their efforts were so successful that there was only minimal disruption in the banking system following the 9/11 attacks, and the stock markets were able to reopen the following Monday. The industry has subsequently undertaken more initiatives to disperse assets, develop more detailed contingency plans, and establish hot backup sites. This represents a success story for the industry.

Four Policy Recommendations for senior U.S. government leaders are discussed in detail below:

- Integrate the financial regulatory environment
- Increase support for the defense industrial base by reducing its cost of capital
- Strengthen protection of critical financial systems and protect individual privacy
- Reform Fannie Mae and Freddie Mac

***Recommendation #1***: ***Integrate the Regulatory Environment***

Prior to the 1980s, Federal law prohibited activities such as interstate banking and established firewalls between banks, securities companies, and insurance companies. Some changes, such as the revocation of the Glass-Stiegel Act (which was enacted to prevent runs on banks in the 1930s) marked the beginning of the consolidation of these formerly segregated industries.

However, most of the regulatory framework in financial services industry remains outdated. Examples include regulation of the stock exchanges by the Securities Exchange Commission, while the Commodities Futures Trading Commission (within the Department of Agriculture) regulates the options exchanges. The Department of Housing and Urban Development regulates Fannie Mae and Freddie Mac.

New regulations are usually issued in response to a problem, and results in sacrificing flexibility for speed. Throughout our travels, we heard how the recent passage of Sarbanes-Oxley regulations imposed a significant burden on companies – a burden that may be easily affordable for large companies, yet represents a significant burden on small and medium-sized businesses.

We characterize the current regulatory environment as disjointed; what is needed is not necessarily more or less regulation – just better, more efficient regulation. Both the United Kingdom and Japan have consolidated government oversight into a single Financial Services Agency that reports to their respective finance ministers. We are not prepared to recommend such a comprehensive approach, however.

Our recommendation, therefore, is that the Federal government reevaluate and update all existing regulatory laws to bring them in line with the new integrated financial environment. We recognize that this may require unprecedented cooperation among disparate congressional oversight committees in addition to Executive Branch Agencies. Top level agreement among

key Cabinet-level and Congressional, as well as industry, leaders will be required to make forward progress in this area. We admit this is easier said than done.

***Recommendation #2*: Reduce Cost of Capital for the Defense Industrial Base**

The cost of capital paid by the five largest defense contractors is higher than for comparable businesses, in part due to government rules. In order to reduce the cost of defense material, supplies and services to the taxpayer, we should:

- Streamline government accounting rules and the acquisition process, and speed progress payments to the contractor. The approval process for a new program is too cumbersome, and funding is often not fully identified at program initiation. Streamlining will cut the amount our contractors must borrow and, therefore, reduce the cost to the taxpayers.

- Similarly, the government should institute a partnership with defense contractors to give them access to cheaper capital. As it currently stands, the government drives contractors to borrow money at commercial rates that are higher than the government's cost of capital. This adds costs to our acquisition programs and other operations. If the government provided (or borrowed) more of the capital, the cost of acquisition would be reduced, and the taxpayer would save money.

- Third, we should revise the Federal Acquisition Regulation (FAR) to allow higher profit margins, especially through better-designed incentives. Currently, the FAR limits profits on negotiated contracts to 15%, while most contracts actually generate only 8-10%. With these small returns, Wall Street often does not find defense contractors to be an attractive investment.[xxix]

- Fourth, use multi-year funding for long-term projects. This is a widely used technique in the U.K. and Australia. More than one bond investor at various institutions told us during our visits that they can't or won't buy Air Force housing bonds because these aren't assured of funding beyond the current year. In this case, the perceived vagaries of the appropriations process (that, in this case, are very unlikely to suffer funding cuts) reduce the demand/marketability of bonds funded by airmen's housing allowances. The result is an increased cost of military housing due to bond ratings suffering unnecessarily. Multiyear funding might also permit defense companies to raise capital via equity vice debt in more cases. An assured funding line would reduce the risk to investors, and therefore the cost of capital for defense.

- Fifth, we should recognize that surge capability is not the same as overcapacity. We must manage surge capacity as a public good and pay increased cost.

- Sixth, increase the use of leasing of military material to allow contractors to remove debt from their balance sheets while ensuring the stability of funding lines for development projects. (Using "other people's money" to finance defense programs may be advantageous to the taxpayer).

- Finally, and perhaps most importantly, institute educational programs for senior decision

makers and program managers to insure that the designers of acquisition, procurement, and defense supply programs understand the impact and dynamics of the efficient use of capital. Requiring contractors to obtain capital at (potentially) high market rates often passes these costs to the government.

***Recommendation #3*: Strengthen Protection of Critical Financial Systems and Protect Individual Privacy**

As we mentioned earlier, the financial services industry has made a strong effort to protect its computer systems and networks from attack or natural disaster. To further protect this critical infrastructure, we recommend several actions.

- First, the government must better enforce the computer security and privacy laws. What does this mean exactly? We recommend enforcement much like what happens in a securities fraud incident. The Justice Department takes strong, swift, and *PUBLIC* action to send a stronger message to the industry. This same kind of strategy should be adopted for computer security and privacy violations.

- Second, the government should encourage and even sponsor more disaster or attack defense/response exercises. In 2003, the Department of Homeland Security sponsored the Livewire exercise, that tested the procedures within the financial community. It provided a valuable, controlled environment, and training experience.

- Third, the Financial Services industry is only as strong as its weakest link. Large institutions have the resources to develop a strong protection program. However, smaller ones may not, and, therefore, may introduce vulnerabilities into the industry. Therefore, the government should extend public/private partnerships to smaller companies in the industry.

- And finally, the protection of critical systems should be an explicit responsibility of senior management. The Sarbanes-Oxley Act holds CEO's personally liable for the accuracy of their company's financial statements. As you can imagine, this really got the attention of CEOs…and improvements were made. A similar approach should be taken with regarding the protection of a company's critical systems.

***Recommendation #4*: Reform Fannie Mae and Freddie Mac**

Fannie Mae and Freddie Mac are Government-Sponsored Enterprises, originally chartered to ensure mortgage loans are available for low- and medium-income Americans. They have grown into two of the largest financial companies in the world.

To grow to these proportions, they used their position as quasi-government organizations to borrow capital at below-market rates while charging market rates for their loans. This unfair advantage has allowed them to eliminate competition and monopolize the market (which they helped create but now dominate). In addition, they use derivatives to mitigate risk in the face of

rising interest rates. The good news is that they made the right bet on the direction of interest rates last year, and made over $50 billion in profits from derivatives – separate of normal operating profits.[xxx] The bad news is, had they been wrong, they could have lost an equally significant amount. The fact that they made these profits indicate that the companies were not properly hedged against an interest rate rise – or to put it another way, they were engaged in moral hazard behavior and gambled (successfully) on the direction of interest rates.

The market perceives that the government would bail them out if they were in danger of failing. This is a position the government has repeatedly denied; the government states these are private corporations and the investors should be shouldering the risk. The market apparently does not believe these denials. Therefore, the government should take actions that will send an unmistakable message to the markets that it is no longer a financial backer for Fannie and Freddie. To do that, the government should:

- Move Fannie Mae and Freddie Mac from the regulatory oversight of the Department of Housing and Urban Development (HUD) and place them under the oversight of the SEC or the Fed to ensure oversight by financially savvy regulators.

- Second, require Fannie Mae and Freddie Mac to comply with the same requirements as the other commercial players in the financial sector. This would include raising their minimum capital reserves, limits on the amount of loans on their books, and so on.

- Finally, central bank actions which enhance their access to below-market-rate capital should be removed (e.g., eliminate their line of credit with the Federal Reserve). This will foster competition to grow in the sector, thereby driving down Fannie Mae and Freddie Mac's market shares, and reducing the chances of a cascading failure should either of them have financial difficulties.

Conclusions

As we stated at the beginning of this report, the financial services industry is the lifeblood of the economy. Without ready access to capital, industry in general can not operate efficiently – or in some cases, can not operate at all. Despite the downturn in the economy following the stock market bubble bursting, the industry remains strong.

In addition, this industry learned the lessons of 9/11 very well, and has made significant upgrades to enhance its security posture. These efforts should be strengthened.

Perhaps the most important recommendation we can make is to address the relationship of the federal government with the defense industrial base. The financial sector finds the defense sector an unattractive place to invest. The government needs to make some policy changes to make our defense base a more attractive sector – not to improve the financial condition of a few large companies, but, rather, to provide more defense capability for the government's dollar.

Finally, the role of government – at all levels – needs to be addressed. Although this industry has evolved significantly over the last two decades, the regulatory environment has not

mirrored those changes.  Therefore, the regulatory environment needs to be realigned with the reality on the ground.

## APPENDIX – SURPRISING LITTLE FACTS*

*We provide this list of items, in no particular order, simply to highlight things we learned during our studies and travels which surprised many of us.

- The Financial Crimes Enforcement Network still relies predominantly on paper currency transaction reports. Of the more than 10 million annual reports, approximately 2/3 are submitted in paper form.

- The Defense sector is a relatively unattractive place to invest. Bonds of the largest defense companies are rated slightly better than "junk" by ratings agencies.

- There are more financial services professionals in London than there are citizens in Frankfurt.

- "Jobs for Life" in Japan is a thing of the past.

- Competitive Advantage in the Financial Services Industry is ultimately gained via timely, accurate and manageable information. We saw this in everything from multiple screens on each trading floor desk to financial analyst intelligence gathering efforts and sophisticated risk management formulas.

- The U.K. passed a law setting inflation target of < 2% as a national goal for its Central Bank to use as its primary metric when establishing monetary policy.

- Buyers of DOD bonds (yes, DOD issues bonds) believe there is a possibility of default due to the vagaries of the appropriations process.

- Approx 50% of stocks on Tokyo Stock Exchange are bought/sold by foreigners. But then....Approx 50% of U.S. Treasury Bonds are owned by foreigners.

- In Japan, there is almost no tolerance for risk in investing. The stock market is perceived as gambling by much of the general population. Interest rates are low (or zero) yet consumer debt/finance is frowned upon – the consumer finance companies that exist charge very high (29% and up) rates of interest in return for privacy. Until recently, the government backed all deposits with full faith and credit of the country – without limit. "Time deposits" are still popular.

- "Private Banking" divisions of banks court clients with "$10 million and over".

- The scope / effectiveness of the financial regulators is limited ... for example, approximately 250 investigations at NASDAQ are resulting in about 5 convictions per year.

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[xiv] Mitchell Pacelle and Jathon Sapsford, "Trends (A Special Report): Banking; Size, Smiles and Scandals*, Wall Street Journal* (Eastern edition), New York, (Feb 9, 2004). Online from proquest.

[xv] Nelson W. Aldrich, Jr., *Old Money: The Mythology of America's Upper Class* (New York: Alfred A. Knopf, 1988), p. 216.

[xvi] *Standard & Poor's, Industry Surveys, Banking,* (November 6, 2003), p. 12.

[xvii] Mishkin, Frederick S. and Eakins, Stanley G. *Financial Markets and Institutions.* New York: Addison Wesley 2003, 4th edition, p. 449.

[xviii] *Standard & Poor's, Industry Surveys, Banking,* (November 6, 2003), p. 10.

[xix] Mishkin and Eakins, p. 452.

[xx] David Rockefeller, *David Rockefeller Memoirs*, (New York: Random House, 2002).

[xxi] Daniel Yergin and Joseph Stanislaw, *The Commanding Heights: The Battle for the World Economy* (New York: Simon & Schuster, 2002).

[xxii] "Stocks dive after Greenspan's words," USA Today, Apr 21, 2004. Stocks tanked late Tuesday after Federal Reserve Chairman Alan Greenspan made comments some traders construed as a warning of an impending interest rate increase.

[xxiii] A more detailed discussion on asset- and liability-sensitive strategies is found in *Standard & Poor's*, p. 16.

[xxiv] *Standard & Poor's, Industry Surveys, Banking,* (November 6, 2003), p. 4.

[xxv] The Bank of Japan publishes voluminous statistics in the Tankan Report, available at: http://www.boj.or.jp/en/stat/stat_f.htm.

[xxvi] For a summary of banking business strategies to increase scale, see Mitchell Pacelle and Jathon Sapsford: "Banking; Size, Smiles and Scandals", Wall Street Journal, 9 February 2004, page R.8.

[xxvii] Of note, the market price for seats on the stock exchanges has declined substantially over the past decade.

[xxviii] Homeland Security Presidential Directive/Hspd-7, Subject: Critical Infrastructure Identification, Prioritization, and Protection, 17 December 2003, http://www.whitehouse.gov/news/releases/2003/12/20031217-5.html.

[xxix] Equity investors seek returns of in excess of 20% to make up for the risk associated with such ventures.

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