

FINANCIAL SERVICES

A Report on the Industry

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FINANCIAL SERVICES

Nobody ever lost money taking a profit.

- Bernard Baruch

ABSTRACT

Although the instruments of national power – diplomacy, military might, information, and economics – are highly interrelated, a strong economic base is arguably the foundation for the success of the other three. Similarly, the financial services sector of an economy facilitates the efficient deployment of capital and minimizes business risks – functions upon which all other industry sectors vitally depend. The egregious financial collapse of several Asian economies in the late 1990s, and the continuing economic malaise of Japan, have had far-reaching consequences and reveal growing economic globalization, which relies heavily on the financial services industry. These examples, along with the more recent collapse of several American multinational corporations such as Enron and WorldCom, have eroded international investor confidence and highlight the requirement for solid financial environments, or infrastructures. Such infrastructure includes political stability, rule of law, transparency, and balanced industry regulation.

As the linchpin to all other industries, it is incumbent upon the financial services industry to restore investor confidence through effective regulation, improved physical and cyber security of its networks and markets, and promotion of a robust, competitive banking element. It is in the interest of the United States to promote these measures at home and abroad to minimize distortion and excessive risk within the financial services industry.

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Domestic Briefs:

Federal Reserve Bank, Washington, DC
Bank of America, Washington, DC
Securities and Exchange Commission, Washington, DC
Pentagon Federal Credit Union, Alexandria, Virginia
Financial Crimes Enforcement Network, Tysons Corner, VA
U.S. Commodity Futures Trading Commission (CFTC), Washington, DC
World Bank, Washington, DC
Japanese Embassy, Washington, DC
US-China Commission, Washington, DC
US Federal Bankruptcy Court, Washington, DC
Sec. of the Air Force, Office of the Comptroller, Washington, DC
American Bankers Association, Washington, DC
The Heritage Foundation, Washington, DC
Hong Kong Economic & Trade Office, Washington, DC
Credit Suisse First Boston, Washington, DC

Domestic Travel:

Boeing World Headquarters, Chicago, IL
Chicago Board of Trade, Chicago, IL
Chicago Board Options Exchange, Chicago, IL
CNA Insurance, Chicago, IL
Brian Sullivan, Incorporated, Chicago, IL

American Institute of Certified Public Accountants (AICPA), New York, NY
UBS/Paine Webber, New York, NY
American Stock Exchange, New York, NY
American Securities Capital Partners, New York, NY
Inner City Capital Ventures, New York, NY
Hong Kong Shanghai Bank (HSBC), New York, NY
Citibank Private Bank, New York, NY
TIAA-CREF, New York, NY
Moody's Investors Service, New York, NY
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Bank of America Global Operations Center, Bromley, England
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Citigroup, London, England
Hong Kong Shanghai Bank Corporation/HSBC, London, England
Lloyd's of London, London, England
European Bank for Reconstruction and Development, London, England

U.S. Embassy, Tokyo, Japan

U.S. Dept. of State – Economic Office, Tokyo, Japan
New York Times, Japanese Economic Desk, Tokyo, Japan
State Street Trust, Tokyo, Japan
Morgan Stanley Japan Limited, Tokyo, Japan
Financial Services Agency, Tokyo, Japan
Shinsei Bank, Tokyo, Japan
Industrial Revitalization Corporation, Tokyo, Japan



THE FINANCIAL SERVICES INDUSTRY

If you would like to know the value of money, go and try to borrow some.
- Benjamin Franklin

Introduction

Unlike most of the industries studied at ICAF, the relationship between national security and financial services may not be intuitively obvious. Munitions, Land Combat, and Strategic Supply, for example, have a more straightforward connection. Yet the college's mission is more than cultivating strategic thinking and executive leadership for national security. Our future strategic leaders must understand how national security strategy is *resourced*.

All instruments of national power are interrelated: national strength flows from an effective integration of diplomacy, military might, information and economics. A strong economic base, however, is fundamental to the other elements. It funds national defense, information technology research, and is a source of influence at the diplomatic table. The current *National Security Strategy*, published in September 2002, devotes an entire section to the goal of "Igniting a new era of Global Economic Growth through Free Markets and Free Trade."¹ The document lists the following key policy avenues to promote this growth:

- legal and regulatory policies to encourage investment, innovation, and entrepreneurial activity;
- tax policies that improve incentives for work and investment;
- rule of law and intolerance of corruption so investors benefit from economic initiative;
- financial systems that allow capital to be put to its most efficient use; and
- sound fiscal policies to support business activity.

The financial services industry may be considered the lifeblood of a nation's economy, and is therefore an essential component to national security. The US financial industry, because of its quality, resilience and vast dimension, along with the solid financial infrastructure upon which it rests, may be held up as a model to other countries.

This paper encapsulates a five-month study of the financial services industry. It seeks to define the industry and identify several current conditions and challenges. Next, it reviews one and five-year industry trends, and examines the role of government in shaping its future and overcoming the challenges identified. Three essays provide a deeper examination of several issues most relevant to the industry today – the importance of mature financial infrastructures in a globalized economy, China as an emerging competitor, and the requirement for transparency in financial and business operations.

Defining the Financial Services Industry

The financial service industry is not limited to stocks and bonds or banks and automated teller machines. Although these are all components of the industry, it is far broader. The Value Line Investment Survey, a leading investment information and advice service, defines the financial services industry as an amalgamation of insurance

companies (property/casualty, life, health, bond), credit businesses (consumer, business, mortgage), insurance brokers, asset managers, and other consumer-related finance operations.² The financial services industry is in fact an extensive network of industries and regulatory bodies, integrated at both domestic and international levels.

In its most basic form, the financial services industry is the bridge that connects the borrowers – those who need money – with the investors – those who have available cash. The borrowers are the “good idea” people – entrepreneurs, companies and governments – who create products and services in the worlds’ economies. The investors are banks, brokerage houses, pension funds, mutual funds and individuals who have accumulated cash and are looking for ways to preserve and increase their capital and minimize risk. Intermediaries such as brokers, traders, and bankers assist borrowers by defining their requirements and packaging them in ways to attract investors. These same intermediaries help investors by searching for attractive investment opportunities. Finally, there are the institutions and markets that link borrowers and lenders together. These institutions, such as the Federal Reserve Bank, commercial and private banks, brokerage houses, capital markets, mortgage markets, and insurance offer the mechanisms for transferring capital from investors to borrowers and recording the transactions in a legally enforceable system.

Banking. Banking is central to the financial services industry. It includes “commercial banks and thrifts (savings and loan associations and savings banks) and credit unions.”³ Traditionally, these institutions made profits on the margin between what they paid customers to maintain deposits in the bank and the amount they could charge other customers for borrowing the depositor’s money. This is the so-called rule of “3-6-3,” where bankers would pay depositors 3% interest, charge borrowers 6%, pocket the “spread” and get to the golf course by 3:00 PM. Because of increased competition in the banking sector, this paradigm no longer holds. Bankers are currently working much longer and harder due to aggressive competition and resulting slimmer margins.

Brokerage Services. Brokerage service is a well-known aspect of the financial services industry. Brokers are essentially intermediaries, linking investors with cash, to borrowers who wish to raise money through the equity markets. There are four major types of retail brokerage firms. They are the “national full-service firm, regional full-service firm, discount firms that operating exclusively online, and the so called ‘brick-n-click’ firms that combine an extensive branch network with online presence.”⁴

Insurance. Organized into two major components, Property & Casualty (P/C) and Life & Health (L/H), the insurance accounts for approximately 12 percent of the financial services industry.⁵ The industry’s capital assets amount to over five trillion dollars, annual income revenues top \$600 billion and the industry employs nearly two million Americans.

Exchanges and Regulators. Almost every country has its own set of securities, bond and commodities exchanges: the New York and American Stock Exchanges in New York City, the NASDAQ in Washington DC, and the Chicago Board of Trade are well known. Other major exchanges include the Nikkei in Japan, the Hang Seng in Hong Kong and the DAX in Germany. All of these exchanges are closely interlinked and function to bring together buyers and sellers of capital and commodities. They track and enforce contracts and agreements, and even underwrite sales as required to provide a stable environment in which investors and business can conduct financial transactions.

Exchanges also function as self-regulating bodies by defining standards of ethics, protocol and procedure and conducting censure of offending parties. Other industry professional associations, such as the American Bankers Association and the American Institute of Certified Public Accountants, seek to enforce high ethical standards within the financial services industry. Governments, likewise, have important roles to play in the industry, such as regulating the money supply, monitoring the conduct of stock, bond and currency brokers and preventing money laundering and financing of terrorist organizations. All of these organizations work together in concert in an attempt to keep the financial environment as efficient, honest and transparent as possible. This provides stability to the financial marketplace, making it safe for all parties to conduct business effectively.

Current Conditions

Observations. The US financial services industry is the largest and most vibrant in the world. As previously stated, the U.S. FSI comprises two thirds of the \$2.9 trillion dollar global industry. In the past ten years, the US FSI increased in aggregate size from \$1 to \$2 trillion dollars, increasing from 16% to 20% of U.S. GDP. Current indicators forecast this growth to continue. However, individual financial services industry segments' performance will vary as they continue to adapt to changes in regulatory, geopolitical and economic environments, increased competition, and decreasing profit margins.

Critical Principles. The health of the financial services industry in the United States, or any country for that matter, depends on the following criteria and principles:

- Political stability
- Rule of law
- Corporate governance
- Regulatory oversight, and
- Transparency of business operations.

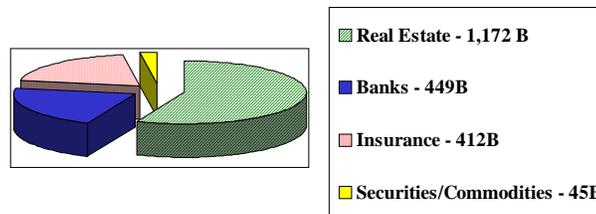
These principles constitute a financial environment or architecture that is essential for an effective financial industry. Considering the size and scope of this industry, there are many entities required to control and regulate it. All three branches of the US government, for example, (at federal and state levels) are deeply involved, providing oversight, laws, regulations – and enforcement – to minimize illegal or objectionable practices. Equally important are other organizations such as the independent media that report objectively on the industry, rating organizations such as Moody's Investor Services that provide unbiased ratings of everything from stocks to the health of sovereign nations, industry associations and government oversight organizations such as the Securities and Exchanges Commission. These groups play overlapping and complimentary roles in promoting transparency in financial services through legal and self-regulating mechanisms, both internal and external to the industry.

The Role of Technology and Security. Technology and security are integral to the operation and success of the financial services industry. The industry could not survive in today's global economy without heavy reliance on information technology. Through the speed, accuracy, and ability to provide new and innovative products to the consumer, information technology has enabled the industry to operate with greater agility and flexibility in this dynamic, global environment. Increasing technology use, however,

brings new security requirements. With murky and asymmetric threats, security is critical to the health, and even existence, of the industry. Today’s industry security centers on transaction, infrastructure, physical and cyber and geopolitical security. Preparing for Y2K helped the industry appreciate the need for redundant and backup capabilities. The events of September 11, 2001, however, exposed a rash of new vulnerabilities and risks – especially over-concentration of the industry in one location. Since then, the industry has made significant efforts to mitigate risks by decentralizing and replicating critical databases to multiple locations throughout the country.

Diversification. Another factor instrumental to success in the financial services industry is diversification. Although some sectors of the economy in general and a few components of the financial services industry in particular hit some rough spots over the past few years, the financial industry as a whole prospered. It did so primarily through diversification. Companies and institutions that spread their holdings (or business operations) across multiple investment vehicles will see gains and losses, but the aggregate will grow over time.

Financial Services Components (\$Billions)



Source: 2003 Financial Service Fact Book

The international financial service industry is highly interconnected, global in scope yet concentrated in a few geographic areas: New York, London, Hong Kong and Tokyo are its major centers. The strength of financial services in the United States is its resilience: the ability to adapt and flourish in a dynamic environment. Going forward, it will continue to be the cornerstone for the US economy and thus national security more broadly.

Banking. During the past 30 years, regulatory liberalization, improvements in credit rating services and rapid advances in information technologies (IT) “eroded the bankers’ specialized knowledge,” of market interest rates and management of credit risks.⁶ These factors combined to increase competition, causing bankers to have to pay more for deposits while charging less for loans, to the point where traditional banking methods can no longer cover the bank’s costs. “Bankers’ hours” have grown. Bankers are currently working much longer and harder due to aggressive competition and resulting slimmer margins. In addition to rising operating costs and increased competition, banks must manage an increasing number of risk factors, including interest rates, transactional risk, political risk, exchange rate risk, reputation risk and default

risk.⁷ According to the 2003 Financial Services Fact Book, “the US banks’ share of the loan market had fallen 75 percent to less than 50 percent” by the 1990s.⁶ During the same period, deposits fell by nearly half.⁸ As a result of these trends, banks have been forced to cut costs, merge, and look for other ways to make money, such as “off balance sheet activities.”

Banks quickly adapted to emerging IT, and increased profits by reducing labor costs and raising productivity. Throughout our domestic and international travel, we saw a recurrent theme calling for higher transaction volume with lower head-count. Advances in IT have already enabled significant efficiencies in some areas, specifically clearing operations. IT has greatly facilitated back-office clearing operations, allowing banks to clear transactions anywhere in the world at the lowest possible labor cost, while reducing the error rates to insignificant levels. Better than 90% of all clearing operations at the Bank of America Global Operations Center in Bromley, England, are conducted electronically using a technique called straight through processing, greatly reducing the need for human intervention in cross-border financial transactions.

Banks have also sought to generate additional income from fees for new services including, on-line banking and Automated Teller Machines (ATMs). On-line banking, although much promoted, has been slow to generate significant income but larger banks provide it to remain competitive. ATMs, on the other hand, have been very profitable and their use has dramatically increased. However, increased reliance on IT and Internet communications has also exposed banks to cyber security threats that have added costs of securing networks and databases and protecting their accounts and customer privacy. Today, IT permits global, 24 hour-a-day, high volume banking operations that were inconceivable just two decades ago. In this regard, IT has facilitated the consolidation of the industry as banks seek to grow and merge in search of efficiencies and market position.

In addition to reengineering operations and greater use of IT, US banks pressured the federal government to loosen the restrictions that kept them from making money in other segments of the industry, such as brokerage services and insurance. In 1986, the Federal Reserve ruled that bank holding companies could engage in limited securities underwriting under the 1933 Glass-Steagall Act.⁹ The November 1999 Gramm-Leach-Bliley Act (GLB), repealed some previous legislation, including Glass-Steagall. As a result of GLB, banks may form financial holding companies which may engage in “securities underwriting, dealing, and market-making activities, as well as others of a financial nature as long as they do not pose a substantial risk to the safety and soundness of the institution.”¹⁰ In the US, well established regulating agencies, public disclosure and corporate reporting requirements provide a high degree of transparency into banking operations.

Brokerage Services. There are two main issues confronting the brokerage industry today. First is the shakeout in the structure of the industry; second is the emerging litigious climate due to sizable losses in the equities markets over the past several years.

The trend for brokers in the DOT.COM era was to provide the lowest cost trades while foregoing the expense of professional service and advice. As markets continued to rise in the 90’s, full service brokers watched their client base fall by the lure of cheap trades. This trend has shifted as the markets slowed and volume declined. Industry

experts indicate that full service brokers still compete with low cost brokers – however their focus has shifted to personalized attention to wealthy investors – typically investing greater than one hundred thousand dollars. The trend toward increased consolidation will likely continue.

Brick-n-click brokering is an emerging market. These are brokerage firms that offer discount, on-line trades as well as full service brokering at a local office. This emerging market is replacing strictly discount brokers, as profits are squeezed by the commoditization of the equity trade. This decline in discount brokers is likely to continue.

Finally, several banker-brokerage houses are facing charges of conflict of interest. Recent judgments against the industry, totaling more than \$1 billion have been confirmed, and there appears to be more coming. As banks and brokerage companies have merged, financial intermediaries on the borrower and investor side, as well as brokerage analysts, now reside within the same company. There is tremendous pressure to “make the deal,” and it appears as though many analysts have skewed reports to investors. Unfortunately, investment operations have become less transparent and it is likely that additional legislative controls will be forthcoming.

Insurance. As is the case throughout much of the US economy, the insurance component of financial services has struggled with the post-2000 downturn of the equities markets and the tragic events of September 11, 2001. Many industry insiders thought the Gramm-Leach-Bliley Act would facilitate the integration of financial service institutions; instead, it exacerbated the insurance industry’s upheaval over the last few years. Their overall concerns have not yet materialized, and may never reach the anticipated level of damage to the insurer’s competitive advantage. “The ongoing competitive threat from banks and other financial intermediaries continues to transform the life insurance industry. At one time, life insurers provided only one thing: financial remuneration in the event of a policyholder’s death. Today, they provide an array of financial services and play an integral role in many people’s financial planning, including complex areas such as tax, retirement, and estate planning.”¹¹ The insurance component of American financial services is conservative and slow to meet dynamic change. It is working through a volatile period of economic downturn, low interest rates and return on investments, heightened competition, unexpected risk, catastrophic loss and intense debate on regulation. The combined effect to-date on the industry’s bottom line has been mixed at best. This trend is expected to continue for the near term.

Summary. The financial services industry is truly undergoing a period of remarkable change. Globalization, brought about by advances in IT plus significant international trade agreements in the early 1990s, has facilitated unprecedented freedom for capital flow among global markets. During the same period, a series of financial crises and geopolitical shocks have added new dimensions of risk. Deregulation has heightened competition, resulting in convergence of services and consolidation of the marketplace. This, in turn, has resulted in international partnerships and structures, such as financial holding companies, in order to mitigate risk by concentrating financial strength while expanding market share.

Although each of industry segments discussed above performs vital functions in the overall financial services industry, the lines between them have blurred. Elements of each sector have felt the pressure of increased competition and declining profit

margins and have sought to grow through acquisition and mergers - often with or by a foreign entity. Advances in IT have accelerated the pace of change, while at the same time providing financial services firms new ways to conduct more profitable operations while increasing the richness of their relationships with their clients. And, despite the dislocation brought about by accelerating global change, the financial services industry is emerging larger and stronger than it was only a few years ago, having doubled in value since 1990. One projection forecasts nearly 300% growth to \$9.3 trillion by the year 2013.¹² The US piece, which currently comprises two-thirds of the global total, will continue to grow and profit as the global industry expands.

Challenges

Current challenges to the financial services industry include issues of financial transparency, banking regulation, and managing operational risks on national and international scales. As businesses throughout the world become more globally and deeply intertwined, open markets will become increasingly interdependent and therefore increasingly affected by these issues.

Transparency. The ability to improve a country's economic growth and stability depends on the degree their respective governments choose to adopt open and free market practices which promote relevant market information provided to all parties. The meltdown in currency, bond and equity markets over the past several years has contributed to massive credit rationing for East Asia, particularly by foreign creditor banks. Even countries with advanced markets, such as the United States, Great Britain and Germany, continue to experience setbacks – such as accounting fraud at ENRON and WorldCom – that blemish otherwise solid records. Moreover, the recent fine levied on Citigroup for inappropriate investment/banking actions comes at a time when the ink on the Gramm-Leach-Bliley legislation is barely dry.

Analysts at institutions such as Moody's Investor Services believe there is a perception that credit ratings are driven by financial accounting inputs and that these ratings reflect well-established ratios or other performance measures that affect investor behavior. This may hold to a certain extent in the United States and other developed countries with advanced reporting and regulatory controls. However, where transparency is weak in parts of the world such as China or Russia (because of a lack of standards, rule of law, regulations, etc.), rating analysts are forced to use soft data sources.

Indeed, the lack of transparency in many parts of the world constrains analysts to base opinions on criteria obtained through indirect means that limit investor confidence. In nations that lack transparency, data are typically short on objectiveness but long on the vagaries of relationships and cultural nuances. For instance, in Japan, long-term business partnerships and the societal proclivity to provide jobs have played a greater role in business decisions than has bottom line profitability. As a result, it is difficult for outside investors to determine the soundness of some Japanese business decisions; some of these decisions have deployed capital inefficiently and have contributed to a torpid economy and government now deeply in debt.

Banking Regulation. Efforts in the United States to prevent banks and corporations from taking part in moral hazard behavior, reflective of the savings and loan activities in the 1980s and the recent accounting debacles of WorldCom and Enron in 2002, will require more time before it is truly known whether passage of legislation such

as Sarbanes-Oxley and Gramm-Leach-Bliley really improve transparency. But it is difficult for governments on the international stage to effectively regulate their financial services industry. From the international perspective, problems in banking occur when banks are engaged in activities that allow them to readily shift their business from one country to another. Bank regulators examine the banking operations in their country, but often do not have the ability to closely monitor them in other countries. In addition, when a bank operates in many countries, it is not always clear which national regulatory authority should have primary responsibility for keeping the bank from engaging in overly risky activities. There is also concern regarding how new US regulations will affect foreign securities traded in US markets. In August 2002, the German Industry Federation wrote a letter to the SEC asking that German corporations that trade shares in New York be exempt from parts of the law because the new regulations risk creating legal problems as different sets of corporate governance systems clash.¹³ Cooperation among regulators from other countries and international standardization of requirements may be solutions to the difficulties of regulating international banking.

Operational Risk. The terrorist attack on the World Trade Center on September 11, 2001, was a defining moment for the United States and its financial services industry. It was an event that nearly caused the American financial markets to fail, one that highlighted vulnerabilities in existing and new facets of operational risks, and drove home the necessity of managing those operational risks.

The industry as a whole, has always dealt with external, people, process, and systems risks – so what changed? Exposed were those areas that were outsourced and were never considered in detailed contingency planning, such as the physical routing of telecommunication lines. Every corporation obtained telecommunication services from at least two sources for contingency planning, then leapt to the conclusion that outsourcing a service from two independent sources equated to diverse physical routing of infrastructure. However, this was not the case; both sets of lines ran in parallel in close physical proximity to one another. What was considered a redundant system was not. Potential terrorist attacks are the external risks that challenge the industry today in terms of people, systems, and infrastructure. These have pushed the financial industry to take new steps to provide redundancy and continuity of operations planning. Many firms have relocated data centers and established back-up sites. Some firms and key agencies, however, continue to concentrate operations.

Managing operational risk, be it external risk, people risk, process risk or system technology risk is no longer an individual firm's responsibility, but rather an industry imperative. Without the markets, clearinghouses, and other key components, the industry is unable to operate. The challenge for the financial services industry, therefore, is to find ways to mitigate and manage operational risks both at individual firms and collectively as an industry – balancing effective competition with industry survivability.

Outlook

The outlook for the financial services industry contains both short and long-term trends. Short-term trends are those that will occur within the next one to three years, while long-term trends are those in the three to five year timeframe.

Overall, we do not expect any major shift within the industry globally over the next 24 months. Industry executives uniformly expressed the view that the US economy

and global markets will not resume significant growth until the second half of 2004. It will be a period of continued uncertainty in the global markets, as most investors remain wary with their capital on the sideline.

Drilling deeper into short-term trends, there is still the continuing debate on government regulation and free market principles in the US. In the wake of the Enron and WorldCom fiascos, plus increased attention on the fight against terrorism, Congress has reacted with new laws and regulations. Many companies see these new laws and regulations as imposing additional labor and administrative costs, making them less competitive in the global markets. There is a constant tug of war in the financial services industry between protecting consumers from lack of transparency and excessive risk, while also keeping business costs competitive. Even with this internal debate, the US as a whole will continue to promote transparent capital markets and strong legal structures worldwide.

Another short-term trend is the lack of investment opportunities in global markets. There are literally trillions of dollars in idle cash looking for a home. Investors do not want to invest in the US because of its recent transparency and confidence issues. Japan continues to wrestle with a massive non-performing loan crisis and deflation, while Europe muddles forward in a state of economic malaise. The Chinese market has been providing superior returns, but it is risky and not a place for the small investor.

The remaining short-term trends concern further specifics about Japan, China, Europe and the United Kingdom. Japan will continue to pursue a slow and methodical approach to address its non-performing loans, thereby resulting in few changes in their uncertain financial service industry. Like Japan, China will struggle with reform and disposing of its own non-performing loans. Unlike Japan, however, China's industry will continue to grow quickly, but in a climate of uncertainty. Economic growth and related reforms will likely open China further, thereby putting Hong Kong's position as the sole gateway to China in jeopardy to other locations such as Shanghai. The European Union will largely remain a union in name and currency only. The single regulatory framework it seeks will remain illusory. The United Kingdom, on the other hand, will continue to ponder its full entry into the European Economic Union and whether or not to adopt the Euro.

In the longer term, the US will maintain its dominance in the financial services industry. There will be a return to confidence and thus recovery of the US capital and securities markets. In the midst of this recovery, there will be further consolidation and growth in the financial services industry.

The spread of capitalism will mean even greater emphasis on promoting transparent capital markets and legal structures worldwide. In Japan, it remains unclear if or when banks and government regulators will take the necessary steps to eliminate the non-performing loan debacle. It seems safe to say, however, that a period of economic struggle will follow real banking reform there. China will continue implementing changes with a sense of determination. The greatest challenge China faces in determining whether it will be a global competitor or liability is how it handles social issues resulting from its transition to capital markets.

Finally, the United Kingdom's entry into the full European Monetary Unit, or Eurozone, and its adoption of the Euro over the Pound Sterling is an issue that is just too hard to call in the long run. At present, while the Eurozone continues to grow, mostly

through additional membership of smaller countries, it has yet to produce results that threaten the UK's dominance of European financial services. Despite many predictions to the contrary, the United Kingdom, not Germany, remains the financial capital of Europe and it should retain this status for at least the next five years. As for the Eurozone itself, it may have a single currency, but will likely not have a single regulatory system that governs all the member states.

The Role of Government

Financial markets perform a vital function in any capitalist economy: they provide the fuel for the economy as a whole. As stated earlier, from the securities markets to banking to real estate, the government plays a major role in the financial services industry. Providing a framework of transparency, sound property and bankruptcy laws, and a legislative system that responds quickly to problems is essential to efficient markets. Government facilitates these functions. Strong government is possible without strong financial markets but strong financial markets are impossible without sound government backing.

Most financial market regulations function to eliminate asymmetric information in the market. 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. For example, the seller of a used car has better, more complete information about the condition of that car than the buyer does. This creates an obvious risk problem for the buyer. This logic also applies to the financial markets.

Adverse selection describes the problem that asymmetric information causes before a transaction occurs. Adverse selection results because the borrowers (sellers of a financial instrument) who are most likely to produce an adverse result – bad credit risks – are the ones that most actively seek the loan. They are, therefore, the most likely to be selected. Because loans are more likely to be made to bad credit risks, lenders are less likely to lend even to low risk borrowers. The outcome is that less money is available for legitimate, productive purposes.

Asymmetry in financial relationships can also result in overly risky lending or so-called *moral hazard* behavior. This is the case when banks, soothed by the knowledge that federal insurance provides a safety net, approve loans at high risk for default. Regulators seek to minimize these conditions so the markets can facilitate the efficient flow of capital for economic growth. Price manipulation, insider trading (a form of asymmetric information) and accounting fraud are among other issues that periodically plague the industry.

Since the early 20th Century, the US Congress has passed several laws to help control and manage the financial services industry. The Sarbanes-Oxley Act of 2002, in response to the accounting fraud at Enron and other corporations, is a good example. State governments are also active in regulating the industry. The \$1.4 billion judgment this year against several major investment houses for misleading and defrauding investors, was brought by the State of New York – under state law.

In the executive branch, the Securities and Exchange Commission oversees the self-regulatory functions of the securities markets while the Federal Reserve Board regulates all national banks and the banking system as a whole. In addition, the Financial Criminal Enforcement Network is playing an increasing role in combating terrorist

financing and money laundering in general. These are just three of many government organizations that play a role in the complex regulation of this expansive industry.

Finally, the judicial branch plays a critical role in regulation and enforcement through adjudication of bankruptcy, protection of property rights, and – in the extreme – criminal prosecution. Each branch of government, all the laws and all of these regulatory organs comprise an effective rule of law that lays the foundation that makes everything work.

Again, a financial environment, or infrastructure, built on security and trust is essential for capital to flow freely through a market. Although the markets themselves play a significant role in providing this environment, the role of government is important, too. A review of other countries' financial services industries (and overall economies) demonstrates that those that lack a cohesive and effective financial infrastructure can languish in economic malaise or suffer devastating economic crises.

Essay 1

THE IMPORTANCE OF FINANCIAL INFRASTRUCTURE LESSONS FROM ASIA

Our industry research has confirmed the requirement for a national environment and financial infrastructure that provides for the efficient allocation of capital to develop and/or sustain a robust economy. The components of such a system include a sound, secure political and open economic environment along with the key financial elements of transparency, corporate governance and balanced government regulation. In this era of globalization, however, the requirement for such a financial system extends to all countries. This essay evaluates the financial systems of Japan and the so-called Asian Tigers of the late 1990s, to demonstrate that Japan's continued long-term economic depression, and the spectacular collapse of many Asian economies in the late 1990s, were largely caused by the compromise of the components required for a healthy financial system.

In the decades after World War II, the Japanese economy grew at an astounding rate, averaging annual gross domestic product (GDP) increases of 9.3 percent from 1956-74 and 4.1 percent from 1975-91. Between 1955 and 1973, per capita GDP for Japanese workers quadrupled from \$3,500 to \$13,500. From 1946 to 1975, the Japanese economy increased fifty-five fold. Fueled by exports, particularly of consumer electronics and automobiles, beginning in the 1960s, Japan enjoyed broad economic prosperity. It eventually became the second largest economy in the world, with a current GDP of approximately \$4.3 trillion. During the latter half of the 1980s, however, its economy overheated. This distortion resulted from speculative valuations of equities and real estate. The collapse of the prices of these assets in 1990 marked the end of the Japanese miracle – the bursting of the so-called bubble economy.

In the ensuing years, the Japanese economy experienced tepid to negative growth. Attempts by the government to stimulate the economy using fiscal measures – primarily, public works projects – have failed. Most economists today agree that the Japanese economy requires fundamental structural changes for the restoration of growth. Such changes include the termination of government intervention on behalf of failing companies and an end to the interlocking relationship involving banks, corporations and

the government. Most importantly, the Japanese government must effectively address the problem of non-performing loans (NPLs), which threatens a banking crisis and results in the inefficient allocation of capital.

NPLs are rooted in the late 1980s and early 1990s, when the Japanese economy enjoyed rising domestic demand, both by consumers and corporations. Consumers borrowed to invest in the housing boom and for leisure activities, such as golf club memberships. Corporations sought capital not for business expansion, but in some cases to obtain cash they could put away for future needs. Other corporations borrowed to speculate in stocks, rather than to concentrate on their core businesses – a strategy known as *zaitech*. During this time, Japanese banks lent huge amounts of money to various corporations without strict asset assessment.

Japan's failure to confront the looming crisis caused by NPLs reveals significant flaws – partly cultural and partly political – in its economic system. For example, Japanese banks have refused to declare the bad loans of corporate borrowers in default because, typically, the two parties were tied together in long-standing relationships. Therefore, to foreclose on these loans would be a sign of disrespect. The nation's financial system has been characterized by a “too-cozy” relationship between banks and industry. In addition, many companies concentrated in the real estate and construction industries account for a significant portion of NPLs. These same companies are supporters of the powerful Liberal Democratic Party (LDP), which has exerted political pressure on their behalf, postponing decisive action on the problem. Furthermore, the LDP fears the inevitable political backlash stemming from massive lay-offs that would result from bankruptcies following the foreclosure of NPLs.

As Japan procrastinates on its NPLs, capital continues to be allocated to failing companies. Were these so-called “zombie” corporations forced into bankruptcy and their assets sold to investors, more money could be allocated to stronger companies and entrepreneurs to produce economic growth for the nation. Simply put, the country must solve the issue of NPLs to effect an efficient allocation of capital.

Though democratic and free-market, the Japanese economy has been widely regulated and state assisted – with the government indirectly involved in picking winners and losers. Lacking the political clout of major companies, for example, small businesses often have trouble obtaining loans. Such structural flaws, combined with the fall-out from NPLs, account for the protracted economic stagnation. Japan must adopt a model of freer, less regulated capitalism. As highlighted by the economic torpor of the last decade, the old system no longer works.

As with Japan, several countries in Asia experienced vibrant GDP growth in the 1980s and '90s. Particularly during the latter decade, many investors, including fund managers wielding billions of investors' dollars, rushed to place their capital on what seemed then as sure bets.¹⁴ International banks, too, lent capital to Asian businesses at unprecedented rates. Many feared that if they did not get in quickly, they would be shut out of the Asian financial market. Low interest rates, particularly in Japan, further fueled lending to other Asian enterprises.¹⁵

As a result of this lending, many Asian countries were awash in cheap capital. Much of this capital was plowed into the development of manufacturing facilities and, like Japan, into speculative, existing assets such as outstanding shares of stock, land and real estate ventures.¹⁶ Significantly, many lenders and investors failed to conduct

sufficient due diligence on these ventures; most turned out to be of limited, or in some cases, nonexistent, profitability. This lack of comprehensive cost-benefit analysis was due in considerable part to moral hazard, which was widespread throughout the region in the '90s: both borrowers and lenders were convinced that Asian governments would not permit these significant loans to fail. As a result, the lending-spending spree was broad and deep.

Perhaps equally significant, most of this borrowing was from foreign banks/investors in foreign-denominated debt. Further, as most countries' currencies were pegged to the US dollar, the currencies were considered generally stable; most governments stated that they were committed to the peg and would not let their currencies float.

By early 1997, it became clear that several Asian currencies were overvalued: current accounts were negative and increasing, calling for currency depreciation. International currency traders (speculators) and major investors – both foreign and domestic – perceived the misalignment of value and began to sell equities and other investment vehicles. This led to increasing balance of payments deficits as the supplies of local currencies expanded while demand for them contracted: most demanded payment in US dollars. To keep their currencies pegged to the US dollar, each government began to buy up its excess currencies (denominated in dollars) with their foreign reserves. Currency speculators perceived that the reserves were not bottomless, so sensed an opportunity and focused on these currencies.

Governments in Thailand, Malaysia, Indonesia, the Philippines, Hong Kong, Taiwan and Korea found their currencies under extreme pressure and were ultimately forced to devalue. As each currency devalued, the other currencies experienced a relative *appreciation* in value that was effectively “not sustainable given the shaky financial conditions of the countries;” each successive depreciation round thus fed a spiral of the next series of depreciations.¹⁷

While the fundamental overvaluing of Asian currencies was the root cause for the ultimate currency crashes and subsequent recessions in these countries, there were other influences that exacerbated the overall crisis. First, the currency depreciations worsened the external debts of these countries (governments, financial institutions and businesses) that had borrowed extensively in foreign-based currency. Second, financial difficulties that many Asian firms and financial institutions faced proved worse than originally announced which generated further uncertainty about the true financial conditions of firms and banks. A third factor that also contributed to an environment of uncertainty was political weakness throughout the region. Some governments reshuffled cabinets or collapsed altogether under the economic-induced pressures. Other leaders refused to acknowledge the fundamental economic misalignments and instead claimed that international currency speculators were conspiring against them.¹⁸ The continued economic malaise in Japan, the leading regional economic and financial power, constituted a fourth contributing factor.

Finally, regional governments failed to tighten the money supply in the early days of the crisis; this should have increased interest rates and slowed capital outflows and thus the devaluations. Most governments enacted tight monetary policies only after their currencies had experienced significant devaluations. Paradoxically, this made things worse. The rounds of depreciations had increased the external liabilities of borrowers so

that when the money supply contracted, a capital crunch ensued that increased the number of non-performing loans, exacerbated financial conditions of banks and firms and precipitated a distinct deflationary effect on overall economic activity in the several countries.¹⁹

The Asian Economic Crisis of the late '90s provides an excellent, if sobering, example of what can happen when countries' financial infrastructures are immature relative to the demands of a 24hr, high-speed, highly integrated global financial system. As it became clear that these countries' infrastructures and investment opportunities were unsound, international capital quickly departed which resulted in economic devastation from which these countries are still rebounding today.

Similarly in Japan, international investors remain wary that the financial infrastructure of that country continues to be less sound than it should be for the world's second largest economy in a democratic, free-market state. Capital will remain outside of Japan until greater financial reforms are made and inefficient businesses and their related non-performing loans are written off. Once Japan demonstrates that its doors are open for free-market-based economic operations on a level playing field, it can expect renewed foreign direct investment and a return to higher GDP growth rates and greater economic prosperity.

Although imperfect, the United States constitutes perhaps the best example of a financial system that facilitates a robust financial services industry that, in turn, enables solid GDP growth. This system, including stable politics, a legal system that objectively adjudicates the rights of property holders, transparent operations between businesses and the investors that support them, and finally, a balanced degree of governmental regulation, stands as perhaps the best example for the world to emulate. Countries that compromise any of these criteria present barriers and/or challenges to the free flow of capital into such countries and thereby shackle their own economic expansion and slow opportunities to increase their citizens' standards of living.

As the world's single superpower democracy, the United States should aggressively promote the concepts and principals of free market capitalism and open, democratic societies worldwide. As we have explored in this essay, these principles are the bedrock of any effective financial system in today's globalized economic environment: capital will only flow (long-term) to countries that embrace the rule of law, have sound financial architectures and stable and secure labor and consumer bases. A financial infrastructure based upon these principles is what gives the US its competitive advantage in the financial services industry. Underdeveloped nations in particular will benefit from enhanced economic growth if they adopt these principles. As these countries raise their standards of living, this will, in turn, expand the global market for financial services. As the world leader in financial services, the US will benefit the most from such expansion. Increased global prosperity and stability enhances US national security. In this globalized era, what's good for the world is good for America.

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Essay 2

CHINA: EMERGING COMPETITOR OR GLOBAL LIABILITY?

During the last 25 years, the Chinese economy has gradually transformed from a centrally planned system to one influenced by market forces. As a result, China's economy has realized a remarkable annual growth of between 7-10% over the past two decades. While this growth is robust, many have disputed the accuracy of the figures.

Underlying these attractive numbers are paradoxes that have existed in China since reforms began. In the 1980s, foreign investment was attracted to China by a seemingly infinite supply of cheap labor, and generous tax incentives provided by the government. By the late 1990s, the attraction of these benefits cooled as investors found a myriad of bureaucratic barriers, protectionist measures, poor financial and physical infrastructures, and a lack of underlying institutional mechanisms necessary to support sustained productivity and growth. In addition, China faces a tremendous non-performing loan problem identified officially as approximately 25% of GDP. As with China's growth rates, however, industry experts place the figure at closer to 50% of China's \$1.3 trillion GDP. These loans are a result of the Chinese government's influence on the four state commercial banks to channel funds to inefficient, state-owned enterprises. The inability to verify these and other economic figures, coupled with a history of actual figures closely reflecting government projections and a recent occurrence of country economic statistics being released shortly after the closing of the fiscal year, contributes to a lack of confidence in China's financial environment and infrastructure – its rule of law, corporate governance and transparency of business operations.

Although many believe future gains in output, trade and employment may be difficult due to reform and restructuring of the state-owned industrial and financial sectors. Others take the contrary view, as demonstrated by the substantial increase in foreign direct investment, totaling upwards of \$50 billion in 2002 – surpassing that of the United States. Much exuberance within the financial services industry is attributed to two factors. The first is China's sheer size. With a population of 1.3 trillion people,²⁰ an estimated \$1.8 trillion of combined business and individual deposits,²¹ a consumer consumption rate that accounts for 48 percent of GDP²², and severe shortcomings in the products and services offered by the domestic financial services industry, China is a market ready for the picking by those able to exploit it.

The second and most important factor contributing to recent investment exuberance was China's accession into the World Trade Organization (WTO) in December 2001, resulting in the creation of a rules-based system and the liberalization of the previously restricted area of foreign direct investment. In the last several years, China has aggressively worked on structural reform of its institutional, legal, and judicial systems to comply with WTO-related undertakings, and has begun to clamp down on corporations and individuals through prosecution and penalties. However, the quality of Chinese reforms remains in question. Nevertheless, China - unlike Russia and Japan – is implementing change with a sense of determination. For this reason we believe China stands a good chance of succeeding in its reforms and emerging as a global economic competitor.

That said, the greatest challenge China faces in determining whether it will become a global competitor or liability, is its potential for social unrest caused by first, second, and third order effects of the structural reforms. Increasing unemployment caused by government and state-operated enterprise restructuring; resulting low severance and non-existent welfare payments; loss of pension and health benefits; and an increasing gap between urban and rural incomes have all contributed to increased unrest. For the last several years, the government has attempted to introduce a revamped social security and pension system concurrent with the streamlining of the state-operated enterprises – but with limited success. Government incentives for entrepreneurs to create businesses that employ laid-off workers and high government spending in recent years on infrastructure projects - in transportation, utilities, and information technology - between the coastal and inland regions are steps towards a solution. However, until China is willing to aggressively and systematically implement and enforce social security reforms, pension reforms, and secure rural property rights across the country - as has been done in other areas - social unrest remains a wild card.

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Essay 3

TRANSPARENCY

ENRON, INVESTOR CONFIDENCE AND THE FUTURE OF AMERICAN FINANCE

A constant theme of the financial services industry is the importance of transparency and its relationship to investor confidence. The need for clear and correct investment information inextricably links transparency to investor confidence and is critical for sustaining strong capital markets. US markets have repeatedly proven this fact, even before the Great Depression. However, part of the challenge is how to balance government regulation and corporate governance to ensure transparency. The Enron collapse dealt a severe blow to investor confidence and put into question the transparency of US markets. To restore investor confidence, Congress passed the Sarbanes-Oxley Act of 2002 (P.L. 107-204) which represented the most sweeping changes to securities laws since the 1930s - even though that era saw the establishment of the Securities and Exchange Commission (SEC), the federal regulatory arm. The recent loss of investor confidence has not only translated into a tepid securities market in the US, it also has had global ramifications. Today, large institutions are not investing much capital; instead, they are holding them in reserve, waiting for the air to clear. Let's explore whether Sarbanes-Oxley will result in expected transparency enhancements and hence restore investor confidence.

Investor confidence is the result of many factors, ranging from financial security for individuals to sales and profit projections for businesses. When the criteria for these factors are satisfied, investors then look at how the financial markets are managed, as well as perform appropriate risk assessments before deciding on investments. Such assessments require the basic assumption that the information is reliable and verifiable. This is the crux of transparency. The degree of transparency, however, can vary greatly dependant upon the extent of government regulation/oversight, integrity of corporate governance, reliability of the self-regulating organizations in the exchanges (e.g., NASD,

NYSE, AMSE, CBOT), and the objectivity of professional industry observers (e.g., rating agencies, securities analysts and the media) who advise investors. The aftermath of Enron and other corporate scandals has brought to light the importance of these issues to investors – large and small alike. Furthermore, the United States' quest to remain dominant in the global financial industry has created an environment where Congress, the regulators, and the industry are trying to strike the right balance. How the investors respond is a good measure of the success of this balance. This applies to investors both domestic and foreign.

In the US, passages of the Gramm-Leach-Bliley (GLB) and Sarbanes-Oxley Acts have had a tremendous influence on the financial services industry. However, did one beget the other? More specifically, did the effects of GLB – deregulation of banking - precipitate the collapse of Enron? Questions abound as to whether the corporate diversification facilitated by GLB encouraged lenders to extend Enron more credit than they should have in order to win its investment banking business. For example, Citigroup was one of the two financial companies with the most exposure to the Enron scandal. Yet when the Federal Reserve probed this issue, its response was that Citigroup did nothing improper in its extensive dealings with Enron. The Federal Reserve Chairman stated that prudent risk-taking by banks is healthy to remain competitive in the global marketplace.²³ However, regardless of the Federal Reserve's position on this controversial issue, investor confidence in fact declined, especially by new, individual investors whose pensions or life savings depend on the accuracy of the financial statements presented by Enron or any publicly traded firm. Citigroup had to place \$1.3 billion in reserve to cover its Enron losses.²⁴ Another revealing fact that became evident from the Enron scandal was the power of securities analysts on the market. Investment banks like Citigroup and J. P. Morgan Chase employ analysts to provide analysis before making buy, sell and hold recommendations. Many investors circulate and rely on these recommendations. For Enron, analyst support was crucial because the company required constant infusions of funds from the financial markets to propel its (fraudulent) growth. Even more revealing is how major firms' analysts responded after Enron's stock had fallen 99% from its high on November 29, 2001.²⁵ After rating companies downgraded Enron's debt to "junk bond" status, only two of 11 major firms' analysts rated its stock a "sell."²⁶ This certainly raised concerns about the analysts' objectivity as it relates to providing unbiased recommendations without pressure from the investment bank to recommend otherwise. At the firm behest of the SEC, this apparent conflict of interest resulted in investment banks taking steps to insulate their analysts from banking operations. Additionally, Sarbanes-Oxley requires the SEC to study the role of investment banks in accounting deception and report its findings to Congress.²⁷

In addition to the financial markets, Congress also subjected the commodities markets to closer scrutiny in the wake of the Enron collapse. This is because a portion of Enron's core energy business dealt with derivative contracts, which market forces tie to the prices of oil, gas, electricity, and other factors.²⁸ Since the markets where Enron traded are largely unregulated, it is difficult to verify the extent of profitability of Enron's derivatives activities beyond what was provided by the company's financial statements.²⁹ Even though trading in derivatives is a risky activity, there has been no evidence that shows these speculative losses contributed to Enron's collapse.³⁰

More troubling, however, was the practice of making “wash trades”, which gave the appearance of greater market volume than what actually existed.³¹ This also facilitated deceptive accounting since Enron reported these *virtual* trades as *real* revenues. The California electricity crisis is a case in point. By engaging in a variety of manipulative trading practices, Enron was able to buy electricity at a fixed price in California and sell it elsewhere at the higher market price.³² This created and/or exacerbated electricity shortages within California. The moral to this story is that although derivatives trading were not a major cause to Enron’s collapse, it does raise the issue of supervision of unregulated derivatives markets. This makes it difficult for regulators to assess the risk exposures and portfolio of major dealers in derivatives due to little or no information available.³³

Transparency concerns are hardly confined to the US. Even though many international investors see China as a country with potential great returns, verifying economic and financial data has been difficult. This is a result of China’s communist system: a result of the lack of democratic principles, rule of law and corporate governance. Despite the government’s claims to have made necessary market reforms, many business operations in China continue to be opaque, making investment there precarious. Problems such as a rising unemployment rate, the revamping of state-sponsored pension funds, non-performing loans (NPLs- estimated to represent 25-50% of China’s GDP), continue to raise doubts for many investors. China promises to fully open its market and balance sheets. Until this happens, many major investors are keeping their capital out of that market.

Japan, too, is grappling with transparency problems, but primarily only with respect to non-performing loans. The enormity of these NPLs - approximately 20% of Japan’s \$4 trillion GDP - not only negatively influences investor confidence, it results in the inefficient allocation of capital to weak companies and may threaten an all-out banking crisis. Investors are taking a wait-and-see posture on whether the structural reforms put into place by Prime Minister Koizumi will bear the economic fruit Japan – and the rest of the global economy - so desperately needs.

The UK has a solid rule of law and in some respects leads the US in the areas of transparency and corporate governance. For example, the UK already has laws that make corporate boards more independent from senior management and limit the power of CEOs. The UK prides itself on corporate governance for public companies through the use of principles-based guidance. It considers its Combined Code for governance and best business practices as simpler than the US’s comprehensive, rules-based approach to regulation.

Even though recent corporate scandals have tainted the US capital markets, the federal and state governments’ swift responses to remedy the problem will go a long way in restoring overall transparency and investor confidence. Increased oversight by the regulators (i.e., Federal Reserve, SEC, CFTC, etc.), reliability of the self-regulatory organizations, and the integrity of the various industry professionals who influence investors’ decisions will ultimately regain investor confidence. Technology has also enhanced transparency. For example, electronic communications networks (ECNs) enable buyers and sellers to post orders for efficient matching. They provide greater transparency and competition with the other exchanges. Moreover, this competition has served to lower the cost of trading. The challenge for the US in the information age,

however, is to ensure that ECNs are secure against cyber attack. Finally, if the U.S. continues to be responsive to the changing global environment investors demand, it will significantly grow in revenue and continue to be the dominant player in the financial services industry.

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Conclusion

After five months of intense industry study, to include research, lecture, discussions, and observation, it may be safely concluded that the US financial services industry is on solid footing. Its infrastructure is solid and the industry is growing at a steady rate. With the US financial industry comprising 2/3 of global financial GDP and 20% of total US GDP, it is clearly the backbone of the American economy that, in turn, under girds the diplomatic, political and informational elements of national power. The quality, maturity, and sheer size of the US financial services industry allows it to serve as a model for the rest of the world. Conversely, the lack of both quality and maturity in the other countries' financial infrastructures and industries – as demonstrated in Japan, China and some other Asian countries - is a contributor to current global instability.

For the US to maintain its preeminence in this industry, it must strive for an appropriate and balanced set of government regulations that will continue to facilitate the profit motive, while simultaneously preserving transparency. Clarity in investment and business operations, in turn, stimulates investor confidence in the financial services sector and thus reinforces the cycle. Additionally, it is in the self-interest of the US to expend diplomatic capital through continuously and firmly promoting the concepts and principles of free market capitalism and open democratic societies worldwide. These principles are the bedrock for financial services: capital will only flow (long-term) to countries that embrace the rule of law, have sound financial architectures and stable and secure labor and consumer bases.

Underdeveloped nations in particular will benefit from enhanced economic growth if they adopt these principles. As these countries raise their standards of living, this will, in turn, expand the global market for financial services. As the world leader in financial services, the US will benefit most from such expansion. Increased global prosperity and stability enhance US national security. It appears in this globalized era that what is good for the world ends up being good for America. Furthermore, the US must take strides to advance compatible global infrastructures, including IT, legal and industry standards. Doing so will further liberalize the global flow of capital beyond its current restrictions while leveling the playing field and improving access to all market-based, democratic nations.

Finally, because profit margins are diminishing and consolidation is a means of increasing revenues while contributing to efficiencies in the market, security enhancements are necessary for consumer confidence to aid in the stability of the industry. The bottom line is the industry is resilient: it has withstood major shocks both domestically and internationally, yet after each event the industry has emerged a stronger entity.

Despite the future's uncertainty, there will always be demands for capital and risk management – on a global basis. The American financial services industry is poised to continue its international leadership and market share. It will remain a cornerstone of the US economy and a vital contributor to our national security.

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