4-2000

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Recommended Citation
2 J. Int'l Banking Reg. 39 (2000)

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We are living through a time of significant consolidation in worldwide financial services. Rarely do several weeks go by without the announcement of a large merger or acquisition in financial services (broadly defined here to include banking, insurance, and investment banking). Many transactions involve combinations in a domestic market.[1] Increasingly, mergers involve cross-industry and even cross-border transactions in which a particular kind of financial firm in one country joins with a different kind of firm in the same or another country.[2]

The reasons for this activity are many and are generally familiar to those who follow the financial services industry. Encouraged by academics and financial policy analysts, legislators and banking regulators have abandoned (or are abandoning) laws and regulations that keep separate different kinds of financial services firms or that restrict them to certain geographic areas. For example, the United States has seen the repeal of the Douglas Amendment to the Bank Holding Company Act, which prevented a bank holding company from establishing a U.S. nationwide bank through the purchase of banking subsidiaries in different states,[3] as well as the 1999 repeat of the well-known law separating banking from investment banking (Glass-Steagall) with a new regulatory structure permitting the combination of commercial and investment banking in one financial services group.[4] Similar developments characterize the European Union, through the elimination of artificial restrictions on financial firms conducting their activities throughout the member states.[5]

Expansion through a merger or acquisition makes sense only if there are business reasons for the transactions, which, according to classic economic theory, mean either to provide lower-cost products (economies of scale) or to use resources (whether assets, people, or ideas) of one business in another (economies of scope).[6] Economy-of-scale arguments certainly exist for the current banking mergers: for example, a firm can deliver many banking services at a lower cost if it makes a significant investment in new technological resources, and only large banks can make such investments.[7] Yet economy-of-scope arguments may be even more significant.[8] Several premises underlying the current expansion suggest that both institutional and retail bank customers want (or can be made through marketing to want) a variety of financial services available in one organization, and that there will be, accordingly, cross-selling of products as financial firms take advantage of distribution networks for both traditional banking and non-banking products.[9] As the theory goes, customers come to banks for transaction services, the traditional province of banking, but would also be happy to purchase investment and insurance products from them.

I briefly discuss the economy-of-scope assumption about cross-selling financial services from a particular perspective, that of investor education. The scope economies depend partly on the existence of at least a significant number of financially educated consumers. That is, the financial firms need one of two kinds of consumers: 1) those who simply hand their money over to the firms (not likely ever to be a large group), or 2) those who, among other things, understand the use of, and their need for, all the services (payment systems, investments, and insurance) that the "universal" financial firms offer. Yet it is far from clear that this latter kind of consumer in fact exists in any great numbers, even in many developed countries. The realization of the merger "synergies" that combining firms so often trumpet in their press releases thus depends on the increasing financial sophistication of consumers, which can be achieved only through their financial education. The large financial services firms thus have to "create" their customers through education, not simply by marketing.

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Here, however, a potential contradiction surfaces. Financial education (which is not beyond the abilities of ordinary people) produces sophisticated consumers in several respects, for it teaches people about the need to save and to insure themselves, the methods by which to accomplish these goals, and the electronic tools for managing their money. Yet the logical question arises whether, as consumers develop their financial and even technological sophistication, they will continue to use all the services of the financial conglomerates (as opposed to shopping around for the best financial bargains). Paradoxically, the more institutions succeed in the financial education necessary for the realization of the benefits of the large mergers, the less likely they can keep their customers without adding value to their services in some other fashion.

WORLDWIDE FINANCIAL CONSOLIDATION

It is worth making a few additional observations about the merger wave among financial services firms. While the reasons for the merger activity in numerous countries are varied and echo the classical justifications for mergers (e.g., to expand market share, to add to a line of products),[10] many of these transactions are designed to expand the sale of financial services by the resulting firm to retail consumers through large geographical areas (even worldwide).[11] The largest U.S. financial services merger to date, the merger between Citicorp and Travelers into the new Citigroup, was partly premised on offering consumers banking, insurance, and investment services, all in one firm.[12] Banking mergers designed to create nationwide full-service banking, which in the U.S. we have seen in the BankAmerica/NationsBank[13] and BancOne/First Chicago[14] mergers, are similarly intended to give mobile consumers the ability to do all their banking (and other financial) services in one organization throughout the country. Many mergers involving investment banks, such as Morgan Stanley and Dean Witter, link the traditional investment banking with a business, whether mutual funds or retail brokerage, that reaches consumers.[15]

> The realization of the merger "synergies" that combining firms so often trumpet in their press releases thus depends on the increasing financial sophistication of consumers, which can be achieved only through their financial education.

It is important to emphasize the several (but not the exclusive) premises underpinning this merger activity. One reason for the transactions is the creation of value through cross-selling of financial products: consumers will value, and therefore use, a firm that offers all kinds of financial services and different means of providing them. Financial firms need to combine in order to be able to offer the desired services. Similarly, firms need to reach a critical size so as to be able to make the investment in technology (and to spread the cost of this investment among many products) that increases the ways of providing the services, such as online access.[16] Technology also allows a firm to identify the use of its services by, and thus to target better the sales of products to, particular customers.[17]

EDUCATIONAL CONDITIONS TO MERGER SUCCESS

Because government control over consumers' financial decisions is not a realistic policy, whether in the United States or elsewhere, the success of the current strategy in financial mergers presumes an educated consumer of financial services.[18] Except for wealthy people who can use private banking services, middle-class consumers do not generally have the option of handing their funds over to financial services firms which then provide all the necessary financial services (investing, insurance, etc.) with little involvement by the customer. For financial firms to attract the business of ordinary people, consumers have to understand their need for, and the value of, the kinds of financial services that firms offer. While most people in developed countries understand the importance of payment services, one of the traditional banking services, they may not similarly appreciate the other services, such as investing and insurance.

> Paradoxically, the more institutions succeed in the financial education necessary for the realization of the benefits of the large mergers, the less likely it will be that they can keep their customers without adding value to their services in some other fashion.

A consideration of the skills that ordinary consumers need to appreciate these services shows that financial institutions cannot take this educated consumer of financial services for granted. Saving, for example, is a relatively simple skill to understand: it means deferring consumption now for later or spreading consumption of resources over the life cycle. This skill, however, is not necessarily easy to put into action. To save means to resist the natural psychological inclination to focus on the present,[19] which is often exacerbated in a consumption-oriented society, like in the United States. Moreover, extensive social safety nets in some developed countries may undermine the savings behavior of their citizens.[20]

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Similarly, many people in any given developed country may be incompetent in investing. Despite the tremendous recent growth in the United States in individual investing, most notably by way of the Internet, for example, finance specialists find that people often follow inappropriate investing strategies.[21] For an ordinary person to engage in this activity, there must first be a willingness to invest, which presupposes a basic understanding of the advantages of putting one's disposable funds to a productive use and a confidence in available investments and securities markets. This confidence should not be underestimated, because it may well be based on an existing system of market regulation, laws giving investors rights, and a court system allowing enforcement of these rights.[22] Then follow all the skills associated with investing, which enable an individual to competently manage his or her money and/or to speak with financial professionals. These skills include understanding the basics of finance — in particular, the relation between risk and return, the benefits of diversification, and the need for life-cycle investing.[23]

If the successful realization of the synergies of financial services mergers presumes a knowledgeable consumer in many countries, and if this consumer does not widely exist *anywhere*, this success depends on consumer financial education that teaches ordinary people about the basics of saving, investing, and using other financial products. Yet the content and design of this education are complex, particularly when one realizes that it must be adjusted for the given cultural context.[24] For example, in the United States, there is much popular knowledge about investing (although only about 50% of U.S. households invest in securities), and investor education is available from a bewildering number of education providers.[25] Yet the U.S. savings rate is dismally low, which suggests that more education is needed on simply how to save.[26] In many continental Western European countries, by contrast, the savings rate is high. However, because capital markets there have traditionally been small and dominated by wealthy families, ordinary people are both suspicious about investing in securities and not particularly knowledgeable about it. Accordingly, investor education in these countries would need to be different from that in the United States in order to be effective.[27]

It is not surprising that, given that financial firms need educated consumers to appreciate the value of, and thus to use, their financial services, there have recently been massive investor-education efforts. A main impetus for this education has come from governments that must address a significant problem arising from the demographic time bomb in their countries — the growth in the ratio of retired or retiring persons to the working population — which places enormous pressure on the traditionally generous social safety nets.[28] Often encouraged by the government, large financial services firms or their trade associations have provided much of the investor education.[29] This activity demonstrates that firms recognize that their future success depends on an educated consumer who can make use of their numerous services.

To save means to resist the natural psychological inclination to focus on the present, which is often exacerbated in a consumption-oriented society, like in the United States.

But in the rush to complete the mergers and to integrate the complex operations of two or more companies, financial services firms may forget or neglect consumer financial education. Just as mergers often decrease shareholder value because the companies involved become so focused on the logistics of combining that they ignore their customers,[30] so financial firms may ignore the educational prerequisite to their success. Not only might financial mergers produce large firms that, through lack of organization or excessive operational complexity, are unresponsive to customers,[31] such firms may fail to realize that their success depends on creating a customer competent to use them.

Despite the tremendous recent growth in the United States in individual investing, most notably by way of the Internet, for example, finance specialists find that people often follow inappropriate investing strategies.

THE EDUCATIONAL DILEMMA

An additional problem, however, faces financial firms if their educational efforts are successful. While they must educate consumers to obtain the benefits of cross-selling, it is not entirely clear what this educated consumer will do. The educated consumer — that is, one who develops a competence in saving, finance, insurance, and the handling of electronic means of financial services delivery — may simply take his or her business elsewhere, a possibility that the new technology facilitates.[32] As is becoming clear, it is difficult to have much of a "first mover" advantage in financial services because most new entrants to this industry can rapidly and inexpensively imitate existing products. It may well be that large financial firms can provide a technological platform for the delivery of financial services that is superior to those of smaller firms and that can be highly responsive to the needs of each customer.[33] But even this assumption is questionable when one considers how fast computer technology and telecommunications are themselves changing.

As more consolidation occurs, and as more individuals become educated consumers of financial services, there may well happen an opposite movement of "disintermediation" of financial services. Certainly we are seeing this phenomenon occur in the United States among the most highly educated or technologically sophisticated investors who use the direct or on-line investing services. These investors collectively dominate some industries and increasing demand direct access to all kinds of investments. Their activity has led to the creation of smaller financial firms that fill their needs and that often challenge the dominant firms.[34] Indeed, financial regulators are devoting much of their current attention to these new firms and networks.[35]

Financial education, so necessary for the success of the current financial services merger wave, may carry with it the seeds of the firms' own destruction. It may well be that the margins on providing worldwide transaction and payment services will financially justify the large mergers, but even these services may become increasingly contested.[36] The diverse range of products, the customer focus, and the technological platform provided by the large financial services firms may make the consolidation valuable in the short run. But this outcome will likely be unstable as the large financial services firms encounter considerable competition in both the financial and technological sectors.[37]

Successful realization of the synergies of financial services mergers depends on consumer financial education that teaches ordinary people about the basics of saving, investing, and using other financial products.

CONCLUSION

Tremendous financial services mergers are occurring around the globe, arising from the relaxing of regulatory regimes, technological advances, and other industry-specific factors. A major premise underlying this consolidation is that a financial firm can maximize its profits by providing all financial services under its umbrella. As I have suggested, the success of this merger wave in financial services at least partly depends on the existence of a certain kind of consumer, the financially and even technologically sophisticated person who can use these services. Yet this kind of investor does not yet exist in large numbers, even in most developed countries. A necessary condition to the success of the merger wave in each country is, therefore, an educational program that will "create" such consumers, but a context- and culture-specific program.

In the rush to complete the mergers and to integrate the complex operations of two or more companies, financial services firms may forget or neglect consumer financial education.

Once created, the educated consumer of financial services may, however, be reluctant to commit all his or her resources to the services of the new financial conglomerates. This kind of person can easily move around in search of other, better-priced financial services, which are likely to be provided by new entrants to the industry. Unless the financial megafirms make sure to offer financial products and services that are lower in cost or significantly better than those offered by smaller or newer firms, the very consumer education that is a prerequisite to their success may ultimately undermine them.

ENDNOTES

[1]Examples of these combinations are too numerous to cite. Foust [1999] describes the formation of BankAmerica, a result of the merger between NationsBank and BankAmerica Corp. *The Economist* [1999] describes bank consolidation in France, Germany, and Japan.

[2]Sapsford and Zuckerman [1999] describe the proposed merger between Chase Manhattan Corp. and investment bank Hambrecht & Quist. Silverman et al. [1999] describes the formation of Citigroup, a merger between Citicorp (banking firm) and Travelers (an insurance firm with an investment bank subsidiary), and its problems. Guyot and Beckett [1999] review the acquisition of Republic New York by the Hong Kong and Shanghai Banking Corporation.

[3]See Malloy [1999].

[4]See Gramm-Leach-Bliley Act Pub.L. No. 106-102, 113 Stat. 1338 (1999).

[5]See Smith and Walter [1997].

[6]See Chandler [1990].

[7]See Berger [1999].

[8]Milbourn [1999] questions the "scope" assumptions behind bank consolidation.

[9]Kane [1999] critically discusses the marketing thesis behind megamergers of financial institutions.

[10]See Shy [1995].

[11]Drucker [1999] argues that the future success of financial services firms absolutely depends upon their reaching retail customers.

[12]Silverman [1999, pp. 130-131].

[13]Foust (endnote 1), p. 148.

[14]Cahill [1999] describes BankOne's decision to avoid further takeovers so as to develop consumer-oriented electronic banking services.

[15]Gasparino et al. [1999] describes the developments in this investment bank that are designed to enhance its trading operations for retail customers.

[16]Thakor [1999] explains the justifications for financial firm investment in technology.

[17]Fairlamb [1999] observes that on-line banks can more easily trace their customers' use of products than can "brick and mortar" financial institutions.

[18]On consumer financial education, see Fanto [1998a].

[19]Weiss [1999] outlines the psychological pressures affecting savings behavior.

[20]On social security programs, see Gruber and Wise [1997], which has a table describing programs in developed countries.

[21]The literature on this subject is voluminous. For one example, see Odean [1998] which describes empirical results indicating unjustifiable overconfidence of investors.

[22]La Porta [1999] discusses data showing that countries with good rules of shareholder protection have widely-owned firms.

[23]See Fanto [1998a, pp. 132-133].

[24]On the need for cultural diversity in investor education, see Fanto [1998b].

[25]See Fanto [1998a, pp. 137-146].

[26]See Bernheim [1991, pp. 66-92].

[27]See Fanto, [1998b, pp. 1101-1104].

[28]Group of Ten, *The Macroeconomic and Financial Implications of Aging Populations*, 1998, pp. 5-10 (presenting statistics on potential demographic burden on state-sponsored retirement systems).

[29]See Fanto [1998a, pp. 143-146].

[30]See Sirower [1997].

[31]See *The Economist* [1999], which describes the complexities arising from combining different financial services in one firm.

[32]See, e.g., Fairlamb (endnote 17), who says,

> Online bank customers are not a loyal breed: They can shop around readily now for the best deals, so they're no longer as dependent on their bankers.

[33]See Berger (endnote 7), pp. 148-149.

[34]In response to this phenomenon, large financial firms are developing on-line services for these investors, which potentially conflict with their other "full service" financial approach. See Gasparino (endnote 15), p. A4.

[35]Remarks by Arthur Levitt, Chairman of the U.S. Securities & Exchange Commission, September 23, 1999 (available at http://www.sec.gov/news/speeches/spch295.htm), discussing the impact of electronic trading networks on the traditional stock exchanges.

[36]Hancock et al. [1999] describe the steady decline in costs of payments systems due to, among other things, technological changes.

[37]See Thakor (endnote 16), p. 700, who says,

> The next phase of evolution will involve the financial and information services industry beginning to disintegrate as more focused and specialized players emerge. That is, part of the current consolidation we are observing will actually be unraveled.

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