



The Financial Modernization Act: new perspectives for the finance curriculum

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Abstract

The Financial Modernization Act (FMA) of 1999 permits banks, securities firms, and insurance companies to combine and compete with each other in all types of financial services. No longer are the names of financial institutions synonymous with their particular products. This suggests moving from an “institutional perspective” that focuses upon the historical specializations of institutions, to a “functional perspective” that focuses upon the value added by financial services. The functional approach offers the finance curriculum a broad and flexible methodology for covering financial services. © 2001 Elsevier Science Inc. All rights reserved.

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1. Introduction

In 1999, Congress passed the Gramm–Leach–Bliley Financial Modernization Act (Pub. Law 106-102, 113 Stat. 1338), henceforth referred to as the “Financial Modernization Act” or simply “FMA”. The FMA repealed federal laws that restricted institutions to banking, securities, or insurance activities. It allowed them to combine into single “Financial Holding Companies (FHCs)” that could compete with each other in all types of services. This change in the industry structure of financial services has been termed “convergence”.

We argue that convergence under the FMA mandates a *functional perspective* to understanding and explaining financial services. A functional approach lays out the general types of financial services, and then explains how financial institutions have efficiency in producing them (i.e., the economic rationale of the financial sector). This differs from an

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institutional perspective that describes and compares the “names” of institutions in terms of their historical product specializations. The functional approach narrows the vast product list of financial companies into broad categories. For example, all of the deposit and lending products of banks, savings and loans, investment banks, and finance companies may collapse into a single function that could be termed “financial intermediation”.

A functional perspective clearly has applicability to courses in financial markets and institutions. However, it is also useful in other finance courses that tangentially cover material about the financial sector. In the case of corporate finance, this approach explains how non-financial businesses utilize financial services in a value-adding process to maximize their shareholder wealth. In the case of investments, the approach shows how financial services create value by transforming real assets into liquid and tradable surrogate financial assets. In courses in personal financial planning, it articulates the value of financial services to consumers who use them and pay for them. To illustrate, students are better served by understanding how insurance companies add value by underwriting risks to life and property, as opposed to simply grasping the elements of insurance policies.

Various formats of a functional approach have been advocated for at least a decade. Merton (1995a,b) and Merton and Bodie (1995) have written articles proposing functional methodologies. Moreover, textbooks by Bodie and Merton (2000), Dietrich (1996), Kohn (1994), and Scott (1991) have employed functional approaches. Nevertheless, the functional pedagogy has not gained widespread appeal. However, the passage of the FMA has made it more relevant than before, as is discussed in the sections that follow.

Section 2 discusses the provisions of the FMA and contrasts the financial services industry before and after its passage. Section 3 surveys the impact of the FMA and how it has led to industry reorganization along multifunctional lines. Section 4 lists and explains the benefits of the new curricular perspective in the post-FMA environment. Finally, Section 5 provides concluding comments.

2. The Financial Modernization Act

The FMA was landmark legislation. It overturned the regulatory separation of commercial banking, securities, and insurance activities that had existed since the Great Depression. The FMA ended the sub-industries of “banking”, “securities”, and “insurance”, and then combined them into the comprehensive “financial services industry”. Now, all financial institutions may legally offer all types of differentiated financial services and compete with each other for the same customers.

Principle parts of the Act repealed sections 20 and 32 of the Banking Act of 1933 (U.S.C. 377 and 78, respectively), also known as the Glass–Steagall Act. The omnibus legislation also amended the Bank Holding Act of 1956 (12 U.S.C. 1843). Besides permitting convergence in the financial sector, the FMA had other provisions that affected the provision of financial services. It addressed the issue regarding the sharing of customer information among financial services firms in the context of consumers’ privacy. It also made sure that its provisions reflected and supported the intent of the Community Reinvestment Act in terms of fair lending practices.

Specifically, the FMA states that a financial holding company or its subsidiary may engage in any activity that is financial in nature, incidental or complimentary to a financial activity, and does not pose a substantial risk to the safety and soundness of depository institutions or the financial system in general. Those activities are allowed so long as: (1) the Federal Reserve Board and the Secretary of Treasury permit it; (2) the depository institution is well capitalized; and (3) the depository institution upholds a satisfactory record of meeting community credit needs as determined by the Community Reinvestment Act of 1977. Furthermore a firewall requirement has to remain between the securities subsidiary and the commercial bank unit, i.e., cross-marketing by these two entities is forbidden. The oversight over the holding company *per se* rests with the Federal Reserve Board, but particular financial services they offer are regulated by authorities who have traditionally overseen these functions, as is discussed later in this section.

The FMA limits FHCs to offering only financial products. Non-financial, commercial products and services are not covered. Non-financial activities that were pursued before the Act's passage are only grandfathered for an initial 10 years, or at most 15 years, if they do not receive more than 15% of the consolidated annual gross revenues of the firm. The extent that FHCs may engage in particular activities that are incidental or complimentary to financial activities (such as real estate brokerage) is not yet fully defined and probably will take time to evolve. The FMA was particularly directed toward commercial banks. The principal issue was whether or not banks should be allowed to combine with non-bank financial firms (securities and insurance companies), much more so than should non-bank firms be allowed to combine with each other. This is attributable to the fact that banks accept checking deposits, and because of this, they have been much more regulated than securities and insurance companies. Public policy desires to maintain the solvency of individual banks as well as the integrity of the entire monetary system. Federal authorities do not want to see depositors lose their paychecks due to bad management of their banks. Moreover, authorities do not want the entire banking system to experience contagious bank runs, as occurred in 1929. In this context, it becomes easy to understand why regulators and legislators were reluctant to combine banking with other financial services that might introduce additional risks.

Table 1 (based on the American Bankers Association (1999)) summarizes the major provisions of the Act in terms of its impact upon the financial sector. It illustrates the commercial banking focus of the FMA and shows how the Act largely addresses bank product powers and bank regulation. Securities and insurance companies have already had considerable flexibility in their activities, thus, the principal issue of the FMA was combining these activities with banking. Nevertheless, the Act does introduce more competition for non-bank institutions, among each other as well as from banks.

The first row of Table 1 addresses how financial institutions may combine in holding company structures, before and after the FMA. Before the Act, banks and Bank Holding Company (BHC) affiliates were restricted to "activities close to banking". Bank Holding Companies were regulated by the Federal Reserve, and their subsidiaries were regulated by banking authorities (the Federal Reserve, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and state banking commissions in the case of state-chartered banks). After the Act, FHCs could legally be formed to have both bank and non-bank

Table 1

Convergence of banking with other financial services under the Financial Modernization Act

	Before the Act	After the Act
Holding company structure and regulatory authority	Bank Holding Companies (BHCs) may have banking subsidiaries and other affiliates offering only services that are “close to banking” Federal Reserve regulates BHCs; bank regulators supervise subsidiaries	Financial Holding Companies (FHCs) and BHCs may have banking subsidiaries as well as non-bank affiliates that offer all types of financial services Federal Reserve regulates FHCs as well as BHCs Bank subsidiaries accountable to the bank regulators; securities subsidiaries accountable to the Securities Exchange Commission; insurance subsidiaries accountable to state insurance commissioners
Permissible securities functions	Bank Holding Companies or their affiliated banks may not engage in underwriting corporate securities; nor may they have securities affiliates that do so. BHCs may only underwrite government and municipal securities After 1989, particular BHCs or their affiliates may underwrite corporate securities to a limited extent, depending upon approval by the Federal Reserve	Financial Holding Companies may have banking subsidiaries as well as securities subsidiaries that may underwrite and deal in all types of corporate securities as well as government and municipal securities without limitation; they may also distribute mutual funds
Permissible insurance functions	Banks may only underwrite credit life insurance Only banks in small communities could engage in insurance agency activities	FHCs may have bank affiliates as well as non-bank affiliates that engage in insurance agency and underwriting activities

subsidiaries. The Federal Reserve regulates the FHC, and the non-bank subsidiaries continue to be regulated by the Securities Exchange Commission (securities subsidiaries) and the state insurance commissioners (insurance subsidiaries). The next two rows of Table 1 show how securities and insurance functions may be combined with deposit-banking functions in a much more significant way than before the legislation. In particular, the FMA allows FHCs to combine deposit-banking with full scale securities underwriting and insurance activities that before were either prohibited or significantly limited.

The FMA also regulates thrifts, which are deposit-taking institutions. Like banks under FHCs, thrifts under Unitary Thrift Holding Companies are allowed to own securities and underwriting subsidiaries.

3. Impact of the Financial Modernization Act: industry reorganization along multifunctional lines

Convergence was largely a fact even before it became legal after the FMA. Some financial institutions began *de facto* convergence through developing product substitutes. For example, the securities firm Merrill Lynch began competing with banks with its Cash Management Account that combined check-writing, money market investing, and credit extensions (see Scott, 1991, p. 16). Others exploited regulatory loopholes and permissiveness in interpreting and implementing laws—the merger of Bank of America and discount broker Charles Schwab in 1981 and the 1987 decision by the Federal Reserve to allow limited investment banking by Bankers Trust, Citicorp and J.P. Morgan (Johnston & Madura, 2000, p. 19). The interaction between institutions aggressively seeking new powers and federal law reached an apex in 1998 when the large bank, Citigroup, sought to merge with an insurance company, Travelers Group, and a securities company, Salomon, Smith, Barney. This cross-functional merger hastened the passage of the FMA, since the huge Citigroup would have had to dispose of Traveler's insurance operations (for a complete discussion of this merger, see Carow, 2001).

Enactment of the FMA empowered and further enhanced the process of convergence in the financial industries that had already begun. Many financial institutions, both large and small, converted to FHC status immediately after its passage. Bennett (2000) reported that within 6 months after the Act, around 200 banks, mainly community banks, gave up their status as Bank Holding Companies and became FHCs in order to expand product offerings.

Following passage of the Act, a significant blending of the functions of financial services firms resulted. Non-bank intermediaries encroached on deposit banks. Sweeney (2000a) reports that among the “10 largest U.S. banks” are Charles Schwab Corporation and Morgan Stanley Dean Witter—both traditionally securities firms—as well as Provident Financial Corporation and Capital One Financial Corporation—traditionally credit card lenders. The Wall Street Journal (12 June, 2000) has noted that most major on-line brokerage firms have added banking transactions to complement their computerized trading facilities. These include Ameritrade, Schwab, Datek, DLJ Direct, E*Trade, Fidelity Investments, Merrill Lynch, Morgan Stanley Dean Witter, National Discount Brokers, and TD Waterhouse. On the other hand, banks have moved in on non-banks. Bank Holding Companies and many consumer banks provide discount brokerage and mutual funds. Many large Bank Holding Companies have established or acquired subsidiaries to engage in securities transactions, investment banking, and asset management. For example, in a recent merger, the investment banking emphasis of J.P. Morgan has been blended into the commercial banking emphasis of Chase Manhattan Bank. Fabozzi, Modigliani, Jones, and Ferri (2002, p. 113) have an excellent discussion of the history of J.P. Morgan and its merger with Chase Manhattan Bank.

Insurance has also converged with other intermediary functions. This has mainly occurred by banks moving into the insurance business, rather than *vice versa*. Streeter (2000) reported that Bank One operates nine insurance companies and agencies covering all states; Bank of America focuses on direct marketing of auto, homeowners, and term insurance, and even uses Internet sales methods. Additionally, Sweeney (2000b) provides survey statistics to

show that bank-generated insurance premiums grew by roughly 35% in 1998, and that about 43% of banks surveyed offered insurance products. Going the other direction, some insurance firms have moved into banking. State Farm Insurance Company has started the State Farm Savings Bank to sell banking products at its representative offices throughout the country and on the Internet, while other insurers have used their savings banks to set up trusts for individuals. The National Underwriter (2000) stated that between October 1997 and March 2000, the Office of Thrift Supervision (OTS) granted 34 insurance firms thrift charters.

The industry convergence in response to the FMA is clearly explained by economic motives. Firms have combined and moved into multifunctional operations to enhance the wealth of their shareholders. Apilado, Gallo, and Lockwood (1993) investigated the Federal Reserve ruling in 1987 that expanded the securities underwriting capability of large banking organizations, Citicorp, J.P. Morgan, and Bankers Trust. This event study explored the stock price reaction of shares in these firms to the event of the Federal Reserve decision. Their factor-analytic study showed that these banks' stocks enjoyed significant positive returns based on the favorable ruling. Bhargava and Fraser (1998) also conducted an event study and found positive responses to the Federal Reserve's initial decision to allow Bank Holding Companies to engage in investment banking through their Section 20 subsidiaries. Studies by Carow (2001) and Johnston and Madura (2000) extended the analysis to explore whether or not the event of the Citigroup merger signaled positive benefits for other large banks, life insurance companies, and brokerage services. Both studies found a positive stock price reaction, indicating that the equity market found cross-functional mergers to be value-adding.

All in all, the evidence is overwhelming that the FMA is a positive outcome for the financial services industry. Clearly, the industry focuses on how different financial functions are valuable to financial companies, and by implication, to consumers as well. Therefore, it makes sense to consider moving wholeheartedly to a functional approach to teach about the financial sector, which is discussed in detail below.

4. Benefits of a functional perspective in the post-Financial Modernization Act environment

Given the FMA, a functional perspective is called upon to accomplish an efficient learning process. Five reasons for this are explained below.

4.1. Properly characterizing the financial sector after the Financial Modernization Act

Fig. 1 maps financial functions across financial institutions and shows the changes before and after the FMA. Doing so, it shows how the financial structure may be described by the intersections of particular types of functions that are identified with particular types of institutions. For expositional simplicity, Fig. 1 assumes only three types of institutional specializations (commercial banks, securities firms, and insurance companies), and three arbitrary but readily recognizable functions (payments services, securities transactions, and

Panel A. The Old, Segmented Industry

<i>Function:</i> <i>Institution:</i>	Payments Services	Securities Transactions	Risk Underwriting
Commercial Banks	X		
Securities Firms		X	
Insurance Companies			X

Panel B. Encroachment of Institutions into Others’ Products After the Financial Modernization Act

<i>Function:</i> <i>Institution:</i>	Payments Services	Securities Transactions	Risk Underwriting
Commercial Banks	X	X	X
Securities Firms	X	X	X
Insurance Companies	X	X	X

Panel C. Birth of the Financial Holding Company by the Financial Modernization Act

<i>Function:</i> <i>Institution:</i>	Payments Services	Securities Transactions	Risk Underwriting
Financial Holding Company	X	X	X

Fig. 1. The Financial Structure Matrix.

risk underwriting). Although other institutional specializations and functions are omitted, the matrix makes an important point: the financial sector may be studied by focusing on the columns (functional approach) or the rows (institutional approach).

Panel A of Fig. 1 illustrates the segmented industry sector prior to the FMA. An “X” appears when a particular type of institution was permitted to offer a particular function. The diagonal of X’s shows that particular types of firms offered only one function, in keeping with their legal specializations. For example, commercial banks could offer payment services but not security transactions and insurance. In this environment, the institutions characterized the functions, thus the columns in the matrix were irrelevant.

Industry convergence following the FMA led to the practical reality of having X’s at all of the intersections of function and institution, as is illustrated in Panel B of Fig. 1. Under the FMA, all types of firms may have all types of functions. Now there is a choice of using either rows (institutions) or columns (functions) to characterize the financial sector. Moreover, it is probably most efficient to begin the discourse by defining functions, since after the FMA institutions have become only historical names that no longer connote functional specializations. Even more important, after the FMA the list of institutions begins to give

way to the formation of FHCs, so institutional names drop out of the matrix. Only the functions remain an important attribute of the financial sector (Panel C). Therefore, it becomes most effective to describe the financial services industry by function rather than institution.

4.2. Providing a flexible pedagogy for studying the financial structure

Major changes have occurred in the financial structure and even continue today, so that institutional approaches lack flexibility to accurately describe and explain it. As Merton and Bodie (1995) have argued, “functions are much more stable than institutions”. A functional approach, then, provides an enduring pedagogy for explaining the financial sector. If functions and/or institutional specialties change, there is no need to revise material that describes the financial sector. Additionally, the functional perspective allows for easy integration of universal banking practiced abroad. While financial institutions may have diverse specializations and names across different countries, the functions nevertheless remain stable and consistent for comparative purposes.

4.3. Explaining financial services in a value-added context

The functional approach is firmly rooted in extant financial theory and therefore enables a broad understanding of how institutions create value through their products. Financial intermediaries add value since they minimize the *transactions costs* requisite to the financial contracting and networking that financial services embody. They have the capability to gain and interpret information that is necessary to produce their networking services, e.g., information to search for prospective suppliers of funds as well as users of funds, credit information, information to assess and monitor risk.

Allen and Santomero (1998) summarize the theoretical literature that shows how intermediaries add value by overcoming information asymmetries as discussed above. They note that the proliferation of new information technology in recent years has reduced information asymmetry and thus lowered transactions costs of financial services. Therefore, the volume of financial intermediation should have decreased, since market participants could more easily conduct financial transactions for themselves. However, the authors note that the volume of intermediation has increased, not decreased, which fails to support the theoretical argument. Allen and Santomero seek to reconcile this inconsistency, arguing that new functions of the financial sector have appeared which minimize transactions costs.

In addition to clarifying the general role of intermediaries, understanding product and function is crucial to the effective management of individual financial institutions. This is particularly true for those functions for which new information technology has reduced their value as services. For example, owing to declined information asymmetries, managers of firms with products in indirect financial channels have received strong competition from those in direct financial channels. Borrowing and lending counterparties are better able to find each other, so the value of indirect finance declines relative to that of direct finance. Evidence of this is the declining market share of banks in the funds intermediation process. Wheelock (1993) found that in 1964 banks had 60% of U.S. financial assets, but this had

declined to less than 30% in 1992. Later statistics on banks' share of consumer assets show that the downward trend continued. The Chicago Tribune (2000) reports that while banks held 25.2% of consumer financial assets in 1975, they held only 9.9% in 1999. Scholtens and van Wensveen (2000) confirm the earlier finding of funds outflows from depository institution, and note that the beneficiaries were pension funds, mutual funds, and money market funds. Astute managers of financial institutions have responded to the pressure by recognizing and implementing new products within the direct funds intermediation function. For example, they have developed off-balance sheet loans and other contingent lending exposures to creatively earn revenues from notionally participating in the direct financial channels (Boot & Thakor, 1991).

4.4. Defining new functions of the financial sector

As innovations and competitive changes alter the financial marketplace, the optimal product mix in the financial services industry is significantly modified. Old products fade in importance and new ones emerge. This has been particularly true in past decades as information technology has proliferated. Since financial services are largely information-based, financial institutions are able to minimize costs by producing standardized products in volume. This has commoditized some traditional products and thereby reduced their contribution to financial intermediaries' profits.

This is particularly true in the case of the payments function. Payments services involve a production process that is greatly enhanced by computers and information flow. The processing and clearing of checks has been improved by computer networking and electronic data manipulation. Use of electronic payments has become ubiquitous; the Federal Reserve's new study shows that in 2000, 40% of non-cash payments were made electronically (Federal Reserve System, in press, Financial Services Website). Furthermore, technology has allowed e-banking to emerge as a product with a tremendous potential for scale economies in production (Byers & Lederer, 2001). This development has made payments services into a commodity wherein non-banks such as mutual funds, securities firms, insurance companies, and VISA have entered into competition with banks.

The funds intermediation function has also not escaped the pressure of commoditization. New technology has significantly diminished information asymmetries so that all types of institutions have equal access to credit information. Therefore, no single institution or type of institution may earn excess returns based upon information asymmetries. This has led to the decline in the funds intermediation of depository institutions.

Allen and Santomero (2001) argue that financial institutions are now more in the business of facilitating risk transfer and enhancing customer participation in the financial sector, than their traditional role as payments providers and funds intermediators. Risk transfer products include over-the-counter derivatives such as forward rate contracts and interest rate swaps, as well as other customized risk management tools. Participation products help individual investors enter markets, such as mutual funds that accomplish trading, asset allocation, and risk management more efficiently than individual investors may do so for themselves.

It is also interesting to note that financial institutions have begun to compete with securities exchanges in what may be termed a "liquidity" function. This encompasses the

market infrastructure necessary to produce transactions so that financial market participants may reposition their exposures. Over-the-counter dealer markets have developed in order to compete with the trading floors of organized exchanges. Securities firms as well as banks have developed electronic platforms that offer on-line, 24 hour trading of securities (Colby, 1993).

Evidence of the growth of new products is the increase in fee income at banks relative to lending spreads earned; while “spreads” account for income from traditional products, “fees” represent income of new products. To illustrate, Chase Manhattan Bank reported that for 1999 fee income increased by 104%, while income from retail banking, credit cards, and mortgages was flat (New York Times, 2000).

The functional approach is well adapted to embrace product changes. Derivatives and mutual funds escape the traditional definition of a bank as it appears in the institutional approach, although banks vend these innovations. However, the functional approach would only have to add these new functions to the list.

4.5. Identifying common elements in producing various financial services

A functional perspective is especially useful in educating future managers of multifunction FHCs. The managers of these new organizations must have a broader view of products and product markets than their predecessors in the old specialized financial institutions. They must develop production techniques and marketing strategies for a variety of functions, not just a single one.

Furthermore, viewing the economic rationale of financial institutions draws attention to the resource inputs that are required to produce the functional outputs; and even more important, how these inputs may be common to all outputs. Thus, a functional perspective would consider the production of financial services as well as simply defining these services. Specifically, it would recognize that all the functional outputs rely upon firms’ management of information and risk exposures. These inputs are common to all functional areas.

Information processing is necessary in banking, securities, and insurance functions that are performed by financial holding company subsidiaries. Banking subsidiaries must process information in order to clear checks and search for borrowers and depositors. Securities subsidiaries must process information about market prices and market trades, as well as financial information about the client businesses they underwrite acting as investment bankers. Insurance subsidiaries must gather information about property and casualty loss rates and actuarial life spans, and maintain considerable records about policyholders and payment of claims.

In terms of risk management, banking subsidiaries must understand, measure, and adopt policies to handle liquidity risk, credit risk, and interest rate risk. Securities subsidiaries must manage their market exposures in investment banking, market-making, and asset management. Insurance subsidiaries have to manage risk by actuarially estimating policyholder losses and providing adequate reserves to cover these losses.

Clearly, new information technology contributes to the efficiency of using inputs that are common to many product outputs. McAndrews (1997) shows that information processing networks provide complementary components of technology to produce multiple financial services.

5. Conclusions

The FMA and the evolution of the financial industry provide substantial impetus for changing the pedagogy for teaching about the financial sector. The curricular focus should become relevant to the new world of convergence in the financial industries. We advocate a functional, value-added approach to the curriculum. This format allows defining the financial sector not by the old names of institutions, but instead, by the functions that all institutions may now provide. This approach helps students understand how and why financial firms gather profits, and how new communication and information technology are redefining production techniques and competitive advantages. Finally, the functional/value-added approach helps students understand the structure and economic rationale of the new financial holding company.

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