

**"NATIONAL AND GLOBAL COMPETITIVENESS"
OF NEW YORK CITY AS A
FINANCIAL CENTER"**

by

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**Report to the Mayor's Committee on
Financial Services Competitiveness**

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NATIONAL AND GLOBAL COMPETITIVENESS OF
NEW YORK CITY AS A FINANCIAL CENTER

Executive Summary

Recent years have seen remarkable changes in the financial services industry, both domestically and internationally -- changes that have led to intense competition among financial services firms as well as among the financial centers in which those firms are based and in which they operate.

The financial services industry is of critical importance to the future of New York City. Together with tourism, advertising and the media, it is one of the major industries (all of them in the services sector) in which New York retains a significant competitive edge in supplying customers elsewhere in the nation and the world. They are industries that have managed to take up the slack in employment and output as the New York manufacturing base has eroded under pressure from domestic and international competition. A threat to any of these industries is a threat to the future of the City as a viable economic entity.

Other American cities have failed to husband their own core competitive-advantage industries, leaving behind hollowed-out municipal economies with little realistic expectation for revival without massive and indefinite public subsidies. The same danger faces New York City in the 1990s as other regions compete vigorously -- promoting well-trained labor pools, benign and transparent regulation, attractive tax environments and superior social and economic infrastructures -- for a share of the City's remaining core sectors. This is not only occurring on a national basis, but globally as well.

In this study, we are concerned with one of these industries, financial services, in which New York City has traditionally been preeminent. It is an industry undergoing dramatic change as financial firms and their clients reposition themselves continually to cope with competitive threats and opportunities coming in rapid-fire succession. It is an industry in which sustained competitive advantage cannot be taken for granted -- neither by the firms involved, by those who regulate and supervise them, by their employees, nor by the cities and regions in which they do business. Today, competition among firms, among regulators, and among financial centers is the name of the dominant fact of life.

New York City may well be seriously disadvantaged in this competition because the United States is virtually alone in traditionally debating regulatory, tax and other conditions affecting the financial services industry with little reference to the potential competitive consequences they hold for the industry's

ability to compete internationally. It is vital for New York City that the United States recognize that the marketplace for financial services is already global and getting more so. And that, in particular, a sensible domestic regulatory structure for the industry must transcend parochial interests and be designed with a view to actual and prospective financial globalization.

The study begins by reviewing the significance of the financial services industry for the New York City economy. It proceeds to consider the economic determinants of global competitive advantage in terms of the locations where financial activities are undertaken, where the underlying value-added is generated, and where the jobs are created. This is followed by a discussion of the principal policy determinants of competitive advantage in this industry, and forms the basis for a set of compelling policies to assure the future of financial services as a source of strength for the City in the years ahead.

The financial services sector is demonstrably vital for the future growth and prosperity of the New York City economy. It is, therefore, imperative that New York City stay in the game, and that its competitive position be bolstered to the extent possible by affirmative public policies, some of which are set at the City and State level, but the most important of which are set at the federal level. Critically important agenda items for New York City government are:

>> The City should work intensively for the elimination of restrictions bearing on the **lines of business** that can be engaged in by firms in the financial services industry. This includes in particular scrapping the Glass-Steagall Act and the restrictive provisions of the Bank Holding Company Act, encompassing barriers to activities in all types of financial and non-financial (commercial) businesses, including elimination of barriers between banking and insurance. British-style direct-subsidiary universal banking should be permitted as the model for the organization of American financial services firms, should they choose to avail themselves of this structure. This can be reconciled with the existence of federal deposit insurance and other aspects of the financial safety net as long as regulators close the parent bank before capital -- the owners' equity stake -- is fully dissipated. Firewalls should be limited to those absolutely necessary to ensure the safety and soundness of that part of the firm benefiting from federal insurance guarantees.

>> Likewise, the City should work intensively for the elimination of **geographic restrictions** on the operations of firms in the financial services industry, in particular the McFadden Act restrictions on nationwide branching and the Bank Holding Company Act restrictions on multi-bank holding company structures. Geographic barriers can be argued to have seriously damaged New

York money center banks, both by limiting their access to profitable clients in other parts of the country and by limiting the scope for diversification. Only by permitting New York City-based institutions to choose their organizational forms as well as theaters of operation can they be assured a reasonably level playing field against their major international and regional rivals.

>> New York City should actively oppose any moves to limit foreign direct investment in New York City or elsewhere in the United States. Limitations imposed on Japanese or other foreign firms' expansion -- whether de novo or by acquisition -- can only harm the demand for New York City-based financial services, since empirical evidence clearly indicates that foreign direct investment and financial services growth are closely linked. Foreign investment, by industrial companies as well as financial firms, helps provide the critical mass necessary to assure New York City's future as a world-class financial center. Similarly, New York City should work actively to support Administration "Fast Track" efforts to reach a successful conclusion with respect to the GATT Uruguay Round of trade negotiations as well as Free Trade Area negotiations with Mexico -- in both cases, the financial services provisions are fundamentally in the interests of the City as a financial center.

>> The viability of the City's securities industry must be bolstered by aligning the U.S. Investment Company Act and the Investment Advisers Act with evolving international norms for cross-border distribution and trading of equities and debt instruments, as well as investment advisory services. The ability of New York City's securities exchanges to attract more listings by first-class foreign companies, thus responding to the growing demand by U.S. investors for the securities of such companies, must be enhanced by reevaluating certain U.S. Securities Act and Securities Exchange Act regulations that discourage foreign companies from entering the U.S. financial markets. This includes rules requiring a foreign company to present a quantitative reconciliation to U.S. accounting principles of its financial statements prepared on the basis of home-country accounting standards. Together with other obsolete technical requirements bearing on the securities industry, such regulations have failed to keep up with the increasingly "seamless" nature of world securities markets, and constitute a growing threat to New York City's competitive position.

>> The City's tax environment should be as competitive as possible with the other major "functional" financial centers. Taxes are part of the overall cost of doing business. It is not necessary that taxes be minimized in an absolute sense. What is necessary is that the tax load imposed on firms or on individual lines of business be commensurate with the perceived benefits of locating or carrying out certain activities in New York City. For some such

activities, the maximum bearable tax incidence is zero; others are able to support significant local taxation and still be highly competitive. Clearly, an optimum tax structure presupposes a solid understanding of the dynamics of the financial services industry.

>> Some tax issues are beyond the City's direct control, and progress is therefore a matter of persistent lobbying in Washington. Areas of prime emphasis include full deductibility of state and local income taxes, reduced or indexed capital gains taxation, elimination of double taxation of dividends, and preemptive action against possible future securities transfer taxation.

>> Streamlining the U.S. regulatory structure is perfectly consistent with a more competitive as well as a stronger and more secure banking system. The available evidence shows that the thrift crisis, which many associate with greater banking powers, was in fact caused by regulatory flaws that created perverse incentives for shareholders, managers and depositors alike, alongside mis-priced insurance, inadequate supervision, and the unprecedented rise in U.S. interest rates in the early 1980s. Properly designed, a regulatory framework that allows financial services firms the freedom to choose organizational forms, lines of business, and geographic scope according to market imperatives will increase, not decrease, financial stability in the United States.

>> Intensification of efforts to maintain a viable economic and social infrastructure. New York City must be perceived as a highly desirable, affordable place to live and work for a range of individuals from back-office employees to senior executives used to operating in world-class financial centers. New York City must not allow itself to be compared unfavorably in the minds of decision-makers with Chicago, Boston, Stamford, London, Tokyo or Frankfurt as a place that "works" for banks and other financial services firms. Failure to achieve this objective will lead to a gradual reduction in the value-added core of the industry -- no matter how conducive are the public policies that govern the industry -- leaving behind mainly locally-oriented retail and middle-market businesses and possibly the booking of transactions undertaken elsewhere. All such efforts are ones that New York City should in any case pursue for the benefit of its own people. It may simply be that the financial services sector is more sensitive to short-falls in this regard than are other sectors of the City's economy.

Most important among all of the factors that will determine the future of the financial services industry in New York City is the national regulatory structure. What now exists is obsolete and damaging to the national interest. It has delivered neither efficiency, stability nor competitiveness to the United States financial system. Observers abroad, engaged in efforts to reconfigure and modernize their own systems at the national and (in

the case of the European Community) regional level, regard our structure with bemusement and look forward to leapfrogging the United States in the financial services sweepstakes. New York is uniquely exposed to experiencing the most acute form of pain from this form of federal "regulatory masochism." Here is truly a case where what is in the national interest -- regulatory restructuring fully cognizant of the industry's continuing reconfiguration and globalization -- is doubly in the interest of New York City.

Introduction

For purposes of this study, we can define the financial services industry relatively broadly, to encompass deposit-taking, lending, underwriting and distribution of new issues of debt and equity securities, securities trading and brokerage, investment management, fee-based advisory activities, life insurance, property and casualty insurance, foreign exchange transactions, and a range of derivative instruments related to the management of risk -- such as forward contracts, futures and options.

Economic Significance

The economic significance of the financial services industry to New York City can be measured in a number of ways, all of which have both direct and indirect components. Direct measures attempt to specify the quantitative importance of the financial services industry itself, while indirect measures take into account the vertical and horizontal linkage-effects to industries that are suppliers, users, and otherwise complementary to the financial services sector. Further indirect linkages may be ascribed to the incremental activity in a given industry that is attributable to the financial services firms as suppliers or customers, for example, and its knock-on effects on that industry's subsequent linkages to still others.

Assessment of the overall regional importance of an industry must encompass both the direct and the indirect impacts, wherein statistical problems center around the need to understand regional input-output relationships, that is, how much each industry buys from,

and sells to, every other industry. This also permits assessment of how much each industry exports, and how much it imports, both interregionally and internationally. In this way, it is conceivable that one could quantify the overall economic activity generated through the provision of financial services by firms doing business in New York City for customers located elsewhere in the nation and the world; and how much such activity would be lost if these services migrated to other parts of the metropolitan area or to other financial centers in the United States and abroad.

Once the measurement problems have been resolved, the key question is what should be measured. The most obvious is the volume and share of gross regional product (GRP), measured either by the market value of output or by the returns to factors of production in the form of salaries and wages, interest and dividends, and rents paid -- both by the industry itself and by linked industries. In markets where prices for financial services and productive factors are freely determined by supply and demand, this represents a defensible measure of economic contribution.

A second measure of economic contribution, closely but not perfectly related to the first, is employment creation. Jobs are almost always the principal focus of regional economic impact analyses due to their political as well as economic importance, especially in urban areas where unemployment is particularly visible.

A third measure involves the generation of tax revenues, obviously a critical factor in maintaining and augmenting the social and economic infrastructure, improving social support levels, and generally augmenting the quality of life.

Subsidiary measures, important principally insofar as they are determinants of the first

three, are sectoral trade balances and investment levels. The reason for their importance is that net exports and investments carried out by an industry have regional economic impacts that greatly exceed their nominal amounts, as a result of the regional income multiplier. That is, increases in net exports or investments undertaken by an industry generates income to productive factors which is then re-spent by the recipients on goods and services, which generates further output and income in the recipient industries, which in turn is re-spent, and so forth -- each time diminished only by the share of the incremental income that "leaks" into savings and into imports of goods or services produced outside the region.

Unfortunately, regional input-output models and regional multipliers are generally poorly developed, in terms of statistical quality, compared with the corresponding relationships at the national level. The best data at the regional industry level cover employment and tax measures of economic impact.

In 1988 the financial services industry (finance and insurance) was the largest single employer in the City. It accounted for 438,000 jobs, compared with 366,000 in all of manufacturing, 399,000 in retail trade, 220,000 in wholesale trade, 257,000 in business services, and 104,000 in tourism, lodging and entertainment. Due to cyclical and structural problems affecting the financial services industry, toward the end of 1990 it was estimated that the financial services industry accounted for roughly 400,000 jobs in New York City -- about 12% of the City's work force. [New York State Department of Labor, 1990] With a labor-market multiplier or linkage-effect of 1.6, that would bring the overall -- direct and indirect -- employment impact in late 1990 to about 640,000, accounting for about 17.8%

of the City's total work force of 3.61 million [New York City Comptroller, 1990].

A broader measure of the financial services industry employment is to use the FIRE definition - see Figure 1. FIRE includes all people employed in banks, security and commodity brokers, insurance and real-estate. As can be seen the 1989 figures for employment in the broader FIRE sector was 520,400. The City of New York, Department of Commerce, Bureau of Economic Analysis's 1988 Input-Output Model suggests a 1.6 employment linkage multiplier for finance but only 1.25 for insurance. These multipliers might be used to create a hybrid employment weighted average multiplier for the FIRE sector of 1.474¹ This suggests an overall employment impact of the FIRE sector of $1.474 \times 520,400 = 767,070$ or 21.25% of total NYC employment. Thus, these approaches suggest that approximately 20% of the City's workforce is linked, directly or indirectly, to the financial sector of the City.

Figure 1 gives the employment breakdowns by sectors (including real estate) for 1980 and 1989, showing a disproportionate increase in the securities industry's share in the New York City employment picture as compared with the nationwide employment profile in these three sectors.

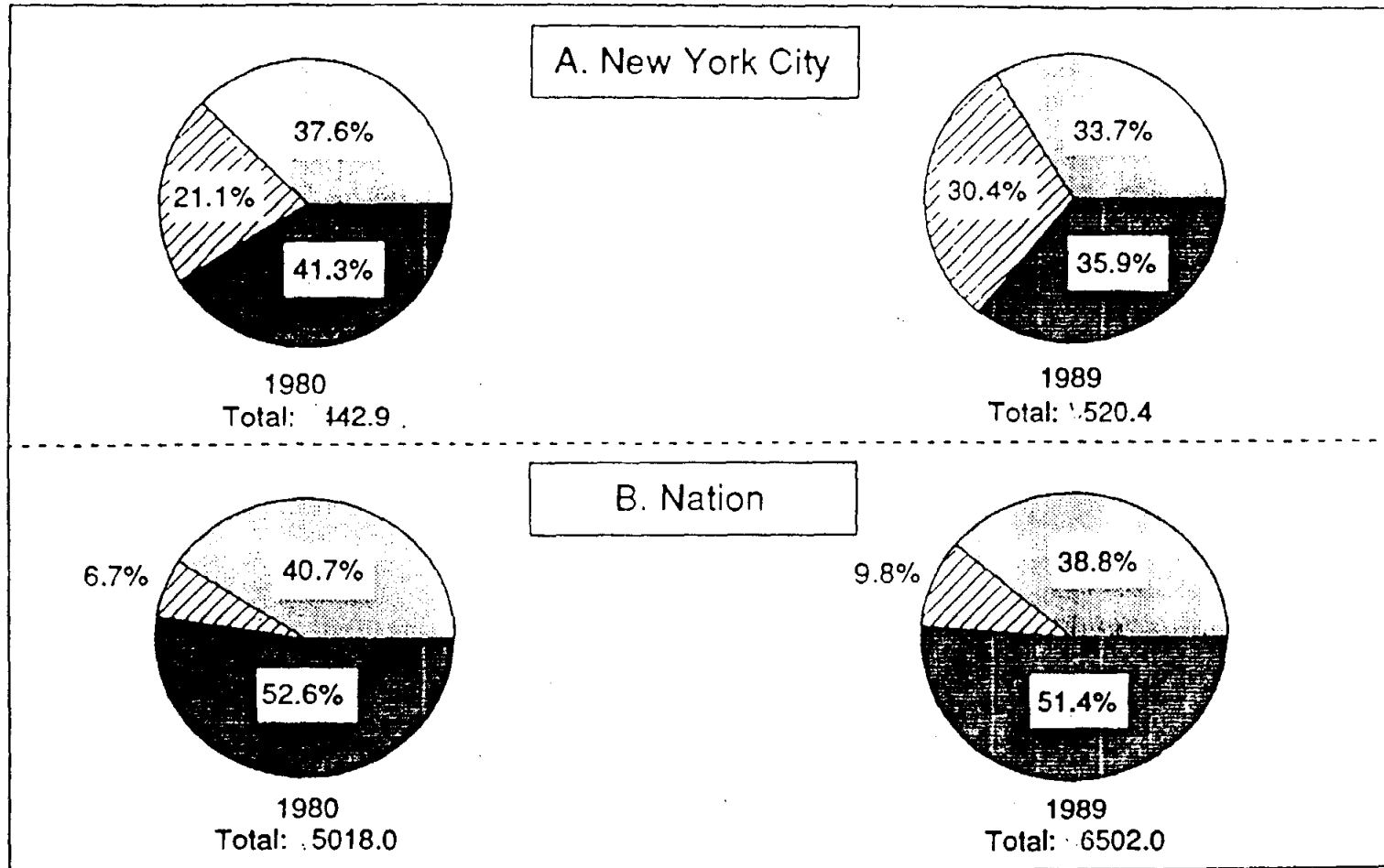
Not only is the financial services industry paramount in the City's employment picture, but it has also contributed much of the growth in employment. Total employment in New York City grew by 307,000 (9.3%) during the decade of the 1980s, private-sector employment grew by 7.9%, while employment in finance and insurance grew by 60,000

¹This was calculated as $[(.64(1.6)) + (.36(1.25))] = 1.474$. See, Figure 1 for the relative shares of the different sectors for 1989.

Figure 1

COMPONENTS OF FIRE EMPLOYMENT¹

Banking² Security and
Commodity Brokers³ Insurance and Real Estate



1. Totals are expressed in thousands.

2. Credit agencies are included under banking.

3. Holding and investment companies are included under security and commodity brokers. Source: BLS

(17.6%) over the same period. However, as Figure 2 shows, New York City's share of employment in financial services and real estate declined somewhat during the 1986-89 period. Figure 3 shows this decline in growth by sector. Note the negative growth in FIRE employment for the 1986-1989 period for all sub-sectors except Security and Commodity Brokers.

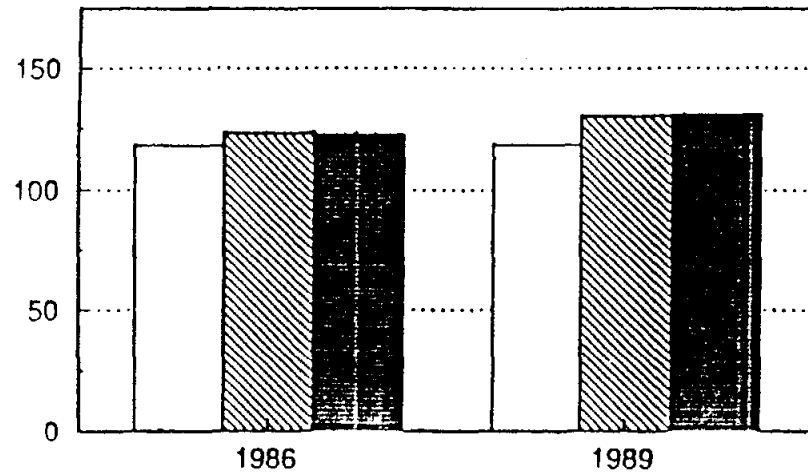
It may be, of course, that employment conditions in the financial services sector are quite income-elastic. That is, job growth is disproportionately high in periods of economic expansion, while job losses are disproportionately high in recessions. Since most of the 1980s consisted of an uninterrupted macroeconomic expansion, the rapid growth in financial services jobs (nationally and in New York City as the premier financial center) may not be as impressive as the raw data suggest. Nonetheless, it is clear that the New York employment picture is inexorably tied to its financial services sector, and the structural or cyclical weakness in this sector will be directly and immediately transmitted to the City's employment picture as a whole.

In terms of the overall U.S. employment picture, New York City accounts for only about 3% of total national employment but 7.8% of employment in the national financial services industry by virtue of the City's role as a domestic and international financial center. However, this share has fallen from a high of 12.6% in 1970 as New York City's relative dominance in financial services has eroded -- even as its absolute size has increased in terms of employment levels -- see Figure 4. Moreover, in terms of international

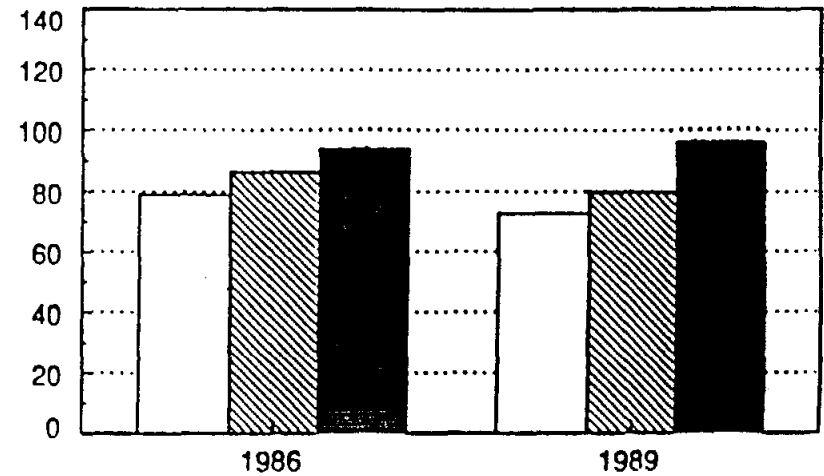
Figure 2
EMPLOYMENT BY SECTOR

■ New York City ▨ NY Metro. Region ■ Nation

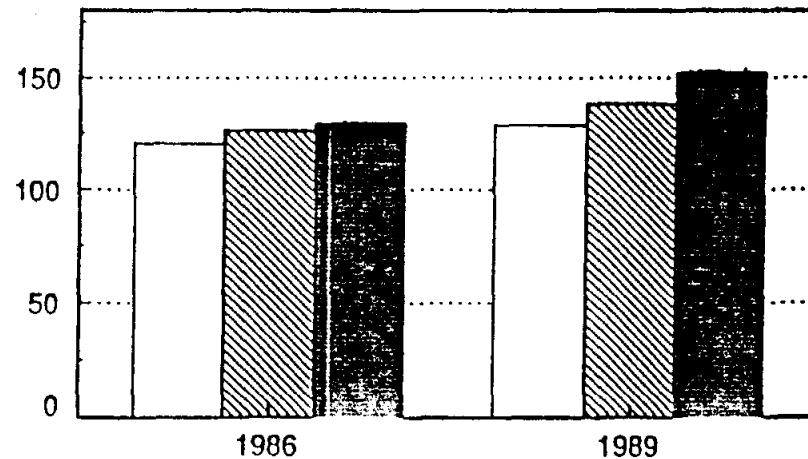
Index:
1980 = 100 A. Finance, Insurance, Real Estate



Index:
1980 = 100 B. Manufacturing



Index:
1980 = 100 C. Services

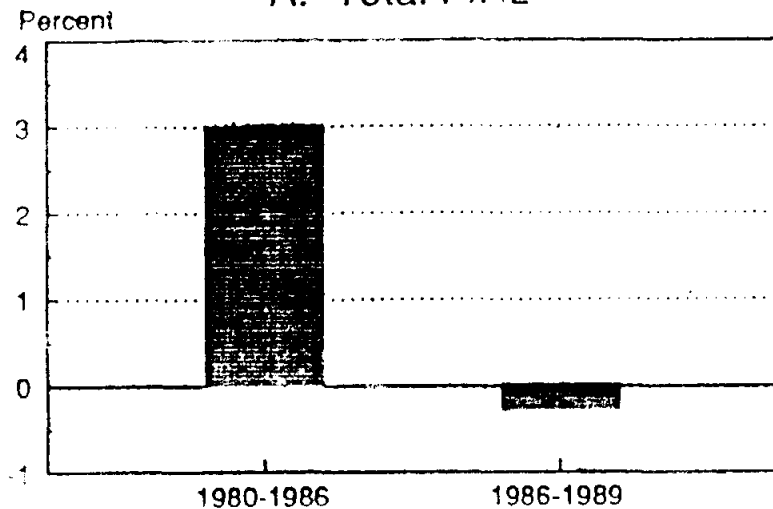


Source: BLS and Port Authority.

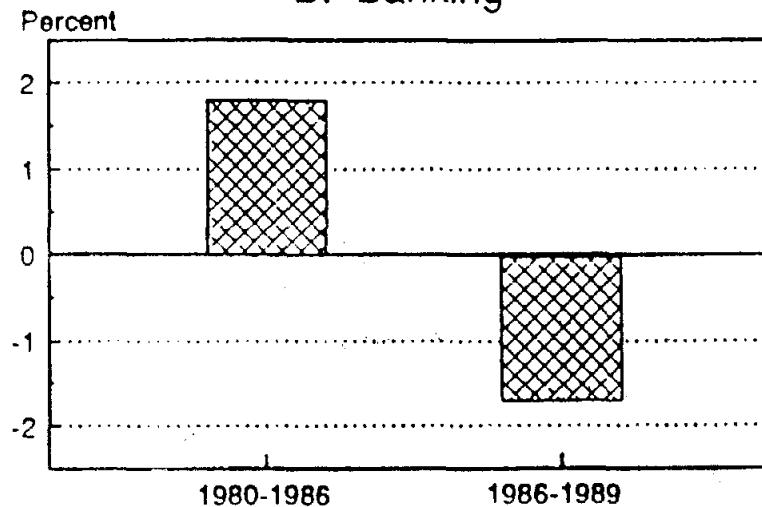
Figure 3

NEW YORK CITY FIRE EMPLOYMENT GROWTH (P.A.)

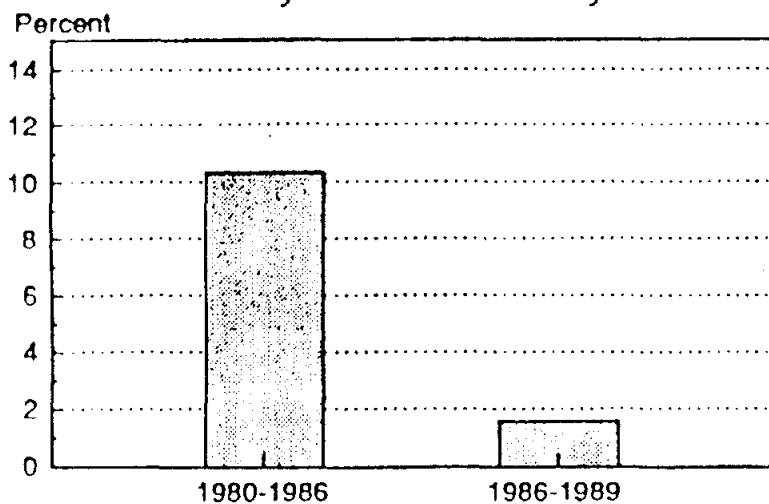
A. Total FIRE



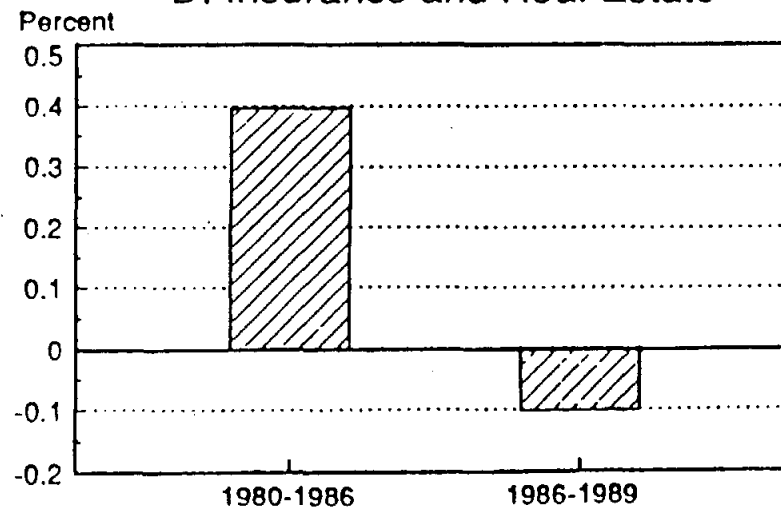
B. Banking



C. Security and Commodity Brokers



D. Insurance and Real Estate

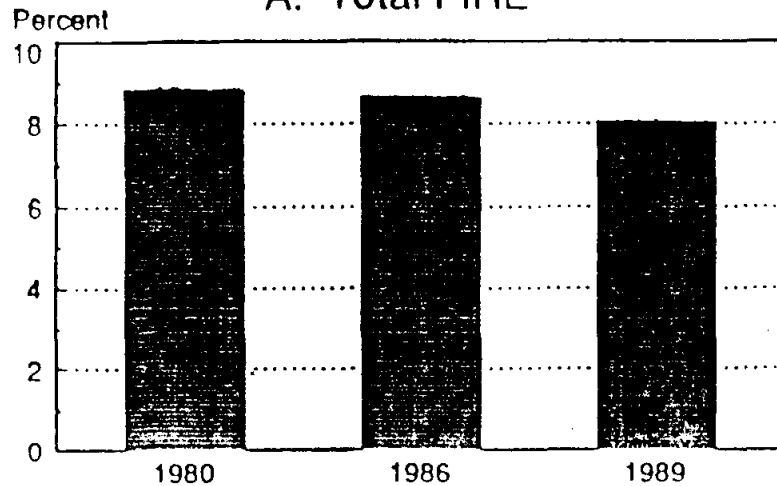


Source: BLS

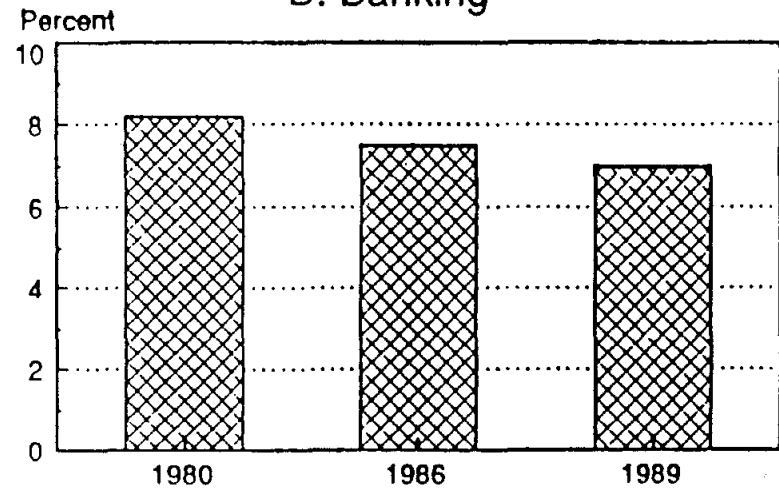
Figure 4

NEW YORK CITY SHARE OF NATIONAL FIRE EMPLOYMENT

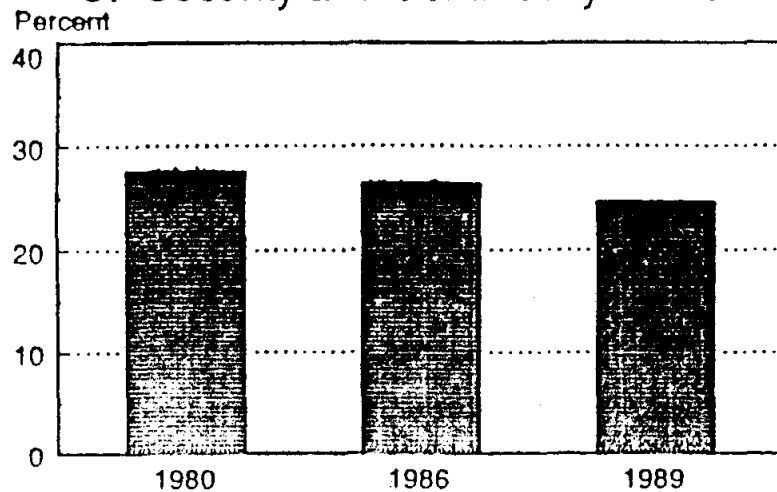
A. Total FIRE



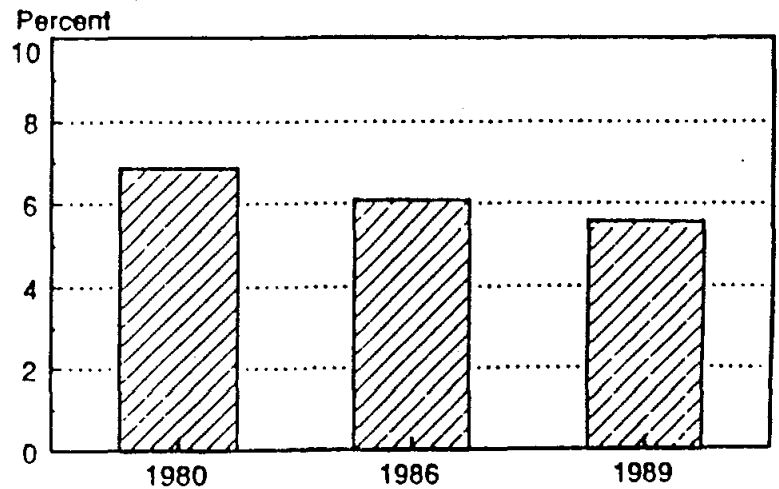
B. Banking



C. Security and Commodity Brokers



D. Insurance and Real Estate



Source: BLS

employment comparisons, New York City lags far behind London, which employs over twice as many people in the financial services industry -- with direct employment growth of 47% during 1982-89, about three times the growth in New York City. However, the London growth pattern would have been affected by the "Big Bang" deregulation of 1986, which probably caused a significant short-term increase in employment. If U.S. deregulation along the lines of the 1991 Treasury proposals (or some variant thereof) is carried out, a similar "Big Bang" effect could be expected for New York City.

Foreign-based financial firms have been among the most rapidly-growing in New York City. Foreign banks and securities firms are attracted to New York City by the large domestic market, the need to secure dollar funding, the need to undertake foreign exchange and risk-management activities in the New York City time-zone, the desire to deal in U.S. government securities, and the importance of tapping into financial innovations originating in the unusually creative New York City environment. Not least important, bankers note the equality of regulatory treatment in New York City and the United States in general. They have created roughly 40,000 jobs in the New York metropolitan region, most of them in New York City [Kraus, 1990].

Comparisons between New York City and London are often brought up in the context of economic contribution of the financial services sector to the respective municipal economies. As of the end of 1989, 258 foreign banks operated in each financial center. By the end of 1990 there were 298 in New York City and 254 in London, defined to include both branches and agencies. The change was probably driven by increased lending in the U.S. by foreign banks at a time when domestic banks were cutting back, as well as difficult

conditions in the highly competitive London securities markets.

Compensation differentials appear to favor the financial services industry as well. It accounted for 22% of total wages paid in New York City in 1988, as against its 12% direct employment share. That is, financial services employees tend to be relatively high-earners, and thus more than proportionately affect the per capita level of expenditures in other goods and services sectors of the regional economy.

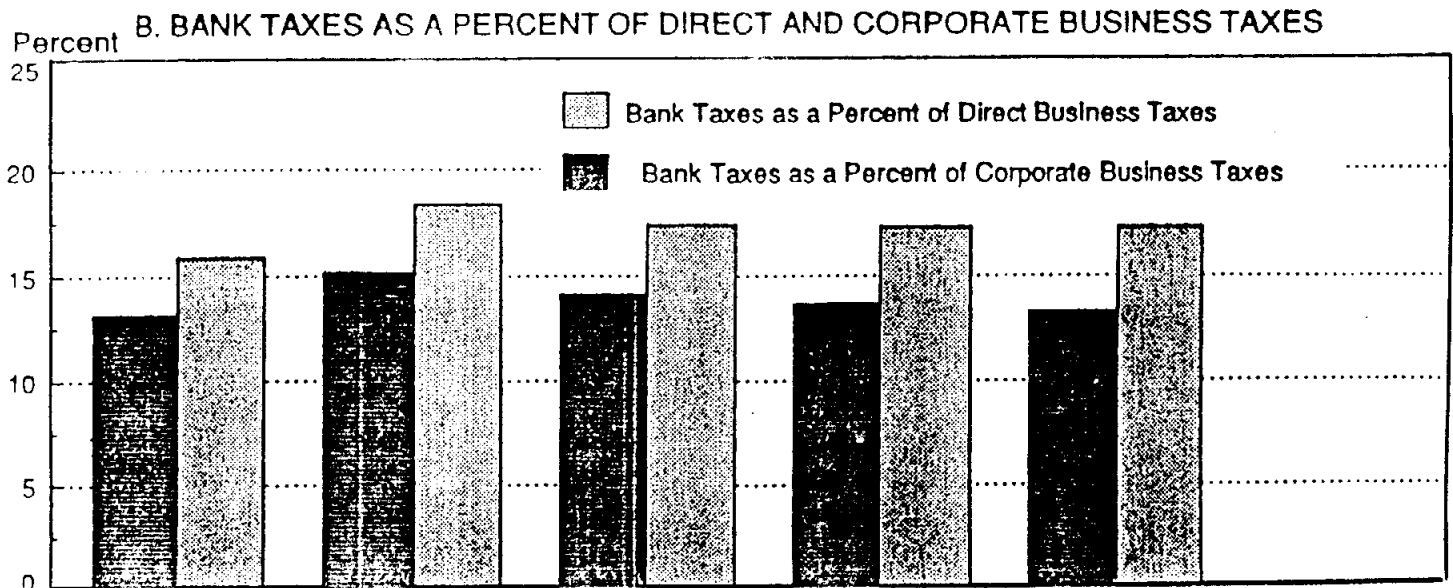
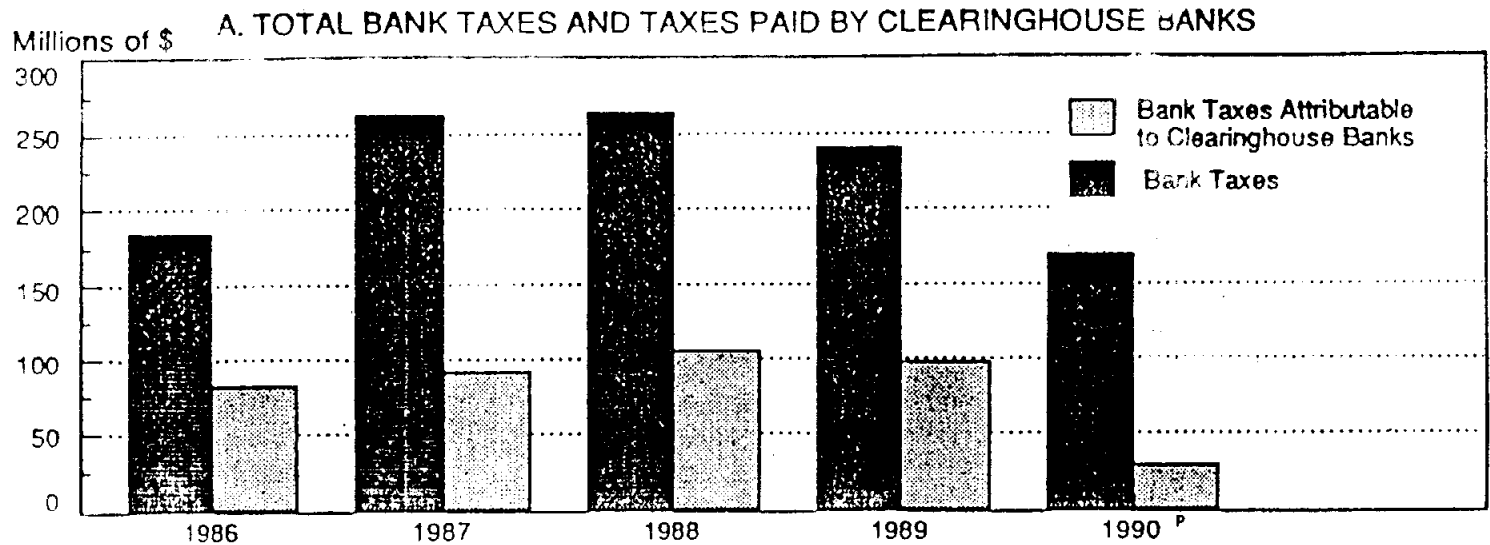
With respect to the generation of tax revenue, the financial services industry in 1988 contributed about \$3 billion at both the state and local levels (including business, real estate and personal taxes).

Figure 5 and Table 1 show the revenue-raising track record of the financial services industry (excluding insurance companies and finance companies) in New York City during the 1986-1990 period. Figure 5A shows total bank taxes peaking in 1988 and then declining dramatically to 1990 (fiscal years), with the same pattern holding for clearinghouse banks. Figure 5B shows that bank taxes as a whole accounted for about 17 percent of direct business taxes and 13 percent of corporate business taxes, respectively, during the 1986-90 period. According to Table 1, whereas taxes paid by S&Ls and clearing house (money center) banks declined dramatically during much of this period as those sectors came upon hard times, all other categories rose just as dramatically, so that total receipts averaged about a quarter of a billion dollars during this period (calendar years). The most significant of all were gains in revenues from foreign banks, which rose by 250 percent, and from less than one-fifth to almost one-half of receipts from financial services firms from 1986 to 1990. Overall, revenues showed substantial year-to-year volatility but did not increase materially

Figure 5

NYC BANK TAXES

Fiscal Years 1986 through 1990



Source: Office of Tax Policy, New York City Department of Finance, April 8, 1991

Table 1

New York City Calendar Year Payments, 1986-1990 *

<u>Bank Type</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>
Foreign	\$42,440,802	\$61,035,925	\$68,614,995	\$75,771,418	\$108,608,868
Savings & Loan	\$57,920,729	\$77,567,712	\$54,523,758	\$38,954,591	\$43,549,744
Commercial	\$19,259,241	\$22,822,962	\$25,953,340	\$37,791,872	\$41,420,817
Clearing House	\$98,038,015	\$86,910,731	\$132,067,441	\$66,074,679	\$21,132,036
"Other"	\$5,044,084	\$5,807,586	\$6,007,143	\$8,808,196	\$9,667,949
Total	\$222,701,871	\$254,144,916	\$287,166,677	\$227,400,756	\$224,379,414

* The payments included are gross regular payments. They do not include audits and refunds have not been netted out. Overpayments in any one year can be carry-forwarded to the next year, leading to a reduction in payments in subsequent years.

Note: Clearing House banks are commercial banks that are 'money center' banks and members of the New York Clearing House Association. These banks must have their principal offices in New York City. Commercial banks specialize in accepting corporate demand and time deposits and make commercial loans to businesses. In addition, commercial banks are active in securing small business loans and mortgages and accepting savings and time deposits for individuals. Foreign banks are commercial banks that have their principal office outside the United States. Thriffs are both savings and loan associations which specialize in savings accounts for individuals, with investments of these savings accounts for long-term bonds, consumer installment loans, long-term mortgages, and corporate preferred stock. The Other category includes Edge Act corporations, trust companies, and nonbanking banks. Edge Act corporations specialize in aiding the financing and stimulation of foreign commerce of the United States. All Edge Act transactions must be directly related to international trade. Trust companies are those banking corporations which provide trust services. Nonbank banks are limited-service banks which include certain leasing corporations, mortgage and loan production offices.

Source: Office of Tax Policy, New York City Department of Finance, April 8, 1991

over the period -- and therefore declined in real terms.

Beyond such quantitative measures of the financial services industry's significance, there are also qualitative aspects. Many jobs in financial services are well-suited for entry-level employees, with good working conditions and opportunities for advancement. They are also well suited as a training-ground for employees who will eventually transfer to other industries.

Whereas it is possible to identify conceptually, and sometimes factually, the current and past contribution of the financial services sector to the New York City economy, the real question concerns its prospective contribution in the future. This raises at least three important issues.


First, past structural changes affecting the City's economy, such as the loss of part of the manufacturing base and the exit of some corporate headquarters in recent decades (see Figure 6), were "masked" by the rapid rise in public-sector employment, as well as expansion in the financial services and a few other industries. We know of no new economic sector that is poised to offer comparably rapid expansion in the 1990s to take up the slack in the event of a serious and permanent decline in financial services employment. Nor is it likely that public sector employment growth will be able to provide much relief, given fiscal constraints that are likely to continue at least through the first half of the 1990s.

Second, the spectrum of the labor force that was most affected by the corporate headquarters losses (professional, secretarial and clerical employees) broadly overlapped the skills-profile required by the expanding financial services industry during this period.

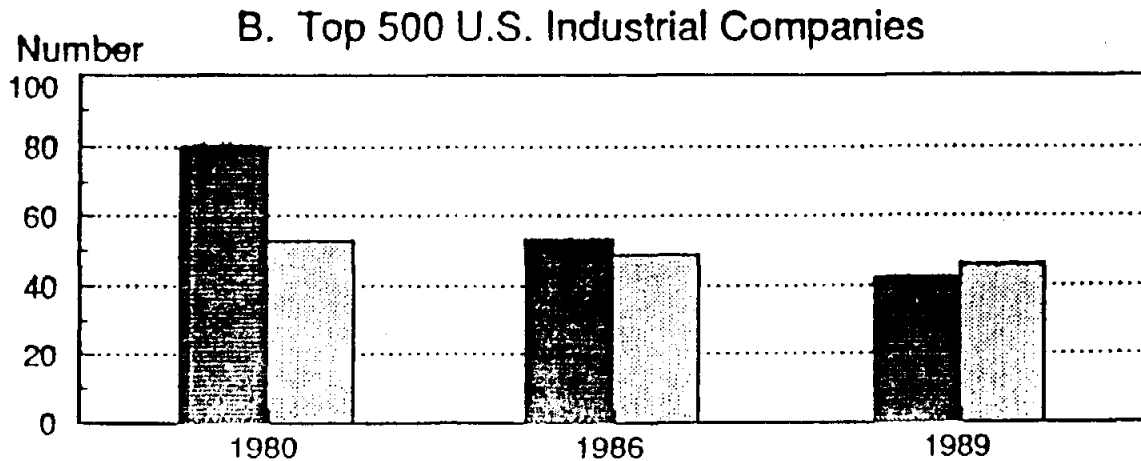
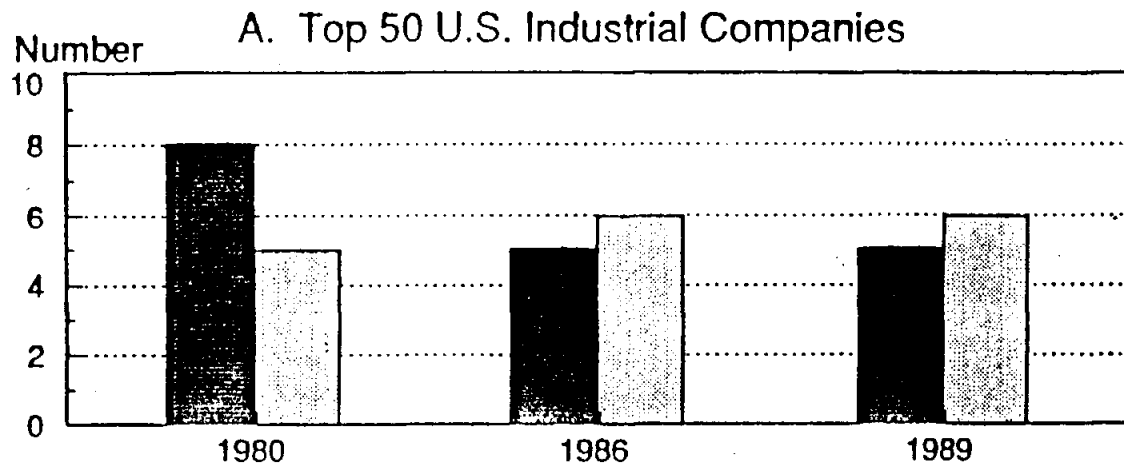
Figure 6

INDUSTRIAL COMPANY HEADQUARTERS: NEW YORK CITY REGION¹

Ranked by Sales

 New York City

 New York City Region,
excluding New York City



¹ The New York City Region is comprised of the New York Metropolitan Region, as well as Putnam County, New York, and Fairfield County, Connecticut.

Source: Fortune Magazine

Together with interregional labor force movements, this made the transition problems less serious than they might otherwise have been.

Third, the economies of agglomeration that are at the heart of financial center economics (proximity to other firms, customers, educational infrastructure, etc.) may be more important during periods of rapid industry growth than when growth is less rapid and a period of consolidation takes hold. If this occurs in financial services, as now seems likely, firms may become much more cost-conscious and attentive to micro-management issues, including reexaminations of locational options -- especially for back-office operations.

Competitive Dynamics

The financial services industry has changed dramatically over the years due to technological change in products and processes, competitive structure, and globalization -- changed in ways that systematically affect New York City's competitive position. It has become a much more mobile industry, one that is particularly sensitive to an adverse regulatory environment.

Perhaps the most powerful catalyst affecting the competitive dynamics of the financial services industry has been financial product and process innovation and technological change. Product innovations usually involve creation of new financial instruments (e.g., caps, futures, options, swaps) along with the ability to replicate certain instruments by bundling existing ones (synthetic securities) or to highlight only a single financial attribute by unbundling an existing instrument. [Levich and Walter, 1990] Process innovations have included contract design (e.g., cash settlement futures contracts), methods of settlement and trading, methods for efficient margin calculation, methods of contract pricing, passive

The economics at the left end of the scale can be described as centrifugal or supply-oriented, with information and transactions technologies making it possible to shift to remote locations relatively easily in order to take advantage of lower labor or real estate costs, improved quality of life, and other considerations that can differ markedly interregionally as well as internationally. The economics at the right end of the scale can be described as centripetal or demand-oriented, and are highly dependent on proximity, personal contact, social relationships and other qualitative factors.

One can imagine a threshold, somewhere along that scale where the supply-side forces may outweigh the demand-side forces with a given state of technology. Traditionally one can argue that this threshold has been biased to the left, with the need for substantially all functions to be carried out in-house and on-site. The need to locate in proximity to clients and other financial firms traditionally biased that location toward the major financial centers. Technological change, and the ability to "unbundle" the various functions, appear to have moved that threshold significantly to the right, with back-office activities, investment management, and various trading-related activities, as well as remote client servicing easily done from sites removed from the center of the firm. Technology can be used to convert front-office activities to those that can be effectively done in the back office. The key question for New York City, of course, is how much further that threshold can still move to the right, and how sensitive that movement is to factors such as labor cost and quality, tax differences, and the like.

An important psychological consideration might be termed the "radar-effect." Once management has determined that the threshold can in fact be overcome, and takes on a

mind-set that relocation is feasible and may indeed be desirable, mobility inherently increases as the firm starts looking, as the implementational parameters are discussed in meetings, and as the rumor-mill starts working among employees. Excitement develops among managers and employees alike, which may be difficult to reverse. The burden of proof may then become "why not move," as opposed to "why move?" Subjective factors like those reported in survey results such as Table 2 can obviously have a significant effect.

Outsourcing and Resource-Pooling

Relocation of back-office operations is only one aspect of a complex process of rationalizing information and transactions processing in financial firms -- functions that are absolutely essential to their competitive survival. Cost and efficiency aspects of transactions processing are obvious competitive variables. Back-office capacity must be on-line to handle existing and expected future business volume, transactions security, and a variety of contingencies ranging from power failures to software problems. Control is critical. In addition, financial services are often described as comprising what is essentially an information business. Information and interpretation and interpretation advantages related to clients, products and markets are central in separating the winners from the losers among rival firms. For both reasons, the proprietary nature of back-office activities is central to the way they are structured and managed. These functions frequently encompass the firm's total position, and thus form the basis of business strategies and tactics in competitive markets derived from its real-time transactions. This implies the need to keep data in-house.

It does not, however, imply that a New York City firm necessarily has to site its

Table 2

**Factors Influencing the Decisions by Foreign and Domestic
Financial Institutions to Locate/Expand/Reduce Operations in New York City**

<u>Factor</u>	<u>(1) Evaluation</u>		<u>(3) Trend</u>	<u>(4) Ranking</u>	
	<u>Foreign</u>	<u>Domestic</u>		<u>Foreign</u>	<u>Domestic</u>
	<u>Firm</u> (++,+,0,-,--) ¹	<u>Firm</u> (++,+,0,-,--) ¹		<u>Firm</u> (1 to 5) ²	<u>Firm</u> (1 to 5) ²
1. Local Business Climate (NYC fiscal situation, Financial Sector difficulties, etc.)	-	--	worsening	4	3
2. Direct Business Costs (labor, rent, etc.)	+	-	no change	2	2
3. Taxes	-	-	worsening	2	2
4. Proximity to Customers	+	+	less relevant	1	1
5. Proximity to Financial Markets	++	++	no change	1	2
6. Cost of Living	+	-	improving	4	4
7. Personal Safety/Crime & Drugs	--	--	worsening	3	3
8. Arts, Entertainment and Culture	+	++	no change	5	5
9. Depth/Breadth of U.S. Financial System and Markets	++	++	no change	1	2
10. U.S. Macroeconomic Environment (Budget/External Deficits, Breadth of the economy etc.)	-	0	no change	5	5

¹ ++ Means strongly positive, 0 means neutral, -- means strongly negative.

² The most important factors are noted by "1", the least by "5".

Source: Federal Reserve Bank of New York

information processing in New York City, or even in the United States. The cost and reliability of transmitting information is an important factor determining location, as are the potentially large economies of scale and scope that exist in back-office functions, regardless of their location. This explains a number of efforts to "outsource" back-office functions to firms such as IBM and EDS -- even "selling" back-office facilities to such firms and buying-back transactions processing services. Other efforts involve "pooling" of back office functions among a number of firms on a cost-sharing basis in order to rationalize these functions and drive down costs.

The two motivations are clearly in conflict. Measures that would achieve optimum cost economies may compromise proprietary information and complete control. For this reason, outsourcing and pooling of back-office functions has some clear limits. It is certainly feasible for some functions, but probably not for others. Most initiatives at back-office pooling in the investment banking industry, for example, have not borne fruit. [Eichenwald, 1991]

The outsourcing and pooling issue is of importance to New York City. Outsourcing back office services to data processing firms may be more likely to involve relocation of these functions to major EDP "factories" serving multiple clients from remote sites. Pooling of back office services between firms may, in the process, require construction of new, high-capacity facilities. In the restructuring process, the decision may be made to establish such joint facilities at remote locations.

Competition Among Financial Firms and Financial Centers

It is against the backdrop of financial innovation, most especially in the United States

and the United Kingdom, that international financial markets and institutions have evolved during the 1980s. These were innovations that affect the linkages between those markets, and between the ultimate sources of funds and the ultimate users of funds domestically and internationally. Global financial markets for foreign exchange, debt and even equity have developed various degrees of "seamlessness" that turn constants into variables in terms of modes and places of operation.

Coinciding with rapid technological change has been a wave of regulatory reform that has gripped all of the major financial centers and intensified competition among them. Beginning perhaps with the 1975 New York Stock Exchange introduction of negotiated securities commission rates on May 1, 1975, there followed liberalization of restrictive pricing, trading practices and market access rules in Britain's "Big Bang" (announced in 1983 and implemented in 1986), in Japan after the "Ad Hoc Agreement" (1982), in Canada after the "Little Bang" (1984), in Australia (1984), France (1988-89) and to a significantly lesser degree in the Netherlands, Germany, Switzerland and several other countries. Governments in one industrial country after another sought a better balance between the efficiency of the financial markets and the stability of the financial system, with almost all of the regulatory change favoring more efficient capital markets.

In the European battle for preeminence among financial centers, for example, a recent survey by the Institut fuer Kapitalmarktforschung in Frankfurt comparing London with Frankfurt and other continental financial centers rated (a) the variety of markets, (b) the availability of qualified personnel, (c) quality of life, (d) cost of personnel and (e) flexibility of regulation among the top ten criteria for evaluating financial centers. [Dobie, 1991]

Competition between London, Luxembourg, Zurich, Paris, Frankfurt and Amsterdam in particular has intensified significantly. For example, there is often a larger trading volume in French stocks on the London Stock Exchange than on the Paris Bourse. A pan-European capital market has also begun to take shape, which promises to be a formidable competitor to U.S. and Japanese markets. In all of these markets, there is active debate regarding future patterns of concentration or dispersion of financial transactions based on market depth, liquidity, efficiency, client location, and other factors.

The conventional wisdom is that the size, openness of markets, trading activity, sophistication of institutional investors, quality of research, transaction services, and innovative thinking that have traditionally characterized London and New York City will be subject to challenge in specific areas by various other financial centers. The financial centers of the world are thus caught in a vigorous struggle for market-share in back-office, primary- and secondary-market financial transactions. Still, in each of the financial centers there are powerful entrenched interests, as well as differences of view between governments and the financial services industry itself, that will help shape future events.

Prospective developments in global financial markets carry equally serious implications for the various strategic groups of firms competing for business, and much reshuffling of clients can be expected as traditional relationships are gradually eroded by pressure for access to creative financing structures, capable and efficient execution, and performance-oriented investment management. Over time, firms capable of offering integrated financial services of various types and with substantial trading capabilities will emerge among the market leaders alongside more specialized firms and universal banks.

In the process, traditional relationships with clients will be much more difficult to maintain.

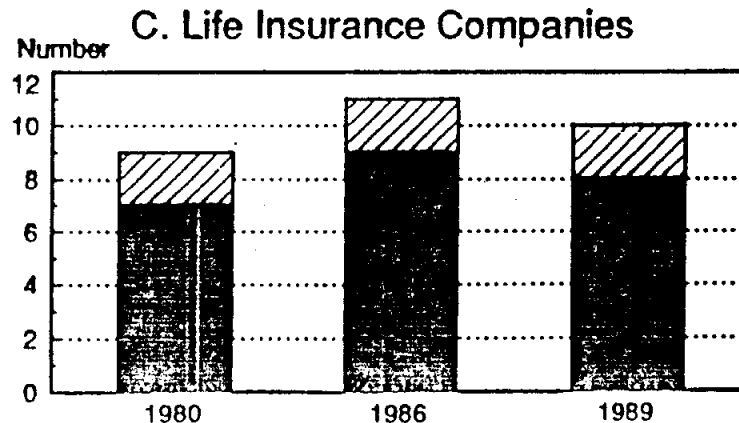
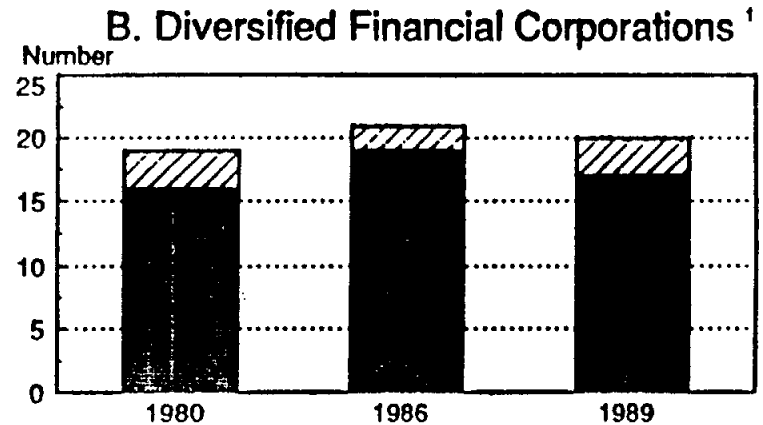
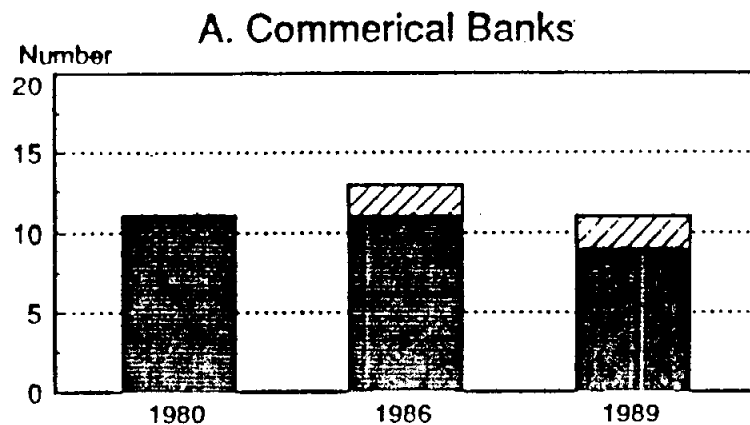
Figures 7-9 give some indication of changes in New York City's position in terms of the proportion of headquarters of American financial services companies, foreign banks' U.S. offices, and stock market performance indicators, respectively.

The changing competitive environment in financial services and its implications are well recognized in countries like the United Kingdom -- for example during the debates on the 1986 Financial Services Act -- where the global competitive performance of its national financial institutions and markets were considered of paramount importance. In countries like Canada, Australia, France, Japan, the Netherlands and Germany, discussions of conditions affecting the financial services industry are invariably set against the need to jostle for advantage in the highly competitive global financial marketplace. None of the financial centers in any of these countries is prepared to see its significance on the global stage decline, and all are acutely aware of the benefits of achieving a greater share of financial activity.

By contrast, it is only recently that the U.S. Treasury [1991] and the Securities and Exchange Commission [Investment Company Act, Release No. 17534, 15 June 1990; Facilitation of Multinational Securities Offerings, Securities Act Release No. 6568, February 28, 1985; SEC Report on the Internationalization of Securities Markets, 27 July 1987; U.S. Securities and Exchange Commission Policy Statement on International Securities Markets, November 1988; and Concept Release on Multinational Tender and Exchange Offers, Securities Act Release No. 6866, June 1990] have assessed the effects of globalization of U.S. financial services firms on U.S. banking and securities markets.

Figure 7
**TOP 50 FINANCIAL SERVICE COMPANIES
 HEADQUARTERED IN NEW YORK CITY REGION**
 Ranked by Assets

New York City
 New York City Region,
 excluding New York City



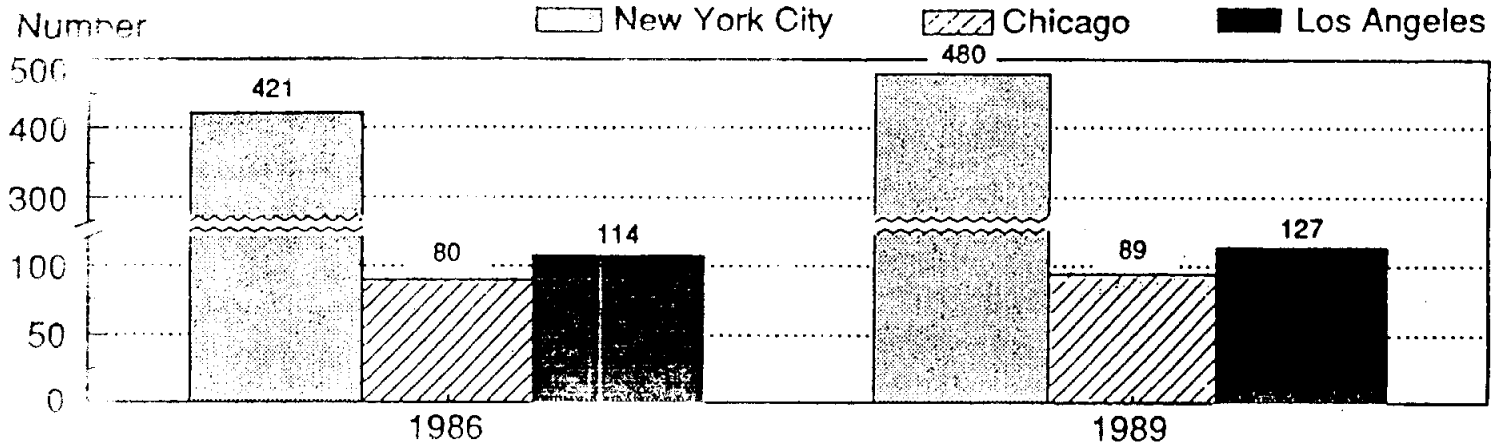
1. Includes holding companies engaged in commercial banking, savings, or insurance, whose assets from those businesses represent less than 80% of the company's total assets.

Source: Fortune Magazine

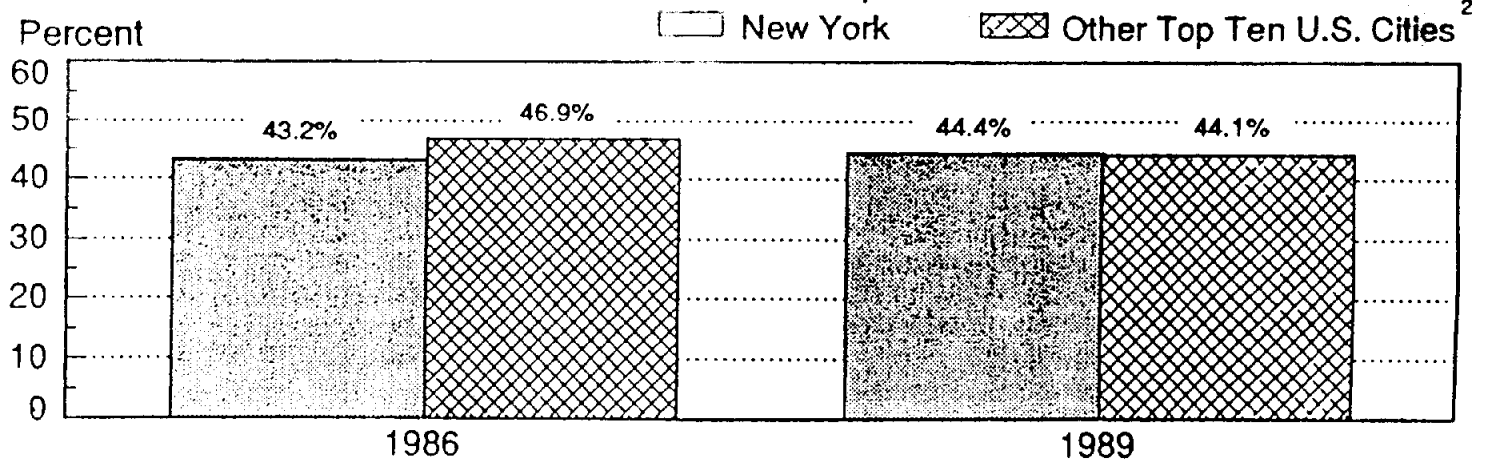
Figure 8

Foreign Banks' U.S. Offices¹

A. Top Three U.S. Cities



B. Shares of New York and Other Top Ten Cities

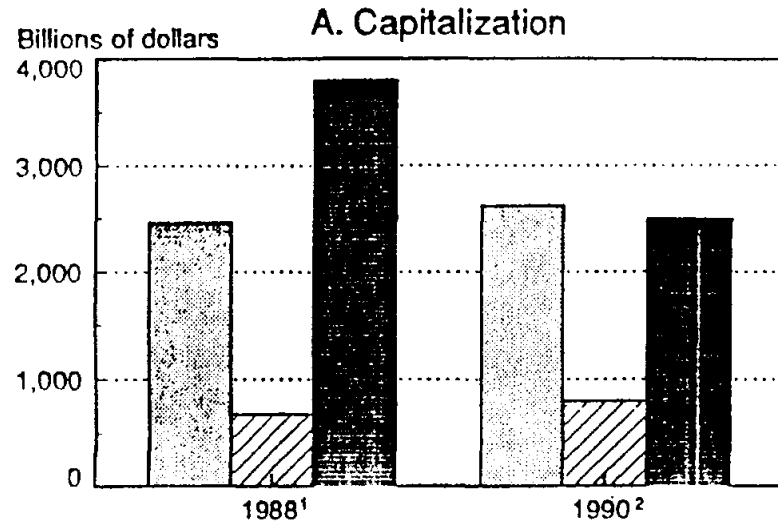


1. Includes foreign banks' agencies, branches, subsidiaries, Edge Act banks, representative offices, and investment companies.

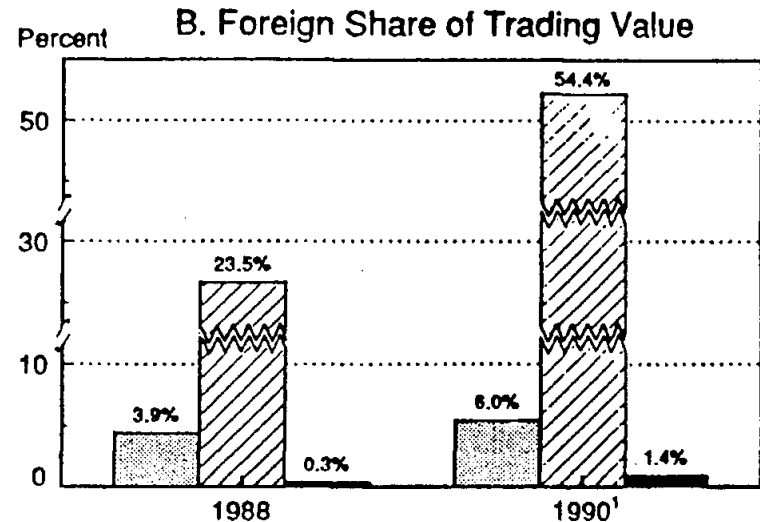
2. Other top ten U.S. cities are Los Angeles, Chicago, San Francisco, Houston, Atlanta, Washington, D.C., Miami, Dallas and Seattle.

Figure 9

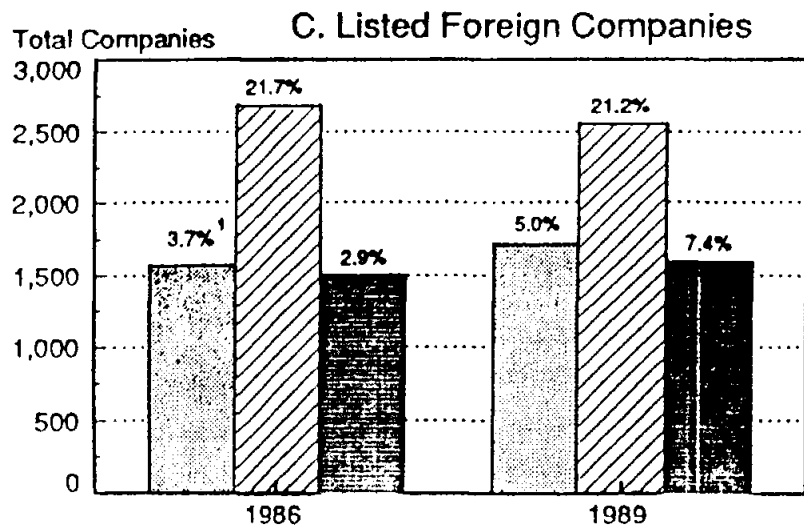
STOCK MARKETS: NEW YORK, LONDON AND TOKYO



1. December, 1988.
2. September, 1990.



1. First half of 1990.



1. Foreign companies as a percent of total companies.

Source: IBCA

■ New York Stock Exchange
▨ London Stock Exchange
■ Tokyo Stock Exchange

Perhaps the most important historical example of large-scale migration of financial services activities internationally involved the creation of the Eurobond market in the 1960s [Smith and Walter, 1990]. The interest equalization tax (IET), imposed in order to deal with the U.S. balance of payments problem at the time, was intended to force American and European international companies to finance their expansion outside the United states in order to reduce capital outflows. This was accompanied by limits imposed on equity capital investments by the Office of Foreign Direct Investment (OFDI).

Together with capital income tax and regulatory advantages (including the use of bearer securities and the absence of new-issue disclosure rules) the IET represented a policy shift that made new debt issues in the United States relatively unattractive for many borrowers, and this activity developed rapidly in London after 1963. Initially considered a temporary and insignificant departure from the U.S. corporate bond market, its growth over the next two decades was spectacular, especially as additional financial firms became involved and the market's infrastructure matured. Eurobond offerings have encompassed most major corporate and institutional issuers around the world, and dollar-denominated Eurobond volume for the first time surpassed U.S. domestic corporate bond market new issue volume in 1986.

Despite significant streamlining of the tax and regulatory environment in the United States, including Rule 415 (shelf) registration procedures, elimination of the withholding tax on interest due to foreign investors, and adoption of Rule 144A for non-public offerings (discussed below), market activity has not come back to New York in a significant way. This suggests a ratchet-effect at work. Once financial activity migrates and a viable

market develops elsewhere, it is virtually impossible to reverse what has happened.

Competitive Standing of U.S. Financial Firms

The aforementioned globalization, technological, regulatory and back-office trends appear to have had a generally negative effect on U.S. firms at the international level as well as affecting locational choice at the national level. Indeed, U.S.-based firms and markets appear to have been major losers in terms of various definitions of market share in the 1980s. See Table 3 for an overview of changing performance indicators of U.S. banking and securities firms among a broad cohort of international competitors.

First, with respect to banking, the U.S. share of International bank assets declined from 26.4% in December 1984 to 14.6% in June 1989. Over the same period, Japanese banks' share increased from 23% to 37.6% [BIS Annual Reports; Spindler, Howe and Dedyo, 1990]. Consequently, at the end of 1990, only one U.S. banking organization was among the world's ten largest measured by asset size -- see Table 3. While on-balance sheet asset size is only one dimension or measure of market share, and ignores important off-balance sheet activities, these changes in rankings are nevertheless indicative of the contracting global position of U.S. banks.²

The relative standing of U.S. firms in the securities industry appears to be somewhat stronger. Six (five) of the top ten firms in early 1990 were U.S.-based, as measured by their assets (capital). [Worldscope, May 1990 and Table 3-Annex)] The same is true of the insurance industry, where five of the top ten firms were U.S.-based in mid-1990, as

²For example, measured by revenue (which includes fees earned from OBS activities. 3 of the top 10 banks in the world are from the U.S. (see Table 3).

Table 3
PERFORMANCE SUMMARY
OF SAMPLE BANKS AND SECURITIES FIRMS
BY COUNTRY GROUP*

Banks

Securities Firms

OVERALL PERFORMANCE	UNITED STATES	CANADA	FRANCE	GERMANY	JAPAN	SWITZERLAND	UNITED KINGDOM	UNITED STATES	JAPAN
<u>SIZE</u>								Comparable	
Total Assets	1 of top 10	0 of top 10	2 of top 10	0 of top 10	6 of top 10	0 of top 10	1 of top 10	7.0%	37.1%
Real Asset Growth	2.2% (6)	0.5% (7)	3.1% (4)	5.5% (2)	12.6% (1)	3.1% (5)	3.6% (3)	Comparable	
Total Revenue	3 of top 10	0 of top 10	2 of top 10	1 of top 10	0 of top 10	0 of top 10	4 of top 10	11.7%	22.1%
Real Revenue Growth	4.3% (7)	6.1% (2)	4.3% (6)	5.6% (4)	16.0% (1)	4.9% (5)	5.7% (3)	0.33%	1.83%
<u>PROFITABILITY</u>								9.7%	19.6%
Real Return on Assets	0.08% (7)	0.17% (6)	0.21% (4)	0.24% (3)	0.27% (2)	0.32% (1)	0.20% (5)		
Real Return on Equity	1.6% (7)	3.5% (6)	9.7% (2)	6.8% (3)	11.5% (1)	5.3% (4)	4.2% (5)	1.12	2.16
<u>PRODUCTIVITY</u>									
Total Revenue/ Non-Interest Expense	1.51 (4)	1.74 (2)	1.46 (5)	1.44 (6)	2.06 (1)	1.36 (7)	1.52 (3)	3.4%	9.6%
<u>CAPITALIZATION</u>									
Shareholders Equity Ratio	4.8% (4)	4.9% (3)	2.2% (7)	3.6% (5)	2.5% (6)	6.2% (1)	5.1% (2)	9	21
Price-Earnings Multiple	8** (4)	8** (5)	No Data	19 (3)	74 (1)	21 (2)	6** (6)		

* Ordinal ranking among the seven national groupings of banks appears in parentheses where appropriate.

** Average price-earnings multiples of the U.S., Canadian, and U.K. bank groups are calculated from their 1985 and 1986 results only.

Source: Federal Reserve Bank of New York

Table 3 (Annex)

Banking Organizations and Securities Firms in Sample

<u>Country</u>	<u>Banks</u>	<u>Total Assets Year-end 1989 (US\$ millions)</u>
CANADA:	1 Royal Bank of Canada	88,446
	2 Canadian Imperial Bank of Commerce	78,398
	3 Bank of Montreal	64,780
	4 Bank of Nova Scotia	62,251
FRANCE:	1 Banque Nationale de Paris	231,463
	2 Credit Lyonnais	210,727
	3 Societe Generale	175,787
	4 Banque Paribas	82,164
	5 Banque Indosuez	55,316
GERMANY:	1 Deutsche Bank	198,254
	2 Dresdner Bank	143,866
	3 Commerzbank	111,277
JAPAN:	1 Dai-ichi Kangyo Bank Ltd.	389,134
	2 Sumitomo Bank Ltd.	370,516
	3 Fuji Bank Ltd.	364,888
	4 Mitsubishi Bank Ltd.	362,256
	5 Sanwa Bank Ltd.	339,490
	6 Industrial Bank of Japan Ltd.	248,730
	7 Bank of Tokyo Ltd.	201,827
	8 Long-Term Credit Bank of Japan Ltd.	175,351
	9 Mitsubishi Trust & Banking Corp.	174,961
	10 Sumitomo Trust & Banking Co. Ltd.	152,330
	11 Mitsui Trust & Banking Co. Ltd.	142,097
SWITZERLAND:	1 Union Bank of Switzerland	112,503
	2 Swiss Bank Corp.	104,487
	3 Credit Suisse	75,885
UNITED KINGDOM:	1 Barclays PLC	204,874
	2 National Westminster Bank PLC	186,529
	3 Midland Bank PLC	100,303
	4 Lloyds Bank PLC	92,378
	5 S.G. Warburg Group PLC	21,640
	6 Kleinwort Benson Group PLC	14,234
UNITED STATES:	1 Citicorp	230,643
	2 Chase Manhattan Corp.	107,369
	3 BankAmerica Corp.	98,764
	4 J.P. Morgan & Co. Inc.	88,964
	5 Security Pacific Corp.	83,943
	6 Chemical Banking Corp.	71,513
	7 Manufacturers Hanover Corp.	60,479
	8 Bankers Trust New York Corp.	55,659
	9 First Chicago Corp.	47,907
<u>Securities Firms</u>		
JAPAN:	1 Daiwa Securities Co., Ltd.	44,924
	2 Nomura Securities Co., Ltd.	38,989
	3 Nikko Securities Co., Ltd.	29,674
	4 Yamaichi Securities Co., Ltd.	29,547
UNITED STATES:	1 Salomon Brothers Inc.	118,250
	2 Merrill Lynch	63,942
	3 Shearson Lehman	63,548
	4 Goldman Sachs & Co.	61,298
	5 Morgan Stanley & Co.	53,276
	6 First Boston Corp.	46,313

Note: Assets of Canadian firms are as of October 31, 1989, and assets of Japanese firms are as of March 31, 1990.

Source: Federal Reserve Bank of New York

measured by asset size. [Swiss Re, August 1990] But securities and insurance firms, too, are under increasing threat as the globalization of international portfolios and money management gains pace.

For example, the global share of insurance premiums for North America fell from 47% in 1980 to 40% at the end of 1987. [Swiss Re/Sigma, March 1989] Further, while the U.S. share of world private pension fund assets was 68% compared to Japan with 10.5% at the end of 1988, the Japanese market continues to be the fastest growing in the world. Three of the top ten managers of international securities for U.S. pension funds are currently based outside the U.S. And while U.S. pension funds in 1990 held about 3-5% of their investments in international securities, this proportion is expected to double during the 1990s. [Bernstein Research, 1991] These trends reflect shifts in relative market growth rates, the internationalization of pension fund portfolios, and increased cross-border competition for market share -- such as competition from Japanese trust banks.

Globalization is not only affecting financial firms' relative market shares, but also the shares of U.S. markets in different product areas. For many years the U.S. was the world's preeminent capital market. In 1980, the U.S. equity market (measured in capitalization) exceeded the next largest equity market by a factor of four. Between 1980 and 1990, the U.S. share of the global equity market fell from 53% to 30%. Total U.S. equity market capitalization stood at \$2.6 trillion at the end of 1990, compared with \$2.5 trillion for Japan, with the U.S. ranked only 16th among developed nations in terms of its growth in market capitalization over the 1980's. [International Finance Corporation, *Emerging Stock Markets Factbook - 1990*]

Moreover, while only 95 (out of a total of 1,800) foreign firms are listed on the NYSE, 551 non-U.K. companies are listed on the London Stock Exchange, 601 non-German firms on the various German exchanges and 120 non-Japanese firms on the Tokyo Exchange's Foreign Stock Section. Thus, not only is the U.S. equity market shrinking in relative terms; it also appears to be increasingly unattractive to foreign companies compared to other international stock markets.

A major reason appears to be the onerous U.S. GAAP accounting reconciliation and other disclosure requirements, which foreign firms view as excessively costly compared to the benefits of a listing on the NYSE. Because of these requirements, for example, there are no world-class German firms listed on the NYSE.

While New York and New York banks, such as Bankers Trust, have historically held a prominent position in foreign exchange dealing and trading with average daily net U.S. foreign exchange turnover of \$129 billion compared to \$187 billion in the U.K. and \$115 billion in Japan, this position has become increasingly threatened by large Swiss and U.K. banks offering a perceived high quality of service and by the relative decline of the dollar as an international reserve currency. Both trends are likely to continue [see Hirtle 1991]. For example, the Tokyo market is currently growing faster than the U.S. with growth of 140% from 1986 to 1990 compared to 120% and 108% in the U.S. and U.K. respectively [Survey of Foreign Exchange Activity, BIS, Basel, February 1990].

The dominance or predominance of U.S. financial firms in developing new markets or new products has already been noted. One of the largest of the derivative securities markets is for foreign exchange options. While the major market centers in the U.S. for

these instruments are Chicago and Philadelphia rather than New York, New York institutions are nevertheless dominant players in this market. Moreover, the BIS estimated that in April 1989 the average daily turnover of FX options was \$22.1 billion, of which \$11.1 billion was U.S. based (50.2%). However, it might be noted that a rapidly growing competitive threat is emerging in the U.K. and France, with Paris becoming the leading center for derivative securities in Europe.

Activity-Relocation and New York City

These increased competitive and technological pressures have also had locational effects within the U.S. as well as internationally. Among the early departures from New York City during the decade of the 1980s was Citibank's Credit card operations, relocated to South Dakota in response to New York State's slowness in raising its usury ceilings in a period of high and rising interest rates. South Dakota moved quickly to capitalize on a situation Citibank considered untenable and attracted the operation to Sioux Falls. In 1990, Citibank was the largest single employer in South Dakota. Despite New York's subsequent removal of the offending usury ceilings, the business never returned.

Meantime, other firms such as American Express located customer-contact telephone operations where the necessary human resources were plentiful and relatively low-cost, such as Florida.

More recently, the wrangling about relocation in the financial services sector has coincided with expiration of major real estate leases in New York City, the onset of difficult times in the banking and securities industries (including diminished business volumes,

increased competition, enhanced attention to operating costs, and periodic business losses), as well as increased mobility especially of back-office systems and transactions processing functions.

For example, in 1989, Dreyfus Corp. threatened to move to New Jersey, and remained in New York City only after receiving significant tax concessions. In 1990, Prudential-Bache announced that it was considering moving approximately 2,000 employees to Jersey City after expiration of its New York City lease in 1994. At about the same time, Smith Barney Harris Upham & Company indicated that it was considering moving some of its 3,500 employees out of the City of New York, with Connecticut one option being considered.

Among the back office operations of firms that New York City has been able to retain are Chase Manhattan and Chemical Bank. Chase was offered an abatement package of about \$230 million in 1990, after it agreed to move some 5,000 back office employees to a new Metrotech complex in downtown Brooklyn instead of New Jersey. Chemical Bank, which considered moving some 3,000 back office employees to Secaucus, N.J. in 1990, was also persuaded to remain in New York City.

In October 1990, the five New York commodities exchanges negotiated with the City of New York an arrangement for construction subsidies and various concessions, estimated to have a present value of some \$100 million, spread out over 20 years. Alternative sites were offered to the exchanges by the Harborside Financial Center in Jersey City, located less than ten minutes by rail from the World Trade Center in Manhattan. Occupancy costs of \$20 million annually in New Jersey compared with \$30 million in New York City. The exchanges employed 11,700 people in 1990, a number expected to grow to perhaps 23,500

by the year 2000, and generated some \$300 million annually in taxes [Levine, 1990].

In January 1991, Salomon Brothers, Inc. was reported negotiating the transfer of approximately 700 jobs in its operations division (back office) out of New York City to a site in Tampa, Florida by the end of 1993, while retaining roughly 3,000 jobs in New York City following a move of the firm's headquarters to the World Trade Center complex [Eichenwald, 1991]. The move was confirmed the following month, with Salomon indicating that it would in any case have had to build a new back-office technology center, and this was roughly one-third cheaper in Florida [Thomasson, 1991]. The Tampa work force, moreover, was deemed well-suited to back-office functions. This clearly represented a back-office shift going beyond the contiguous counties and states, indicating the increasing ease with which remote-processing can be moved to areas with perceived lower costs, improved labor skills, or better quality of life. The Salomon move followed several other relocations of computer-related activities to the Tampa area by Citicorp and Chase Manhattan.

In April 1991 Metropolitan Life indicated that it would reduce its New York City employment by 4,000 as it renovates one of the buildings in its headquarters office complex. Of these, 1,000 would be dropped permanently and the remainder would be transferred to various sites in New Jersey, upstate New York, Colorado, Indiana, Florida and Georgia. Prominent among those transferred are 1,200 employees to be relocated in a new administration center in New Jersey. A later decision will determine whether any of the 3,000 transferred personnel will be brought back to New York City once the renovation is complete in 1996. These changes would leave about 5,000 of Metropolitan Life's 54,000

work force in New York City.

Internationally, the Equitable Life Assurance Society of the United States has shifted part of its claims-processing operations to Ireland. Claims submitted by customers are flown to Shannon and transported by road to a processing center in County Cork -- a region characterized by high-quality, eminently trainable semi-skilled (mostly female) labor. Data from the claim forms are converted to machine-processable form and electronically transmitted back to the United States, where the processed claims are printed, the checks cut, and mailed to claimants.

Going beyond relocation of back office activities, in 1990 Morgan Stanley & Company took an option on a lease in Stamford, Connecticut, and indicated that it was considering moving the entire firm out of the City, leaving behind only such facilities as might be necessary for client contact.

While the economics of back-office mobility are clear -- with growing technological mobility determined by factors such as labor cost and quality, real estate prices and tax rates -- this may be somewhat different in the case of activities requiring direct contact with customers. Were the corporate finance unit of a major investment bank to move out of New York City to a location such as Stamford, Conn. or Princeton, N.J., for example, its ability to solicit clients could be seriously impaired. A client visiting New York City for discussions with a number of prospective investment banks, involving several relationship officers and specialists in each case, might at the margin decide against making the time-consuming trek to a remote location after seeing several first-rate presentations by the firm's competitors in New York City. Even if the remote firm did maintain a

high-quality office in the City for such occasions, the presentation by people parachuted-in from head-office for the meeting might simply not be as convincing, or lack the on-call specialists that are sometimes needed on the spur of the moment. These issues are, of course, speculative and qualitative in nature, but nevertheless should give pause to any decision to move front-office activities to remote sites, no matter how well costed-out, as a being a very high-risk venture indeed.

This assumes that client firms of financial institutions remain in New York City. Significant additional losses of corporate headquarters of American companies (or location outside the City of U.S. headquarters of foreign companies) threatens the critical mass of clients. Once that critical mass is lost, the corporate financial services and related units of financial firms will find it easier to relocate as well. In turn, there may be a multiplier effect regarding firms that supports the financial services industry.

Finally, it has also been argued that relocation decisions should not be viewed only in terms of their microeconomic dimensions, but rather should be considered in a broader employment management context. Under personnel cost pressure, a firm may find it expensive or difficult to reduce staff. But relocating a function may be combined relatively easily with staff downsizing. Some employees may choose not to move, or may be satisfied with severance packages less costly than might otherwise be the case. Such "soft" downsizing may thus provide savings that can help offset the costs of relocation. In the process, the net job losses to New York City may not be as large as might otherwise be the case if it is likely that the downsizing would have occurred anyway, even without a relocation of the facilities involved. On the other hand, the lower cost of this type of downsizing may be an

additional motivation in favor of relocation.

Financial Centers: Determinants of Competitive Advantage

Efforts on the part of cities and countries to become financial centers can take two forms. One is to become a "functional" center, where transactions are actually undertaken and value-added is created in the design and delivery of financial services. Examples of functional centers include New York, London, Singapore, Tokyo and Hong Kong. The other is to become a "booking" center for transactions whose underlying value-added is created elsewhere. Examples in this category include the Bahamas, Cayman Islands, Seychelles, and Vanuatu. In order to attract financial booking business, one prerequisite is a highly favorable tax climate, alongside a benign regulatory and supervisory environment as well as, sometimes, strict financial secrecy or blocking statutes.

By these definitions, it is generally agreed that New York City is both an international as well as a domestic functional center. However, the economic factors that determine its domestic prominence are not necessarily the same set of factors that determine its international prominence.

Conceptually, one can view any firm that is part of the financial services industry as comprising a set of domestic and a corresponding set of international activity-related assets and liabilities, as well as an array of off-balance sheet activities falling into both categories. Thus, changes in international rankings across financial firms, such as the list of the world's top 300 banks -- and, by implication, the relative importance of the cities in which those banks are headquartered -- can be due to changes in any of the industry's underlying areas

of business. Here we consider the economic factors impacting on the growth rates of each of these areas of business, and how they in turn feed back into the relative importance of New York City as a financial center.

Domestic Banking Activities

Regional banking and financial centers arise when a local population finds it convenient to centralize its financial arrangements in a geographically-proximate urban center. Historically, in the U.S. there has been a strong correlation between the population in an urban area (as a percentage of the national whole) and its share of the national deposit base (a measure of the share of domestic banking services). However, a recent study by Goldberg and Hanweck [1990] has shown that this correlation has been weakening over time. In particular, while the correlation appears to have been quite strong between 1920 and 1960, it is now much less strong. Indeed, during the 1960-1980 period New York City was able to capture an increasing share of the domestic deposits of the top 100 banks in the nation (from 14.8% to 20.5%) even as its share of the total U.S. population was declining -- the population of New York State has remained roughly constant at 17.5 million over the past decade even as the U.S. population as a whole has risen from about 220 million to about 250 million according to the 1990 census.

This suggests not only that New York's prominence as a domestic financial center was well established by 1960, but also that national communications and technology have improved since that time to the extent that geographic proximity has become less important for the delivery of domestic financial services than it was earlier. The development of sophisticated cash management services, for example, has allowed deposit

accounts to be increasingly centralized. A further implication is that any future population erosion in the New York City area in the 1990's may not have the feared negative effect on the overall demand for financial services generated by New York City-based institutions, whose markets are largely national and global.

Population growth is not the only economic factor potentially impacting the relative growth of domestic financial centers such as New York City. Indeed, the statistical evidence is that it is largely national rather than local economic factors that make domestic banking centers expand or contract. Goldberg and Hanweck tested a number of other local and regional factors, including the annual change in personal income of the local area and the change in retail sales in that area (as a measures of the health of the local economy). Their general finding is that neither local income per capita nor retail sales had a significant effect on national bank deposit shares.

While the Goldberg-Hanweck study examined the effects of domestic financial-center development over time, another recent study by Goldberg, Helseley and Levi [1989] sought to determine what local factors impact a domestic center's overall national market share at any point in time. Using, alternatively, the size of total bank assets in each state and employment in the financial sector in that state as the variable to be explained -- defined to include domestic and foreign banks and near-banks, and based on data for 30 states including New York for the year 1984 -- they found a positive relationship between regional center importance and (i) state personal income, (ii) imports from abroad booked through the state's customs office, (iii) the number of (non-bank) multinational corporations located

in each state,³ and (iv) the number of employees of foreign (non-bank) corporations in each area. Importantly, however, they could find no negative effect of state corporate tax rates on domestic financial center size. Of course, corporate tax rates are levies on "net" returns, whereas transactions taxes are "gross" levies and therefore are likely to have a much larger effect on the viability of financial centers [Levich and Walter, 1990].

This study appears to confirm what one might realistically expect -- that the presence of foreign firms and multinational corporations is a positive benefit for the volume of local financial-service activity. It suggests that policies having the effects of discouraging foreign corporate investment in the New York metropolitan region could ultimately harm the city's financial services industry. Moreover, rising housing costs, commercial rents, and other infrastructure considerations that induce multinational and other foreign corporation to relocate will tend to be harmful to the New York financial services industry in the 1990's.

International Banking Activities

One common feature of recent rankings of the top-10, top-100 or top-300 international banks, cited earlier, is that U.S. banks' relative position has declined compared to Japanese and European banks. However, it should be recognized that part of this decline is simply

³Interestingly while branches and agencies of foreign banks accounted for 17.9% of total U.S. bank assets in 1989, they accounted for only 0.9% of individual, partnership and corporation (IDC) transaction deposit accounts. This suggests that foreign banks are not significant suppliers of retail banking services in the U.S. since IDC deposits are a good measure of retail capacity [see FRB of NY, March 1991].

The growth of the foreign banks' share of lending is indicative of the competitive pressure in the domestic wholesale market, which is in part reinforced by the lack of loyalty of domestic firms to any "main" or "group" bank, as is common to firm-bank relationships in Japan and Germany. Indeed, the costs of branching (or establishing a nationwide branching system) allied to the presence of "main bank" relationships are the principal reasons why U.S. banks have made so few inroads into either the domestic deposit or lending markets of Germany and Japan. This suggests that the domestic market franchise of U.S. banks in the U.S. is probably weaker than that of German and Japanese banks in their own domestic markets [see Hirtle, FRB NY, March 1991 for a similar view].

due to exchange rate changes, and the declining dollar in particular since early 1985.

Exchange Rates and the Declining Dollar. In view of the fact that Japanese banks have more yen denominated assets than do U.S. banks, and that since 1985 the dollar/yen exchange rate has declined to a greater degree than the relative inflation differences between the two countries, the relative share of U.S. banks in world bank assets, measured in dollars, must have declined as well. The same is of course true for the relative shares of all other U.S. financial services firms. In a Federal Reserve study Dohner and Terrell [1988] estimated that over the 1972-86 period alone, 40% of the growth differential between the largest U.S. and Japanese banks could be explained by the declining real value of the dollar. One implication is that as long as economic fundamentals and policies such as fiscal deficits cause the value of the dollar to fall, the dollar share of U.S. firms in the global financial services industry will continue to decline regardless of any changes in real demand and supply conditions for the services they provide.

Ultimately, however, the decline in the dollar is likely to lower the real demand for U.S. bank services as well. This is because a declining dollar adversely affects its use and value as the international medium exchange in world commercial and financial transactions. For example, exporters rather than billing in dollars (and using dollar letters of credit), will likely prefer to re-denominate their transactions in appreciating or stable currencies such as the yen, the DM or even the ECU (the European Currency Unit). Looking ahead to the mid- or late-1990s, the currency of the European Monetary Union (EMU) will become a very strong contender with the dollar for the position as the world's preeminent medium of exchange. This would ultimately erode further the

dollar-denominated transactions-base and, therefore, the competitive position of U.S. financial institutions.

Foreign Direct Investment. One factor believed to impact the development and growth of international financial centers is foreign direct investment. This is because financial firms tend to follow their clients abroad so as to be in a better position to meet their financial needs (especially in the domestic currency). Thus, for example, the establishment of a major German corporate presence in New York City is likely to be followed by the companies' "Hausbanken," such as Deutsche Bank, Commerzbank or Dresdner Bank. A number of studies by Hultman and McGee [1988] and Goldberg and Saunders [1981] have found that foreign direct investment in the United States has been a powerful causal factor in determining the level of foreign bank activity in the United States. This, in turn, suggests that attempts to restrict Japanese and other countries' foreign direct investment will adversely affect New York's position as an international financial center. This is especially important since, as Figure 10 shows, New York already has a disproportionate share of the top 100 Industrial Companies in the world when compared to London and Tokyo.

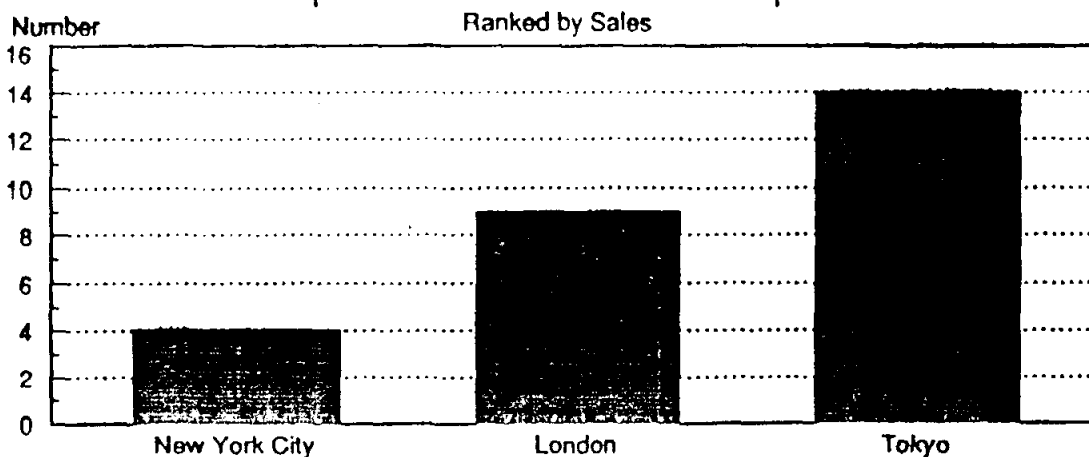
Foreign Trade. Not surprisingly, foreign trade is also believed to be a strong determinant of an international financial center's growth, as found in a number of studies by Dohner and Terrell [1988], Goldberg, Helseley and Levi [1989], Goldberg and Johnson [1990], as well as Hultman and McGee [1988]. The greater the volume of foreign trade passing through a given financial center, the greater the volume of financial services likely to be demanded. Interestingly, however, an additional dollar of U.S. imports is more likely to increase the demand for financial services sold out of New York City than an additional

Figure 10

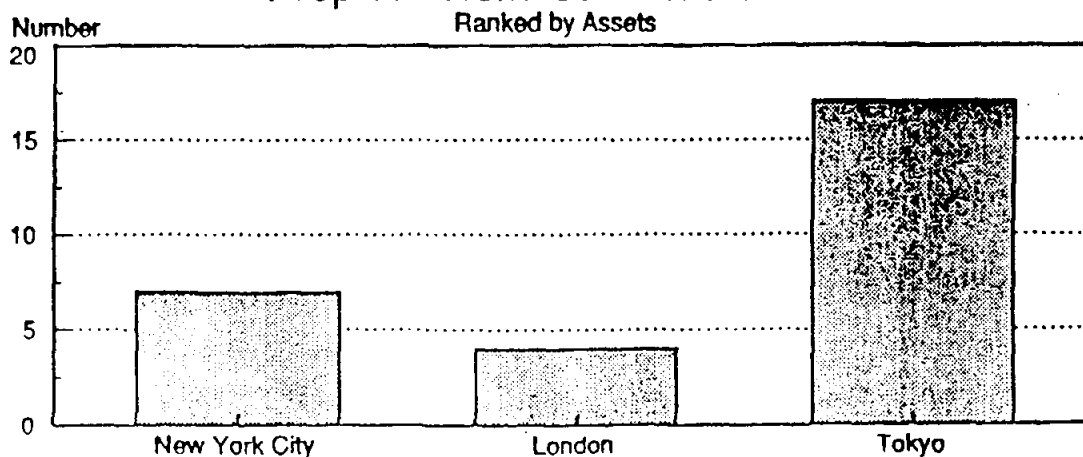
LOCATION OF WORLD'S TOP 100 INDUSTRIAL COMPANIES AND COMMERCIAL BANKS

New York City, London, Tokyo: 1989

A. Top 100 World Industrial Companies



B. Top 100 World Commerical Banks



Source: Fortune Magazine

dollar of exports. This is because U.S. imports are more likely to be financed by dollar loans or letters of credit than are exports -- which are relatively more likely to be financed in the currency of the foreign importer. This in turn implies that a high-level of U.S. imports may have a "silver lining" in that they have a significant positive effect on New York City's role as a financial center.

GNP Growth. The relative growth of the national economy is also a factor that appears to affect the size of an international financial center. This is because financial services, along with labor and capital, are important resources (or inputs) in the production of final output. Consequently, a recession in the real sector of the national (or regional) economy is likely to lead to a decline in the volume of financial services demanded relative to countries not in recession. To the extent that recent U.S. weakness in aggregate economic activity turns out be longer or deeper than that of other national economies, the demand for New York City-based financial services is likely to fall relative to that of other international financial centers.

Infrastructure Factors. It is widely believed that a financial center's infrastructure will affect its overall level of local, interregional and international activity. Infrastructure might, in general, include such factors as: (i) the percent of the work force in local financial service industries (as a measure of the pool of skilled financial employees), (ii) the time-zone of the city (i.e., where it stands in terms of the 24 hour international financial market clock), (iii) the age of the city (the older the city, the worse may be its stock of physical capital, such roads, airports and subways), (iv) its status as a capital city (as a measure of its political influence), and (v) communications (electronic and print media,

as well as access to long-distance travel).

In a study that examines the relative size of 31 world financial centers (including New York) in which 750 of the world's largest banks are headquartered Goldberg, Helseley and Levi [1989] found that, the more service-oriented the city's working population, the greater its level of financial-services activity. Moreover, the time-zone location of the city was found to be of high statistical significance while, by comparison, neither the age of the city nor its status as a political capital appeared to matter very much.

Moreover, a study by Reed [1981] confirmed that a city's role as a high-quality international communications center is a critical factor in attaining and retaining the status of an international financial center. It should be noted that Reed's concept of "international communications" extends well beyond telecommunications to management services such as advertising, accounting and legal services, as well as the quality of airline routes. It was also found that a high quality of local management services appears to allow an international financial center to attain a high degree of autonomy and power over competing financial centers.

From the above list of infrastructure factors, New York appears to have a broad array of competitive advantages: (a) It is preeminent in the provision of bank-related management services such as advertising, legal and accounting services; (ii) It is placed in a very attractive time-zone, falling between the European markets' close and the Japanese market's opening; and (iii) It has excellent airline routes and telecommunications with the rest of the world. The fact that the "age" of the city was found to be an empirically insignificant factor suggests that any deterioration of publicly-supplied services (subways,

sewers, streets and highways) may not necessarily deter a financial center's growth prospects.

Cost Factors. It has already been noted that New York appears to be favorably placed in terms of its communications technology. To the extent that communications represent just one aspect of overall financial services technology, only the most cost-efficient firms in the most cost-efficient centers are likely to survive in the globally competitive environment. Unfortunately, there is little or no empirical evidence on the overall cost-efficiency of U.S. banks and securities firms relative to their major foreign (international) competitors. Nevertheless, the evidence on the relative cost efficiency of different-sized U.S. banks might be extrapolated to project some possible future outcomes to the market for international bank services. The U.S. evidence suggests that there may be economies of super-scale among very large banks, but that very small banks may be cost inefficient -- see Shaffer and Edmond [1988], and Pugel, Saunders and Walter [1991]. If the largest financial institutions have a cost advantage, they can increase market share by undercutting smaller institutions in domestic markets.

To the extent that there are also economies of super-scale at the international banking level, then those financial centers where the largest international banks are headquartered are likely to capture increasing shares of global business. As has already been noted, currently U.S. banks -- even ignoring the exchange-rate effect -- appear to be losing international market share. This may well be due to economic and regulatory considerations (see below), which inhibit their growth and their ability to fully exploit potential economies of super-scale, as well as potential economies of scope (cost savings

that arise from selling multiple products using the same labor, capital and technology inputs). Such restraints on growth inhibit the cost-efficiency of institutions, and ultimately the market share of the international financial centers in which they are based.

With respect to cost of living factors, Figures 11 and 12 indicate that New York City is not particularly severely disadvantaged with respect to major domestic or foreign financial sectors.

Off Balance Sheet Activities. The third area of a financial firm's activity comprises off-balance sheet activities. Broadly speaking, off balance sheet activities other than financial advisory services and transactions services are "below the bottom line," or contingent asset or liability activities. The main categories are: (i) making loan commitments and providing lines of credit, (ii) selling letters of credit and other financial guarantees, and (iii) engaging in forward, future, swap, cap and option contract arrangements. Domestically, these activities have grown to such an extent that total off-balance sheet activities of all U.S. banks at the end of 1989 exceeded their on-balance sheet assets by 60%. That is, "invisible" banking is now bigger than "visible" banking in terms of notional dollar volume. For some institutions it is even more dramatic. In recent years, Citibank's off-balance sheet activities exceeded those on its balance sheet by a factor of four.

While the letter of credit, foreign exchange forwards, futures/options and similar contingent business depends in large part on the growth of world trade and investment, probably the most important factors enabling banks to engage in off-balance sheet activities are: (i) their perceived creditworthiness and (ii) their cost of capital. For

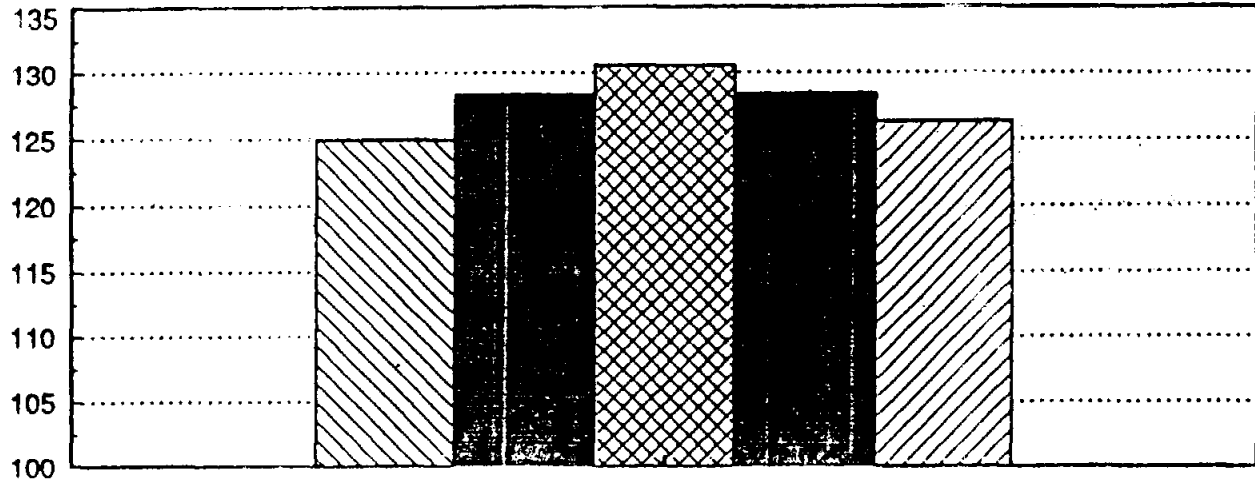
Figure 11

COMPARISON OF LIVING COSTS IN U.S. METROPOLITAN AREAS: 1989

Chicago Los Angeles New York Philadelphia San Francisco

A. Consumer Price Index

1982-1984 = 100



B. Median Sales Price of Existing Homes

Thousands of dollars

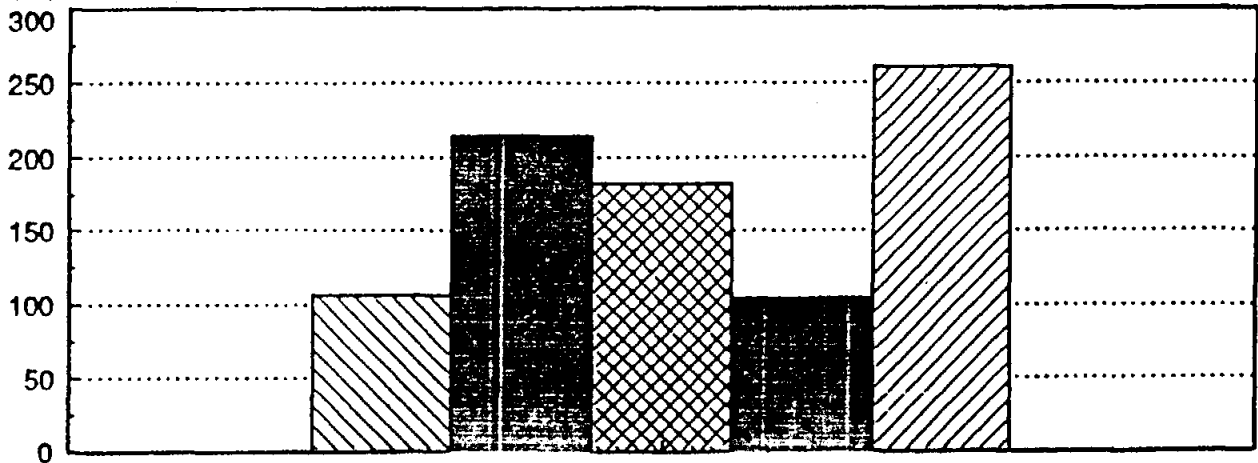
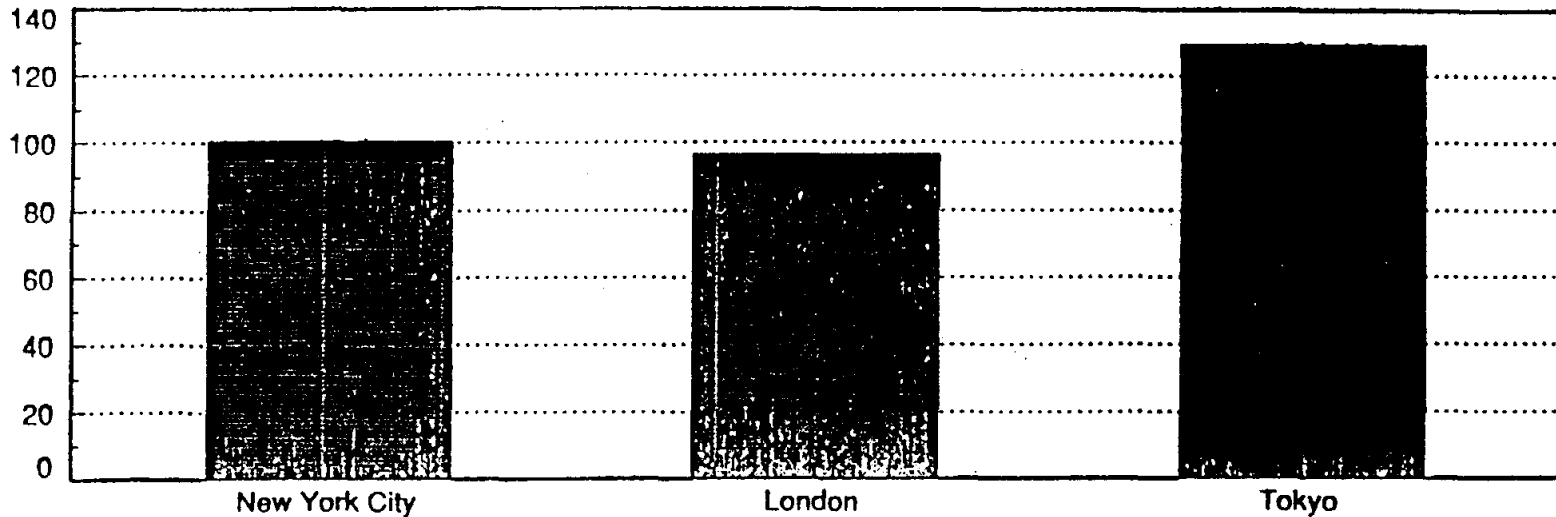


Figure 12

INTERNATIONAL COMPARISON OF LIVING COSTS: 1989

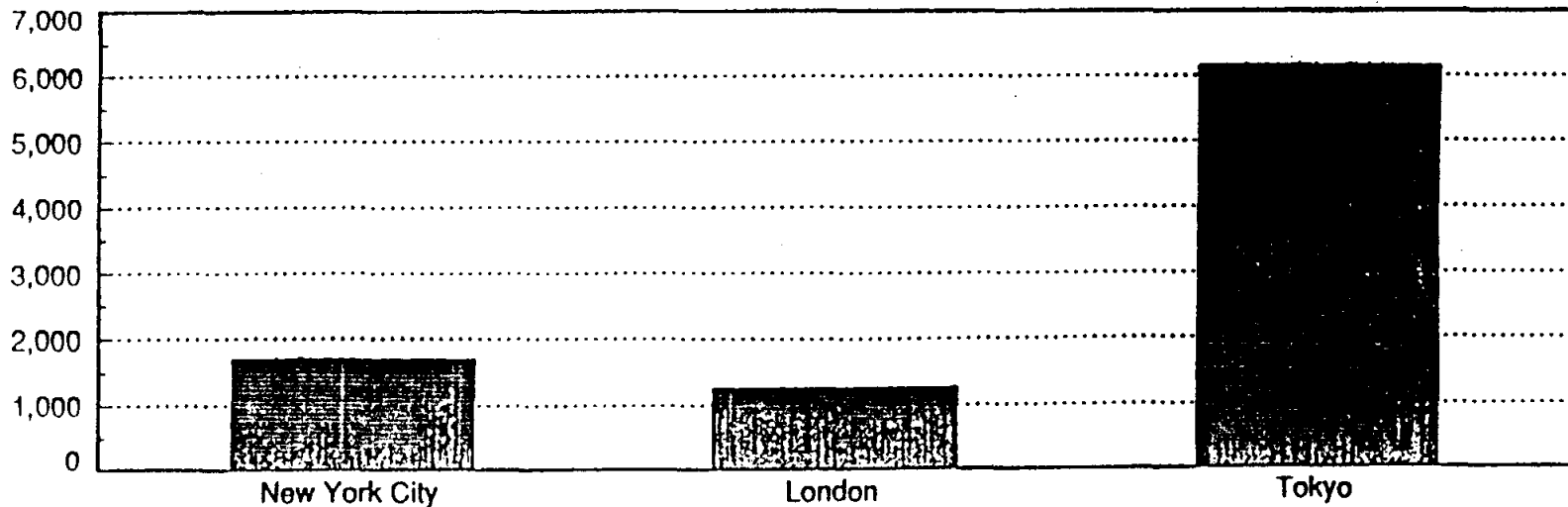
A. Living Costs

New York City=100



B. Monthly Rent for a Three Room Apartment

Dollars



Source: United Nations' Bulletin of Monthly Statistics and Fortune Magazine.

example, it is very hard for a bank to sell financial guarantees if it has poor credit-ratings, since in selling guarantees it is substituting its own credit standing for those of its clients.

In recent years, the creditworthiness of the large New York banks has declined precipitously. As a result, their ability to maintain off-balance-sheet market share in competition with more highly rated Japanese and other foreign institutions has become increasingly difficult -- J.P. Morgan is the only U.S. money center bank that retains a AAA credit rating. This dramatic decline in banks' creditworthiness has also fed back into their cost of capital -- i.e., cost of debt and equity financing -- with large New York City banks such as Chemical Bank and Chase Manhattan paying rates of between 13% and 15% on their new preferred stock and subordinated debt issues in 1990. These capital costs have made it increasingly difficult and expensive for the large banks to meet the Fed's new 8% capital requirement against their risk-based off- and on-balance sheet activities.

As a result, the ability of New York City banks to maintain market share in off balance sheet activities is likely to become increasingly difficult. To the extent that foreign banks replace domestic banks by supplying these activities through their New York City offices -- as in the case of Japanese and European banks' provision of municipal bond guarantees, -- for example, New York City as a financial center may be able to maintain its preeminence in this regard. However, to the extent that highly-rated foreign banks originate and sell these products out of their home bases, New York City could decline in relative importance in this area of financial activity.

Regulatory Determinants of Competitive Advantage

In the previous section, we analyzed the economic factors likely to have an impact on the level of financial activity in New York City in the 1990s. While a broad array of local, national and international economic factors were identified as being important, these are likely to be dominated, in absolute terms, by regulatory factors -- particularly at the federal level.

When analyzing the effects of regulation and taxation on the level of activity in a financial center, it is useful to think of regulation as, in effect, imposing a set of "taxes" and "subsidies" on the operations of financial firms. On the one hand, the imposition of reserve requirements, interest/usury ceilings, truth-in-lending laws and financial disclosure requirements can be viewed as imposing additional implicit "taxes" on a financial firm's activities in the sense that they increase the costs of financial intermediation. On the other hand, regulator-supplied deposit insurance and lender-of-last resort facilities serve to stabilize financial markets and reduce the risk of systemic failure, thereby lowering the costs of financial intermediation. They can therefore be viewed as implicit "subsidies."

The difference between these tax and subsidy elements of regulation can be viewed as the net regulatory burden (NRB) faced by a financial firm in any given jurisdiction. [Kane, 1987] Private, profit-maximizing financial firms tend to migrate toward those financial centers where the NRB is lowest (assuming all other economic factors are the same). Thus, at any point in time, NRB differences will induce firms to relocate as long as NRB savings exceed the transaction, communication, information and other economic costs of relocating. We have argued that, in today's global financial marketplace, transaction and other

economic costs of relocating are likely to be small and declining. One can therefore expect financial market participants to be extremely sensitive to changes in current and perceived NRBs among competing financial centers.

To some extent, the regulators responsible for particular jurisdictions (nations, states, cities) appear to recognize this sensitivity and in their competition for employment and value-added creation, taxes and other revenues. They have engaged in a form of competition over their levels of NRB, as discussed by Kane [1987], and by Levich and Walter [1990].

In the context of New York City as a financial center questions arise as to: (1) In which areas has New York City already engaged in this form of competition in order to retain existing firms or to attract new ones; and (2) In which areas does it need to become more competitive in order to retain existing business?

To a significant degree, New York City is limited in its ability to change its own NRB relative to other financial centers by the fact that most financial services regulation is undertaken at the federal rather than state or local levels, e.g., by Congress, the Federal Reserve, the SEC, and other national regulatory bodies. For example, under current federal banking regulation, even if all the large New York City banks were to convert from national to state charters, they would still be unable to lower their levels of non-interest bearing reserves even if state regulations permitted.

In terms of New York City's financial markets, there are four important areas of financial activity where federal regulation has shaped the size of the NRB by financial institutions based there: (i) the degree of inter-state bank competition that is permitted, (ii)

restrictions on entry of foreign banks into domestic markets, (iii) the degree of separation required among different financial service firms -- especially commercial banking vs. investment banking and commercial banking vs. insurance -- and (iv) measures that limit the competitiveness of U.S. securities markets. Restrictive laws and regulations in these four areas tend to raise New York City-based institutions' NRB relative to that of competitors based in other financial centers. It is useful to examine their structural effects on New York City's NRB in somewhat greater detail. We will argue that significant U.S. levels of NRB bear disproportionately on New York City-based institutions, and that encouraging timely and far-reaching reform of a kind that reduces NRB is a matter of great urgency for the City.

Activity Limits

In the pervasive economic restructuring that goes on in response to changing consumer and industrial demand patterns, resource costs, international competition, perceived economies of scale and scope, individual firms in search of maximum shareholder value constantly reassess the activity-span of their businesses. Vertical integration to secure sources of supply or downstream distribution may serve this purpose. Horizontal and geographic expansion to acquire market share, complementary product lines or risk-spreading may be attempted for the same reason.

When management appears to be on the wrong track, the financial markets provide appropriate signals leading to further restructuring or retrenchment. When the firm's objectives collide with the public interest in keeping markets functioning efficiently or in achieving non-economic objectives -- even at a cost to the economy -- regulatory constraints

are imposed in the form of antitrust, environmental, employment, consumer protection or other types of legislation, along with appropriate enforcement measures. These involve a delicate balancing act to insure that the social benefits of regulation more than justify the social costs (which come in the form of less efficient use of resources and possibly slower growth). Within the bounds of such constraints, industrial restructuring and shifting forms of business organization in market-oriented economies are allowed to be driven mainly by the economic fundamentals.

Restructuring in the financial services sector is conceptually no different than restructuring in any other industry. Market forces may dictate vertical positioning somewhere on the spectrum from the ultimate consumer to the wholesale financial markets, or horizontal positioning ranging in breadth from the financial specialist to *Allfinanz* or *Bankassurance* -- the respective German and French terms for providing the full range of financial services under one roof. As in other industries, the functions to be performed and the underlying demand and supply characteristics in a highly competitive market tend to dictate the sizes and forms of the organizations that compete in the marketplace.

It has been argued extensively that financial services firms are "special" -- either in view of their fiduciary responsibilities to clients or in terms of the macroeconomic role performed by banks at the core of the national and international payments and credit system [Walter, 1985]. Firm or system-wide failure can impose costs on those firms insufficiently informed to make rational financial choices or on society at large as the credit and monetary base contracts. Alternatively or in addition, the degree of control that financial firms exercise over other parts of the economy may be deemed in a political

context to be excessive.

Specialness can be considered in both a narrow and a broad sense. In the former, specialness is considered to bear only on the deposit/credit and monetary policy dimensions, and therefore applies only to "commercial banks" under the U.S. institutional definition, but not to other types of financial services firms. However, to the extent that either of these dimensions bear on other types of financial services firms as well, or on sectors such as housing that are viewed as being socially desirable, other financial services firms such as S&Ls can also be considered "special." Moreover, Kane [1987] and others have argued that all financial services firms vulnerable to crises of confidence or failure-related negative externalities could be considered special, and should therefore be subject to certain assistance and regulatory treatment on the part of government that need not apply to other types of firms such as industrial companies.

A variety of constraints ranging from capital adequacy standards to liquidity requirements and periodic compliance reviews are usually set in place in order to mitigate concerns related to specialness. Each may involve economic costs, and may therefore erode the static or dynamic efficiency properties of the financial services industry. Whether the social gains in terms of improved firm and industry stability and fiduciary performance exceed these costs is a complex and difficult matter for debate.

Moreover, since such improvements can only be measured in terms of events that did not occur and costs that were successfully avoided, the arguments are invariably based on "what if" hypotheticals. There are no definitive answers with respect to optimum regulatory structures. There are only "better" and "worse" solutions as perceived by the

electorate and their representatives. Consequently, collective risk-aversion and political reaction to past regulatory failures in the financial services sector can easily produce overregulation. This is also reflected in the reward system of bureaucrats charged with operating the regulatory structure, which causes them to be excessively risk-averse and prone to overregulation.

In addition to conventional forms of fiduciary and stability-oriented regulation, the financial services industry in some countries -- most notably in the United States and Japan -- has been subject to activity-limitations that constrain access to geographic markets, services or clients. In the United States, these are anchored in the Glass-Steagall provisions of the Banking Act of 1933, the 1956 Bank Holding Company Act and its 1970 Amendments, and the 1927 McFadden Act and the Douglas Amendment. Within the financial services sector, they have traditionally prevented or limited cross-penetration between banking and securities activities, between banking and insurance, but not between insurance and the securities business. Likewise, they have prevented or inhibited geographic cross-penetration in banking, but not in securities or (despite fragmented state-level regulation) in insurance. And they have prevented cross-penetration between banking and industry, but not between industry and the securities or insurance sectors -- including long-term shareholdings in those sectors.

In the United States, the freedom of banks and other financial services firms to choose their own organizational forms and span of activity (line of business) has thus been subject to far greater restrictions than in many competitor countries, carrying with it the potential for significant erosion of New York City's position as a financial center.

Interstate Banking

At the national level, interstate banking has been restricted since the passage of the McFadden Act in 1927. This Act restricted the ability of the largest nationally chartered banks to branch across state lines (e.g., for a bank in New York City to branch into New Jersey). To circumvent these restrictions, a number of banking organizations established multi-bank holding companies, through which a parent bank holding company could acquire out-of-state banks. This loophole in the law appeared to be closed in 1956 with the passage of the Bank Holding Company Act.

However, beginning in 1975 with Maine, states discovered that they had the power to lower their own NRBs (relative to other states or regions) by engaging in regional banking compacts, which are essentially reciprocal interstate agreements to allow out-of-state banks to acquire in-state banks. Since 1975, all but three states have passed some form of interstate banking legislation.

For example, New York State allows banks from any U.S. state to enter its market, as long as New York banks can enter the other state's markets. So far, only 19 states have given New York banks powers of entry. However, California will allow New York banks to enter beginning in January 1991. At that time, California banks will also be able to enter the New York market. One possibility is that financially strong California banks will seek to acquire New York banks. Perhaps more likely is that troubled New York banks will view California as an attractive and growing market in which to expand, re-orientating some of their activities away from the New York area to the West Coast. Such reorientation might have the added advantage of placing them closer to the expanding

countries of the Pacific rim.

In the light of such a scenario, it might take the full-scale demolition of the McFadden Act and the emergence of a nationwide banking/branching system, such as that recommended in the Treasury Report [1991] for New York City to benefit from the demise of interstate banking restrictions. Under this scenario, we might expect that all the major domestic banks elsewhere in the United States would seek to establish a greater presence in New York City, probably by some form of branch operation. Moreover, repeal of the McFadden Act would bring the U.S. banking system into much closer conformity with the national banking systems of its major competitive rivals such as Germany, Japan, the U.K. and Canada, and thereby attract greater foreign entry at the retail level. This development alone would be of immense benefit to the New York City economy.

International Bank Regulation

Prior to the passage of the International Banking Act of 1978 (IBA), foreign banks were largely under the jurisdiction of the states where they established operations such as branches, agencies and subsidiaries. Foreign-based institutions were exempt from membership in the Federal Reserve System, from Bank Holding Company Act and the McFadden Act restrictions on branching across state lines, and from the Glass-Steagall prohibitions against involvement in both commercial and investment banking.

Because of the perceived inequity with respect to the rules governing federal regulation of national banks, Congress in 1978 passed the IBA, subjecting foreign banks to the same federal regulations as domestic banks. The one exception was that any banks established in the U.S. prior to 1978 that had any federally "illegal" activities, such as inter-state

branching and investment banking operations, were "grandfathered" under the Act -- that is, they could keep them but not expand them or change them in any material way.

The IBA thus eliminated regulatory discrimination in favor of foreign banks, although the grandfathering created a degree of tension that became more important especially with the continued securitization of financial flows in the United States.

Given the continued restrictive effect of Glass-Steagall in the U.S. domestic market on their American competitors, the 15 foreign banks that were grandfathered under the IBA (and could thus maintain both a commercial and investment banking presence in the American market) as well as foreign-based securities houses, many of which are among the principal competitors of U.S. commercial and investment banks, did not exercise their full potential power in the U.S. capital market.

Beginning in 1986, however, some began to flex their muscles. Sumitomo Bank and Trust Company purchased a 12.5% share in Goldman Sachs, in spite of Article 65, Japan's version of Glass-Steagall, albeit under tight restrictions on the part of the Federal Reserve. Securities affiliates of Swiss Bank Corporation, Union Bank of Switzerland and Deutsche Bank led 15 debt issues amounting to over \$2.5 billion in that year alone. American commercial banks that were attempting to be important players in global finance saw some of their principal rivals do deals in their own home market that were prohibited to them -- a rare case of foreign firms being treated significantly more favorably than domestic firms.

The IBA has allowed foreign banks full access to domestic retail banking, and does not appear to have harmed their ability to compete at the wholesale/corporate banking level.

This is evident by the fact that U.S. assets of foreign controlled banking offices grew from \$86.8 billion in 1979 to \$579 billion as of the end of 1989 (approximately 20% of all domestic banking assets), with \$428 billion of these assets booked in New York offices.

It might also be noted that, in 1989, \$221 billion of the New York City-based bank assets (and \$276 billion nationally) were held in special-purpose International Banking Facilities (IBFs). These IBFs can only take deposits from, and lend to, non-residents and other banks and can be viewed as bringing off-shore banking business back on-shore. They have been so successful largely because federal and state regulators have worked together in reducing the NRBs of the organizations involved close to zero. Specifically, IBFs are subject to neither reserve requirements nor local income taxes. The success of IBFs in New York City is a clear indicator of the importance of NRB as a determinant of the overall level of activity in a financial center.

The Glass-Steagall Act

The Glass-Steagall provisions of the Banking Act of 1933 sought to separate commercial banking (deposit-taking and lending) from investment banking (underwriting and dealing in corporate and certain other types of securities). However, since its passage commercial banks have increasingly challenged perceived "grey-areas" of the Act.

In an attempt in 1987 to bring some order to commercial banks' investment banking activities, the Federal Reserve allowed a small number of New York City and other bank holding companies to establish separate investment banking subsidiaries -- so-called "Section 20" subsidiaries designed to circumvent Section 20 of the Glass-Steagall Act -- through which to conduct investment banking activities. Currently, the activities in which

these subsidiaries are allowed to engage range from commercial paper and municipal revenue bond underwriting and dealing, to corporate equity and bond underwriting. However, there are some very stringent restrictions on the activities of these organizations: (i) Very strict "firewalls" separate the activities of the investment banking subsidiary from its bank affiliate, thereby limiting any economies of scope; and (ii) There is a Fed-imposed 10% cap on the revenues emanating from "ineligible" securities activities within the investment banking subsidiary itself.

While Section 20 subsidiaries partially ameliorate New York's NRB in this area, and the 1991 Treasury Report has recommended the abolition of the Glass-Steagall Act subject to a number of "firewalls" between the bank and securities affiliate remaining in place, other financial centers are far less encumbered by firewall-type restrictions. For example, in neither Germany nor Switzerland are the domestic "universal" banks subject to a separation of commercial banking from investment banking. In fact, full "in-house" integration of these powers is permitted. Moreover, the U.K. permits investment banking affiliates to be established as direct subsidiaries of a bank rather than as subsidiaries of a holding company, as in the United States.

To the extent that the Glass-Steagall legislation has prevented New York City banks from competing in an unencumbered manner over the full range of financial services with foreign universal foreign banks, it has hindered the development of New York City as an international financial center. Indeed, to avoid the restrictive provisions of the Glass-Steagall Act, New York banks have established extensive offshore operations through which to engage in bond and equity underwritings, pursuant to Regulation K of the Federal

Reserve Board. Such NRB-avoidance has been a major factor in the growth of London as an international financial center. This suggests that it would be in the best interests of New York City to see the Glass-Steagall Act repealed in such a way that U.S. banks could undertake securities activities via direct subsidiaries with a minimum of firewalls -- see Pugel, Saunders and Walter [1991] for a detailed discussion of this issue.

Banks and Insurance

Banks also face considerable regulatory barriers in their endeavors to engage in insurance activities. The opposition of Federal regulators to banks selling insurance (other than credit life insurance) has been amply confirmed by the Federal Reserve's restrictions on a Citicorp subsidiary that sought to sell insurance products using a recently-passed Delaware law. Again, it should be noted that this aspect of the NRB is considerably lower in competing foreign financial centers. Thus in both Germany and the U.K., banks can engage in insurance activities as part of their universal banking product range through directly owned bank subsidiaries.

In the U.S., the states have greater powers over insurance and insurance-related activities than they do over banking and securities activities. This is because insurance is still primarily regulated at the state level. Indeed, in 1984 New York State established a commission to investigate the case for and against banks selling insurance, the so-called Dewind Commission [1984]. While the Commission's recommendations were never acted upon, they did recommend that banks be allowed to sell insurance, with certain restrictions. In order to lower its NRB and attract more domestic and international insurance business, New York could actively consider implementing some of the Dewind recommendations --

even in the face of Federal Reserve and insurance industry hostility.

Banking and Commerce

The 1956 Bank Holding Company Act and its 1970 Amendments limit banks' non-banking activities to those closely related to banking. As a result, such holding companies cannot own more than 5% of the equity of commercial firms, and vice-versa. As the Treasury [1991] has recognized, such a policy has a number of costs. Most importantly, it cuts off badly needed capital injections into banking, thereby inherently contributing to safety and soundness problems. Moreover, it dichotomizes the capital market and removes a significant degree of stock market discipline from bank managers. Since commercial firms can acquire insurance companies and securities firms, it seems irrational to prohibit properly structured bank-commerce linkages, especially since such linkages are very common in major competitor countries such as Germany and Switzerland -- see Saunders [1991] for more details. Thus, the Treasury's 1991 proposals for banking reform should be supported in large measure in this regard.

Regulatory Issues and Securities Firms

As the principal regulator of securities firms, rule changes by the SEC have a major impact both on the growth of the securities industry as a whole as well as on New York City and the domestic/national market shares of the global securities business. As with banking, certain SEC rules (and rule changes) have had favorable effects on the industry's NRB, while others have had negative effects. However, foreign firms have generally felt that SEC regulations are overly intrusive and involve considerable compliance and

information costs. This has tended to reduce the attractiveness of U.S. and New York City financial markets to foreign securities issuers -- that is, the U.S. level of NRB is perceived to be high.

Nevertheless, there have been two major SEC rule changes providing positive benefits for New York City financial markets and alleviating NRB to some degree: Rules 415 and 144A. In November 1983 the SEC finally approved Rule 415, which allowed large firms to pre-register new issues of debt (and eventually equity). Thus firms had up to two years after SEC registration to offer securities to the market (by taking them "off-the-shelf"), thereby better timing an issue to when market conditions were right and benefiting from greater competition among underwriters. The approval of Rule 415 has been extremely favorable to NYC-based securities firms relative to smaller regional firms. This is because an off-the-shelf offering requires a very short window in bringing the issue to market, so that issuers have very little time to organize an extensive underwriting syndicate. Rather, the tendency has been to use one or a few large underwriters for the whole issue. Indeed, the Securities Data Corporation has reported that the share of non-syndicated U.S. corporate debt offerings rose from 36% in 1983 to 89% in 1989.

The second potentially positive development was the approval, by the SEC, of changes in the rules governing the private placement market in the U.S. (Rule 144A). Prior to this rule change, market liquidity had been inhibited by SEC restrictions on the secondary market resale of privately placed issues, and was reflected in an interest-rate penalty that issuers had to pay to compensate investors for the reduced liquidity. The rule change will now allow privately placed securities to trade in a secondary market between qualified

institutional buyers -- defined as those with owned or managed assets exceeding \$100 million -- without the type of disclosure required for public issues. As a consequence of Rule 144A, a safe haven thus is provided to any issuer (domestic or foreign) offering securities to qualified institutional buyers on an unregistered basis.

Whereas SEC Rule 415 earlier permitted qualified issuers to sell securities under a shelf-registration procedure, Rule 144A omits registration requirements altogether, thereby greatly simplifying new-issue procedures for international borrowers unwilling to submit to the trouble and cost of preparing a registration statement [SEC, 1988]. This could potentially lead to a wave of foreign and domestic issuers utilizing U.S. (and New York City) markets, as opposed to the Euro-markets, in a so-called capital market "flow back" or "reintegration" effect.

For all practical purposes, Rule 144A could transform the U.S. institutional market for debt securities into an equivalent of the self-regulated and highly innovative Eurobond market. Rule 144A contemplates a substantial increase in the number of non-U.S. debt and equity financings done in the American capital market, many of which will be offered not only to domestic investors but also, simultaneously, to investors in Europe and Japan. Debt issues brought to the public European and Japanese markets -- whether by U.S. or other corporate issuers -- may also be concurrently offered to institutional investors in the United States under Rule 144A. From a regulatory viewpoint, Rule 144A has eliminated some of the remaining obstacles to full international market integration. Issuers will, as always, choose the lowest-cost market for the securities they wish to offer -- which may or may not be in the United States -- regardless of regulatory considerations.

Rule 144A also permits banks to broaden and perfect their distribution of loans. During the 1980s, many U.S. banks adopted the practice of "selling down" loan participations to other banks. This process could be made more efficient by securitizing the loans through Rule 144A provisions that would permit liquid markets to develop and extend the group of investors to whom they are offered to encompass non-bank financial institutions as well. Should such practices become widespread, the market for bank loans would come to be more highly integrated with the bond market, thereby facilitating the development of meaningful placing power by banks in the securities field -- but also raising questions as to how such loans/securities should be treated for accounting and regulatory purposes.

Despite the bullish long-term outlook for business development under Rule 144A, the experience to date has been somewhat disappointing with only a few foreign issuers (such as British Airways) availing themselves of this market. The problem seems to be a number of other (NRB-type) barriers that the U.S. might consider alleviating. These include the tax requirement that all U.S. securities must be in registered form (non-U.S. investors prefer securities in bearer form). Moreover, there have been problems with the NASD's computerized trading system for private placements (PORTAL), including restrictions on exit and the definition of PORTAL-designated accounts, which may limit effective foreign access.

In addition, restrictions that New York State and other states place on the amount of foreign securities their insurance companies can buy provide a continuing constraint on the potential growth of the 144A market, and thus on the potential benefits of this rule change for New York City. This portfolio restriction is clearly one policy area that New York's city

and state governments can directly influence.

The other side of the NRB coin has been the continued presence of SEC rules and securities laws constraining the growth of foreign securities firms in the U.S., as well as reducing the attractiveness of the U.S. public securities market for foreign issuers. According to IDD Information Services, during the 1980's 94 foreign acquisitions of domestic securities firms took place, or about 17% of the total. Using a definition that a foreign controlled securities firm is one in which foreign citizens own at least a 25% share of the firm, the proportion of all public offerings underwritten by foreign firms peaked at 19% in 1987. Since then, their share has declined to 15% (as of the end of 1989).

Given this decline in foreign market share in the securities sector (unlike the banking sector), the growth of international asset portfolios under professional management, and the recent developments in the European Community -- where a single license in one country will allow (by the end of 1992) a securities firm to sell stocks or bonds registered in that country in the eleven other countries of the Community -- important changes to U.S. securities regulations and the securities laws should be considered in order to maintain New York City's attractiveness to foreign securities firms and foreign issuers. Such changes might include the SEC being required to consider adopting similar "mutual recognition" rules to those developed in the EC on a bilateral or reciprocal basis. As noted below, securities registered in Canada might be directly offered for sale to investors in the U.S. and vice-versa. Eventually, such reciprocal agreements could be developed with both the EC and Japan.

Other aspects of the existing NRB on foreign securities firms is the requirement that

foreign investment advisers (under the Investment Advisers Act of 1940) must register with the SEC, while a foreign broker-dealer does not have to register if it is associated with a broker-dealer already registered with the SEC. This barrier to foreign-based investment advisers might be reduced by treating foreign advisers on a similar basis to foreign broker-dealers. As noted earlier, three of the top ten asset managers of U.S. pension funds are currently based outside the U.S. Reducing such barriers may induce them to locate onshore, which almost certainly would be in New York City. One approach is the one discussed as part of the Canada-U.S. Free Trade Area (FTA) negotiations, whereby advisers registered with one jurisdiction are automatically accepted by the other. While implementational issues are difficult, an extension of this concept to cover investment advisers licensed in other major financial markets would do much to alleviate this problem.

Finally, an important and often hidden cost or regulatory burden facing foreign firms considering U.S. public offerings is the SEC's requirements on financial statement or accounting disclosure. Many countries (such as Germany) operate under accounting standards that are quite different from U.S. Generally Accepted Accounting Practices (GAAP) standards. Currently, in registration and other SEC disclosure documents, a foreign issuer has to present a quantitative reconciliation between its financial statements (based on its home-country accounting standards) and U.S. GAAP standards. The production of such information is both costly and difficult, and acts as a significant barrier to foreign firms considering whether to issue securities in U.S. markets rather than their domestic markets or in the Euro-markets.

This requirement may be one reason why so few foreign-based firms (only 95 out of the

1,800 largest foreign companies) are listed on the NYSE and why no world-class German firms are listed. Moreover, this disclosure requirement was one reason why many felt that 144A would be so attractive to foreign issuers (since they could avoid such information-production costs). It is not unreasonable to believe that for first-class foreign issuers such as Deutsche Bank, Dresdner Bank, Imperial Chemical Industries, Honda and the like, U.S. investors know a sufficient amount about them through their own financial statement, due diligence, and S&P/Moody's ratings etc., that such required accounting reconciliations are indeed excessively costly relative to their supposed benefits to investors. For example, due to recent EC directives German authorities have removed most of the non-GAAP information/disclosure problems affecting German companies. Given this, the SEC might be encouraged to allow large first-class foreign firms to publicly offer securities in the U.S. based on full SEC-mandated disclosure but excluding the mandated quantitative reconciliation requirement. For example, such a requirement could be optional for the largest foreign issuers.

As noted, the number of non-U.S. companies that comply with the quantitative reconciliation requirement and enter the U.S. capital market each year remains extraordinarily low, despite the rapidly growing demand by U.S. investors for foreign securities. This demand is expected to grow dramatically in the near future as the importance of globally diversified portfolios becomes better known and acted upon by investors. If foreign securities are not available in U.S. markets U.S. investors will find them, at greater transaction costs and with far greater custody charges, in foreign markets.

The "pent-up demand" for foreign securities can be roughly measured by looking only

at U.S. pension funds, which today hold between 3% to 5% of their total assets (some \$2 trillion) in foreign securities. Over the next five years it is estimated that this percentage will increase to about 15%, with the largest funds being more influenced by modern international portfolio theory, moving to a range of from 20% to 40% invested in foreign securities. The critical point here is that this massive portfolio rebalancing will occur only once, after which activity will be limited mainly to minor adjustments in country and asset weightings. If the sourcing for most of the desirable foreign securities remains offshore, the necessary broker-dealer and custodial relationships established in foreign markets to fill this pent-up demand will make it very hard for the U.S. to recapture that business, even if the foreign securities eventually become available here.

It might also be possible to allow the largest and best foreign firms to entertain exchange and similar types of offshore offerings with U.S. holders on the basis of their home-country (non-GAAP) accounting rules and disclosure requirements. This could be aided by a greater transparency and investor understanding of foreign accounting and disclosure standards. For example, in October 1990 the SEC issued a revised proposal for a multijurisdictional disclosure system (MJDS) between the U.S. and Canada. Such a system might usefully be extended between the U.S. and the EC and the U.S. and Japan.

NRB and Taxation

Since the lowering of the federal corporate tax rate in 1986, U.S. corporate tax rates are now lower than those found in many rival financial centers (most notably Germany). Moreover, the lowering of the short-term capital gains tax to the same level as the long-term capital gains tax has also served to reduce the level of taxes on U.S. financial

services activity.

Nevertheless, there is still a widely-held perception that, relative to other financial centers, New York City is a high-tax location. Although there are no definitive studies that explicitly compare tax rates bearing on corporations and financial firms across financial centers, it is interesting to note that Germany, Belgium, Italy and the Netherlands have no capital gains tax, and Japan's capital gains tax is lower than that of the United States. Along with Sweden and the Netherlands, the United States is also one of the few countries that double-taxes dividends, once at the corporate level and once again at the level of the dividend recipient.

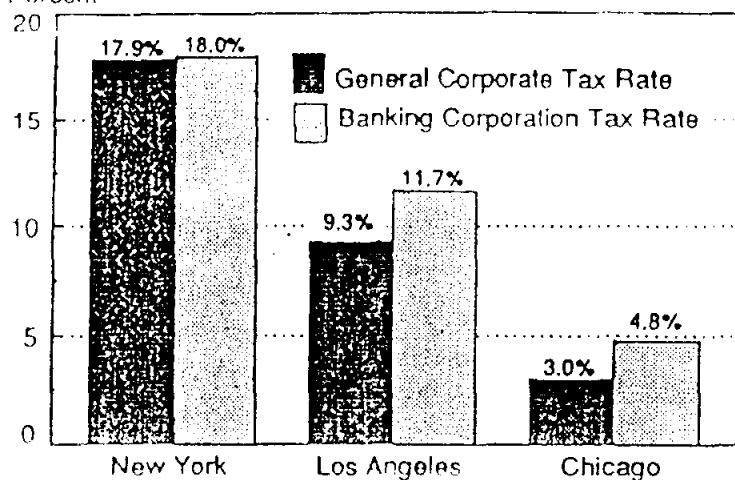
Since local taxes on profits and employment income are part of a financial center's overall NRB, it is incumbent on local governments to set a level of local tax rates and user fees comparable with those imposed on financial firms in competing domestic centers. As Figure 13 shows, New York City has high corporate and personal income tax rates in relation to other U.S. financial centers. At the national level, local government needs to be in a position to effectively oppose attempts to levy new federal taxes that adversely impact financial activity in New York, and to argue for taxation that effectively lowers New York's NRB in competition with foreign financial centers.

For example, in 1990 there was a debate in Congress over the imposition of a tax on stock-market turnover (STET). Not only would such a tax have increased New York City's relative NRB, but it would most probably have harmed the liquidity of the stock market as well. This in turn could be expected to increase the degree of stock price volatility and further deter retail and institutional investors from investing. Fortunately for New York

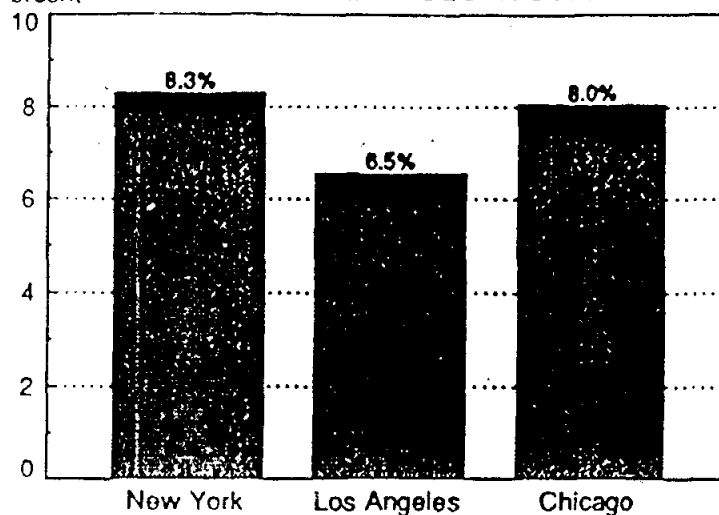
Figure 13

1990 TAX RATE COMPARISON: NEW YORK CITY, LOS ANGELES AND CHICAGO¹

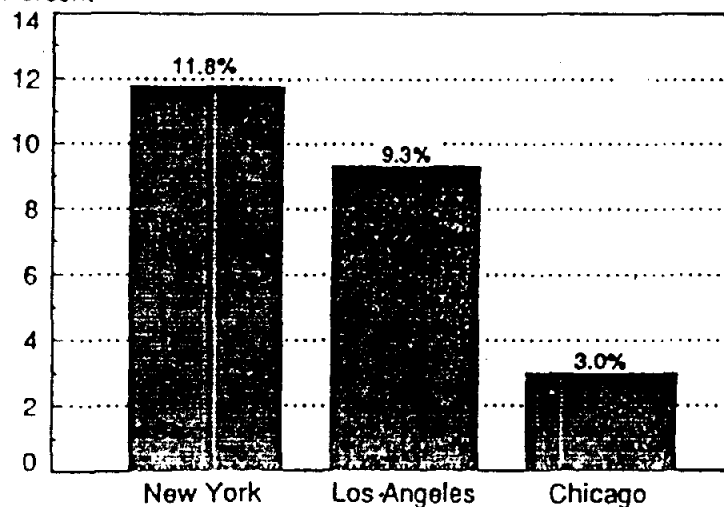
Percent A. CORPORATE INCOME TAX RATES



Percent B. GENERAL SALES TAX RATE



Percent C. PERSONAL INCOME TAX RATE



Source: Office of Tax Policy, New York City Department of Finance, April 8, 1991

City, this tax was not included as part of the final 1990 Budget package.

Trade Liberalization in Financial Services

The Uruguay Round of trade negotiations, due for completion in 1991, is intended to anchor liberal market access in the financial services industry. Together with the financial services provisions of the recently completed Canada-U.S. Free Trade Area (FTA) and 1991 negotiations with Mexico aimed at forming a North American Free Trade Area, are fundamentally in the interests of New York City.

The concept of "reciprocal national treatment" would seem to be the substantive equivalent of liberal international trade in this sector. This means that foreign-based players are subject to precisely the same regulatory and prudential controls as domestic players. Even so, this standard can produce differential effects on domestic and foreign-based institutions because of different starting-positions and operating characteristics. Further unintended distortions can arise because of stringent home-country capital requirements for institutions doing business in international and foreign markets, where they may compete with players based in other countries who may be treated much more leniently.

What is really required in an implementational sense is "equality of competitive opportunity", in the sense of a level playing field -- an extraordinarily difficult concept to define, much less to deliver, in the case of an industry as complex as financial services. This can be viewed as comprising the following components:

(a) Freedom to establish branches, agencies, subsidiaries, representative offices or other affiliates within a national market on a basis identical to that applying to locally-owned

financial institutions. National antitrust and other policies relating to establishment would bear on foreign players identically to domestic players.

(b) Regulatory symmetry, insofar as possible, with respect to domestic and foreign competitors. This includes the incidence of prudential controls such as capital requirements, asset ratios, lending limits and reserve requirements. It also involves equality of access to the domestic securities markets, including lead-managing local-currency issues in the local and offshore markets, as well as equal access to the national payments clearing system, money markets and central bank discount facilities, and trust and investment businesses.

(c) Freedom to import critical resources, including travel and resettlement of professional staff, subscriptions of capital in the case of certain non-branch affiliates, data processing and telecommunications equipment on the same basis as local firms. Included is equality of access to transborder communication and data transmission.

(d) Symmetry with respect to the application of exchange controls, if any, as between foreign and local players. This bears on capital outflows such as foreign borrowing in the local markets and local investments abroad, as well as remittances of earnings.

(e) Equality of access to domestic client groups, financial institutions and product markets, including branching privileges equal to those of local firms and the right to purchase shares in local financial institutions consistent with domestic laws regarding competition.

Together, these elements would provide a consistent set of benchmarks for equality of competitive opportunity which, as noted, is the equivalent of liberal trade in the financial services sector. This does not mean that foreign-based financial institutions should be able

to avoid the effects of national tax, prudential and monetary control policies, and it is clear that the implementation of a truly level playing-field is made vastly more complicated because of these considerations.

Overseas activities of financial services firms based in New York City represent a substantial source of employment and income. Just as liberal access to other parts of the United States through interstate branching and other market-access vehicles is important for New York City financial institutions, so is effective market access and liberal regulatory environments abroad. Like expansion of domestic activities, they provide large numbers of supervisory and support jobs in New York City, permit institutions to diversify their exposure to risk, and foster value-added and employment in linked non-financial sectors.

In the banking sector, for example, U.S. banks have been exempted under Regulation K from onerous activity-limits that apply at home, and have been able to enter the securities and insurance businesses abroad, sometimes with considerable success. Similarly, foreign deposits of U.S. banks are not insured by the FDIC, and are not assessed FDIC charges. American banks thus compete abroad on essentially the same regulatory footing as their local rivals.

Efforts to narrow the ability to compete in foreign markets by, for example, imposing U.S.-type activity limits by narrowing Regulation K exemptions or subjecting foreign deposits to FDIC insurance assessments, would bear disproportionately on banks based in New York City -- which have roughly two-thirds of all foreign deposits in U.S. banks. This would seriously erode their competitive position internationally, and could have a serious impact on employment and income in New York City. Similarly, increasing the regulatory burdens

associated with transactions done in the New York international banking facility (IBF) -- which competes actively with London and with various offshore booking centers, and where the tolerable NRB is close to zero -- would quickly drive business away.

Because of the importance of foreign market-access on the part of New York City banks, insurance companies and securities firms, as well as the value-added, employment and tax contributions of foreign-based financial firms in New York City, it is vital that a level playing field be sought internationally as well as domestically. Currently, the President has "fast-track" authority to present trade agreements to Congress for their approval (or disapproval) without amendment. However, this authority will run out in the middle of 1991. Consequently, the "fast track" authority extension, sought by the President with respect to the GATT negotiations as well as the negotiations on a Free-Trade agreement with Mexico, should be supported vigorously by New York City.

The Thrift Crisis and Financial Deregulation

The insolvency of the Federal Savings and Loan Insurance Corporation (FSLIC) and the continuing problems of S&Ls -- approximately one-third are unprofitable, according to White, [1990] has created a public-policy concern that the thrift experience should not be repeated for banks. This concern has been heightened by reports that the Bank Insurance Fund (BIF) had less than \$8.5 billion in resources in April 1991, and could well be rendered insolvent within two years barring dramatic increases in bank insurance premiums and/or loans from the Treasury or the Federal Reserve.

A popular view (or even conventional wisdom) is that it was the deregulation of the thrifts' activity and investment powers in 1980 and again in 1982 under the Depository

Institutions Deregulation and Monetary Control Act (DIDMCA) and the Garn-St Germain Act that somehow "caused" the thrift crisis. What is often ignored is that institutions whose activities (both product and geographic) are constrained, as the thrifts were at the time of the 1980-82 reforms, are especially vulnerable to external shocks.

Indeed, it may be convincingly argued that it was a significant external shock that lay at the heart of the thrift crisis. This was the Fed's significant tightening of monetary policy (with interest rates rising close to 20%) during the 1979-1982 battle against inflation, which targeted non-borrowed reserves. That policy had a particularly adverse effect on thrifts relying on traditional residential mortgage lending, with long-term assets and short-term liabilities. It raised their cost of funds relative to the returns on assets such as fixed rate mortgages. This is not to suggest that the thrift crisis was due to external shocks alone and had no internal causes. Rather, the point is that the effects of the former are often forgotten.

Moreover, while thrift stockholder and managerial risk-taking behavior does indeed lie at the heart of many thrift failures, laying the blame on deregulation as the "cause" is incorrect. It is now generally agreed -- see Kane [1985] and White [1990] -- that the incentives for greater risk taking in the thrift industry were created by a mis-priced deposit insurance system, regulatory forbearance over capital requirements, and poor regulatory supervision. That is, deregulation per se only provided an opportunity for thrifts to expand the risk scope of their lending powers. The incentives to take more risk lay elsewhere. Even without deregulation, banks and thrifts have traditionally had sufficient powers to pursue exceedingly risky lending policies if they so choose.

The key to understanding the incentives for thrift-owners to take high-risk investment strategies can be seen very easily by analyzing the current deposit insurance system. A bank or thrift that has declining profits and net worth can easily exploit the deposit insurance system by borrowing deposits at close to the risk-free rate (due to federal insurance protection for depositors up to \$100,000 per account) and investing the proceeds in high-risk assets. If these investments pay-off, the bank earns profits and the stockholders' equity stake in the bank is improved. If the investments fail or go bad, the stockholders' lose what little capital investment they have invested and the insurance fund bears almost all the costs of failure. That is, the current and existing (at the time of the thrift deregulation) insurance contract has an inherent "moral hazard" problem that results from the non-pricing or mis-pricing of risk.

With respect to the thrift industry during the post-1982 period, the pricing of risk was conspicuously absent. First, regulators did not charge the more risky thrifts higher insurance premiums as a disincentive to risk-taking. Second, regulators allowed many thrifts to keep operating and growing in terms of deposits and assets (so-called "regulator forbearance") even when their net worth was negative, thereby accentuating the moral hazard problem. Third, as White [1990] points out, thrift regulators failed very badly in their monitoring and surveillance activities.

This latter failure is especially important, since strict monitoring and supervision of banks/thrifts was absolutely necessary if thrifts were to be given wider powers to take risk. That is, supervision can be viewed as a way of implicitly pricing bank risk-taking -- see Buser, Chen and Kane [1981]. For example, between 1981 and 1984 the examination and

supervision staff of the FHLBB actually declined from 1,385 in 1981 to 1,337 in 1984, and the number of examinations per billion dollars of thrift assets declined from 4.96 to 2.40 per year [White, 1990]. Moreover, the deficiencies in thrift supervision (even as thrift powers were being expanded) was still more extreme for state-chartered thrifts in Florida, Texas and California, where the most egregious examples of stockholder-manager moral hazard behavior have been evident.

Finally a number of recent studies analyzing actual thrift failures in the 1980's have found support for the moral hazard hypothesis over the deregulation hypothesis [Barth, Bartholomew and Labich, 1989; Barth, Bartholomew and Bradley, 1989; Cole, McKenzie and White, 1991]. For example, Cole et al. found that thrifts with low capital levels invested in more non-traditional assets than thrifts with high capital levels. Also consistent with moral hazard, they found that "limited liability" stockholder controlled thrifts invested in more risky assets than mutually controlled thrifts.

Given this evidence and the clear incentives for risk-taking that exist in a world of mispriced deposit insurance, low or non-existent capital requirements, and ineffective regulatory supervision and surveillance, the cause of the thrift crisis was not deregulation but rather the moral hazard incentives associated with the existing system of pricing and monitoring risk.

Indeed, it is arguable that even more thrifts would have taken high-risk gambles after 1982, a time when they were faced with contracting profits in traditional mortgage lending, if they had not been given additional powers to diversify-away at least some mortgage lending risk. This also suggests that any future bank deregulation requires: (i) Risk pricing

of deposit insurance premiums; (ii) Strong capital standards and enforcement; and (iii) Strong bank surveillance and supervision.

As part of the "solution" to the thrift crisis, bank insurance premiums have risen from 8.33 cents per \$100 of domestic deposits in 1989 to 12 cents in 1990, 19.5 cents in 1991 and a proposed 23 cents in June 1991, representing a virtual quadrupling of the insurance "tax" on healthy banks over a three-year period.

Summary and Conclusions

This paper has emphasized the critical importance of the financial services industry for the future economic health of the City of New York. Whether defined in terms of income and employment generated at a given point in time, or in terms of its past and potential future contributions to the City's growth and development, the financial services industry is arguably more important today than it has been at any time in the City's history -- if only because New York City today has a narrower economic base than it had in decades past.

We have also emphasized that the financial services industry continues to be profoundly influenced by structural change, going beyond the kinds of transitory problems emanating from macro-financial currents to basic structural change within the microstructure of the industry itself. Driven by technological and regulatory change, competitive shifts are reshaping the industry into new patterns, many of which are difficult to foresee. Within this structural change, many of the assumptions about ways of doing business and locations where business is done are coming under challenge. Competition continues to heat-up, both among financial firms as well as among financial centers.

Unlike the decision-making process with regard to the regulation and taxation of financial services firms in other countries -- which usually relies heavily on assessment of the public interest in the context of professional and technical analyses -- the U.S. approach has traditionally been much more heavily political, emotional and special-interest oriented. In this context, the national interest often gets submerged. But in view of the nature of the U.S. political decision process, this is a constraint that has to be lived with. It is therefore incumbent on New York City to see to its own fundamental interests in this context.

The key question is whether activity-limitations and geographic constraints imposed on financial services firms or micro-behavioral requirements imposed on securities markets in today's environment represent a necessary regulatory component in order to achieve a politically acceptable degree of financial stability and fiduciary performance. Dramatic changes in the conduits of financial intermediation, information technologies, and the global competitive environment may well have altered the balance to the point where such limitations have become increasingly dysfunctional from the standpoint of the national interest.

In particular, the changing structure and extent of competition in the financial services industry has focused the spotlight on whether the costs associated with traditional U.S. regulatory structures may have risen in relation to their presumed benefits in a world in which there is keen rivalry among regulators themselves as well as among financial firms. If so, then a reexamination of these barriers may well be in order.

Activity limits represent an especially onerous millstone imposed by federal regulations,

one that inhibits the range of activities and operating efficiency of New York City financial firms. To the extent that New York is in an internationally competitive race to attract and retain existing and new financial services firms (in a world where the costs of re-locating are continually decreasing) it needs to support federal legislation that would lead to the repeal of the McFadden Act, the Bank Holding Company Act and the Glass-Steagall Act as a matter of urgency. At the same time it must press for enabling New York City-based banks to engage in insurance activities and to press the SEC to take a more global or international view of securities market regulations.

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90/38 MKT	Wilfried VANHONACKER	"Managerial Decision Behaviour and the Estimation of Dynamic Sales Response Models", (Revised February 1990).	90/49 TM	Soumitra DUTTA	"Approximate Reasoning by Analogy to Answer Null Queries", June 1990.
90/39 TM	Louis LE BLANC and Tawfik JELASSI	"An Evaluation and Selection Methodology for Expert System Shells", May 1990.	90/50 EP	Daniel COHEN and Charles WYPLOSZ	"Price and Trade Effects of Exchange Rates Fluctuations and the Design of Policy Coordination", April 1990.

90/51 EP	Michael BURDA and Charles WYPLOSZ	"Gross Labour Market Flows in Europe: Some Stylized Facts", June 1990.	90/63 SM	Sumantra GHOSHAL and Eleanor WESTNEY	"Organising Competitor Analysis Systems", August 1990
90/52 FIN	Lars Tyge NIELSEN	"The Utility of Infinite Menus", June 1990.	90/64 SM	Sumantra GHOSHAL	"Internal Differentiation and Corporate Performance: Case of the Multinational Corporation", August 1990
90/53 EP	Michael Burda	"The Consequences of German Economic and Monetary Union", June 1990.	90/65 EP	Charles WYPLOSZ	"A Note on the Real Exchange Rate Effect of German Unification", August 1990
90/54 EP	Damien NEVEN and Colin MEYER	"European Financial Regulation: A Framework for Policy Analysis", (Revised May 1990).	90/66 TM/SE/FIN	Soumitra DUTTA and Piero BONISSONE	"Computer Support for Strategic and Tactical Planning in Mergers and Acquisitions", September 1990
90/55 EP	Michael BURDA and Stefan GERLACH	"Intertemporal Prices and the US Trade Balance", (Revised July 1990).	90/67 TM/SE/FIN	Soumitra DUTTA and Piero BONISSONE	"Integrating Prior Cases and Expert Knowledge In a Mergers and Acquisitions Reasoning System", September 1990
90/56 EP	Damien NEVEN and Lars-Hendrik RÖLLER	"The Structure and Determinants of East-West Trade: A Preliminary Analysis of the Manufacturing Sector", July 1990	90/68 TM/SE	Soumitra DUTTA	"A Framework and Methodology for Enhancing the Business Impact of Artificial Intelligence Applications", September 1990
90/57 FIN/EP/ TM	Lars Tyge NIELSEN	Common Knowledge of a Multivariate Aggregate Statistic", July 1990	90/69 TM	Soumitra DUTTA	"A Model for Temporal Reasoning in Medical Expert Systems", September 1990
90/58 FIN/EP/TM	Lars Tyge NIELSEN	"Common Knowledge of Price and Expected Cost in an Oligopolistic Market", August 1990	90/70 TM	Albert ANGEHRN	"'Triple C': A Visual Interactive MCDSS", September 1990
90/59 FIN	Jean DERMINE and Lars-Hendrik RÖLLER	"Economies of Scale and Scope in the French Mutual Funds (SICAV) Industry", August 1990	90/71 MKT	Philip PARKER and Hubert GATIGNON	"Competitive Effects in Diffusion Models: An Empirical Analysis", September 1990
90/60 TM	Peri IZ and Tawfik JELASSI	"An Interactive Group Decision Aid for Multiobjective Problems: An Empirical Assessment", September 1990	90/72 TM	Enver YÜCESAN	"Analysis of Markov Chains Using Simulation Graph Models", October 1990
90/61 TM	Pankaj CHANDRA and Mihkel TOMBAK	"Models for the Evaluation of Manufacturing Flexibility", August 1990	90/73 TM	Arnoud DE MEYER and Kasra FERDOWS	"Removing the Barriers in Manufacturing", October 1990
90/62 EP	Damien NEVEN and Menno VAN DUK	"Public Policy Towards TV Broadcasting in the Netherlands", August 1990	90/74 SM	Sumantra GHOSHAL and Nitin NOHRIA	"Requisite Complexity: Organising Headquarters- Subsidiary Relations in MNCs", October 1990

90/75 MKT	Roger BETANCOURT and David GAUTSCHI	"The Outputs of Retail Activities: Concepts, Measurement and Evidence" October 1990	90/87 FIN/EP	Lars Tyge NIELSEN	"Existence of Equilibrium in CAPM: Further Results", December 1990
90/76 MKT	Wilfried VANHONACKER	"Managerial Decision Behaviour and the Estimation of Dynamic Sales Response Models", Revised October 1990	90/88 OB/MKT	Susan C. SCHNEIDER and Reinhard ANGELMA	"Cognition in Organisational Analysis: Who's Minding the Store?" Revised, December 1990
90/77 MKT	Wilfried VANHONACKER	"Testing the Koyck Scheme of Sales Response to Advertising: An Aggregation-Independent Autocorrelation Test", October 1990	90/89 OB	Manfred F.R. KETS DE VRIES	"The CEO Who Couldn't Talk Straight and Other Tales from the Board Room," December 1990
90/78 EP	Michael BURDA and Stefan GERLACH	"Exchange Rate Dynamics and Currency Unification: The Ostmark - DM Rate", October 1990	90/90 MKT	Philip PARKER	"Price Elasticity Dynamics over the Adoption Lifecycle: An Empirical Study," December 1990
90/79 TM	Anil GABA	"Inferences with an Unknown Noise Level in a Bernoulli Process", October 1990			
90/80 TM	Anil GABA and Robert WINKLER	"Using Survey Data in Inferences about Purchase Behaviour", October 1990	1991		
90/81 TM	Tawfik JELASSI	"Du Présent au Futur: Bilan et Orientations des Systèmes Interactifs d'Aide à la Décision," October 1990	91/01 TM/SM	Luk VAN WASSENHOVE, Leonard FORTUIN and Paul VAN BEEK	"Operational Research Can Do More for Managers Than They Think!," January 1991
90/82 EP	Charles WYPLOSZ	"Monetary Union and Fiscal Policy Discipline," November 1990	91/02 TM/SM	Luk VAN WASSENHOVE, Leonard FORTUIN and Paul VAN BEEK	"Operational Research and Environment," January 1991
90/83 FIN/TM	Nathalie DIERKENS and Bernard SINCLAIR-DESGAGNE	"Information Asymmetry and Corporate Communication: Results of a Pilot Study", November 1990	91/03 FIN	Pekka HIETALA and Timo LÖYTTYNIEMI	"An Implicit Dividend Increase in Rights Issues: Theory and Evidence," January 1991
90/84 MKT	Philip M. PARKER	"The Effect of Advertising on Price and Quality: The Optometric Industry Revisited," December 1990	91/04 FIN	Lars Tyge NIELSEN	"Two-Fund Separation, Factor Structure and Robustness," January 1991
90/85 MKT	Avijit GHOSH and Vikas TIBREWALA	"Optimal Timing and Location in Competitive Markets," November 1990	91/05 OB	Susan SCHNEIDER	"Managing Boundaries in Organisations," January 1991
90/86 EP/TM	Olivier CADOT and Bernard SINCLAIR-DESGAGNE	"Prudence and Success in Politics," November 1990	91/06 OB	Manfred KETS DE VRIES, Danny MILLER and Alain NOEL	"Understanding the Leader-Strategy Interface: Application of the Strategic Relationship Interview Method," January 1990 (89/11, revised April 1990)

91/07 EP	Olivier CADOT	"Lending to Insolvent Countries: A Paradoxical Story," January 1991	91/19 MKT	Vikas TIBREWALA and Bruce BUCHANAN	"An Aggregate Test of Purchase Regularity", March 1991
91/08 EP	Charles WYPLOSZ	"Post-Reform East and West: Capital Accumulation and the Labour Mobility Constraint," January 1991	91/20 MKT	Darius SABAVALA and Vikas TIBREWALA	"Monitoring Short-Run Changes in Purchasing Behaviour", March 1991
91/09 TM	Spyros MAKRIDAKIS	"What can we Learn from Failure?", February 1991	91/21 SM	Sumantra GHOSHAL, Harry KORINE and Gabriel SZULANSKI	"Interunit Communication within MNCs: The Influence of Formal Structure Versus Integrative Processes", April 1991
91/10 TM	Luc Van WASSENHOVE and C. N. POTTS	"Integrating Scheduling with Batching and Lot-Sizing: A Review of Algorithms and Complexity", February 1991	91/22 EP	David GOOD, Lars-Hendrik RÖLLER and Robin SICKLES	"EC Integration and the Structure of the Franco-American Airline Industries: Implications for Efficiency and Welfare", April 1991
91/11 TM	Luc VAN WASSENHOVE et al.	"Multi-Item Lotsizing in Capacitated Multi-Stage Serial Systems", February 1991	91/23 TM	Spyros MAKRIDAKIS and Michèle HIBON	"Exponential Smoothing: The Effect of Initial Values and Loss Functions on Post-Sample Forecasting Accuracy", April 1991 (Revision of 90/46)
91/12 TM	Albert ANGEHRN	"Interpretative Computer Intelligence: A Link between Users, Models and Methods in DSS", February 1991	91/24 TM	Louis LE BLANC and Tawfik JELASSI	"An Empirical Assessment of Choice Models for Software Evaluation and Selection", May 1991
91/13 EP	Michael BURDA	"Labor and Product Markets in Czechoslovakia and the Ex-GDR: A Twin Study", February 1991	91/25 SM/TM	Luk N. VAN WASSENHOVE and Charles J. CORBETT	"Trade-Offs? What Trade-Offs?" April 1991
91/14 MKT	Roger BETANCOURT and David GAUTSCHI	"The Output of Retail Activities: French Evidence", February 1991	91/26 TM	Luk N. VAN WASSENHOVE and C.N. POTTS	"Single Machine Scheduling to Minimize Total Late Work", April 1991
91/15 OB	Manfred F.R. KETS DE VRIES	"Exploding the Myth about Rational Organisations and Executives", March 1991	91/27 FIN	Nathalie DIERKENS	"A Discussion of Correct Measures of Information Asymmetry: The Example of Myers and Majluf's Model or the Importance of the Asset Structure of the Firm", May 1991
91/16 TM	Arnoud DE MEYER and Kasra FERDOWS et.al.	"Factories of the Future: Executive Summary of the 1990 International Manufacturing Futures Survey", March 1991	91/28 MKT	Philip M. PARKER	"A Note on: 'Advertising and the Price and Quality of Optometric Services', June 1991
91/17 TM	Dirk CATTRYSE, Roelof KUIK, Marc SALOMON and Luk VAN WASSENHOVE	"Heuristics for the Discrete Lotsizing and Scheduling Problem with Setup Times", March 1991	91/29 TM	Tawfik JELASSI and Abbas FOROUGH	"An Empirical Study of an Interactive, Session-Oriented Computerised Negotiation Support System (NSS)", June 1991
91/18 TM	C.N. POTTS and Luk VAN WASSENHOVE	"Approximation Algorithms for Scheduling a Single Machine to Minimize Total Late Work", March 1991			

91/30 MKT	Wilfried R. VANHONACKER and Lydia J. PRICE	"Using Meta-Analysis Results in Bayesian Updating: The Empty Cell Problem", June 1991
91/31 FIN	Rezaul KABIR and Theo VERMAELEN	"Insider Trading Restrictions and the Stock Market", June 1991
91/32 OB	Susan C. SCHNEIDER	"Organisational Sensemaking: 1992", June 1991
91/33 EP	Michael C. BURDA and Michael FUNKE	"German Trade Unions after Unification - Third Degree Wage Discriminating Monopolists?", June 1991
91/34 FIN	Jean DERMINE	"The BIS Proposal for the Measurement of Interest Rate Risk, Some Pitfalls", June 1991
91/35 FIN	Jean DERMINE	"The Regulation of Financial Services in the EC, Centralization or National Autonomy?" June 1991
91/36 TM	Albert ANGEHRN	"Supporting Multicriteria Decision Making: New Perspectives and New Systems", August 1991
91/37 EP	Ingo WALTER and Hugh THOMAS	"The Introduction of Universal Banking in Canada: An Event Study", August 1991