Summary of Session 3 Panel Discussion

The presenters were Tony Candito, President and Chief Information Officer of NEF Information Services, a subsidiary of MetLife; Michael J. Castellano, Chairman of Merrill Lynch International Bank and Senior Vice President and Chief Control Officer of Merrill Lynch & Co., Inc.; and Richard Heckinger, Senior Vice President at State Street Bank. The session was moderated by Darryll Hendricks, Senior Vice President at the Federal Reserve Bank of New York.

This session gathered representatives from the three major financial services industries—banking, insurance, and securities—to provide their views on the strategic question of specialization versus diversification in a world of technological and regulatory change.

Despite the speakers' different positions in the financial services industries, several common themes emerged from the presentations and discussion. Most important, Heckinger, Candito, and Castellano all emphasized that the strategic choice of whether to specialize or diversify ultimately depends on the demands and the needs of the customer. After establishing what their core products are and identifying the corresponding customer bases, all three panelists discussed the importance of diversifying into supporting products that would add value to their clients, as well as cement and deepen these primary customer relationships.

A second common theme was the emphasis on information technology as a driving force behind strategic choices and entry into new businesses. An effective information technology infrastructure allows firms to provide new products, reduce costs, and better serve existing customers. Each of the panelists discussed the ways in which information technology is transforming their existing businesses and opening up new ones, as well as the information technology challenges they face.

The panel concluded that both specialization and diversification strategies are critical to continued success. Specialization allows a firm to focus on its core strengths, products, and markets, while diversification into complementary products opens up new markets and new opportunities. Both strategies are necessary for a financial services firm to compete successfully in today's environment of rapid technological and regulatory change.

Richard Heckinger

Richard Heckinger began with a brief overview of State Street Bank, describing its committed focus on servicing institutional investors. Its services are strictly business-to-business activities, including trade execution, analysis, custody and investment management, and foreign exchange services for large institutional clients, as well as new e-finance products. He emphasized that although chartered as a commercial bank,

Kevin J. Stiroh, an economist at the Federal Reserve Bank of New York, prepared this summary.

State Street does not maintain a traditional banking presence and does not take deposits or make loans; it sold the last vestiges of its commercial banking operations in 1999.

Heckinger described State Street's approach to specialization as trying to master specific competencies, particularly in the information management businesses. State Street remains specialized in its key investment management and custody businesses, but it also wants to be sensitive to changes in the operating environment. For example, while State Street is now known mostly for its post-trade processing services such as custody, recordkeeping, accounting, and settlement, it is also moving aggressively into various pretrade and trade execution areas, particularly where e-commerce is important. This strategy reflects several important business advantages. These include economies of scale in custody businesses; access to unique data (for example, State Street maintains a proprietary database with nearly 2 million identified securities); and customer lock-in through strong relationships, which builds inertia and helps maintain key relationships. All of these advantages serve as barriers to entry for other firms and make direct competition in State Street's core businesses difficult.

According to Heckinger, the question of specialization versus diversification strategies also falls into a long list of operational challenges that are directly changing the way State Street operates. For example, the introduction of the euro, Y2K, decimalization, "T+1" settlement, and the extension of trading hours are all current or recent events that have affected the way in which State Street conducts its business, and they have opened up several new businesses for the organization.

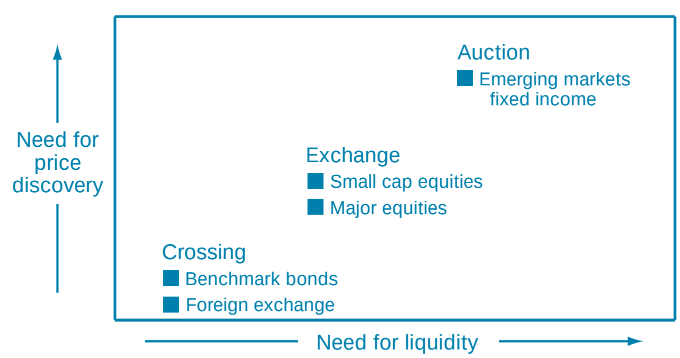
State Street's move toward diversification of its activities and services has been driven, in large part, by the needs of its primary customers. Investment manager clients, for example, want to avoid the costs of maintaining and retooling their internal systems to be better able to specialize in their own core competencies like making investment decisions and selling mutual funds. These needs create new opportunities for State Street, as its clients outsource ancillary tasks like recordkeeping and other mechanical aspects of their businesses. By providing "soup to nuts" services, State Street is developing new businesses for itself as it enables its clients to specialize more effectively.

This broadening of the scope of State Street's services is facilitated by the company's strong investment in information technology. State Street commits nearly 20 percent of its operating expenses to information technology, observed Heckinger, a proportion that has been relatively constant over time. This is part of a long-term commitment to information technology investment that is also driven by client needs. Some customers, for instance, have hard-wired access to their account information, while others use the U.S. Postal Service or a fax machine among all types of data interfaces. In this sense, the Internet is just another information network that allows State Street to communicate more effectively with its clients.

Because specialization and diversification strategies ultimately are determined by the needs of State Street's clients and since these clients perform a broad range of tasks and operate in various markets, State Street provides a correspondingly broad range of services. As a specific example, Heckinger discussed the various needs associated with the different types of e-commerce market structures in which States Street's clients participate (Exhibit 1). Auction-style markets—for example, the trading of emerging market debt—are characterized by low liquidity and low pricing information; they are quite different from crossing markets—for example, foreign exchange or benchmark bonds—which are highly liquid and typically contain a great deal of pricing information. In the middle are exchange markets like a major stock exchange. State Street's clients operate in all types of markets, so the firm must be able to provide a broad array of services required by each client in each situation. State Street has become a "multiple provider of multiple products," according to Heckinger.

A second example of diversification offered by Heckinger is State Street's ability to leverage its proprietary data to create new economic products and services. Because the organization currently performs various recordkeeping duties for a large number of equities and fixed-income transactions on behalf of numerous clients, it has a unique advantage in terms of data. That is, State Street's long-standing experience and large-scale custody operations provide direct access to clean, well-defined

Exhibit 1
e-Commerce Market Structures



Source: Richard Heckinger, State Street Bank.

data on a daily basis that are ideally suited for data aggregation and data-mining exercises. Recently, explained Heckinger, State Street developed “portfolio holdings indicators” and “portfolio flow indicators” for forty-six countries, which track cross-border equity purchases from these proprietary data. The data are collected daily, and provide timely indicators of financial investment flows. Again, this activity provides State Street with an opportunity to leverage its core strengths in custody into new business areas to serve its clients better and to generate new business.

In conclusion, Heckinger reiterated State Street’s reliance on information technology as the critical element in providing its primary services to institutional clients. These clients, exclusively in the business-to-business areas, require a wide range of services that new technology enables State Street to offer.

Tony Candito

Tony Candito began with a brief overview of NEF Information Services and its parent company, MetLife. MetLife is the largest U.S. life insurance company and it operates the largest individual life and annuity franchise in the United States. The company is broadly diversified within the insurance industry, with major operations in MetLife Financial Services, New England Financial, and GenAmerica; it also offers other nonproprietary products that target a broad range of customer bases. In addition, MetLife runs a strong institutional insurance business, which is an industry leader and one of the organization’s primary growth engines.

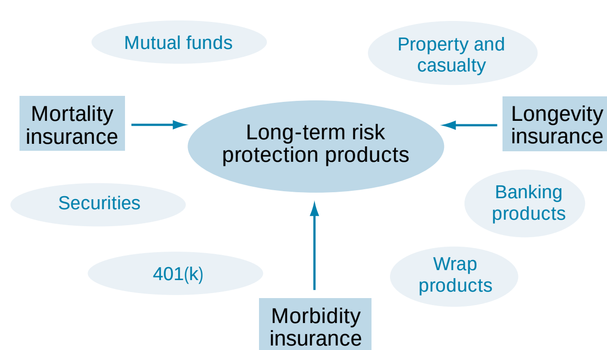
Candito’s remarks focused on the technological and strategic challenges facing the individual insurance markets. He discussed several factors that were critical to the broad provision of insurance products to individuals. First, MetLife’s large and flexible distribution network allows a variety of products to be sold across several types of customer groups. This network includes more than 11,000 insurance agents in its primary markets, which span a wide range of customers and essentially make up the individual insurance business. Second, the company maintains a sophisticated information technology infrastructure to support these agents via a long-term commitment to technology. Currently, MetLife makes a $300 million annual investment in technology for its individual businesses and has more than 1,100 full-time-equivalent employees on its technical staff. The network allows agents to market their products effectively.

Regarding the issue of specialization versus diversification, Candito indicated that MetLife pursues both strategies. He identified long-term risk protection products as the core of MetLife’s individual insurance business. These products relate to three primary business lines—longevity insurance (protection against outliving assets), morbidity insurance (protection against loss of income due to injury or health problems), and mortality insurance (protection against early death). MetLife specializes by developing various products, such as life insurance and annuities, to meet its customers’ needs in these key business areas.

At first glance, this description suggests a relatively specialized portfolio of insurance products. However, Candito emphasized that MetLife is actively diversifying into new products by filling in functional gaps between these three primary business lines (Exhibit 2). For example, the offering of mutual funds can be seen as an ancillary product that fits in between the primary mortality and longevity insurance products. Similarly, securities sales and 401(k) activities bridge the gap between mortality and morbidity insurance. MetLife is developing new products, and even offering nonproprietary products, to serve its clients better, add value, and deepen its customer relationships. Thus, there is a definite move to diversify in response to client needs. Moreover, Candito pointed to MetLife’s position as a trusted and objective advisor as a key factor that allows this type of cross-selling to be successful.

The move toward diversification brings with it a number of fundamental information technology questions, Candito explained. For example, by offering many complementary products on a large scale, MetLife has the potential for economies of scale and scope with very low unit costs. This operational goal, however, must be weighed against the need to maintain the flexibility and brand distinctiveness across products that are essential to penetrating a target market

Exhibit 2
Primary and Ancillary Products



Source: Tony Candito, NEF Information Services.

effectively. The benefits of providing a wide range of products also raise important strategic questions about how to operate successfully in many highly competitive markets. He noted that there are many alternatives—such as large internal investments, partnerships and alliances, and integration with competitors—all with various risks and costs that must be considered. Finally, this type of leading-edge information technology presence relies on highly skilled technical labor to be successful. However, this requires direct competition with technology start-ups and poses a serious obstacle for many established financial services firms.

With these challenges in mind, Candito outlined a broad business model designed to allow MetLife to offer a wide range of products as a well-diversified financial services firm. The backbone of this model is a common platform that integrates the primary financial and support functions across several business lines. That is, MetLife plans to use a common structure and system for its technology, financial, human resources, legal, and investment operations for all of its many product lines. Candito explained that this strategy should lower costs for the company through economies of scale and scope as a whole—for example, through a reduction in back-office expenses, as well as through an increase in customer information that can be used to improve cross-selling opportunities.

In conclusion, Candito reiterated that MetLife has specialized in risk protection products as its core business. However, the company is also actively diversifying into ancillary products to serve its primary customers better.

Michael Castellano

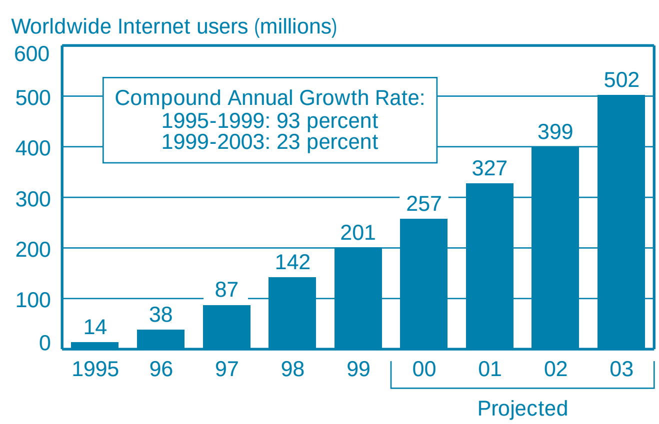
Michael Castellano began with an overview of the significant trends driving the fundamental changes in the structure and scale of all financial services industries. These trends include broad regulatory reform of financial services, globalization of markets, and widespread technological advances. As a direct consequence, the pace of change is accelerating, clients are becoming better equipped with more information and power, competition is increasing, margins are shrinking, and cross-industry entry and consolidation are accelerating. According to Castellano, these powerful forces are affecting all financial services providers at a basic level, and they require a new business model.

Castellano described a number of these changes. In terms of globalization, there has been a rapid rise in cross-country mergers, as international markets have become increasingly linked—for example, the deal value of cross-border mergers and acquisitions increased from $129 billion in 1993 to $1,275 billion in 1999. This rise has directly affected Merrill Lynch's business, he observed, because as clients become more global, the firm must also become more global to serve them better.

Although these globalization trends are impressive, the most significant change is likely to occur from the continued evolution of technology, according to Castellano. For example, the number of worldwide Internet users increased from 14 million in 1995 to 201 million in 1999, and that figure is projected to rise to 502 million by 2003 (see chart). Affluent households use the Internet even more than the average household, and the value of assets in on-line accounts is projected to grow by 70 percent per year over the next three years. Finally, noted Castellano, in the next phase of the Internet revolution, growth and diffusion of e-commerce, broadbanding, and other wireless technologies are expected to be even more dramatic. These changes will profoundly affect the retail and wholesale financial businesses, as clients demand better services, electronic communications networks provide increased information, trading volumes rise steadily, and spreads continue to shrink.

The Internet revolution will have several direct implications for the future of retail financial firms, according to Castellano. For example, the availability of low-priced financial services will not be enough to sustain a competitive advantage; content will become increasingly important. In a time of potential information overload, customers will place a premium on advice. Transparency and the ability to provide a wide range of products will also become more important to customers. Moreover, Castellano expects that financial services firms that

The Internet Is Revolutionizing Business



Source: Michael J. Castellano, Merrill Lynch & Co., Inc.

can maintain a strong brand identity will enjoy a strong edge, as customers look for names with which they are comfortable and in which they have confidence. Finally, improved customer service will be essential in the more competitive world, as agents will need to be empowered to make decisions and better serve clients.

In terms of specialization versus diversification strategies, Castellano emphasized that the bundling of commodity products, such as cash management and e-commerce services, will enhance client relationships and increase the retention of existing customers. One potential outcome of this trend is the formation of new alliances, as traditional competitors like Merrill Lynch, Morgan Stanley, and Goldman Sachs begin to co-invest in alternative ventures to maintain competitiveness. He pointed to the recent joint venture between Merrill Lynch and HSBC as an example.

This trend suggests a growing role for a diversified financial firm that can provide many products to maintain its core customers. Indeed, Castellano noted that Merrill Lynch is undergoing a strategic transformation as it moves to a three-pillared, multifaceted global firm that serves private clients, institutional clients, and asset management clients. This change can be seen through the large revenue gains Merrill Lynch has made from its international businesses and from its growing role in international mergers and acquisitions.

Specifically, Castellano discussed Merrill Lynch's recent move into Internet brokerage activities, in which it introduced several different products tailored to different clients. After matching competitors in terms of price and technology, he said, Merrill Lynch tries to compete in terms of content, such as underlying research and service, where it feels it has a competitive advantage. Similarly, the firm's banking strategy is to expand activities in order to increase the convenience and value to existing customers. Castellano noted that the recent passage of the Financial Services Modernization Act opens a new door to holding deposits, increasing lending, and taking advantage of lower cost funding, all of which provide new opportunities for Merrill Lynch and its clients.

Merrill Lynch's long-term strategy was summed up by Castellano as a desire to be "all things to some people." By developing broader, deeper relationships with its core clients in the most attractive market segments, he said, Merrill Lynch is making this diversification strategy an integral part of its view of a successful future.

Questions and Answers

The comments from the audience centered on information technology. In response to a question about the role that technology plays in the distribution process—particularly with regard to increased synergies with affluent customers—Castellano replied that Merrill Lynch now maintains an important presence. Nonetheless, he said that the firm's primary value-added still results from a strong financial relationship with its clients. Information is currently available from many sources, ranging from CNBC to general worldwide web portals, so customers—particularly affluent ones—rely on Merrill Lynch to supply useful information and advice. As the Internet provides commoditized information, Merrill Lynch hopes to focus on the high-end value services that high-net-worth customers desire from a full-service firm.

Candito emphasized that the Internet was primarily a means of "e-service," and not an "e-sale" tool in MetLife's individual insurance markets. He said that the Internet is not particularly conducive to the sale of insurance products; rather, the primary advantage it offers is in the form of distribution and the ability to view account information.