



Is Consolidated Financial Regulation Appropriate for the United States?

Product Convergence: Permanent Trend or Momentary Illusion?

February 21, 2003



AGENDA

- Overview
- Convergence: Traditional products
- Convergence: Hybrid products
- Convergence: Unregulated products
- Distribution channel convergence
- Conclusion



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Overview

- Convergence defined:
 - When two financial products are viewed as virtual equivalents by consumers
 - Virtual equivalence is further defined as highly similar economic outcomes or risk characteristics
 - Converged products do not need to be available to all consumers equally



Overview (continued)

- Three strong factors affect convergence:
 - consumer preferences
 - the nature of information products
 - technology
- One weak factor affects convergence:
 - regulation



Overview (continued)

- We found three kinds of convergence:
 - Traditional products, cross industry
 - Hybrid products
 - Unregulated products
- Distribution channel convergence, while not a form of product convergence, has a strong bearing on product convergence



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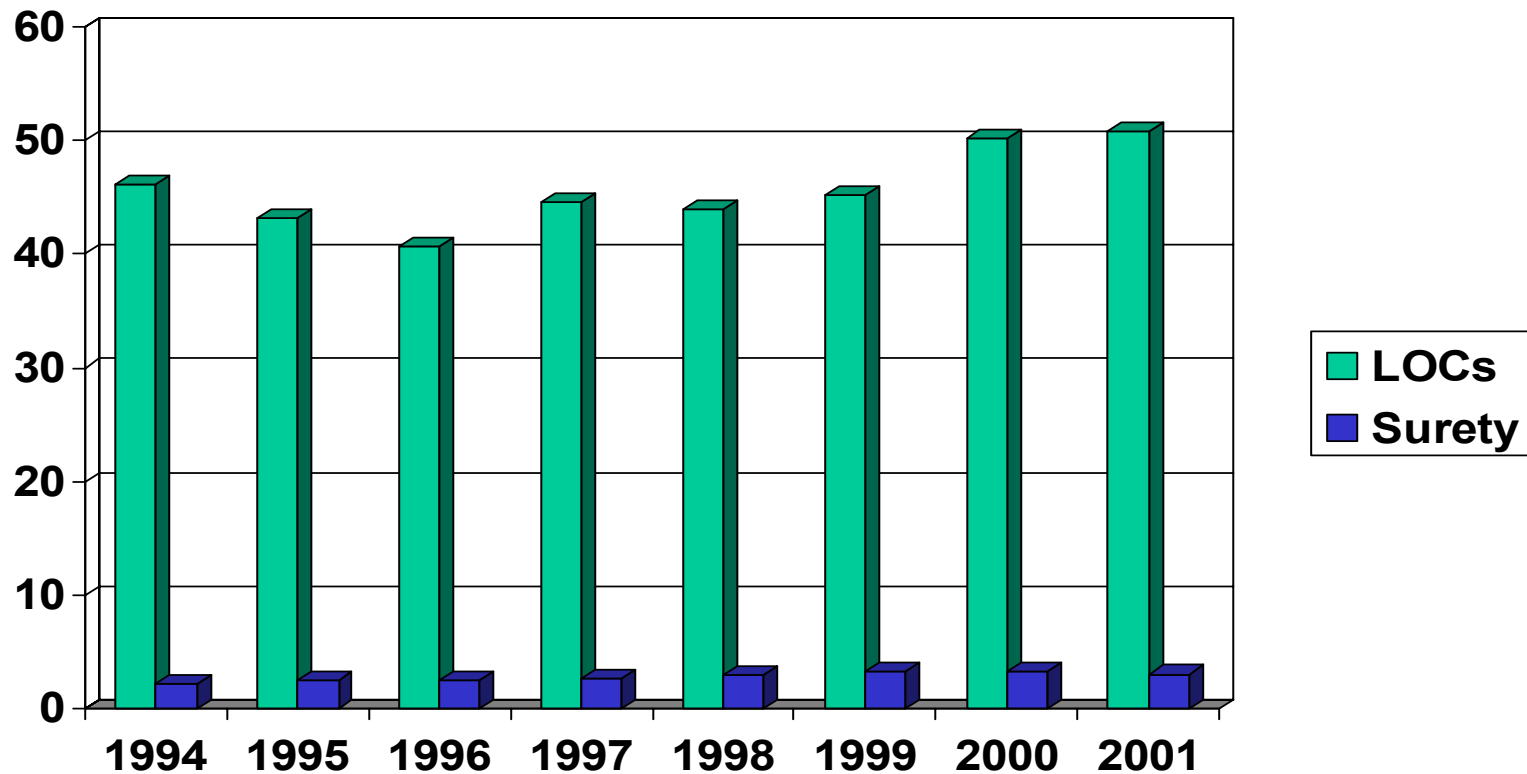
Convergence: Traditional Products

- Banking vs. Insurance
 - Time deposits vs. fixed annuities
 - Standby LOCs vs. surety bonds
- Securities vs. Banking
 - MM funds vs. demand deposits
 - MTNs & CP vs. commercial loans
- Insurance vs. Securities
 - Variable annuities vs. equity mutual funds
 - Reinsurance vs. catastrophe bonds



Standby LOCs Converged with Surety Bonds

Growth in both markets has been modest

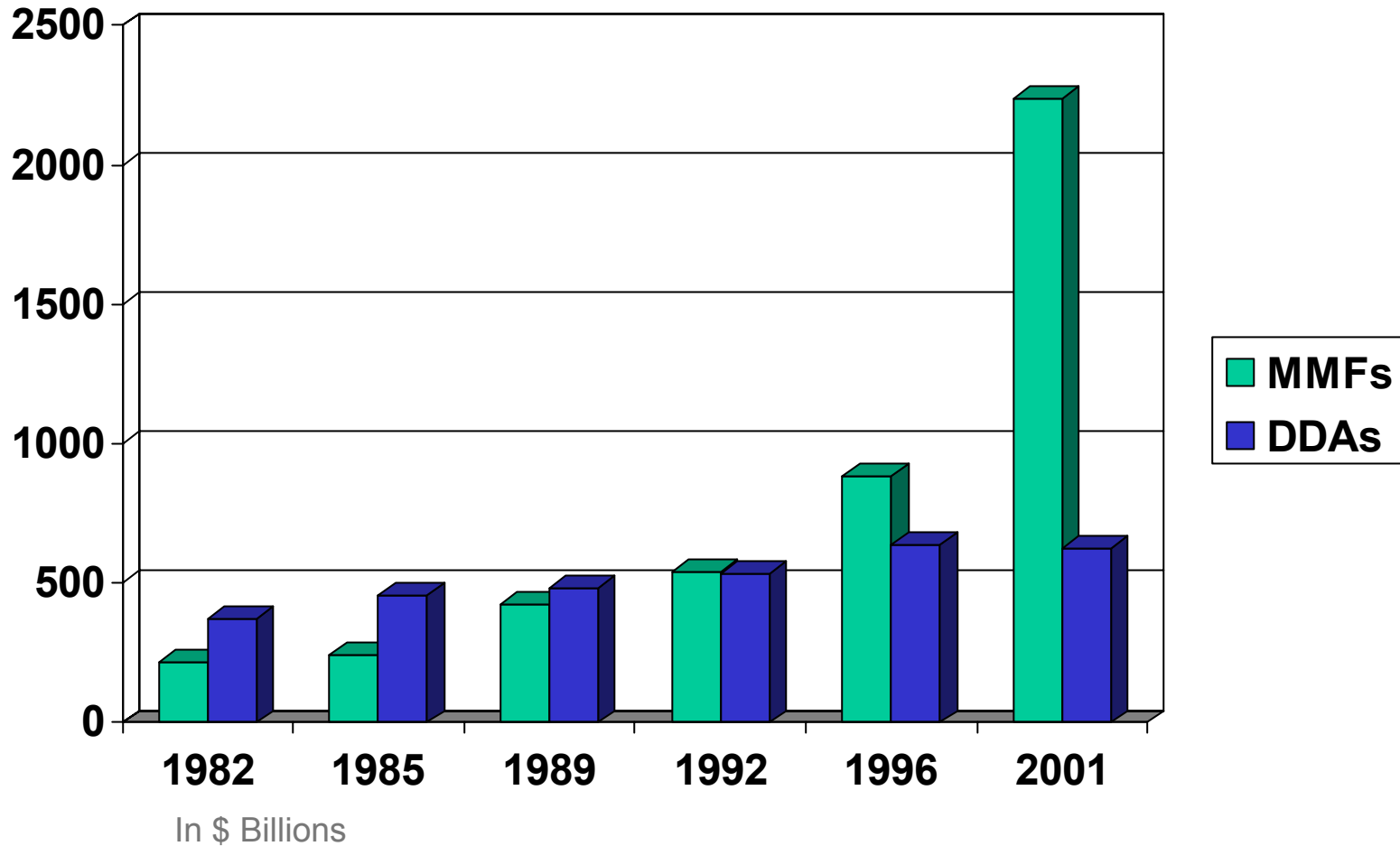


In \$ Billions



MMFs Have Converged with DDAs

MMFs have far outstripped DDAs



Reinsurance Has Converged with Cat Bonds

Cat bond issuance levels to date have been small

Catastrophe Bond Issuance		
Period	Amount in \$ Millions	Number of Transactions
1996/Prior	288	6
1997	657	6
1998	1,211	14
1999	1,059	12
2000	1,136	9
2001	778	6



Convergence Addresses Economic Needs

Insured Losses In \$ Billions (at 2001 prices)		
Year	Natural Disasters	Man-made Catastrophes
1985	4.94	2.85
1986	2.00	2.88
1987	8.96	3.85
1988	3.45	6.46
1989	12.60	7.09
1990	19.16	4.37
1991	16.30	4.38
1992	30.90	5.34
1993	8.48	5.38
1994	21.57	4.95
1995	16.82	2.56
1996	9.27	4.92
1997	4.62	3.15
1998	16.47	3.79
1999	28.77	4.60
2000	8.36	3.14
2001	10.00	49.00



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Convergence: Hybrid Products

- Principal protected notes
- Security futures
- Mortgages with “debt cancellation”



Principal protected notes

- Typically structured as a bank time deposit
- Return is tied to performance of a securities index (e.g., S&P 500)
- If held to maturity, at least principal investment will be returned
- Can be distributed through any channel: banks, securities firms, insurance agents



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Convergence: Unregulated Products

- Over-the-counter derivatives
- Hedge funds
- Stored value cards



Over The Counter Derivatives

Why do derivatives matter?

- **Banks, insurance companies and securities firms all issue standardized OTC derivative products**
- **Derivatives compete with a wide array of regulated banking, insurance and securities products**
- **Derivatives are embedded in hybrid products**
- **The “on-balance sheet/off-balance sheet” dividing line for regulation is out of touch with current market realities**



Stored Value Cards

- Any type of company can issue stored value cards
- Originally intended as replacements for paper gift certificates, they have taken on many uses
- Technology enables credit, debit and stored value accounts on a single chip
- Estimates of outstanding amounts range to \$10 billion



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Channel Convergence Affects Product Convergence

Partial listing of financial institutions and products available as of 8/02

Sector	Auto/ Home Ins	Life/ Hlth Ins	Comm Ins	Annuities	Ret Fds *	Pers Bkg	Sec/Inv Bkg	Comm Bkg	Mtges/ Credit Cards
Diversified									
General Electric	X	X	X	X	X		X		X
Citigroup	X	X	X	X	X	X	X	X	X
American Express	X	X	X	X	X	X	X	X	X
Securities									
Merrill Lynch		X		X	X	X	X	X	X
Lehman Brothers	X	X		X	X	X	X	X	X
E*Trade Group	X	X		X	X	X	X		X
Commercial Banks									
JP Morgan Chase	X	X	X	X	X	X	X	X	X
Wells Fargo	X	X	X	X	X	X	X	X	X



Channel convergence (continued)

Sector	Auto/ Home Ins	Life/ Hlth Ins	Comm Ins	Annuities	Ret Fds *	Pers Bkg	Sec/Inv Bkg	Comm Bkg	Mtges/ Credit Cards
Savings Banks									
Golden State Bancorp	X	X	X	X		X	X	X	X
Sovereign Bancorp	X	X	X	X	X	X	X	X	X
Property/ Casualty									
Am. Intl. Group	X	X	X	X	X	X	X		X
Nationwide	X	X	X	X	X		X		X
Life/Health									
Met Life	X	X	X	X	X	X	X		
Prudential	X	X	X	X	X	X	X		X
Mass. Mutual		X		X	X		X		X



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Conclusion

- Permanent trend or momentary illusion?
 - 22 of our 25 senior executives said long-term trend
 - All of the executives cited strong market forces as drivers of this trend
 - None of our executives saw any significant factor blocking convergence



Conclusion (Continued)

Financial product convergence...

- Consumer preferences and competitive pressures force it
- Technology enables it
- Distribution channels need it
- Industry executives assume it
- Regulators have no reason to inhibit it



Conclusion (Continued)

Regulatory and public policy implications...

- It does not make sense to regulate products with similar economic outcomes differently
- At best, we have regulatory confusion
- At worst, we have regulatory arbitrage
- It is time to consolidate our regulatory structure

