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Financial Modernization Act - Enterprise value and Reputation

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Abstract: ***The Financial Service Modernization Act of 1999 has been crucial to the financial service industry ever since its creation. There are two primary reasons this Act was mandated to aid the financial service industry- the merger/barrier reason and consumer privacy reason. This paper evaluates whether this policy has achieved this object and how the effect the policy has had on the financial service industry compares to the non-policy effect on wholesale trade industry, retail trade industry and service industry. This paper finds that this policy is one of the significant reasons, If not the primary reason, for the increase in the Enterprise Value (EV) of firms within the financial service industries over the industries. Furthermore, the findings suggest that customer complaints may have lessened within the financial service industries more than Wholesale and Retail trade industries but not the service industries.***

I. INTRODUCTION

On November 12, 1999, the Financial Services and Modernization Act of 1999 repealed the Glass-Steagall Act. The Glass-Steagall Act forbade banks from offering other financial services, such as investments and insurance. This Act which passed in 1933, catered for bank failures during Great depression. However, in the last 1990s, this Act lost its potency in the late 20th century. It means that the Act prohibited the commercial banks, investment banks, and insurance firms from merging. For customers to gain access to the services each institution offers, they would need to visit different institutions (Zamanian, B. 2007). Despite the later lost in potency, the Glass-Steagall Act had a positive impact on commercial banks. For instance, Cornett, Ors, and Tehranian (2002), as well as Cyree (2000), found the Act to improve the performance of commercial banks relative to risk significantly. It is no wonder why there have been calls to reinstate the Act following the financial crisis of 2008. Reinstating Glass-Steagall might go a long way in better protecting depositors during current times (Amadeo, K. 2020). However, calls for reinstatement lessened for the very reason why the Financial Services and Modernization Act of 1999 got enacted in the first place. Glass-Steagall would make banks incapable of competing on a global scale (Amadeo, K. 2020).

The Financial Services and Modernization Act of 1999, also known as the Gramm Lynch Bliley Act, totally "modernized" the financial service industries. It protected the privacy of consumers and mandated financial institutions to disclose their information-sharing exercises to customers. It allowed sensitive information of the consumers to be protected, especially when this Act also allows for merging activities to take place amongst the financial institutions. Mamun, Hassan, and Lai (2004) argued that systematic risk exposure has reduced within the financial industry since the Gramm Lynch Bliley Act got enacted. This Act broke down barriers that limited the potency of financial institutions. For instance, was not only the Glass-Steagall Act of 1933 barriers abolished but also the National Banking Act of 1864 and Bank Holding Company Act of 1956 (Carow and Heron 2001). More importantly, the broken barriers paved the opportunity for healthy competition to take place. This increased competition resulted in profitable financial conglomerates (Carow and Heron, 2001).

There are two significant effects the policy meant to have on the financial service industry, and they are the merger effect and consumer privacy effect. The merger effect refers to the removal of the barriers that would allow financial institutions to consolidate and offer other services they would not have othered under the previous Act (Glass-Steagall). This merging effect has raised the issue of consolidation versus specialization. Many believe that this policy has harmed value and stability (Lin and Li, 2017). They argued that the Act is mainly for the benefit of large firms and has allowed large firms to prioritize consolidation over-specialization, which is detrimental to the financial service industry. There are also other researchers such as Sanya and Wolfe (2011), who argued that the Act had had a positive impact as it has allowed Financial Institutions to benefit from revenue diversification.

The other is the consumer privacy effect which refers to the Act mandating consumer privacy from financial institutions and abolishing pretexting. Pretexting is gaining access to consumer information under a false alias. Also, consumers can decide to opt-in or opt-out of information sharing; however, it is worth noting that the Act does not impose public information from being shared.

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The merging effect resulted in consolidations and mergers with other firms within the financial industry. It meant the acquirer would take up both equity and debt. Not many researchers have explored value from an equity perspective, but none had explored value from the enterprise perspective. This paper focuses on the effect the Act has had on the Enterprise value of firms in the financial industry. This paper contributes to the effect of the Financial Services Modernization Act of 1999. The value investigated in previous studies refers mainly to equity, but enterprise value considers the debt undertaken by the firms following consolidation. More importantly, it compares the effect this Act has had on firms in the financial industry compared to other industries (specifically retail, wholesale, and service industries). Also, this paper attempts to investigate the effect the Act has had on consumer complaints in financial industries and how it compares with other industries.

This paper takes all financial institutions (investment banks, commercial banks, retail banks, insurance, together, and security firms), which is affected by the Act to be under the Financial Service Industry. Wholesale and retail industry together were referred to as trade industry (See Appendix 2). Service industry includes firms that work for customers. The service industry refers to other services provided by Hotels, Hospitals, Education, Engineering, and Programmers. These industries were selected randomly from on random number generator after both the wholesale and retail industry were lumped together as trade industry. This paper leans towards a natural experiment as it employs the difference-in-differences technique to study the differential effect of the treatment Act on a treatment group (Financial Services Industry) versus a control group (Other industries in which the Act do not affect).

One key challenge was examining the effects of the Act on consumer complaints, whether it had reduced or increased in comparison to other industries sampled. The author could not find any previous article that examined this effect because the Consumer complaints database only has a dataset of complaints from 2011. Therefore, the author examined a firm's reputation, using as a proxy, goodwill. The idea is that the financial service industry is mainly service-oriented towards customers, so the quality of service can "make or break" firm perception. Therefore, a bad reputation is likely to increase consumer complaints, while a good reputation is likely to result in a reduced consumer complaint. This paper found that the Act to be the primary reason why the enterprise values of firms in the financial industry are more significant than other industries (specifically retail, wholesale, and service industries). Furthermore, the findings suggest that the Act has resulted in lesser consumer complaints in the financial service industry compared to firms in just the Trade industries.

II. RELATED LITERATURE

Several studies have provided evidence of the benefit of mergers. One popular benefit is the synergy effect. Portfolio theory indicates that diversification has led to smoother revenues (Lin and Li, 2017). However, motivations behind profit generation impede mergers. The synergy theory of mergers and acquisition indicates that resource sharing leads to a synergistic effect on firm value. However, many believe that mergers hold no effect on value. For instance, Stiroh and Rumble (2006) provided evidence that a bank's extension to non-banking activities provided no benefits, except to only large firms. The Act is also said to have a limited effect on bank profitability and productivity regardless of the bank size (Yeager, T. 2007).

A few studies also attempt to show the influence of the Act on one of the financial institutions with the financial industry. Carow and Heron (2001) investigated capital market reactions and how the Act has gone about resolving uncertainties. Bhargava and Fraser (1998) and Narayanan, Rangan, and Sundaram (2001) investigated stock reactions of commercial banks following the adoption of the Act. They all found large banks to experience the most massive return. Another area largely debated is the effect of the Financial Services and Modernization Act on risk-taking by banks, some authors found an increase in the systematic risk exposure of banks while some did not. For instance, commercial banks are said to lack the expertise of investment banks or insurance banks; therefore, there is a risk to the services they render. Ghosh, A. (2020) called for banks to gain the managerial expertise required to conduct activities related to other financial institutions to reduce risk and increase profits.

The financial industry has had its growth limited ever since the Glass-Steagall legislation passed in 1933. Other industries thrived more than the financial industry. The trade industry, since the trade Act of 1974 enacted made the industry more competitive since it allowed workers to phase to other companies. It was something lacking in the financial service industry. The passage of the Gramm Lynch Bliley Act welcomed mergers and acquisition. Thus, increasing competition within the industry. How the Gramm Lynch Bliley Act effect compares to the Trade Act of 1974 remains to be seen.

Many scholars have claimed the Gramm Lynch Bliley Act only benefit large firms. Filson, D. and Olfati, S. (2014) argued that diversification mergers had yielded abnormal returns for large firms. However, an argument can also show support for mergers being beneficial to small firms. The need to innovate and increase market share is advantageous to small firms. Phillips, G. M. and Zhdanov, A. (2013) found evidence that the potential acquisition by large firms is an incentive to small firms.

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Many studies continue to use methodologies that estimate volatility in the financial market. Chen, Robinson, and Siems (2003) used a generalized autoregressive conditional heteroskedasticity process to examine wealth effects from a subordinated debt policy following the passage of the Gramm-Leach-Bliley Act. They found that portfolios of banks with large amounts of subordinated debt experience positive and significant wealth after the passage of the Act. Crow and Heron (2001) focused on stock price movements following the passage. They employed a multivariate regression to measure the effect of critical legislative events. They found no effect of the legislation on stock prices of banks, for both small and large firms. Asides the portfolio theory link, another theoretical link for this paper is the synergy theory which is the idea that the whole is more than the addition of each element. While there are many benefits to synergies, some of which include economies of scale, competition, and risk reduction, there are also many who believe that synergy cost can be high that can be detrimental to the merger, not to mention an increase in ambiguity and conflicts from lack of clarity of roles. This paper differs from previous research in the sense that it evaluates the effect of the policy on Enterprise value which is the effective costs of purchasing a company. It considers not just equity returns but also asset claims from debt, as well as ownership interests. Interestingly, given that a critical reason for the enactment of the Gramm-Leach-Act was to protect consumer privacy, little to no research has been done on how the Act might have changed the perception of consumers on the financial industry relative to other industries. Also, previous studies embarked on cross-sectional analysis within the financial service industry. This paper differs by employing cross-sectional analysis across industries.

III. DATA AND METHODOLOGY

To carry out this study and reduce bias, the author employed a difference-in-differences approach which is a quasi-experimental research design to study causal relationships where randomized controlled trials are not feasible. The essence of this is to examine the policy effect where there is one group that is affected by the policy (financial institutions within the Financial service industry) and another group (trade and service industry) that is not. Then, the author observes the outcomes (Enterprise value) of both groups before and after policy implementation. The author created a dummy variable (Time) to indicate the time when the treatment started. The treatment started in 2000. In this case, years before 2000 will have a value of 0, and from the year 2000 will be 1. The author also created another dummy variable (Treated) to identify the group exposed to the treatment. Financial service Industry with code range 6000 - 6799 was treated as 1, while Industries {5000-5199 (wholesale trade) & 5200-5999 (retail trade)} or 7000-8999 (service industry) were not treated (=0). Since the author has an individual-level data, the author can now estimate the difference in differences with a regression model.

$EVit = \beta 0 + \beta 1 * Timet + \beta 2 * Treatedi + \alpha (Treatedi * Timet) + \beta 3*Xn\ldots.. + \mu i + \varepsilon it$

Where EV is the enterprise value of the firm in a year. ε is the white noise error term. α is the coefficient of interest on (Treated * Timet). μi is the unobserved time-variant (firm and year effects). Xn is control variables.

Enterprise value is a more accurate estimation of a firm's value than market capitalization because it includes debt and cash reserves which is absent to the market capitalization. The formula for Enterprise value is as follows:

EV = Common Shares + Preferred Shares + Market Value of Debt + Minority Interest – Cash and Short-term investments.

The author obtained data on firms in the sampled industry from COMPUSTAT. The sample period is from 1997 to 2002. That is three years before the Act enactment and three years after the enactment of the Act. Data that makes up the Enterprise value were from COMPUSTAT. Data on consumer complaints were difficult to source since the dataset from the Consumer Financial Protection Bureau was difficult only begins from 2011. Also, the dataset only has a record of consumer complaints in the financial service industry. Search for possible alternative sources proved in vain. For instance, the author searched for articles in journals that included "consumer dissatisfaction", "customer complaints", "customer dissatisfaction" and "consumer complaints" conditioned to years within my sample period and found none that met my criteria. Therefore, the author decided to estimate the effect the Act has on firm reputation. The intuition is that in a competitive market, firms do not just compete for customers but also to increase their reputation status (Henard and Dacin, 2010). Perceived reputation is sure to influence consumer trust (Keh & Xie, 2009). Therefore, breaking that trust is most likely going to increase consumer complaints which would reflect negatively on a firm's reputation.

As a proxy for reputation, the author examined the effect the policy has on reputation. Goodwill is an intangible asset of the firm, while reputation refers to the way people feel about a business based on past experiences from the firm. Goodwill and reputation are interchangeable (Ampong, M. 2020). The author also regressed (using Ordinary Least square regression) enterprise value to goodwill to examine the effect of enterprise value on reputation. The idea is that should a firm enjoy certain benefits and favourable events, which results to increase in earnings, the value of goodwill increases. Also, since enterprise values consider debt, a firm with high debt will incur more interest from income and goodwill lessens.

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IV. MAIN RESULT

A. Summary statistics

Table 1 reports industry-level summary statistics for the variables used in this study. The unit of observation is firm-year. The sample includes 13,187 firms in the financial service industry, 10,977 firms in the service industry, and 4,738 firms in the trade industry. "Size" refers to the market capitalization of the firm. "Owners" is the number of shareholders in a firm. "Revenue" is the income generated by the firm. Leverage is the sum of total current debt and total long-term debt divided by total assets. Net income is net earnings. Goodwill is the quantifiable intangible asset related to the acquisition of a company by an acquirer. The table suggests that the trade industry is larger, more popular, and more successful than the service industry.

Table 1Summary Statistics

Panel A
Financial Service Industry and Service Industry

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Variables	Mean	SD	P10	P50	P90	Obs	N
Goodwill	113.1535	793.7803	0.0	0.0	89.36	17,101	24,164
Size	1285.387	9972.762	4.2343	70.49	1545.217	16,861	24,164
Owners	15.05545	377.1685	0.086	0.901	10.325	12,836	24,164
Revenue	989.8114	5039.582	1.7095	51.7115	1081.021	20,550	24,164
Employees	4.289092	20.62502	0.015	0.293	7.4	16,547	24,164
Leverage	0.7607369	21.81115	0.0	0.1351808	0.6850294	20,455	24,164
Net Income/Loss	49.49646	511.8127	-24.171	1.187	80.852	20,045	24,164
EV	1704.355	15335.5	-0.102	38.719	1223.182	19,115	24,164

Panel B
Financial Service Industry and Wholesale and retail trade Industry

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Variables	Mean	SD	P10	P50	P90	Obs	N
Goodwill	132.5358	876.6679	0.0	0.0	109.586	12,376	17,925
Size	1477.377	9073.873	5.9628	82.278	1801.772	11,903	17,925
Owners	19.93878	552.5168	0.084	1.2115	15.9	8,474	17,925
Revenue	1789.953	7375.803	5.788	108.205	2796.852	14,592	17,925
Employees	7.563895	34.52811	0.018	0.443	14	11,798	17,925
Leverage	0.7535748	24.43934	0.0	0.182552	0.6618419	14,540	17,925
Net Income/Loss	87.8641	518.1095	-8.081	4.755	140.669	14,090	17,925
EV	2453.108	18281.43	0.939	101.41	2234.4	13,416	17,925

Table 2 reports the result of the difference in differences estimation. By including both years (pre and post years) and the control as well as treatment, the author was able to isolate the effect of the Gramm-Leach-Bliley in the regression. The inclusion of the Time dummy will take care of the time trend problem, whether the enterprise value has been going up over time or down over time. The inclusion of the Treated dummy will take care of the inherent differences between the treatment and control group. "DiD" is the interaction term (treat * Time). "Did" will provide the actual estimated treatment effect. Column 1 reports the result without control and robust. Column 2 reports the results with robust but no control. Column three reports the results with control and robust.

* indicates statistical significance at the 10% levels.
** indicates statistical significance at the 5% levels.
*** indicates statistical significance at the 1% levels.

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B. Standard Deviation is in Parentheses.

Table 2, This shows the regression of the difference in difference estimate on enterprise value, and also the results of the OLS regression.

PANEL A

Financial Service Industry & Trade (Wholesale and Retail)

	Enterprise Value		
	(1)	(2)	(3)
Time	157.3295	132.0772	-85.39562
	(159.8451)	(33.72185)	(70.15012)
Did	662.3643 ***	863.4092 ***	280.5694 ***
	(216.7319)	(203.2751)	(99.307)
size			0.1239465
			(0.0647535)
reputation			0.7427026
			(0.8097679)
No of owners			-0.0036871
			(0.0026534)
Revenue			0.2835684
			(0.2536759)
No of Employees			22.8187
			(33.96462)
Leverage			-0.0901215**
			(0.0354093)
Net income			1.273764***
			(0.4901332)
Robust	No	Yes	Yes
Control	No	No	Yes
Year Effect	Yes	Yes	Yes
Firm Effect	Yes	Yes	Yes
N	10,987	13,416	5,032

PANEL B

Financial Service Industry and Service Industry

Enterprise Value			
	(1)	(2)	(3)
Time	51.54696***	51.54696***	24.06431***
	(93.57787)	(11.18826)	(11.25931)
Did	943.9394***	943.9394***	199.2356***
	(136.3394)	(200.7581)	(74.73439)
size			0.1164327
			(0.0679449)
reputation			1.759929***
			(0.3638922)
No of shareholders			0.0034544
			(0.003876)
No of Employees			14.71572

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			(14.61354)
Leverage			-0.096878***
			(0.0359197)
Net income			0.5470402
			(0.3408726)
Robust	No	Yes	Yes
Control	No	No	Yes
Year Effect	Yes	Yes	Yes
Firm Effect	Yes	Yes	Yes
N	19,115	19,115	7,873

PANEL C

Reputation

Financial Service Industry and Service Industry

	(1)	(2)
EV	.0202126***	.0263158***
	(0.0003781)	(0.0106344)
Robust	No	Yes
Year Effect	Yes	Yes
Firm Effect	Yes	Yes
N	15,875	15,875

PANEL D

Reputation

Financial Service Industry & Trade (Wholesale and Retail)

EV	0.0195583***	0.0259734***
	(0.0004036)	(0.0105627)
Robust	No	Yes
Year Effect	Yes	Yes
Firm Effect	Yes	Yes
N	11404	11404

Panel A and B show that the Act passed has had a positive and significant effect on Enterprise values. The result implies that the Gramm-Leach-Bliley enacted Act increases Enterprise values of firms in the financial service industry. The time dummy variable is positive and significant in panel B, which indicates that the Enterprise value was trending up over time. This result is consistent with the synergy theory and previous studies that indicated mergers and acquisition are having a positive effect on firm value. It is also consistent with previous studies (Filson, D., and Olfati, S., 2014) that indicated that diversifying mergers increases value. Panel C and D show the results of the ordinary least square regression. The results indicate that enterprise value has a positive and significant effect on the reputation of a firm. This result is consistent with previous studies that view value has sending a signal to the public about the efficiency of firm operations.

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Table 3: This reports the regression of the difference in differences estimation on reputation

PANEL A
Financial Service Industry & Trade (Wholesale and Retail)

	Reputation		
	(1)	(2)	(3)
Time	23.66988	23.66988***	-4.395577
	(17.58772)	(7.305129)	(4.719)
Did	53.82427***	53.82427***	20.22273***
	(21.00395)	(18.08301)	(7.998)
size			-0.0084478***
			(0.00341)
No of owners			-0.0006027***
			(0.000239)
Revenue			0.0296424***
			(0.00712)
No of Employees			9.118849***
			(3.197)
Leverage			-0.011321
			(0.00339)
Net income			0.2750417
			(0.0978)
Robust	No	Yes	Yes
Control	No	No	Yes
Year Effect	Yes	Yes	Yes
Firm Effect	Yes	Yes	Yes
N	12376	12376	5301

PANEL B
Financial Service Industry and Service Industry

	Reputation		
	(1)	(2)	(3)
Time	28.4612***	28.4612***	8.953091***
	(10.489)	(6.909)	(4.149)
Did	49.03295***	49.03295***	-3.618564
	(14.660)	(17.926)	(7.477)
size			-0.0072553***
			(0.002554)
No of shareholders			0.0006067
			(0.0010603)
No of Employees			2.521917
			(2.281)
Leverage			-0.0061092*
			(0.0036023)
Net income			0.0933695
			(0.0875)
Revenue			0.086378***
			(0.0295)
Robust	No	Yes	Yes
Control	No	No	Yes
Year Effect	Yes	Yes	Yes
Firm Effect	Yes	Yes	Yes
N	17101	17101	8293

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Table 3 shows the result of the regression of the difference in differences estimates on reputation. The result shows a positive and significant effect in panel A but no significance in panel B, which suggests that the increase in reputation of the financial service industry more than trade industry is as a result of the effect of the passage of the Gramm-Leach-Bliley Act. However, there is no significance of the effect of the Act in panel B. This result suggests that the Gramm-Leach-Bliley Act has had more of an effect on the financial service industry compared to the effect the trade Act of 1974 has had on trade industry. Results from Columns 1 and 2 of table 3 panel B, panel A of Table 3, and panel C and D from table 2 suggests that the Act, in general, had an effect on the reputation of firms in the financial service industry which is likely to reduce consumer complaints of firms in the financial industry—thereby showing the Gramm-Leach-Bliley Act to fulfil its objective adequately.

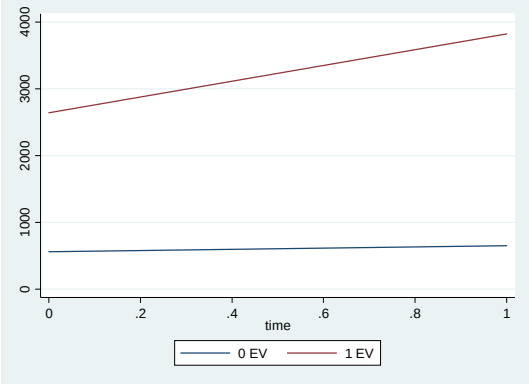
V. CONCLUSION

The Gramm-Leach-Bliley has been a revolution to the financial service industry. Call for mergers were on the rise before the enactment of the Act. This Act has been beneficial to every stakeholder affiliated with financial institutions. Not only did it allow resource-sharing amongst financial institutions, but it also promoted portfolio diversification and competition. Since resources were shared, there is always a risk for the private information of consumers to become public. This Act went a long way in solving the consumer privacy issues that result from the merger. This paper provides evidence of the influence the Gramm-Leach-Bliley Act has had on the Enterprise values of Financial Firms. It contributes to the growing literature on the effect of mergers and acquisition in the Financial Industry. It also provided further evidence of the influence reputation can play on the Enterprise values of the company.

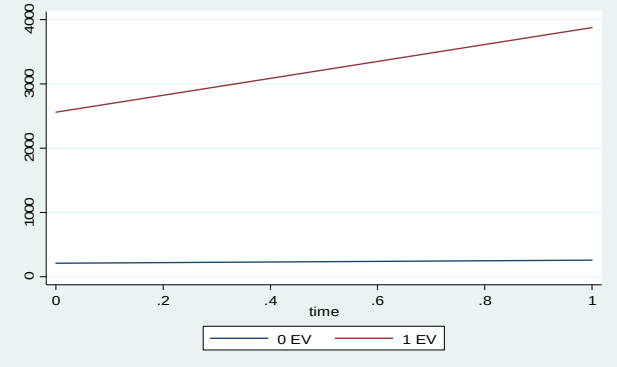
More importantly, it shows how invaluable the right policy can be in any industry. Government regulations can make or break a financial economy. This paper suggests that policies that protect stakeholders in a firm are always welcome since it is beneficial to the industry as a whole.

Appendix 1

New Policy Enacted (Diff-in-diff): Financial Services Industry and Trade Industry (Wholesale and Retail)



New Policy Enacted (Diff-in-diff): Financial Services Industry and Service Industry

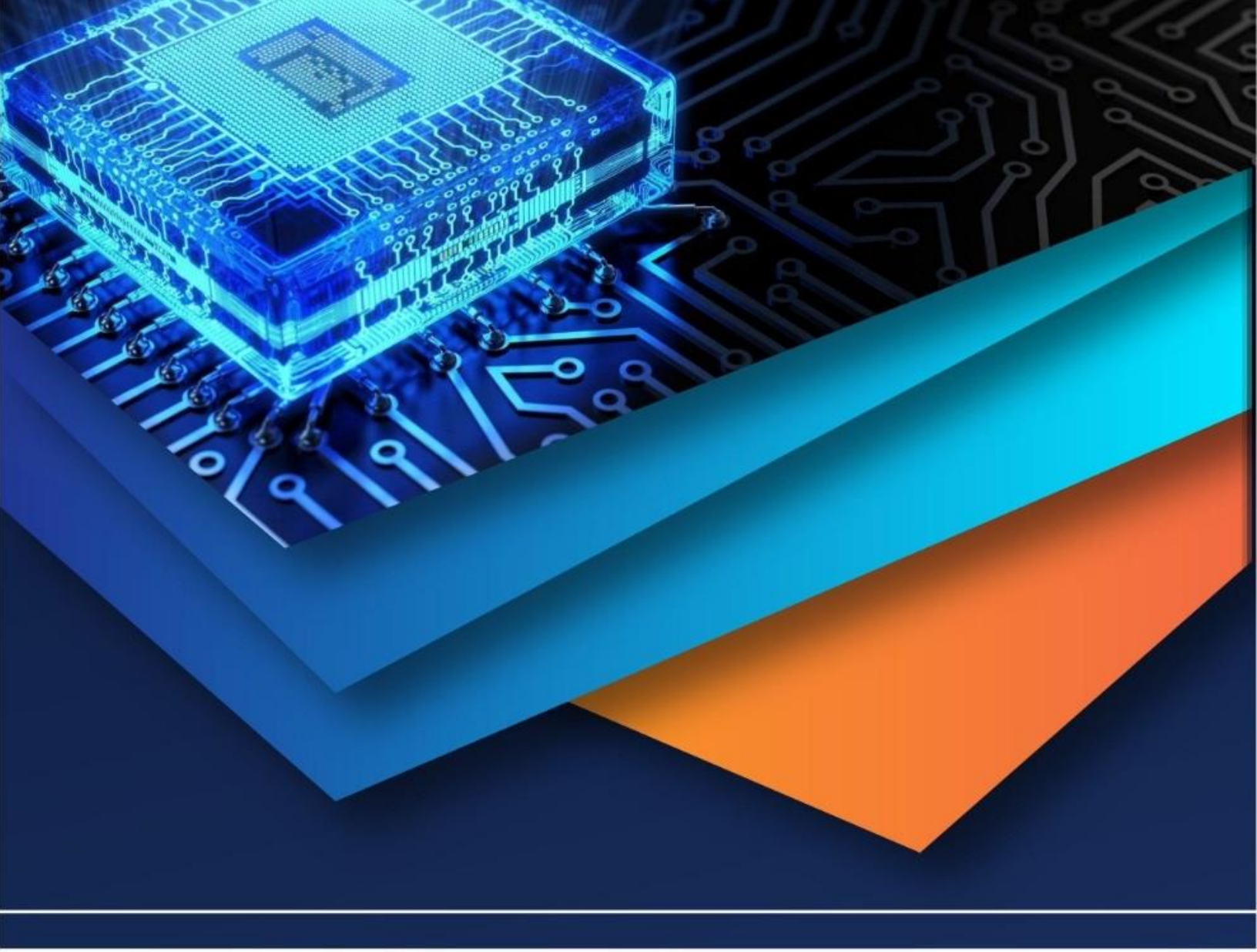


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