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A conference on "The Emerging Law of Cyberbanking and Electronic Commerce" is an excellent venue to take stock of important trends and developments in the financial industry. During the past year, the content, implications and implementation of the Gramm-Leach-Bliley Act (GLBA) often were the centerpiece of discussions of change in the financial industry. But, this year, one of the most significant -- and technology-driven -- trends becoming evident in the banking industry represents quite a different dimension of financial modernization.

Make no mistake: GLBA is landmark legislation. It allows types of financial companies to affiliate that previously were not permitted to do so, and it allows companies directly to provide products previously allowed to be provided only by other types of firms. In broad terms, GLBA facilitates growth in the size of financial services firms, and may encourage consolidations, because it enables financial companies to acquire more types of other financial companies and to commence new lines of business.

In contrast to this trend, however, one of the most interesting and potentially far-reaching developments in the financial industry today is one based on a type of deconsolidation -- I'll call it "deconstruction." The process of separating out the different functions of a financial instrument -- origination, servicing, absorbing particular risk components -- has been a revolutionary development in financial markets over the last 20 years. Today, we see this same process of "deconstruction" engulfing all aspects of the banking business. By "deconstruction" I mean the separation or segmentation of banking products, services and operations into their component parts or processes so that they can be provided or obtained separately.

Discussions of how "deconstruction" affects the banking business typically focus on how deconstruction of banks' traditional functions enables their *competitors* to "cherry-pick" segments of their business. Certainly, advances in technology make the component functions of banking ever more divisible. But my premise today is that a deconstructed perspective of its own business may be a key to a bank's success. Put another way, if banks' competitors gain advantages by "cherry-picking" segments of their banking business, why shouldn't banks do the same to themselves? The manifestations and implications of deconstruction of the business of banking, and how those are aided and abetted by technology, are what I will talk about today.

So what is being deconstructed? The traditional vertically and horizontally integrated banking firm that produces and delivers *its* products, through *its* outlets, to *its* customers is being picked apart. Examples are easy to find. What is easy to miss, however, is how the examples are pieces of a larger picture puzzle that represents a fundamentally different way of looking at the business of banking; one in which the different capacities, competencies and attributes of a banking firm are the pieces.

Consider the example of the most traditional of bank products -- a loan. One way to look at a loan is as a single product. Deconstructed, however, a loan is a series of functions: evaluating risk; originating the loan; funding the loan; servicing/administering the loan; and holding the loan asset. None of these functions is necessarily unique to a bank, and any particular bank could chose to do some or all of them, depending upon its comparative advantage relative to competitors performing the same functions. A bank with a capacity for a particular function, such as loan servicing, could "export" that capacity by marketing it to other businesses, while another bank might determine that it does not want to develop that capacity and would look for a third party from which it can "import" the function.

Similarly, a bank may decide that it is important for its customers to have access to a broad range of products, but rather than producing those products itself, it will import the choices and, as finder, give its customers access to products from other providers. Or, a bank may even detach its name and regulatory status from its own products and services and market under the bank's name products or services produced or originated by a third party -- in effect, deconstructing its brand and its reputation.

This kind of "deconstructed" perspective on the banking business enables a banking firm to analyze the components of how it does business, what it does, what it does well, and where it may have a particular advantage in an activity. A banking firm may decide, piece by piece, whether the firm commits resources to perform a particular function itself, or hires another company to do it; whether it produces a particular product, or makes products originated by third parties available to its customers; whether it has particular capacities and competencies that translate into new business opportunities; and whether there are other attributes of the bank that are marketable.

Why is all this important? Because a view of the banking business as divisible into component pieces enables banks to play to their strengths; to commit resources to the particular processes they do best, where they have a comparative advantage, and to gain access to skills, expertise and products that they need, without having to develop them in-house. A bank's advantage in conducting an activity itself may come from economies of scale, its particular competence, or attributes that distinguish it from other providers of the same product or service. When the banking firm does not have an advantage producing the product, service or function itself, however, it can look to "import" it from another source.

In addition, when a line of business is viewed as a series of functions, entry and exit barriers should be lowered since a banking firm may enter a new activity without developing an entire productive process, and may exit a business line without having to dismantle the infrastructure for an entire function. A bank may make a strategic, limited entry into a particular activity, limit its expenditures, and exit with a containable exposure. Thus, in general, it should be desirable for a banking firm to have the ability -- to have the option -- of analyzing its current and prospective business in a deconstructed fashion.

Technology both vastly enhances the ability of banking firms to deconstruct and segment their business and creates new opportunities for them based upon strategic exploitation of advantages associated with particular segments of that business. Generally, we can see the effects of deconstruction of the banking business, and the impact of technology on this trend, in four basic ways:

- ***Using third parties to perform functions on a bank's behalf.*** A bank contracts with third party providers to perform components of the bank's operations.

- ***Providing access to products and services of other providers.*** The bank makes products and services originated by others available to the bank's customers.

- ***Marketing processes and activities for which the bank has particular capacities and competencies.*** Functions and activities that the bank performs for its own operations are marketed to third parties.

- ***"Franchising" the bank's attributes.*** The bank "franchises" its attributes, lending its name or its regulated entity status to products and services originated by others or activities predominantly conducted by others.

Let's look more closely at each of these situations.

Using third parties to perform functions on a bank's behalf.

It is well-recognized that third-party vendors, brokers, dealers and agents offer banks a variety of systems and services, as well as products designed to diversify bank assets and sources of revenue, and to reduce costs. Use of third party vendors for various back-office systems and software is common, and the more recent development of banks' retaining third party vendors to establish and operate their Internet web sites is becoming increasingly so. Other more unusual, recent manifestations of this aspect of deconstruction are initiatives by some banks to contract out bank internal functions, such as human resources administration and internal audit.

When it comes to innovations in technology, this trend has some interesting twists. In the typical, traditional third party vendor scenario, a banking firm contracts with a third party vendor to provide a specified back-office system or function. Today, a bank may be exploring *new* technologies that support the creation and provision of *new* financial products and services. In other words, the sought-after technology or new product or function may not yet exist -- is not on the shelf -- at least not in the form the banking firm wants it.

In this setting, participation in the development of standards and industry protocols for new technology, and in the development of delivery systems and equipment, are vital in order to ensure that the new standards and equipment are optimal for delivering the types of banking products and services that a bank wants to provide. And, involvement of a continuing nature may be necessary in order to insure that the product or system remains available to the bank and is developed consistent with the bank's needs.

To be able to guide the creation, deployment, and access to an innovation, however, may require that the banking firm participate in some form of joint arrangement with the other companies participating in the project. One efficient way is for a banking organization to do this is to make strategic investments in those companies or ventures with which it seeks to partner in the development of technology related to producing and delivering financial products and services. This enables the banking firm to explore a variety of initiatives, while containing its exposure by making only the limited investments necessary to gain a technology partner needed for particular technology-based initiatives.

The use of third parties to develop standards, products and services based on new technologies is one current example of deconstruction. The example also illustrates that the most effective -- perhaps the necessary -- way to do so is through relationships with third parties that go beyond simply contracting for a product or service. In this context, the OCC's minority investment precedents are significant because they recognize non-controlling investments by national banks in companies where the investment is "incidental to banking" because they are "convenient or useful" to accomplishing a bank's banking business. Given the pervasive implications of technology on the banking business, these investments could easily be viewed as *necessary* to the future success of banking firms. The Federal Reserve Board also has recognized this vital linkage in its recent proposal asking for comments on whether such strategic investments should be viewed as financial in nature, incidental to a financial activity, or "complementary" to a financial activity.

Providing access to products and services of other providers.

Offering financial products and services also can be deconstructed; banks have options how, and which, financial and non-financial products and services to make available to their customers. A banking company may decide that it wants to meet customers' desires for access to certain non-financial products and services by arranging for them to be available from a third party. For example, banking companies could offer insurance from an affiliated insurance company, or securities brokerage through an affiliated brokerage firm, or could chose to make arrangements with one or more non-affiliated third parties to provide those products and services to the bank's customers.

These choices may take the form of joint marketing arrangements, where, for example, a bank will contract for a company to offer its products or services to the bank's customers from the bank's premises. Or the bank may provide statement stuffers and other marketing materials of sellers of various financial products and services, or identify other service providers as an accommodation to its customers. Essentially, these are old-fashioned examples of how a bank deconstructs aspects of its relationships with customers; determining what products and services they want and then how best to provide them. Traditionally, these types of activities were referred to as acting as a "finder."

The authority of national and many state banks to act as "finders," bringing together buyers and sellers of products and services for transactions that the parties themselves negotiate and consummate, is well-recognized. With advances in technology and increased use of the Internet, however, banking firms are able to act as a finder electronically on a far broader scale. The new technology introduces a new dimension of finder activities, providing not just a new channel for banks to market their own financial products and services, but a vastly expanded means to provide customers with access to those of third parties. Technology also helps a bank couple functions offered by the bank with the products and services of third parties that the bank makes available. Banks may become full service providers without being full service producers.

For example, both national banks, and more recently, financial holding companies, have been recognized to have authority as finders to host "virtual mall" web sites that provide links to the web sites of third party buyers and sellers, and allows sellers (or buyers) to submit expressions of interest, bids, offers, orders and confirmations at the linked sites. Similarly, both national banks and financial holding companies are able to operate Internet marketplace web sites that allow multiple buyers and sellers to exchange information concerning the products and services they are willing to buy or sell, locate potential counterparties for transactions, aggregate orders for goods and services with those made by other parties, and enter into transactions between themselves at the bank's site.

In either approach, the bank or financial holding company may negotiate with sellers to provide preferred terms to buyers that purchase through the web link or web site, and may establish rules of general applicability governing how its finder function operates. These operating rules could, for example, establish parameters under which buyers and sellers submit bids and offers to the finder, the circumstances under which the finder will match bids and offers, and rules that govern the manner in which buyers and sellers bind themselves to the terms of a transaction that is facilitated by the finder. The finder authority is not limited to provision of financial products and services, so these activities could pertain to transactions involving *anything.*

This last point raises various issues. One vital question concerning the bank's role is the extent to which it may couple its functions and activities with the products and services of third parties that it makes available. In the case of financial holding companies, the finder authority has just been recognized and no precedents yet exist outside of the new rule. In the case of national banks, precedents support combining the finder authority with other functions that are permissible as part of the business of banking, such as payments processing and information management, as well as with a limited amount of non-banking activity that is permissible because it is "incidental" -- convenient or useful -- to the bank-permissible activities including the finder function. For example, national banks offering to host commercially enabled web sites may also, as an incidental service, offer web site design and development.

Finally, whenever a banking firm is providing its customers access to products not originated by the bank, a wide range of customer relationship issues arise. Does the customer using a bank's finder service understand that the products and services being obtained are those of a third party, not the bank, and that the bank does not warrant their quality? How realistic is it for the bank to assume that it can divorce itself entirely from the product or service procured through the bank's facilities and how involved does the bank want to become in quality control of those products and services?

What risks does a consumer face? If a banking organization establishes operating rules for transactions conducted via its web-based finder capacity, can its rules allocate the risk of unauthorized use of an access device to the consumer? If so, what is the consumer's potential exposure and how effectively is he or she informed of this?

High-tech finder functions are also fertile ground for privacy issues. When a bank acts as a finder, what kind of information does the bank acquire about the customers of that service and transactions they execute? What does it do with that information?

Marketing processes and activities for which the bank has particular capacities and competencies.

Yet another manifestation of a deconstructed perspective of the banking business happens when a banking firm has a particular skill, competency or other advantage in providing a product or service. In that case, the reverse of the first example occurs. Rather than "importing" a particular function from a third party vendor, the bank "exports" to third parties components of operations that it conducts for itself. In doing this, the banking firm is optimizing the use and value of its facilities and competencies as well as avoiding economic waste. It is effectively cherry-picking its own operations.

This can occur in a variety of settings. There may be some activities where large scale is a comparative advantage, and a bank with a capacity for the activity will exploit that competency by performing the activity, not just for itself, but for other banks and non-banks. Current examples include mortgage servicing, credit cards, payments processing and administration and the fiduciary and securities custodial business.

Technology affords new opportunities here as well. And national banks have authority to pursue these opportunities in marketing their electronic competencies and capacities to others. For example, a subsidiary of a national bank approved to act as a certification authority is also "manufacturing" digital certificates for third party certificate authorities. Since the issuance of digital certificates is part of the business of banking, the production of the certificates for others to issue is likewise permissible. Here, the bank is exporting to others its competence in producing digital certificates.

Likewise, the OCC has authorized a national bank that has developed extensive competence in digital imaging to export that service to other financial institutions. This is a permissible correspondent service. We also have found that national banks may, as part of the business of banking, market to non-financial firms imaging services that focus predominantly on banking, financial or economic data. The OCC has also held that where a national bank has acquired good faith excess capacity in imaging (due to, for example, the batch nature of its operations), the bank may sell that capacity to others without regard to the nature of the firm or its images.

Finally, OCC has permitted national banks that develop competence and capacity in electronic finder activities (including commercially enabled web hosting) to sell these wholesale to other financial institutions that wish to offer these services to their merchant customers. This is both an exercise of the bank's electronic finder authority and a valid correspondent service.

"Franchising" the bank's attributes.

Finally, some banks have recognized that deconstruction can go so far as to enable them to exploit certain reputational and regulatory attributes that may give them a competitive advantage. To that end, the bank performs services in its own name, but in association with third parties and, thereby, effectively endows that third party's products or activities with the bank's attributes.

Technology both encourages and facilitates this approach. Non-banks increasingly find that technology enables them to successfully enter "bank-like" services, but without the expense of a bank branch system or a bank charter. Computer systems enable these non-banks to integrate a set of distinct operations -- some performed by banks and some by themselves -- such a scoring a loan applicant and funding a loan, into what appears to the consumer as a single seamless product or service.

This approach goes beyond deconstruction of the bank's special skills and competencies, discussed above; it involves deconstructing the advantages in market perception and legal treatment that arise from status as a regulated financial institution. For example, because they are subject to an extensive regulatory regime, banks generally benefit from a high level of public trust. In addition, banks have unique access to payments systems that non-banks covet. And, in the case of national banks and federal thrifts, certain state laws are not applicable because of principles of federal preemption.

This fourth type of deconstruction is the newest, and potentially most problematic. In this type of deconstruction, a bank is detaching its name and reputation from its own activities and permitting its attributes to be used in connection with the products and services of a third party. The implications of this type of "franchising" of a bank's attributes are considerably more complex than when Harley Davidson decides to associate its brand with a new line of clothing.

Recent manifestations of this type of deconstruction appear in various efforts by non-banks to obtain access to bank funding and payments systems. One example is the so-called "Rent-a-BIN" arrangement, designed to afford a non-bank access to a credit card payments system. In this type arrangement, a bank permits a non-bank to use the bank's BIN ("Bank Identification Number") issued by VISA, by issuing a credit card to be used for the third party's products or services. In exchange for a fee paid to the bank when the account is opened and periodically thereafter, the non-bank acquires all the credit card receivables, receives all interest payments and other finance charges, and benefits from the bank's authority to use the interest rates permitted in the state in which the bank is located, regardless of the limits on rates that may apply in the state in which the customer is located.

In another example, non-bank financial product vendors seeking to avoid the application of state consumer protection laws may approach banks to enter into marketing arrangements where banks fund certain types of loans marketed by the vendor, such as so-called “payday” or “title” loans. The loans are actually offered, not at the bank’s regular branches, but at offices of the third party vendor at other locations. After the bank funds the loan, the third party then immediately purchases all or virtually all of the loans from the bank. For this activity, the bank is paid a fee.

In these situations, the third party’s objective is to involve a national bank or a federal thrift. By having its loans funded by an entity that enjoys federal preemption, the third party seeks to avoid compliance with a variety of state consumer protection laws, yet the third party itself is not subject to the responsibilities and federal regulation applicable to a national bank or federal thrift.

However, when a bank is offering products and services actually originated by third parties as its own, the bank can be exposed to substantial financial loss and damage to its reputation if it fails to maintain adequate quality control over those products and services and adequate oversight over the third party activities. Simply the act of delegating customer interactions to a third party also risks a priceless asset -- the bank’s good name -- if customers are not treated according to standards expected from the bank.

Unfortunately, in recent examples of this type of deconstruction, we have seen banks associate their name and special status with products that were abusive to consumers and with third party vendors that did not conduct their operations with the diligence expected of a regulated financial institution.

This is not to say that this category of deconstruction is always inadvisable or inappropriate. Experience does strongly indicate, however, that when a bank’s role in the origination and marketing of a product or service is only superficial and its actual involvement in the substance of the transaction is limited, the bank may have placed its reputation and safety and soundness at risk. Moreover, in those cases, it is questionable as a policy matter whether the bank or thrift should be able to simply bestow the benefits and attributes of its regulated entity status on a third party that is not subject to the responsibilities and regulation that apply to the bank and thrift.

Conclusion.

This framework of analysis demonstrates how technology is propelling fundamental changes in the financial industry. Although I have touched on many issues in this review, in many ways, I have barely scratched the surface. But, the abundance of issues to consider should not obscure the core message: “Deconstruction” of banking functions should not be confused with “destruction” of the banking business. To the contrary, when coupled with the potential of technology, prudent, strategic and responsible deconstruction of banking functions may be vital to the future of the business of banking.