

The Door Is Open, but Banks Are Slow To Enter Insurance and Investment Arenas

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More than five years have passed since Congress enacted the Gramm-Leach-Bliley Act, tearing down regulatory barriers that separated commercial banking, investment banking and insurance underwriting. Many thought the new law would create a profusion of “universal banks,” whose one-stop shop for financial services would not only make money for them but save money for consumers. Have these benefits come to pass?

The biggest potential benefit of the law is that it allows financial institutions to exploit fully the revenue efficiencies and cost savings that accrue from offering an array of financial services. The concept is similar to a grocery that also houses a pharmacy and a video rental department. The grocery earns additional revenue because the shopper buying a gallon of milk finds it convenient to fill a prescription and rent a movie. The grocery also sheds costs relative to three stand-alone stores because it can use the grocery’s back-office functions, such as inventory, accounting and marketing systems, to service the pharmacy and video department. Shoppers benefit from added convenience and lower costs.

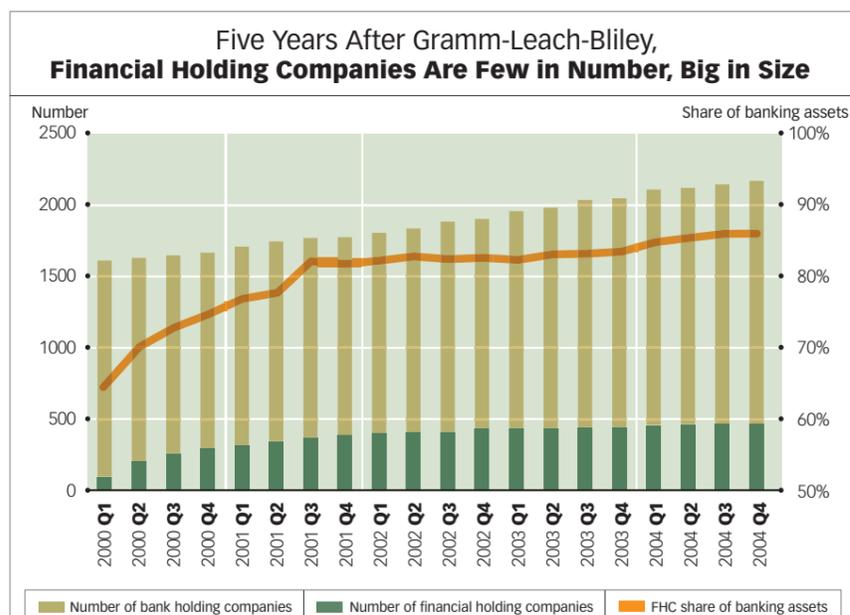
Similarly, consumers conceivably can go to their local bank to deposit funds, add the teenage driver to the insurance plan and invest savings in a mutual fund. In addition, business customers may wish to borrow money by taking out a bank loan or by selling corporate bonds. With the same banking organization handling both activities, businesses save time and money by going through the costly process of proving their

creditworthiness to only one firm instead of two or more firms. Because of these advantages, supporters of the Gramm-Leach-Bliley Act promised it would save consumers billions of dollars.¹

Despite the hype over the act, many analysts argued that it would have only minor effects on the financial industry because the potential revenue gains and cost savings from creating universal banks are small. To the extent that these advantages exist, banking organizations had already found ways to exploit them partly before March 2000—the month that the act took effect—by conducting investment banking activities in so-called Section 20 affiliates. (See article on Page 7.) The legislation simply made it easier for organizations to continue to engage in the activities they had already undertaken.

More than five years have passed since the adoption of the act, enough time to examine the early impact that the legislation has had on the banking industry. The evidence, thus far, suggests that the effects of the law have been modest; consequently, banking customers should not expect significant price reductions for their primary

financial services. Two pieces of evidence lead to this conclusion.² First, most financial holding companies (FHCs) continue to conduct traditional commercial banking activities; very few firms are also engaged heavily in insurance underwriting and investment banking. Second, FHCs on average are no more profitable or cost-efficient than they were before passage of the legislation.



	Before becoming an FHC, the average BHC had these ratios:	Three years after becoming an FHC, the average FHC would have these ratios:
Balance sheet ratios (percent of total assets)		
Loans	62.30	58.90
Securities	25.80	27.80
Deposits	79.40	80.40
Equity	9.21	9.59
Income ratios (percent of average assets)		
Interest income	7.49	7.46
Interest expense	3.47	3.39
Net interest income	4.02	4.07
Noninterest income	1.58	1.7
Noninterest expense	3.55	3.76
Provision expense	0.23	0.32
Net income (ROA)	1.28	1.19
Return on equity	13.92	12.78
Performance ratios (percent)		
Efficiency ratio	62.60	64.30

NOTE: Ratios in bold indicate statistically significant changes.

FHCs Move Slowly

One measure of the impact of the act on the financial services industry is the extent to which financial holding companies have taken advantage of their new powers to conduct insurance and investment banking activities. The larger the cost savings and revenue benefits, the more quickly banks should respond to the legislation.

To take advantage of the act, firms must become financial holding companies. The chart above plots the number

of FHCs and BHCs—bank holding companies that have not elected to become FHCs—between March 2000 and December 2004.³ The number of FHCs increased rapidly from 94 in March 2000 to 466 in December 2004; nevertheless, FHCs have never accounted for more than 23 percent of all banking organizations. As a percentage of assets, however, FHCs account for a significant share of total banking assets because most large banking organizations elected to become FHCs shortly after passage of Gramm-Leach-Bliley. As the line in the nearby chart shows, in March 2000, FHCs accounted for 65 percent of industry assets; their share in December 2004 was 86 percent.

A firm's designation as an FHC does not necessarily mean that it is engaging in insurance underwriting or investment banking. Indeed, the process to become an FHC is quite simple. To be eligible, each depository institution controlled by the banking organization must be well-capitalized and well-managed as of the date the company submits its declaration, and it must have a satisfactory Community Reinvestment Act (CRA) rating from its primary bank regulator. An election to become an FHC is effective on the 31st day after the date that the declaration was received unless the Federal Reserve's Board of Governors notifies the company prior to that time that the election is ineffective. The organization need not ever conduct the newly permissible activities authorized under Gramm-Leach-Bliley.

One indication of the weak response of the banking industry to the law is that, to date, financial holding companies are involved only modestly in their new universal banking powers to conduct investment banking and insurance underwriting. Moreover, the few that are heavily engaged in these activities are the large money-center banks that dominated the banking industry even before passage of the act. On average, FHCs hold less than 1 percent of assets in investment banking subsidiaries and just 0.24 percent of assets in insurance subsidiaries, and these activities account for just 7 percent of revenue. In fact, investment banking and insurance underwriting are highly concentrated in just a few financial holding companies. As of December 2004, of the 41 FHCs that held any investment banking assets at all, three organizations—Citigroup, Bank of America and JPMorgan Chase—accounted for 72 percent of the total. Moreover, of the 22 FHCs with insurance underwriting assets, just two firms—MetLife and Citigroup—accounted for 96 percent of the total, and the concentration has since increased. In the first quarter of 2005, Citigroup sold the bulk

of its life insurance business to Met Life. It had already sold its property and casualty business in 2002. Citigroup's rationale was that the capital could be invested more profitably in other lines of business.

In sum, of the nearly 500 financial holding companies, only a handful of them have significant investment banking and insurance operations. Most FHCs are not that different from more traditional banking organizations. The lack of activity provides circumstantial evidence that the synergies between these activities are relatively weak.

FHC Performance Then and Now

A more direct approach to observing the effects of Gramm-Leach-Bliley on financial institutions is to measure changes to a bank's balance sheet and profitability after it becomes an FHC. Statistical techniques can isolate and measure the average change in performance after banks become FHCs relative to their performance before becoming FHCs.⁴ We analyzed bank performance between the years 1996 and 2003, assessing the marginal contribution from becoming an FHC. The results are in Table 1 on Page 6.

Three years after becoming an FHC, the average banking organization shows modest changes to its balance sheet. The typical BHC holds \$62.30 in loans for every \$100 in assets; that amount drops to \$58.90 three years after becoming an FHC. The drop in loans is expected because the organization presumably is diversifying into insurance and investment banking assets. As a percent of assets, securities holdings increase by two percentage points, and deposits increase by one percentage point. Equity—the difference between assets and liabilities—increases somewhat after a firm becomes an FHC. The boldfaced font indicates that all of these changes are statistically significant—that is, the changes are not simply the result of chance. Yet, given the relatively wide dispersion of loan, securities, deposit and equity holdings among banking organizations, none of these changes is economically large.

In addition to the balance sheet changes, the typical FHC shows a slight decline in profitability. A banking organization that transitions from loan-making to insurance underwriting and investment banking would expect to see its interest income decline while its non-interest (fee) income increases. After all, insurance and investment banking are fee-driven services. Indeed, the typical FHC experiences these changes. Interest income as a percent of average assets declines by three basis points, while the ratio of noninterest income to average

As Memories Fade, So Do Restrictions on Banks' Activities

To place the Gramm-Leach-Bliley Act in historical context, it is helpful to examine the legislative events that separated banking from insurance and investment banking. The National Banking Act of 1864, which established the national bank charter, permitted banks to engage only in activities that were "incidental" to the business of banking. Insurance activities were excluded. Securities activities, however, were permissible as long as banks conducted these activities through affiliates. Investment banking grew quickly in the 1920s, fueled by the explosion in bond underwriting to finance World War I and a booming economy and stock market.

The stock market crash of 1929 ushered in the Great Depression. Because of the perception that banks' involvement in securities activities facilitated the Depression, Congress passed the Glass-Steagall Act of 1933, which prohibited banks from issuing, underwriting, selling or distributing any type of securities with the exception of U.S. government and government agency securities and certain municipal bonds.

By the 1970s, Depression-era conditions had faded from the minds of the American public. In turn, the rationales for the compartmentalization of the financial sector were questioned. A number of government-mandated studies called for banking deregulation and greater reliance on market forces.¹ In addition, several studies argued that securities activities of commercial banks were not significant factors leading to the banking crises during the Great Depression.² (See article on Page 8.)

Barriers between commercial banking and investment banking were lifted gradually. Under Section 20 of the Glass-Steagall Act, banks were prohibited from affiliating with other financial institutions that were "engaged principally in the issue, floatation, underwriting, public sale or distribution of financial assets." Over the years, however, the term "engaged principally" became subject to reinterpretation. Through a series of court rulings and Federal Reserve Board interpretations, the type of securities and the proportion of assets that bank affiliates could devote to these securities were broadened. By 1996, bank affiliates were allowed to derive up to 25 percent of their revenue from underwriting corporate bond and equity issues. By late 1999, with passage of the Gramm-Leach-Bliley Act imminent, the number of so-called Section 20 banks stood at 45.

Given the gradual breakdown of Glass-Steagall and the merger-led growth of bank holding companies in the mid-1990s, the largest banking organizations pressed for congressional action to repeal fully Glass-Steagall and other barriers in the hopes of further exploiting revenue efficiencies and cost savings. Citigroup received a temporary exemption in September 1998 from the Federal Reserve to buy Travelers Insurance, with the expectation that Congress would act before the exemption expired.

On Nov. 12, 1999, laws separating commercial banking, investment banking and insurance activities for U.S. institutions were effectively removed with the enactment of the Gramm-Leach-Bliley Act. Banking organizations have since been allowed to form financial holding companies and to engage in any activity that is financial in nature.

¹ See, for example, Benston (1972).

² See White (1986); Ang and Richardson (1994); Kroszner and Rajan (1994).

Re-emergence of Universal Banking Raises Specter of Earlier Banking Crisis

Will the re-emergence of universal banking authorized under the Gramm-Leach-Bliley Act harm investors and reintroduce instability into the U.S. financial system? This question presumes that universal banks were harmful to the financial system in the 1930s.

The Glass-Steagall Act of 1933 separated commercial banking from investment banking because of the perception that organizations commingling these activities harmed public investors and contributed to the banking crisis during the Great Depression. Two related arguments were advanced by Sen. Carter Glass, D-Va., and others in the early 1930s to separate commercial and investment banking.

First, universal banking creates significant conflicts of interest within the firm—conflicts that potentially harm investors. Suppose a bank has a loan outstanding to a corporate customer, and the bank—but not the public—knows that the creditworthiness of the customer is deteriorating. The universal bank has an incentive to repackage the loans into securities and misrepresent the quality of the securities to the unsuspecting public. Alternatively, investment analysts of the universal bank might provide overly optimistic assessments of a firm's earnings potential if the bank also has a lending relationship with the firm.

Second, the volatile investment banking business could contribute to banking instability by draining the commercial bank's capital or by harming the bank through reputational risk. The investment bank might take even more risk, knowing that the bank would bail it out if the business soured.

But recent research disputes these perceptions.

If universal banks exploit their information advantage to underwrite corporate securities so that the corporation can pay off a high-risk bank loan, then securities underwritten by universal banks should be riskier and have higher defaults than securities issued by stand-alone investment banks. The evidence from the 1930s suggests the opposite to be true.¹

The evidence also refutes the notion that universal banks fostered banking instability.² In fact, banks that had investment banking affiliates were less likely to fail in the 1930s than banks without such affiliates. In addition, investment bank affiliates did not drain equity from commercial banks.

Finally, commercial bank earnings and investment bank earnings were not highly correlated, suggesting that universal banks may have had more stable earnings than stand-alone banks.

That universal banks did not contribute negatively to the 1930s banking crisis is not proof that they are a good idea today. The conflicts of interest and potential for financial instability still remain. Indeed, JPMorgan Chase and Citigroup—banking organizations that had exemptions to engage in limited investment banking before passage of the Gramm-Leach-Bliley Act—recently paid fines over their alleged role in fueling the Enron boom and bust.³ One of the charges was that they used creative bank financing to lend to Enron to court more investment banking business. Another charge was that analysts at the banks were promoting Enron to investors even when the analysts knew the firm was financially unsound.

Despite the potential for abuse from universal banking, today's financial environment is much more tightly regulated than the pre-Depression financial environment. The Securities Act of 1933 requires corporations to register their securities with the Securities and Exchange Commission. Investors can be better informed, which helps them to make better investment decisions. One study documents the reduction in the variance of investor returns following implementation of the Securities Act.⁴

Bank regulation has also improved. The introduction of federal deposit insurance came with mandated safety and soundness examinations. Examiners can limit capital distributions from a troubled bank and force recapitalization if necessary. In addition, affiliate transactions must be done at arm's length. In other words, a commercial bank cannot give lending terms to its affiliates that are better than others could get in a competitive market. These changes limit the ability of a troubled investment banking affiliate to drain equity from the commercial bank.

Given that universal banks contributed little to the 1930s banking crisis and that stronger regulations are in place to prevent abuse, the return of universal banking in the United States is unlikely to contribute to financial instability.

assets jumps by 13 basis points. However, the increase in noninterest income is offset by an even larger increase in noninterest (or overhead) expense. Noninterest expense to average assets surges by 21 basis points. In addition, provision expense—the income set aside to cover future credit losses—increases by nine basis points. Overall profitability, then, as measured by return on assets, slips by nine basis points to 1.19 percent, and return on equity drops by 114 basis points due to the drop in net income and the increase in equity. Only about half of the income ratio changes are statistically significant.

Do the FHCs gain cost advantages relative to BHCs? The increase in noninterest expense noted above suggests that the answer is “no,” and another measure—the efficiency ratio—confirms this result. The efficiency ratio is calculated as overhead costs divided by operating income. Intuitively, the efficiency ratio shows how much overhead the organization spends to earn \$1 in operating income. Lower values signal better cost efficiency. The average BHC between 1996 and 2003 had an efficiency ratio of 62.6 percent, suggesting that it took 63 cents in expenditures to yield a dollar in operating income. Three years after becoming an FHC, however, that ratio increased to 64.3 percent. In other words, FHCs were less cost-efficient than they were as BHCs. To be sure, part of the increase in costs may reflect one-time expenditures to acquire and absorb investment banking and insurance units into the organization. In the short run, however, FHCs did not gain a cost advantage over BHCs.

Are the Section 20 Banks Different?

As the article on Page 7 notes, Section 20 of the Glass-Steagall Act allowed the Federal Reserve to grant permission to select banking organizations to conduct limited investment banking activities prior to passage of the Gramm-Leach-Bliley Act. Some organizations began underwriting previously ineligible debt and equity issues as early as 1986. It could be the case that only those firms with previous securities activities (through Section 20 exemptions) were in a position to take immediate advantage of the new universal banking powers granted in the Gramm-Leach-Bliley Act. If so, a separate analysis of the so-called Section 20 FHCs—FHCs that had Section 20 affiliates before passage of the act—may reveal synergies between investment banking and commercial banking that are absent in other FHCs.

Indeed, such an analysis shows that three years after becoming Section 20

TABLE 2	Before becoming an FHC, the average Section 20 BHC had these ratios:	Three years after becoming an FHC, the average Section 20 FHC would have these ratios:
The Section 20 FHC Metamorphosis		
Balance sheet ratios (percent of total assets)		
Loans	60.30	52.10
Securities	18.10	22.30
Deposits	64.00	65.50
Equity	7.75	8.43
Income ratios (percent of average assets)		
Interest income	7.04	6.66
Interest expense	3.49	3.21
Net interest income	3.55	3.45
Noninterest income	2.77	3.00
Noninterest expense	3.89	4.06
Provision expense	0.36	0.49
Net income (ROA)	1.38	1.24
Return on equity	17.38	14.91
Performance ratios (percent)		
Efficiency ratio	61.80	63.20
NOTE: Ratios in bold indicate statistically significant changes.		

FHCs, the organizations sharply reduce their loan holdings by 8.2 percentage points and they increase securities holdings by 4.2 percentage points. In addition, the ratio of equity to assets increases by 68 basis points. All of these changes, which can be seen in Table 2 above, are statistically significant.

Despite the balance sheet changes, there is little evidence to support profit or cost advantages for Section 20 FHCs. Interest income decreases by 38 basis points, although noninterest income increases by just 23 basis points. Return on assets is 14 basis points lower for Section 20 FHCs than for Section 20 BHCs, and return on equity dips by nearly 2.5 percentage points. Finally, the efficiency ratio at Section 20 FHCs is a statistically insignificant 140 basis points higher than the ratio at Section 20 BHCs, suggesting that the Section 20 FHCs did not experience cost advantages after becoming FHCs.

In sum, the effects of the Gramm-Leach-Bliley Act on Section 20 FHCs are modest, but certainly larger than the effects on other FHCs. Although Section 20 FHCs do not appear to be more profitable or cost effective than other FHCs, the former do appear to be repositioning themselves to exploit presumed synergies between investment banking and commercial banking.

Some anecdotal evidence indicates that these synergies are developing. A recent *New York Times* article documented the relative decline of two stand-alone investment banks—Merrill Lynch and Morgan Stanley—relative to the investment banks that are part of banking organizations such as Citigroup and JPMorgan Chase.⁵ An integrated investment bank is able to provide its customers with a broad range of services that stand-alone investment banks cannot match.

Whether Gramm-Leach-Bliley will affect the viability of the stand-alone investment bank in the long run is not clear. What is clear is that the act to date has not caused a financial revolution; rather, it has contributed to the deregulation of financial markets and institutions within the United States with remarkably little impact.

Conclusion

One justification for the Gramm-Leach-Bliley Act of 1999 was to provide new opportunities to financial institutions to exploit revenue opportunities and cost savings by becoming universal banks. We fail to find evidence, however, that FHCs were able to capture significant and immediate benefits from this legislation.

These results should not be construed as evidence that the act was a step in the wrong direction. Rather, the act is a further step in the evolutionary process of financial deregulation that gives financial institutions more flexibility to adapt to their global environment. Indeed, our results are consistent with the view of Philadelphia Fed President Anthony Santomero, who wrote in 2001 that financial modernization is not a single event or law, but rather a relentless process of eroding the constraints placed on the financial marketplace during the Great Depression. Perhaps the short-run synergies between commercial banking, investment banking and insurance are modest, but the long-term synergies may be much larger.

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ENDNOTES

- 1 See Anason (1999) and Zaretsky (2000).
- 2 This article summarizes research by Yeager et al. (2005). Refer to the full paper for more details.
- 3 Although FHCs are technically also BHCs, we treat these groups as mutually exclusive. The data include all top-tier domestic banking organizations that file the Federal Reserve's FR Y-9C—the Consolidated Financial Statements for Bank Holding Companies. By including only top-tier organizations, we avoid double counting parent companies and their subsidiaries. Mandatory Y-9C reporters include all domestic BHCs and FHCs with total consolidated assets of at least \$150 million. Smaller organizations are omitted from this sample.
- 4 The statistical technique employed is a fixed-effects panel regression.
- 5 See Thomas (2004). The animation studio DreamWorks proved a specific example of how JPMorgan Chase was able to use its bank relationship with the firm to win the investment banking business.

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¹ See Kroszner and Rajan (1994) and Ang and Richardson (1994).

² See White (1986).

³ See McLean and Elkind (2003).

⁴ See Simon (1989).