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

By Ellen Harshman, Fred C. Yeager and Timothy J. Yeager

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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. 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.

Five Years After Gramm-Leach-Bliley, Financial Holding Companies Are Few in Number, Big in Size

A more direct approach to observing the effects of Gramm-Leach-Bliley on financial institutions is to measure changes to a bank’s asset mix 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.

TABLE 1

<table>
<thead>
<tr>
<th>The FHC Metamorphosis</th>
<th>Before becoming an FHC, the average FHC would have these ratios</th>
<th>Three years after becoming an FHC, the average FHC would have these ratios</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance sheet ratios (percent of total assets)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loans</td>
<td>58.90</td>
<td>51.30</td>
</tr>
<tr>
<td>Securities</td>
<td>37.60</td>
<td>25.30</td>
</tr>
<tr>
<td>Deposits</td>
<td>80.60</td>
<td>82.50</td>
</tr>
<tr>
<td>Equity</td>
<td>9.59</td>
<td>8.92</td>
</tr>
<tr>
<td>Income ratios (percent of average assets)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest income</td>
<td>7.61</td>
<td>3.87</td>
</tr>
<tr>
<td>Interest expense</td>
<td>7.46</td>
<td>11.73</td>
</tr>
<tr>
<td>Net interest income</td>
<td>4.07</td>
<td>1.74</td>
</tr>
<tr>
<td>Noninterest income</td>
<td>1.56</td>
<td>2.74</td>
</tr>
<tr>
<td>Noninterest expense</td>
<td>2.30</td>
<td>3.22</td>
</tr>
<tr>
<td>Provision for loan loss</td>
<td>1.00</td>
<td>1.12</td>
</tr>
<tr>
<td>Net income (ROA)</td>
<td>0.23</td>
<td>0.32</td>
</tr>
<tr>
<td>Return on equity</td>
<td>13.12</td>
<td>12.78</td>
</tr>
<tr>
<td>Performance ratios (percent)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Efficiency ratio</td>
<td>64.30</td>
<td>44.60</td>
</tr>
</tbody>
</table>

NOTES: Series 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 likely 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. 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 activities. The largest and most active 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 a legal 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 previously 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 JP Morgan 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 MetLife. It had already sold its property and casualty business in 2002. Citigroup’s rationale is that the capital it 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

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 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. In addition, several studies argued that securities activities of commercial banks were not significant factors leading to the banking crises during the Great Depression.5 (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 not necessarily a factor in the issue, floatation, underwriting, public sale or distribution of financial assets.6 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 Glass-Steagall-Billy Act 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.

See, for example, Benson (1972); McKenzie (1974); White (1984); Ang and Richardson (1994a); Kroszner and Rajan (1994).
Will the re-emergence of universal banking threaten the banks' bottom line?

Re-emergence of Universal Banking

The re-emergence of universal banking is a concern for banks because the combination of financial services that universal banks offer may make it more difficult for banks to compete.

Will the re-emergence of universal banking under the Gramm-Leach-Bliley Act harm investors and reintroduce instability into the U.S. financial system?

The Gramm-Leach-Bliley Act of 1999 allowed for the re-emergence of universal banking in the U.S. This legislation has been criticized for allowing banks to engage in a range of financial activities that were previously prohibited, which has led to concerns about increased systemic risk.

Will the re-emergence of universal banking under the Glass-Steagall Act harm investors and reintroduce instability into the U.S. financial system?

The Glass-Steagall Act of 1933 banned commercial banks from engaging in investment banking activities, which was seen as a way to prevent conflicts of interest and rein in the making of risky financial products.

The evidence from the 1930s suggests that universal banking can be risky.

The evidence also refutes the notion that universal banking fosters instability.

In fact, banks that had investment banking affiliations were less likely to fail in the 1930s than banks without such affiliations.

In addition, investment bank affiliate failures 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, the Morgan Chase and Citigroup—banking organizations that have engaged in limited investment banking prior to the passage of the Glass-Steagall Act—recently paid fines over their alleged role in fueling the Enron boom and bust.

The changes were that they used creative bank subsidiaries to engage in investment banking.

Another charge was that the banks were promoting Enron to investors even when the analysts knew the firm was financially unsound.

Despite the potential benefits to today's financial environment, universal banking is much more tightly regulated than the pre-Glass-Steagall 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 financial decisions.

One study documents the reduction in the variance of investor returns following implementation of the Securities Act.

Bank regulation has also improved.

The introduction of federal deposit insurance came with various checks and balances, ensuring that the system was more stable.

Universal banks, however, can engage in a broader range of financial activities than stand-alone banks.

The combination of financial services that universal banks offer may make it more difficult for banks to compete.

Will the re-emergence of universal banking under the Gramm-Leach-Bliley Act harm investors and reintroduce instability into the U.S. financial system?

The evidence from the 1930s underwritten by universal banks should be riskier and have higher defaults than might provide overly optimistic assessments of a firm's earning potential if the bank repackage the loans into securities and misrepresent the quality of the securities.

The universal bank has an incentive and others in the early 1930s to separate commercial and investment banking.

Harmed public investors and contributed to the banking crisis during the Great Banking because of the perception that organizations commingling these activities

Bank regulation has also improved. The introduction of federal deposit insurance

Point: If so, a separate bank subsidiary may be preferable.

A separate bank subsidiary may have fewer incentives to engage in the kinds of risky activities that contribute to the failure of universal banks.

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 effective than other FHCs, the former do appear to be repositioning themselves to exploit preshared synergies between investment banking and commercial banking.

The anecdotal evidence indicates that these synergies became even more pronounced since the recent New York Times article documented the relative decline of two stand-alone investment banks—Lennich and Morgan Stanley—relative to the investment banks that are part of banking organizations such as Citigroup and JPMorgan Chase.

The separated investment bank is able to provide its customers with a broader 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 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 insurers are modest, but the long-term synergies may be much larger.