REUNITING INVESTMENT AND COMMERCIAL BANKING

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Papers on the Glass-Steagall Act are difficult to write these days. Most economists who have examined the effects of the act have concluded that it has unwisely protected investment banks from competition and has been unnecessary to prevent banks from undertaking excessive risk. The legal profession, meanwhile, has created virtually a cottage industry in the discovery and exploitation of loopholes in the act that render its intended restrictions less and less relevant to the marketplace.

The key question, therefore, is not whether investment and commercial banking should be fully reunited, but how quickly and under what circumstances this marriage in activities will be permitted to occur. If history is any guide, Glass-Steagall will not be removed all at once but rather will continue to be eroded piecemeal, through liberalized interpretations by federal regulators and affirmative expansions of powers of state-chartered banks by state legislatures. Although the ultimate outcome of this process will be desirable—at some point, commercial and investment banking will be reunited—the process itself is less than ideal. During the transition, the economy will not only lose the benefits of unrestrained competition between commercial and investment banks, but the American financial industry as a whole will lose business to foreign competitors in markets abroad where commercial and investment banking are already combined.

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I believe there is a way to accelerate removal of the Glass-Steagall restrictions. It lies in constructing a framework for allowing all types of financial organizations to diversify their activities without jeopardizing the deposit insurance system, and thus without running afoul of the key objections to financial product diversification that many opponents have raised. In this framework, firms that wish to own an insured depository may engage in any other kind of activity provided they confine the activities of the insured institution to accepting deposits and investing them only in liquid, safe securities. This approach is outlined briefly at the conclusion of this paper.

The Steady Erosion of the Glass-Steagall Restrictions

The principal objective of the sponsors of the Glass-Steagall Act, of course, was to sever ties between commercial and investment banks that, at the time, were believed to have contributed to the rash of bank failures experienced during the Depression. Several provisions of the act were instrumental. Sections 16 and 20 prohibited national and state-chartered banks belonging to the Federal Reserve System from underwriting corporate debt and equity securities. Similarly, section 21 made it unlawful for any entity underwriting the prohibited securities to accept deposits. And section 32 prohibited officer, director, or employee interlocks between member banks and securities underwriters.

What is not widely known—outside the legal establishment that specializes in the subject—is that by unwitting omission or design, the Glass-Steagall Act left open numerous ways in which banks could nevertheless participate in various facets of the securities business. Perhaps the longest recognized exception to the act's restrictions is the fact that the act does not bar banks from underwriting debt instruments of the federal government and general obligation bonds issued by states and municipalities.[1] Similarly, the prohibition on bank underwriting of corporate securities does not extend to securities issued abroad.[2] As a result, banks have become major underwriters in both permissible arenas.[3]

[1]The Housing and Urban Development Act of 1968 also enabled commercial banks to underwrite municipal revenue bonds used for housing, dormitory, and university purposes.

[2]The Federal Reserve Board, however, does limit American bank holding companies to $2 million in uncovered commitments of corporate equities in foreign securities markets. But the Board does not restrict corporate bond underwriting in foreign markets by bank holding companies.

[3]Banks currently underwrite about half of the total volume of general obligation municipal bonds. See Kaufman (1985).

In recent years, bank interest in exploiting other cracks in the Glass-Steagall edifice has grown, particularly as securities houses have found ingenious ways to engage in banking.[4] In 1982 and 1983, the Comptroller of the Currency and the Federal Reserve Board approved bank entry into discount securities brokerage, or the execution of securities trades without the provision of investment advice.[5] Today, over 2,000 banking organizations offer discount brokerage services.

The spirit of Glass-Steagall was frontally assaulted in 1986 by several events. Among the most controversial was the Federal Reserve Board's approval of the purchase of a limited-partnership interest in one of America's leading private investment banks, Goldman Sachs, by one of the largest banks in the world, Sumitomo Bank of Japan.[6] Although foreign banks had already acquired minority ownership interests in two other leading American investment banking houses (First Boston; and Drexel, Burnham & Lambert), Sumitomo's application sparked considerable interest, given both the size of the commercial bank itself and the fact that the bank was headquartered in Japan.

The Federal Reserve Board also signed off during 1986 on a plan effectively allowing bank entry into the mutual fund business, an activity otherwise long off-limits to banks under Glass-Steagall.[7] To circumvent the act's underwriting restrictions, the commercial bank applicant (Bank of America) proposed that its discount brokerage subsidiary (Charles Schwab) would sell its customer list to an invest-

[4]The two most prominent routes through which nonbanking firms have entered banking are by opening limited service (or "nonbank") banks and by owning and operating a single savings and loan. Under the first device, an organization may escape regulation as a bank holding company by operating an insured depository that only extends consumer (but not commercial) loans. The second device allows organizations that own a single thrift to escape the activity limitations imposed by the Savings and Loan Holding Company Act amendments.

[5]Both these decisions were upheld by the courts against challenge by the Securities Industry Association. See Securities Industry Association v. Comptroller of the Currency, FED. BANKING L. REP. (CCH) Par. 99,732 (September 23, 1983); and Securities Industry Association v. Board of Governors of the Federal Reserve System, 716 F.2d 92 (2d Cir. 1983), *aff'd,* 104 S.Ct. 1905 (1984).

[6]The purchase was effected through Sumitomo's American bank holding company headquartered in the United States. Although the Bank Holding Company Act permits bank holding companies to own no more than 5 percent of the voting securities of enterprises engaged in impermissible nonbank activities, the Federal Reserve Board approved Sumitomo's application, which proposed the acquisition of only a passive ownership interest in Goldman Sachs.

[7]Indeed, the Supreme Court's leading decision on the scope of the Glass-Steagall Act, Investment Company Institute v. Camp, 401 U.S. 617 (1971), reaffirmed the act's prohibition against bank offerings of mutual fund shares.

ment bank (Lazard Frères), which would market the mutual fund shares and inform potential customers that they could be bought through the discount brokerage affiliate of the commercial bank.

Perhaps the most significant blow to defenders of the Glass-Steagall restrictions in 1986, however, came in the last days of the year when a federal appellate court upheld a Federal Reserve ruling that banks were not prohibited under the act from privately placing commercial paper on behalf of corporate issuers.[8] This is a highly significant decision because major money center banks in recent years have lost many of their prime-quality corporate borrowers to the commercial paper market, which thus far has been dominated by investment banks. In 1975, for example, the nine largest money center banks extended 25 percent of all short- and intermediate-term commercial credit in the United States. By 1985, the money center share had fallen to just 15 percent. To compensate for the erosion in their competitive position in this market, banks have been forced to lend to borrowers with higher credit risks. The new court ruling allowing bank entry into commercial paper placement should enable at least some banks to reverse this trend.

Finally, the Federal Reserve Board issued a ruling in April 1987 that could punch the largest hole yet in the wall that Glass-Steagall was supposed to have erected between commercial and investment banking. The Board approved applications by Citicorp, J. P. Morgan, and Bankers Trust for permission to underwrite commercial paper, mortgage-backed securities, municipal revenue bonds, and securities backed by consumer installment debt (automobile loans and credit card receivables) through separate subsidiaries "not principally engaged" in these underwriting activities.[9] The "not principally engaged" exception was written into the Glass-Steagall Act, and the Federal Reserve Board is now in the process of more fully clarifying its meaning. The courts will have an opportunity to rule

[8]See Securities Industry Association, v. Board of Governors of the Federal Reserve System, slip. op. (D.C. Cir., December 23, 1986). Technically, this decision did not permit banks to underwrite commercial paper, that is, to purchase the securities and then resell them. Rather, the decision approved the narrow activity of banks placing commercial paper with ultimate purchasers for a fee without actually taking title to the securities.

[9]Significantly, the superintendent of banking for the State of New York issued a ruling in the closing days of 1986 permitting state-chartered banks in that state to underwrite otherwise impermissible corporate securities (as well as mortgage-backed securities, obligations backed by consumer receivables, and commercial paper) through separate subsidiaries of the banks, provided the underwriting of the otherwise impermissible securities constitutes no more than 25 percent of the affiliate's total underwriting activities.

on the Fed's actions because the Securities Industry Association has already challenged the new regulation in federal court.

If Glass-Steagall contains as many exceptions as it now appears, why has it taken banks so long to exploit them? A major reason, as already noted, is that not until recently have banks faced significant competition from nonbanking firms, particularly those engaged in securities brokerage and underwriting. With the advent of asset management accounts pioneered by Merrill Lynch, many securities firms now offer a full range of depository services in direct competition with banks. Not surprisingly, banks have attempted to counter the new competition by maneuvering through every loophole that Glass-Steagall permits and that the courts uphold.

Nevertheless, until the act is actually repealed, banks will continue to face some important barriers in competing with investment banks. For example, even though the Federal Reserve has allowed bank holding companies to underwrite various securities through separate subsidiaries, the "not principally engaged" limitation of the act will still impose costs on banking organizations that investment banks do not bear. More importantly, standard corporate debt and equity issues remain off-limits to bank underwriting affiliates, at least until the Federal Reserve broadens the "not principally engaged" exception to cover them as well. In short, while Glass-Steagall may continue to be construed by federal authorities in a progressively liberal fashion, the transition will be time-consuming and costly, both for banks seeking to engage in the broad spectrum of investment-banking activities and for society generally, which must continue to wait for the full benefits of unrestricted competition to materialize.

Benefits of Commercial Bank Entry into Investment Banking

Unrestricted bank entry into all facets of investment banking would prove to be socially beneficial primarily because it would strengthen competition in an industry that at present is imperfectly competitive in terms of a number of measures.

First, profits in investment banking outdistance those of all other financial services providers, including commercial banks. Between 1975 and 1984, securities underwriters as a group earned an after-tax return on equity (ROE) of 16.2 percent. Profits were even higher at the 10 largest investment banks, which recorded an after-tax ROE of 21.5 percent. By comparison, commercial banks during the 1975–84 period had an after-tax ROE of just 12.3 percent.[10]

[10]To be sure, investment bank earnings were more variable over this period than those

Second, as high as the profits among securities underwriters are, they conceal the high salaries and profit-sharing draws that investment banks pay their personnel, a fact consistent with the tendency of firms in imperfectly competitive markets to incur excessive costs. In the United States in 1985, for example, 5 of the top 25 highest paid executives at publicly held corporations were officers of investment banks (*Business Week* 1986, p. 49). That same year, personnel costs for the 10 leading investment banking firms averaged over $100,000 per employee, compared with approximately $50,000 for the two leading wholesale commercial banks (Bankers Trust and Morgan Guaranty), and $33,800 for all 12 money center banks.[11] Bank entry into the full range of securities activities would compress these differentials in personnel costs because it would reduce profits earned by investment banks as well as permit personnel now employed by commercial banking organizations to be involved in a broader range of investment banking activities.[12]

High profits and salaries, of course, do not mean that an industry is necessarily imperfectly competitive. If entry is relatively free—that is, if the market is "contestable"—excess profits will be driven down as new competitors arrive on the scene.[13] Precisely because of the Glass-Steagall restrictions, however, entry by commercial banks into investment banking is not costless, and in areas such as corporate securities underwriting, it is not even possible. Yet, in the absence of these restrictions, commercial banking organizations would be highly likely entrants into a broad range of investment banking activities. The skills used to evaluate credit risk in extending bank loans, for example, are readily transferable to underwriting securities. Simi-

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of commercial banks. Still, the average ROE of the 10 largest investment banks stood at more than one standard deviation (7.7 percent) above the average bank ROE between 1975 and 1984. The data for all these profit calculations come from the annual editions of the *Securities Industry Association Yearbook* and the *Statistical Abstract of the United States*.

[11]Securities industry data are drawn from Securities Industry Association research reports. Banking industry data are drawn from Salomon Brothers (1986, p. 74).

[12]It is true, of course, that commercial banks now find it difficult to attract high-quality personnel from investment banks without paying the kind of six—and even seven—figure salaries these individuals now earn at investment banks. However, commercial banks are competing in a market in which investment banks still are protected from competition by the Glass-Steagall Act. If that protection were removed, the added competition should reduce profits from investment banking activities. This, in turn, would reduce the marginal revenue product generated by personnel employed by investment banks, which would cause salaries and profit shares to fall.

[13]The new literature on "contestability" demonstrates that even in a concentrated industry, market participants will behave competitively, provided entry is unrestricted. See Baumol et al. (1982).

larly, banks have networks of relationships with other financial institutions, as well as their own customers, that they can easily use to market securities. Finally, banks already trade government securities and, as discussed below, underwrite certain government obligations domestically, as well as a wide range of corporate securities abroad.

The anticompetitive effects of Glass-Steagall are clearly demonstrated by the fact that concentration levels are considerably lower in underwriting markets in which banks are permitted to participate than in the markets from which banks are excluded. As shown in Table 1, the top five investment banks in 1985 were lead managers for 70 percent of U.S. corporate securities sold in that year (up from 54 percent as recently as 1982) and for 96 percent of all commercial paper placed through dealers. As already noted, banks are effectively prohibited by Glass-Steagall from underwriting in either of these markets. In contrast, five firm concentration ratios in the Eurobond market, in which banks are permitted to participate, have been substantially lower, on the order of 33 to 41 percent. Similarly, the figures in Table 1 illustrate that in the United States, concentration levels have been far lower for underwritings of general obligation municipal bonds, which banks are allowed to underwrite, than for new issues of municipal revenue bonds, which remain off-limits to banks.

Collectively, the foregoing evidence suggests that added competition in investment banking would produce lower fees in each of the securities markets and in other investment banking activities that would be opened to new entry.

Revenue Bonds

Numerous studies have examined the potential benefits of bank underwriting of municipal revenue bonds by comparing underwriting spreads and fees in that market with those for underwritings of state and municipal general obligation bonds. For example, William Silber (1979) reported that all 12 of the studies that had addressed the issue up to that time had found underwriting costs in the municipal revenue bond market exceeded costs in the market for general obligation securities by 7 to 13 basis points. In 1979 that translated into $150 to $300 million in added costs to issuers of those securities. More recent studies making the same comparison come to similar conclusions (Pugel and White 1985, pp. 128–35).

Corporate Securities

It is unclear whether the competitive benefits of permitting bank entry into the underwriting of corporate securities would be of the

TABLE 1

MEASURES OF SECURITIES UNDERWRITING CONCENTRATION IN THE U.S. AND EUROPEAN SECURITIES MARKETS

	1980	1981	1982	1983	1984	1985
Markets In Which Banks May Not Underwrite Securities						
U.S. Corporate Securities[a]						
Top 5	59	64	54	56	71	70
Top 10	83	84	71	79	91	91
Municipal and State Revenue Bonds[b]						
Top 4	23	27	27	27	N/A	N/A
Top 10	43	50	50	49	N/A	N/A
Dealer-Placed Commercial Paper[d]						
Top 5	N/A	N/A	99	99	98	96
Markets In Which Banks May Underwrite Securities						
Eurobonds[c]						
Top 5	33	37	41	N/A	N/A	N/A
Top 10	47	52	57	N/A	N/A	N/A
Municipal and State General Obligations[b]						
Top 4	15	14	14	18	N/A	N/A
Top 10	31	29	29	32	N/A	N/A

N/A = Not available.
Note: Concentration data based on dollar volume of lead managers for securities offerings.
[a]Federal Reserve Bank of New York, *Recent Trends in Commercial Bank Profitability*, p. 364.
[b]Public Securities Association, *Statistical Yearbook of Municipal Finance: The New Issue Market* (1980–83 editions).
[c]Levich (1985, p. 273).
[d]Data supplied by the Federal Reserve Board.

same order of magnitude as the benefits estimated for bank underwritings of revenue bonds.

On the one hand, the fact that concentration is even higher in the market for corporate securities issues than it is for municipal and state revenue bonds would suggest that the potential benefits of bank entry into the corporate securities field would be even greater than

those that have been estimated for the state and municipal bond market. On the other hand, competition among corporate securities underwriters appears to have intensified in recent years, despite the increase in market concentration, which suggests that less room is available for improvement. The new factor is Rule 415, introduced in 1982 by the Securities and Exchange Commission (SEC), which permits a company to register all securities of a particular type that the firm reasonably expects to issue over a two-year period. By allowing issuers to pull securities "off the shelf," Rule 415 dramatically reduces the time required to complete an underwriting. Although this provision has given larger investment bankers, which have the capabilities to perform "due diligence" reviews and to purchase entire issues on short notice, an advantage over their smaller competitors, Rule 415 has also made each security more of a "commodity" and thus has intensified competition among underwriters for business. Knowing the volumes of securities on the shelf, investment banks now actively solicit issuers for business, while issuers themselves appear more willing to shop around—tendencies that lead to more competitive bidding (Pugel and White 1985). Studies by the SEC confirm that, on balance, Rule 415 has had a procompetitive effect, lowering spreads on equity issues by roughly 1 percent and spreads on bonds by approximately 30 to 40 basis points (Pugel and White 1985, p. 122).

Nevertheless, opportunities for lowering corporate securities underwriting spreads should remain. The competition is more vigorous among underwriters in the Euromarkets, in which banks are permitted to engage in investment banking, than it is in our own corporate securities markets, providing evidence that permitting bank entry here would strengthen competition.

Merger Advisory Services

Relaxing the Glass-Steagall restrictions against bank underwriting of corporate securities should also benefit corporate customers of advisory services now offered primarily by investment banks. As it is, securities underwriting makes up only a small portion of total revenues generated by investment banks. A far more sizable proportion of investment bank earnings arises out of advisory fees, particularly those collected in connection with mergers and acquisitions.[14]

[14]For example, of the $10 billion in revenues earned by the 10 largest investment banks in 1984, $6 billion originated from activities other than trading and underwriting; indeed, underwriting accounted for only $734 million, or little more than 7 percent of total revenues. Of all national full-line securities firms, only $1.5 billion of $13.1 billion in 1984 revenue was generated by underwriting activities. See Staff of the Federal Reserve Bank of New York 1986, p. 354.

It is true that the Glass-Steagall Act does not currently bar commercial banks from offering advisory services in competition with investment banks. However, firms allowed to offer both underwriting and advisory services simultaneously have a strong competitive advantage because many mergers and acquisitions require financing through additional securities offerings to the public, whether through debt or equity. The rapid rise of Drexel, Burnham & Lambert to the upper echelons of the investment banking elite, for example, was made possible by the marriage of that firm's merger and acquisition (M&A) advisory talent with its extraordinary ability to place sub-investment-grade securities (or "junk bonds") with investors. Because of the Glass-Steagall Act, however, banks face a severe disadvantage in competing for M&A business because they cannot underwrite securities and may be unwilling or unable to extend loans in the volumes required to complete the necessary financing.[15] Without this disadvantage, certain banks with extensive networks of customer relationships that they could use to market or place securities should be able to provide strong and effective competition for investment banks, and thus bring down advisory fees.

Effects on the U.S. Financial Services Industry

Finally, the early relaxation of the Glass-Steagall restrictions would have another not widely recognized benefit. As discussed further below, recent liberalizations in Great Britain have enabled large foreign banks to affiliate with securities firms headquartered in London and thus to underwrite securities in the London market. As competition for underwritings in London intensifies—and, in particular, as it lowers underwriting spreads—American borrowers should increasingly turn to offering their securities through underwriters operating in Great Britain rather than in New York. This would accelerate a trend that has already materialized toward Euromarket financings by American corporations.[16] Although some of this business will go to London-based securities affiliates of American banking organizations, a good portion can be expected to go to foreign

[15]It is not surprising, therefore, that between 1981 and 1984, banks participated as advisers in only 5 of the largest 100 merger transactions during a period of intensive merger activity (Staff of the Federal Reserve Bank of New York, p. 321).

[16]The limited evidence available indicates that in the recent past, underwriting spreads have been higher in the Eurobond market than in the United States, primarily because it has been essential for Eurobond underwriters to gain the participation of Continental banks (see Levich 1985, p. 277). However, with the entry of major American and Japanese banks into the Eurobond market through British securities subsidiaries, additional competition should bring down underwriting costs in the European securities markets.

financial organizations, particularly Japanese-owned financial institutions, which are now dominant in the world market and deeply involved in banking and securities activities in London.

Securities business that is lost to foreign competitors, of course, reduces income flows earned by American banking securities firms. Moreover, foreign-owned underwriters will inevitably want to leverage their ability to market the securities of American corporate issuers into capturing other banking and financial business of their corporate customers as well, thereby posing the threat of greater losses in market share for American-based financial institutions. Therefore, the sooner American banking organizations are allowed to compete in an unrestricted fashion in corporate securities underwriting activites in the United States, the more quickly this expected outflow of financial services jobs and income will be halted. Indeed, employment by foreign banks and securities houses operating in London jumped by over 11,000, or 26 percent, in 1986 alone, the largest single-year increase in the last two decades (Blanden 1986, p. 69). Citicorp already has 4,500 employees in Great Britain, Chase Manhattan has more than 2,000, and Security Pacific has more than 1,000 (*American Banker* 1986, p. 19). It is safe to say that many of these employees would be working in the United States rather than abroad if Glass-Steagall were repealed.

Risks of Combining Commercial and Investment Banking

Glass-Steagall was enacted—and has since been defended—primarily to protect banks against excessive risk. Banks, it has been said, would be able to exploit conflicts of interest if they were permitted to underwrite corporate securities, thereby threatening bank soundness and exposing securities customers to potential harm. In addition, securities underwriting itself has been alleged to be inherently too risky for banks to undertake. Finally, it has been argued that depositors' confidence in even a healthy bank could be undermined by bad news from affiliates of the same holding company. Each of these arguments will be discussed in turn below.

Conflicts of Interest

Recent research has cast a much different light on the conflict-of-interest argument than appeared at the time Glass-Steagall was adopted (Walter 1985). Much of the discussion about conflicts before the act was passed was conducted in hypothetical terms, centering on charges that affiliations between commercial banks "might" lead to the fol-

lowing practices: bank lending to securities purchasers to support buying of securities sold by the underwriting affiliate; bank lending to support issuers of securities underwritten by the affiliate; placement by banks of securities offered by the underwriting affiliate in bank trust accounts; and promotion by money center banks affiliated with underwriters of poor quality securities to correspondent banks.

Although congressional committees investigated these subjects before the Glass-Steagall Act was passed, the hearings centered on only a few banks and produced no evidence of large-scale, industry-wide abuse. In fact, Congress had rejected earlier variations of Glass-Steagall in previous sessions but was finally energized to take action in 1933 by the emergency atmosphere surrounding the bank holiday and by the disclosure that several leading bankers had evaded income taxes by failing to report substantial sums as income.

To be sure, many securities firms engaged in abusive practices during the 1930s, but these problems were hardly attributable to the securities-underwriting activities of banks. Congress addressed these evils in the Securities Act of 1933 and the Securities Exchange Act of 1934 by imposing strict disclosure and registration requirements on all securities firms. Recently, the Federal Deposit Insurance Corporation (FDIC) has added supplemental protection aimed specifically at the securities-underwriting affiliates of state-chartered banks, as discussed below.

Finally, and perhaps most important, banks are already actively engaged in the underwriting of corporate securities in Europe, where securities trading generally is subject to a less intensive regime of regulation than in the United States. Yet there is no evidence that banks have exploited conflicts of interest in that market (Levich 1985).

The Inherent Risks of Underwriting

The second argument supporting Glass-Steagall—that securities underwriting is inherently too risky for banks to undertake—is also flawed. In fact, the underwriting of corporate securities probably involves less risk than extending and holding loans. In a typical securities offering, the underwriter bears the risk of loss for only a few days, whereas a commercial bank bears the risk of a loan default until the loan is due. In addition, by definition, the underwriter deals in assets that are liquid and readily traded; despite the progressive securitization of commercial bank balance sheets, most bank loans remain illiquid because of their borrower-specific characteristics. Moreover, it is ironic that recent research has demonstrated that if anything, the risks of corporate securities underwriting are lower

than for other types of securities that banks are already permitted to underwrite under exceptions written into Glass-Steagall (Giddy 1985; Saunders 1985).

In any event, as Ely (1988) discusses in a companion paper in this volume, it simply cannot be shown that bank affiliations with securities underwriting operations in the 1920s and 1930s were responsible for the rash of bank failures during the Depression. Less than 600 of the nation's 27,000 banks in 1930 were engaged in securities underwriting, yet 9,000 banks closed their doors between 1930 and 1933 (Peach 1940). Significantly, neither of the money center banks singled out for underwriting abuses in the congressional hearings held prior to the enactment of Glass-Steagall—Chase Manhattan and National City Bank (predecessor of Citibank)—failed.

Affiliation Risk

Although each of the most frequently mentioned risks of permitting banks to underwrite corporate securities is overstated, one risk cannot be dismissed. As discussed earlier, securities underwriting provides only a small portion of the revenues generated by investment banks. Among other activities related to underwriting, investment banks also engage extensively in trading, which can carry with it significant risk.[17] Although banks, too, currently engage in trading activities (related to their holdings of government securities and foreign exchange), the banking industry as a whole has historically displayed far less variability in its earnings than the investment banking industry.[18] Moreover, the earnings patterns of the two industries have been mildly related in recent years; that is, they have fluctuated somewhat together rather than in offsetting fashion.[19] In combination, these patterns suggest that through their affiliations with full-scale investment banking enterprises, some commercial banks may in fact expose themselves to greater risk, particularly as they enter new activities with which they have little experience.

[17]Between 1980 and 1984, for example, profits from securities trading accounted for roughly one-third of the revenues of the 10 largest investment banks (Staff of the Federal Reserve Bank of New York, p. 360).

[18]Based on the same data discussed in the text above, the standard deviation of after-tax ROE for the commercial banking industry between 1975 and 1984 was 1.3 percentage points (around a mean of 12.3 percent). By comparison, the standard deviation of the after-tax ROE for the 10 largest investment banks over this period was 7.7 percentage points (around a mean of 21.5 percent).

[19]Between 1975 and 1984, the correlation coefficient of after-tax ROE for commercial banking and all securities underwriters was .41; for the large investment banks, the correlation was .28.

The likelihood that certain depository organizations would diversify in a risk-enhancing fashion is not easily dismissed because of the moral hazard effects created by the current system of deposit insurance. Since the inception of the insurance programs, premiums have been assessed as a constant percentage of deposits.[20] As numerous commentators and the FDIC itself have observed, this feature of the insurance system encourages risk taking because it allows federally insured depositories to gather funds at costs that do not fully reflect the risks of the investments those institutions make (Benston 1983; FDIC 1983). Because there is ample evidence that managers of bank holding companies tend to view their organizations as integrated entities (Rhoades 1985; Eisenbeis 1983), the incentives that depository institutions have to take risks at the expense of the insurance agencies can also induce them to assume risks in diversifying into investment banking (as well as other nonbanking activities).

These risks should not be so great, however, that they warrant continuation or even strengthening of the Glass-Steagall restrictions. Moreover, they can be contained with appropriate safeguards to insulate banks from their troubled affiliates, as discussed further below.

Removing Glass-Steagall: The Policy Alternatives

The elimination of the remaining barriers separating commercial and investment banking is inevitable. The only important question is the manner in which this will occur, either in piecemeal fashion or in a clean break.

Piecemeal Erosion

For the past four years, Congress has been deadlocked over the issue of expanded bank powers, including the repeal of the Glass-Steagall Act. The stalemate reflects not only the reluctance of many legislators to settle what has thus far been widely portrayed as a "turf war" between banks, securities houses, insurance companies, and real estate firms, but also an uneasiness about permitting federally insured depositories, albeit through their holding companies, to venture into other businesses.

Even if this deadlock persists in the short run, the Glass-Steagall restrictions will continue to be assaulted from at least three directions.

First, the Federal Reserve itself has begun to gradually widen the exceptions to the act. The recent decision by the Federal Reserve

[20]The statutory insurance premium for both banks and thrifts is one-twelfth of 1 percent. In 1985, however, the Federal Home Loan Bank Board imposed an additional assessment of one-eighth of 1 percent on thrift deposits.

Board to allow Citicorp, J. P. Morgan, and Bankers Trust to underwrite otherwise prohibited noncorporate securities through subsidiaries "not principally engaged" in these activities laid the foundation for broadening that exception to cover corporate securities as well.

Second, it is inevitable that the states will liberalize the authorities of their state-chartered banks, just as they led the way toward deposit interest rate deregulation in the 1970s and thus far toward nationwide interstate banking in the 1980s. Indeed, a number of states have already permitted their state-chartered banks to underwrite corporate securities.[21] As the states finish eliminating the remaining geographic restrictions on banks and their holding companies, the liberalization of product-line authority for state-chartered banks will continue.

Indeed, the FDIC has already anticipated the movement toward broader state banking powers. In 1984, the agency issued a rule requiring state-chartered banks not belonging to the Federal Reserve System—or those directly supervised by the FDIC—to conduct any corporate securities underwriting their states may allow solely through "bona fide" subsidiaries.[22] According to the FDIC, a "bona fide" subsidiary is one that is capitalized at levels commensurate with the industry standard and that operates with employees, officers, directors, and a trade name different from that of the bank parent.[23] Significantly, the FDIC's 1984 rule also prohibited a bank affiliated with a firm engaged in underwriting from purchasing securities offered by that affiliate during the period in which the underwriting is carried out.

Finally, if liberalizations of Glass-Steagall by federal regulators and by the states are not sufficient by themselves to induce Congress to repeal the act at some point, financial deregulation abroad should do the trick. Other countries (notably West Germany and Switzerland) have long permitted their commercial banks to engage in the

[21]As noted earlier, the boldest step yet has come from New York. But several other states have also permitted banks at least some corporate securities underwriting; these include Alabama, Alaska, California, North Carolina, and Ohio.

[22]Although the FDIC insures both national and state-chartered banks, it supervises only those state-chartered banks that are not members of the Federal Reserve System. Significantly, the Glass-Steagall Act prohibits only national banks and state-chartered member banks from engaging (directly or indirectly) in securities underwriting. State-chartered banks not belonging to the Federal Reserve System are not so restricted.

[23]In addition, the offices of the subsidiary must be physically separate from the bank, although the two may be entered through a common lobby. In 1985, the FDIC proposed a similar rule that would require all insured banks to conduct any insurance underwriting or real estate development activities that their states may allow through bona fide subsidiaries. But as of this writing, the FDIC has not yet implemented this proposal.

full range of investment banking activities. Earlier this year, Great Britain opened up its securities business to foreign banks and removed its regulation of securities brokerage fees. The London financial markets are booming as a result. Canada is planning to allow its commercial and investment banks to combine later this year. Where commercial banks are able to engage in investment banking abroad, competition among underwriters is more intense—and growing more so—than in the United States. This has not escaped the attention of American corporations, which are turning increasingly to the Euromarkets for financing. This trend is certain to continue, and as it does, American financial institutions will lose business to foreign competitors, especially the Japanese banks that now dominate the list of the top 10 banking organizations in the world. In my view, Congress at some point will react to the expected erosion in the competitive positions of American-based financial institutions by either substantially modifying or repealing the Glass-Steagall Act.

Repealing Glass-Steagall: A Clean Break

The eventual demise of Glass-Steagall is good news for those who are waiting for the benefits of increased competition in investment banking. The bad news is that the piecemeal erosion of the act will take time. In the interim, corporate customers of investment banking services will not only lose the opportunity to obtain immediate benefits of the added competition, but financial business will continue to shift away from American shores.

I have outlined elsewhere a financial restructuring plan that I believe could end the political stalemate over expanded powers more quickly and, in the process, make a clean break with Glass-Steagall (Litan 1987; Litan 1986). Briefly, that plan calls for the creation of a new voluntary option for organizations that own or wish to own an insured depository and also wish to engage in an unrestricted set of nondepository activities (outside those permitted to bank and multithrift holding companies). In exchange for broader powers, those highly diversified institutions that want to operate an insured depository would have to confine the activities of their insured institution solely to accepting deposits (of any maturity) and investing the proceeds in safe, liquid securities.[24] This "narrow bank" could not make

[24]Under one version of the proposal, the permissible asset list would include all Treasury securities and federally insured bonds, which collectively amount to about $1.5 trillion, or twice the total amount of loans held by the top 35 bank holding companies combined. Under an alternative version, the permissible asset list could be expanded to include certain highly rated securitized instruments such as mortgage-backed securities and instruments backed by consumer installment loans (automobile loans and credit card receivables).

loans. All lending by these highly diversified organizations (as well as all other nondepository activities) would be conducted through separate affiliates, which would rely for funding on uninsured liabilities and equity (just as such nonbank lenders as General Electric Credit Corporation and Commercial Credit do today). No restrictions would be placed on the cross selling of services by these diversified supermarkets.

Several other features of the proposal are worth noting:

- Narrow banks would be eligible for deposit insurance, but at reduced premiums to reflect their lower risk. In addition, narrow banks could be required to report their financial status on a market value basis (rather than historical cost) and adhere to capital requirements on that basis.
- To avoid undue pressure on the securities markets, banking organizations would be allowed to diversify freely as long as they adhered to a 10-year schedule in transferring their loans out of their existing bank to a separate lending affiliate.
- The proposal would apply equally to both banks and thrift organizations, but the smallest banks and thrifts allowed by relevant state or federal law to diversify broadly would be exempted from the separation requirements.

This proposal, which has also been discussed and endorsed in general terms by several others (Wallich 1984; Angermueller 1985; Golembe and Mingo 1985; Karaken 1986), would address each of the concerns that opponents of broader bank powers—including broader securities powers—have raised. First, it would prevent a financial holding company from using the resources of its bank(s) to bail out "risky" nonbank affiliates. In the structure just outlined, deposit-taking subsidiaries would be limited to investing solely in high-quality, marketable instruments; they could not legally channel funds to support affiliated corporations or their customers. Second, the fact that deposits could not be used to finance loans should remove most of the concerns about potential conflicts of interest. Third, the proposed structure should ease qualms that these financial organizations would hold excessive concentrations of economic power. These fears stem in large part from the fact that deposit insurance allows banks to gather large pools of funds and thereby to exercise significant control over the allocation of credit. If the banks in financial holding companies could not fund loans with insured deposits, there would be much less reason to be concerned about the size of the holding company.

Finally, and perhaps most important, the proposed separation requirements have the political advantage of helping to move all of

the interested financial industries beyond the stalemate that has surrounded the issue of expanded bank powers for the past several years. One does not have to buy my proposal to gain the repeal of Glass-Steagall, however. That day is coming. It is only a matter of time.

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