

Conference Report

Assessing “Financial Modernization” in the United States, Europe, and Japan

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Laws governing financial institutions—especially what types of business they can conduct and who can own them—in the United States, Europe, and Japan have begun to converge. For years, there were stark differences. Many European countries allowed “universal banking,” or bank participation in a wide range of financial activities, whereas the United States and Japan generally segmented banks from other types of financial service firms.

But this has changed markedly over the past several years. In the United States, the legal lines between banks and other financial firms were in fact more porous than was generally recognized, and they became more so in the late 1980s and 1990s, when a series of rulings by regulators allowed banks broader authority to sell insurance products and to affiliate with securities underwriters. In 1999 Congress enacted the widely hailed Gramm-Leach-Bliley Act (GLBA). This reform tore down the remaining impediments to banks’ affiliating with other financial firms, but at the same time erected new barriers to alliances between or common ownership of banks and commercial firms. In Japan in the late 1990s, new rules similarly allowed banks to own financial subsidiaries, but also permitted commercial firms to own banks.

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What has been the effect of all this activity? And what are the financial issues likely to occupy policymakers' attention—especially in the United States—in the next few years? To address these questions, the Brookings Institution and the Nomura Institute for Capital Markets Research organized a conference on October 5, 2004, based on presentations by six leading experts on the U.S., European, and Japanese financial systems. In this conference report, we summarize the highlights of these presentations and the ensuing discussions among the other participants.

Assessing the Impact of GLBA

One of the underlying assumptions of GLBA was that it would facilitate the formation and growth of financial “supermarkets”—institutions offering a full range of financial services. But if the act’s “success” is to be measured by how many firms actually have taken advantage of this new authority, then the record so far is mixed, if not somewhat disappointing. The prime mover behind passage of the Act was Citigroup, in the belief that the legislation would help ensure the success of the prospective merger between Citibank and Travelers (although at the time it was widely believed that a way could have been found to complete the merger under existing law). But Citigroup has since unloaded Travelers’s property-casualty underwriting business. Relatively few other banking organizations have since sought to become financial supermarkets, though over 600 have registered with the Federal Reserve as financial holding companies (FHCs). Many of these have used GLBA to find their way into insurance brokerage, rather than underwriting. Conversely, only two nonbanking organizations have registered to become FHCs; that is, to acquire banks.

Richard Herring of the University of Pennsylvania, among others, offered several reasons why the financial market model envisioned by proponents of GLBA has not been more widely embraced. First, in retrospect it is not surprising that many banking organizations have been more interested in building out their *banking* networks geographically within the United States than in getting into new businesses. After all, banks only received the authority to operate branches nationwide in 1994, under the Riegle-Neal Interstate Banking Act, whose provisions did not become fully effective until 1997—just two years prior to GLBA.

Second, GLBA effectively authorized only two additional financial businesses for banking organizations (reorganized as FHCs): insurance underwriting and brokerage. Of the two, brokerage is the less risky, and it is at least as profitable as underwriting (if not more so). In addition, there are probably more consumer-based synergies between banking and brokerage activities than between banking and underwriting, though some life insurance products are complementary to bank deposits (as is borne out by the European experience with universal banking, discussed below). Nonetheless, as Lawrence White of New York University pointed out, the virtues of the “one stop” financial conglomerate may well have been oversold.

Third, many participants believed that though in letter the GLBA provided a two way street—both banks and nonbanks could become FHCs—in practice, the terms were not equal. This is because FHCs are regulated by the Federal Reserve (though more “lightly” than were the earlier bank holding companies). While banks have long been accustomed to such regulation and supervision, nonbanks have not, and thus it is perhaps not surprising that only two have chosen to become subject to the Fed’s purview.

Fourth, GLBA did not authorize commercial firms to own banks, or vice versa—though it did exempt until 2009 nonfinancial enterprises that owned banks if their bank revenue

accounted for no more than 15 percent of the total revenue of the firm. Peter Wallison of the American Enterprise Institute argued there was no basis for allowing banks to affiliate with or be owned by financial but not commercial enterprises. Dan Tarullo of Georgetown Law School responded that the benefits of commercial ownership did not justify the risks of going beyond “banking and finance” to “banking and commerce.” In any event, GLBA did not completely close off links between commerce and banking. In Utah, commercial companies (or other sponsors) may still obtain charters for industrial loan companies which are bank-like in character. Though there were complaints about this loophole in the last Congress, Wallison suggested that support from Congress or the administration for closing it would depend on the outcome of the 2004 election. (Given that in the event the Republicans captured both the Congress and the White House, such action is now unlikely.)

Fifth, Robert Litan noted that though GLBA gave the Federal Reserve and the Treasury Department authority to expand the list of permissible financial activities for FHCs, Congress can override them both. A case in point was real estate brokerage, which for many banking organizations would appear complementary to banking. The Fed and the Treasury did indeed exercise their authority under GLBA to propose that FHCs might engage in real estate brokerage. But they were forced to back off the idea by Congress, under pressure from the real estate brokerage industry.

Sixth, Litan also argued that whatever one may think of the benefits brought by GLBA, it is unfair to attribute to it the various misdeeds in the financial sector during the past several years. In particular, some have alleged that GLBA enabled certain banks, apparently looking to obtain investment banking business from Enron, to assist that company in establishing the off-balance-sheet special purpose entities (SPEs) that eventually contributed to Enron’s downfall.

But these banks had investment banking affiliates even before GLBA. Moreover, even if they had not, they still could have become involved in the Enron fiasco by unwisely loaning funds to the company or its SPEs in the hope of enticing Enron to buy other, nonunderwriting banking services (such as merger and acquisitions advice). Perhaps most important, each of the banks that were embroiled in the Enron affair has been sued, and these lawsuits will deter other banks from repeating their mistakes in the future. As for the other scandals, relating to mutual funds and financial analysts, no connection can be drawn with the activity authorized by GLBA. And the same is true of the more recent investigation of insurance agents and underwriters undertaken by the New York State Attorney General.

In general, there was consensus among participants that whatever the disappointments and complaints about GLBA, it was unlikely that it would be significantly altered by Congress.

What's Next on the U.S. Financial Agenda?

Since the conference was held a month before the U.S. elections, participants had no way of knowing what the political environment would look like in the coming years, especially in relation to financial issues. Nonetheless, there was an implicit belief that certain financial issues would at least be debated in the political arena, regardless of the election outcome.

Topping the list of priorities at the conference was the need for more vigorous oversight of the large government-sponsored enterprises (GSEs) for residential mortgages: Fannie Mae and Freddie Mac. This topic was specifically addressed by Lawrence White and was uppermost in the minds of participants because only days before Fannie Mae's regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), had issued a report that was highly critical of certain accounting practices that Fannie Mae had engaged in since at least 1978.

White began his presentation with data indicating significant growth in Fannie Mae and Freddie Mac in the past three years. In combination, the two GSEs increased the size of their mortgage portfolio from \$1 trillion in 2000 to almost \$1.6 trillion in 2003. The corresponding totals for the mortgage-based securities they guaranteed were \$1.3 trillion and \$2.1 trillion, respectively. Collectively, the two mortgage GSEs either own or guarantee nearly half of all outstanding mortgages in the United States.

White argued that this exposes taxpayers to potentially significant risks, since the federal government implicitly backs the debt of both entities (a perception that is ratified by the market, which has given Fannie and Freddie access to funds at anywhere from 35 to 40 basis points below what they otherwise would have to pay). Taxpayers' exposure may grow in the future because Fannie and Freddie are now facing and will continue to face stiffer competition, both from the Federal Home Loan Banks (also GSEs) that are now buying mortgages and from commercial banks, which under new international capital rules planned to become effective in 2006 will have incentives to hold more mortgages as a way of reducing levels of required capital. Fannie and Freddie may respond to the increased competition by taking more risks.

How policymakers respond to this unfolding dynamic is more important than the immediate reaction to any accounting misdeeds of Fannie Mae recently uncovered by OFHEO. White suggested that while the first best solution would be to privatize both mortgage GSEs, this was politically unrealistic. He therefore called for stiffer regulatory oversight, starting with higher amounts of required capital. White also asserted that the GSEs would not be open to criticism if they were required to mark to market all of their assets and liabilities. Peter Wallison, a noted critic of GSEs, responded that both GSEs had too much political power to be successfully regulated. In his view, privatization was the only realistic way to remove taxpayer

risk. Barry Bosworth of Brookings offered a different course: simply ban the GSEs from holding mortgages in portfolio but permit them to continue securitizing them.

The discussion turn briefly to several other financial issues that might occupy policymakers' attention in coming years. Dan Tarullo considered the wish lists of various industry segments for post-GLBA reform, including greater permission for cross-marketing by FHCs of their bank and nonbank activities; the creation of an optional federal insurance charter; uniform national standards for consumer privacy protection; uniform national securities regulation; and the removal of the 2009 sunset on the grandfathering of nonfinancial company ownership of banks. Several participants suggested that in the current post-scandal environment, it was not likely that Congress would act on many, or indeed any, of these items. At the global level, the implementation of the next version of the Basel capital accords is likely to occupy the attention of banks and policymakers in the years ahead.

Perspectives from Europe and Japan

Many European countries have long allowed universal banking—banks' direct participation in nonbanking activities, notably insurance—and in the late 1990s Japan also authorized bank and financial affiliations. What lessons can be learned from these experiences?

Anthony Saunders of New York University focused on “bankassurance” in Europe, or financial firms that offer both banking and insurance services. Such marriages have been defended on various grounds, including alleged economies of scale and scope, risk diversification, or, if the entity is large enough, the possibility that it could benefit from an implicit “too big to fail” subsidy. Saunders reviewed the evidence on each of these justifications.

Saunders cited U.S. studies that found no evidence of economies of scale at the level of the largest European (or U.S.) banks, insurance companies, or securities firms; however, he pointed to strong evidence of scale economies in certain activities, such as asset management, transactions processing, and custodial services. As for economies of scope, Saunders noted that while there was some evidence of cost diseconomies among diversified U.S. banking organizations, there was no evidence available for financial conglomerates that included banks. Similarly, there is little evidence that financial conglomerates can realize revenue economies from cross-selling multiple services, though Saunders suggested that some economies might exist for very specific product lines, such as combinations of life insurance and pension management, for example.

On bankassurance firms in particular, Saunders pointed to research suggesting reduced risk from banks affiliating with life insurance, a result anticipated by Litan in his opening remarks, since bank deposits and life insurance products are both savings vehicles. Citigroup's spinoff of Travelers's property-casualty business after the merger that helped prompt the passage of GLBA suggested to Saunders that synergies between these two lines of business are not likely. Market reaction to the divestiture supports this view: Citigroup's share price rose 3 percent after the transaction was announced.

Adam Posen of the Institute for International Economics surveyed the evidence on universal banking in Germany and Japan and found the verdict decidedly negative. In his view, universal banking—especially bank ownership of the stock of commercial loan customers in both countries—helped entrench management in both the banks and the non-financial firms, to the detriment of both. German banks also have increasingly been lending to uncompetitive, small and medium-size borrowers, as the larger companies have moved to the capital markets for their

financing. Meanwhile, Posen believed that universal banks have used their insurance operations to fund noninsurance operations.

Posen found fault with the regulators of universal banks as well. Regulators in both Germany and Japan have engaged in forbearance, or not strictly enforcing capital standards—a practice that has been found wanting in the United States. As for the wider economic impact of universal banking, Posen suggested that there was no evidence that such banking arrangements have contributed to macroeconomic stability; to the contrary, there is some indication that economies with universal banking systems are prone to deeper crises when times turn bad. During the discussion, however, Gerald Caprio of the World Bank argued to the contrary that evidence from multiple countries shows that bank participation in equity underwriting is associated with greater macroeconomic stability.

Yasuyuki Fuchita presented his perspective on the Japanese experience with universal banking. He reminded the audience that the Japanese model differed from the European model and also was much more recent. In Japan, banks are allowed to own other financial companies only through subsidiaries (rather than the banks conducting nonbanking operations directly, as is the case in parts of Europe), and they have only been able to so do since 1992. In 1998 Japan anticipated the passage of GLBA in the United States by authorizing the creation of financial companies, and it was only then that banks were allowed to sell mutual funds. Unlike both Europe and the United States, however, Japan allows commercial companies to own banks. Fuchita pointed specifically to the example of Sony, which owns not only a bank but also insurance companies.

Japanese consumers have long placed most of their financial assets in banks (much more so than is the case in the United States, Canada, or the United Kingdom, for example). But

Fuchita highlighted evidence that this is gradually changing. More Japanese consumers are putting their money into mutual funds. Furthermore, since gaining the authority to sell mutual funds in 1998, Japanese banks have been steadily increasing their share of all mutual fund sales, accounting for nearly half the market by mid-2004.

The deep turmoil in the Japanese banking system since the stock and real estate market crashes in the late 1980s has led to a dramatic consolidation among banks. As of March 2004, the six largest Japanese banks accounted for well over half of all domestic banking deposits (although only one-third when the more than \$1 trillion in the postal banking system is taken into account). Fuchita expressed concern about growing concentration in the Japanese banking industry. He pointed to the tougher competition policies in the United States and the United Kingdom, which, in his view, help keep banking market power in check, relative to Japan. (In the United States, though, the fact that banks have only recently been allowed to branch nationwide accounts to some degree for the relatively low, but increasing, concentration in the banking system.)

During the discussion, Dan Tarullo asked if there was evidence that banks that engaged in equity underwriting were more prone to lend to companies whose stocks were underwritten. The Enron affair, with the claims that banks loaned to Enron in order to get its underwriting business, has made this a concern. Saunders responded that his studies found banks were only marginally more likely to lend to their underwriting customers than to other customers.

Finally, Richard Herring noted the differences in financial sector regulation between the United States and Europe, in particular. Authorities in EU member states tend to practice “consolidated supervision,” or oversight of an entire financial conglomerate, not its individual components. This process is formalized in such countries as the United Kingdom, which has

integrated financial regulation in a single Financial Supervisory Agency (FSA). In the United States, by contrast, though some degree of consolidated oversight of FHCs is vested in the Federal Reserve, financial organizations are still regulated primarily by function. Diversified financial institutions that do not own banks—combinations of securities and insurance firms—are not subject to any form of overall supervision, except the disclosure requirements of the Securities and Exchange Commission (SEC) if they are public companies (as virtually all of them are).

Herring observed that this difference in financial regulatory regimes is important because the EU has issued a Financial Conglomerates Directive that will extend EU-type consolidated supervision to all financial institutions operating in Europe, including those headquartered in the United States, unless EU authorities find that foreign institutions are subject to “equivalent” consolidated supervision in their home countries. At this writing, though it is likely that FHCs will meet the equivalency test, it is doubtful that diversified nonbank financial organizations based in the United States will do so. Will it be sufficient for these institutions to establish “subholding companies” in Europe, subject to consolidated supervision that would not extend to their U.S. parents? Or will the United States authorize the creation of a supervised investment bank holding company, regulated by the SEC, that ideally would meet the EU’s equivalency requirement? These questions are likely to be answered in the near future.

Conclusion

The Gramm-Leach Bliley Act turns out to have ushered in much less of a revolution in financial services than was anticipated at the time. Now, other financial issues—in part prompted by scandal and in part growing out of ongoing market developments—are coming to the fore, in

the United States and elsewhere. Among the financial systems of the United States, Europe, and Japan, however, differences are narrowing, while financial markets and institutions continue on their path toward further integration.