Statement No. 174

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Statement of the Shadow Financial Regulatory Committee

On

The Gramm-Leach-Bliley Act

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In November, the Gramm-Leach-Bliley Act reached its second anniversary—enough time, the Committee believes, to make some judgments on whether it has resulted in any significant improvement in the structure of the financial services market. Measured against the balkanized financial services industry that existed in 1999—with bank holding companies unable to affiliate with insurance underwriters, or with securities firms that were principally engaged in underwriting and dealing in securities—there has been some improvement in market structure. Many bank holding companies have been able to acquire or establish securities and insurance activities, and this has improved competition and enhanced consumer choice.

However, measured against what the Committee believes the Gramm-Leach-Bliley Act should have achieved—the creation of a two way street in which insurance companies and securities firms could acquire or establish banks, and vice versa—the Act has been a failure. In the two years since it was enacted, hundreds of banking organizations have extended their activities into securities and insurance activities, but only one significant securities firm and one significant insurance company has acquired or established a bank. It thus seems apparent that, instead of creating a level playing field in which organizations engaged in banking, securities and insurance could compete with one another by offering a broad range of financial services, the Act has in fact created a strong bias in favor of product expansion by banking organizations and a corresponding
bias against similar expansion by the other financial services providers.

The Committee believes that the principal reason for this bias is the Act’s unreasonable and unnecessary requirement that organizations that own or control banks be engaged solely in activities that the Federal Reserve Board declares to be “financial in nature.” This requirement has two major flaws.

First, any insurance or securities organization that acquires a bank automatically becomes subject to restrictions on any new activities that the Fed does not consider to be financial in nature. Up to now, insurance and securities organizations have been able to expand their activities into any sector of the economy, without regulatory restrictions. It is not surprising that their managements are now reluctant to give up flexibility that allows them to respond to changes in the market or to new opportunities. That the Act’s restrictions can be significant is illustrated by the Fed’s inability, for almost one year, to decide whether real estate brokerage is a financial activity, and thus an activity that could be undertaken by an organization that controls a bank. In part, this is the result of opposition by the realtors, a politically powerful group. Few managements are likely willingly to subject their organizations to a process in which their expansion is held hostage to the political power of the groups that do not want new competition.

Second, in the Committee’s view there is no way to draw an objective distinction between a financial activity and a nonfinancial activity. Again, the Fed’s inability to resolve the real estate brokerage question is a vivid example of this problem. Brokerage of any kind—bringing together buyers and sellers—is the same function, no matter what the nature of the underlying asset. If securities brokerage is a financial activity so is real estate brokerage. If a distinction is to be made between these two types of brokerage it will inevitably be completely arbitrary and possibly the result of political pressures. It is understandable that companies that do not face such constraints on their expansion into new activities have been reluctant to place themselves in this position by acquiring banks and becoming subject to the activities restrictions of the Act.

A third reason why nonbanking organizations may be reluctant to acquire banks and become subject to the Act is the Fed’s authority under the Act to review the capital position of any nonbank subsidiary of a company that controls a bank as well as the holding company itself. Although this power cannot be exercised without consultation with the primary regulator of the holding company subsidiary, the Fed is authorized to take this action if it believes that the capital position of the holding company or its subsidiary poses some risk to an affiliated bank. In many cases, this would subject nonbank affiliates of banks to another layer of capital regulation or to regulatory capital requirements that they have not confronted before.

All of these restrictions are the result of the mistaken belief in Congress that there is some reason to separate banks from other kinds of activities, and that banks are likely to be adversely affected by the activities of their affiliated companies. As the Committee has noted in many prior statements (see nos. 139, 142, 150 and 155), there is no rational basis for separating banks from other kinds of activities. By permitting banking organizations to expand into nonbanking services such as securities and insurance, Congress has taken a limited step forward, but has also introduced unwarranted and unnecessary bias into the
structure of our financial system. To achieve a satisfactory and fair reform of the nation’s system of financial regulation, Congress should promptly repeal those portions of the Gramm-Leach-Bliley Act that place restrictions on the activities of organizations that control banks and subject those organizations and their subsidiaries to regulation by the Federal Reserve Board.