Chapter 2

GRAMM-LEACH-BLILEY ACT: CREATING A NEW BANK FOR A NEW MILLENIUM

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Abstract

The Gramm-Leach-Bliley Act (GLBA) was signed into law on November 12, 1999 and essentially repealed the Glass-Steagall Act (GSA) of 1933 that had mandated the separation of commercial banking activities from securities activities. It also repealed provisions of the Bank Holding Company Act (BHCA) of 1956 that provided for the separation of commercial banking from insurance activities. The major thrust of the new law, therefore, is the establishment of a legal structure that allows for the integration of banking, securities and insurance activities within a single organization. The GLBA will be explained and discussed, with special emphasis on its importance for U.S. banks in a world of ever increasing globalization of financial services.

Keywords: banking laws; bank regulations; securities; insurance; financial modernization; financial holding companies; Glass-Steagall; globalization; thrifts

2.1. Introduction

The Gramm-Leach-Bliley Act (GLBA) was signed into law on November 12, 1999 and provided for sweeping changes in the allowable activities of banks in the United States (Barth et al., 2000). The GLBA, also known as the Financial Modernization Act, essentially repealed the Glass-Steagall Act (GSA) of 1933 that had mandated the separation of commercial banking activities from securities activities. In addition, the GLBA repealed provisions of the Bank Holding Company Act (BHCA) of 1956 that provided for the separation of commercial banking from insurance activities. While the GLBA formally changed the face of banking, in recent years the regulatory environment had been evolving away from a stringent interpretation of the GSA.

The major thrust of the new law is the establishment of a legal structure that allows for the integration of banking, securities, and insurance activities within a single organization. The GSA was enacted during the Great Depression following the market crash of 1929. The intent was to provide for the separation of banking activities from securities activities based on the view that undue speculation and conflicts of interest had, at least in part, led to the market crash and the subsequent failure of numerous banks. As much as anything, the GSA was supposed to restore confidence in the banking system and securities markets. However, its restrictive provisions eroded gradually over the years, and more rapidly in the past 20 years. In fact, many view the enactment of the GLBA as merely serving to formalize what had already been happening *de facto* in the financial marketplace, as the distinction between different types of financial service firms and their products had become quite blurred.

A particularly important reason to understand the GLBA at this time is globalization. Banks in the United States have operated for decades under some of the most restrictive regulations when compared to banks in most of the other industrial countries around the world. While the GLBA improves the position of banks in terms of global competitiveness, U.S. banks still do not enjoy the same degree of freedom with respect to activities and organizational structure as banks in many other countries.

2.2. Major Provisions of Gramm-Leach-Bliley Act

2.2.1. Financial Holding Companies

The GSA and the BHCA restricted bank affiliations with securities firms and insurance companies. Figure 2.1 provides a schematic of the allowable activities and organizational structure under the prior law and under the new provisions of the GLBA. Essentially, the new law repealed earlier activity restrictions and created new financial holding companies, which are allowed to engage in a wide range of activities, as long as the Federal Reserve determines that the activities do not pose a substantial risk to bank safety or soundness.

The GLBA provides for a new holding company category, the financial holding company. A bank holding company may become a financial holding company provided its depository institutions are adequately capitalized, properly managed, and has a ‘‘satisfactory’’ rating under the Community Reinvestment Act (CRA). The new holding companies may engage in activities deemed to be financial in ‘‘nature’’ or ‘‘incidental’’ to financial activities. The Federal Reserve may also allow activities termed ‘‘complementary’’ to financial activities after determining that the activity does not impair the safety or soundness of banks. One caveat is that the Federal Reserve may not determine an activity to be financial in nature if the Treasury Department objects. Obviously, this provision may result in disputes regarding the interpretation of the law, and hence add to uncertainty regarding approval of certain activities for banks. The new holding company may own banks as subsidiaries as well as other subsidiaries that engage in other approved financial activities. Activities that the GLBA specifies to be ‘‘financial in nature’’ include underwriting and dealing in securities, insurance underwriting and agency activities, merchant banking, mutual fund sponsorship, and insurance company portfolio investments. Insurance agency activities are regulated solely by the individual states, and therefore may face state imposed restrictions. However, states are precluded from restricting any activity that is specified in the GLBA.

2.2.2. National Bank Financial Subsidiaries

The new law also creates new financial subsidiaries of national banks (and subject to state law, of state banks) that may engage in all the financial activities authorized by the new law. Exceptions include insurance or annuity underwriting, insurance company portfolio investments, real estate investment and development, and merchant banking. These latter activities may only be conducted in financial holding company subsidiaries. Furthermore, there is a limitation of the total assets of all financial subsidiaries of 45 percent of the total assets of the bank or $50 billion.

2.3. Functional Regulation and Equal Treatment for Foreign Banks

The new law generally adheres to the principle of functional regulation, which holds that similar activities should be regulated by the same regulator. Thus, banking regulators regulate bank activities, securities regulators regulate securities activities, and insurance regulators regulate insurance activ-

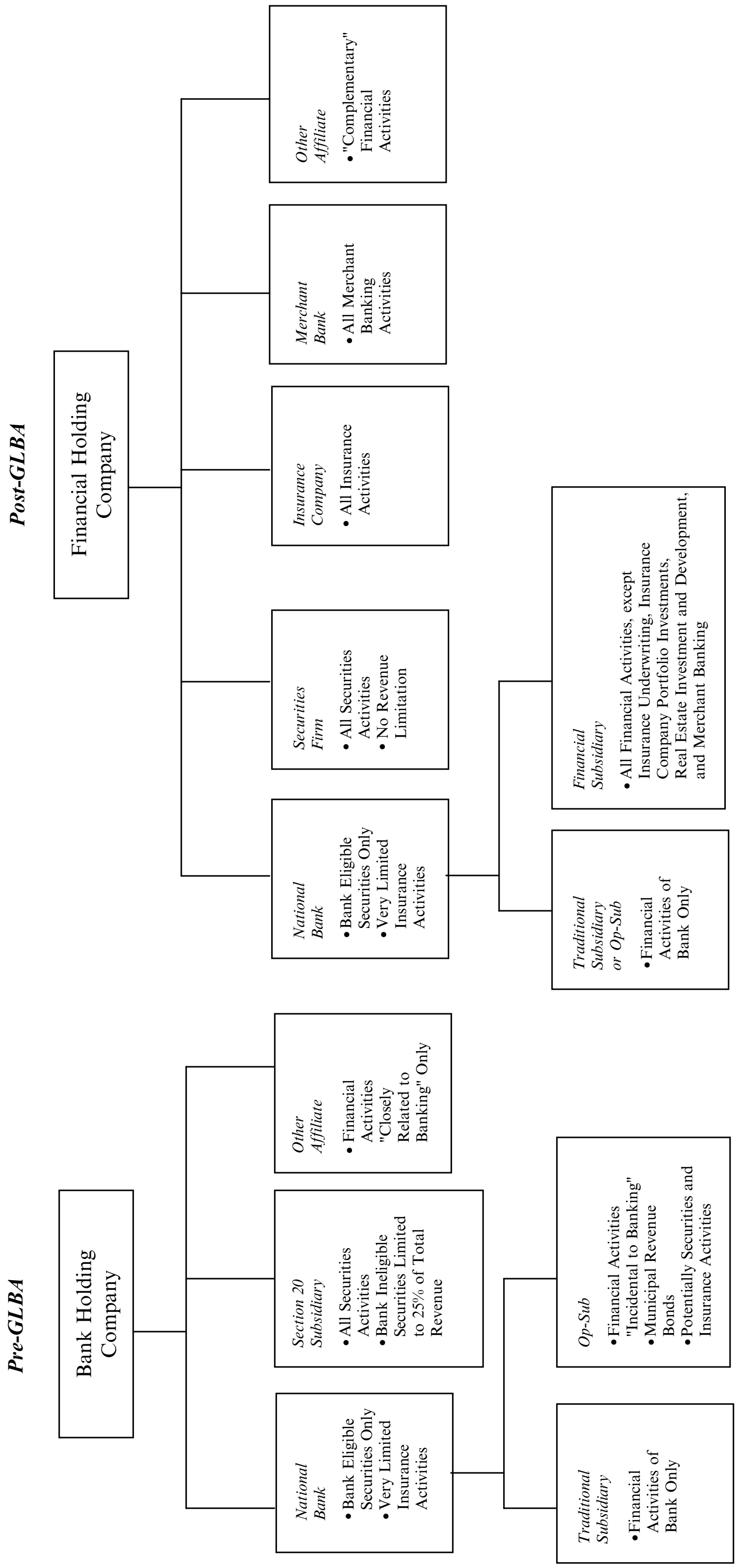

Figure 2.1. Past and new bank permissible activities and organizational structure.

ities. The Federal Reserve, as an umbrella regulator, is authorized to examine financial holding companies and their subsidiaries, but may specifically examine functionally regulated subsidiaries only under limited circumstances. For those entities, the Federal Reserve will generally rely upon the examinations by other federal and state securities and insurance regulatory authorities.

The new law does exempt some banking activities that are deemed to have a "securities" component from the regulatory authority of the Securities and Exchange Commission (SEC). However, the law provides a process that requires the SEC to act by rulemaking before seeking to regulate any bank sale of any new hybrid security product. Finally, if a new product is determined to be an insurance product by the state insurance regulator, then national banks are prohibited from providing it as principal in that state. Any conflicts must be resolved in a court of law.

The GLBA provides for national treatment whereby foreign banks may engage in the newly authorized financial activities on the same basis as domestic banking organizations.

2.3.1. Retention of Thrift Holding Companies

The new law retains the federal savings and loan charter, and allows thrift holding companies to conduct banking, securities, and insurance activities on the same terms as bank holding companies. The law, however, closes a loophole permitting the mixing of banking and commerce by prohibiting thrift holding companies from acquiring commercial firms, or engaging in new commercial activity.

The law also creates new community financial institutions that may obtain long-term federal home loan bank advances for lending to small businesses, small farms, and small agribusinesses. These institutions must be FDIC-insured depository institutions with less than $500 million in assets. Thus, Congress is providing new government directed subsidized lending to selected institutions to induce them to provide credit to businesses favored by it.

2.3.2. Community Reinvestment Act Provisions

The CRA was enacted to ensure that banks do not lend the deposits gathered from individuals in one area to those living in another area in significant proportions. It thus requires banks to make credit available to the communities in which they obtain deposits. Prior to passage, there was concern that the CRA would be weakened. The GLBA therefore required that financial holding companies could not be formed until their insured depository institutions received and maintained a satisfactory CRA rating. Smaller institutions were granted some relief with less frequent CRA examinations. Banks with less than $250 million in assets are to undergo a CRA examination once every five years if they have prior outstanding ratings, and once every four years if they have prior satisfactory ratings. The GLBA further requires than banks and community groups must disclose certain CRA agreements, and provide annual reports on the use of funds and resources utilized in fulfilling such agreements. Financial holdings companies and banks with financial subsidiaries are prohibited from new activities or acquisitions unless each insured institution within the company has earned at least a "satisfactory" CRA rating.

2.3.3. Other Components of the GLBA

Automated teller machines that charge fees must be labeled with a notice of the fee. The machine must also give customers a notice on the screen that a fee will be charged, with the option of canceling the transaction.

The new law also requires the relevant regulators to establish standards for ensuring the privacy of consumers' personal information maintained by financial institutions. Surprisingly, congressional negotiations towards the end was dominated by whether consumer privacy would be adequately protected with the expansion of bank powers In the House of Representatives, shift in a mere 13 votes on the privacy provisions would have defeated the entire legislation.

The law, as passed, requires regulators to establish standards to ensure the privacy of personal financial information held by financial institutions. In addition, consumers must be presented the opportunity to "opt out" of having their financial information shared with nonaffiliated third parties. Further, mandatory disclosure of the institution's privacy policies must be made on an annual basis to all customers.

One other feature designed to benefit consumers is the mandate that federal banking agencies must use "plain" language in all rules made after January 1, 2000 (Banerji et al., 2002; Broome and Markham, 2000; Carow, 2001; Wilmarth, 2002).

2.4. Potential Benefits to Banks and their Customers

Banks potentially benefit from the expanded range of permissible activities through higher average profits resulting from scale and scope economies. The fixed overhead cost of managing a customer relationship can be spread over more services. Banks can also use existing technology, personnel, and delivery channels to distribute securities and insurance services at a relatively low marginal cost. Finally, there may be economies coming from overhead in administration, back-office operations, and information technologies being spread over a bigger base of financial services.

Because of greater opportunities for diversification, a bank with broader powers may also have lower profit variability than a traditional bank. Broad banks will be affected less when firms bypass banks and raise funds directly in the capital markets because a decline in the banks' lending activity will be offset by an increase in their securities activity. In addition, if profits from different financial activities are not highly correlated, then the total profits of a broad bank will be more stable than that of banks specialized in relatively few activities. Customers may also benefit from the broad bank. If a bank achieves greater scale and scope economies, competition should lead to a sharing of these benefits with customers and firms in the form of lower prices. Also, they may benefit from lower search and transaction costs because of "one-stop" or "one-click" shopping.

2.5. Potential Risk Elements to Banks and their Customers

Two main concerns arise when combining banking, securities, and insurance activities within the same banking organization where the contagion effect of problems in one unit affects other units. The greater range of activities may increase the risk of insolvency to the organization. This might happen if banking organizations encounter unexpected difficulties in the nontraditional activities, due either to a lack of the banks' business experience or because the regulatory authorities might be less able to contain excessive risk-taking in the new activities.

Empirical evidence, however, suggests that the expansion of securities and insurance powers need not put banking organizations at greater risk of insolvency, and may actually reduce the probability of bankruptcy. Policy makers have echoed these views. The FDIC supported the repeal of the GSA on the grounds that this would advance financial modernization without sacrificing safety and soundness (Barth et al., 2004).

The federal safety-net problem is the second concern. It refers to extending the benefits of federal deposit insurance and access to both the payment system and the discount window of the Federal Reserve to a broader range of activities. If banks receive a subsidy from access to the federal safety net and if it can be extended to additional activities, then banks possess an unfair advantage vis-à-vis their nonbank competitors in these activities. Furthermore, such a situation might encourage banks to engage too heavily in additional activities.

Banks, however, also incur special costs associated with the federal safety net. They pay premiums for deposit insurance, hold interest-free reserves, and bear costs to satisfy numerous banking rules and regulations. These costs must be subtracted from any gross subsidy to obtain the net subsidy. Recent estimates of net subsidies indicate that, for most banks, they are either close to zero or zero.

2.6. Implications for the Future

Of all the 19 nonoverlapping G-10 and E.U. countries, Japan and the United States were the most restrictive in their treatment of securities and insurance activities prior to 1999. Japan and the United States were also the most restrictive regarding the mixing of banking and commerce. The majority of the G-10 and E.U. countries place no restrictions on banks owning commercial firms and vice-versa, which was also the case in the United States before 1956. Many other countries also permit banks more latitude to choose the organizational form in which to conduct securities and insurance activities.

An analysis of more than 60 countries has found that tighter the restrictions placed on securities and insurance activities, the more inefficient are banks and greater the likelihood of a banking crisis. The likelihood of a banking crisis is also greater, the tighter the restrictions placed on bank ownership of nonfinancial firms. In fact, none of the securities, insurance, real estate and ownership restrictions produce any beneficial effects with respect to bank development, bank performance, or bank stability.

By permitting banks to engage in banking, securities, and insurance activities, and by providing even broader powers to financial holding companies, the new law will likely rejuvenate banking. While banks held nearly three-fourths of the total assets of all financial intermediaries in 1860, recently their share had declined to less than one fourth. The combined assets of commercial banks, insurance companies, securities firms, and investment companies are almost two-thirds of the assets of all financial intermediaries. Thus, the new broad banks may return to be dominant institutions that they were a century ago.

The importance of capital markets (stocks and bonds) as compared to bank loans is far more important today than in the last century. This shift in the composition of the financial system reflects the fact that financial intermediation based upon a securities-based system is more cost-effective than a bank loan-based system. Today, the cost of intermediation through a bank is about 400 basis points as measured by net interest margin. This compares to less than 100 basis points as measured by the operating expense ratio of mutual funds.

These newer developments have forced banks to transform themselves from traditional spread-income based institutions to nontraditional fee-based institutions. Reflecting these changes, commercial loans are only 16 percent of total assets, while demand deposits are a slightly lower 13 percent. Indeed, non-interest income as a percentage of net operating revenue is 46 percent for banks with more than $1 billion in assets and 27 percent for banks with less than $1 billion in assets. The emphasis of banks is increasingly on asset and risk management, especially for the bigger banks.

Broad banks will therefore not be the banks of the recent past. They will reflect the historic changes brought about mainly by technology and globalization, as well as the corresponding regulations these developments engender. Providing liquidity in the form of deposits and loans to businesses will undoubtedly remain an important service of banks, but it will be subsumed in the broader strategy of asset and risk management using modern information technology.

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