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The Honorable James A. Leach
Chairman, Committee on Banking and Financial Services
House of Representatives

Subject: Separation of Banking and Commerce

Dear Mr. Chairman:

In a recent discussion with you about financial services modernization legislation, you asked us to review the literature regarding the potential benefits and risks of eliminating the current separation of banking related activities and commerce, and to assess the extent of the empirical support for taking such action. In your subsequent letter of February 12, 1997, you expanded your request by asking for any recommendation that we might have for the Banking Committee on this issue. In that letter, you also asked for our views, and any recommendations that we might have, on the need for consolidated supervision of bank holding companies. To respond to your request, we (1) obtained and reviewed relevant economic literature concerning the mixing of banking and commerce, (2) interviewed academic experts, and (3) reviewed our prior work related to this issue and the need for consolidated supervision of bank holding companies.

Our review of existing literature found that the potential benefits of eliminating the current separation of banking and commerce generally lacked empirical support and that most such benefits could be realized through other means. Our review of these studies and our own prior work also indicated that there are risks associated with conglomerations of banks and commercial firms that could affect the safety and soundness of the financial system, the deposit insurance funds, and consumers and taxpayers. The exact magnitudes of such risks, however, are uncertain and depend, in part, upon the effectiveness of regulatory and legislative safeguards. Moreover, these benefits and risks may be affected by the rapid changes that are occurring in the industry today. Although Congress must ultimately make its own policy judgment, we thus urge that Congress proceed cautiously if it decides to relax the current restrictions. If Congress does decide to relax these restrictions, the associated risks could be reduced by doing so in an incremental manner.

Regarding supervision of bank holding companies, we have stated in previous reports and congressional testimony that financial services holding companies should be subject to comprehensive regulation on both a functional and consolidated basis.[1] Based on our extensive work assessing the severe problems that affected thrifts and banks in the 1980s and early 1990s and evaluating the effectiveness of financial institution examination and supervision, we believe an umbrella supervisory authority needs to exist to adequately assess how risks to insured depository institutions may be affected by risks in the other components of a holding company structure. If the current separation between banking related activities and commerce is eliminated, having an umbrella supervisory authority would thus imply an extension of some regulatory supervision to commercial firms.

## ELIMINATING THE CURRENT SEPARATION INVOLVES POTENTIAL RISKS

Our review of existing studies, as well as our own prior work assessing past financial institution failures, indicated that eliminating the separation of banking and commerce might subject the financial system, the deposit insurance fund, and consumers and taxpayers to a variety of risks.[2] The exact magnitudes of almost all of these risks are uncertain, and would depend, in part, upon what types of protections or firewalls were included in any financial services modernization legislation to insulate banking operations from nonbanking activities, and how well regulators monitor and

[1]See, for example, Financial Regulation: Modernization of the Financial Services Regulatory System (GAO/T-GGD-95-121, Mar. 15, 1995); Bank Oversight: Fundamental Principles for Modernizing the U.S. Structure (GAO/T-GGD-96-117, May 2, 1996); Bank Oversight Structure: U.S. and Foreign Experience May Offer Lessons for Modernizing U.S. Structure (GAO/GGD-97-23, Nov. 20, 1996); and Bank Powers: Issues Related to Repeal of the Glass-Steagall Act (GAO/GGD-88-37, Jan. 22, 1988).

[2]See, for example, Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 16, 1989), Bank Supervision: OCC's Supervision of the Bank of New England Was Not Timely or Forceful (GAO/GGD-91-128, Sept. 16, 1991), and Bank Insider Activities: Insider Problems and Violations Indicate Broader Management Deficiencies (GAO/GGD-94-88, Mar. 30, 1994).

enforce such firewalls. Thus, it is not possible to measure or quantify these risks at this time.

The primary risks include those associated with (1) a potential expansion of the federal safety net provided banks to commercial operations, (2) the potential for increased conflicts of interest within a banking and commercial conglomerate, (3) the potential for contagion effects from commercial operations spreading to insured banks, and (4) a potential increase in economic power exercised by large conglomerate enterprises.

Potential Expansion of the Federal Safety Net

The federal government provides a safety net to the banking system that includes federal deposit insurance, access to the Federal Reserve's discount window, and final riskless settlement of payment system transactions. Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, recently testified that this safety net, while helping to ensure the safety and soundness of the banking system, also provides a subsidy to commercial banks and other depository institutions by allowing them to obtain low-cost funds.[3] Allowing conglomerations of banks and commercial firms would increase the risk that the safety net, and any associated subsidy, might be transferred to commercial operations and result in inappropriate risk-taking, misallocations of resources, and uneven competitive playing fields in other industries. While such risks could be mitigated by establishing firewalls between banks and their commercial affiliates, our work has shown that such firewalls may not work in times of stress, or where managers are determined to evade them.[4] Moreover, firewalls require regular monitoring and enforcement by regulators and, if set too high, may prevent the realization of whatever potential benefits were expected to derive from allowing such conglomerations to occur.

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[3]Statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Banking and Financial Services, U.S. House of Representatives, Feb. 13, 1997.

[4]Using Firewalls in a Post Glass-Steagall Banking Environment (GAO/T-GGD-88-25, Apr. 13, 1988).

Potential for Increased Conflicts of Interest

Allowing conglomerations of banks and commercial firms could also add to the potential for increased conflicts of interest and raise the risk that banks might engage in anticompetitive or unsound practices. For example, some have argued that, to foster the prospects of their commercial affiliates, banks might begin to restrict credit to their affiliates' competitors, or tie the provision of credit to the sale of products by their commercial affiliates.[5] Perhaps more likely, banks might begin to extend credit to their commercial affiliates when they would not have done so otherwise, thus increasing the risks to the deposit insurance fund and to taxpayers.[6] Such behavior could also undermine the valuable monitoring function that banks provide in our economy. As long as banks are perceived as providing credible, objective assessments of the creditworthiness of companies and their activities, bank credit decisions can provide valuable information to the market about the soundness of these companies and their activities. The value and reliability of such signals could be diminished if banks were viewed as having conflicts of interest that adversely affected the objectivity of their credit decisions.

Potential for Increased Contagion Effects

Allowing conglomerations between banks and commercial firms could also increase risks to the deposit insurance fund and taxpayers if affiliated commercial firms were to extend any financial stress they experienced to their banking affiliates. Even if firewalls were able to keep such problems from actually being transmitted to bank affiliates, depositors who believed that commercial affiliates were experiencing financial problems might decide to withdraw their funds from the commercial firms' bank affiliates for fear that the banks' soundness might also be in jeopardy. If enough depositors did this, the fear could be self-fulfilling in that the viability of both the affiliated banks and the commercial firms could become threatened.

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[5]A. Saunders, "Banking and Commerce: An Overview of the Public Policy Issues," Journal of Banking and Finance, 18 (1994), 231-254.

[6]In our review of the 286 bank failures that occurred in 1990-1991, we found that insider problems and associated conflicts of interest were cited as contributing factors in 175 of the failures. See Bank Insider Activities: Insider Problems and Violations Indicate Broader Management Deficiencies (GAO/GGD-94-88, Mar. 30, 1994).

Possible Increased Concentration of Economic Power

There are also concerns that ending the current restrictions between banking and commerce could promote the formation of very large conglomerate enterprises with substantial amounts of economic power. Such enterprises could adversely affect the efficient operation of the economy and place consumers at risk of increased prices if they began to exert market power in either their banking or commercial operations. This risk would be enhanced to the extent that these new conglomerates could effectively access the subsidy inherent in the safety net and gain advantages over their competitors.

## POTENTIAL BENEFITS GENERALLY LACK EMPIRICAL SUPPORT

The major potential benefits that have been mentioned in recent years in support of eliminating the separation of banking related activities and commerce include (1) increased economies of scale, (2) greater diversification of risks, and (3) synergies that may result from affiliations between banks and commercial firms. In our review of the literature, we found that these potential benefits generally lacked empirical support and that such benefits could be realized without having to remove the barriers between banking and commerce.

Increased Economies of Scale

Some observers claim that the U.S. banking industry would benefit from the relaxation of banking and commerce restrictions because it would allow banks to expand their scale of operations and lower their unit costs of production. While some early studies seemed to indicate the presence of significant scale economies in banking,[7] the results of more recent work have been mixed.[8] Moreover, to the extent that scale economies exist and are significant in banking, banks should be able to capture them through mergers

[7]A review of the literature is provided in G. Bentson, G. Hanweck, and D. Humphrey, "Scale Economies in Banking: A Restructuring and Reassessment," Journal of Money Credit and Banking, 14 (1982), 435-456.

[8]See L. Mester , "Efficient Product of Financial Services: Scale and Scope Economies," Federal Reserve Bank of Philadelphia Business Review, January/February (1987), 15-25, and S. Shaffer, "A Revenue-Restricted Cost Study of 100 Large Banks," mimeo, Federal Reserve Bank of New York, 1988,.

with other banks. Banks do not need to combine with commercial firms to be able to achieve scale economies.

Greater Diversification of Risks

Some observers also claim that banking and commercial conglomerations would be beneficial because they would allow for greater diversification of risks across more product lines and thus reduce the variability of corporate earnings. Because the gains from this type of diversification rise when firms' earnings are less correlated, and fall when firms' earnings are more correlated, this argument rests on the assumption that the earnings of commercial firms fluctuate independently of the earnings of banks. We found the empirical evidence on this point to be inconclusive. One study we reviewed found some evidence that the returns on banking stocks and commercial firm stocks were not highly correlated, and thus concluded that diversification benefits were possible.[9] However, a more comprehensive study that examined a longer time period and controlled for more factors found that the variation in the stock returns of bank holding companies and nonfinancial companies are reasonably highly correlated and concluded that the benefits of diversification are overstated.[10]

Moreover, banks do not need to combine with commercial firms to reduce the variability in their earnings through diversification. For example, banks can diversify their assets through their loan portfolios and other investments, and their ability to diversify geographically was recently enhanced by the Interstate Banking and Branching Efficiency Act of 1994.

Synergies

Some observers argue that conglomerations of commercial firms and banks might result in other efficiencies, often referred to as synergies. Two possible sources of synergies are economies of scope and information efficiencies. Economies of scope exist if a combined firm can produce a mix of products at a lower cost than if the products were produced separately.

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[9]A. Saunders, and P. Yourougou , "Are Banks Special: The Separation of Banking from Commerce and Interest Rate Risk," Journal of Economics and Business, 42 (1990), 171-182.

[10]M.J. Isimbabi, "The Stock Market Perception of Industry Risk and the Separation of Banking and Commerce," Journal of Banking and Finance, 18 (1994), 325-349.

The main source of the cost savings comes from using the same inputs to produce multiple outputs. The virtually unanimous finding in the literature is that economies of scope are insignificant in banking.[11] We were unable to find any studies on the existence of potential economies of scope between banking and commercial activities.

Another possible synergy might result from improved informational flows within a combined entity. For example, by combining with commercial firms, banks might obtain better information about the commercial firms' activities, which the banks could then use to reduce the default rate on their loans. In addition, the commercial firms could benefit by obtaining bank loans at lower interest rates. However, the increased information flows might also induce banks to approve more risky loans.[12] We were unable to find any studies that attempt to quantify these potential effects.

Other Theoretical Arguments

Some observers have also argued that restrictions on bank affiliations lead to inefficiencies, because such restrictions impede the free flow of capital or managerial resources.[13] Although impediments to resource flows can lead to inefficiencies in certain cases, we found no clear evidence that such inefficiencies exist in the banking industry at the present time.

Those who argue that there is a capital shortage in banking believe that banks have a difficult time attracting capital, and that allowing banks and commercial firms to affiliate is necessary to allow the banking industry to attract capital from other industries. However, there are many sources of capital, such as new stock issues, that are open to banks and we are not aware of any empirical evidence that the U.S. banking industry is currently suffering from a capital shortage. In fact, the banking industry currently is very well capitalized by historic standards. The average capital asset ratio in

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[11]Mester (1987) surveys a number of studies.

[12]A summary of the trade-off is provided in K. John, T.A. John, and A. Saunders, "Universal Banking and Firm Risk-taking." Journal of Banking and Finance, 18 (1994), 307-323.

[13]See A. Saunders, (1994).

the industry in 1996 was 8.3 percent, compared to 6.7 percent in 1991.[14] By regulatory standards, capital in the banking industry is also high. At the end of 1995, 98.4 percent of banks were considered well capitalized, compared to 93.8 percent at the end of 1992.[15]

Another argument, which holds that separating banking and commerce causes inefficiencies by blocking resource flows, focuses on managerial talent and cost consciousness. According to this argument, allowing banks and commercial firms to merge would generate fears of a potential takeover resulting from poor performance and thus would induce managers to increase efficiency. It should be noted, however, that this type of discipline can take place even if banks and commercial firms are not allowed to merge. As long as better managed banks are allowed to purchase weaker banks, this efficiency-enhancing mechanism, to the extent that it works, would still be operable.

## FINANCIAL SERVICES INDUSTRY IS UNDERGOING SIGNIFICANT CHANGE

It is important to recognize that the benefits and risks associated with ending the separation of banking and commerce may be affected by the rapid changes that are currently occurring in both the regulatory environment and the structure of the financial services industry. For example, in recent years, a number of large mergers have occurred and some of the major effects of past legislative and recent regulatory actions are only beginning to appear. Until the effects of such developments are better understood, Congress may wish to act cautiously if it decides to relax the current restrictions.

One recent major legislative change was the Interstate Banking and Branching Efficiency Act of 1994, which authorizes interstate mergers between banks beginning June 1, 1997, regardless of whether the transaction

[14]The FDIC Quarterly Banking Profile: Commercial Banking Performance-Third Quarter 1996, p. 5.

[15]See Bank and Thrift Regulation: Implementation of FIDICIA's Prompt Regulatory Action Provisions (GAO/GGD-97-18, Nov. 21, 1996), p. 28.

is prohibited by state law.[16] The act also allows banks to branch across state lines if the host state has a law permitting the establishment or acquisition of branches by out-of-state banks. Even before the passage of the act, and certainly since its passage, there has been a strong tendency toward consolidation in the banking industry. In 1991, there were 12,000 banks and 2,600 thrifts. By September 1996, there were 9,586 banks (a 20-percent reduction) and 1,961 thrifts (a 25-percent reduction). Because the act allows multistate bank holding companies to become banks with multiple branches, the number of banks is likely to continue to shrink.

Not only has there been a large decline in the number of banks, there has also been considerable consolidation among large banks. This consolidation is driven by forces similar to those causing the decline in the number of banks, as well as by changes in the banking business, as more large banks enter into securities brokerage and underwriting, mutual funds, and insurance sales. In 1986, the 10 largest banks controlled 26.3 percent of industry assets. By 1994, they controlled 33 percent of assets.

In addition to legislative changes, there have been two important regulatory initiatives in the past year that are intended to allow banks to expand their nonbanking activities. First, the Federal Reserve enacted a revised regulation Y that includes (1) an expedited review process for bank and nonbanking proposals by well-run bank holding companies; (2) an expansion of the regulatory list of permissible nonbanking activities and removal of restrictions on those activities by reducing or eliminating certain firewalls between nonbank subsidiaries and banks; and (3) removal of the regulatory extension of antitying restrictions that apply to bank holding companies and their nonbank subsidiaries. Second, the Comptroller of the Currency also provided the opportunity for national banks to engage in additional nonbanking activities by establishing operating subsidiaries. Such subsidiaries might be permitted to engage in activities that are part of, or incidental to, banking, but are different from those activities permissible for the parent bank.

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[16]The Interstate Banking and Branching Efficiency Act gives states the right to opt out of this arrangement if they pass legislation before June 1, 1997 prohibiting merger transactions with out-of-state banks.

## VIEWS ON CONSOLIDATED HOLDING COMPANY SUPERVISION

In previous testimony before this Committee, we presented our views on the need for financial services holding company oversight.[17] That testimony, based on our extensive work evaluating the effectiveness of bank supervision and examination during the 1980s and 1990s, discussed the specific safeguards that we believe should be included in any financial services modernization legislation to protect against undue risks. These safeguards include the following:

1. Comprehensive regulation of financial services holding companies on both a functional and consolidated basis–While firewall provisions are extremely important to prevent potential conflicts of interest and to protect insured deposits, we believe an umbrella supervisory authority needs to exist to adequately assess how risks to insured banks may be affected by risks in the other components of the holding company structure.

2. Capital standards for both insured banks and financial services holding companies that adequately reflect all major risks, including market and operations risk–Because our past work on failed banks and thrifts found that capital can erode quickly in times of stress, we believe regulators should also be required to conduct periodic assessments of risk management systems for all the major components of the holding company, as well as for the holding company itself.

Our belief in the importance of consolidated oversight and consolidated capital standards is partly based on the fact that most, if not all, bank holding companies are managed on a consolidated basis, with the risks and returns of various components being used to offset and enhance one another. Such a consolidated supervisory approach is flexible enough to recognize and account for the contagion risks inherent in a holding company structure,

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[17]See Financial Regulation: Modernization of the Financial Services Regulatory System (GAO/T-GGD-95-121, Mar. 15, 1995).

and is similar to the approach that is now in place under the Bank Holding Company Act.[18]

One concern we have with a functional regulatory approach that does not include consolidated oversight is that it may prove too dependent on the establishment and maintenance of firewalls to control risks. Lack of a consolidated perspective could inhibit the ability of functional regulators to establish appropriate firewalls–i.e., ones that allow for appropriate spillover benefits but minimize contagion risks. Furthermore, past experience has shown that, regardless of whether firewalls are set properly, even periodic examinations cannot ensure that those firewalls can be maintained in times of stress if managers are determined to breach them.

Finally, we believe that consolidated holding company supervision is needed regardless of whether banks and commercial firms are allowed to affiliate under a holding company structure. Thus, combining banks and commercial firms under a holding company structure would subject commercial firms to regulatory oversight. Furthermore, such action might raise issues about the adequacy of bank supervisory resources and about regulatory burden.

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Sincerely yours,

James L. Bothwell
Chief Economist
(972629)

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[18]Currently, the Federal Reserve acts as the overall regulator for bank holding companies, which includes setting consolidated capital requirements for the company as a whole, exercising supervisory authority over the company, determining what types of activities can be affiliated with banks under the holding company structure, and approving such holding company activities as mergers and acquisitions.

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