Losing Ground: Gramm-Leach-Bliley and the Future of Banking

By Peter J. Wallison

Banks are regulated and their activities limited because their deposits are ultimately backed by the government. As a result, they are often unable to respond to competitive challenges. This can have a substantial adverse effect on their safety and soundness and is one of the reasons the recent financial crisis has been so severe. For the past forty years at least, banks’ role as lenders to public companies has been eroding because advances in technology and communications have made it easier for public companies to access securities markets. As banks’ lending to public companies declined, banks increased lending to the volatile and cyclical real estate sector. In 1965, loans to this sector accounted for less than 25 percent of all bank loans; in 2008, they accounted for more than 55 percent. This resulted in a banking crisis when the residential mortgage market collapsed. The Gramm-Leach-Bliley Act of 1999 (GLBA) is often and ignorantly blamed for “repealing” the Glass-Steagall Act—which it did not do—but its real purpose was to enable banking organizations to compete more effectively with other kinds of financial institutions and business models. For reasons that are not yet clear, the GLBA has not achieved its purpose; banks have continued to focus on traditional lending activity and are now more heavily committed to the real estate sector than they were in 1999. The continuation of this trend will result in more bank instability in the future. The answer is not more regulation, as the Obama administration would have it, but policies like the GLBA that make it possible for banking organizations to meet their competition by broadening the range of their financial activities.

Most longtime observers of the debate in Washington over financial regulation are probably puzzled by references to the GLBA as a cause of the financial crisis. At the time of its adoption, the GLBA was hailed as a forward-looking effort to bring new flexibility and change to the banking industry. As described by John LaFalce, then the ranking Democrat on the House Financial Services Committee, “The Act does not freeze-frame the financial services industry into its current structure and function, but removes obstacles to, and indeed promotes, its continued evolution. . . . It will allow U.S. financial institutions to remain at the cutting edge of economic change both here and abroad.”¹ Today, however, the GLBA is mostly cited—and reviled—as the statute that “repealed” the Glass-Steagall Act.

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Key points in this Outlook:

- At least since 1965, banks have been losing corporate customers to the securities markets, where financing is less expensive than borrowing from banks.
- In response, banks have increased lending in the real estate sector, a volatile and cyclical business that, in the last forty years, has seen an increase from less than 25 percent of bank lending to over 55 percent.
- Although the GLBA was intended to free banking organizations (including banks and their holding companies) from a regulatory straitjacket that was impeding their ability to compete, it has not yet had a significant effect.
- Unless banks can be weaned from their focus on real estate lending, future banking and financial crises are inevitable.
and thereby precipitated the financial crisis. Statements like this arise out of ignorance; the act did not repeal Glass-Steagall. Indeed, the current financial crisis shows that the underlying purpose of the GLBA was sound.

The balance of this Outlook will discuss the underlying purposes of the GLBA, the long-term prospects of the banking industry, and the difficult choices ahead for policymakers.

The GLBA and Banks’ Securities Activities

The GLBA was based on ideas originally developed in 1981, during the Reagan administration. In the early 1980s, it was becoming clear that banks were losing corporate financing business to securities firms. As figure 1 shows, this trend is now clear, and it is linked to differences between the business models of banks and securities firms. Bank intermediation involves principal transactions; a bank operates by borrowing short and lending long. This business model requires the bank to put both the asset (the loan) and the liability (the deposit) on its books and requires a strong capital position to reassure its lenders and regulators that it is able to withstand both the credit and liquidity risks that result. This is an expensive way to intermediate between lenders and borrowers. Securities firms, on the other hand, are able to place securities as agents and receive only a commission; even in underwriting securities, securities firms do not have to incur the capital costs of holding securities on their balance sheets for extended periods. Accordingly, the business model of securities firms requires less capital and is more cost efficient in raising funds for corporate clients than borrowing from a bank.

Despite this cost disadvantage, banks were able to maintain their financial dominance for many years because they had an information advantage. By aggregating the contributions of many depositors into a loan, they were more cost-effective for analyzing the financial condition of potential borrowers than any single depositor. This was the heart of the bank’s intermediary function. As telecommunications became more sophisticated and the Securities and Exchange Commission required public companies to disclose more, and more current, information, however, banks’ information advantages eroded. It became possible for investors and creditors to evaluate the creditworthiness of companies for themselves without significant expense, and this facilitated the growth of a large market for both long- and medium-term securities, such as bonds and notes, and a short-term market for corporate commercial paper. Securities firms were the intermediaries in these transactions. Over time, this form of intermediation wrested most lending to public companies away from banks. In figure 1, accordingly, the “other financial intermediaries” are predominantly securities firms.

The obvious remedy for the gradual erosion of banks’ corporate lending business was to free them from some of the regulations that kept banks tied down to an uncompetitive business model. Banking laws in place in the 1980s, and until the adoption of the GLBA, restricted the ability of banks to compete for corporate securities business. First, the provisions of the Glass-Steagall Act prohibited banks themselves from engaging in a full securities business (banks could act as securities brokers—that is, they could buy and sell securities as agents for customers—but they could not engage in underwriting and dealing in securities, which involves taking risks as principals). In addition, Glass-Steagall prohibited banks from affiliating with firms that were engaged in underwriting or dealing in securities, so banks could not be affiliated through holding companies with full-service securities firms. Finally, the Bank Holding Company Act of 1956 (BHCA) prohibited affiliations

**FIGURE 1**

**Banks’ Share of U.S. Financial Intermediation Compared to Other Institutions, 1945–2008**

![Graph showing banks' share of U.S. financial intermediation compared to other institutions, 1945–2008](source: Derived from data in Ron J. Feldman and Mark Lueck, “Are Banks Really Dying This Time?” Federal Reserve Bank of Minnesota, September 2007, available at www.minneapolisfed.org/publications_papers/pub_display.cfm?id=1139 (accessed December 11, 2009).)
between banks and any activity that was not “closely related to banking.” The Federal Reserve (which administers the BHCA) interpreted this language very narrowly, essentially to mean that bank holding companies (BHCs) could engage only in those activities in which banks themselves were authorized to engage. Under these circumstances, banks and BHCs could not participate in the growing trend among public companies to meet their financing needs in the public securities markets by issuing notes, bonds, and commercial paper.

Although an obvious reform would have been to repeal Glass-Steagall in its entirety, that was neither politically feasible nor sensible as policy. Bank deposits are insured by the Federal Deposit Insurance Corporation (FDIC) and provide banks with a source of funds with which other businesses cannot compete. Moreover, dealing in securities involves holding an inventory of securities that is subject to wide swings in value, and this would not be consistent with a government policy of insulating banks from the daily vicissitudes of the market. Accordingly, the solution adopted by the Reagan administration was to allow banks to affiliate with securities firms through their holding companies. That idea was eventually embodied in the GLBA, which repealed the affiliation restrictions of the Glass-Steagall Act and thus permitted BHCs—but not banks themselves—to engage in securities underwriting or dealing and in any activity that the Federal Reserve might determine to be an activity “of a financial nature.” BHCs are ordinary corporations, do not take deposits, and are not backed by the government or entitled to any of the other privileges of banks. The act also gave the Fed—as the administrator of the BHCA—some limited “umbrella” supervisory authority over the activities of the nonbank subsidiaries of BHCs, in coordination with the primary regulators of these institutions.

Thus, the idea behind the GLBA was to enable BHCs to take over more of the financial activity of the combined bank-BHC entity, extending BHC activities into securities and insurance underwriting as well as other financial activities that might become important over time. Although many BHCs have ventured into financial businesses of various kinds following the enactment of the GLBA, the purposes of the act have not been realized; BHCs continued to be dominated by the lending activities of their subsidiary banks, and the role of banks as financial resources for public companies has continued to decline.

Bank Responses to the Decline in Corporate Lending

If lending to public companies was declining as a percentage of bank activity, what took its place? The answer is commercial and residential real estate lending. Banks continued to grow along with the rest of the economy, but the nature of their assets changed significantly, as shown in figure 2. To replace their corporate customers, banks became lenders to small businesses (which do not have access to the public securities markets) and to consumers through auto loans and credit cards. But increasingly, banks became real estate lenders. Indeed, as figure 2 shows, the dollar value of commercial and residential real estate loans increased from less than 25 percent of all bank loans in 1965 to over 55 percent in 2008. This is an unhealthy trend. In 1997, the FDIC published a study of the severe banking crises of the late 1980s and early 1990s. During that period, the savings and loan industry collapsed, and almost 1,600 commercial banks also failed. In its study, the FDIC compared the failure rates of banks that had high percentages of real estate assets with those that did not and consistently found a significantly higher rate of failure among the former. Commercial real estate, as the FDIC observed in its study, is one of the riskiest market sectors; it is subject to boom and bust cycles, information limitations, local issues, liquidity problems, and other deficiencies that can cause large losses and bank failures. Indeed, national banks were prohibited from making real estate loans from their inception in 1864 to the adoption of the Federal Reserve Act in 1913. The current crisis demonstrates that residential mortgages can also be risky, especially when—as has been true since the early 1990s—the government has fostered the growth of a subprime and Alt-A mortgage market that now includes almost half of all U.S. mortgages.

The important point is that as banks have been forced out of lending to public companies—which in themselves offer significant diversification—they have focused more and more of their resources on fewer and fewer market sectors, particularly riskier kinds of business like commercial and residential real estate lending. As former chairman of
the FDIC L. William Seidman once observed, “Banks' troubles began when they lost their big corporate customers to the commercial paper market early in the 1970s.”7

Assessing the GLBA

At this point, it is difficult to look on the GLBA as a success. Figure 1 shows a continuing trend toward financial intermediation by nonbank financial institutions, but some of this relative growth may be the result of activity by the nonbank subsidiaries of BHCs. What seems clear is that the relative efficiency of intermediation in the securities market is continuing to take corporate lending business away from banks. There is probably no way to stem this long-term trend, which is an example of how the dead hand of regulation can impede the ability of whole industries to respond to new forms of competition generated by technological change. Like the railroads, the banking industry may be doomed by government's efforts to protect it from risk taking.

It is puzzling why more BHCs, once they have become financial holding companies (FHCs) as permitted by the GLBA, have not made extensive use of this business model; the lending objectives of banks have continued to dominate their holding companies. It may be that ten years is too short a period in which to judge whether FHCs could become major players in financial markets. Perhaps the conservative culture of banking could not be changed in so short a period. More likely, the Fed's tight regulation of FHCs has suppressed the risk taking and initiative necessary for growth. This would explain why securities affiliates acquired by the major FHCs never became significant players in the securities business. Despite complaints that the GLBA permitted the formation of huge and risky conglomerates, the opposite seems to be true: the investment banks that remained independent of the large FHCs grew to enormous size after 1999, while those that were acquired by the large FHCs remained minor players in the securities business.

Citigroup is a good example of this phenomenon. When it merged with Travelers Corporation in 1998, Citi acquired two large and aggressive investment banking firms: Salomon Brothers and Smith Barney. Despite their affiliation with what was then the largest banking organization in the United States, neither firm grew at the rate of the independent investment banks or became a major player in investment banking.

In light of experience in the financial crisis, it is difficult to claim that the diversification made possible by the GLBA contributed to the stability of large FHCs such as Citigroup, Wachovia, WAMU, or Bank of America. All of them either became unstable and required government assistance or were acquired by stronger institutions. At the same time, as noted in the October Outlook,8 there is no evidence that nonbanking or trading activities conducted at the holding company level contributed significantly to the losses these institutions suffered. These losses seem to have come entirely from imprudent banking practices—particularly purchasing either subprime mortgages or securities backed by subprime mortgages for investment purposes. The fact that this is the same activity that brought down the large independent investment banks seems to demonstrate that the proliferation of these mortgages was the underlying cause of the financial crisis, which would have occurred even without the adoption of the GLBA.

**Figure 2**

MORTGAGE LOANS AS A PERCENTAGE OF TOTAL LOAN DOLLARS, COMMERCIAL BANKS, 1965–2008

![Mortgage Loans Graph](image-url)
Conclusion

We need a policy that will enable banks to adjust to changes in the economy and the financial system in the future. If the GLBA is not effective for this purpose, then another mechanism should be tried. Banks should not be required—as they are now—to focus their activities only in the areas of the economy where they are still competitive. As long as banks issue deposits that are seen as government insured, however, they must be regulated and limited in their activities. The result, as we see today, will be continuing weakness in the banking sector.

Recently, commentators and government officials have outlined proposals for what might be called narrow banks: utility-like institutions that invest in safe assets such as U.S. government securities and are funded by insured deposits. This would satisfy the political demand for a completely safe instrument for savers, but that is not a business model that can sustain the banking industry over the long term. Some way must be found to enable the capital now imprisoned in the banking business to be used more effectively. The method adopted in the GLBA still seems to be the most promising way to free the banking industry from the strictures required by the government backing that banks enjoy. By transferring more activities and more capital to their holding companies, banks may gradually shrink as they lose the ability to compete with other, more flexible and innovative financial intermediaries. The Fed currently has the authority necessary to see that the underlying policy of the GLBA is put into practice. Instead of encouraging lending, the Fed could encourage more innovative activities on the part of FHCs. It is clear, however, that unless current banking policies are changed, and banking organizations have profitable alternatives to lending, the increasing bank commitment to the real estate business will bring another financial crisis in the future.

Notes

3. Figure 1 is derived from data in Ron J. Feldman and Mark Lueck, “Are Banks Really Dying This Time?” Federal Reserve Bank of Minnesota, September 2007, available at www.minneapolisfed.org/publications_papers/pub_display.cfm?id=1139 (accessed December 11, 2009).