FRBSF WEEKLY LETTER

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Uniting Investment and Commercial Banking

Banking organizations in the U.S. face obsolete legal prohibitions on the products and services they can provide. In particular, the Glass-Steagall and the Bank Holding Company Acts limit the ability of banks to underwrite corporate securities and to hold investments in the equity of nonbank enterprises.

Nevertheless, banks have had some success at circumventing legal barriers. For example, because state-chartered banks that are not members of the Federal Reserve are not covered by Glass-Steagall, they or their subsidiaries are allowed in some states to provide many investment banking services, including securities underwriting and direct equity investment. Likewise, subsidiaries of U.S. bank holding companies are able to perform some investment banking activities in offshore markets.

In addition, the interpretation of Glass-Steagall by regulators has evolved over time. For example, on April 30, the Federal Reserve approved applications that gave limited authority to bank holding companies to underwrite certain securities through subsidiaries "not principally engaged" in underwriting. (The Fed approved underwriting and dealing in municipal revenue bonds, mortgage-backed securities, and commercial paper.)

Full-fledged integration of commercial and investment banking would require changes in existing statutes. As Congress considers a one-year moratorium on any new banking powers legislation, the immediate prospect of such change has dimmed. Nevertheless, we discuss some of the policy issues involved in integrating commercial and investment banking.

Forces for change

It is apparent from the vigor with which banks and nonbanks are seeking to realign their traditional functions that the underlying economic forces stimulating change are strong. One of the forces has been the high degree of instability of interest rates, prices, and exchange rates that has characterized the world economy in recent years. This instability has not only stimulated the demand for specific risk-management products, such as options and futures, but also increased the complexity of traditional financial instruments and heightened the need for institutions to diversify their activities and portfolios.

The declining cost of gathering, managing, transmitting, and analyzing the data required to produce financial services has enhanced the feasibility of diversifying and realigning financial activities. Innovation in electronic data processing and communication makes new financial services feasible and makes it possible to repackage old financial services into more convenient combinations.

To a large extent, regulations separating commercial and investment banking have long been in conflict with economic forces. In the absence of prohibitive regulations, banking and investment banking traditionally have been affiliated both in this country and abroad. In the United States, for example, commercial banks began forming securities affiliates before World War I, and, within two decades, underwrote almost 60 percent of new corporate security issues. Even now, U.S. commercial banks are major providers of those investment banking services they are allowed to offer, such as underwriting general obligation municipal bonds.

In Great Britain, the historical regulatory practice of separating commercial and investment banking has eroded and it is common for the large commercial banks (the "clearing banks") to perform investment banking functions through subsidiaries. More recently, the ability of organizations (including banks) to own securities brokerage houses in Britain was expanded, enhancing integration of banking and brokerage. In West Germany and Austria, so-called "universal banking" is practiced — commercial banking organizations perform not only investment banking and brokerage functions but also take major equity positions in commercial enterprises.

Benefits

The tendency for commercial and investment banking services to be integrated when allowed is partly due to the complementarity of their

functions. Virtually all of the functions performed by investment banks have a counterpart in commercial banking operations. In evaluating borrowers, or in originating, syndicating, and selling loans, commercial banks perform the component activities involved in underwriting corporate securities and distributing them in the marketplace. Similarly, the payments services that banks provide are a valuable adjunct to the business of investing in corporate securities. Indeed, nonbanks have found that providing payments services (checkable accounts) is crucial in marketing money market mutual funds, cash management brokerage accounts, and other retail investment products.

If these potential synergies between commercial and investment banking activities could be realized, the economies of operation that would result would benefit customers and the economy as a whole. The cost of raising or investing in corporate capital also would decline, in part, because the competitiveness of the investment banking market would increase. Presently, 12 firms generate over 50 percent of all U.S. investment banking revenue. "Deepening" the investment banking market may be particularly important in light of the rapid growth of primary securities markets.

Conflicts of interest

Resistance to the integration of commercial and investment banking stems in large part from turf considerations of the now separate industries. In addition to these private concerns, there are important public policy concerns. Glass-Steagall has been defended, and, in fact, was enacted primarily on the grounds that it prevents conflicts of interest and thereby protects banks and the securities market against excessive risk.

Many have argued that conflicts of interest might occur if banks were both major lenders to corporations and also underwriters, and possibly even major purchasers, of corporate securities. The concern is that banks would fraudulently misrepresent the securities underwritten on behalf of firms to which they were creditors, or lend preferentially to those entities in which they had equity or underwriting stakes.

Most independent observers, however, discount such concerns. Although the activities of bank securities affiliates were cited at the time for contributing to the bank failures of the Great Depression, recent research by Mark Flannery and others has been unable to find an association between the securities underwriting activities of banking firms in the 1920s and 1930s and subsequent bank failures. Similarly, concerns over conflict of interest in West German banking also were reviewed extensively and rebutted by the Gessler Commission in 1979. In addition, economist Richard Dale, in a more recent examination of the West German banking system, finds no association between the securities activities of that country's universal banks and their stability.

Conflicts of interest also are relatively easy to monitor and to control directly if necessary. In fact, such conflicts could arise today in the activities of banks and their trust departments, but are uncommon. This suggests that bank regulatory powers and the protections against securities abuse afforded by the Securities Act of 1933 and the Securities Exchange Act of 1934 are adequate to the task. Moreover, competitive market forces should provide a check on self-dealing in securities. Institutions that engaged in such activities, and thus failed to act in the best interests of their customers, might soon find themselves with many fewer customers.

Moral hazard

A more legitimate public policy concern in the debate over integrating securities activity and commercial banking is whether such integration would lead to an undesirable propagation of the deposit insurance guarantee and its corresponding moral hazard. Deposit insurance, which can prevent bank runs, is a central, and, many believe, essential feature of our present banking system. However, it can create an undesirable side effect — an incentive for excessive risk-taking because an insured bank can attract funds at a risk-free rate regardless of the riskiness of the bank's portfolio.

Under these circumstances, only regulation will restrain an insured institution, acting in the best interest of its shareholders, from assuming more risk than is socially desirable. If bank powers were expanded, such as through the integration of investment and commercial banking, it might become increasingly difficult for regulators to assess and limit a banking organization's level of risk-taking. Put differently, the "subsidy" provided by deposit insurance would propagate to the nonbanking activities of the organization,

where any problems that develop could be an additional source of instability for banking.

Corporate separateness

One method proposed to prevent the undesirable effects of deposit insurance from propagating is the strict enforcement of "corporate separateness". Corporate separateness entails putting all nontraditional financial functions in subsidiaries of bank holding companies and then trying to insulate the bank from the risks of the nonbank subsidiaries.

There are several reasons corporate separateness is unlikely to work very well. Most important is the very strong profit incentive for a corporation (in this instance, a bank holding company) to manage its various subsidiaries as a single entity. While it might be possible to enforce corporate separateness strictly, and thereby truly insulate the bank, doing so might severely restrict or even eliminate any synergies the consolidated organization might otherwise enjoy. Thus, from a purely organizational viewpoint, the erection of legal barriers between banks and their securities affiliates, in itself, would be unlikely to remove incentives for the propagation of deposit insurance guarantees.

In fact, there is abundant empirical evidence that bank holding companies in the U.S. are run as consolidated enterprises. For example, such companies tend to use affiliate relationships to avoid capital and other regulatory constraints imposed on banking activities, and are reluctant to let their nonbank affiliates fail. Indeed, even from a purely legal standpoint, it is unclear whether the liability of a subsidiary can be effectively separated from that of its parent.

Capital regulation

While the enforcement of corporate separateness is not the solution to the problems presented by the integration of investment and commercial banking to the deposit insurance system, there are a number of ways in which the insurance system itself could be restructured to prevent the same problems. Perhaps most promising would be a move toward much more stringent capital regulation, whereby banks would always be closed when they could not or would not maintain sufficient capital as valued on a current market basis.

Such reform would require fundamental changes in the rules governing the valuation of banks' capital and those determining when institutions would be declared legally insolvent. Specifically, it would require a shift from measuring capital on a historical book-value basis, as is done now, to a current or market-value basis and closing banks before their market value of capital could fall below zero. If both could be accomplished, bank powers could be expanded and nonbank financial firms allowed access to the payments system without threatening the viability of the deposit insurance fund.

To be effective, such an approach might require increased and more frequent supervision of insured institutions to monitor closely the market values of their equity. One major practical difficulty in doing so lies in assigning market values to nontraded assets and liabilities. However, many investment banking functions entail holding traded assets and liabilities whose market values are readily ascertainable. Moreover, valuation procedures could be structured conservatively to avoid overevaluation of an organization's net worth.

One way such a system could be phased in would be to require banks that wished to offer investment banking services to submit to stringent market-value capital regulation of the sort outlined above. Thus, banks actually expanding their services would do so because they expected to realize the efficiencies involved, not because they wished to exploit the deposit insurance system.

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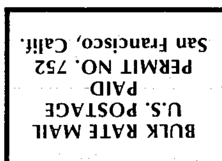

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 5/27/87	Change from 5/20/87	Change from 5/28/86 Dollar	Percent[7]
Loans, Leases and Investments[1] [2]	205,832	– 707	2,835	1.3
Loans and Leases[1] [6]	182,569	– 1,268	– 1,318	– 0.7
Commercial and Industrial	53,570	– 206	661	1.2
Real estate	68,360	– 79	1,798	2.7
Loans to Individuals	37,315	114	– 3,537	– 8.6
Leases	5,386	13	– 250	– 4.4
U.S. Treasury and Agency Securities[2]	15,959	565	4,691	41.6
Other Securities[2]	7,303	– 6	– 539	– 6.8
Total Deposits	206,081	504	1,419	0.6
Demand Deposits	53,012	470	1,756	3.4
Demand Deposits Adjusted[3]	36,102	– 779	– 10,937	– 23.2
Other Transaction Balances[4]	19,174	– 46	3,470	22.0
Total Non-Transaction Balances[6]	133,894	79	– 3,808	– 2.7
Money Market Deposit Accounts—Total	44,723	3	– 1,831	– 3.9
Time Deposits in Amounts of $100,000 or more	31,831	4	– 5,054	– 13.7
Other Liabilities for Borrowed Money[5]	25,894	2,197	1,424	5.8

Two Week Averages of Daily Figures	Period ended 5/18/87	Period ended 5/4/87
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	81	19
Borrowings	43	104
Net free reserves (+)/Net borrowed(–)	38	– 84

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change