FRBSF Weekly Letter

Number 95-20, May 19, 1995

The Economics of Merging Commercial and Investment Banking

In recent weeks, both houses of Congress and the Administration have put forward proposals to reform the Glass-Steagall Act. Since 1933, the Act has separated commercial banking from investment banking. Rep. James Leach (R–Iowa), Chair of the House Banking Committee introduced the Financial Services Competitiveness Act, which would grant securities powers to banking organizations. Senator Alfonse D'Amato (R–New York), Chair of the Senate Banking Committee, introduced the Depository Institution Affiliation Act, which would repeal not only Glass-Steagall but also the Bank Holding Company Act, which separates banking from commerce; this proposal would allow banks to be affiliated with any firms, financial or commercial, effectively granting all financial and commercial powers to banking firms. Finally, Treasury Secretary Robert Rubin suggested granting both securities powers and insurance powers to banking organizations.

Although the proposals differ on how far to integrate banking and other financial services firms, they all are in accord on granting securities powers to banking organizations. This suggests that, at a minimum, the Glass-Steagall barrier between commercial and investment banking may fall.

A thorough analysis of all the issues involved in these proposals is beyond the scope of this article, and a number of important regulatory issues, such as the risks of investment banking activities on commercial banks and ultimately the bank safety net, and the potential concentration of financial power, will not be discussed here. Instead, this *Weekly Letter* is limited to highlighting several economic justifications for reconsidering the relationship between commercial banking and investment banking: empirical evidence on investment banking activities conducted by commercial banks before 1933, current related banking and securities regulations, and theoretical support on the grounds of both economies of scope and superior capital allocation.

The banking environment—then and now

When the Glass-Steagall Act was passed in 1933, people were concerned about various kinds of abuses by commercial banks' investment banking affiliates. The alleged abuses included overstating the quality of the underwritten securities issued by the commercial banks' clients, packaging bad commercial loans into securities, misusing responsibility for trust accounts—and the list goes on. The Glass-Steagall Act was designed to protect public investors from these potential abuses by prohibiting commercial banks from conducting investment banking activities.

Recent research has cast new light on whether the concerns that led to Glass-Steagall warrant the separation of commercial banking from investment banking. For example, two studies examine the period before Glass-Steagall and find little evidence that the investment banking affiliates of commercial banks tended to underwrite poor quality securities. Kroszner and Rajan (1994) find statistically significant evidence that issues underwritten by commercial banks before 1933 defaulted less often than similar issues underwritten by investment banks. A separate study by Puri (1994) reports similar findings. Their results suggest that corporate bonds underwritten by commercial banks actually performed better than similar bonds underwritten by investment banks. Ang and Richardson (1994) take a different approach to this question. Rather than conducting a matched-security comparison that controls for the differences in bond attributes across underwriters, they examine various performance measures of bond issues underwritten by security affiliates of commercial banks as a group *vis-à-vis* those that are underwritten by investment bankers. They do *not* find that bonds underwritten by commercial banks as a group were in any way inferior to those underwritten by investment banks. These research findings suggest that the motivation for the separation of commercial and investment banking was ill-founded in the first place.

Furthermore, since 1933, Congress has passed various securities laws that target specific areas of concern related to Glass-Steagall. For example, there are securities laws that prohibit the use of inside information for financial gains; there are rules that govern initial public offerings and insider trading; and there are disclosure requirements that must be met by publicly traded firms. Moreover, the Federal Reserve has written banking regulations that specifically prohibit unfair or anti-competitive banking practices. To the extent that existing laws and regulations adequately address the abuses Glass-Steagall is meant to avert, the barrier between commercial and investment banking no longer seems necessary. In other words, the Glass-Steagall Act may be redundant in today's environment.

Economies of scope

A stronger case for repealing Glass-Steagall's barrier between commercial and investment banking can be made in light of the potential gains from combining these two types of financial activities. One source of such gains is economies of scope. Economies of scope exist when it is cheaper to produce a set of goods together than to produce each good separately. Economies of scope could arise in combining commercial and investment banking, because information-gathering is an important part of providing both credit and underwriting services. As a lender, a commercial bank collects extensive information from borrowers to evaluate their creditworthiness and to price loans to compensate for the risk of default. As an underwriter, an investment bank collects very similar information from firms whom they assist in issuing public debt or equity securities; an investment bank uses this information to advise the issuing firm on the pricing of the public security offering, which reflects the underlying risks of the issuing firm, and on the method of issuance. In economic parlance, the means of collecting the information, and the information itself, are inputs of a financial firm's production function. To the extent that the same production technology can be used to produce two different financial products, a combined entity of commercial and investment bank should be able to derive efficiency gains from economies of scope.

For example, scope economies in producing bank credit and underwriting services jointly derive from the higher utilization rate of capital and labor, such as using the existing data processing subsidiary of the bank holding company to support investment banking activities, or using the same corporate training program to train both commercial and investment bankers. To the extent that the existing corporate overhead structure is capable of handling higher levels of economic activities, the joint production of credit and underwriting services should result in cost savings. In a competitive market, some of these savings would be passed to the users of financial services.

Furthermore, the raw material that is used to produce these financial services—information—can achieve higher productivity as well. Firm-specific information is a costly input in making loans and underwriting securities. As noted earlier, both commercial bankers and investment bankers gather similar information from the same firm to make loans and to underwrite securities. With the barrier between commercial and investment banking, the loan officer and the investment banker must collect information separately from the same firm, doubling the cost of information-gathering. However, if the same financial institution is allowed to provide both credit and underwriting services, the information gathered in the lending activities can be *reused* when the banking organization underwrites public securities for the same client, and vice versa. The information gathering costs are incurred only once, thus reducing by half the amount of raw material (information) to produce *both* credit and underwriting services. The higher productivity of the raw material in the joint production plan provides another source of scope economies.

Superior capital allocation

In the current environment, while large firms are actively courted by investment bankers, small- to medium-sized firms generally find the cost of issuing public securities expensive and sometimes prohibitive, because the smaller the size of the issue, the higher the underwriting fee per dollar. In addition, information asymmetry tends to be greater for smaller firms, further exacerbating the problem of offering their securities to the public. As a result, most small firms have very limited financing alternatives and tend to rely on loans from commercial banks as the major source of financing.

Relying solely on commercial bank loans to finance capital investment has some undesirable properties, stemming from the short-term nature of most bank loans. Because of the banks' short-term liability structure, banks are reluctant to make long-term commercial loans. More importantly, because of the moral hazard in lending, where the borrowers have private incentives that are hazardous to the lenders' interests, banks can keep the borrowers on a tight leash by shortening the loan maturity. However, firms that use short-term bank loans to finance long-term projects may render too much control to the bank. If the project underperforms, the bank can liquidate the project prematurely when its loan is due. Knowing that the fate of the project is subject to the bank's control, a rational entrepreneur may choose to bypass an otherwise profitable project. Hence, the lack of financing alternatives to smaller firms may result in underinvestment in the economy.

If banking organizations were allowed to underwrite corporate securities, especially equities, they could widen the financing choices for these smaller firms, hence improving the allocation of capital and mitigating the underinvestment problem. Notice that these smaller firms would have the full attention of an investment banker due to their established commercial banking relationship. Commercial banks, which have years of experience with these firms, have already collected the bulk of information necessary to underwrite their securities. Hence, it is likely that a commercial bank with an ongoing relationship with an issuing firm can underwrite its securities at lower cost. Furthermore, because the market is aware of the bank's inside knowledge of the firm, the bank has a comparative advantage in certifying the securities that it underwrites (assuming the bank's conflict of interest can be mitigated by its reputational capital). Both the quantity and the quality of information released by the underwriter can lower the risks of the securities, which increases the expected proceeds to the issuing firm. Not only would commercial banks expand the financing sources of smaller firms, they would be in a unique position to underwrite their public securities.

Conclusion

The Glass-Steagall Act does not seem to be serving our society well in the current environment. The law was passed in 1933 to provide blanket protection against potential abuses by the securities affiliates of commercial banks by separating commercial and investment banking outright. As the threat of financial abuses diminishes, Glass-Steagall appears to be more of an obstacle to economic efficiency than a guardian of financial safety and soundness. Specifically, the blanket protection Glass-Steagall provides no longer seems necessary, as we have developed a sophisticated regulatory apparatus to police financial activities. Furthermore, combining commercial and investment banking activities is expected to result in efficiency gains due to economies of scope as well as improvements in the allocation of financial capital in the economy, which should lead to higher economic activities. On the grounds of economic efficiency, at least, combining commercial and investment banking seems desirable.

Simon Kwan
Economist

References

Ang, J. S., and T. Richardson. 1994. "The Underwriting Experience of Commercial Bank Affiliates prior to the Glass-Steagall Act: A Re-examination of Evidence for Passage of the Act." *Journal of Banking and Finance* 18, pp. 351–395.

Kroszner, R. S., and R. G. Rajan. 1994. "Is the Glass-Steagall Act Justified? A Study of the U. S. Experience with Universal Banking before 1933." *American Economic Review* 84, pp. 810–832.

Puri, M. 1994. "The Long-Term Default Performance of Bank-Underwritten Security Issues." *Journal of Banking and Finance* 18, pp. 397–418.

Research Department
Federal Reserve
Bank of
San Francisco

P.O. Box 7702
San Francisco, CA 94120

Printed on recycled paper
with soybean inks.

Index to Recent Issues of *FRBSF Weekly Letter*

The *FRBSF Weekly Letter* appears on an abbreviated schedule in June, July, August, and December.