FRBSF Economic Letter

2000-10 March 31, 2000

Subscribe RSS Feed Share

« More Economic Letters

The Gramm-Leach-Bliley Act and Financial Integration

Fred Furlong

After more than two decades of debate, full affiliation of commercial banking with other financial services became a reality in March 2000. The Gramm-Leach-Bliley Act (GLBA), signed into law last November, authorized the certification of financial holding companies, the structure that looks to be the main vehicle for linking commercial banks with securities firms, insurance firms, and merchant banking. Subsequent to the March 11 effective date, the Federal Reserve released a list of the first 117 institutions certified as financial holding companies.

This *Economic Letter* shows how the GLBA provides a more sensible, straightforward path toward financial integration. Before the act was passed, banks and other financial firms had to take a variety of side routes to integrate financially. Their progress toward integration–not surprisingly–was, for the most part, piecemeal. The *Letter* also reviews some key provisions of the act, including the Federal Reserve's role as the umbrella supervisor for financial holding companies.

Side routes to financial integration–before GLBA

Perhaps the best example of a side route to financial integration is one that banks have used to get involved in securities underwriting–the so-called Section 20 securities subsidiary. Section 20 refers to part of the Glass-Steagall Act of 1933 that separated commercial and investment banking. While banks retained the ability to handle certain securities such as Treasuries, Section 20 prohibited banks from affiliating with firms "engaged principally" in underwriting and dealing in securities, like corporate bonds and equity. That phrase–"engaged principally"–left room for a bank holding company to form a subsidiary that conducted a large portion of permissible activities and a smaller portion of otherwise prohibited activities.

The Federal Reserve first authorized such a subsidiary in 1987. Today banking organizations operate 51 securities subsidiaries, including some that were acquisitions of well-known securities firms–for example, Solomon Smith Barney and, in this Federal Reserve District, firms such as Montgomery Securities and Robertson Stephens.

Banks also have gotten into insurance through side routes. For example, some states passed laws allowing state-chartered banks to sell insurance, and the Comptroller of the Currency's interpretation of federal law permitted national banks to sell insurance nationally from offices in small towns (populations under 5,000). Despite the attention given to banking and insurance, apparently few banks felt compelled to take full advantage of these side routes into selling insurance.

One obvious exception would seem to be the creation of Citigroup, which combined Citicorp, a large bank holding company, with Travelers, a large insurance company. But this move to integration is not really representative of organizations taking a side route. Instead, the creation of Citigroup is better viewed as a move in anticipation of the main road being opened up by the passage of legislation like GLBA.

Figure 1 gives some perspective on how much banks had integrated before GLBA. The bars show banking assets as a share of bank holding company assets for the largest organizations. Citigroup is an outlier, as is J.P. Morgan, which traditionally has looked more like an investment bank. For the other large banking organizations, bank assets make up the lion's share. While the figure masks some financial integration such as the sales of mutual funds and annuities by banks, clearly most of the large banking organizations have a way to go if they choose to move toward the Citigroup model.

Financial integration also has come from the other direction–securities firms and insurance companies have found side routes, mainly by linking up with certain types of depository institutions whose activities are restricted in some ways. One such type of depository is the so-called nonbank bank. This includes industrial loan banks, several of which operate in Utah; for example, American Express owns an industrial loan bank with about $12 billion in assets. Another option has been credit card banks, such as the one owned by Household Finance in Nevada. Finally, the law allowed securities firms, insurance companies, and even nonfinancial firms to link up with depositories through the acquisition of a single thrift, known as a "unitary thrift."

Figure 2 shows how some of the bigger players among independent securities firms have used these byways and side routes to acquire depositories. The top two–Morgan Stanley Dean Witter and Merrill Lynch–both own depositories. In this Federal Reserve District, Schwab has announced plans to purchase U.S. Trust, located in New York, and E*TRADE recently acquired Telebank, a thrift.

Insurance companies also have acquired depositories. Among the top twenty life insurance underwriters, for example, twelve own depository institutions, mainly thrifts. For the most part, the depositories owned by insurance companies are small. For example, Prudential, with consolidated assets of $280 billion, has depositories with about $1 billion in assets.

Key provisions of GLBA

The Gramm-Leach-Bliley Act makes the path toward financial integration more straightforward for those interested in pursuing it. It breaks down barriers–some of which are seven decades old–and allows full affiliation of banking with underwriting and agency activities in securities and insurance. The act goes further by allowing affiliation between commercial and merchant banking; that includes allowing banks to hold equity in firms for the purpose of eventual resale.

To keep regulation responsive, the act also gives the Fed and the Treasury the authority to define new activities that are financial in nature, or incidental to financial activities.

Regarding banking and commerce, the act for the most part keeps them separate, but leaves the door ajar by letting the Fed determine when some nonfinancial activities are complementary to financial services. The act does close the unitary thrift door for new acquisitions.

Corporate structure

In the debate over the GLBA, one of the main sticking points was where these new activities would be conducted, and the act represents a compromise on that issue. While a number of activities, including underwriting municipal securities, can be done within the bank, most of the avenues for financial integration are pushed out to holding company affiliates or bank subsidiaries. Figure 3 illustrates two possible structures–in practice, institutions may use a combination of the two structures shown. All of the new activities can be in a holding company affiliate and some in a financial subsidiary of a bank. At this time, insurance underwriting and merchant banking can be conducted only in financial holding company (FHC) affiliates. For the other activities, banks face limitations on the size of financial subsidiaries: A subsidiary cannot be too large, either in absolute terms or relative to the size of its bank; specifically, taken together, the assets of *financial subsidiaries* have to be the lesser of $50 billion or 45% of the consolidated assets of the bank. (Banks also can have *operating subsidiaries* engaged in activities permitted for the bank.) While some institutions probably would find it difficult to get around these limits, there is scope for others to move activities under a bank.

Certification and supervisory structure

The GLBA also lays out the requirements for certifying a FHC or bank to engage in expanded powers. A bank holding company that has U.S. commercial banks can be certified as a FHC if all of the banks are well capitalized, well managed, and have at least a satisfactory CRA rating. A securities firm or insurance company that acquires one or more banks must apply to be a bank holding company along with filing for certification as a FHC.

A bank seeking to operate financial subsidiaries faces similar requirements and must file for certification with its primary federal regulator. Moreover, the larger national and state member-banks must satisfy a "rating requirement" if they have a financial subsidiary acting as a principal (that is, not just as an agent or broker): Those ranking among the largest 50 must have at least one issue of outstanding eligible debt that is rated within the three highest investment grades, and those among the second 50 can meet the same requirement or have a comparable "long-term issuer rating."

Finally, a foreign banking organization with only branches or agencies in the U.S. can become a FHC if it is certified by the Federal Reserve to be well capitalized and well managed.

An important contribution of the GLBA is the framework for supervising integrated financial firms. It designates the Fed as the umbrella supervisor for financial holding companies, while the securities and insurance affiliates are subject to functional regulation by the SEC, the Commodity Futures Trading Commission, and state insurance commissions. The GLBA directs the Federal Reserve to rely as much as possible on the functional regulators for examination and other information. Likewise, the primary federal regulator of a bank also must rely on the functional regulators when securities and insurance activities are in financial subsidiaries of a bank.

The rationale for having an umbrella supervisor over FHCs is based on the fact that large financial institutions tend to manage their risk on a consolidated basis and operate along business lines that cut across legal entities. However, it is important to realize that a critical goal of the framework, especially for the umbrella supervisor, is to protect the bank or banks from undue exposure to risk from the other affiliates in the organization. The corollary of that goal is to ensure that the market does not come to think that umbrella supervision implies enhanced federal protection of FHCs' nonbank affiliates compared to their independent counterparts. In other words, it is important to avoid the unintended implicit extension of the federal safety net to nonbank affiliates of banks.

Several provisions of the act point to the primacy of protecting the banks in a FHC. For example, the act keeps in place limits on the financial transactions between a bank and the other holding company affiliates. Also, if the Fed has concerns about a bank's exposure to risk from a functionally regulated affiliate, the Fed can interact directly with the nonbank affiliate, including conducting examinations.

Parallel provisions apply for financial subsidiaries of banks, including limits on financial transactions between the bank and its subsidiaries. In addition, a bank's outstanding equity investments, including retained earnings, in its financial subsidiaries are to be deducted from the bank's capital. To ensure transparency for the bank, published financial statements must present separate financial information on the bank.

Conclusion

Legislation removing decades-old barriers between banking and other financial services has been a long time coming. While waiting for such legislation, financial integration did move forward. The routes, however, have been indirect and the results piecemeal. The current legal structure provides a more straightforward path for institutions that choose to venture down it. At the same time, the new road clearly has retained the traditional caution signs to address concerns over the potential risk exposure of banks and the need to limit distortions from the federal safety net.

Fred Furlong
Vice President
Finance and Regional Studies