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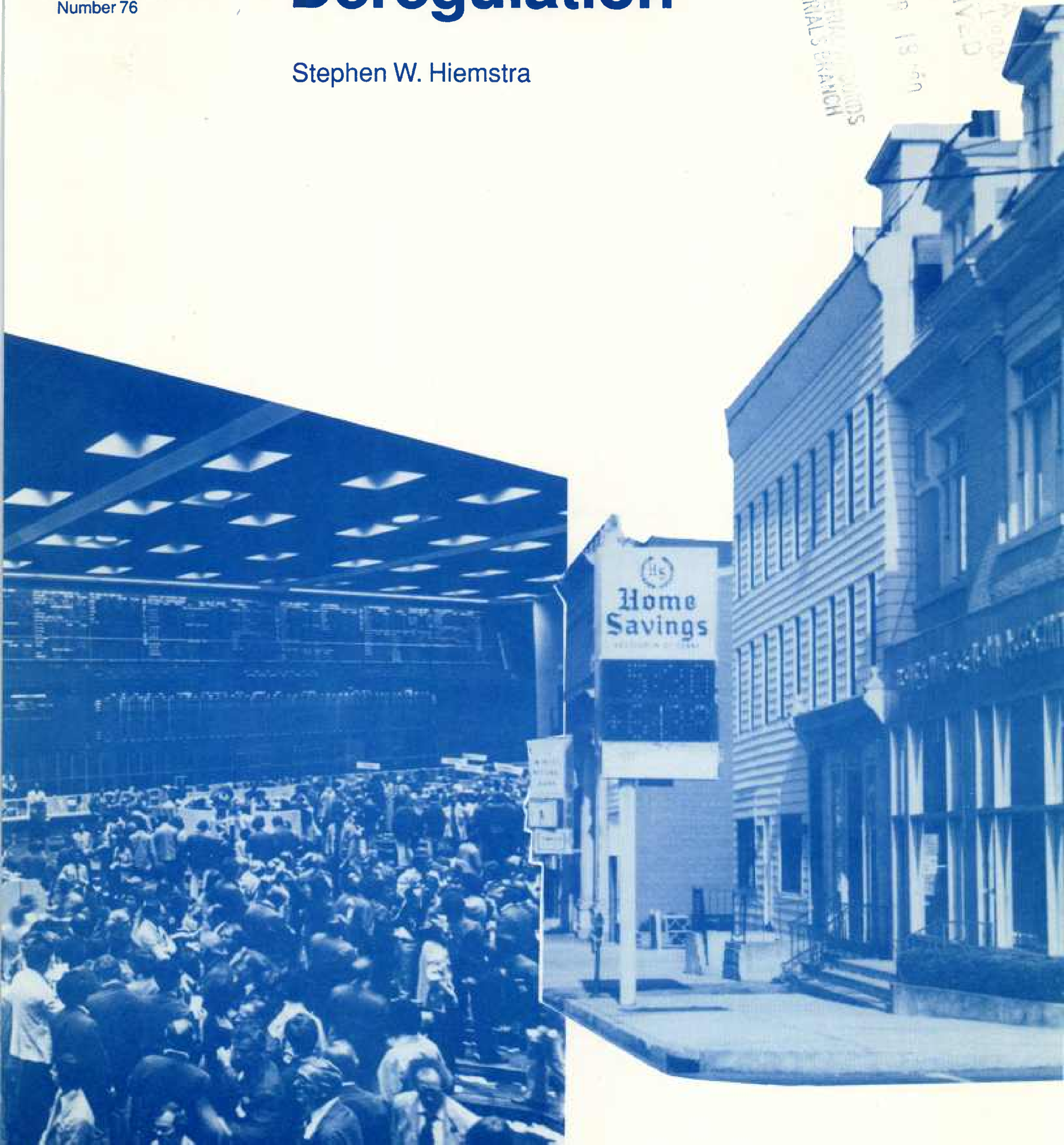
Prospective Rural Effects of Bank Deregulation

Stephen W. Hiemstra



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Prospective Rural Effects of Bank Deregulation. By Stephen W. Hiemstra. Agriculture and Rural Economy Division, Economic Research Service, U.S. Department of Agriculture. Rural Development Research Report No. 76.

Abstract

Congressional legislation in 1988, not passed but still under consideration, would repeal provisions of the National Bank Act of 1933, known collectively as the Glass-Steagall Act. The proposed legislation would expand the powers of commercial banks to underwrite securities both in the bank and through a bank holding company affiliate. These powers may generally encourage greater bank operating efficiency and reduce portfolio risk through diversification. Rural bank participation, however, is expected to be low because most rural banks are small, and they have relatively little experience with securities markets. Little net increase in rural growth is expected because efficiency gains are likely to be small. Few benefits of new bank powers may accrue to rural banks to offset insolvency risks and increased competition from innovative urban banks.

Keywords: Banks, deregulation, bank regulation, rural development, Glass-Steagall Act, rural banks, agricultural finance, investment banking, securities markets, commercial banking, credit markets, agricultural credit markets, rural credit markets, and bank powers.

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Note

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Preface

The Financial Modernization Act of 1988 (Senate Bill 1886) and the Depository Institutions Act of 1988 (House of Representatives Bill 5094) updated existing commercial bank regulations to conform to a changing marketplace. Both bills were reported out of committee, but because of disagreements in the House a conference committee never convened. Congress is likely to act on the issue of bank product deregulation in the future because of Administration support, regulatory innovation, and market incentives.

Recognizing the ongoing nature of the bank product deregulation discussion, this study outlines some of the issues affecting rural institutions and rural growth. By focusing on rural issues, the hope is that future legislation will be better able to meet the challenges facing rural America.

Contents

Summary

Congressional legislation in 1988 tried to repeal provisions of the National Bank Act of 1933, known collectively as the Glass-Steagall Act. The proposed legislation would expand the powers of commercial banks to underwrite securities both in the bank and through a bank holding company (BHC) affiliate. These powers may generally encourage greater bank operating efficiency and reduce portfolio risk through diversification. Rural bank participation, however, is expected to be low because most rural banks are small and have relatively little experience with securities markets. Little net increase in rural growth is expected because efficiency gains are likely to be small. Few benefits of new bank powers may accrue to rural banks to offset insolvency risks and increased competition from innovative urban banks.

Current analyses provide few solid conclusions about how repealing the Glass-Steagall Act will affect rural banks and issuers. The precise form of the eventual legislation has yet to emerge, and rural linkages to national markets are changing rapidly. General observations can, however, be made.

An important starting place in evaluating bank product deregulation is to observe that the benefits of deregulation accrue from increases in firm and market efficiencies. Efficiency increases may result, for example, from shared technology and personnel that might be better utilized by a more diversified banking firm. Efficiency gains are, however, likely to be small. Commercial banks can already offer numerous financial services, including the underwriting and trading of many security products, and most banks do not take advantage of the security powers already permitted. This is particularly true of small, rural banks.

Potential increases in efficiency can accrue to rural banks and rural issuers only if they participate. But, participation appears more likely for large firms than for small, rural firms, limiting extensive benefits to communities not served by large banks. Participation by smaller firms is feasible in the context of BHC's, loan participations, and securities syndications, but the most lucrative profits are likely to accrue to larger firms with enough capital to organize deals and benefit from scale economies. The ability to share in joint securities offerings is unlikely to be as profitable for small banks as for large banks because few advantages exist beyond those currently available to rural banks through loan participations.

While rural communities are unlikely to be net gainers from product deregulation, large, well-managed rural banks could very well benefit. A rural BHC could, for example, form a securities affiliate for purposes of starting a mutual fund and compete nationwide for investors' savings. Most of the alternatives that provide adept bank managers opportunities for growth, however, suggest greater linkage with national than local markets for credit. Prospective examples of successful rural bank entry into securities markets, particularly most new rural business generated by these new bank powers, may come from the substitution of security for loan financing and of rural for urban financing.

Bank product deregulation may entail additional risks for rural firms. Two risks stand out. First, smaller firms are less likely than larger firms to understand securities markets. Before the passage of Glass-Steagall, rural banks were often sold securities at par value that could not be sold

elsewhere. So, new bank powers pose a greater challenge to managers of small banks than to large banks because securities markets are more removed from the basic business of rural banking and because more demands are already placed on individual managers in a small bank than in a large bank. The same kinds of problems can arise for small issuers. Second, increased risk from any source that results in insolvencies may affect rural banks more than urban banks because of their smaller size and the general tendency of bank regulators to treat smaller banks as more expendable. If regulators were to provide the small banks the same treatment as large banks, this problem would, in part, be alleviated. If small rural bank failures have a larger impact on rural communities than small urban bank failures have on urban communities, then equal bank treatment may not imply equal prospects for economic development.

Abbreviations

BHC	Bank holding company
CAMEL	Capital, assets, management, earnings, and liquidity
CD	Certificates of deposit
CRA	Community Reinvestment Act of 1977
DFHC	Diversified Financial Holding Company
DIDMCA	Depository Institutions Deregulation and Monetary Control Act of 1980
EC	European Community
FADA	Federal Asset Disposition Association
FDIC	Federal Deposit Insurance Corporation
	Federal Reserve Board of Governors of the Federal Reserve System
FSLIC	Federal Savings and Loan Insurance Corporation
GAO	General Accounting Office
LBO	Leveraged buyout
MBHC	Multibank holding company
MMMF	Money market mutual fund
Metro	Metropolitan
SEC	Securities and Exchange Commission
SIPC	Securities Investor Protection Corporation

Glossary

Agricultural bank. A bank that has at least 25 percent of its assets invested in agricultural loans.

Agency issue. A security, typically a bond or pass-through security, that is issued by the Federal Government or a government-sponsored enterprise (public corporation).

Basis points. One hundred basis points are defined to equal 1 percent.

Bank holding company. A company that owns one or more separately incorporated banks.

Broker. An agent that arranges transactions between buyers and sellers without taking title to the underlying commodity, such as common stock.

Commercial bank. A bank that takes deposits and makes loans as its primary business.

Dealer. An agent that purchases a commodity, such as common stock, in large quantities like a wholesaler with the objective of selling smaller lots to the public like a retailer. The New York Stock Exchange employs dealers as market makers who keep the market liquid by standing ready to buy and sell stock at market prices. The difference between quoted purchase and sale price is the dealer's margin.

Deregulation. Regulatory reform designed to increase reliance on market incentives.

Economies of scope. Exist when the cost of providing joint products (or services) declines as the production volume increases.

Investment bank. A bank that underwrites corporate stocks and bonds as its primary business.

Leveraged buyout. The acquisition of a corporation financed by unsecured debt. This debt will presumably be repaid with revenues generated by future profits, the closing of unprofitable divisions, and asset sales.

Money center bank. A large bank located in a major financial center, such as New York.

Rural bank. A bank that has its headquarters in a nonmetropolitan county.

Scale economies. Exist when the cost of providing a product (or service) declines as the quantity produced increases.

Shelf-registration. A program introduced by the Securities and Exchange Commission that allows issuers to complete the registration procedure in advance so that once the decision to issue bonds is made, they can be issued with minimal administrative delay.

Prospective Rural Effects of Bank Deregulation

Stephen W. Hiemstra

Introduction

The Financial Modernization Act of 1988 (Senate bill 1886) was one of several failed attempts in the 1980's to expand the types of financial services that commercial banks can offer.[1] In particular, this legislative proposal would have repealed provisions of the National Bank Act of 1933 (commonly known as the Glass-Steagall Act) that limit commercial banks from underwriting various classes of securities[2] and separate commercial banking from investment banking. Under this proposal, banks underwrite securities only after being restructured as a bank holding company (BHC). Underwriting activities are confined to a securities affiliate of the BHC. Other provisions of the legislation expand the power of regulators to oversee these changes, mandate disclosure of contract terms to depositors and borrowers, and clarify existing regulations that allow banks to underwrite insurance. Parallel legislation in the House of Representatives (H.R. 5094) provided more limited security underwriting powers and expanded the list of consumer protection provisions required as compensation for the advantages bestowed on commercial banks.

The Bank Holding Company Act of 1970 defined commercial banking as the business of taking deposits and making loans (Huertas).[3] Commercial banks can be free-standing firms, a branch office, or a subsidiary of a holding company. Commercial banks raise funds through many different channels, such as time and demand deposits and the sale of certificates of deposit (CD's). Their investments are largely short-term commercial and industrial loans, Treasury securities, and obligations of State and local governments. Commercial banks are regulated by the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), the Comptroller of the Currency (an agency of the U.S. Department of the Treasury), and State chartering agencies.

Investment banking is the business of assisting public agencies and private corporations in raising capital through underwriting stocks, bonds, and asset-backed securities. Underwriting is the core function of investment banking and consists of three components: origination, risk-bearing, and distribution (Pugel and White; Giddy). Other functions performed by investment bankers include brokering, dealing, risk arbitrage, and management counseling (Bloch). The markets served by investment bankers are divided mainly into these categories: corporate and government securities, negotiated versus

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The author wrote this report while a financial economist with the Agriculture and Rural Economy Division, Economic Research Service, U.S. Department of Agriculture. He is currently a financial economist with the Farm Credit Administration.

[1]The Senate passed a similar bill (S. 2851) on September 13, 1984, which permitted bank holding companies to underwrite municipal revenue bonds, mortgage-backed securities, and commercial paper. No action was taken by the House of Representatives (Proxmire).

[2]In this report, securities means common stock, bonds, government issues, mortgage-backed obligations, and any other obligation issued by a corporation or government entity for purposes of raising investment capital or transferring ownership.

[3]Names in parentheses cite sources listed in the References section.

competitive bidding, publicly offered or privately placed, underwriting versus brokerage/dealing, mergers and acquisitions, regional versus national, and domestic versus foreign (Hayes, Spence, and Marks). The investment banking business is regulated in public offerings by the Securities and Exchange Commission (SEC).

This report focuses on rural implications of the expansion of commercial banks into investment banking and addresses these specific questions:

- What provisions were in the proposed legislation?
- What will be the general effects of bank product deregulation?
- How might these proposals have affected rural issuers and banks, and rural economic growth?

This report evaluates the proposed legislation against existing research and frames questions for further discussion and inquiry.

The Financial Modernization Act of 1988

The objective of deregulation is to reduce the regulatory barriers to entry into commercial and investment banking, insurance underwriting, real estate investment, and other financial services. Reduced barriers to entry should increase competition, lowering prices to consumers and enhancing the competitiveness of U.S. firms. Bills introduced in 1988 proposed to lower some barriers to entry and to compartmentalize financial activities to simplify regulation. These bills require Federal banking regulators to analyze ways of providing more consistent and equitable regulation.

New Powers and Restrictions

Bank deregulation legislation in 1988 focused on Senate bill 1886, known as the Financial Modernization Act of 1988.[4] Table 1 presents an outline of the titles of this and the parallel House bill, the Depository Institutions Act of 1988. Provisions affecting rural areas are highlighted below. The appendix provides a more detailed review of the provisions.

The House and Senate bills both balance the new bank powers with new regulations protecting consumers.

New Commercial Bank Powers

The Senate bill's first title repeals sections 20 and 32 of the Glass-Steagall Act which forbid commercial bank entry into securities underwriting. Parallel provisions restricting investment banks' entry into commercial lending were not repealed. The House bill amends these sections, retaining the prohibition on the underwriting of corporate equities. This prohibition is significant because corporate equities are the most risky and the most profitable securities to underwrite.[5]

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[4]Wirth (1986) provides a legislative history covering product deregulation bills introduced in the Congress during 1983-85.

[5]The standard deviation of returns is a proxy for risk, and mean return is a proxy for profitability. During 1947-84, corporate stock had a mean return of 12.48 percent, with a standard deviation of 17.17 percent. All other individual investments, as a class, had lower mean returns and lower standard deviations. A typical market portfolio for this period had a mean return of 7.92 percent and a standard deviation of 4.64 percent (Irwin, Forester, and Sherrick).

Table 1--Titles contained in Senate bill 1886 and House of Representatives bill 5094, 1988

Title	Senate 1886	House of Representatives 5094
I	Securities affiliates of BHC's (pp. 4-49)	Securities activities of national banks and BHC subsidiaries (pp. 3-57)
II	Expedited procedures (pp. 50-61)	Bank and consumer safeguard provisions (pp. 57-82)
III	Brokers and dealers (pp. 61-70)	Insurance activities (pp. 82-95)
IV	Bank investment company activities (pp. 70-79)	Consumer protection provisions: Community benefits Agency reforms Access to financial services Notice of branch closures by bank and thrift institutions Truth in savings Home equity loan requirements Expedited funds availability amendments Access to credit (pp. 96-237)
V	Strengthened enforcement authority (pp. 79-131)	Real estate activities (pp. 238-42)
VI	Truth in savings and investment (pp. 132-53)	Enhanced enforcement power: Insider abuse prevention and enhanced enforcement powers Report to Congress (pp. 242-342)
VII	Home equity loans (pp. 154-69)	Federal asset disposition association (pp. 343-55)
VIII	Insurance activities (pp. 169-79)	Miscellaneous provisions and technical and conforming amendments relating to reorganization (pp. 356-76)
IX	Miscellaneous (pp. 180-93)	

BHC = Bank holding company.

New Commercial Bank Restrictions

The House and Senate bills impose different restrictions for the privilege of underwriting securities. The House bill places more emphasis on new banking restrictions than the Senate bill.[6] The House bill's amendments to the Community Reinvestment Act (CRA) of 1977, for example, constitute a major policy initiative directing bank resources toward urban and rural community development projects. The Senate bill outlines broad policy parameters while the House bill details specific regulatory guidelines.

The House and Senate bills agree on other new restrictions. The bills require that banks adopt a BHC structure and provide securities services through an affiliate,[7] giving the Federal Reserve primary jurisdiction over the new entities. The BHC structure retains an organizational separation of commercial and investment banking activities, facilitates regulatory oversight by function, and insulates the bank from affiliate losses. The bills forbid commercial banks from underwriting insurance, except as permitted by State law and except in small, rural communities. They also strengthen regulatory oversight and consumer disclosure requirements and expedite bank conversion into BHC's.

New Regulatory Focus

These proposals shift the focus of bank regulation and call for greater coordination among Federal banking regulators to reduce financial incentives to change bank structure or recharter (regulatory arbitrage). Both bills propose a new balance between consumer and industry benefits, but bankers prefer the Senate version.

Provisions of Special Interest to Rural Areas

Some provisions in both bills were written specifically to benefit agricultural banks and small banks. Amendments to the Bank Holding Company Act permit small banks to organize BHC's so that rural banks can participate in securities markets.

Rural banks also benefit from exemptions to new restrictions imposed on commercial banks. Banks with $500 million or less in assets are, for example, exempted from prohibitions on individuals serving on the boards of directors of several banks (interlocking directorates). Small banks ($25 million or less in assets) and agricultural banks with no more than $50 million in assets are also exempted from most CRA amendments. Some assets of special interest to rural banks are exempted from SEC registration and may be originated by banks directly, rather than through an affiliate. These assets include municipal bonds, Farmer Mac[8] securities, and investments in small business investment companies.

Both the House and Senate bills exempt rural banks in communities with populations below 5,000 from general prohibition on underwriting insurance.

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[6]The title strengthening enforcement powers, for example, takes up 52 pages in the Senate bill and 100 pages in the House bill.

[7]In a legal sense, an affiliate of a corporation is a person that controls, is controlled by, or is under common control with the corporation. A "person" in this context may be a natural person, corporation, partnership, some kinds of trusts, or other organized groups of people (R. Clark).

[8]Farmer Mac is the trade name of the Federal Agricultural Mortgage Corporation organized under provisions of the Agricultural Credit Act of 1987. Farmer Mac will guarantee pools of agricultural real estate loans (Hiemstra, Koenig, and Freshwater).

This exemption provides no new authority, however, because Federal bank regulators previously granted this exemption in agency regulations.[9]

The Future of Congressional Action on Product Deregulation

Two considerations affect the future of congressional attempts to repeal the Glass-Steagall Act. First, Federal Reserve Chairman Alan Greenspan strongly endorses bank deregulation and has used regulatory innovation (allowing selected banks to underwrite securities) to prompt Congressional action. The FDIC has likewise issued opinions that allow some commercial banks more securities powers (Eisenbeis). Second, resolution of the thrift crisis took precedence over deregulation in Congress in 1989. Soundness considerations are now expected to receive a higher priority in future deregulation proposals.[10]

The General Case For Bank Product Deregulation

The commercial and investment banking industries are highly regulated. Past deregulation focused on relaxing deposit interest rate ceilings, expanding permissible financial services, and easing geographic limits on branching and acquisitions. The objectives of deregulation are to increase competitive equity ("level the playing field"), customer convenience, and firm profitability (Wirth). Bank product deregulation focuses on eliminating the separation of commercial and investment banking mandated by the Glass-Steagall Act of 1933.

At the time of its passage, the Glass-Steagall Act had three objectives: to discourage speculation, to prevent conflicts of interest, and to promote bank soundness (Hayes, Spence, and Marks). Recent congressional hearings cited these objectives in regulating commercial banking:

- o To ensure market access,
- o To balance competition and soundness,
- o To enhance market efficiency by preventing conflicts of interest,
- o To ensure responsible financial management,
- o To promote economic growth, and
- o To protect consumers.

Structural separation of commercial and investment banking presumably fosters these goals by: ensuring adequate financing for all sectors, widening informed opinion on financial policy, preventing conflicts of interest and concentration, minimizing the policing of transactions, and encouraging competition (Wirth).[11]

The case for repealing the Glass-Steagall Act rests on presumed efficiency benefits. The debate over these benefits has focused on scale economies in banking and securities underwriting, competitive effects, and activity

[9]Efforts to deregulate financial services in the European Community (EC), while more advanced in the area of allowing commercial banks to underwrite securities, have also not shown much success in liberalizing insurance markets. A fair degree of reciprocity among member states is provided to commercial banking services, some is allowed for securities services, but almost none is allowed in insurance services (Key).

[10]Gilbert surveyed the wider array of proposals for reforming banking legislation.

[11]Eisenbeis pointed to five considerations in evaluating the desirability of policy reform in banking: (1) economic efficiency, (2) risk, (3) conflicts of interest, (4) concentration of power, and (5) competitive equity.

diversification. Arguments against repeal focus on bank safety and soundness.[12]

Factors Motivating Reform of Banking Legislation

The factors motivating repeal of the Glass-Steagall Act may be classified as pressures on commercial banks, pressures on investment banks, and miscellaneous factors, such as changing political values, international competition, and technological change.[13] Because the Glass-Steagall Act remains an unresolved issue, review of these motivating factors is appropriate.

Pressures on Commercial Banks

The 1980's have been hard on commercial banks. Rising interest rates have increased the cost of loanable funds and motivated investment in riskier assets. New financial products and innovative nonbank firms led to increased competition. Increased competition and more volatile interest rates have raised the risk of existing assets. Problem loans in energy, real estate, agriculture, and developing countries have led to losses. Bankers have reacted by calling for more equitable regulatory treatment and increased bank powers.[14]

Rising Interest Rates. Interest rate deregulation and rising interest rates have provided incentives for change in the financial services industry in recent years. Following the Penn Central bankruptcy in 1970, the Federal Reserve permitted banks to issue large denomination CD's at market rates to restore liquidity in the commercial paper market (Brimmer). Securities brokers responded by introducing money market mutual funds (MMMF's). In turn, these MMMF's drew deposits away from banks and thrifts too small to issue large CD's whenever interest rates rose above interest rate ceilings on their deposit accounts (Wirth). Interest in MMMF's was accordingly strongest when interest rates rose above 5.25 percent. Figure 1 shows selected long-term interest rates, 1970-86.

The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) and the Garn-St. Germain Depository Institutions Act of 1982 (Garn-St. Germain Act) phased out the Federal Reserve ceilings found in Regulation Q. These acts permitted banks and savings and loan companies (thrifts) to offer financial products, such as money market accounts and adjustable-rate mortgages, to enhance their competitive position (Federal Reserve Bank of Chicago).

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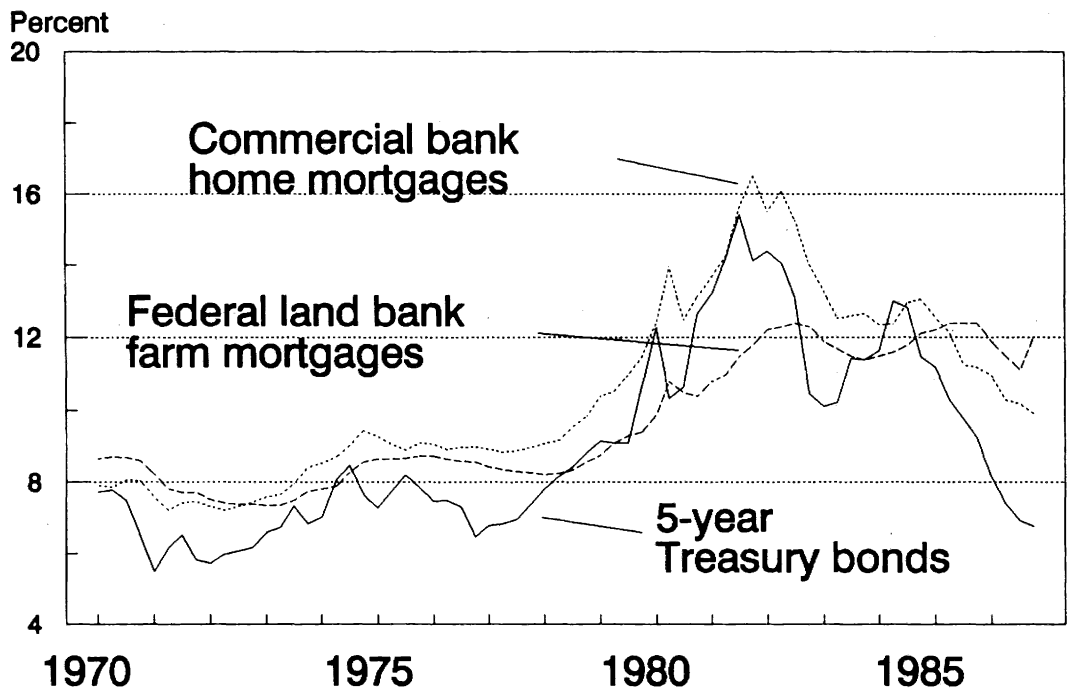
[12] The Securities Industry Association published a white paper which outlines its perspective on commercial bank deregulation and seeks to rebut many of the arguments supporting repeal of Glass-Steagall. Kaufman (1988b) provides a recent review of bank securities activities. Cargill argues that the Glass-Steagall Act is still needed.

[13] In a similar review, Kaufman (1988b) cited five factors influencing banks to expand their securities operations: (1) advances in information-processing and communications technology; (2) declining profitability of permitted bank activities; (3) rapid growth and large profits in full-service securities activities; (4) a more liberal interpretation of the Glass-Steagall Act by regulators and the courts; and (5) growing internationalization of financial markets.

[14] Commercial banks have also introduced financial products competing with the investment banks and investment trusts. In the early 1970's, for example, a number of banks began offering "automatic investment services," (AIS's) and related "closed-end investment funds." An AIS is an investment service in which bank customers can elect to withdraw a fixed amount each month from their checking account for investment in any of the top 25 corporations listed in the Standard & Poor's Industrial Index. A closed-end investment fund is an investment fund that "does not continuously engage in issuing and redeeming shares for customers' accounts, nor will it issue new shares after an initial offering, except at infrequent intervals, and will not redeem issued shares" (Clark and Saunders).

Figure 1--Selected quarterly interest rates, 1970-86



Competition from New Financial Products. Several financial innovations were particularly damaging to commercial banks as interest rates rose in the 1970's. Corporate borrowers increased use of commercial paper and private placement bonds and decreased use of commercial bank loans. Commercial paper, bonds, and large denomination bank CD's compete in money markets. Bank reserve requirements increased the cost of bank CD's. Higher interest rates reduced bank access to deposit funds and increased reliance on CD's. The cost of holding reserves, therefore, disadvantaged banks in competing for corporate accounts (Zigas; Rowe; Ricks).[15] MMMF's provided a similar alternative for small investors (Federal Reserve Bank of Chicago; Rosenthal and Ocampo). These innovations made it harder for banks to keep both corporate clients and depositors when interest rates rose above Regulation Q ceilings. Bank profitability suffered.

Geographic Restrictions on Branching and Firm Acquisition. Bank failures have risen rapidly in the 1980's. The number of banks closed by the FDIC rose from 10 in 1980 to a record 184 in 1987 (fig. 2). These failures were concentrated in energy- and agriculture-dependent regions and rose with reduced bank profitability and portfolio assets (Savage; Kling; Simmons). Following the 1981-82 recession, for example, oil-dependent communities in the Southwest suffered from lower oil prices that reduced employment and growth in the local economy. Agricultural communities likewise suffered losses during this period as higher exchange rates reduced agricultural exports and farm incomes (Gajewski and Burkhart). The close tie between commercial banks and their

[15]In a review of the growth in the commercial paper market in the 1970's, Rosenthal and Ocampo estimated that AAA corporate borrowers saved 70 basis points (0.7 percent) in 1970 by switching from bank loan to commercial paper financing.

communities led to pressure to remove geographic restrictions on branch banking and BHC's (Korobow and Budzeika; Amel and Keane; Rhoades).

Developing-Country Debts. OPEC earnings deposited in U.S. banks after the 1973 oil embargo pressured the banks to extend profitable, large-dollar loans to developing countries. Debt-repayment difficulties followed the change in U.S. monetary policy after the 1978 oil crisis and led to bank losses. The failure of the Continental Illinois National Bank and Trust Company, a commercial bank with assets of $41.4 billion was, for example, partly attributed to developing-country debts.[16] Developing-country debt repayment problems continue to depress the earnings of the Nation's leading commercial banks relative to foreign and regional competitors (Shane and Stallings; Truell; Board of Governors, Federal Reserve System, 1988).[17]

Pressures on Investment Banking

The pressures on investment banking for regulatory change arise, in part, from poor public relations and a perception that the industry is tightly held.

Poor Public Relations. The effort to repeal Glass-Steagall garners support from the public's general uneasiness with the securities market following the crash of October 19, 1987, and recent insider trading scandals. More focused concern centers on excessive use of low-grade corporate bonds (alternatively, "high-yield" or "junk" bonds) to finance leveraged buyouts (LBO's) (Rudnitsky and others).

An LBO is an acquisition of a corporation using future profits, the closing of unprofitable divisions, and sales of assets to generate revenues needed to retire the bonds issued (Vise and Coll). Because many of these unprofitable divisions are older, labor-intensive production facilities, the rapid growth of LBO's in the 1980's may have accelerated unemployment in some areas of the country (Bluestone and Harrison). The increased debt burden may leave the reorganized firm vulnerable to cyclical decline. Congress has been concerned about tax revenues lost as companies switch from equity to debt financing. Discontent with LBO financing has often been directed at the investment banking industry even though commercial banks often play an important role (Thompson; Linowes; Victor).[18]

LBO's played an important role in restructuring food system corporations in the early 1980's. Companies in the meatpacking industry made extensive use of LBO's in the early 1980's to introduce new technology, reduce labor costs, and reduce losses on unprofitable plants (Business Week, 1982, 1983, and 1984; Wiener; Kichen and Ozanian; Farhi; Coll, 1988b).

Need for Greater Domestic Competition. An important argument for repealing the Glass-Steagall Act is that restrictions on commercial bank entry into

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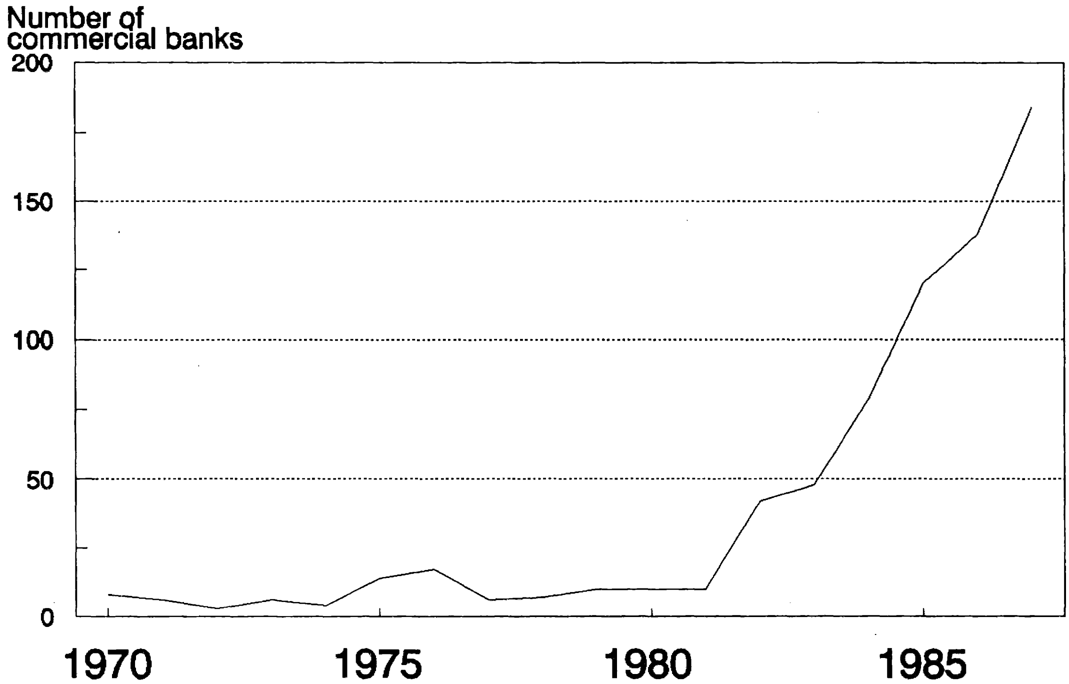
[16]Continental Illinois failed in May 1985 and was bailed out by the FDIC with the cooperation of other Federal bank regulators. To put this failure into perspective, the total assets of the 79 commercial banks and thrifts that failed in 1984 amounted to $3.3 billion (Jackson).

[17]Meltzer used market value to book value ratios to evaluate the strength of 40 publicly traded U.S. banks and reported that the 10 lowest valued banks had ratios ranging from 55 to 75 percent. Included among these poor performers were "several of the largest banks in the country." On average, these poor performers had invested one-third of their portfolios in foreign loans. The poor valuation of these banks reflects the fact that developing-country debt, such as loans to Mexico, currently trade on secondary markets at 30 to 40 cents on the dollar (Melloan).

[18]A typical LBO financing consists of 50-60 percent secured bank loans, roughly 30 percent low-grade bonds, and 10-20 percent equity financing. The Comptroller of the Currency estimated that of the $150-$180 billion in LBO debt outstanding, $80 billion is held by commercial banks (Thompson).

Figure 2--Commercial bank failures reported by the FDIC



investment banking raise underwriting costs. For markets in which commercial banks underwrite securities--U.S. treasury obligations, general obligation municipal bonds, bond issues for housing, and other securities--in competition with other underwriters, most studies show that competition lowers the cost to issuers. Silber (1980), for example, surveyed studies of commercial bank underwriting of municipal revenue bonds and concluded that eligibility to underwrite a particular class of municipal bond reduced the net interest cost for issuers from 3.5 to 14 basis points.

Pugel and White studied competition in underwriting and concluded that spreads in underwriting fees are smaller for debt than equity issues, well-known companies making second issues, large issuing companies, large dollar amount issues, and competitive rather than negotiated underwritings (by public utilities). This pattern is consistent with cost factors. When combined with other evidence (such as high employee salaries), it suggests that increasing competition may lower issuing costs.[19]

The securities industry is not always more profitable than commercial banking. It is, however, generally more profitable than manufacturing or commercial banking (Pugel and White). The investment banking profits during the last bull market (August 1982 through August 1987) came at a time when commercial

[19]This is clearly the position of commercial bankers. Advocates for investment bankers stress the relationship between issue characteristics and cost factors. They also point out that competitive conditions have changed dramatically in the 1980's with the introduction of shelf registration, new technology, and because of the October 1987 market crash. A leading firm in the municipal bond market (Salomon Brothers), for example, recently left the market entirely following losses suffered, in part, because of changes in the tax law, technological and organizational change, and increased market competition (Doran, Mysak, and McCorry; Bianco).

bank failures were high and rising (fig. 2), suggesting perhaps why money center banks have taken an interest in new bank powers (Ford).

Other Pressures for Change

Efforts to repeal the Glass-Steagall Act gather support from groups generally opposed to regulation and from perceived weaknesses in the legislation. New financial products, offshore banking, and competition from nonbank financial firms weaken the separation of commercial and investment banking.

Pro-Competitive Political Values. Deregulation advocates prefer market outcomes and focus on increasing economic efficiency. They typically discount bank safety and soundness concerns because deposit insurance ensures that bank insolvencies do not individually threaten financial system stability. On the contrary, they welcome insolvencies as a market incentive encouraging improved credit pricing and lower costs (Meltzer).

Efforts to repeal the Glass-Steagall Act continue. Implementation of a risk-based capital requirement will simplify repealing the act by discouraging excessive risk-taking. Changes in Federal Reserve regulations have lowered the threshold between commercial and investment banking by allowing several BHC subsidiaries to underwrite certain classes of securities. These BHC's may underwrite commercial paper, municipal revenue bonds, and asset-backed securities, provided such activities do not exceed 5 percent of gross earnings (Taylor, 1988a and 1988b; and Guenther, 1988a).

International Competitive Pressures. The globalization of trading and dealing in bond and equity markets may have reduced the effectiveness of the Glass-Steagall Act. Several observations support this argument. First, problems created during the October stock market crash in 1987 in one national market spilled over into other markets (Anders and Forman). The separation of commercial banking and investment banking in the United States provided no bulwark against this instability because banks operating abroad, including U.S. banks, underwrite securities. Second, large U.S. commercial banks have recently suffered significant losses. Finally, the Glass-Steagall Act[20] may disadvantage U.S. banks relative to foreign banks. Large corporate clients may find cheaper financing through offshore banking centers, such as the Eurobond market[21], where foreign banks offer additional competition.[22]

The United States has promoted international financial services liberalization through the General Agreement on Tariffs and Trade (GATT) and other forums. At least some barriers between commercial and investment banking have been reduced in Canada, the United States, Japan, and the United Kingdom (Ford;

[20]Glass-Steagall is not the only structural difference between U.S. and foreign banks. Japanese and West German banks are, for example, much larger than U.S. banks, measured by the dollar value of their assets and are permitted to take equity positions in foreign firms (Wellons). In Germany, but not Japan, commercial banks are allowed to underwrite securities.

[21]The Eurobond market has two key features. A Eurobond is underwritten by an international syndicate and it is offered simultaneously in a number of countries. A foreign bond, by contrast, is a bond underwritten for a foreign company by a domestic investment bank for sale in the domestic market. Eurobond underwritings amounted to $50 billion in 1982. Private corporate issues in the United States were $53.4 billion in 1982 (Levich).

[22]Guenther (1988) cites an example in which Chase Manhattan Bank lost a corporate account to Deutsche Bank AG because the German bank was able to underwrite corporate bonds in the United States while Chase could not. Levich (1985) cites underwriting costs for domestic U.S. corporate bonds at 0.75-1.0 percent while Eurobonds cost 2.0-2.5 percent. Domestic underwritings are therefore likely to be preferred by issuers.

Kincaid). Progress has also been made in negotiating international capital adequacy standards (Ingersoll).[23]

Tradé liberalization focused briefly on bank deregulation in 1988. The European Community (EC) initially requested repeal of the Glass-Steagall Act as a compensation condition for "national treatment" of U.S. banks in the EC, where universal banking, a combination of commercial and investment banking, is the norm. National treatment was initially interpreted to mean application of home country regulations. Later, an alternative to repealing Glass-Steagall--"better than national treatment"--was suggested so that EC banks might enjoy the same freedom in the United States as U.S. banks enjoy in the EC. More recently, the EC has dropped the insistence on reciprocity and has interpreted "national treatment" to mean accepting host country banking regulations (Key).

Changing Technology. The 1980's have been a period of rapid technological change for commercial and investment banks (Hunter and Timme, 1986). Innovations that were novelties in the 1970's, such as credit cards, automated teller machines, automated clearinghouse facilities, microcomputers, and photocopy machines, are now in widespread use (Frisbee; Hannan; McDowell). Innovations in investment banking include around-the-clock trading, new products such as financial options and futures, and program trading (Kincaid; Linowes).

Technological change challenges the distinction between commercial and investment banking. Asset-backed securities, for example, have permitted commercial banks to tap the liquidity of securities markets and avoid reserve requirements (Rosenthal and Ocampo; Johnson and Murphy; GAO, 1988b). Such new risks have raised questions about the adequacy of the current regulations to promote soundness of the banking system (GAO, 1988a; Coll, 1988a; Meltzer, 1986).

Competition from Nonbank Banks. The Bank Holding Company Act of 1970 defined a bank as a financial corporation which takes demand deposits and makes commercial loans (Huertas). When interest rates rose and banks experienced declining liquidity, finance companies evolved that either took deposits or made loans but not both. Such institutions were called nonbank banks.[24] These nonbank banks avoided Regulation Q, restrictions on bank acquisitions, and geographical regulation because they were not considered banks by regulators. They were also subject to less stringent reserve requirements than banks. Asymmetries in regulation have accordingly made nonbank banks highly controversial.[25]

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[23]The agreement was worked out by the Basle Committee on Banking Regulations and Supervisory Practices composed of the Group of Ten countries plus Luxembourg. The objectives of the Basle Committee are: (1) to strengthen the stability of the international financial system; (2) to provide a fairer and more consistent basis for evaluating bank capital positions; (3) to take asset risk into account in determining capital adequacy; and (4) to avoid discouraging banks from holding liquid, low-risk assets (Board of Governors, Federal Reserve System, 1988).

[24]Nonbank banks need to be distinguished from other financial services firms competing with commercial banks. Nonbank financial services firms can be classified as retailers (such as Sears), industrial-based companies (such as General Motors Acceptance Corporation--GMAC), diversified financial firms (such as Merrill-Lynch), and insurance-based firms (such as Prudential). Nonbank banks are not all equally profitable, and they do not all compete effectively with banks (Parvel and Rosenblum).

[25]A life insurance company subsidiary can, for example, operate a mutual fund while a bank subsidiary may not. Life insurance companies have likewise operated "disguised" investment companies through cleverly designed life insurance products. Similar bank innovations have been forbidden by the courts (Clark, R.). These and other developments may have contributed to the consolidation of financial conglomerates (Wirth).

The Competitive Equity Banking Act of 1987 amended the Bank Holding Company Act by defining a bank as any institution offering FDIC-insured deposits and restricting nonbank bank activities. The nonbank bank issue was not settled, however, because the 1987 Act contained many exemptions, and some restrictions expired on March 1, 1988.

Potential Efficiency Gains with Deregulation

The efficiency arguments favoring repeal of the Glass-Steagall Act are difficult to evaluate, and the net benefits of repeal are expected to be small. Large banks will likely benefit more than small banks. Some securities markets may become more competitive. An effective manager may reduce portfolio risk through diversification into securities underwriting. These conclusions depend on management objectives and quality, the generation of new underwriting business, and improved use of bank resources.

Scale Economies

Providing new bank powers may lower unit costs because scale economies exist in bank operations or securities underwriting. Scale economies exist when the per-unit cost of producing a given product or service declines as the volume of production increases. Economies can exist because overhead costs, such as machinery or advertising, are better utilized by larger firms or because the product itself is not easily divided up for use by smaller firms. The existence of scale economies is widely recognized in securities underwriting (Hayes, Spence, and Marks), while the issue of scale economies in commercial banking has not been resolved.[26]

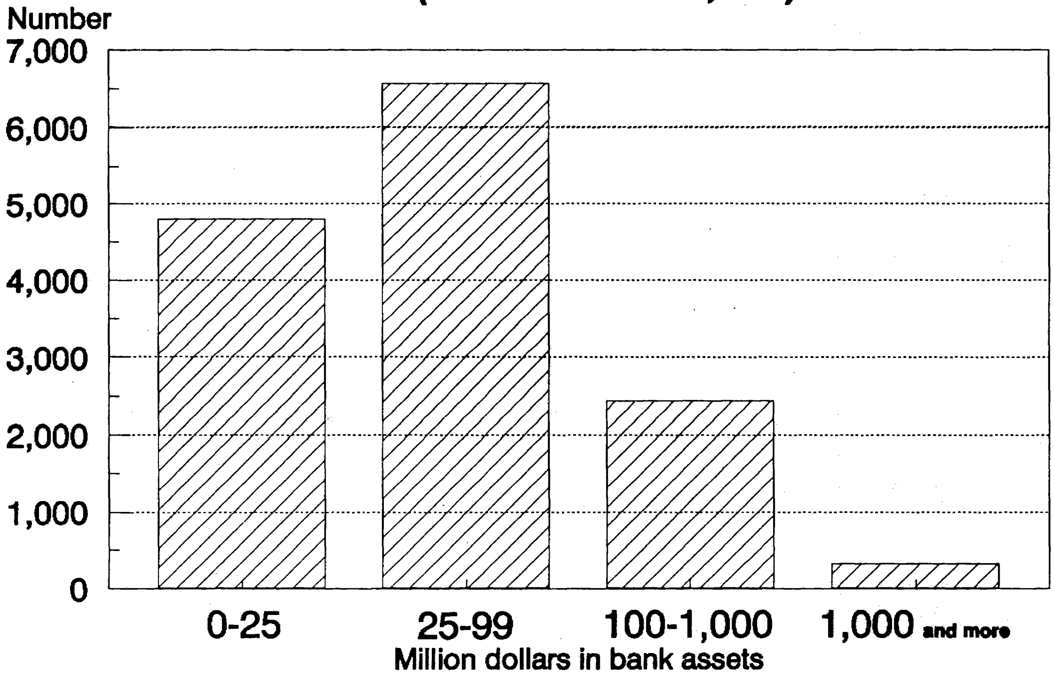
Securities Underwriting. In the 1988 proposals, commercial banks were exempted from restrictions in the Bank Holding Company Act on forming BHC's, apparently to permit small banks the opportunity to participate in securities underwriting. Congress appears to believe that scale economies exist in securities underwriting.

The ideal size of a Federal agency issue provides a benchmark for analyzing the number of banks that could maintain a securities affiliate. Silber (1974) reported that the average cost of issuing agency securities declined until size of the issue reached a value of approximately $300 million. The Senate bill requires that banks hold no more than 15 percent of total assets in securities. A bank accordingly needs a minimum of $2 billion in assets to underwrite a $300-million issue. Figure 3 shows that 340 commercial banks (of 14,200, or 2.4 percent) in the United States had more than $1 billion in assets in 1986 (FDIC, 1986). Clearly, most commercial banks need either to join a BHC or to participate in a syndication to service an optimal-sized agency issue.

While agency issues are not the only alternative for an underwriter, they are important in establishing the firm as a leader in the industry and in developing expertise in pricing bond issues. Bond issues are typically priced relative to U.S. Treasury bonds. The difference in price between private and

[26]R. Clark raised the possibility that the holding company form of corporate ownership may itself benefit from scale economies. These economies might exist because of scale economies in raising capital, because excess capacity could exist in some firm operations that might be sold, because of reduced transactions costs from sharing information within the firm, and because of superior management controls over poor performance. He cites claims by independent data-processing firms that BHC's underprice information services within the firm.

Figure 3--FDIC-insured banks in the United States, 1986 (total banks--14,300)



public agency issues arises from factors such as the reduced liquidity and increased risk of private issues relative to public issues (Bloch). If an underwriter is too small to underwrite Treasury bond issues, the firm may incur a higher operating cost.[27]

The recent controversy over LBO financings provides insight into the structure of the evolving market. Participating banks typically earn fees of 129 basis points (compared with 62 basis points for working capital loans) and may price debt 200 to 250 basis points above the London Interbank Offer Rate (LIBOR). These loans are profitable but risky. Money center banks have kept 10-20 percent of these loans in portfolio and sold the remainder to large regional banks to spread their risk (Wiener; Guenther, 1988c). Were they able to underwrite low-grade corporate bonds as well as loans, commercial banks could attract a wider group of investors and potentially earn larger fees.

The pyramidal structure of investment banking dates back more than a century.[28] An underwriting syndicate may have four or more tiers of participants. The managing firm is responsible for organizing the deal, soliciting participants, stabilizing market prices during distribution, keeping records, and enforcing contracts. Participating firms are ranked according to the capital provided in purchasing blocks of stock and their role in distribution. The prestige enjoyed by the managing firms in the pyramid

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[27]Not only are there likely to be scale economies in underwriting, there may also be scale economies in securities brokering and dealing, and in exchange operations as a whole. The New York Stock Exchange, for example, has had a market share in excess of 50 percent for decades (West and Tinic).

[28]The term pyramidal structure is attributed to Judge Medina who presided over an antitrust suit brought under the Sherman Act against the major investment banking firms in 1947 by the Department of Justice. Medina dismissed the case in 1953 on the grounds of insufficient evidence (Bloch). According to Hayes, Spence, and Mark, the real point is not whether a pyramidal structure exists in the investment banking industry, but whether it is being misused.

stems from their ability to manage and fund the largest deals, provide expert advice, meet deadlines, and operate with discretion (Hayes, Spence, and Marks).

The introduction of Rule 415, which provides for shelf-registration, may have altered the terms of trade between underwriters and issuers. Shelf-registration permits the issuer to reduce the time required to register an issue with the SEC, waiting risk, from weeks to just days or hours. Because issuers may now react more quickly to market developments, the bond market has become more volatile. In the case of firm-commitment deals, greater market volatility raises underwriting costs. Because waiting risk has declined and underwriting risk has increased, a more competitive market has evolved since 1982 when this rule was introduced (Bloch; Rosenthal and Ocampo).[29]

For bond and other small underwritings characterized by low volatility, shelf-registration has led to a collapsing of the pyramidal structure. The pyramidal structure of syndications remains important for equity issues generally and for all issues during volatile periods, when the need to diversify underwriting risks and to place securities quickly becomes more critical.

Shelf-registration may also reduce the distinction among loan participations, private placements, and public issues. These distinctions have always been subject to interpretation and may depend mostly on marketing considerations.[30] If a loan financing has a large number of purchasers, small dollar-amount participations, an active secondary market, and a large number of nonbank participants, then it could be classified as an underwriting under the Glass-Steagall Act. If it has a small number of bank purchasers who hold large dollar-amount participations, then Glass-Steagall may not apply. In this sense, a loan participation should bear a closer resemblance to a private-placement bond than a public-issue bond. A loan participation agreement must also carry language protecting the purchaser against default of the originating bank, and the loan sale must be without recourse to the originating bank under regulatory accounting principles and standards provided by generally accepted accounting principles (Rosenthal and Ocampo).

Underwriting fees in syndications still, however, reflect the old pyramidal structure. The lead underwriting firm earns a management fee equal to 20 percent of the top gross spread. This fee represents compensation for negotiating the deal, preparing the issue, and organizing the syndication. Participants in the syndication earn their fees by purchasing securities at discounts to the par value given in the prospectus. The lead underwriter earns the largest fee, in part, because of larger security purchases and because of a deeper discount from par than other participants. Other participants in the syndication are permitted to purchase securities at a lesser discount which is determined by their willingness and ability to share in the underwriting risk and merchandising the issue (Bloch).

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[29]Some critics have argued that shelf-registration has reduced competition because the short turnaround time in underwriting has increased the competitive position of larger underwriters located near stock exchanges. Smaller, regional underwriters that used to join syndicates in marketing issues have, as a consequence, either had to develop a presence nearer to the exchanges and become lead underwriters or give up participating in underwritings (Bloch).

[30]Securities industry representatives have argued that the Glass-Steagall Act forbids commercial banks from engaging in loan participations and private placements in general and from providing advice to accompany such transactions in particular. The rationale for these objections stems from the close substitutability of these transactions for securities transactions in spite of explicit language in the act allowing at least some such activities (Clark and Saunders).

The existence of scale economies depends on production cost savings as the size of issue increases. Issuing costs appear to decline with issue size because of reduced pricing, underwriting, and liquidity risks. Distribution costs may also decline with issue size, although they are not typically counted in discussions of scale economies. The fee structure in syndications does not appear conducive to passing these cost savings back to issuers, however, because management fees are levied on a percentage basis.

Commercial Banking. Researchers are divided as to the existence and significance of scale economies in banking. Fraser and Kolari conclude, after a review of the literature, that scale economies are exhausted when banks reach $25 million in portfolio assets. Litan conducts a similar review of both scale economies and scope economies. While acknowledging that past studies have reported few economies and that large firms are typically excluded from the data sets employed, Litan argues that studies of bank performance have little relevance in analyzing recent changes because of the introduction of new products and banking services. The addition of new services to existing customer networks, computer systems, and marketing channels should result in efficiency gains. Other authors have pointed to technological changes as the source of new efficiency gains likely to increase optimal bank size (Hunter and Timmer, 1986 and 1987). Bryan and Allen cite five classes of banks--small and large community, small and large regional, and top 20 in the United States--and discuss how specific innovations will increase the efficiency of each class. Kaufman, Mote, and Rosenblum suggest that marketing efficiencies may likewise reinforce production efficiencies to increase optimal bank size.

The option to underwrite securities, both within the bank and through an affiliate, will result in scale or scope economies to the extent that complementarities (shared inputs that are underemployed) exist between these products and existing products in production or marketing. In agricultural lending, which has a strong seasonal component, such complementarities could exist if securities underwriting enables banks to utilize employees and other resources more fully in slack periods. Complementarities are more likely when securities are underwritten within the bank because more overhead costs can be shared. If economies exist, optimal bank size could increase.

Diseconomies may also exist. The existence of economies presumes that fixed resources are either underutilized or that they have public good characteristics, as in the case of a shared logo or shared advertising. When fixed resources are fully employed, the addition of new opportunities either means that resources must be diverted from existing activities or that resources are spread more thinly. In a small bank, the scarcest resource is likely to be management expertise, and new securities powers are likely to be difficult to employ effectively, particularly for small banks without a trust department or comparable securities activity. Managers are likely to enter these markets gradually and to specialize in securities closest to the markets they already understand (Kaufman, 1988b).

Diversification into Securities Underwriting

Portfolio diversification may provide an important economic justification for allowing commercial banks to underwrite securities. Diversification decreases profit variability when losses in one activity are offset by gains in another (FDIC, 1987). The diversification benefits accruing to rural banks from securities underwriting will depend critically on the quality of bank management and are likely to be small in the absence of special management expertise.

Table 2 displays the activities permitted under the Senate and House bills and previous legislation.[31] Several observations can be made. First, many securities activities are permitted within bank departments and need not be confined to the BHC affiliate. Second, many activities approved for banks were previously permitted by Federal bank regulators. The Federal Reserve already allows several banks to earn up to 5 percent of total revenue in new securities activities. Kaufman (1986 and 1988b) provides a summary of currently allowed bank securities activities. Third, securities activities may not have the desired diversification effect. The industry and region that are financed and the point in the business cycle may be as important as the credit instrument used to determine the benefits of new bank powers.

Several authors have examined diversification effects resulting from differences in the timing of activity profitability. In a survey of such activities, Saunders reported banks may increase profits by adding underwriting or brokerage activities. He reported that the partial correlation between the underwritings of commercial and industrial loans and underwritings of nonconvertible debt (mostly corporate debt) over the period from 1973-83 was -0.5. This implies that a 10-percent increase in the profitability of loan originations is associated with a 5-percent decline in the profitability of nonconvertible debt underwritings. In other words, a bank diversifying into securities activities could on average expect to reduce its profit variability.

Litan reported low correlations between the after-tax earnings in banking activities and a wide range of possible alternative financial activities. Comparing his own estimates with those of other authors, he shows that the correlation between securities activities and banking activities varied over different time periods. The correlation between after-tax earnings in banking activities and "securities brokers, dealers, and flotation companies" was reported as 0.06 for 1973-82 and -0.11 for 1962-82. Litan concluded that "the opportunities for reducing risk through pair-wise combinations of bank and nonbank activities appear impressive" because low correlation means that firms can lower the variance of their profits by entering into new activities.

Repealing the Glass-Steagall Act may therefore permit commercial banks to reduce portfolio risk through diversification. Whether banks choose to use these new powers to reduce risk depends on management objectives.

Competitive Effects

The entry of commercial banks into securities underwriting will affect competition in both commercial banking and investment banking. The competitive effects within these two markets are unlikely to be significant. Cross-market effects may, by contrast, be very significant.

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[31] In 1985, the nonpermissible securities activities for Federal Reserve banks were: (1) underwriting, trading, and distributing corporate bonds, corporate equities, commercial paper, and some municipal revenue bonds; (2) mutual funds underwriting and distributing; and (3) full-service brokerage and investment advising (Kaufman, 1986).

Table 2--Underwriting and investment activities permitted by Senate bill 1886 and House of Representatives bill 5094

Approved for banks 1/	Restricted to BHC affiliates
Unsolicited brokerage services (S)	Corporate equities (S)
Trust or fiduciary activities	Corporate bonds
U.S. Government securities	Convertible bonds (H) 2/
Commercial bills and paper	Securities not exempted (S)
Bankers acceptances	Commission and solicited sales (S)
Municipal securities 3/	
Asset-backed securities	
Private placement activities	**Not allowed for banks or BHC affiliates**
1,000 transactions not otherwise exempted	
Securities brokerage (H)	General insurance underwriting
Mutual fund sales (H)	Real estate activities (H)
Buying and selling on own account (H)	
Information processing activities (H)	
Small business investment company activities (H)	
Activities incidental to foreign business operations (H)	
Insurance underwriting in small, rural communities	

BHC = Bank holding company.
S = Senate bill only; H = House bill only.
1/ Most of these activities are currently permitted under Federal bank regulator agency regulations.
2/ Convertible bonds may be underwritten if the conversion price is set at least 15 percent above the equity price at the time the bond is issued.
3/ If the bank has a securities affiliate, then these activities must be transferred from the bank to the affiliate.

Commercial Banking. The impact of increased securities underwriting on competition in commercial banking depends, in part, on the extent to which banks compete on a geographic, customer service, or product basis (Bryan and Allen). Allowing banks to underwrite securities will place banks in competition not only with other financial services firms, but also with other banks.[32] A bank underwriting a mutual fund, for example, can be expected to compete nationally with other mutual funds. Some large banks currently compete nationally for credit card accounts and home mortgage loans (Guenther, 1988b and 1988d; Rosenblum, Clemente, and O'Brien).

[32] The expectation under product deregulation is that banks will compete on a *de novo* basis with established securities firms. In the past, however, "structural and regulatory efforts to promote competition within the financial services industry have stressed the need to prevent impediments to competition that result from conflicts of interest, tie-ins, and the concentration of financial resources" (Wirth).

The size of commercial banking markets relates to the size of corporate borrowers. For borrowers with less than $1 million in assets, the workable market is the local metropolitan (metro) area. Larger borrowers are able to search more widely (Edwards). Because only the largest firms can issue securities,[33] commercial banks offering underwriting services and commercial loans may draw profitable customers from small banks not offering this service. This service could be attractive to potential issuers if securities financing is preferred to loan financing or if customers prefer one-stop financing. If the underwriting bank drew customers from across State lines, product deregulation could undermine State bank regulation and bring about a form of de facto geographic deregulation in States where it does not currently exist.

Investment Banking. Entry of commercial banks into more securities markets is promoted as a mechanism for increasing the competitiveness of investment banking. A high degree of market concentration in underwriting suggests the need for greater competition. Four-firm concentration ratios (that is, the market share of the top four firms) in negotiated underwriting averaged 41.4 percent in 1988. In competitive bid markets, the four-firm ratio was 32.2 percent.[34] By contrast, four-firm concentration ratios in commercial banking are much lower (table 3) (Savage).[35]

The high level of concentration in investment banking supports two interpretations of market behavior. Industry critics argue that the high shares of leading firms result from a lack of competition, which leads to higher prices. Industry defenders argue that investment banking is a highly competitive industry with price differences that result from differences in underlying costs. The industry view is credible if scale economies in securities underwriting and a small market size preclude the profitable entry of additional firms.

Empirical studies of the competitive effects of commercial bank entry into investment banking have focused on the influence of commercial banks on the underwriting of municipal bonds. The observation that general obligation municipal bonds are better collateralized than revenue bonds may explain why commercial banks are permitted to underwrite general obligation bonds but not revenue bonds. Silber (1980) reported that virtually all studies looking at the distinction between general obligation and revenue bonds agreed that commercial bank eligibility reduced the cost to issuers of issuing bonds. For this reason, most public issuers explicitly encourage commercial bank eligibility. Studies comparing the effect of competitive bidding with negotiated underwritings reinforce this point of view (Ederington). The larger the number of bids on an issue, the lower the cost to issuers.

Bierwag, Kaufman, and Leonard (referred to here as the BKL study) question these results. They argue that earlier studies of the municipal bond market misspecified the equations in their statistical analysis by not including bond purpose as an explanatory variable. Commercial banks may underwrite some bonds, but not others, which makes it likely that bond value will reflect its purpose. By testing this hypothesis, the authors found that commercial bank eligibility was no longer a significant explanatory variable once a variable

[33]A firm contemplating going public should have a minimum of $1 million in net annual income and $15-20 million in annual sales with good growth prospects (Bloch).
[34]These figures were provided by the Securities Industry Association. Pugel and White cited comparable figures for 1972-77.
[35]Pugel and White, and Litan summarize the issues raised by commercial bank entry into investment banking.

Table 3--Concentration levels in selected financial service industries, 1984

Industry	All firms	Top 10 firms: Total asset value	Top 10 firms: Share of total assets
	Number	Million dollars	Percent
Securities	7,802	11,206	46.6
Commercial banks	11,451	723,940	25.6
Thrifts	3,159	152,324	15.6
Life insurance	2,134	352,689	48.7
Other insurance 1/	1,773	71,350	27.0
Institutional investors	300	569,880	24.0

1/ Property and casualty insurance.
Source: (Wirth).

for bond purpose was added. From their perspective, this result is intuitively correct because entry into investment banking is restricted only for commercial banks. Other adequately capitalized firms can freely enter and compete in the bond market because a charter is not required to enter investment banking.

Several observations are pertinent in reconciling the BKL study with previous studies. First, the BKL study results are inconsistent with the structure-conduct-performance perspective. We normally expect competition to lower issuer costs. Second, the correlation between bond purpose and bank eligibility suggests that multicollinearity may make it impossible to distinguish independent effects. The BKL results depend on the credibility of the Theil test which separates these effects. Finally, the conclusion that bank eligibility did not previously affect issuer costs does not imply that increasing bank underwriting powers will not decrease issuer costs now. If banks could not take advantage of scale economies in the past because of insufficient underwriting powers, new bank underwriting powers may encourage more commercial banks to enter investment banking, which could lower issuer costs.

Several reasons can be cited for why industry market shares may understate the competition in investment banking. First, the market for investment banking services is segmented, with little competition between segments and intense competition within segments. Market share data accordingly focus on the wrong level of aggregation (Hayes, Spence, and Marks). Second, although corporate clients relied traditionally on their investment banker for most of their financial advice, large corporations have increasingly upgraded the quality of their finance staff. Corporate managers are accordingly much more capable of evaluating the quality of the advice they receive from investment bankers and the competitiveness of the spreads they are offered on their issues (Levich). Third, the Eurobond market is generally perceived to be more competitive than the U.S. bond market, giving large corporations an alternative to domestic financing that serves to limit oligopolistic pricing (Levich). These reasons suggest that at least the market for large corporate issues is fairly competitive. Small firms competing in less profitable market segments, having no endogenous financial staff and without the reputation needed to enter the Eurobond market, are less likely to receive competitively priced service in the securities market.

Cross-Market Effects. Cross-market effects could become more important with repeal of the Glass-Steagall Act. Direct market linkages include vertical integration and illegal activities, such as tied sales. Indirect market linkages include shared costs, cross-subsidy effects, and development of financial conglomerates. The independent effects of new bank powers may not be important, however, in view of market innovations, such as securing bank assets (that is, the sale of securities backed by bank assets).

The effect of product deregulation in a competitive sense may be close to that of forward integration. Where secondary markets exist, the bank could serve as originator, pooler, and distributor. A bank's competitive position in all three activities might improve because it possesses better market information than firms that specialize in any one function or because the bank can cross-subsidize the more competitive activities.[36] The bank could also switch between loan and securities financing as market conditions vary, thereby gaining a straightforward marketing advantage.

Large, multimarket financial conglomerates could develop around BHC's that have new powers. Because insurance company holding companies have already expanded into underwriting, however, BHC conglomerates do not provide a unique threat (Clark, 1979).[37] In fact, limits on interstate branching may make it difficult for BHC's to gain the advantages of vertical integration already available to other firms.

Safety and Soundness Considerations

The thrift crisis has forged a link between the issues of financial safety and soundness and bank product deregulation that had been missing. Deregulation advocates previously dismissed bank failures as individual events not threatening the viability of the whole banking system or as a regional problem associated with recession. Now that the errors made in the name of thrift deregulation have been exposed, bank risk exposure under deregulation is being seriously discussed.

Lessons from the Thrift Crisis

The savings and loan association crisis of the 1980's is important in approaching the repeal of the Glass-Steagall Act for several reasons. Legislative action to deregulate bank products has been held up in Congress because of the urgency posed by the thrift crisis. Congressional action on the thrift crisis will shift the focus of the deregulation debate to place greater stress on bank safety and soundness than might otherwise have evolved.

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[36]A recent example has been provided by Citicorp's development of a nationwide mortgage underwriting business, wedding this activity to an inhouse mortgage-backed securities underwriting business (Harney; and Guenther, 1989). While Citicorp has used mortgage-backed securities to market its mortgages in the past, it has only recently acquired the right to underwrite them inhouse (Rosenthal and Ocampo). This is, by no means, a recent phenomenon. Cross (1923) reported that a Chicago area bank was doing this at the turn of the century.

[37]Fears of financial conglomeration are often raised by citing the Japanese example of the Zaibatsu corporation. A Zaibatsu conglomerate owns both banks and manufacturing concerns. Firms in the Zaibatsu cooperate not only in financing but also in pricing practices and management (Clark, 1979).

Some feel that fundamental reform of financial services regulation is necessary.

These elements contributed to the thrift crisis:

- o Portfolio restrictions encouraged thrifts to extend 30-year, fixed-rate mortgages in spite of rising interest rates.
- o A flat fee for deposit insurance encouraged thrifts to make riskier loans than is normally prudent (Kane).
- o Deposit insurance was underpriced, increasing unfunded Treasury contingent liabilities (Kane).
- o Delay in closing insolvent thrifts led them to borrow high-cost funds which increased risk exposure.
- o Changes in State laws encouraged real estate developers to acquire and manage thrifts in a manner considered a conflict of interest by bank regulators.
- o Congressional intervention slowed regulators in closing insolvent thrifts, which raised Treasury losses.
- o Staffing cuts reduced the number and extent of thrift examinations facilitating fraud and abuse.
- o Private auditors valued bank assets at book rather than market values and provided a clean bill of health to some thrifts only weeks before Federal regulators closed their doors.[38]

Each element contributed to the crisis and if any subset of these elements were absent, the crisis or associated costs might have been avoided. Estimates of the cost of closing insolvent thrifts or finding buyers for productive assets range from just under $50 billion to over $150 billion, depending on assumptions with respect to the number of thrifts affected, prevailing interest rates, and the state of the economy. Cost estimates rise as time passes.

The chief lesson learned from this crisis is that regulatory laxity yields costs too large to be dealt with administratively or legislatively without testing the political consensus. The deposit insurance system was successful in averting thrift runs and a collapse of the financial markets, but only at enormous taxpayer expense. Although banking regulation has clearly been more stringent than thrift regulation, common problem areas, such as the deposit insurance system, are obvious.[39] It seems likely that further product deregulation efforts will receive more scrutiny than might have been true in the past and will need to be compatible with a safe and sound banking system.

Sources of Bank Risk

Benston, and Kaufman (1986) outline nine sources of bank risk: fraud, credit risk, interest rate risk, securities speculation, foreign-exchange risk, risk-taking by related organizations, regulatory risk, operations risk, and liquidity risk.

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[38]Reporting bank assets at book value follows "generally accepted accounting principles" or GAAP. When market values for an entire region deviate substantially from book values, as recently happened in energy and agricultural regions, traditional GAAP procedures can obscure insolvencies (Kane).
[39]Cargill argues that we need to develop a policy for dealing with failed institutions and to redefine the Federal guarantee provided through deposit insurance before considering repeal of the Glass-Steagall Act. Litan has suggested elimination of deposit insurance in favor of portfolio limitations on deposit institutions to require that funds obtained from depositors be invested only in federally guaranteed securities that carry no default risk.

Benston, and Kaufman (1986) reviewed the literature on bank failures and reported that the risk of fraud was a factor in more than half of all bank failures. This observation was borne out in the thrift crisis. Simple looting of bank vaults was less prevalent than making questionable loans to friends and insiders who invested in risky ventures or spent the money outright. Minimizing the risk of fraud clearly remains an important objective of bank regulation.[40]

Credit (or default) risk was an important problem in recent rural bank failures. Rural banks often serve a narrow set of industries, such as energy and agriculture, which makes them profitable in good times and leaves them poorly diversified in bad times. Product deregulation may reduce credit risk, if new customers in new regions and industries are served. Loan sales, for example, could provide this advantage. Geographic deregulation is normally felt to be more important than product deregulation in reducing credit risk although product and geographic deregulation may have similar effects.

Interest rate risk, the risk of unexpected change in interest rates, is less of a problem for banks than for thrifts. Banks generally specialize in offering short-term production and consumer credit which more closely match the maturities of their short-term time and demand deposits and reduce interest rate exposure. Thrifts, by contrast, have in the past been encouraged by regulators to specialize in offering home mortgage loans at fixed interest rates. The thrift crisis evolved, in part, because thrifts were exposed to losses when interest rates on deposit accounts rose above those received from old mortgages in the late 1970's and early 1980's.

Minimizing the losses associated with securities speculation was a major objective of the Glass-Steagall Act. As outlined earlier, banks may underwrite and trade numerous classes of corporate and public bonds, particularly when managing trust accounts. Commercial bank trading and holding of LBO loans and low-quality bonds has recently been a concern, although bank insolvencies have not been associated with such activities since the Great Depression.

Foreign exchange risk has not been an important concern for rural banks. Trading in foreign exchange markets was, however, a major source of revenue earnings for money center banks following the October 1987 crash of the stock market.

Risk-taking by related institutions has likewise not recently been an important problem for rural banks. Rural banks suffered numerous insolvencies before Glass-Steagall, however, as a result of loan participations and security syndications that left them exposed to risks they could not themselves evaluate. In the 1920's, money center banks sold securities at par to rural institutions that could not be sold at par through the exchanges. Money center banks often subjected their own trust departments to this same sort of treatment.[41]

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[40]Bank examiners are sensitive to cases involving fraud. An FDIC study of resolution costs for bank failures in 1985 and 1986 showed that fraud was a factor in 25 percent of the cases studied. The cost of resolving these cases was, however, lower than the average cost. The authors hypothesized that examiners were quicker to close banks in the case of fraud, accounting for the lower cost (Bovenzi and Murton).

[41]This practice is currently illegal in the United States. The practice of stuffing investment or trust accounts with securities priced above market rates remains, however, a problem in some European banks participating in the Eurobond market (Levich).

Regulatory risk is the risk that regulators will misuse the authority granted them and cause banks to suffer losses. Two kinds of regulatory risk currently concern rural banks. First, regulators may view rural banks as more expendable than larger, urban institutions and provide them less assistance than larger banks in stressful times. Second, asymmetric regulation can motivate product and institutional innovations that raise costs or result in unwarranted risk-taking. Thrift regulation in the early 1980's, for example, may have allowed thrifts greater freedom than banks to take risks and resulted in an unnecessary increase in insolvencies. The risks for rural banks of policy failure may, in general, be greater than those of urban banks if they are not as well represented as urban banks in the political process.

Management risk, the risk that management will lack for expertise or attention to detail, is probably greater for small banks than large banks. Rural banks probably suffer no more operation risks than any other small bank or small business.

Liquidity risk, the risk of running out of cash to meet current obligations, is often associated with other forms of risk as a bank nears insolvency. Because the Federal Reserve normally stands ready to lend money to solvent institutions experiencing temporary cash shortages, liquidity risk is not currently an issue (Meltzer).

Deregulation Issues Affecting Rural Areas

Rural banks and issuers are not the major beneficiaries of new bank powers, and rural economic growth is not expected to be significantly affected. Repealing the Glass-Steagall Act may simply allow competitive rural banks a chance to participate in changes already taking place and allow rural issuers slightly more options in financing. Additional insolvency risks may also accrue.

Effects on Rural Banks

The effects on rural banks of increased bank powers can be divided into these categories: locational effects, scale effects, diversification effects, and competitive effects.

Locational Effects

Milkove analyzed the difference between metro and nonmetro banks and reported that nonmetro banks tend to be small, and their problems stem more from bank size than location. He concluded that nonmetro and metro banks of equal size are likely to do equally well in adjusting to the increased market competition created by bank price deregulation. If Milkove's conclusions are accepted, then the locational benefits accruing to rural banks with product deregulation are also likely to be small.

Milkove's conclusions are worth examining more closely. Location may affect bank performance for several reasons. First, bank location determines, in part, whom it will serve. Second, bank location influences accessibility to major financial markets. Third, bank location determines the State laws that regulate chartering, organization, and branching opportunities.

Location determines in large measure what corporations the bank will serve. A large rural corporation is likely not to patronize a small rural bank, even if the bank could offer both commercial loans and underwriting services, because it has capital and management requirements too large for a small bank to serve. A large rural bank may, however, find that being able to offer underwriting services significantly enhances its ability to attract and hold large corporate accounts within its usual marketing area and beyond.

Accessibility to major markets may be a problem. Several observations about locational effects can be drawn from table 4. First, the largest number of banks are located in the North-Central region. These banks are the smallest of any region in average value of assets, loans outstanding, and deposits. The North-Central region has a large proportion of agricultural banks and several States with unit banking laws that restrict or forbid branching. Second, the smallest number of banks and the largest in size are found in the Northeast region, which includes New York. Third, totally rural banks (that is, those headquartered in counties with no town larger than 2,500 inhabitants and not adjacent to a metro area) make up 1,107 of 7,742 nonmetro banks, or about 14 percent. These banks are, on average, smaller than metro or other nonmetro banks, in the value of assets, loans outstanding, and deposits. Nonmetro banks in general were larger than totally rural banks, although nonmetro banks were themselves smaller than metro banks in 1985.

Given the relationship between location and structure, several provisions in the House and Senate bills potentially affect banks in some locations more than others. Most obvious of these effects is size: the large banks of the Northeast are more likely than the smaller banks of other regions to be able to underwrite optimal size security issues because of the capital requirements of large issues. A large bank in another region would not, however, be disadvantaged in issuing minimum cost security issues.

Location still affects the State laws that apply, but the growth of interstate branching in the 1980's has reduced the differences among State statutes. Only three States still have unit banking, for example, and only one State prohibits multibank holding companies (MBHC's) that could substitute directly for branches. Repealing the Glass-Steagall Act is therefore unlikely to stimulate changes in bank behavior designed solely to circumvent State restrictions on branching.

Scale Economies in Securities Underwriting

The chief impediment to rural bank participation in securities markets is size: rural and agricultural banks are typically smaller than metro banks. The average nonmetro bank in 1985 had $42.8 million in assets and the average agricultural bank (that is, banks with 25 percent or more of their loans in agricultural loans) had $27.6 million in assets compared with an average of $360.9 million in assets for metro banks. The six largest nonmetro banks had average assets of $1.5 billion in 1985 (Mikesell). Some nonmetro banks might be able to own a securities affiliate able to take advantage of scale economies in the securities market. The majority would need either to join a BHC or to participate in a syndication.

This basic conclusion will apply to even the smallest of issues, such as issues of rural municipal bonds, which are not particularly large--roughly, at least $1 million in face value. A small municipal issue is likely to be a negotiated, rather than a competitive, underwriting. For some classes of

Table 4--Selected mean characteristics of nonmetropolitan banks, 1985

Classification	Banks	Assets	Loans	Deposits	Net income
	Number	Thousand dollars			
All U.S. banks	14,357	189,349	114,407	146,817	1,264
All metro banks	6,615	360,917	221,962	274,351	2,359
All nonmetro banks	7,742	42,756	22,508	37,849	328
Branching law:					
Unit	3,089	32,492	16,004	28,902	193
Limited	3,830	44,295	23,179	39,300	349
Statewide	823	74,121	43,797	64,672	744
County type:					
Totally rural	1,107	23,936	11,688	21,272	171
Agricultural	2,255	26,853	12,817	23,839	149
Mining and oil	571	46,878	23,533	41,221	407
Bank size:					
Very small	3,475	14,323	7,107	12,733	69
Small	3,672	48,032	24,483	42,822	368
Medium	589	162,937	91,970	142,389	1,480
Large	6	1,483,681	914,472	1,277,963	13,459
Region:					
West	646	39,841	22,290	35,432	151
North-Central	4,019	34,710	17,345	30,877	206
South	2,822	49,681	26,549	43,809	474
Northeast	255	100,324	59,707	87,891	1,100

Source: (Mikesell).

municipal bonds, the primary underwriter is usually the local bank because few other underwriters can effectively evaluate credit risk (Sullivan, 1983b). The issue will likely be placed with a small number of investors (or held by the bank itself), and the issue will likely not be actively traded. The lack of an active market raises interest rate risk, which in itself justifies a larger underwriting spread (Sullivan, 1983a)[42] and suggests that bank loans are a close substitute.

Consider the case of an average-sized agricultural bank with $27.6 million in assets. If the bank regulator constrains the maximum financing to 3.5 percent

[42]The lack of competition may explain why negotiated municipal bond sales tend to carry higher interest costs than competitive bid sales. High transaction costs are another explanation (Silber; West; Ederington; Hendershott and Kidwell).

of bank assets,[43] for example, this bank could underwrite an issue no larger than $970,000. Portfolio diversification requirements accordingly make the average agricultural bank too small for even a small municipal bond issue.

A special problem may exist in the case of small, rural firms not quite at the point of going public. Unless the firm is a high-technology firm with good prospects for growth and able to attract outside funding, the firm will likely depend on local banks for funding until it reaches a size of $1 million in annual net income and annual sales of $15-$20 million (Bloch). If the common stock issue has a price-to-earnings ratio of 12, then the initial public issue for this small firm would be $12 million. A sum this large poses much too big an underwriting risk for the average rural or agricultural bank. Beyond the problem of the issue, however, the majority of nonmetro banks do not themselves earn so much income and might have difficulty providing loans large enough to support a firm just under this size (table 4) (Rogers, Shaffer, and Pulver). If this is the case, the chief credit problem for rural firms might arise in obtaining the "bridge loans" necessary to grow to the point of going public because firms large enough to go public will likely search outside the local area for assistance in underwriting.

A commercial bank entering the underwriting business may specialize in such small issues. Alternatively, it might begin by cooperating in a joint offering. If smaller issues are expensive because of a lack of competition (negotiated underwritings), then repealing the Glass-Steagall Act might conceivably encourage more banks to enter this market and reduce costs to issuers. If smaller issues are more expensive because of added risk and scale economies, then repealing Glass-Steagall may have little or no impact on the market for smaller bond issues. Research reviewed in previous sections suggests that new competition may indeed lower issuing costs (Silber, 1980), but there is no guarantee that repealing the Glass-Steagall Act will initiate new competition because of the existence of scale economies in underwriting (Hayes, Spence, and Marks).

Providing banks with new securities powers seems unlikely to benefit rural banks because of scale economies in underwriting. The advantages of securities market participation seem to benefit large banks and large issuers. Even if small banks and small issuers can participate, the benefits are modest relative to those of large banks and large issuers.

Diversification into Securities Underwriting

The association of rural bank failures in the 1980's with stress in the agricultural and energy sectors of the Southwestern States suggests that the diversification effects of product deregulation may be important. Available research suggests that geographic deregulation offers more diversification potential than product deregulation. These results may, however, be sensitive to cyclical change and the securities activities taken up.

[43]This is the constraint imposed in the Agricultural Credit Act of 1987 on the largest loan in a Farmer Mac pool (Hiemstra, Koenig, and Freshwater). A similar constraint may also be imposed on the total percentage of that class of assets. No standard has as yet been proposed. The Federal Reserve recently permitted several money center banks to earn up to 5 percent of their revenues through securities underwriting and trading. This is a stringent standard and it may soon be relaxed to 10 percent. By contrast, the National Bank Act allows an unsecured loan to be as large as 15 percent of unimpaired capital and a secured loan to be as much as 25 percent.

Product deregulation does not offer significant potential for diversifying rural bank portfolios according to existing studies. A study of changes occurring with the Bank Holding Company Act of 1970 concluded that because geographic deregulation requires no departure from retail banking, it has a higher probability of success than product deregulation that involves managing new products and accepting new risks (Eisenbeis, Harris, and Lakonishok). Research on product expansion through nonbank acquisition of banks likewise reported no significant stockholder benefits (Born, Eisenbeis, and Harris). These results are sensitive to the financial condition of individual banks. Several studies have reported that shareholder benefits of superregional banks of interstate expansion were likely to be positive while those of money-center banks strapped by developing-country debts would likely be negative (Black and others; Meltzer). While these studies do not address the rural bank diversification problem specifically, their conclusions seem consistent with rural bank experience.

The time period chosen for study may also affect these results. Securities underwriting is a highly cyclical business. Hayes, Spence, and Marks reported:

> Smaller and usually more marginal issuers tend to drop out of the public offering markets during slack periods identified with economic slumps and with more quality-conscious investor sentiments. These second-tier-quality issuers are principally associated with the smaller investment banks. The large, more powerful investment banks tend to be associated with the larger first-tier-quality corporate issuers, who usually have continued access to public markets, even during recessions.

If smaller investment banks are disadvantaged more than larger investment banks by cyclical downturns, and the diversification benefits of securities underwriting are generally small, rural banks are unlikely to benefit significantly from underwriting activities.

The potential for rural bank diversification may also depend on the class of securities underwritten and traded. If rural banks are more likely to participate in regional or national securities markets, diversification into securities markets will probably lower risk, all other things being the same. If rural banks begin to offer securities as a service to their existing customer base, little or no net reduction in risk may occur because losses on local loans and local issues are likely correlated.

Competitive Effects in Commercial Banking

Efforts to increase competition among commercial banks through interest rate and geographic deregulation in the 1980's appear to have benefited rural borrowers. The small decrease in the number of independent rural banks because of insolvencies has been more than offset by the entry of new banks and branching of urban banks into rural communities. The number of bank offices in nonmetro counties rose 11 percent from 1980 to 1986, and a growing number of nonmetro countries are now served by a lender experienced in commercial and industrial lending (Milkove and Sullivan).

The repeal of the Glass-Steagall Act could have two important competitive effects on rural banks and borrowers. First, money center banks may gain a competitive edge over rural banks in some product markets by vertically integrating in secondary market transactions. Second, increased competition in some loan and security product markets may motivate banks to redistribute the allocation of overhead costs away from the more competitive product markets. Greater competition could, for example, raise the cost of "character" or "good neighbor" lending practices and thus reduce its incidence in rural banking.[44] By making cross-product subsidies more obvious, this could decrease the subsidization of low-quality loans by high-quality loans.

Rural banks could be disadvantaged in this new, more competitive environment relative to urban banks. Being smaller than other banks, they may simply lack the assets, the employees, and the expertise to enter securities underwriting directly, and lack the merger appeal of larger institutions to enter the business indirectly. A study of the effects of eliminating restrictions on interstate banking, for example, suggests that small rural banks are likely to be spectators rather than players in a merger movement (Philis and Pavel).[45] Securities products closer to the basic business of retail banking--those that can be underwritten within the bank--may pose a greater problem for rural banks than those confined to a securities affiliate because more diversification and efficiency benefits potentially accrue.

The opportunity to join a BHC may also be unattractive, because the securities business is too distant from familiar markets and customers. This may explain why a recent survey of bank managers showed that while managers of large banks generally favored product deregulation, managers of small- to medium-size banks ($10-$250 million in assets) generally opposed deregulation (Horowitz). The advantage of large size in securities underwriting should not, however, be overstated because large banks may have already achieved this advantage by virtue of size alone (Hanweck and Rhoades).

Although deregulation legislation has been promoted primarily by large money center banks, several analysts have suggested that large regional banks may also benefit for several reasons. First, the securities that banks were allowed to underwrite in the past, particularly general obligation municipal bonds, did not provide enough business to keep a bank underwriting business afloat. By increasing the number of products banks can offer, the legislation may allow regional banks enough business to benefit more from scale economies. Second, most underwriters are located in major metro areas. Regional banks entering the underwriting business may accordingly serve investors and issuers who might not otherwise be adequately served by large, money center underwriters. These bank underwriters might expand the securities market and have a comparative advantage in local markets (Kaufman, 1988b; Hayes). Third, the superregional banks are better capitalized than the money center banks (Meltzer; Black and others). Although the superregional banks may benefit from new powers, this development may be accompanied by geographic consolidation and a reduction in bank numbers (Kaufman, Mote, and Rosenblum). If so, then the basic analysis holds--big banks benefit most--with the recognition that some large regional banks may also benefit from new powers.

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[44]Rural banks may also be significant recipients of goodwill business. I found that regional chain stores felt a strong obligation to support local suppliers by channeling some fixed portion of their business to them, in spite of cost and quality considerations. Even though these local suppliers provided only an insignificant portion of total inputs to the chain, this business represented a significant share of the business available to these local suppliers (Hiemstra). While such practices are often viewed as motivated strictly by philanthropic motives, the chains could be using these alternative suppliers as a means of keeping track of competitive conditions in their input markets and reducing their dependence on national suppliers (Porter).

[45]Milkove and Sullivan argue that rural banks may see less change than urban banks with reduced regulation because they are less specialized. The argument here does not dispute this observation but rather interprets it to mean that rural banks may be less competitive on account of their lack of specialization.

Competitive Effects in Investment Banking

If repeal of the Glass-Steagall Act leads to additional bids from commercial bank underwriters, then rural issuers may see the cost of underwriting services decline. This result depends on the significance of scale economies in underwriting, competition from loan financings, and the entrance of new investors along with commercial banks into the market for rural issues.

The larger, better capitalized corporate issuer can hire a competent finance staff, is likely to attract multiple bids on issues, and may be big enough to view the Eurobond market as an alternative, as argued before. For the typical rural issuer, the Eurobond market is not an option and competition from loan financing and loan participations is likely to be important.

The difference between a loan participation and a securities financing lies primarily in the number and nature of investors included in marketing. If the target market is a small number of commercial banks or institutional investors, then a loan participation makes sense and the cost of public registration is eliminated. If the target market is the public, then a securities underwriting is warranted. The competitiveness of loan participations relative to securities underwritings, therefore, depends on local market conditions, the point in the credit cycle, and other factors, such as the number of firms willing and able to compete in these markets.

Freedom of entry into investment banking and the offset of cyclical profits by cyclical losses in underwriting may also affect competition in the rural credit market. The effect of commercial bank entry into the underwriting business over the course of the business cycle may depend on what the new investors commercial banks bring into the market and the importance of scale economies in securities underwriting. If commercial banks bring new investors in the market, more firms will be viable in the market in view of scale economies. This new competition could then reduce the underwriters' spread on new issues.[46] Because underwriters are often dealers in the secondary market, greater competition would also likely reduce price variability and the cost of trading outstanding issues in the secondary market (West and Tinic). If repeal brings little or no new investment to the market, then the number of firms in the industry is unlikely to change as new entrants are offset by the exit of less competitive firms.

Cross-Market Effects

Secondary market activities may increase vertical integration opportunities and significantly affect competition in rural credit markets. A money center bank could, for example, follow the example of the home mortgage market and integrate back into the market for farm mortgages by (Guenther, 1989; and Harney):

- o Purchasing agricultural or rural housing mortgages through rural agents who receive a commission for brokering borrowers with good collateral and cash-flow characteristics;
- o Assembling a pool of agricultural or rural housing mortgages;

[46]The need for new competition is underscored by the periodic appearance of a "hot issues" market when fringe underwriters take advantage of small, startup companies in selected industries by offering their stock at a larger discount than normally prevails (Ritter).

- o Issuing Farmer Mac guaranteed securities collateralized by that pool; and
- o Distributing those securities to institutional investors (Hiemstra, Koenig, and Freshwater).

Competition between rural and money center banks might improve the service and pricing of high-quality agricultural and rural housing mortgages.

Increased market competition could improve pricing as increased market arbitrage links thinly traded product markets and regional interest rate differences. This competition may reduce the costs to high-quality credit applicants and raise the cost to other applicants as overhead costs are shifted toward less competitive products.[47] A rural borrower that qualifies for security financing, for example, will be in a better position to negotiate loan financing than a rural borrower unable to employ the securities market.[48] CRA amendments proposed in the 1988 House Act to provide low-cost check cashing and transactions accounts could likewise become expensive and disadvantage small banks depending more heavily on deposit funds.[49]

Effects on Rural Issuers

New bank powers could benefit rural issuers by increasing competition and lowering underwriting spreads. Low rural bank participation in the securities market and limited substitutability between loan and securities financing may, however, limit the competitive effect. If the average rural bank is not large enough to provide the loans needed by public corporations, then it is unlikely that the introduction of securities financing will increase competition for their established customer base.

Increased competition in the investment banking industry could improve rural service, but only if current service is poor. The cost of securities financing may be higher in rural than urban areas because of cost factors, but there is little evidence that suggests rural issuers cannot obtain underwriting services.

Pugel and White hypothesized that increasing the distance from a major financial center reduces the number of bids on an issue and raises the size of the underwriter's spread in initial public offerings. They reported that a 10-percent increase in distance is associated with a 0.01-percent increase in the underwriter's spread. This variable was not statistically significant. Pugel and White used market data for 1981.

This result is expected: While a small company or municipality far from a major financial center might have trouble attracting bids from major underwriters, large companies probably would not. Large rural businesses are

[47]The existence of cross-subsidies to less desirable borrowers seems likely if rural credit markets are not highly competitive. Following Leibenstein's theory of X-inefficiency, firms do not use their market power so much to achieve higher economic profits as to make their life easier. In a rural context, this might be exemplified by "good neighbor" or "character" lending policies that give borderline borrowers the benefit of the doubt under normal circumstances.

[48]This is an application of the theory of price discrimination (Henderson and Quandt). The demand by a rural borrower able to obtain security financing will be more elastic than the demand by a rural borrower unable to obtain such financing. Consequently, theory predicts that the borrower with the more elastic demand will receive credit on more favorable terms.

[49]A recent study found scale economies in complying with Federal Reserve regulations B (Equal Credit Opportunity) and Z (Truth in Lending). These economies were quickly exhausted as bank size increased and diseconomies were reported for the larger banks. The proposed CRA amendments, which are more substantive than regulations B and D having an elaborate compliance mechanism yet similar in intent, seem likely to share in these scale economies (Elliehausen and Kurtz).

often subsidiaries of even larger, urban-based conglomerate firms that have no problem attracting major underwriters and, in any case, arrange for financing through their corporate headquarters. Improvements in communication technologies in recent years have, in any case, probably reduced the significance of location in participating in financial markets.

Repealing the Glass-Steagall Act may not change this result for several reasons. First, most nonmetro banks are too small to underwrite an issue or own a securities affiliate. Second, securities activities allowed within the banks provide the most important benefits. Most of these activities are already permitted and few changes are expected. Third, BHC's organized by nonmetro banks might expand competition. BHC underwriting would still be small compared with large underwriters and rural companies. Scale economies will raise their costs and limit the competitive benefit. Fourth, the securities affiliate of a BHC may specialize in a narrow set of securities activities, such as managing a mutual fund, that provides no special advantage to rural customers. Fifth, if the affiliate specializes in offering rural services, participating banks may receive only minimal diversification benefits because the health of the local economy affects loan and security financings equally.

If repealing the Glass-Steagall Act increases competition, then issuers will benefit most. Because issuers generally have better credit ratings than nonissuers, new competition is more likely to lower financing cost than to increase its availability. Security issues may compete effectively with bank loans, but only loans too big to be obtained from an average rural bank. Security issuers may therefore experience lower financing costs, but only at financing costs competitive with other large bank customers.[50] Rural banks will be affected only to the extent that they lend to corporations and municipalities large enough to issue securities.

Even if rural banks entered securities underwriting, their competitive effect could be small. In a study of competition in investment banking, Hayes, Spence, and Marks reported that customer loyalty (low client turnover) tended to be more important for the leading investment banking firms than for other firms in the industry. Because rural BHC's are unlikely to become leading investment banking firms, they may enter market segments only where competition is not a problem. The advantage to rural issuers may, therefore, not be significant.

Effects on Rural Economic Growth

Repealing the Glass-Steagall Act may increase competition in underwriting and improve the availability or the pricing of rural financing. Theory and empirical studies show little increase in economic growth with institutional changes in the financial sector under normal circumstances. By contrast, distributional effects are expected. If repeal increases the likelihood of bank failure and if regulators let more rural than urban banks fail, rural banking services could be lost and economic growth could be slowed.

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[50]The National Federation of Independent Business reported a study showing that "three-fourths of all bank loans to small business were made by small- and medium-sized banks, and that loans to small firms make up 95 percent of the commercial loan portfolio of small banks and 77 percent at medium-sized banks, compared to just 13 percent at large banks." (Wirth).

Theoretical Linkages between Financial Structure and Growth

The role of financial intermediaries is to facilitate linkages between savers and investors and to reduce transactions costs. Once a market is established, the primary effect of changes in the structure of financial institutions is to redistribute funds. Some reduction in transaction costs is possible with increases in competition, but cost savings are expected to be small in the absence of significant barriers to entry. The effect on economic growth of structural change is likewise expected to be small because redistributing funds among competing investors normally yields comparable contributions to growth.[51]

This result is possible in the case of rural financial markets in the long run so long as the rural economy is essentially open and prices are allowed to vary with market conditions. If there were no access to underwriting services in the rural areas, for example, then the reduced investment would lower wages and raise interest rates stimulating an outflow of labor and an inflow of capital. The inflow of capital could take place through bank loans, government transfer payments, or direct investment by large commercial firms hoping to take advantage of lower wages. To argue that rural financial markets constrain economic growth, therefore, one needs to demonstrate that prices are inflexible, that barriers to trade exist, or that markets are monopolized.

Because these conditions are not fully met in rural America, we expect that rural credit markets will not pose large constraints on economic growth. The speed of adjustment to changing economic conditions may be slow. Transactions costs may be higher than in urban areas. We expect, however, that the differences between urban and rural areas in economic growth in the aggregate over the long run are roughly comparable.

Effects of Changing Financial Structure on Economic Growth

Regional economic growth is defined as an increase in aggregate demand and is measured by increases in the gross domestic product. Measurable economic growth accordingly occurs whenever a firm increases its demand for inputs, or whenever consumers make additional purchases. Economic growth will normally be accompanied by employment growth.[52]

At least three possible links between product deregulation and rural economic growth can be cited. First, rural bank profitability could increase, spurring local growth as profits are distributed to shareholders and bank employment increases. Second, the securities market could expand, alleviating local financing constraints to increase rural investment. Third, market competition could increase, lowering rural financing costs and increasing rural investment.

Rural Bank Profitability Effects on Growth. Repealing the Glass-Steagall Act presumably could stimulate economic growth by reducing bank portfolio risk or

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[51] O. Williamson's work on transactions costs suggests that market allocations and allocations within firms, particularly large conglomerate firms, are roughly substitutable. In the event of market failure or high transactions costs within the market, we therefore expect to see greater use of intra-firm allocations. In other words, institutional structure only matters when transactions costs are high. In the literature on institutional economics, this is known as the "Coase hypothesis." See, for example: (Coase).

[52] The normal case holds, provided that labor-saving technological change is not an important source of the economic growth.

increasing bank profitability. Scale economies in securities underwriting, however, suggest that significant rural bank participation in securities underwriting is feasible only through joining a BHC. Because the primary benefit of BHC participation is bank portfolio diversification and participation is likely to be low, rural bank profitability is not expected to increase significantly. The contribution to economic growth is consequently expected to be small.

Effects of Reduced Financing Constraints on Growth. Repealing the Glass-Steagall Act could presumably alleviate local constraints on financing and spur economic growth as rural issuers increase investment. These constraints could take the form of credit rationing or overpricing.

Credit rationing--inadequate access to credit--is sometimes alleged to constrain rural growth. The significance of this effect depends on the number of rural firms that have sought financing unsuccessfully and the number that will now find financing because of increased underwriting. Rogers, Shaffer, and Pulver explored the question of rural capital market adequacy in a study of Wisconsin rural nonfarm businesses. After adjusting for risk, they concluded that firms with assets under $100,000, which were small relative to the largest local lender, and had a lender very familiar with their industry were more likely to be denied credit. Firms with assets over $500,000 and with a relatively large number of medium- and long-term loans were more likely to experience an underfunding of a loan request. Lenders were reported to discriminate against firms with declining sales, high debt-sales ratios, and limited management experience, and firms in the startup or expansion stage of growth in extending loans. If these denials ultimately lead borrowers to give up seeking the credit desired, the authors' conclusions suggest that untapped growth potential may exist in rural Wisconsin and, by analogy, in rural areas more generally. Alternatively, lending requests denied by one lender may be funded by another.

Another constraint could arise because of overpriced credit. Overpricing could occur either because the local market has excess demand for credit or because the local supply of credit is constrained either through a low savings rate or monopoly pricing.

Some evidence of rural-urban pricing discrepancies can be cited. Freshwater, for example, cited a survey that reported small rural businesses paid 2.2 percent above the prime lending rate for credit that cost firms in large metro areas 1.7 percent above prime. Hiemstra and Lee reported statistically significant differences in agricultural mortgage interest rates among lenders, regions, ownership classes, and classes of land for fixed-rate mortgages. While such discrepancies are often cited as evidence of insufficient rural credit (or a rural credit "gap") or rural market inefficiencies, they may not be statistically significant after adjusting for differences in borrower risk characteristics. The causes of the discrepancies are generally not analyzed.

Concerns about credit rationing and overpricing most likely arise not from a general problem with availability or with pricing, but because credit availability and pricing change over the course of credit cycles. If rural credit markets have been isolated from the national capital market in the past, then deregulation could increase credit market integration and improve both credit availability and pricing through regional inflows and outflows. Rural areas, therefore, experience the same advantages and disadvantages of the national credit market as urban areas.

Rural market integration into the national credit market has clearly increased in the 1980's (Mikesell and Davidson). Rural banks can already import capital through the market for Federal funds, relationships with the Federal Reserve, loan participations, and correspondent relationships with larger urban banks. Rural banks may, however, be reluctant to use these linkages in extending credit for fear of unforeseen risk or out of inexperience. Repealing the Glass-Steagall Act will likely increase the integration of rural credit markets in the national market, but increased integration seems unlikely to stimulate rural growth significantly in view of existing market linkages.

<u>Competitive Effects on Growth</u>. Repealing the Glass-Steagall Act could presumably stimulate economic growth by lowering rural financing costs and increasing rural investment.

To argue that new competition in financial markets will increase economic growth, one must demonstrate first that the new competition will significantly benefit either rural banks or rural issuers. I have argued that these effects are likely to be small and that the primary market affected would be the market for bank loans to public corporations. Because this market is always expected to be more competitive than the market for bank loans to smaller firms, the independent effect of Glass-Steagall is not expected to be large. We might expect to see a small increase in the rate of growth of large public corporations in the rural areas relative to smaller firms. We would not expect to be able to measure an increase in the aggregate rate of rural economic growth.

This result is consistent with past studies that have analyzed the effect of banking structure on economic growth. Lombardi and Zink reported in a study of eight Southwestern States that the four with statewide branching grew faster than the four without during the 1960's. Loan-to-deposit ratios were higher in the States with statewide branching laws. Shane reached compatible conclusions in a Minnesota study, observing that the average Minnesota bank in 1974, when unit banking laws applied, could not provide the average financing requirements of the average commercial farm borrower in the State. The implication is that constraints on loanable funds made it difficult for banks to meet the reasonable credit demands of local business.

These studies have their critics. A higher loan-to-deposit ratio, for example, does not imply that loans are made locally or that a demand exists for additional funding. Darnell observes that unit banking States have lower loan-to-deposit ratios. He argues, however, that higher rates of growth should be associated with the longer term debt required to finance plant and equipment, not the short- and intermediate-term usually obtained from banks. He also observes that bank size is the factor that best explains high loan-to-deposit ratios because of the greater opportunity a large bank has to diversify its portfolio. In a county-level study of banks and regional growth in Appalachian States in 1974, Dreese is skeptical that banks and bank structure contribute significantly to regional growth. Dreese reported that employment growth was a better explainer of commercial and industrial loan growth than vice versa. Loan growth follows deposit growth. Dreese concludes that the availability of loanable funds is probably a necessary but not a sufficient condition for regional growth. Milkove and Weisblat reported that banks in competitive markets had higher loan-to-deposit ratios. They were unable, however, to demonstrate that a competitive market stimulated economic growth.

Empirical studies of previous changes in the structure of rural financial institutions clearly show mixed results. This supports the contention that the link between institutional changes in rural financial markets and economic growth rates is weak.

Growth Effects of Bank Failures

Product deregulation is promoted as a means of allowing commercial banks to diversify portfolio risk. Because investment banking is a highly cyclical business, risk reduction may be a long-term result but not a short-term result. Product deregulation may increase profits during cyclical upswings and decrease profits during cyclical downswings, actually increasing risk rather than decreasing it in the short to intermediate term. Increased risks might also arise out of problems with commercial bank management of securities activities due to inexperience, insufficient scale, or problems in the relationship between the BHC and the securities affiliate. Whatever reasons are cited, product deregulation could raise, rather than lower, the probability of bank insolvencies.

The risk of increased rural bank failures with product deregulation may be more important than upside gains, even if rural banks do not fail any more often than urban banks of a similar size. Two reasons can be cited. First, if rural areas have an industrial base more specialized than urban areas (Killian and Hady), rural bank failures could have a larger impact than urban bank failures on local growth. Second, if bank regulators are less likely to intervene to prevent a rural bank failure than an urban bank failure, then rural policymakers should accept fewer risks than urban policymakers, all other things being the same, because they face larger downside risks.[53]

In a 1988 study of bank failures in three Great Plains States, Gilbert and Kochin reported that, on average, Oklahoma communities experiencing a bank failure had a 20-percent decline in local employment within 10 months after the bank closed. Estimates for Kansas show a 2-percent decline in employment 6 months after the bank closed. Estimates for Nebraska showed no employment effect. Employment effects arise, presumably, because shareholders and uninsured depositors lost money, and because borrowers lost established relationships with their lender. Alternative lenders presumably discounted the ability of these borrowers to repay loans (that is, "rationed" them) and provided them less credit or credit on less favorable terms.[54] These costs reduced rural employment by depressing the local economy.

Given the wide variation in employment effects, what role do banks play in the local economy? Minisky (1965a) cites seven possibilities: allocating capital funds, providing legitimate credit needs, servicing the flow of savings, facilitating capital inflows, transmitting Federal Reserve policy, managing the economy's payment system, and providing financial services.

Banks can absorb or amplify shocks to the local economy. The banking system amplifies a shock when losses are passed through the financial system to

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[53]It should be recognized that bank failures are often caused (or at least associated) with problems in the local economy. High levels of unemployment and firm failures may, therefore, cause a bank to fail rather than the other way around.

[54]A study of the closing of a bank branch office in Philadelphia in 1980 reported neighborhood lending declined 62 percent, while areawide lending increased 40 percent. Small businesses in the area not only received fewer loans, but they experienced a loss of business (Community Resource Center).

liability holders, when by protecting itself from losses the bank generates greater losses and defaults than might otherwise occur, and when financing conditions tighten whenever income has fallen. Gilbert and Kochin observed little or no additional unemployment when failed banks were kept open through takeovers arranged by bank regulators. Minisky (1965b) observed that banks absorb shocks to the local economy up to a point and amplify shocks after that point. The net worth of the bank, the character of its liabilities, and the actions of regulators determine the ability of banks to absorb financial shocks. These conclusions are consistent with recent work in macroeconomics (Gertler; Williamson; and Bernank).

Highly specialized rural areas may face higher opportunity costs when banks fail than more diversified areas because fewer financing alternatives exist in rural than urban areas. Hard evidence to support this contention is not available.

The second hypothesis, that the attitude of banking regulators could disadvantage rural areas, appears almost self-evident. In a recent study of bank failures, Gajewski concludes:

> Banks specializing in farm finance or headquartered in gas-[energy] dependent counties are found to face higher closure probabilities. Large banks and banks affiliated with MBHC's that have many other subsidiaries are found to have lower closure probabilities.

Because bank regulators focus primarily on the cost of bank failures in determining how to resolve them, this result might follow because failed rural banks are simply cheaper to close than to sell.[55] Because small banks are no more expensive to close than large banks (Bovenzi and Murton), however, it seems more likely that regulators treat small rural banks as expendable while larger urban banks are considered too large to fail (Kaufman, 1988a).[56] If this is true, then rural development suffers disproportionally more than urban development from bank failures under similar circumstances. Some of these bank closings may, of course, be offset by the entry of new rural financial firms (Milkove and Sullivan). If product deregulation raises the risk of rural bank failure, however, then rural growth prospects may bear more of the cost than urban growth.

Safety and Soundness Considerations

If we accept the premise that rural banks are disproportionally affected by bank failures, then the focus of product deregulation efforts needs to shift from what new bank powers are most efficient to what new bank powers are most consistent with a sound banking system (Cargill). The thrust of the 1988 proposals, as they pertain to safety and soundness considerations, is to limit self-dealing, conflicts of interest, and bank insolvencies by confining securities operations to securities affiliates. This approach limits the efficiency gains likely to arise from diversification and better use of

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[55]Bovenzi and Murton list five options open to bank regulators: deposit payoff, purchase and assumption transactions, insured-deposit transfers, open-bank assistance, and bridge banks. While most options result in a change in management and losses to stockholders, only the deposit payoff results in the immediate closing of the bank.

[56]Usually this argument is stated the other way around. In examining the bailout of Continental Illinois Bank, Jackson, for example, asks whether money center bank depositors enjoy a full Government guarantee at the expense of smaller bank depositors whose partial guarantee comes at greater relative expense. If the cost of the guarantee to money center depositors is lower than that paid by other depositors, then an incentive to consolidate banks exists and a disincentive exists to bank with a smaller institution.

overhead costs, but facilitates regulation by making commercial relationships more transparent, allowing regulators to maintain the current division of labor.

Another approach is to ask whether repealing the Glass-Steagall Act is the most effective way to deregulate financial product markets in view of the structure of rural financial markets. The small size of rural banks and the existence of scale economies in securities underwriting make it clear that rural banks will not be the biggest beneficiaries of this form of deregulation. The small size of rural banks might not preclude them, however, from taking a larger role in insurance and real estate markets, which require less overhead capital and local, rather than national, market expertise.[57] There may also be ways that regulators can help reduce the transaction costs required in the market for loan participations by providing underwriting standards and encouraging the development of secondary markets in rural loans.

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[57] Rural banks evidently are anxious to underwrite revenue bonds, to be able to organize mutual funds, to broker insurance, and to broker and invest in real estate. Even though banks are forbidden in general to offer these services, rural banks are often a family affair and these services may be provided legally through a separate business run by a spouse of the bank president. This arrangement may add cost to the basic service, however, without adding value.

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Appendix: Detailed Legislative Review

The review that follows examines the titles found in Senate bill 1886 and House of Representatives bill 5094, both passed in 1988. The House version of this bill, the Depository Institutions Act of 1988, is lengthier with more detailed consumer protection and regulatory oversight provisions. This summary follows the format of the Senate bill and compares it with corresponding provisions in the House bill.[58] Table 1 shows titles of both bills.

Securities Affiliates of Bank Holding Companies

This title repeals the Glass-Steagall Act, the primary focus of product deregulation legislation.

Senate Bill

Title I of the Senate bill repeals sections 20 and 32 of the Glass-Steagall Act that prohibit commercial banks from having securities affiliates. Upon enactment, commercial banks organized as BHC's will be permitted to own a securities affiliate. Within 6 months, the affiliate will be able to underwrite mutual funds and corporate bonds. If approved by Congress, they will be allowed to underwrite corporate equities in 1991.

This title permits securities affiliates to serve both as underwriters and dealers of securities, subject to SEC regulation. No prior approval of the Federal Reserve is required to acquire a securities affiliate, but the Federal Reserve must be satisfied that the affiliate can be managed safely and soundly, and large BHC's ($30 billion in assets or more) are prohibited from acquiring large investment banking firms ($15 billion in assets or more). The assets and liabilities of the securities affiliate cannot be consolidated with the BHC, and the BHC's capital and total assets must be reduced by an amount equal to its equity investments in the affiliate. The BHC may not extend credit (or guarantees of any kind) to its affiliate (or a customer of the affiliate) and may not purchase the affiliate's financial assets (or vice versa). Officials and directors of the BHC may not also serve in the affiliate, although a special exemption is provided to BHC's with less than $500 million in assets, adjusted for inflation. The affiliate must disclose in writing to its customers that the affiliate is not a bank or federally insured institution and that the securities handled are not insured deposits. The BHC may not recommend securities underwritten or traded by the affiliate and may not disclose confidential information provided by its customers to the securities affiliate. The affiliate may not commence operations unless the BHC has complied with the risk-based capital standards of its Federal regulator.[59]

This title also contains many technical amendments to existing legislation. States may not prohibit BHC's from acquiring a securities affiliate. A BHC may not be an affiliate of a securities firm, except as allowed under the Bank Holding Company Act or the International Banking Act of 1978, or when acquired before March 5, 1987. Limits placed on securities activities in this act do not apply to activities that commercial banks were already allowed to do prior

[58] This section is based on the Senate and House bills and related committee reports (Proxmire).
[59] Commercial bank conflicts of interest were an important point raised by security industry lobbyists (Securities Industry Association).

to the act. Large foreign commercial and investment banks are prohibited from circumventing restrictions imposed on large domestic commercial and investment banks in acquisitions approved under this act.

The title defines a "diversified financial holding company" (DFHC) as a company that controls a bank, engages only in financial activities allowed for BHC's in the Bank Holding Company Act, has less than 20 percent of its assets in FDIC or FSLIC institutions, has no more than 40 percent of its assets in depository institutions, including those abroad, and does not cross-market banking products with products prohibited for BHC's. A DFHC may continue to engage in activities begun before March 1, 1988, provided that they represent less than 20 percent of total assets. A DFHC is also exempt from certain examination and reporting requirements normally required of BHC's (Proxmire). Financial activities of a DFHC are defined to include insurance underwriting and agency activities, real estate brokerage, investment and development activities, travel agency activities, and other activities as determined by the Federal Reserve. If a DFHC fails to maintain the capital standards of its banking subsidiaries required by any Federal banking regulator, the Federal Reserve may require divestment of that bank.

The title requires the Federal Reserve, SEC, FDIC, Comptroller of the Currency, and Commodity Futures Trading Commission to review and coordinate their rules governing capital adequacy, reporting requirements, and transactions between parent firms and affiliates on an ongoing basis to establish greater compatibility and consistency. Regulators are further required to prepare a report for Congress on: the effect and advisability of applying consolidated prudent standards and financial reporting on all financial firms; appropriate techniques for regulating relationships among banks, securities firms, and their affiliates; ways to achieve international harmonization of capital adequacy standards and reporting requirements for all financial firms; the effect of global integration of securities markets; the advisability of establishing a permanent, international framework for coordinating financial market regulation; techniques of financial supervision; and the impact of competition from firms that are neither banks nor securities firms. The title also mandates the Federal Reserve, in consultation with users, other regulators, and equipment providers, to prepare a study of the U.S. large-payments system that outlines the steps necessary to ensure its integrity and reliability as technology changes.

House Bill

The House and Senate bills disagree on the treatment of corporate equities (common stocks). The Senate version permits securities affiliates to underwrite mutual funds and corporate bonds within 6 months and corporate equities in 1991. The House version prohibits affiliates from underwriting corporate equities, although it permits corporate bonds and, subject to limitations, convertible bonds (bonds that can be converted into stocks under specified circumstances). The House bill also requires that BHC's meet the risk-based capital standards established by the Basle Committee and required by the Bank for International Standards before acquiring a securities affiliate.

Expedited Procedures

The provisions in this title are intended to speed up procedures that might impede commercial banks from immediately taking advantage of title I benefits. In particular, this title encourages the formation of BHC's.

Senate Bill

Several provisions encourage formation of BHC's. First, commercial banks are permitted to give 30-days' notice, in place of the current application procedure, to convert to a BHC structure when ownership of the bank and the BHC are roughly the same, capital adequacy standards are met, and the BHC does not engage in any nonbank activities requiring special scrutiny. Second, the procedure for authorizing approved BHC nonbank activities is changed from an application process to a notification procedure. Third, the Bank Holding Company Act of 1956 is amended to permit small banks to form bankers' BHC's for purposes of collectively owning a securities affiliate. Fourth, the waiting period in approving BHC mergers and acquisitions not affecting market-competitive relationships is shortened.

The title also amends the Depository Institution Management Interlocks Act of 1978. The threshold for exempting affiliated institutions from the provisions of the act is lowered. Ownership is interlocked if 25 percent or more of the voting stock (down from 50 percent) of two banks is owned by the same person or persons. Small banks ($100 million in assets or less) and failed or failing institutions are exempted from the provisions of the act. A limited exemption for diversified savings and loan holding companies is also provided.

House Bill

Provisions of the Senate title are dispersed throughout the House bill, although the language is substantially the same. Some confusion may result, however, because title IV of the House bill contains provisions--expedited funds availability amendments--with a similar name that amends the Expedited Funds Availability Act.

Brokers and Dealers

As previously interpreted, the Glass-Steagall Act permits banks to buy and sell securities on behalf of customers provided that no investment advice is offered. The Securities and Exchange Act of 1934 furthermore excluded commercial banks from its definitions of "brokers" and "dealers." Bank brokerage and dealing activities are organized as a "discount brokerage" operation and were, by omission, exempted from SEC regulation.[60] Consequently, the Federal bank regulators, particularly the Comptroller of the Currency, took over regulation.

The Comptroller of the Currency cautiously interpreted Section 16 of the Glass-Steagall Act that covers the activities of discount brokers between 1936 and 1982. Limits were placed on the profits a bank could make through brokerage activities, on the solicitation of customers, and on credit extended

[60]Discount brokers function primarily as order takers and normally do not offer investment advice. Because discount brokers have increasingly offered services comparable to full-service brokers, they are distinguished primarily by their pricing policies. Fee discounting has been allowed since fixed brokerage fees were eliminated in 1975, and depository institutions have been allowed to offer discount brokerage services since 1982 (Winch).

to finance securities activities. Since 1982, the Comptroller of the Currency's and the Federal Reserve's more liberal interpretation of Section 16 has encouraged banks to expand more aggressively into discount brokerage activities through securities affiliates. As a consequence, the SEC adopted a rule on July 1, 1985, requiring bank brokers and dealers to seek SEC registration. This rule requires banks to meet SEC capital adequacy requirements and to be subject to SEC oversight and allows investors to qualify for Securities Investor Protection Corporation (SIPC) coverage.

SIPC, established by the Securities Investor Protection Act of 1970, insures investors against broker and dealer bankruptcy much the same way FDIC insurance protects bank depositors against bank failure. SIPC's authority is, however, more limited than FDIC's. SIPC cannot assist in mergers or make loans to troubled broker-dealers and returns to investors only the cash and securities that can be retrieved from the insolvent firms--no insurance against losses per se is provided (Wirth).

This title attempts to divide traditional bank brokerage and dealing activities, primarily trust department activities, from activities competing with securities brokers and dealers, and requires the latter to be organized into a securities affiliate subject to SEC regulation.

Senate Bill

The title amends the Securities and Exchange Act to include banks that publicly solicit securities brokerage business or that pay incentive commissions. A broker carries out securities transactions for customers without taking title to the securities. Activities exempted from SEC regulation are: dealing in connection with trust or fiduciary activities; dealing in U.S. Government securities, commercial paper, bankers' acceptances, and commercial bills; dealing in municipal securities in the absence of a securities affiliate; and dealing in certain securities secured by obligations originated or purchased by the bank, its affiliate, or its subsidiary (Proxmire). Private placement activities are exempted. A bank is also allowed to make up to a 1,000 securities transactions per year in addition to those allowed under other exemptions. The definition of a dealer is likewise amended to include a bank buying and selling securities on its own account and to require SEC regulation unless specifically exempted, as cited above.

Exempted brokerage and dealing transactions are regulated by Federal bank regulators. Transactions not exempted must be organized into a securities affiliate regulated by the SEC.

House Bill

The House provision (title I) takes a different approach to securities activities. All securities activities, except those explicitly exempted, are required to be transferred to the securities affiliate. The exemptions are similar but not precisely the same. Exempted securities activities include: engaging in securities brokerage and mutual fund sales; underwriting and dealing in U.S. Treasury securities; buying and selling securities in the bank's capacity as trustee, administrator, custodian, and managing agent; engaging in private placement or investment advisory activities; buying and selling investment securities for the bank's own account; engaging in certain information activities; engaging in activities that are incidental to the international or foreign business of the bank or its subsidiary; and engaging in activities through small business investment companies (St. Germain).

Bank Investment Company Activities

Senate Bill

Much as title I permits BHC's to issue certain securities through a securities affiliate, title IV amends the Investment Company Act of 1940 to allow BHC's to underwrite and distribute investment company securities through a securities affiliate. An investment company in this case can be a mutual fund, a closed-end investment company, or a unit investment trust. Amendments in this title regulate the relationship between the BHC and its securities affiliate. These provisions: prohibit affiliate borrowing from the BHC, except as allowed by the SEC; limit BHC officers from serving as directors of the affiliate; require disclosure that securities sold by the affiliate are not federally insured; prohibit the affiliate from purchasing securities used to repay a BHC loan; and provide the SEC with rules-making authority under certain circumstances not covered by the title.

The title also amends the Investment Advisors Act of 1940, much as title III does for brokers and dealers, to require commercial banks' investment advisory activities to be organized in a separate department registered with the SEC. The intent here is to clarify regulatory responsibilities between the Federal bank regulators and the SEC and to place responsibility for all advisory activities with the SEC.

House Bill

The House bill gives no special treatment to investment company securities, although it permits BHC's to sell mutual funds and, in general, to broker securities.

Strengthened Enforcement Authority

Introduced earlier as a separate bill, this title may be cited as the Enforcement Powers Improvement Act of 1988. It was requested by the Federal bank and thrift regulators and is designed to provide uniform penalties across regulators for similar violations. The title is directed at banks rather than their securities affiliates.

Senate Bill

The last significant revision of enforcement powers was contained in the Financial Institutions Regulatory and Interest Rate Control Act of 1978. Those powers were initially considered adequate, but a need to strengthen or clarify previous legislation arose out of subsequent court decisions. This title provides the authority to order affirmative actions, including reimbursements, indemnifications, or restitutions whether or not the offending party was personally enriched by these actions. In other provisions, administrative regulations already utilized were added to existing law (Proxmire). The bill further provides for civil penalties of up to $10,000 per day for violations and forbids anyone convicted of such violations from working in related financial services industries in the absence of prior written approval from the Federal Reserve.

House Bill

The parallel title in the House bill contains substantially the same language as the Senate title, although the civil penalty is reduced to $2,500 per day.[61]

Following this title in the House bill is an unrelated title without parallel in the Senate bill that requires the FSLIC to dissolve the Federal Asset Disposition Association (FADA). FADA was created in November 1985 to assist FSLIC in managing and disposing of assets acquired from troubled and failing thrifts. The committee report on this title maintains that FADA has not fulfilled its announced purpose and should be abolished (St. Germain).

Truth in Savings and Investment

This title was introduced earlier as a separate bill and may be cited as the Truth in Savings and Investment Act of 1988. The need for this title arose primarily because the proliferation of new financial products in the 1980's following interest rate deregulation has made it more difficult for consumers to compare products and to understand the terms of accounts. The title requires uniform disclosure of terms and conditions on which interest and earnings are paid and fees are assessed for savings and investment instruments.

Senate Bill

This title requires disclosure of: the annual percentage yield, the yield period, all minimum balance and time requirements to earn the advertised yield, the minimum initial deposit required to earn the yield advertised, a description of fees or other conditions reducing the yield, and a description of penalties for early withdrawal. Additional disclosure requirements apply for variable interest or multiple rate accounts. The title also authorizes regulators to penalize noncompliance.

House Bill

Consumer protection provisions distinguish the House and Senate bills and opposition to the House version stems from these provisions. Title IV, subtitle E of the House bill addresses the Senate bill provisions in much the same language. Other subtitles in title IV, however, amend the CRA, require each banking regulator to establish a separate consumer division, require banks and thrifts to offer a basic transactions account and check-cashing services to low-income customers, require the last bank or thrift in a service area to provide advance notice of branch closings, and require other reforms designed to assist consumers. The CRA amendments, in particular, require banks requesting any change in regulatory status or notification to meet all requirements of the new provisions at the time of application.

These amendments are designed to toughen up enforcement of the CRA provisions. They establish Community Review Boards for each Federal Reserve District to

[61]The House committee report states its support for this title somewhat more emphatically than the Senate report. It reports, for example, that "during the past three and a half years the Federal Home Loan Bank Board found serious abuse, fraud, or criminal misconduct in 106 out of 210 savings and loan association failures. For the same period of time, the cost to the FDIC, FSLIC, and the NCUA [National Credit Union Administration] from failed banks, thrifts, and credit unions associated with such fraudulent misconduct totaled at least $4.5 billion, and in all likelihood is substantially more." (St. Germain).

review performance of consumer laws, make recommendations on enforcement, and prepare an annual report on financial consumer problems and issues. The amendments revise the CRA ratings system[62] and require that each bank in a BHC be evaluated separately with the lowest rating of any bank dictating the rating for the BHC. These banks would be exempted in evaluating BHC's: newly established banks, independent banks with under $25 million in assets and agricultural banks with assets under $50 million, and institutions acquired under emergency regulatory provisions and banks acquired with a CAMEL rating (capital, assets, management, earnings, and liquidity) of 4 or 5.[63] Banks with less than $25 million in assets and agricultural banks with less than $50 million in assets are generally exempted from these new CRA provisions, although they are still bound by the 1977 Act. These amendments require increased public disclosure of CRA ratings and a new evaluation every 18 months (St. Germain).[64]

Home Equity Loans

This title was introduced in 1987 in the House as a separate bill and may be cited as the Home Equity Loan Consumer Protection Act of 1988. The need arose because the Tax Reform Act of 1986 phased out the deductibility of most consumer credit while allowing continued deductibility of home mortgage interest. Consequently, demand for home equity loans has exploded in spite of the liabilities normally associated with second mortgages.

Senate Bill

This title has two main parts. The first details disclosure requirements that must be met 3 days before the consumer pays a nonrefundable fee. In particular, the consumer must be told that the loan is secured with the home and that the home could be lost in the event of default. The second contains four restrictions on contract terms. The creditor: may not unilaterally change terms of a loan once consummated; must use an index not under his control to determine the interest rate; may not unilaterally terminate a loan, except in the case of fraud, misrepresentation, failure to make payments, or actions on the part of the consumer that reduce the value of the security; must return all fees if the terms covered by the disclosure are changed and the consumer elects not to take the loan (Proxmire).

House Bill

The House bill contains substantially similar language covering home equity loan concerns in its consumer protection title.

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[62]The evaluation of depository institutions under CRA is based on their performance in providing credit for housing, small businesses, small farms, and related needs to their service area. Performance is measured on a 5-point scale: excellent, good, average, limited effort, and poor or substantial noncompliance. Ratings are a comparison among banks with similar resources (St. Germain).

[63]Banking regulators evaluate the quality of a bank based on its CAMEL (Baughn, Storrs, and Walker). The CAMEL system rates banks from 1 to 5 with distressed banks receiving a 4 or 5.

[64]Benston (1986), in a review of the CRA of 1977, argued that if lenders would make such loans in the absence of these regulations, unnecessary compliance costs are imposed. If the loans would not be made in the absence of these regulations, then he argues that the law encourages existing financial institutions to leave the area affected and discourages other institutions from entering the area. From this perspective, the law will benefit consumers only if bankers have been discriminating against borrowers for noneconomic reasons.

Insurance Activity

This title was introduced earlier as a separate bill and may be cited as the Bank Holding Company and National Bank Improvements Act of 1988. The title attempts to clarify another area of product deregulation, insurance, not covered by repeal of the Glass-Steagall Act, but of obvious concern to proponents of a more liberalized financial services sector. In contrast with Glass-Steagall, however, insurance regulation has, since passage of the McCarran-Ferguson Act of 1945,[65] been primarily handled by the States with little or no interference from Federal authorities. This title reflects this tradition by providing only limited authority for BHC's and national banks to underwrite or distribute insurance products.

The insurance business has typically been divided into two separate industries. One is composed of life, health, disability, and annuity insurance ("life and health"). The other consists of auto, homeowners, workers' compensation, marine, and fidelity and surety insurance ("property and casualty"). Property and casualty insurance is normally considered more risky and the industry is subject to significant business cycles (Whiteman).

Provision of insurance has been a grey area for commercial banks because, before 1982, the Federal Reserve permitted BHC's to underwrite and sell credit-related insurance, such as credit-related property and casualty insurance, and to broker insurance in places with 5,000 or fewer residents, provided that the bank was located there. The Garn-St. Germain Depository Institutions Act of 1982 permitted BHC's to underwrite and sell credit life, credit disability, and credit unemployment insurance; certain credit-related insurance sold by BHC subsidiaries; general insurance in places with 5,000 or fewer residents; and general insurance, if the BHC was small ($5 million or less in assets). National banks, not part of BHC's, also were permitted limited insurance activities under the National Bank Act and a provision allowing exercise of "all such incidental powers as shall be necessary to carry on the business of banking." The courts have typically limited these powers to underwriting and selling credit-related life, health, and accident insurance, and general insurance sales for banks headquartered in places with 5,000 or fewer residents (Proxmire).

The continuing restrictions on commercial bank entry into the insurance industry in these proposals are significant because insurance holding companies have recently been permitted by some States to diversify into many of the activities forbidden to banks. Affiliates of these holding companies have acquired controlling interests in other forms of insurance, mutual funds, thrifts, personal finance companies, computer services, computer leasing, and real estate development (Whiteman).[66]

Senate Bill

This title defines insurance as traditional insurance products and services, variable annuity contracts, and variable life insurance contracts. Insurance activities mean providing insurance as principal, agent, or broker.

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[65] The McCarran-Ferguson Act provided States the right to supervise and regulate insurance companies and codified their exemption sections of antitrust law that forbid price-fixing (Wirth; Whiteman).

[66] Clark (1979) provides an extensive discussion of insurance holding companies and lays out the arguments for why securities activities may be considered close to the basic business of providing insurance.

The title establishes the general principle that a BHC, or its subsidiary, may engage in insurance activities only to the degree permitted in State law and only in the State where its largest assets were located in its "home State" as of May 9, 1956, or the date when the company became a BHC. A BHC may not change its home State, and it may provide insurance only in that State. The title further limits national banks from providing credit-related insurance. BHC's and national banks may both provide insurance products in places with 5,000 or fewer residents, provided insurance activities are confined to that place and sold only to State residents (Proxmire).

House Bill

The House bill insurance title is almost identical to the Senate bill. Much like the insurance title clarifies the involvement in the insurance industry, the House bill contains a title that restricts bank or BHC affiliate investment in real estate ventures (as opposed to investment in real estate mortgages) for 2 years. Thrift real estate investment activities, by contrast, are exempted. The committee report expresses concern over the absence of legislative or regulatory guidance in the area of bank real estate activities, notes that some 20 States have begun to allow it, and relates its concerns to the FSLIC crisis. The title requires the Federal Reserve to prepare a study with recommendations on how to protect the safety and soundness of banks engaging in real estate activities and the FDIC insurance fund, to maintain bank competitiveness, and to ensure consumer protection.

Miscellaneous

Both bills contain a title with an assortment of unrelated provisions.

Senate Bill

This title requires the Federal Reserve, in consultation with the Attorney General, the Comptroller General, and the FDIC, to study the effects of hostile acquisitions in the banking industry on the safety and soundness of banking. The Federal Reserve is also instructed to study the need to continue the separation of full-service banking and commerce. Other provisions restrict the powers of nonbank banks and exempt industrial banks from the definition of a bank under the Bank Holding Company Act of 1956.

House Bill

In addition to provisions mentioned elsewhere in the Senate bill, this title contains provisions encouraging the expansion of minority and women's banks, prohibiting discrimination in provision of credit based on a student's course of study, limiting the grandfathering of trust companies to become nonbank banks, and requiring a study of foreign bank acquisitions of U.S. banks.

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