BROOKINGS INSTITUTION

NOMURA-BROOKINGS SEMINAR ON FINANCIAL SERVICES IN THE AFTERMATH OF THE GRAMM-LEACH-BLILEY (GLB) FINANCIAL MODERNIZATION ACT

Tuesday, October 5, 2004

2:00 p.m.

The Brookings Institution
1775 Massachusetts Avenue, N.W.
Washington, D.C.

PARTICIPANTS:

Scott Albinson
Donald Auerbach
Richard Austin
Steven Bartlett
Christine Blair
Martha Blaxall
Barry Bosworth
Gerry Caprio
George French
Yasuyuki Fuchita
Jesse Gurman
Barry Hager
John Hawke
Richard Herring
Lionel Johnson
Cally Jordan
Rose Kushmeider
Robert Litan
Eugene Ludwig
Ron Mayer
Arthur McMahon
Ellen Meade
Suen-Yi Meng
Chuck Muckenfuss
Arthur Murton
Brent Newton
Daniel Nolle
Sadakazi Osaki
Pat Parkinson
Adam Posen
Robin Prager
Jeanne Roslanowick
Penny Rostow
Lee Sachs
Anthony Saunders
Gary Schinasi
Yuta Seki
Masaharu Shibata
Yoshiro Shimizu
Lamar Smith
Jonathan Sokobin
Chester Spatt
Linda Stamp Sundberg
Kiyoshi Takai
Daniel Tarullo
Junichi Ujiie
Donna Vandenbrook

PARTICIPANTS (Cont'd):

Andres Vinelli
Peter Wallison
Lawrence White
Heather Wingate
Rich Whiting
Toshiyuki Yasui

C O N T E N T S

P R O C E E D I N G S

MR. LITAN: I'm Bob Litan from the Brookings Institution, and I'm pleased to welcome you and my colleague, Barry Bosworth, who's trying to hide over there on the side. He and I have helped coordinate this seminar together with the Nomura Institute for Capital Markets Research.

And we thought that it would be a useful thing to do is to collect a lot of the people in Washington around who know, or at least think they know, about what's going to happen after Gramm-Leach-Bliley and what's going to happen after the election, to have a general discussion about so-called financial modernization issues and what comes next, both for the benefit of ourselves and also for our Japanese colleagues.

So before I give some introductory remarks and also some housekeeping details, it's my honor to introduce Mr. Ujiie, who is also -- actually has two hats. He's chairman of Nomura Holdings, and also he is president of the Nomura Research -- or the Nomura Institute for Capital Markets Research.

Mr. Ujiie.

MR. UJIIE: Thank you, Dr. Litan. Good afternoon, everyone, and welcome. I'm very excited about today's Nomura-Brookings seminar. And since its inception in 1987, the Tokyo Club Foundation for Global Studies has supported research conferences held by Brookings and other leading global research institutions to discuss a variety of key issues.

Today marks the first time we have taken the event to a wider level by inviting distinguished scholars from institutions other than our traditional corporate and research institutes. We believe that this format will result in a highly focused, rigorous discussion that will benefit all participants.

The seminar today is devoted to the financial system. The Tokyo Club Foundation for Global Studies has a particularly deep interest in the financial system problems.

As you know, the Japanese market sector is currently in the process of resolving the severe nonperforming loan problem that has plagued it for over a decade.

After a prolonged period in which all energy was focused on the immediate crisis at hand, our banking sector is now finally in the position to establish a foundation for a sounder financial system.

It is important for Japan to now have a financial system so that this kind of serious financial crisis of historical proportions can be avoided in the future.

It might be a strange thing to be proud of, but Japan's financial crisis over the past decade may serve as a valuable lesson for financial authorities worldwide.

While in some ways we would truly like to forget our recent problems, but I sincerely hope that we can use our experience to suggest effective solutions to the mutual issues facing global financial systems.

As a Japanese saying goes, I hope we can turn hardship into happiness.

Today's seminars will focus on the post-GLB state of affairs. As in America, banks in Japan are in the process of expanding from their traditional deposit and lending business model into the securities and insurance businesses.

Even with their nonperforming loan problems behind them, Japanese banks will not be able to base their future growth on their traditional banking businesses.

Many people believe that the banking system will become more stable as the banks expand their line of business. It goes without saying that such expansion may open new problem areas as well, such as increasing risks to investors and policy-holders, confusion -- or confusing capital market pricing, I should say, and creating opportunities for unfair competition.

Well, you came here today to share some experts' views on these issues, not to hear me ramble on and on. So let's get on with the program.

But before we start, I would like to say thank you, Dr. Litan and the members of Brookings Institution, for organizing today's seminar and for inviting such distinguished speakers and such a keen audience. I thank you very much for your attention.

MR. LITAN: Thank you very much. Actually, everyone here in the room is an expert. That's why you were invited. But we picked on six people in two different panels to get the discussion going.

But I want to underscore the word discussion. Our panelists have been given instructions to try to limit their remarks to no more than ten minutes. I'll give you twelve. Such a generous guy.

But that was probably an unwise decision to announce at the beginning. But nonetheless, we want to have plenty of time for all of us to have unrestricted discussion.

Now, speaking of that, we all have microphones here, and we are recording this, not because we want to put this in the front pages of the New York Times, but because we're going to write a summary of today's session and put it on our website and also on Nomura's website.

And here are the rules. First, if you want to talk, the easiest way to let me know that you want to talk is to put your tent card up. And I'll also recognize people from the back, too. You can wave your hand. So that way, we'll collect comments, and then you'll put your tent card down.

The second thing is that when you talk, make sure you find a microphone to talk into so that we will be able to record your remarks. And then you have to punch the microphone to turn it on, but after that try to turn it off because otherwise it will drive the system crazy.

Okay?

So those are the only ground rules. And one other final thing, and that is when you speak, please identify yourself each time for purposes of the transcription.

And if you would not like to have your remarks included in the summary, say so. Okay? Otherwise, the default rule is that when you talk, you could potentially show up in print, unless you don't want to. Okay?

Are there any other housekeeping questions at the beginning? If not, I'll proceed to my five minutes of introduction.

We want to look ahead -- well, actually, we want to look both behind and ahead, given the fact that Gramm-Leach-Bliley is now just about five years old. And we thought it would be productive to start with a U.S. focus and then go international, which will be our second focus or second panel.

Now, all of you around the room know that despite all the hoopla about Gramm-Leach-Bliley, it really came down to, at least in my view, letting banks into insurance underwriting and brokerage.

Banks already had the ability before the act to engage in securities underwriting, subject to the Fed 25 percent cap. But that cap was not all that binding. And so as a practical matter, this is very much about banks and insurance.

At least that was the case for Citigroup because they were the principal financial institution that was lobbying for this bill. And the irony, of course, is that at the time Citi was trying to acquire Travelers and wanted legislative permission to do so, and now five years later Citi has unloaded the underwriting portion of Travelers, which has prompted some people to suggest, well, the whole bill was a waste of time. Why did we authorize this bill if the leading proponent got out of the business?

And I would answer the skeptics with several points. Number one is that we've had some reverse deals. We've had some insurance go into banking. One prominent example is State Farm. They now have a $10 billion bank, even though they don't have any bank branch offices, as one example. And we have other examples of insurance companies going into banking.

Second, I am confident that if regulators would let them do so, you'd see a lot more banks in the real estate brokerage business, where commissions, for the U.S. audience, we all know they're stuck at 6 to 7 percent. And I am confident that if we had more competition in that area, we wouldn't be paying so much for home transactions.

But lobbying from the real estate industry so far has kept the banks -- or at least has kept Treasury and the Fed from allowing the banks into real estate brokerage.

Third point is that we have many banking and insurance alliances in Europe and elsewhere around the world. So somebody somewhere must think that banking and insurance underwriting makes sense. And I suspect that eventually we'll see more of that in the United States, although my guess is that it will probably be in the life insurance business because the life insurance is probably closest to what banks do on the deposit side, and therefore is more naturally conducive to a bank merger alliance.

Second set of observations. There have been some grumblings that Gramm-Leach-Bliley was in some part responsible for the various financial scandals that have happened -- Enron, WorldCom, financial analysts putting out misleading reports, mutual funds trading after hours, and so forth. Let me briefly address these questions.

Let's take Enron. We know now that Enron and the banks are involved in litigation, and there has been charges that the banks, lured by the prospect of doing investment banking deals with Enron, may have made some very unwise banking and underwriting decisions, and that, arguably -- this is again the critics' argument -- the critics would say, well, if we didn't have Gramm-Leach-Bliley, maybe a lot of these banks wouldn't have been so heavily invested in what Enron did.

Here's my own view. The first is that we had banks already engaged in investment banking even before Gramm-Leach-Bliley. So the bill did not lead to these things, even if you accept the premise that the banks were lured by investment banking business to becoming involved with Enron.

The second point is that even if you had barred the banks from investment banking, the banks could have found other ways to try to engage or lure business with Enron. After all, Enron was doing M&A deals, and banks could have found other subterranean ways of enticing Enron to do business with them without doing investment banking.

And the third and, I think, really the most important thing is that each of the banks in this mess have been sued. And there have already been some settlements. And so I think banks in the future would have very strong incentives to avoid the kind of behavior that we saw or may have seen in the Enron situation.

Now, as for the other scandals, financial analysts and the mutual funds and the accountants and so forth, I don't think there's any way you can tie Gramm-Leach-Bliley to any of these scandals. They had nothing to do with them.

Final point, and that is just a gratuitous observation about the SEC and securities oversight and so forth. We got Sarbanes-Oxley as a result of Enron and WorldCom, and I know several people around the room here have very strong views about Sarbanes-Oxley, probably negative views.

But what's happened since, as we all know, is that prompted by Elliott Spitzer, the SEC now has become much more aggressive in going after accounting abuses since Enron.

I think, whatever you believe about the SEC's aggressiveness, I think it underscores the fact that we never needed to create the Public Accounting Oversight Board that is this new separate agency that now oversees the accounting industry.

I mean, I always believed that if there was a mess in the accounting industry, the SEC should have taken care of this at the very beginning, and if it didn't have the legislative authority or didn't have the money, Congress could have changed it and given the SEC the money.

We didn't have to create a new agency, which, by the way, has its own taxing authority and its own extremely well-paid commissioners and staff, to do what the SEC should have been all along.

So I will close with that editorial comment. I hope I have provided enough controversy to get things started.

We'll get more controversy from our next three speakers. And they're all well known to you, and I will not recite their extensive resumes other than to say they all know what they're talking about.

We're going to have Larry White from N.Y.U. lead us off, then we're going to turn to Dick Herring from Penn, and finally to Dan Tarullo from Georgetown Law School. All of these individuals have written about or have been actively engaged in policy-making in finance in the United States. So that's why we're talking about the United States first.

Larry, you're up.

MR. WHITE: Thank you. Does the metric of how long you took to five minutes apply to how long I get to take to twelve minutes?

MR. LITAN: No. We own this microphone here, to paraphrase someone else in politics.

MR. WHITE: Thank you, Bob. I'm very pleased to be here --

MR. LITAN: We're going to need a microphone.

MR. WHITE: A microphone. All right. I was a cheerleader.

MR. LITAN: That's obvious. I think you're going to have to turn a mike on.

MR. WHITE: All right. So if I do my cheerleading and I have the mike on, is that going to be sufficient? All right. Good.

I'm pleased to be here. And, you know, Bob gave me a fairly wide open range of things I could talk about, and I decided. I know a lot about Fannie and Freddie, and besides, unless you've been on Mars for the last two weeks, you know that these are important companies and important issues.

In some sense, it's an interesting thing. You know, go back to 1999, and Fannie and Freddie were probably on very few peoples' screens at the time. Probably on Peter Wallison's screen, but probably no one else in the room at the time.

And yet here it is, a mere five years later, and nobody thinks about Gramm-Leach-Bliley any more and everybody thinks about Fannie and Freddie. So what I want to do is a quick tutorial to sort of, you know, open the box that I hope will then lead to a lot of discussion.

Okay. Good. Great. It does what it's supposed to do. It's a very simple business, and as Frank Raines or Dick Syron will tell you -- and at one level they're right -- it is a very simple business.

They do two things. They issued mortgage-backed securities with their own guarantees as to the timely payment of interest and principal, and they invest in portfolios of residential mortgages, which are funded by debt. That's the basic business. That's where they make their money.

They are special. They are this hybrid organization. They have shareholders. They are publicly traded. Their shares are listed on the New York Stock Exchange. Their capitalization is in the tens of billions of dollars.

But they have congressionally legislated charters. They are not your standard, garden-variety Delaware corporation. The President can appoint five of their 18 board members. Just this year, this President has decided he will foreswear that possibility, but that possibility is there. Note there are no other corporations in the land that I know that have this possibility.

They pay no state or local income taxes. They are not required to register their securities with the SEC and they're exempt from fees. Fannie has voluntarily done so. One of these days, Freddie will get around to doing it as well.

They each have a potential line of credit with the Treasury of up to $2.25 billion, relatively small by their standard but still symbolic. Their securities can be purchased in unlimited quantities by banks and thrifts. Securities can be purchased by the Federal Reserve for open market operations. They can use the Fed as their fiscal agent. These are really special attributes of these companies.

There are some drawbacks. They are allowed only to do residential mortgage finance. So in a sense, it's ironic. In the world of Gramm-Leach-Bliley, which was opening up more possibilities for financial services firms, here are two entities that are very narrowly focused.

They can't originate mortgages. They're subject to a maximum mortgage amount that they can finance or issue a guarantee against, which is called the conforming loan limit, of, at the moment, $333,700. That's linked to an index of housing prices that, with only a few exceptions, goes up every year.

They are subject to mission regulation by the Department of Housing and Urban Development, and they are subject to safety and soundness regulation by the Office of Federal Housing Enterprise Oversight, which is also lodged in HUD.

What are the consequences? Well, basically, the most important of that package of specialness is that the securities markets treat their obligations as special agency debt. And indeed, if you open any major newspaper and look at their financial pages, you will see the debt issues of Fannie and Freddie listed in a special box very close to where the Treasuries are listed.

The box is called "Government Agency and Similar Issues." It's clear that the debt markets really think of these guys as special, and their specialness translates into an ability to borrow at about 40 basis points less than their doubling minus stand-alone rating would otherwise justify. They can borrow at better than AAA, not quite as good as Treasuries.

That differential varies over time with financial conditions, with nature of debt instruments. If there was somebody from Fannie or Freddie in the room, he or she would be shaking his or her head right now, disagreeing. But this is a standard sort of academic estimate.

Further consequences of that 40 basis points? They pass through to the mortgage market about 25 basis points. Again, Fannie and Freddie reps would be shaking their heads. But again, this is a reasonable academic-type estimate. And so mortgage rates for conforming loans, those below $333,000, are lower than they otherwise would be.

But you have to ask: In an economy where we already subsidize housing construction and consumption extensively, through tax advantages, through direct subsidy, through direct building of housing that we then, you know, call public housing, we rent at below -- you know, we do lots and lots of stuff for housing such that my former colleague at Princeton, Ed Mills, about 20 years ago, 15 to 20 years ago, estimated that our GDP is 10 percent lower than it would otherwise be because we push so much of our savings into housing stock rather than other potentially more productive things.

So is this really a good thing, to be piling on, to adding to an already excessive amount of housing? And further, yes, there's a good story, a good case to be made for encouraging home ownership, standard externalities argument that says if you have a homeowner and a renter, the homeowner is going to be more concerned about the neighborhood, about the, you know, simple things like keeping up the house, maintaining the neighborhood, being a good neighborhood citizen.

And there is now a small but growing empirical literature that supports that story, and also there seems to be that homeowners do better things for their families, controlling for all the other attributes.

There's a literature that says home ownership is a good thing. Great, but Fannie and Freddie are not very well focused on encouraging home ownership where it really matters, which is focusing on the low and moderate income first-time buyer household and giving them a little bit of extra help, pushing them over into being owners rather than being renters so as to get those positive externalities.

And, you know, for the most part, what do Fannie and Freddie do, along with much of the rest of housing subsidy? It simply encourages people to buy larger, better-appointed homes on larger acreages, or buy a second home. And it's far from obvious to me that good public policy is being advanced by that kind of encouragement to housing.

Are they efficient? We don't really know.

Because there's only two of them, it's not like their charter is up for auction every five or ten years or so.

Any time they try to expand in a modest direction, immediately those who are affected will cry, your expansion is only based on your 40 basis point advantage; if you really had to compete on a level playing field basis, you wouldn't be expanding. Freddie and Fannie will say, no, no, no. We're really more efficient. And nobody knows because we don't have a market test.

Finally, because of the idea that the financial markets threat their debt as special, treat them as if they expect that the federal government, when push might come to shove, if the companies got into financial difficulties, the federal government would be there to bail them out, which really means bail out their debt-holders -- and very likely this, I believe, would be the case -- taxpayers may well be at risk if the companies do get into difficulties.

And now, you know, these are, you know, to me always breathtaking numbers to look at the growth of the portfolio of Fannie and Freddie. These are either mortgages or their own mortgage-backed securities that they hold in their portfolios, financing this approximately 96, 97 percent by debt, and the growth of the mortgage-backed that are outstanding that are not in their portfolios but are being held across the financial services world. And you just look at those numbers. Look at this breathtaking growth of these two companies.

By the way, I realize I should have entered a disclaimer. Between November of 1989 -- 1986 and August of 1989, I was one of the three board members of the Federal Home Loan Bank Board, and as a consequence of that position, I was also one of the three directors of Freddie Mac.

The growth of Freddie was still very modest during the years that they were under the aegis of the Federal Home Loan Bank Board. It was --

MR. LITAN: And you take credit for that. Right?

MR. WHITE: Well, no. I'll give that one to Fred Grey and Danny Wall. You know, they deserve a little bit of something. It was when Freddie became a publicly traded company in 1989 that, as you can see, that's when their growth just went like that.

And this just gives you sort of some percentage figures. This is just credit risk, and as of 2000, they accounted for a little bit less than 40 percent. Now they're up to just shy of 50 percent of the overall -- this is just single family.

If you look at the overall residential -- let me go back -- overall residential mortgage market, add up all these numbers -- and it's not double-counting; you can go across and add -- and you will get something that's just shy of 50 percent of the residential mortgage markets, these two companies alone. It is breathtaking.

Okay. Why did this happen? Well, no question, mortgage-backed securities were a new technology. There is a great deal of efficiency. But there were differential capital requirements that worked in their advantage. And in addition, they made a decision in the early 1990s to go for aggressive growth both in the portfolio and in the mortgage backs that they were going to issue.

Just to finally, you know, finish things off, there are two -- besides the accounting, which I'm not the strongest guy to talk about accounting, and maybe at some point Chester Spatt will weigh in with -- no, Chester has decided he's not going to do it, either. Or Peter.

Peter will tell us something about accounting. All right.

We may not get to accounting, but there are two other issues that are just worthy of a quick discussion. First, there's some extra competition coming down the road that will put competitive pressure on Freddie and Fannie more than is already there.

One is from yet another GSC, the Federal Home Loan Bank system, of which I was also responsible for during my almost three years at the Federal Home Loan Bank Board, and the other comes from the revised capital regulations of Basel II. Neither of those two sources of competition requires any legislation. They are basically going to happen.

The consequences: I don't have a lot of time to go into the details of exactly how the competitive process will work, but the heightened competition will mean reduced profit margins for Fannie and Freddie, reduced franchise values for Fannie and Freddie, and will effectively reduce their capital levels compared to what they would otherwise be.

And with reduced capital levels, the standard model says you have great incentives for risk-taking, and what that means is a need for heightened regulatory scrutiny.

This just shows you that they have had -- up and through 2001 and for Fannie through 2002, they really did have a substantial amount of franchise value, certainly as compared with the ten largest banks.

Some regulatory issues: Their major safety and soundness regulator is OFHEO. It's been perceived as less effective than the traditional bank regulators, although Mr. Falcon seems to be doing his best to try to reverse that perception over these past two weeks.

But still it's worth remembering that combination of just the inherent characteristics of the agency plus congressional budgetary restrictions, they took ten years to finalize a set of risk-based capital regulations. They were slow to do anything about Fannie's widened duration gap, and Freddie's accounting scandal took them totally by surprise.

There are a set of issues, structural issues. Where do you locate any agency that might succeed OFHEO? Should you bring the Federal Home Loan Bank system under that regulatory structure? Do you fund this agency through normal general revenues or do you give them a devoted revenue stream like examination fees?

The authorities issues are, I think, much more interesting and important. And I hadn't realized till recently, and I owe my awakening to my colleague, Scott Frame, with whom I co-authored a number of Freddie/Fannie papers, and his colleagues at the Atlanta Federal Reserve, the issue of receivership powers is terrifically important.

Right now, the only entity that can put Fannie and Freddie into receivership is the Congress. OFHEO does not have the receivership powers. They have weaker powers. They are trying to come up with a set of regs that might give them receivership powers, but right now they don't have it.

And so if Fannie and Freddie were to become insolvent, if their assets were to become inadequate to cover their liabilities, there is not a receivership process out there.

Everybody would have to turn to Congress, and it's not clear that Congress could act very quickly. In the meantime, what happens, that's just not a happy circumstance. And it may be one of the big risks out there for the financial markets of the absence of receivership powers. What really happens if these companies get into difficulties?

So I don't know whether I'm still within the Litan metric. No? All right. But anyway, here I am. No question these issues are important. They're likely to be with us for a long time. They are not going away. Thank you.

MR. LITAN: Okay. Thank you. Before we go to Dick Herring, some of you may want to ask yourselves, why are we starting off talking about Fannie and Freddie?

Well, the title for this first session is, what are we doing after Gramm-Leach-Bliley? And when we put together the title of this, we did not know how timely -- or I'm sure Larry didn't know how timely --

MR. LITAN: For sure not.

MR. WHITE: -- for Freddie and Fannie would be. And so clearly we marked for further discussion later on something about Fannie and Freddie, and I know there are people around the room here who want to talk about that.

But Dick, I think, Dick Herring, is probably going to talk about something different.

MR. HERRING: Okay. First up, I have to find my presentation.

MR. LITAN: While he's looking for his presentation, just for those of you, most of you, I think, have made reservations for dinner tonight. We're honoring Jerry Hawke tonight, just so you'll be aware. And a last-minute entry for dinner also is Gene Ludwig, his predecessor, who will be introducing him. So we're going to be honored to have both of our Comptrollers for the last eight years here tonight for dinner.

MR. HERRING: Great. Okay. Well, this is, I guess, a reversion back to the GLBA roots, at least. And it's more or less an extension of Bob's original point of departure, which is to say why, looking back, has so little happened in the meanwhile?

And let me just reflect on what GLBA in principle did and what has happened and why it seems to have amounted to so little.

Essentially, what the financial modernization bill did was sweep away the restrictions on affiliation that had accreted over decades, dating from Glass-Steagall up through the Bank Holding Company, that made it difficult, although there were loopholes around, for banks to affiliate with securities firms and for banks to affiliate with insurance companies.

Now, to be sure, there were Section 20(a) subs that got to be expansive enough that in the end, you could drive a whole investment bank through one of the loopholes, as Bankers Trust did and as Citigroup did itself in the end. But nonetheless, they were restrictive and they required lots of regulatory permissions, and there were frictions.

The idea behind GLBA was that it was going to make possible one-stop shopping. It was going to make possible the era of the financial conglomerate in the United States. We saw it happening in Europe, and it seemed time for the U.S. to modernize.

The mechanism through which this was going to happen was going to be the financial services holding company, the FSHC. And the FSHC was going to sit on top of other kinds of holding companies.

It was going to be overseen by the Fed. Now, the Fed was the big winner in this regulatory competition, which had virtually all the agencies grabbing a bigger piece of turf. But the Fed was the unambiguous winner in all of this.

But the Fed was going to exercise umbrella oversight through something that was to be known as "Fed Lite." It was supposed to be deferential to the others, and so there was going to be functional regulation going on below, but the Fed was going to take a look at the overall group and be responsible for the group in some unspecified way.

The comptroller would continue to do his thing, but the Fed was still very much in control. And because the Fed was very much in control, even though it was envisioned there would be a two-way street -- that is, that insurance companies could buy banks and banks could buy insurance companies, investment banks could buy banks, banks could buy investment banks -- it was not to be a neighborhood that was open to commercial firms. Commercial firms were supposed to be out of the financial services business. So the separation between banking and commerce was to be maintained.

They were restricted from ownership of banks. They were forbidden from chartering any additional unitary thrifts, and indeed, there were controls on any sale of existing charters.

This has become somewhat important because some people believe it's the reason that so few non-banks have chosen to become financial service holding companies. Non-bank holding companies who wish to become financial service holding companies can own some non-bank activities or some non-financial activities, up to 15 percent of their gross revenues.

That is a grandfathered privilege, but it sunsets in 2009. And as 2009 approaches, some firms are worried that it doesn't look so appealing to become a financial service holding company.

Nonetheless, we're faced with the fact that here we are five years after. We have now about 600 financial service holding companies. And there are really only two important non-banks that have chosen to become financial service holding companies.

One of them, Charles Schwab, did so for a very significant strategic reason. It bought U.S. Trust. It wanted to move into private wealth management, although it appears to be backpedaling from that strategy and might well spin it off.

The other, Met Life, nobody can quite figure out what they had in mind. They made their move and they still haven't done much with it.

But beyond that, it's all banks. And for banks, it's not a big deal. They were bank holding companies anyhow. Having another option just makes it easier to get all of the approvals they could otherwise have gotten with bank holding companies.

And indeed, virtually all of the bank holding companies that had Section 20(a) subs have simply become financial service holding companies because it makes reporting all that much easier.

They haven't done much with them. Essentially, what you see happening is the same kinds of activities you saw going on before. Most of the insurance activity you see taking place is simply agency business, very little other than that.

The two exceptions would be even though Citigroup did acquire Travelers and get rid of the property/casualty bits, they did save the life and annuity parts of Travelers. So the life insurance bit is still with them.

And Bank One acquired the life part of Zurich. And so I think Bob was right that life insurance appears to have some kind of synergy that appears to make a certain amount of sense.

We're stuck with the question of why. Why has so little happened? Well, one possibility is surely that this whole proposition was oversold. There really isn't that much there. The synergies really may not be that strong.

And as you look around the world, you have to wonder. Thinking back to the earlier generation of financial conglomerates, Sears found that people really didn't want to buy their stocks where they bought their stocks, and underwriting where you bought your underwear wasn't necessarily all that attractive a proposition.

It appears that insurance companies are, in general, not nearly as profitable as banks, and putting them together doesn't really alter that that much. So they may not be that attractive.

Also, when you look abroad, some of the most notable attempts to form ambitious conglomerates, like the Allianz Dresdner deal, is not an obvious winner. It's not clear that there are huge synergies there, either. So it's quite possible that it was something that was interesting in theory but has proven to be not all that attractive or profitable in practice.

Another possibility is that by the time we finally got around to ratifying what had happened on the ground with legislation in GLBA, we had so many loopholes in place that it didn't really matter, that firms could do what they wanted to do without having to have another set of procedures in place.

Now, why is this important? Well, it's important in the sense that unless you wanted to do a really big deal in putting together insurance underwriting, essentially, and banking, as Bob pointed out early on, most of the rest of the stuff was easy enough to get round the various loopholes.

That takes you to point three, which is why the asymmetry. Well, I think there are two reasons for that, the fourth one and the third one. But the third one in particular, GLBA was a much better deal for banks than for non-banks.

For non-banks -- for banks, it actually expanded the range of permissible activities. For non-banks, it actually restricted them because non-banks could generally do a lot of non-financial things that are restricted under the financial services holding company.

But the financial services holding company is actually an expansion of powers for banks. So that grandfather clause, in this case, becomes quite important for non-banks as they think about whether they want to become a financial services holding company.

Then finally, four, the prospect of having the Fed as an umbrella regulator may not be especially appealing unless you have the Fed already as your regulator. So if you're not already a bank holding company, the prospect of Fed Lite may not be very appealing.

Why is that? Well, it's not because the Fed is malevolent in all this. The Fed, in fact, has promised to be deferential to all of the functional regulators. And it's simply going to be looking at the safety and soundness of the group as a whole.

But we're still not very clear on what in the world that means. And indeed, it's not really sufficient to understand what it means currently because it's a quickly moving scene. You really have to project what it may mean.

And in the culture in which we live, any time something goes wrong in the financial system, the Fed will be pressed to correct it. And they're going to be pressed to correct it over the whole domain which they control. So I think there's a very strong presumption that in the end, over time, Fed Lite is not going to be all that light.

There is also, I think, an underlying question that we're not really sure how it should be done. Leaving aside the question of whether it should be done -- on which Peter Wallison is probably the world's most eloquent spokesman -- but leaving aside the question of whether umbrella regulation is a good idea, we're not at all sure how to do it.

And the reason is that there are huge differences in these three different kinds of businesses. They have different purposes, different objectives for regulation. Systemic risk is the preoccupation of bank regulators, but typically it is not the preoccupation of insurance regulators or of securities regulators.

The accounting is also incredibly different. Securities firms tend to be mark-to-market rigorously or fair valued the whole way through. Banks are a hodgepodge of historical value accounting and fair value accounting and market value accounting. And insurance accounting is so arcane that you can't even describe it as a linear combination of the two.

And how you actually amalgamate those into something that you can put an umbrella regulation over I think is not clear to anybody, even the financial service authorities that pretend to do it all. So I think there's some real questions about how that can be done.

Nonetheless, there are pressures from outside the United States to do it as well. The European financial conglomerates directive has pressed the U.S. non-bank conglomerates that are active in their domain to try to urge them to become financial service holding companies, implicitly.

And they've passed a directive that says that if they are not subject to consolidated supervision in the home country that is deemed equivalent to that which they receive in Europe, which is essentially Basel-styled consolidated supervision, then they will be subject to sanctions.

And those could include higher capital requirements and risk control requirements in Europe, which would certainly be a competitive disadvantage for them; or they could be forced to form a sub-holding company in Europe that would be regulated in that way in Europe, or they could be forced to submit their entire U.S. holding company to European consolidated supervision, all of which is very unappealing.

Well, GLBA had an answer to that. GLBA actually amended the SEC Act to provide for a supervisor investment bank holding company. And that's something that the SEC has finally produced in a regulation this summer.

It's not yet clear whether any of the investment banks are going to accept the invitation. It will be voluntary. But the rule indicated that three had indicated a willingness to do so.

And what will happen in this case is that if an investment bank chooses to do so, it can be supervised by the SEC on its consolidated basis using Basel-style capital requirements, and it will be regarded, they hope -- and one assumes there's been a back door deal somewhere -- as equivalent to Basel-style regulation by a European regulator.

GE Capital is, I think, looking for a similar deal via the New York Superintendent of Banks, and AIG, I think, is hoping that the Office of Thrift Supervision is going to be regarded as equivalent as well. But we'll see how that all plays out.

There are, of course, a number of other kinds of issues on the table from GLBA. Bob mentioned some of them, but let me just toss out some others to leave open for debate.

Privacy remains a difficult and rankling question. GLBA left open the door. It lets states regulate their own privacy thing. There are opt-out provisions, but some states can actually choose to do something different. California has done so.

There also are these annual privacy requirements that we all now get in the mail each fall that are opaque and voluminous and probably counterproductive. The firms that have national services really do want to have some sort of national privacy legislation to make all of this easier.

The same is true of predatory lending. It turns out that there are now lots of state and even local statutes on predatory lending, which makes it difficult to have a national mortgage market.

Another difficulty, of course, is insurance. Even some of the insurance companies are now beginning to think it would be a good idea not to get rid of state charters, but to have sitting at least alongside it the possibility of a national charter that could run alongside it.

And then there are the remaining activity restrictions on financial service holding companies. There's a lot of pressure to lift the sunset provisions, perhaps in the hopes that it would become more of a genuine two-way street for the financial service holding company.

And then there's the point that Bob raised. People were not at all happy with the way in which GLBA resolved the choice of what additional activities could be made available to banks.

Many people thought that having either the Treasury or the Fed decide an activity was all right, was okay. Instead, it was said that the Treasury and Fed would have to agree, which sort of gave either of them a veto.

But it turns out to be worse than that because even when they do agree, as they did with real estate brokerage, Congress is still going to intervene on top of it, so that it looks like even in this framework, it's going to be very difficult to expand activities, and in some ways we're still in the old world where any kind of incremental change in activities is very, very hard.

MR. LITAN: Okay. Our last speaker is going to be Dan Tarullo. And actually, I noticed, Dan, on your outline that we have some overlap between you and Dick. So you can feel free to accommodate your presentation to that fact.

MR. TARULLO: Okay. Like Dick, I looked at Bob's list of eight questions, added two of my own, saw that they were ten minutes, and had a choice between either doing ten minutes on one or one minute on ten. And I opted for the former approach.

Let me begin -- and as Bob says, because Dick and I actually have quite complementary presentations, let me begin by adding a couple of things to Dick's very useful, I thought, introduction of this topic.

First, let's recall what at least some of the purposes, the articulated purposes, of Gramm-Leach-Bliley were supposed to be. Now, as anyone who's been in the legislative process knows, there are probably as many purposes as participants in a legislative process. But three that I kept hearing again and again from the time that the people from Treasury came over and told us they'd like to do financial services reform until the end were the following.

One, and the one everybody always led with, was efficiencies and synergies. And although, having had some contact with investment bankers over the years, I've learned to put my hand on my wallet when people talk about synergies, that continued to be one of those themes that one continued to hear, that there will be either production cost efficiencies through having the same organization, for example, do an analysis of the financial circumstances of a customer, or there'll be distributional efficiencies and one-stop shopping, cross-marketing efficiencies, a variety of things.

Second was a kind of deregulatory impulse, and to a considerable extent, one of saying, look. We've gone a long way down this road with Section 20 subsidiaries, with the erosion or the removal of the 1997 -- or the firewalls the Fed had erected between the Section 20 subs and the banks themselves. Why not rationalize what we've accomplished so that at the very least, we will minimize transactions, costs, and administrative expenditures and the like?

And third, not to be under-appreciated, the impulse to keep banks, U.S. banks, competitive, competitive vis-a-vis two sets of competitors: first, non-bank financial institutions in the United States, and secondly, foreign banks, including some of the universal banks that people will talk about in the second session.

Well, so what has happened since Gramm-Leach-Bliley was enacted, as I'm sure most people in this room know, in the first year there were about 500 financial holding companies formed. Then the pace slowed, with another hundred or so.

And in the last couple of years, the number has actually gone down a little bit, up a little bit, down a little bit. So today there are a little over 600. That's about 12 percent of all holding companies. Depending, though, on how you measure banking assets, we're talking holding companies that hold between 70 and 80 percent of national banking assets.

About a quarter of those have involved themselves with insurance agency. Only a couple of dozen have involved themselves with insurance underwriting, and most of those not in a particularly big way.

Fifty-six or 57 -- I couldn't get an accurate count -- have securities subsidiaries. The biggest companies, obviously, as everyone knows, have securities and insurance agency and probably merchant banking type acvns.

Notwithstanding that set of facts, there is a pervasive sense, to which Bob alluded, that Gramm-Leach-Bliley has not been the big deal that some people -- although by no means everyone -- predicted that it would be, not the big deal in that there hasn't been a wider use of the financial holding company form, and not the big deal in that even within the big actors, the big bank holding companies like Citigroup and J.P. Morgan Chase, the pace and nature of the integration of the different kinds of financial services has perhaps been less than might have been anticipated or was advertised.

Moreover, if you look at the most recent spate of big mergers, they seem to be as much or more about trying to establish oneself as a national retail bank than they are about promoting further integration among different kinds of financial services, a point to which I will return.

Well, as a law professor, obviously, I begin by asking the question: Has whatever disappointment is felt arisen from the existence of legal and supervisory barriers? And one can certainly imagine that there are such barriers, which continue to constrain the use of the financial holding company form and continue to impede the evolution of financial holding companies towards something closer to the universal bank model that one finds in some continental European countries.

So Dick has already talked about the potential disincentive of becoming an FHC if you're got the Federal Reserve Bank sitting there as your umbrella regulator.

Then there's a series of substantive restrictions, substantive legal restrictions, that are imposed upon a bank holding company that are not imposed, generally speaking, on big financial firms that are not bank holding companies.

Capital requirements: One, at least I, rather doubt that that's too significant a concern, both because there are capital requirements, market-imposed if not regulatory, for big financial services companies more generally; secondly, the capital requirements have not, by and large, been a binding constraint upon big U.S. bank and financial holding companies.

Dick also mentioned the limitation on non-financial affiliates. I'll come back to that a little bit later.

Then there is a set of restrictions upon transactions among affiliates once you do have them in the same corporate family, Sections 23(a) and 23(b), as interpreted in the comprehensive Regulation W the Fed put out a couple of years ago.

The privacy restrictions to which Dick alluded are also in this category, at least in my view, because they do restrict how much the FHC can do internally to try to develop information and cross-sell.

There are a couple of -- let me just give you a couple of examples of how these things might arguably impede the realization of cost-based efficiencies within an integrated financial services organization.

Reg W restricts, for example, to 50 percent the total amount of loans that a bank may buy from a non-bank affiliate even when the bank has done its own independent credit analysis. This is an extension of a fairly longstanding Fed rule -- Fed interpretation, actually, which then became a rule, which then became part of Reg W.

Moreover, the Fed does not want the holding company -- the bank relying upon the affiliate's application of whatever underwriting standards are applicable. Thus, there's at least the suggestion that a holding company would not be able to have a single set of underwriting standards which then get applied in a more or less comprehensive fashion that's applicable to all affiliates, and thus potentially impedes the realization of one efficiency within the organization.

Similarly, the Section 23(b)requirement that transactions between a bank and its affiliates in any holding company be on market terms might, depending upon how that's interpreted in particular cases, also impede the realization of some efficiencies if the bank has to get the same kinds of terms in a particular transaction that it would from an unrelated company when it deals with an affiliate, it means that the managers of the holding company cannot think of the holding company itself as a single profit center, and they can't realize some of the cost savings that they believe they benefit from when they have related party transactions.

Finally, there are the special anti-tying restrictions, which in the not too distant past became the subject of great uproar with a bunch of requests for investigations from Capitol Hill and the like. This is Section 106, which goes beyond even a generous understanding of antitrust restrictions on tying to restrict the tying of non-banking products to traditional banking products such as loans.

So there are a bunch of potential legal and supervisory barriers which might be getting in the way. And how do we figure out the degree to which it's true?

Well, a sort of soft market test that I thought I would apply was to see what the wish lists of various segments of the financial services industry were last summer when they went up to testify before the House -- no, Senate Banking Committee on Gramm-Leach-Bliley after five years.

Now, some representatives of these very entities are sitting in the room today and may want to elaborate -- or correct me, for that matter, although I am going by their testimony.

So what did they have to say? Well, we'll go through a few, and you have the slides. But what struck me last summer was how few, relatively speaking, of the requests were actually for changes to the Gramm-Leach-Bliley statute as it got enacted.

For example, wanting an optional federal charter for insurance, I understand how it's relevant to what we're talking about here. But it surely goes substantially beyond permitting banks and non-bank institutions to affiliate and to integrate their operations.

The American Bankers Association drew attention to the fact that cross-marketing for non-financial companies that are owned by securities affiliates with banks are restricted, whereas non-financial companies owned by insurance companies may cross-market with a banking affiliate. My understanding, actually, is that the Fed would have no problem with a change in that portion of Gramm-Leach-Bliley, but it hasn't been changed.

And then there were several things that -- not wild about the SEC push-out rules; they'd like the Federal Home Loan Bank Board to be a bit more aggressive in utilizing its expanded discretion as to what is adequate collateral; they want Congress to get off the back of the Fed and the OCC and let them add to the exercise of their K-1 authority, which would have added real estate brokerage to the list of financial activities.

The Securities Industry Association focused big time on the grandfather clause and the limitation on non-financial activities, and then asked for uniform national standards on customer privacy and on securities. This was a federalism issue. In fact, both of those are federalism issues.

Financial Services Roundtable also was focused on the grandfather clause, although I don't think they actually asked for removal of the percentage cap just to make the grandfather clause permanent. Looked to eliminate activity restrictions on financial subsidiaries, which are indeed an anomalous feature within Gramm-Leach-Bliley that came out of that internecine battle between Fed and Treasury in the run-up to Gramm-Leach-Bliley.

Also wanted Congress to step aside on real estate brokerage, and create optional federal charters for insurance and uniform national standards for privacy and predatory lending.

Well, so there are some administrative things, some political things. There's nothing on affiliate transactions. In fact, the American Bankers Association included in its testimony an assessment that things were just ducky in that area because, in fact, they could do most of the things that they would want to do. And they were just making the point that Section 106 doesn't really prevent them from doing very much anyway.

Where changes were sought generally, generally speaking, they're not in response to apparent constraints on realizing synergies within different kinds of financial services as they are included in a single integrated firm, at least not on the production side.

To be sure, cross-selling is there. Maybe implicitly there's some revenue diversification desires here. But you don't get a strong sense that there are existing hurdles to a systematic and more efficient development of information about the customers, whether corporate, small business, or individual consumer, that the holding company is dealing with.

Well, why? Dick asked this same question, and we came up with some reasons. But he and I actually would add to one another's list.

First, as Dick suggested, maybe the banks have pretty much been able to do what they want to do by exploiting regulatory openings. Maybe Regulation W and Section 106 are already being administered in a pretty lax fashion by the bank regulators, you know, given the fact that we have formalistic rules such as, the bank may lend to a customer of a securities affiliate but may not lend to the securities affiliate, and it may just be you have to be a little careful about how you do things but you can pretty much do what it is that you want.

Another possibility, not mutually exclusive, is that most promising integration had already occurred, and that the amount of it was only marginally affected by sweeping away some of the regulatory underbrush.

Third possibility -- Dick suggested this one -- that maybe the efficiencies are actually limited. And I would add to that the possibility that universal banks may not be more efficient, and I gather people will address that this afternoon, but it may simply be that different banking structures evolved with different regulatory systems in different countries for a variety of reasons, and once they got to be where they are, which is to say market leaders and big and having a certain amount of too-big-to-fail protection behind them, that they look like they're kind of the dominant actors in their particular market, but that there's no ex ante reason why one form of the universal bank is more efficient than a less integrated form of financial services firm.

Another possibility is that maybe some of the benefits -- a lot of the benefits -- for the financial firms are going to be derived by shifting revenues from specialized firms to the more integrated non-specialized firms without yielding any particular efficiencies for the economy as a whole.

And finally, and I think this is something that is more significant than I would have anticipated, there may be some important market constraints on the degree to which customers will be willing to deal with an integrated financial services firm.

There has been some research done on IPOs underwritten by the securities parts of universal banks in Germany and Switzerland compared to similar offerings -- and obviously you've got comparison problems -- offered by securities specialists, suggesting that the yields are somewhat lower when the issuer had both a banking relationship and a secretaries relationship with the universal bank.

It may be the investors fear that there's a conflict of interest here, and thus are demanding a somewhat higher premium or are willing to pay less, a different way of saying the same thing, for the initial offering.

On the consumer side, it may be that consumers with the internet are already able to shop for different kinds of financial services so easily -- increasingly, by the way, including real estate brokerage -- that there's just not the attraction of having a one-stop, all our financial services are done by one person in one branch of one bank somewhere because the transactions cost to the consumers of effecting these transactions are not really that high and because they, too, are a little bit suspicious that -- how could you not be suspicious with the way stuff gets pushed at you when you deal with one of these financial services conglomerates -- that these people are not -- they're just looking to add you to one of their customer rolls. So what do I conclude from all of this? Well, it's an interesting set of academic questions, and one of -- a set of nontrivial importance. But I have to say as a non-economist who's tried to canvass such literature as there is out there that addresses these questions, it seems to me it's at best incomplete and it's going to need a lot more work.

When you put that together with the fact that the industry itself is not clamoring for a lot of things that I would regard as relevant to what I have been calling production efficiencies as opposed to revenue diversification or cross-marketing types of efficiencies, it seems to me understandable why this thing is not a high priority and probably shouldn't be a high priority.

I, on the other hand, just to close, think that a more immediate and tractable issue that might bear some discussion is the 10 percent national deposit cap for banks.

The Bank of America acquisitions have pushed it right to the 10 percent level, and it seems to me an opportune moment for a discussion of whether some non-antitrust figure like that is anachronistic, still valuable and if so why -- and that has something to do with what we think is happening in the banking industry.

And then finally, and Bob and some of the rest of you would have been surprised had I not both spoken with and ended with this, the biggest issue, it seems to me right now is Basel II, not because it's got to happen -- it's already -- we've got the 300 to 400 pages -- but because, at least in my judgment for reasons that are not appropriate to discuss today, it is an unwieldy regulatory paradigm that has a significant chance of running into a lot of trouble, and thus the whole basis for safety and soundness regulation of commercial banks -- at least the credit side of commercial banks -- is going to be churning for the foreseeable future.

I think the time for resurrecting some of the ideas the Bob and others have been enamored of lo these many years may be a bit more ripe than it has been for a while. This kind of goes to the heart of a lot of the things that we're talking about today. Thanks.

MR. LITAN: Okay. The floor is open. But before we take specific comments, and I don't know, Peter, if you want to go first -- yes. I'm going to call in Peter in a minute.

I just want to ask one general question that will help me write this summary: Is there anybody who believes that in the next four years, we're going to get any significant backtracking or scaling back of the Gramm-Leach-Bliley authority? Or can we just assume that that's going to be pretty much status quo, at least?

I mean, is there anybody who believes we're going to get backtracking? I mean, I don't. I just want to know if there's anybody who does.

MR. WHITING: Rich Whiting with the Financial Services Roundtable. Whereas going up to

Gramm-Leach-Bliley we had, you know, constituencies on different sides of the issues, here the only -- the constituencies that before were separated and are now together, with the only other constituencies being fairly minor ones, maybe consumers and companies that want to be kept out of it because of certain things like the real estate industry.

MR. LITAN: Okay. I'm going to assume that to be the case, and then let's go forward.

MR. POSEN: But Bob?

MR. LITAN: Yes? I'm sorry. Adam?

MR. POSEN: Yes. Sorry. Adam Posen, Institute for International Economics.

It's just that when you ask that question, it seems to me there's an obvious follow-on: Does anyone believe that some of the things that Dick and Dan just pointed to are going to go away in the next four years and lead to additional consolidation or additional creation of holding companies?

I mean, is this also going to be status quo not just on the regulatory side but on the outcome side?

MR. LITAN: Yes. That is a logical question.

I mean, are there -- in other words, to paraphrase, are we going to see more of these financial conglomerates in the next four years? Anybody want to opine on that before we get to the policy issues? No views about this?

MR. WHITE: Sure. Look. Back to what Dick Herring was saying. It was an oversold model in the sense that there were some companies -- clearly, Citigroup -- that thought they could run a financial services supermarket.

And, you know, in some sense, it was worth letting them try and do that. But to think everybody was going to want to run a financial services supermarket, I think, was wholly unrealistic.

Financial services is much like retailing in general. We see some supermarkets, but we see a lot of stand-along specialty boutiques. And there's room for the specialty boutique who knows its customers, deals with a relatively small group, can make a good living doing that.

There's room for the specialty chain that can make a good living doing that. There's room for the supermarket. There's room for the department store.

There's lot of different models that you ought to make room for so long as if they're called banks and the issue deposits, you've got to worry about safety and soundness.

But subject to that, you ought to be making room for it, but not expect that a lot of people are going to be rushing in to something like the supermarket or department store model.

MR. LITAN: Okay. This is actually a perfect segue to my calling on Peter because one of the handouts -- this is Peter Wallison, who's going to talk next -- one of the handouts we got here is a speech that Peter gave actually right after Gramm-Leach-Bliley was passed in which he basically waved his hands and said, hey, guys, you forgot about commercial alliances with financial institutions.

And so Peter, I'll ask you, because I know you want to talk about this, if somehow we eliminated that ban or somehow weakened it, would we get more of these conglomerates?

MR. WALLISON: Sure. Of course. And, in fact, I think the answer to the main question of why we're not getting conglomerates is relatively simple, and that is, if you were running an insurance company or a securities firm and decided you want to acquire a bank and thus become a financial services holding company, you would then put yourself in the hands of the Fed for the future in terms of expansion of your activities into any other area.

And if we look at what the Fed has done or failed to do in the area of real estate brokerage, we can see what a jeopardy that would be putting yourself into. I mean, it would be an irresponsible thing for a management to subject the entire firm to whatever happens in the future about what is considered a financial activity.

The Fed cannot -- and the Treasury, I guess, together -- cannot decide whether real estate brokerage is or is not a financial activity. And if they decide it's a financial activity, they are subject to interference by Congress.

So this is something that, it seems to me, an insurance management or a securities management would not be willing to do. So in looking at all of these questions, until that issue is resolved so that a management that becomes a financial services holding company by acquiring a bank can have some confidence that they can go out in the future and invest in some other activity that isn't already on the list of financial activities, would seem to me to be a crazy thing to do.

MR. LITAN: But let me ask you. Suppose the list were expanded. In my view, there's no chance at all that Congress would say the Fed is going to be out of business, so that you're still going to be stuck with the Fed even with a broader range of activities.

So if that assumption is correct, would we then still see more financial holding companies?

MR. WALLISON: No. Well, first of all, I don't think you can ever say that there's no chance at all that this will go away. People would say there's no chance at all that we'd ever be able to regulate Fannie and Freddie more strictly than we already have. And in fact, people are now, fortunately, talking about privatization, too. And I'd like to get to that in just a minute.

MR. LITAN: We will. We'll get to Fannie and Freddie later.

MR. WALLISON: Yes. I will -- I just have a couple of comments on that.

But I think the central problem here is this particular problem. When I saw Gramm-Leach-Bliley passed, I could not understand why so many insurance companies and securities firms supported the thing. It seemed obvious to me that you could not -- you would not want to become a financial services holding company.

So at AEI, we held a conference on this subject, and we brought in a whole lot of people from the securities industry and the insurance business, as well as the banking business, and asked, you know, why did you support this?

And it turns out that most of the people there -- and granted, they were mostly Washington types who think in these terms -- but most of the people said, well, the bill was moving. And since the bill was moving anyway -- Gramm wanted a bill and Leach wanted a bill and Bliley apparently was willing to go along with the bill -- since it was moving, we figured we'd better support it because if we supported it, we could get a little thing in it that we wanted.

So it wasn't one of these great policy moves that reflected some major change in the way people thought about banking and commerce, for example. Now, let me talk just a bit about that, if I may.

MR. LITAN: Well, wait a minute. It was moving, though, because Citigroup wanted it to move.

MR. WALLISON: Citigroup wanted it to move, but I don't think that was sufficient to get it going. I think it was more, if you will, an effort on the part of these two guys to accommodate some change -- that is, Gramm and Leach to accommodate some change -- put their name on a bill, put their names on a bill, and get -- and make some changes in the law while still meeting some of the demands of the Fed for continuing control over the financial system through this issue of what is a financial activity.

And that has, in fact, worked. The Fed still has control over what is a financial activity. Now, I want to say this about that whole subject, and that is that in passing this law, Congress completely eviscerated the idea that there is any policy basis for separating commerce and finance.

When it was an issue of separating banking and commerce -- and, in effect, what we have here is son of separating banking and commerce because we have separating finance and commerce -- there were three essential arguments that were made in support of separating banking and commerce, and that is that a bank would lend money preferentially to an affiliated, say, securities firm or automobile company, if it's banking and commerce; or it would not lend to the competitors of this automobile company; or it would be used as a piggy bank by an affiliate that needed financial assistance. Those were basically the three arguments in favor of banking and commerce.

Well, if you allow securities firms and banks to affiliate, you have essentially eliminated all those policy reasons because securities firms are big users of credit, maybe even more than automobile companies. Securities firms are also competing with others so that their bank affiliates might refuse to lend to their competitors. And finally, securities firms have financial difficulties, too, and could use the affiliated bank as a piggy bank if they have financial difficulties.

So there isn't any longer any policy reason for separating finance and commerce, even if intellectually and as a matter of principle it could actually be done. And it can't be done, as shown by this whole issue of real estate brokerage and whether that is a financial activity that can be affiliated with a bank or not.

In fact, there is no principled way to decide whether real estate brokerage is in fact a financial activity. Now, you can decide it, but that would just be completely arbitrary. And there will be another one coming along in the future of the same kind and we'll have another three-year impasse or four-year impasse until that is decided.

In other words, this whole structure is built on sand. And eventually, the Fed, I think, which is an honest broker and is made up of people who are trying to do an honest job, is going to throw up its hands and say, look. We don't want this any more because this makes no sense. We cannot, on a principled basis, decide what's finance and what is commerce.

And that, I think, is the most likely outcome for this whole controversy. That will result eventually, I think, in the elimination of this silly law.

MR. LITAN: Okay. Lots to chew on there. Let's continue this.

Dan?

MR. TARULLO: Just a little bit of a gloss --

MR. LITAN: This is Dan Tarullo.

MR. TARULLO: Dan Tarullo. Sorry. People asked the question that Peter just alluded at one of the early stages of financial services reform proposals: Basically, so why for what you call financial but not for what you call commercial?

And the answer that was given -- which I don't think was -- there was some thought to it. It may have proven not to be correct, but there's some thought to it -- was that we don't think -- we think that there are some increased risks from allowing banks to affiliate more completely with non-banking financial activities such as securities and to affiliate with insurance underwriting, which heretofore has been forbidden.

However, we think that there are some important efficiencies, synergies, to be gained in allowing that to happen, sort of, and then we gave the examples -- you got the examples about things like single credit analyses and the like, and one-stop shopping for financial needs for unrelated customers, whereas with commercial firms, there is also increased risk but we don't see the level of potential efficiencies and synergies.

It seems to me, Bob, that if -- I don't think we could do it now. But if we concluded, on the basis of more research, that the efficiencies in integrating financial services firms are either pretty modest or they're kind of loaded up on the distribution end or revenue diversification sides, then Peter -- then you're left either saying, well, why not allow companies to do the same thing with commercial firms, or you're pushed to saying, jeepers, if there's risks entailed on either sides and you're not getting a whole lot of positive benefit out of allowing it, maybe this is something that we should be having second thoughts about.

The deafening silence that greeted your earlier question suggests that the later won't be the option.

MR. LITAN: Okay. Are there any more comments on this banking and commerce issue before we turn to another issue?

(No response.)

MR. LITAN: Seeing none, let's go to -- the floor is open. I know we're going to get back to Fannie and Freddie so don't worry about that.

I want to know now, are there other issues that people want to raise, either prompted by the presentations or things that the presentations did not leave out?

Rich Whiting?

MR. WHITING: I just wanted to emphasize a point that was made in, I think, all of the presentations, by Dan and Dick's. But -- and that has to do with the impact of the privacy issue.

Before Gramm-Leach-Bliley, safety and soundness was an issue and new activities was always an issue. But Gramm-Leach-Bliley -- I guess it was Title V -- introduced for the first time into this discussion privacy rights of consumers.

And that, I think, has had a profound effect. Not only all banking and financial services practitioners have to become experts in privacy law, but it's put a huge burden on companies that are covered by this law, which are more than financial holding companies. I mean, it's insurance companies. It's securities firms.

But it has also scared some of the companies who are not covered by the law like the real estate firms. It's one of the explanations for them not wanting to be covered by financial services companies.

And it's also been sort of a governor on expansion because now companies have to devote so many resources to compliance with these laws, and the state laws especially.

And companies cannot afford -- who want to do business on a transactional basis cannot afford to have computer systems and operational systems that meet the requirements of each individual state. So it's raised the question of national standards to a height that it's never been to before.

MR. LITAN: Okay. Other commenters on this broad range of other issues? Because if not, I'm going to turn to Fannie and Freddie -- threatening to turn to Fannie and Freddie.

Yes? Down there. Remember to identify yourself.

MR. McMAHON: Art McMahon from OCC. It's more of a question than a comment.

The environment we've had over the last few years has been kind of unusual, and the banks have done exceptionally well, much better than some of the other industries that we're talking about here. And banks, large banks in particular, have seemed to be focusing on getting the economies of scale from the retail side and applying some of the technology that they have available to maximum benefit in that area.

And I'm wondering how much that environment has affected the interests of banks in expanding into some of these other areas.

MR. LITAN: In other words, because banking itself is so profitable?

MR. McMAHON: Right, because banking is doing -- has done quite well, and especially in contrast to some of the other industries over the last few years.

MR. LITAN: I think that will be an additional reason.

Dick, do you want to answer that?

MR. HERRING: No. I wanted to -- I'm sorry.

MR. LITAN: Okay. You want to add another --

MR. HERRING: I want to add to that question because it's in the same vein.

One argument you hear about why there has been so little conglomeration in the States is that because the U.S. has this unfinished sort of geographic agenda, that banks have sort of done the easy bits first.

We're relaxed our sort of interstate branching laws, more or less at the same time that we relaxed the activity restrictions. And banks have first of all done the easy parts, which is to sort of expand their geographic footprints. And maybe the next wave will be thinking about looking at a broader activity domain. The same kind of idea.

MR. LITAN: Yes. Art?

MR. MURTON: Art Murton from the FDIC. I guess this is more of a comment.

But I don't believe we've mentioned ILCs yet today. And Gramm-Leach-Bliley --

MR. LITAN: You'd better explain for the record what an ILC is.

MR. MURTON: An ILC is an industrial loan company. It's a special bank-like charter that five states offer, particularly Utah. It is the only bank-like vehicle now that's available for commercial firms and other firms who want to be in the banking business but not be subject to financial services holding company oversight.

And that's been a fairly contentious issue with our -- among the regulatory agencies. And I think it's a real live issue, that as the industry evolves -- I mean, you know, if you think of banking and commerce in the fourth wave in, you know, the market bringing changes and Congress ratifying them -- you know, interest rate deregulation, relaxing banking, interstate banking, and then repeat of Glass-Steagall -- it seems like the question on the table in the years ahead will be how is that going to be regulated.

And there already are several firms, commercial firms, that own these bank-like entities. Wal-Mart made a run at it a couple years ago. The California state legislature prohibited them from getting that charter. It's, you know, opened a question whether they'll try it again.

And I guess one of the questions I would have is what do people think is the answer there? Is this going to continue? Do we need to think about how these are going to be regulated?

MR. LITAN: Peter, do you want to answer that in the course of making your comment?

MR. WALLISON: Yes. Of course, that is another route for achieving some kind of form of complete deregulation here, which of course is the only ultimate answer.

And that is that if a state would permit Wal-Mart to acquire an ILC and then to expand its activities -- which, incidentally, can offer insured deposits, which you didn't mention, but that's the key element here -- if a state would permit that and then allow Wal-Mart to open branches of this ILC in its stores throughout the country, that would break open this whole question of banking and commerce or finance and commerce.

Because here you would have a company who many might say is not a financial company, Wal-Mart, owning a bank. So it's potentially very important, perhaps even more important in a practical sense than this whole idea of the principles on which this financial -- separation of finance and commerce is built on sand.

MR. LITAN: But Peter, couldn't that also -- that scenario also trigger a backlash? And then, you know, some legislators will say, well, let's close the loophole.

MR. WALLISON: Sure. Oh, of course. I mean, we had non-bank banks, and that triggered that kind of backlash, and they did close a loophole, so-called loophole.

MR. LITAN: Yes.

MR. WALLISON: And sure, that could happen again. But on the other hand, it depends on who's in power at a given time, what the President thinks, and whether the Republicans or the Democrats or some combination of them are in charge in the House and the Senate. I mean, those things can work out in other ways.

I just wanted to make one point, though, about financial conglomerates, and that is that banks got a tremendous benefit out of Gramm-Leach-Bliley. And the others, their competitors, insurance companies and securities firms, did not because banks were already subject to the Fed and to its restrictions.

So to them, expanding into insurance and securities and whatever else they were allowed was simply a freebie, whereas for insurance companies and securities firms to get into the banking business, which was the whole underlying concept of Gramm-Leach-Bliley, this sort of two-way street, was not a freebie. It was a serious, long-term commitment to a regulatory regime that had no principal basis for deciding how they were going to be able to expand in the future.

MR. LITAN: Okay. Anybody else before I go to Fannie and Freddie? If not, let's talk about Fannie and fri.

Again, I want to preface this by saying this probably would not -- except for Peter Wallison, who's been writing about this for years, this wouldn't have been on anybody's radar screen, I think, maybe six months, twelve months ago.

And now we're looking into the next Congress. And regardless of who is president and regardless of what congressional makeup we have, the fact that we now have this major investigation and potential scandal has put this issue now on somebody's radar screen.

And so I'd like to conclude this first session with anybody's thoughts about where they think this is headed. And by the way, I'd invite our international panel to weigh in on this because, you know, a lot of people have looked to Fannie and Freddie as a model for exporting this to other parts of the world as a way to, you know, help advance mortgage markets.

I mean, I myself have given speeches to other countries saying, you know, we helped bring down our cost of mortgages. You may want to think about doing this. But at some point, you know, the institutions can get out of control, and maybe that's where we are now.

So I ask, you know, anybody to weigh in on this. This is a big deal. Anybody?

Before I get to Peter, because he's written too much about this -- I know he's dying and he's chomping at the bit.

MR. WALLISON: No, I'm not, actually.

MR. LITAN: All right. Why don't you give me your -- well, you want to give -- anybody want to weigh in on this?

MR. HERRING: Adam.

MR. LITAN: Adam? Okay.

MR. POSEN: Just briefly, because I think Larry White raised an important thing by going back to that Princeton study about -- by his colleague about the amount of money the U.S. wastes on housing or wastes subsidizing housing.

There is starting to be a consensus, at least in Europe, fed by many factors, that the root of all American evil is suburbia. And there's actually a great substantive basis for this because if you go, for example, to the work of the macroeconomist Robert Gordon, where if you really unpack the well-being of Europeans versus Americans, a significant portion of what you would attribute to Americans as being additional well-being is the extra 800 square feet per capita they get in their houses, and then comes the question if you're commuting an extra hour and a half and burning gas and getting fat and you're in your sprawl, as Rand tells us.

Anyway, the point being, it is not as unimaginable as it is for us in this country to think about rolling back any of these things because of the status quo bias, not least. It is not unimaginable that a bunch of other countries are going to turn around and say, you know, this is just stupid. This is -- I mean, I'm not saying with full justification.

But they -- and they are going to use the combination of the values they see Freddie and Fannie as promoting, the bad values as promoting, along with sort of the scandalous idea that the U.S. is busy subsidizing this huge financial empire, that it's going to get, I think, nasty.

And so there was a bunch of useful things raised by Dan and Dick about the EU/U.S. trying to reconcile the supervisory things. But I think politically, you're going to actually get a lot of Europeans jumping on the anti-Fannie/Freddie bandwagon. That may not affect the domestic legislation, but it's going to affect the climate.

MR. LITAN: Okay. Gerry Caprio?

MR. CAPRIO: Just a quick one. So this means we can look forward to Europeans speaking out against state ownership or state involvement in the financial sector?

(Laughter.)

MR. POSEN: We can look forward to Europeans, no, doing exactly what they do in agriculture: Ah hah. You do it, too, so stop bothering me.

MR. LITAN: Yes. Okay, Peter. Your turn.

MR. WALLISON: I'm sorry. I actually didn't even know Fannie and Freddie was going to come up today, so --

MR. HERRING: Why don't you just say, I told you so. You're entitled to it.

(Laughter.)

MR. WALLISON: I want to deal a little bit seriously with this subject because Larry said something that everyone believes, and I think it's where we are today, and that is that what we need in the case of Fannie and Freddie is heightened regulatory scrutiny.

And I have some real doubts about that. I think that if Fannie and Freddie were to somehow retain the political power that they have always had, I think it becomes -- and that's now doubtful, incidentally, when it may be that they will never be able to restore the coalition that they used to rule the roost for so long.

But assuming that they do retain their political power, I think it's very difficult to regulate politically powerfully organizations. I think they have the ability to intimidate Congress and regulators, and I don't care whether the regulator is in the Treasury Department or is an independent organization. They can control how they are regulated, in the large.

I mean, if we are talking about a regulator having the power, for example, to increase their capital requirement that will have an impact on mortgage interest rates, or at least they will argue that it will have such an impact. And that will have an affect on Congress, and Congress will have an effect on the regulator, and that increase probably won't happen. That's one issue.

Another is what we have just seen with both Fannie and Freddie, is that they are willing to violate the rules. In this case, it was GAAP. But we don't know yet how many other rules, regulatory rules, they are willing to violate.

And there is some sense that people have that if you have a regulator, the regulator knows everything that's going in the organization, which is not at all true.

And the people at OFHEO, who were telling us for a long time that they had people in Fannie and Freddie all the time and were monitoring what they were doing there, had no idea that they were going to fire their top three officers. That was a big surprise. Now, if the regulators really knew what was going on in an institution, then that's something they'd probably know about.

Now, you could have a more competent regulator. Maybe you could have a regulator that had more staff and more authority and so forth. But you still have a problem of knowing what the management is thinking when it gets together in the boardroom. And in fact, there isn't a regulator sitting in there at the time.

So you don't really know what the major decisions are that organizations are making that can have an effect on their financial condition. That is too great a risk, it seems to me, for this country to take, with Fannie and Freddie in particular, because they raise not only questions of taxpayer risk, which Larry mentioned, but I think they also raise systemic problems.

And should there be a serious financial problem with Fannie or Freddie, it would disrupt the real estate market, and that in turn would disrupt the economy as a whole.

So there are substantial systemic risks with these two companies that we can't afford to take, and that's why I think regulation is not the solution. Regulation is sort of kicking the can down the road. The only real solution, I think, is privatization.

And there's one other factor, and that is, of course, when you have regulation -- and Alan Greenspan mentions this all the time -- when you have regulation, there is inevitably moral hazard.

That is, the market thinks that because there is regulation, they don't have to worry too much about what's going on in these organizations. And so there's less market discipline, and hence that causes the problems that we ultimately see in these companies, banks as well as Fannie and Freddie.

So my view is the only solution to this problem is privatization. And that's what I have been talking about for a while, and I hope that eventually when the debate moves on in Washington, someone will bring it out.

MR. LITAN: Barry, you've got to find a mike. This is Barry Bosworth.

MR. BOSWORTH: Yes. I'm a little out of date on this issue. But back in the mid 1980s, I know everybody worked on this subject. And the CBO was heavily involved in it at the time.

I don't -- it seems to me the issue is really much simpler, and that is, securitization was a great idea. And securitization run by a centralized authority gives large economies of scale, and you can show that there are economies of scale from having them do it.

Why the hell they hold those damn mortgages is unrelated to their economic function. And back in the

1980s, the proposal was that they would not be allowed to hold securities on their own account. And if you'd done that back then, right after the experience of the early 1980s, if you remember, one of those agencies almost went under in the first part of the 1980s.

It seems to me the problem goes away. You can't privatize them, in that sense. You just have to have the function done by private activities. And why don't you just cut them back and limit their activities to securitization, which they do very well and there's a big social justification for it.

To me, the answer is, it's hard now because we let them get so big. And you've got to scale them back, and there would be some adjustments. But the fundamental answer was to never allow them to hold mortgage securities on their own account.

MR. LITAN: Dan Tarullo.

MR. TARULLO: It seems to me, Bob, there are a lot of different issues being conflated in talking about Fannie and Freddie. I mean, on the one hand, you've got the allegations which, you know, if it were towards a private -- if it were towards a genuinely private company, the Wall Street Journal would be incensed that anyone was drawing conclusions from a regulator's report or the fact that the Department of Justice had begun an investigation.

But when it's Fannie, it turns out it's gospel, and if it's an allegation, there are allegations about a variety of things that we've seen in publicly owned -- traded corporations which may or may not be true and which seem to be related to the agency-caused problem when you have individuals who are in a position to maximize their own income, perhaps at the expense of their own shareholders, if that's what it turns out to be. That's one kind of problem.

The second kind of problem is the issue of whether there's systemic risk, which is still getting almost no attention. I mean, Peter has always talked about it, but it's not really getting any attention because this is a scandal-driven discussion right now.

Third, the third issue, I guess, is one that does animate some legislators, which is, contrary to Larry, they don't think that the middle class is getting enough of the benefits from a lot of things that are being done.

And so for them, whatever the delta is of benefit to middle class homeowners from the existence of Fannie Mae they see as about all that's headed towards the middle class from this vast array of financial services stuff that those who sit on the relevant committees oversee, and about everything else they think of as more or less irrelevant. So even if you think the delta is rather smaller than greater, they still think there's a delta there.

But fourth, I don't understand Peter's view on the proposition that markets which are supposedly so good at ferreting out information on just about anything, which is why we let them operate, when it comes to the existence of government regulation, market actors have extremely limited or no capacity for figuring out how effective that regulation is.

I mean, it seems to me that sophisticated market actors are going to be behaving there as they behave in other areas, and they're going to be paying people lots of money to tell them, how effective is this regulation and what does it really do, just like they pay people lots of money to tell them about other things as well.

So it does seem to me whatever the arguments, and there are some serious ones, obviously, I don't think that the notion that the market can't figure out how effective or -- the market just simply says, oh, good. You know, Falcon is sitting in HUD. We don't have anything to worry about with it.

That's not why they're reassured by Fannie securities. It's not because of Falcon sitting there. It's because of the implicit guarantee, which is a different thing from saying regulation.

MR. LITAN: Lee Sachs.

MR. SACHS: I just wanted to follow up on something that Dan has started to say, and that's, you know, unless I'm misreading -- unless I misread the report, there were a lot of charges in the OFHEO report, some of which raise questions beyond the existential questions of Fannie and Freddie, that I haven't seen get all that much attention.

And I don't want to take us off on a tangent, but there were certain assertions of fact in the report that, if they're true, and I guess the SEC will end up shedding a lot of light, particularly on the accounting issues, it seems unlikely to me that Fannie and Freddie are the only entities advised by KPMG to take the approach to, say, FAS 133 or 91, that they did.

I mean, there was not a big secret about how they were treating their -- how they were treating the accounting, their derivatives. It seemed to me it was in their public filings. It was on their website. And it was really there for everyone to see, including OFHEO and including the SEC.

And there are those out there, I would say, either at other mortgage companies or potentially at banks -- I'm sure the bank regulators have been looking at this -- but it seems to me that there are issues raised in this report where if the allegations are correct, that we may have other I don't want to say larger problems, but certainly other systemic challenges we need to look at.

MR. LITAN: That's an interesting observation.

Dick Herring?

MR. HERRING: I wanted to pick up a remark that Larry White made, and it related to one that Peter made as well.

Peter mentioned the possibility of systemic risk because of real estate markets. I think there's an even more immediate risk if one thinks about how one would wind down Freddie or Fannie, given the lack of any mechanism other than the normal bankruptcy procedures.

It seems to me that this is a case where you really do need the kind of bridge bank mechanism that the FDIC has in place because Freddie and Fannie are counter-parties to almost all of the major financial institutions in the world in a major way.

And it would be essential to keep their book of business actively managed in whatever you decide to do with the remnants of the corporation, should that ever become necessary.

And if you're ever going to think about having market discipline on either of them, you've got to have a credible way to take them out. And as it is now, there is no credible way to take them out, so they are emphatically too big to fail.

MR. LITAN: Larry White.

MR. WHITE: Let me just sort of clean up and play cleanup here and address a couple of things that have been raised.

First, Peter's point about privatization. As

Peter knows, there's a number of other people around, you know. I would never presume to be philosopher king, but if I were philosopher prince, I would choose to privatize them in a heartbeat.

I didn't think that was my role here. It was a -- you know, a stage setting role that I wanted to play here. But, you know, I would privatize them in a heartbeat, and do it even faster than Peter has proposed doing.

MR. WALLISON: Oh, no, you wouldn't.

MR. WHITE: Oh, yes, I would. But still, unlike Peter, I have -- you know, I don't live in this town. And so I have different perceptions about, you know, political possibilities. And I don't think it's going to happen any time soon. In my lifetime -- I hope to live for a long time, so I don't know about lifetimes.

So at the moment, following on what Dick Herring just said, you know, dealing with the receivership issue, finding some credible way of taking them out, right now all that OFHEO has is conservatorship. It doesn't have receivership powers. And that means it gets thrown back into Congress, as I said, and that can't be a good way to deal with things.

Barry Bosworth brought up this issue of, you know, just have them securitize things. And yes, that would be an improvement over where we are today. But hey, this is the year 2004. Securitization of home mortgages is now a 33-year-old technology.

We don't really even need them any more. Maybe we needed them 20, 25 years ago as further support for what Jenny was doing. But today, hey, BofA and Chase and Citi and three dozen other securitizing entities would take up the slack very nicely and fairly quickly.

As far as what Dan raised about, you know, markets being smart and all, I think Peter's point, and it's a point that Scott Frame and I made, that Chairman Greenspan is making, is that if -- you know, remember, we have this halo that has come around Freddie and Fannie from all those special things about their charter and what they're allowed to do.

And that safety and soundness regulation may well add to that halo, which may well add to the market's belief that, hey, these guys are special, and so the Feds are going to be there when push comes to shove. I think that's the point here.

Last, and -- right, the point about FAS 133. I can't resist the opportunity to say, what this really argues for is market value accounting. On both sides of the balance sheet, everything about -- on and off the balance sheet, you know, we've got this absurd arrangement where some things are marked. Other things you get to carry at historical cost.

That's what drove Freddie -- in the end, that's what drove Freddie to do what it did because it's a market value-oriented organization. It didn't like what it was being forced to do, and so it started fiddling.

You know, the right answer is market value accounting, where everything gets marked. And so if you've got a good hedge, things will move the way you want it to move and you won't get these grimaces and groans about one thing's moving and one thing isn't and oh, what are we going to do. Market value accounting. That is the answer.

MR. LITAN: Cally Jordan, and then we'll wrap this up.

MS. JORDAN: I'm Cally Jordan. I'm actually on leave from the World Bank. I'm back teaching law at the

University of Florida.

I hesitated, but I thought I really had to rise to Bob's request for comments from the international roster. And I must say that I've got a bit of a disclaimer. I did spend two weeks in Cairo with the chief economist of Freddie Mac a few years ago looking at the secondary mortgage market for Egypt. This was at a time when there were virtually no banks which would give mortgages in Egypt because, among other things, cash economy, but only 10 percent of property was actually in any kind of formal land title registration system. And you can imagine the title problems in a place like Egypt.

But I think that Bob really did -- implicit in Bob's comment was the use of U.S. regulatory models as international standards. And that, I think, is something which is worth thinking about and questioning, perhaps, that assumption because we can tell now, just by the conversation around the table, that these models, especially the financial regulatory models, are so rooted in extremely complex and historically determined regulatory and legislative processes.

So I think that we do in the international community have to really think seriously about the use of the U.S. regulatory models and their appropriateness elsewhere.

MR. LITAN: Okay. I want to wrap this up with one observation -- chairman's prerogative -- before we take a ten-minute break.

If you look at Gramm-Leach-Bliley from my perspective, we had a debate for 20 years about, you know, how and whether we should deregulate. So first we did geographic in 1994, and then we did activities in 1999.

And then all hell broke loose, and now we're in scandal era. All right? And it started, of course, with Enron and MCI. And then, of course, it spread to the mutual funds, and now Fannie/Freddie.

And so Washington is seized with scandals. And it seems to me that is sort of like the 1930s environment, which case you don't get, in a scandal-driven environment, I think either political party being very enthusiastic about doing a lot of favors for the financial industry. It just isn't seen politically to be very viable.

And so I would forecast that regardless of who wins the election and who controls the House and so forth, I think it's going to be a hard time for the financial industry to get anything at once.

I mean, Dan had all those wish lists up there at the end, and I think one import of the Fannie/ Freddie thing -- even though Fannie/Freddie has nothing to do with a lot of the burdens, let's say, the financial industry may face in their daily lives and so forth, it's just one more drip in the sort of Chinese water torture of scandal in this town. And it's just going to make it very difficult to get any kind of future legislative change that the financial industry would like.

That's my editorial comment. I will close with that. And we'll take a break for about ten minutes, and we'll come back and we'll talk about the rest of the world.

(A brief recess was taken.)

MR. LITAN: Okay. We're going to get started here. And the premise for this session is to look at the experience with financial conglomerates abroad.

And in fact, you know, one of the reasons we're doing this is this was -- you know, Dan was listing arguments about why we did Gramm-Leach-Bliley, and one of the arguments that was repeatedly made by the financial sector here was, well, we've got universal banking in Europe. And we have these broader activities in Japan, even.

And so we have one of the long-time experts on universal banking in Europe. Tony Saunders is going to start. And then we're going to move to Adam Posen, who knows a lot about both Europe and Japan, and then we're going to conclude with our expert and colleague from Japan, Mr. Fuchita. And actually, where is Yasu Fuchita? Is he here? Oh, okay. Good.

So let's go with Tony.

MR. SAUNDERS: Okay. Thanks, Bob.

One of the harder things of being a later speaker is to say something new. I think most of the things I might say have already been said in one way or the other.

What I thought I would do is focus my time on banking and insurance, the so-called bank assurance model. One thing that distinguishes U.S. universal banking from European universal banking is the relative greater importance of the bank assurance model in the European context.

So I thought I'd first of all just start off with some general trends and data about differences between the U.S. experience from universal banking and European experience.

Then I'll talk a little bit about the advantages and disadvantages of the bank assurance model, banking and insurance. And I'll draw on the academic evidence to the extent it exists to suggest what the current academic thinking is in terms of these consolidations.

Then I'll turn a bit more to anecdotal evidence, looking at two cases of bank assurance models. One actually was in the U.S. with Citicorp, which has been mentioned, and the other is Allianz, which I think Dick Herring also mentioned, and to see if perhaps we can learn some lessons both from the academic evidence and looking at these two cases as to which type of a model might work.

Then perhaps at the end I'll talk a little bit about is there another way. Is there a way, instead of having to actually create a bank assurance integrated financial institution through acquisition or setting up a de novo institution, is there another way to go about this?

And I'll talk about what's called a capital market alternative, how you can perhaps replicate an insurance company through financial securities if you want to get into insurance in your bank; or if you're an insurance company and you want to get into banking, how you could replicate bank-type risk-taking without ever setting up an insurance company or a bank.

If you look at some of the trends going on out there, it seems to be happening, although it's been below the radar screen of a lot of people.

So first, general trends. Most people know there's been a merger wave in the financial services industry in America. And there's been a similar wave in acquisitions, mergers and acquisitions, in Europe. These are mergers and acquisitions in number over $1 billion. And they're both within-industry and across-industry mergers and acquisitions.

These have been really fueled by three things. One was the 1992 recognition of universal banking as being the major form of banking in the European community. Second has been a de-mutualization of a number of banks and privatization of a number of banks in Europe.

And third has been the pension plan problem of the state pension plan in many countries being effectively bankrupt, that led to a growth of private pension plans and has fueled some of these acquisitions and mergers.

What's the difference between U.S. and European style mergers and acquisitions in the financial services sector? This covers the period 1985 to 2001. And the numbers there are showing the dollars of the target institution, the equity value of target institutions. So these are equity values of target institutions.

And these are three by three matrices. So, for example, the first -- this is for the world total. This is showing acquisitions of commercial banks by banks, so this is a dollar, and in brackets, the percentage importance of those acquisitions.

So the diagonal would show within industry mergers and acquisitions. The off diagonals show acquisitions by a bank of an insurance company or securities firm or vice versa.

Since I'm focusing on bank and insurance or the bank assurance model, you see it's not a very heavily used model in terms of the percentages and the dollar values.

But if you look at the U.S., the bank assurance model is virtually absent for a number of reasons that have already been mentioned.

But in Europe, we have sizeable acquisitions of banks acquiring insurance companies and insurance companies acquiring banks. So one distinguishing feature U.S. universal banking and European universal banking is the predominance of the bank assurance model, relative predominance.

So rather than talking about in general, then, I'll focus on bank assurance. What's the benefits perceived by Europeans and others to the bank assurance setup?

First, they may see cost synergies. Generally, the cost synergies are divided into three different types, economies of scale on the cost side, economies of scope -- economies of scale is just simply size driven. Economies of scope is sharing things like information.

And X-efficiency: X-efficiency simply is managerial inefficiencies, the difference between the best or most efficient company in the financial services sector and the distribution of companies around that best practiced institution, which is often called X-efficiency.

There's also revenue potential synergies that people discuss, one-stop shopping, et cetera. There's diversification and risk reduction reasons. And, of course, one reason why an insurance company might want to become a bank is because it gets access to the Too Big to Fail subsidy, potentially, once it acquires a bank.

Well, what do we know as academics? Rather than sort of stressing anecdotal evidence, I'll try to talk about what the academic evidence is.

And unfortunately -- I mean, there's been a lot of research on this, but a lot of it's pretty inconclusive, and not much research on bank and insurance integration in general. So I'll try to say what -- talk about what's there, and perhaps this leaves areas for future research that academics like myself, Dick, and Larry, probably should pursue at some time.

Well, first we know there's economies of scale in banking up to a very small scale, up to about $100 million in assets. And people have found some economies of scale up to about 5 to 10 million -- million, sorry, 5 to 10 billion, a sort of medium-sized, sort of medium-sized institution.

After that, though, scale economies tend to run out in banking. As far as I'm aware, I've never seen any study -- and perhaps some of you will tell me immediately that there is one -- to show that there are economies of superscale, that as you get larger, cost function keeps decreasing, which also raises an issue about why we want to pursue universal banking in the first place. If we want to get bigger, it's not clear that we get a cost benefit on a pure average cost side.

So the international evidence, both Europe and domestically, suggests that economies of scale in banking run out at about 10 billion.

What about economies of scope? Well, one of the most interesting findings, I think, in this area of financial intermediation is nobody can find economies of scope whatsoever. In fact, one off the regularities of empirical research in financial intermediation is that there are diseconomies of scope, not economies of scope.

In fact, study after study has found diseconomies of scope on the cost side. In other words, the idea that sharing information, sharing computer systems, sharing resources, can reduce costs, now the answer seems to be it increases costs. There does not seem to be any persuasive evidence, either in Europe or the U.S., of economies of scope.

What about X-efficiency? Again, X-efficiency both in the banking industry and insurance industry, that the deviation of the worst performing firms from the best performing firms lie in a range of about 5 percent of costs to 25 percent of costs.

But there's no real difference between banking and insurance. We can't say banking is more efficient than the insurance industry or insurance is more efficient than the banking industry.

So on the cost side, I would say the evidence is fairly bleak in terms of why we want to -- banks want to acquire insurance companies and vice versa, whether we're in -- the evidence, whether we're in the U.S. or in Europe.

What about revenue side? So perhaps people will say, okay. There must be evidence on the revenue side for economies of scope. This is the idea of cross-selling.

So they have the cost side, which is synergies, and then the revenue side, which is coming from, okay, a bank can use its branch network to sell insurance products. An insurance company can use its distribution system to sell banking products.

What is the evidence on demand economies of scope? Unfortunately, there's not much data on revenues. There's data on profits, but not much data on revenues.

There's a couple of studies that looked at profit economies of scale, which show limited economies of scale on the profit function. But looking at pure revenue, it's hard.

What does seem to come out, though, is that in terms of cross-selling and insurance products, the cross-selling seems to be more prevalent for retail products, household products. Where the one-stop shopping model does seem to prevail is for retail products.

At the commercial level, it seems that, hey, I'm a firm. I take the best -- I go to the best company for that product. I don't one-stop shop in a single financial services firm. So to some extent, then, perhaps the financial supermarket model is more suited, at least in the bank assurance world, for retail insurance services than commercial services.

Another way to get insights into economies of scope and economies of scale on the cost and revenue side is to look at what's called an event study. An event study tells us what happens to the stock prices of the acquiring firm and the target firm on the announcement of universal bank-type merger, here banking and insurance.

When a bank says it's going to acquire an insurance company or vice versa, how does the stock market react? We call this in finance an event study.

The general findings for mergers and acquisitions in general is that the acquirer's return falls. Negative. They tend to over-pay for acquisitions. And the target tends to rise. And the sum of them is about zero, or might be slightly negative. So the general finding is often that the acquirer overpays.

What about in financial services, in banks and insurance? Is it any different? Do we find any different results? Do we find that the acquirers benefit and the targets benefit and the aggregate is greater?

Unfortunately, the answer is no. The event studies tend to confirm similar findings to what we find in general. The acquirer tends to lose, and the target tends to gain, although there's a recent study looking at European mergers and acquisitions between banks and insurance that finds that the sum of the loss to the acquirer plus the gain to the target is net positive.

So there might be, in general, some slight synergy going. But there's only one study, and it's a fairly limited sample, about 30 or 40 mergers and acquisitions.

Well, if that's bleak on the just pure acquisitions and mergers, here I was really talking about within-country mergers and acquisitions. If I look at the stock market reaction to cross-border mergers and acquisitions, the evidence is even more negative.

In other words, I did personally a study of over 200 cross-border M&As in the financial services industry, and almost universally, on average, the gross returns, the sum of the acquirer and the target's returns, were negative.

So we're still looking for reasons to do this. So it must be risk. It must be something to do with risk.

Unfortunately, many people say, well, banks know nothing about underwriting. So rather than risk-reducing, surely getting into this industry when you don't know much about underwriting -- and we sort of discussed this before -- might actually increase risk.

But then proponents will say, no, you forgot about cash flow diversification. For banks, cash flows negatively, although positively correlated with insurance companies' cash flows, there are diversification benefits. This increases the stability of the holding company and makes the holding company safer.

And that might be reason for a bank and an insurance company getting together, although in finance we often question this because, you know, we argue why not focus and then diversify through the capital markets. But let's not worry about this.

But what's the evidence on diversification? I did a study in the '90s with Ingo Walter that came out as a book looking at European mergers and acquisitions. And there's a federal reserve study looking at mergers and acquisitions -- looking at the risk diversification gains.

And what we did, we took about 200,000 possible simulations of all the insurance companies and banks and we joined them together. We simulated what their returns would look like and their risks would look like after a merger. So it's a simulation study.

The Fed study is exactly the same. It's a simulation study of looking at joining banks and insurance companies and simulating what their stock returns and the risk of their stock returns would look like post-merger compared to pre-merger.

What's interesting in both our study and the New York Fed study shows in that the greatest diversification risks come from life insurance, not property/casualty insurance. But life insurance has significant risk reduction abilities compared to property/casualty insurance for banks.

So if we're looking for sort of -- you know, we're looking for some sort of -- something to hang on here, the diversification story, at least on the life side, seems to work more than on the property/casualty side.

MR. LITAN: If you could wrap up in about four minutes.

MR. SAUNDERS: Yes. Okay. I'm shooting ahead now. So let me talk about examples and lessons.

Let's look at -- I gave you the general academic evidence. What about some anecdotal evidence? We always like to see some of that. So I'll talk about Citicorp and Travelers, and then I'll talk about Allianz.

From this, I think we can learn something about which type of acquisitions and mergers work in the bank assurance model. First, Citicorp and Travelers.

When they announced their merger in April 1998, Citibank's stock price rose 26 percent and Travelers' rose 18 percent. Clearly, this was viewed by the market as a wonderful thing.

And the interesting thing is what happened when -- a number of people mentioned earlier on, Travelers was actually being spun off. The property/ casualty part was spun off. The life insurance part was kept. How did the stock market react to the spinoff of the property/casualty part?

And as you can see, it was positive. So I think this tells us a lot. Basically, property/ casualty, it does not work with banking. What seems to work is life insurance.

And perhaps to drive the point home, since I'm running out of time, let's look at Allianz and Dresdner. This is a classic case of a property/ casualty insurance company merging with a bank. Allianz is the largest property and casualty insurer in the world, and Dresdner was one of the top four or five German banks at the time of acquisition, which was in April 2001.

Here's the pro forma breakdown of the business lines of the two institutions put together. Here you see heavy property/casualty business of Allianz, and about 20 percent commercial banking/investment banking.

Well, does it work? Well, here we're seeing -- now, one way to look at does it work or not is how the stock market reacted to these different mergers of Citicorp and Allianz.

So here I normalized everything in October 2000, both Allianz stock returns and Citicorp stock returns and the S&P 500 index.

This is a period of general recession, general decline. And here's the S&P index in the middle, going down. It's interesting to note that Citicorp still performed better than the market. There might be other reasons other than the fact that it got rid of its property/casualty insurance company part of its activities. But certainly it performed for most of the period better than the market.

But Allianz has been a disaster. And again, you know, I don't like to turn to anecdotal evidence, but it's one of the few anecdotal cases we have where a live property -- sorry, a property/casualty insurer has bought a big bank.

And we see it's sort of minus 70 percent return over a period of approximately two years. Citicorp was performing generally than the market for much of this period.

Finally, which I'd like to get to just to think about, is there another way? Perhaps one reason we're not seeing many banks in America going into insurance and insurance companies going into banks or acquisition is that you don't need to.

Who is the major writer of credit derivatives in America? Insurance companies. What is a credit derivative? It's a loan. It's a banking product. Who's the major absorber of credit risk in the credit derivatives market? It's actually insurance companies. They're selling it to banks.

That's why insurance companies are losing huge amounts of money because they have no idea of the risks, the credit risks. They think it's just like property/casualty insurance. And the banks are very happy.

On the banking side, if a bank wants to get into insurance, it doesn't have to buy an insurance company. It can go to the options market, the futures market, by weather derivatives. It can go and buy catastrophe bonds. It doesn't need to buy an insurance company.

So the final of this whole thing is, I think, one reason we're not seeing much of it in America is a new reason: You don't have to. You have the capital markets. You can replicate a bank. You can replicate an insurance company. So in some sense, the whole issue is moot and we don't have to worry about regulation. Thank you.

MR. LITAN: Thank you very much, Tony. I love presentations that confirm my predispositions that I announced at the beginning, with absolutely no evidence, that banks would find themselves, you know, more inclined to deal with life insurance companies than P/C companies. And you abundantly established that. So I like that presentation.

We're going to go to Adam.

MR. POSEN: All right. Kathleen told me how to do this -- yes. Excellent.

Well, thank you for having me in here. I'm a little more fowl than fish in that while I do work on Japan and Germany, as Bob said, I tend to do it from more of a macro perspective.

And so I think it's important to pick up on what Bob said as starting this international session, which was there were a lot of very broad motivations that lay behind GLB that then get back to Dan Tarullo's more specifics ones having to do with this bill.

But there was a general feeling in the U.S., if you think back 15 years ago, that our financial system was a deep disadvantage for us, that we had impatient capital, short-termism. And be it the Hausbanc system in Germany or the type bank/Kereitsu or type bank/firm relationships in Japan, we're not only going to offer efficiencies in the narrow sense of being better financial firms, but they were going to have wonderful effects for rejuvenating the competitiveness of the whole U.S. economy.

This didn't work out. Before I go into more details about why it didn't work out, let me just point out, strictly speaking, of course, Japan does not yet have universal banking. And my colleague will discuss this in the next shot.

But what did happen was you had a period where Japan started off having more flexibility than the American banks and having increasing room for Japanese banks to get into other activities, starting in 1984. So I'm going to lump it under that heading because they're more on the universal side than the American banks were. And then, of course, Germany was the model of these things.

So want to talk about three points. I first want to point out that not only is there this micro question, which many people have spoken about, both the U.S. and now Professor Saunders in the international context, people aren't leaping forward to create these bank holding companies. There doesn't seem to be a good argument for why, from a macro perspective, you would want to have a universal bank.

The second point I want to raise is sort of -- I had sort of put it in here, but given Peter Wallison's remarks, I have to pick up on it. Like everyone else, I really admire what Peter has done on Fannie and Freddie. But I got to admit, the comments made about commerce and banking really left me quit confused.

Just because you do something -- I think Dan sort of said the same thing -- just because you did something for securities and it hasn't yet broken everything doesn't necessarily mean that extending it to commerce is a perfectly logical thing to do.

And one of the things which is going to be a running theme through this is that a lot of the merchant banking and equity holding activities of the universal banks in Germany or the near-universal banks in Japan actually have had very bad effects.

And so if you're looking forward, breaking down -- those may not be in play in the U.S. But we shouldn't be so casual about breaking down that last barrier, especially given what a great success this barrier has been.

The final point I want to raise is just ask whether or not, speaking from an international perspective, this is all just an effort to keep a dying industry, which is banking, in business.

There's no question the last few years have been relatively profitable, especially for the money center U.S. banks. But there's also no question that as a global trend, there's too much banking capacity in the world, too little capital.

We'd like to see some consolidation. And you have to wonder whether this act was just another attempt by the banking industry to keep themselves in business against the factors they would otherwise do. So that would be my perspective.

So now let me just recap. Do you remember the model? So 15 years ago, Michael Porter is writing in the Harvard Business Review, and other less well-paid people are making similar comments, about patient capital with long-time horizons. There was supposed to be this great competitive advantage for Germany, for Japan. You didn't have to meet quarterly results. All kinds of great things would happen.

You had a high savings rate. You had these great fast-growing countries like Germany and Japan who had a high savings rate, which of course immediately fed growth. And they were very conservative; they didn't waste their money on stupid things like housing mortgages and stuff like that. So you had a great stock of savings for your companies.

In particular, on the corporate governance side, these kinds of banking relationships allowed you to have mixed claims, so that the banks would have both debt and equity. They would have a stock role and a lending role. And therefore, they would be willing to take both the up side but see companies through the down side by providing liquidity.

There would be interlocking boards who would look beyond -- in the best Enron sense, would look beyond the present difficulties and say, you know, we believe in this company for the long haul. We're not going to look at this quarter's performance or cash flow. We're going to keep it going.

And then, of course, the thing which most of the other people speaking, of course, have focused on, the idea that it creates some form of diversification and competition, various efficiencies within the banks themselves.

And as well as was discussed in the first session, you end up with much more centralized and streamlined supervision. Again, this was the theory. This was what we were all fantasizing.

And I wouldn't say that this caused GLB, but this was certainly part of the intellectual background that made us susceptible -- along with the disaster of the savings and loan crisis, that made us susceptible to the successive regulatory changes that were made in the U.S. in the following decade and a half.

The problem is, there's just connections, connections everywhere. Bob Litan in his request for questions spoke about connected lending, especially in emerging markets. I know Gerry Caprio is here. There are various other people who could talk about this much better than I can.

But what's scary is, it happened in Japan and Germany, too, horror of horrors. In fact, you should look at universal banking in Germany and Japan as largely being associated with anti-competitive behaviors.

So even when we've had massive deregulation since 1984 in Japan, particularly since 1996, bank consolidation has been abysmally slow. You still have dozens of small banks in the country, throughout the country. You have many of them under-capitalized. You have seen forced recapitalization/consolidation of the top ten banks, basically, but that was a very recent development.

In Germany, it just hasn't happened yet. Professor Saunders had his whole initial sheet about mergers, and you can see that if you look in Germany, you know, Dresdner was supposed to be taken over by some other bank, and Comerz Banc, which was the other big one, was supposed to go away.

And, of course, they never did. Allianz picks up Dresdner. They all stay in business forever. You've got a whole superstructure of the state-backed savings banks. You've got the Landesbanken. It just -- you're not seeing it happen there.

And this is only partly attributable to the fact that you've got these because savings banks that are undercutting the private sector. And that's clearly part of it. They're making it unprofitable for the retail banks in this sector. But you would think that would, if anything, drive you more towards consolidation.

The mixed claims effort on corporate governance turned out also to be a failure. There was a great deal of interesting detailed research on this. David Weinstein and Yishay Yafeh, Takeo Hoshi and Anil Kashyap, have done work on this.

But what it turns out the further back you go in German or Japanese post-war history, you find that these banking relationships destroyed value from the start. It was always a question of growing despite these relationships.

And what you find is that there is this extreme bias towards over-lending to small and medium business. I stuck out on the table out there a stack of papers that I did last year called, "Is Germany Turning Japanese?", in which I document the fact that there has been an explosive 400 percent growth in lending in the German banking system, credit creation to what's called the Mittelstand, but not even just the Mittelstand: the small and medium enterprises, the least competitive part of the

Mittelstand, the non-financial business services, which in Germany is a completely dead sector.

And this totally apes what happened in Japan in the early '80s about putting more and more money into retail, into other dead sectors. There seems to be a bias in this universal banking system towards pumping money that way.

And then the insurance companies are basically treated as money pots. So Dresdner goes over to Allianz and says, we need a cash infusion. Please come buy. In Japan, you have all these double-gearing of subordinated debt, where the banks with affiliated insurance firms beef up each other's capital but don't really get rid of the risk.

So I'm not going to suggest that this is inevitable. But the record ain't pretty. And by implication, having the single supervisor and the single set of rules doesn't seem to help much.

Was it truly inevitable? Well, obviously, going back to the history point, the starting points were very different, both from each other in Germany and Japan and from the U.S. when this rule goes through in the U.S.

In Germany, you have this tradition of universal banking going back to the 19th Century. In Japan, they start the post-war period basically modeled totally on Glass-Steagall U.S.-style banking. Again, Hoshi and Kashyap have a very good 2001 book in which they go through the history of these developments.

And, of course, as opposed to the U.S., neither country had well-developed securities markets. Neither country had a bunch of investors out there or households with a lot of risk tolerance. So I don't want to suggest that everything that happened in Japan and Germany necessarily translates for the U.S. or other countries.

But the fact remains, if you look at the situation, the incentives for these bank managers to entrench themselves and take advantage of these relationships to maintain their positions, be it as the local bank president, be it as the board member of the given company, be it to please local politicians, are very, very strong.

And so there seems to be a question of you add that with the regulatory incentive we're all familiar with of not wanting any banks to fail on your watch, not wanting any banks to close, and you end up with an over-banked system.

I also, with all due respect to my may friends from the FDIC, the OCC, and other institutions in this room, have to point out that some of your international counterparts, at least, there's a pretty ugly record on supervision.

I mean, we tend to put a lot of effort into supervision. We tend to put a lot of importance in supervision. But ultimately, supervision, like everything else, responds to incentives. And it's very hard to see in any of these systems where the incentives for the supervision actually work.

So in Germany, the Bundesbanke has this system that's existed for decades -- it's just being altered now -- where they were never officially in charge of supervising the banking system. Instead, it was the Bundesaufsicht fur -- Gary what is it -- Kreditwesen? Yes. Anyway, there was a separate central bank regulator.

But any time the little bank regulator would go out, there would be his or her big brother from the Bundesbanke going out and making the trip with them. And the Bundesbanke somehow collected all the data, but then they had no accountability for what actually happened in the regulations. It was a very interesting and confusing way to deal with it.

And then when you get to 2003, when there were some, for the first time, serious tremors in the German banking system, the Bundesbanke isn't even at the table, for all their information. The chancellor holds a special meeting with the heads of the big banks, somebody from the Bundesaufsicht, somebody from the EC. Nobody from the Bundesbanke, last I checked.

Now, of course, the Japanese financial services agency is doing very much better since it had the leadership of Heizo Takenaka, has made some real strides in recent years. But there's still an incredible revolving door between bank supervisors and the people they're supposed to be supervising.

But what's most interesting is a lot of people in this country make a big deal about regulatory competition, whether it's between the various regulatory agencies we have in the U.S. or whether it's between the various state regulators, which of course is less relevant now for banking than it used to be, but of course, insurance it still matters.

What's interesting is even in Japan and Germany where you have very different systems -- where Germany, of course, you have federalism but you do still have a single federal banking regulator, in Japan where it is all centralized -- the influence of local politicians on lending and supervision is still very high.

And I can go through anecdotal matters. But you can see it in the distribution of lending. And this feeds into the cycle I spoke about about the over-lending to small and medium enterprises in both these countries. I don't want to go overtime, so let me try to pick it up.

I would also point out, and this goes with Professor Saunders' first slide talking about mergers and acquisitions -- there has been very little in the way of cross-border mergers, particularly in Europe.

Now, the argument could be, as I think he interpreted it, that this is a revealed preference, that there is no particular advantage. And I think he cited a paper of his in which you look at a series of the cross-border mergers and they were generally value-destroying, I believe.

Another part of it, though, of course, is there is a strong desire to maintain national champions, say, within Europe and with other parts of these countries. There's another contributing factor. And Dan mentioned how when he was sitting there, I guess, at the White House talking about the financial regulation when it was a gleam in Robert Rubin's eye, and part of the motivation was to keep the American banking system strong and competitive. Now, that may be good. That may be bad. But that's not usually an efficiency argument.

One other point. Hidden reserves aren't just for Fannie and Freddie. And I stuck that in even before I knew where things were going today.

One of the big things about the diversified financial institutions, both in Japan and in Germany, is there is this big reliance in their accounting practices on what the Germans call Stiglitz reserve and what the Japanese have -- I can't speak Japanese, so whatever it's called in Japanese.

But they were various hidden reserves, basically untaken profits on equity holdings they held on various securities transactions. And you get a lot of revenue-smoothing of the sort of thing that our friend

Franklin Raines is now being criticized for by OFHEO.

This is again sort of inherent with this view that you want to have the long-term time horizon. You want to balance out. You don't want to be too transparent. You don't want to be too accountable to quarterly shareholder results. And you have these relationships.

And this also goes to what I was mentioning in terms of the commercial banking ties. This incentive is greater if you're sitting there with a stock holding, if a big merchant banking shareholding. You want to keep that down.

Just a quick note. This is a bit off topic, but just to remind people that the record of what this does for macroeconomic performance, universal banking, is not that great, either.

There's some cross-national evidence on average growth rates that the financial system and banking system doesn't matter much. Gerry Caprio and his co-authors have done a bunch. Ross Levine and his co-authors.

As I recall, there's some overlap between the Caprio/Levine schools. And then, of course, the OECD a couple years ago did a study which Michael Leahy, who's now back at the Fed, had supervised.

Anyway, a bunch of things saying there didn't seem to be an obvious, particularly in the rich countries, division between types of financial systems and growth outcomes, which in a sense is the macro analogy to what everyone's been saying so far about it's not clear what the efficiency gains are.

But if you look at some of the time series evidence on sort of the cyclical persistence or on the volatility -- in other words, when Japan gets into a recession, do they tend to stay in the recession? When there is a financial shock transmitted, how long does that shock persist?

That seems to say it's more negative. I mean, part of it is you have a financial accelerator effect. If you have a bank with a lot of capital that is tradeable that's in the shares market, in the equity markets, and the economy is going down, that pulls the bank down with it. And when the economy is going up, that boosts it. Right now Japan is benefitting from that. For a long period, Japan was harmed by that.

Same thing has been happening in Germany. People have been selling down Germany for numerous good, sound structural reasons. But this also contributes to credit crunches within Germany, and this is a pro-cyclical effect. It tends to deepen recessions and increase booms.

Various references; I won't go into it. I talk about this in the paper I left outside.

Bottom line is, if we go back to Dan Tarullo's three reasons why there were -- why this bill was talked about initially, there was the regulatory need, which -- okay.

There was the potential efficiencies, which the distinguished speakers have all indicated from an empirical perspective don't seem to hold up. A priori it was a good theory, but it doesn't seem to come out that way, with the possible exception of the bank assurance/life insurance tie we spoke about.

And then there was the keep the American banking system competitive motivation. Looking at how the universal banking has worked out and been manipulated in Germany and Japan, I worry that as with much other regulation in sort of a Chicago school kind of mindset, even though this looks like deregulation, it's actually protective regulation. We should be shrinking the banking sector, not worried about keeping it in business. Thank you.

MR. LITAN: Okay. Our concluding speaker is Mr. Fuchita from Japan.

By the way, while you're getting ready, Yasu, I just want to make the point that while -- you know, we're throwing cold water on this alliance between banking and at least property/casualty insurance, maybe not life insurance.

As I said before at the introduction, a lot of U.S. banks since Gramm-Leach-Bliley have been in insurance brokerage. All right? A quarter is what Dan said. And if we let them into real estate brokerage, I bet you it would be the same thing.

So this is not a trivial thing, and so we should not just -- in my view, just say Gramm-Leach-Bliley was an automatic failure. The whole idea of financial modernization was failure because I think there are potential benefits in the brokerage business. That's just my personal view.

Okay. Yasu.

MR. FUCHITA: Yes. Well, Japan imported, or, I should say, Japan was imposed the Glass-Steagall type of separation of financial business more than 50 years ago. And then since 1992, however, the walls dividing those business have been falling down, just like in many other countries.

And this is the example of Mitsubishi Tokyo Financial Group. There are commercial bank, trust bank, securities firms, as well as other firms. But they don't have insurance firms as subsidiaries or affiliates.

No other banks -- or, I should say, except for only one case, Japanese banks don't have insurance subsidiaries or affiliates. The only exception is this, Sony.

Sony is not only making Playstations or Walkmen. It has Sony Financial Holdings, under which there are Sony Life Insurance and Sony Assurance and Sony Bank.

This case is also an interesting example of an affiliation between banking and commerce, I think. In Japan, a bank cannot hold more than 5 percent of other firm's share. But an ordinary firm can own even 100 percent stake of a bank, as far as some requirements are met.

Japan's situation is basically the same as that of the U.S. in the sense that it had separated, and then started to deregulate. But I think there are several differences between those two countries, as I list here.

Especially I'd like to focus on the fourth line here. Banks can sell mutual funds, and next, banks can sell corporate securities through tie-ups with securities brokers, starting this year, December, this December.

It's like something called networking in the proposed Regulation B. In the Regulation B in this country, banks are imposed very strict limitations in networking with securities brokers. But we don't have in Japan such strict limitations.

MR. LITAN: Yasu, can I ask you a question about that?

MR. FUCHITA: Sure.

MR. LITAN: You skipped over the bullet that is Peter Wallison's favorite bullet. It says, "Banks and FHC can be fully owned by commercial companies in Japan."

MR. FUCHITA: Yes.

MR. LITAN: And you showed that Sony has.

MR. FUCHITA: Yes.

MR. LITAN: My recollection is Toyota has a bank, too, doesn't it?

MR. FUCHITA: Toyota?

MR. LITAN: Are there other examples in Japan?

MR. FUCHITA: Yes. For example, Ito Yukado, like Wal-Mart. It has bank subsidiaries, 100 percent owned. And it's doing good business. But they are very small.

MR. LITAN: Okay.

MR. FUCHITA: So I guess there are some other. Not so many. There's three or four of them.

But Toyota can buy shares of banks -- well, if you buy more than 20 percent of bank's shares, the you need permission from FSA and you have to -- you may be inspected by FSA if FSA thinks it's necessary.

And if you own more than 50 percent of a bank's stake, then in the case of emergency, the holding company has to put more money to save the bank. So that is our current rule. So it is possible.

And now -- yes. I think I would like to emphasize the characteristics of Japanese system.

Japan's -- difference between Japan and the U.S.

I think we can observe two points. First, generally speaking, Japanese banks face less restrictions in doing securities business than in U.S. banks and GLB. Secondly, so-called function of regulation is different from that in the U.S.

And the GLB function of regulation, the sales of mutual funds, stocks or corporate bonds are defined as securities business, and should be conducted at securities firms instead of at banks. In Japan, banks themselves can conduct pure securities business, such as the sales of mutual funds.

Let me explain why Japan is allowing banks themselves to sell securities. Since the year 2001, Japan has introduced a policy to encourage individual people to invest in securities instead of depositing their money in banks.

This is because in Japan, banks traditionally assume too large portion of nation's money flow. As a result, economic slowdowns meant the overall deterioration of banks' assets, and this deterioration caused a widespread and long-lasting financial instability in the Japanese market.

So the Japanese government policy is to promote securities investment and a more diversified money flow. The hope is that this new policy will make the pjs economy less susceptible to banking problems.

And in order to promote securities investment, the government is thinking that it is a good idea to utilize the banks nationwide, the branch networks, and popularity of bank deposit.

This is the change in the percentage of stock funds sold by banks instead of securities brokers. As you can see, the ratio of sales through banks keeps increasing.

This is regarded as strong evidence to show that it is beneficial to investors to allow bankers to sell not only mutual funds but also as corporate securities. Of course, this is beneficial to banks as well.

In short, Japan is sort of utilizing the banks' power to promote securities markets. And this is to some extent similar to what happened in the UK, Canada, or France, where securities market -- securities firms are regrettably weak, so the large financial institutions such as banks are invited to enter into the securities business.

And it is interesting to see what happened in those countries after that. In Canada, for example, all large independent securities firms are acquired by the big five banks, chartered banks. And meanwhile, in the UK, there still remains one large independent broker named Cazenove. But it seems the firm now is allying with J.P. Morgan.

And the question is whether Japan is heading for the same course as the UK or Canada, or is Japan even stepping toward a universal banking system like in France? This is something that remains to be seen.

Well, of course, in Japan there are lots of arguments going on about potential problems of banks' expansions into other business, such as conflicts of interest, unfair competitions, and risks to payment and settlement systems.

But when we look at Canadian or UK market, it is hard to find evidences of significant problems after they allowed banks to enter into securities business. And the question is, the same thing holds in Japan or not?

And here, I think there is one point we might as well take into account when we think of this question. In Japan, anti-competition policy is not so effective, I should say. And maybe I can even say the importance of competition is not well respected in Japan.

First of all, I should remind you that in Japan, banks as a whole have significant influence in the economy. They have a dominating position in the nation's financial business, and if you take a look at this table, as much as 50 percent of individuals' financial asset is in bank deposit -- not only bank deposit, but cash or bank deposit or postal savings.

So you can imagine the financial institutions specializing in securities market are less significant in terms of economic and political power. And not only banks as a whole are very powerful. We should notice the rapidly increasing dominance of a handful of mega banking groups.

This table shows major mega banking groups' shares in domestic deposit market. There are four mega banking groups in Japan, and as you can see, each mega banking group holds more than 10 percent share of domestic deposit market.

And now MTFG, which means Mitsubishi Tokyo Financial Group, and UFJ Holding is going to merge, or

Sumitomo Mitsui may be successful to snatch UFJ. I don't know.

But anyway, if this kind of merger is successful, the new mega banking group will be -- the share of its deposit tops 20 percent of the total market share.

So I think the emergence of such a large banking group in Japan is a stark contrast with the situation in the U.S., where banks have to divest deposits when the market share becomes larger than 10 percent as a result of the merger.

Also, in the UK and in Canada, I can easily find persistent concerns over the concentration of economic power in banking organizations. Meanwhile, in Japan, after the long period of weak banking system, it seems there is less sense of such concerns now. Not only people don't worry about the increasing market power of banks, but they also let such power extend to securities and insurance business.

And if there are no economies of scale or scope, as many researchers are suggesting, there will be a natural limit on such expansions. In that case, we should not worry too much about it.

But in Japan, economic principles fail to apply often. For example, banks keep lending money at very low rates compared with the risks involved because they are still completing for market share instead of profitability.

So it is likely that given the current policy and the current incentives in Japan, Japan could be the country with the largest and most complex financial institutions in the world.

And I think it may be worth thinking to relate the state of banking industry to the scope of business allowed to banking organization or the degree of strictness in the regulation or supervision of the non-banking business.

To the extent banks as a whole have large powers, and especially have a handful of banks have large powers, there must be more chances, of course, of conflicts of interest, and less chances of that kind of malpractices are being detected.

And in the case of Japan, where generally speaking the competition policy is not so strict and a handful of banks have been gaining much larger shares, it might be more sensible to be cautious of having financial corporation merit.

On the other hand, in those countries where competition policies are well-established and very effective and enforceable, there could be less restriction over the scope of business allowed to financial institutions.

In other words, the real issue here is not whether universal bank is good or bad. If there are enough competitions and market disciplines at work, there might not be much problems.

So the real issue here is how to stem the potential threats caused by LCFIs, large complex financial institutions, and protect most depositors, investors, also protect fair competition, and maybe financial systemic risk as a whole.

In this sense, I think we should be well-equipped with much clearer public policy against financial institutions being too large or being too complex.

That concludes my presentation, and thank you.

MR. LITAN: Thank you. That was fascinating.

The floor is now open. Gerry? You've got to turn your mike on. This is Gerry Caprio.

MR. CAPRIO: Thanks. I apologize for having to speak and run, but I'm already going to be late for a meeting. I just wanted to make a couple of points, since Adam was nice enough to mention some of the research that we've done.

It's true that there's no evidence that one particular structure, financial structure, matters whether, you know, some countries have developed very nicely emphasizing more markets, others more bank-based.

But in a couple of empirical studies -- and this was actually with Ross and Jim Barth and myself -- the countries that gave banks broader powers to do real estate insurance, equity underwriting, did have deeper financial systems, ones that were somewhat less prone to crises.

Supervision, on the other hand, didn't work and, in fact, by and large, except for a small number of countries was negatively and significantly now related to the development of the sector, the extent of crises, the degree of corruption, and the efficiency in the financial system. And this is holding constant, other -- I mean, taking account of other determinants, including the development of the legal system, et cetera.

Market discipline, improving transparency, did seem to help all those left-hand side variables except for crises, where there was no significant relationship between market monitoring and crises.

Crises were lessened and development increased by greater presence of foreign banks, by greater diversification of the financial system. And developing countries are, by and large, small. Somebody mentioned a $10 billion bank. 120 countries' entire financial system is smaller than $10 billion. So diversification is a critical problem that they face.

Therefore, all that they do to help supervision and all the effort that they spend on Basel II, III, or IV is large beside the point. Indeed one of the questions that Bob listed was: Are there any changes in supervision or structure that lie ahead?

I predicted there will eventually be a backlash due to Basel II. The second -- the first pillar is all about devising a formulaic approach to minimum capital requirements, and according to the Basel committee, the second pillar is about supervisors prescribing optimal capital holdings for individual banks.

This may be misguided in countries that are relatively open and transparent. In countries that are not, it's a disaster waiting to happen. And yet the developing countries, even though they sense that there's a lot of Basel II that they can't do, they're not ready to implement, nonetheless they all want to do it.

And one reason why they want to do it is it's a way to get more resources into supervision. I think there's going to be a tremendous backlash coming against this, I hope in industrial countries, but I think it will in developing countries.

MR. LITAN: We've got a lot of cards up. I want to bring in some speakers who haven't talked yet.

George French.

MR. FRENCH: Thanks, Bob. George French at the FDIC. And I'd like these remarks to be stricken from the record, please.

MR. LITAN: So be it.

MR. FRENCH: Maybe it's late in the day, but I've got some grumpy comments to make.

Some thoughts on Adam Posen's paper, which I thought was -- presentation, which I thought was very interesting. Just some additional observations about European supervision.

I think there's almost certainly less of a tradition of onsite supervision in European countries than we have here. I think the capital requirements are significantly lower in European countries. And in fact, the banks operate -- the larger banks operate at significantly lower capital levels than U.S. banks do.

And yet whatever you may think about that, the fact is, you know, maybe the European regulators are pretty smart because they're now in the position of being the arbiters of the quality of U.S. supervision through the European directive on consolidated supervision and the discretion they have to determine what U.S. regimes are adequate for purposes of a bank operating in Europe.

And that's sort of puts the U.S. regulators in a funny position because we all are very strong regulators who believe in what we do. And so, you know, each agency probably has a tendency to sort of promote the quality of its own supervision.

And the decisions that the EU makes about which

U.S. regulator is adequate can have substantial implications from a policy perspective in the U.S. in terms of how, for example, large broker dealers are regulated.

And it just is not clear to me that that's a desirable situation. I don't know how we got ourselves in the position of having important policy positions or developments in U.S. financial services regulation be dictated to us by the European Union.

MR. LITAN: Okay. I see why you want that stricken from the record.

(Laughter.)

MR. LITAN: Larry White.

MR. WHITE: This issue of universal banking and did it work/not work in Europe, et cetera, I mean, it strikes me that a lot of what Adam was talking about was, you know, the context where corporate governance is even in worse shape than it is in the United States. And I think that colors a lot of what Adam was talking about.

But there's also this issue -- I mean, coming back to what Peter had raised earlier about there is no principled way of deciding what ought to be with a bank or not.

And I think what I want to distinguish here, and I think this is terrifically important, Peter's absolutely right if you say what should be with a banking organization or not. There's absolutely no principled way to decide what should or should not be in a banking organization. As far as I'm concerned, anything goes inside a banking organization.

However, there is a principled way of deciding what ought to be inside the bank with insured deposits and what ought to be outside the bank, either up in a holding company, a subsidiary of the holding company, or a separately capitalized subsidiary of the bank.

And that is the principle, and here I differ with Gerry Caprio as to my optimism about bank supervision. What is examinable and supervisable, and what is not?

Stuff that is examinable and supervisable can go inside the insured bank. Why? Because it's examinable and supervisable. A reasonable capital requirement can be set, and examiners come in and can make a judgment about whether management is competent in managing this in a safe and sound way.

Anything else which is not examinable and supervisable can be elsewhere in the banking organization so long as the strictures of an equivalent of 23(a) and (b), transactions with affiliates, are observed so that the transaction with the affiliate isn't a route for draining funds out of the bank.

But that's where the principled issue is. What's examinable and supervisable that can go inside the insured bank? And that -- you know, that is not anything that's set in stone. It's a locally determined thing.

It depends on the sophistication of the local examination and supervision system. One system will decide that X activities are examinable and supervisable and others are not.

Over time, the technology sophistication may improve and so that judgment may change. And then everything else elsewhere -- but you got to worry about the transaction.

But you have to worry about those transactions anyway because it's easy to drain a bank by making transactions with your friends, with your relatives. You don't need a holding company to drain money out of a bank. There are lots of ways to drain money out of a bank.

And so, you know, you've got to have those powers in place anyway. But it all -- again, it all comes back to what's examinable and supervisable inside the bank. Anything else, elsewhere in the banking organization.

MR. LITAN: Okay. Dan?

MR. TARULLO: That's actually a good entre into the question I want to ask the panelists, or anybody else who can answer.

Someone reminded me at the break of an issue that was implicit in something I said. You may recall I alluded to the fact that under current Fed interpretations, if you lend to an issuer whose securities are being underwritten by your securities affiliate, it's not a covered transaction for purposes of affiliate rules. But if you lend to the affiliate itself, it is a covered transaction. And there's a certain form over substance quality there.

Someone reminded me that this is a non-trivial issue in the minds of at least some medium-sized investment banks that believe that they are being disadvantaged by the fact that the integrated financial services firm brings to the table a bridge loan or some other extension of credit for an issuer which they, the independent specialized investment bank, can't match, at least on cost terms, because of the subsidized cost of capital with a loan based on federally insured deposits.

And I was wondering whether the three people on this panel or anybody else was aware of any experience, studies, data, anything, in any of the countries that have well-integrated universal banking operations, but may also have specialized investment banking operations, to suggest whether there's something systematic to this advantage, or whether it's something that the Lehman Brothers of the world think there's more there than there actually is, or what.

MR. SAUNDERS: I'll try and give -- Tony Saunders from N.Y.U. I'll try and give you a general answer. I can't make it specific.

Because the data there is really U.S. data. So what do we know about the power of customer relationship effects? There's a lot of anecdotal evidence, but investment bankers argue, well, banks have an advantage through lending relationships. They can underwrite more deals. They get more debt underwriting, more equity underwriting.

So I have a working paper on exactly this question: What's the probability of doing a bank -- the bank underwriting a security offering if it has a lending relationship with the customer? And it's extremely small, 2 percent, 3 percent more than if it had no lending relationship.

What's the probability, though, of making a future loan if you have a past lending relationship? Seventy percent more. So that for relationships to pay off, I believe it's really within the area of lending to lending. What the data shows is there's very little cross-subsidy from lending to underwriting debt or equity.

So as far as I know, we're the only study that has actually gone out and said, let's look at the data on what is these probabilities. So we've actually estimated the probabilities based on the data.

But as far as where there's no -- it would be very hard to do this for foreign data because you need a lot of databases to be able to do this, like loan pricing corporation database for loans and security data corporation database for securities.

So I don't know if it really answered your question. But at least in the U.S., it's fairly minimal, the cross-subsidy effect.

MR. LITAN: Okay. Before I call on Dick, can I ask Yasu Fuchita to answer a question?

I mean, the bottom line of your presentation is that the Japanese banking system is becoming very concentrated very rapidly. And you're worried about it. Okay? So the question is: Is there anything that can prevent this or mitigate it? All right.

There are two potential options I'm going to throw out to you. I don't think -- well, one is more development over time of securities markets, so that securities markets are more effective competitors to banks. That would mitigate at least some of the bank power on the lending side. And then the second and the obvious one is, of course, more foreign bank institutions in Japan.

And the question is, you know, could even a Citigroup or a Bank of America today, even if the Japanese authorities were inclined to let them in -- well, Citigroup is already there, but --

MR. TARULLO: Sort of. They're on their way out, Bob.

MR. LITAN: Yes. I mean, the point is, is it even possible for a foreign financial institution to make it in this concentrated market? Because that would be one obvious source of outside pressure. And are there any other sources of pressure do you see?

Because you quite legitimately worry -- I mean, you know, wring your hands over this concern. And then inquire, can anything be done about it?

MR. FUCHITA: Well, I worry about this concentration of banking industry. But at the same time, there are concerns over so-called over-banking. So those people are saying that we need less banks, so they might be welcoming the consolidation.

And so the problem -- let me see. Well, you mentioned about the entrance, new entrance, say, foreign banks, more foreign banks coming into Japan. Well, it is very hard to compete in this market because they -- as it is suggested, there is already over-banking situation. Banks are competing for shares at the lower rates than the market suggest.

So it is not a profitable market at all. So it doesn't make sense for foreign banks to come to Japan. They only lose money, unless they can find some targeted or special segments.

Well, probably peoples' attitude should change. People tend to keep depositing too much money in banks. So there are so much money sitting in banks, and so banks having difficulty to find better place to put their money, and so they tend to lend at sub-market rate.

And I think consolidation will not change that because even the banks get larger if there are so much money in the deposit, they keep lend -- they try to keep lend money at sub-market rates.

MR. LITAN: Excuse me. Why are they lending at sub-market rates if the market is concentrated? Why are they doing this?

Well, no, I understand that they've got all this money on the deposit side. All right. I understand that. But when we say that they're lending at sub-market rates, that implies that they're being really stupid about it.

Well, I mean, collectively -- and you would expect, sure. If deposit money is cheap, you would expect lending money to be cheap. All right. I understand that.

But I find it hard to believe that the loan rate is being, you know, "subsidized" or is being underpriced. All right? It's just hard for me to understand that. Or maybe economics doesn't work in Japan.

MR. FUCHITA: No, no.

MR. POSEN: Fujita-san, you go ahead. But I'll add something.

MR. LITAN: Yes. Go ahead.

MR. FUCHITA: Well, I think, first of all, these significant concentration of four major banks worries me, too. And in addition to this concentration, we should really understand that big banking group, they have their own securities subsidiary.

And therefore, there's experience. There's no data, no academic study. I have experienced several times, although that corporation does not clearly tell us, however, that they are really proposing some kind of securitization or bond offering. And they would say, why don't you also weigh the banks who are sitting next to me? That kind of thing I experienced.

After saying this, these four big banks and concentration, yes, it is concentrated. And therefore, I would think in the relatively near future their pricing mechanism is going to change in such a way to cover enough the credit cost and additional spread, and probably it's a normal spread, in the relatively near future.

And so far, it was not being the case.

MR. LITAN: Right.

MR. FUCHITA: But I think in the future, it is going to be the case.

MR. LITAN: It will change. Adam, did you want to add to that?

MR. POSEN: Just a couple points real quick.

First is part of the reason you're running into trouble, Bob, is because they're not lending. That's the whole point. They're putting huge amounts of their loanable funds in the Japanese government bonds, which pay zero point blah blah blah percent. And that's been part of the issue. They've got all these loanable funds and they've got nothing else to do with it.

The second point, picking up on what Mr. Fujita was saying, is I think you have to remember that the figures he's showing are on the deposit side. I mean, as our friends from Nomura are very much aware, the deregulation has worked to a large degree on the product selling side. I mean, the lending side, the spreads, when they are lending, the various securities operations, the spreads have gotten shrunk a huge amount.

And that's part of the problem. Right? You've got all these loanable funds, and every company worth its salt in Japan is going to the markets and avoiding the banks. So that's the fundamental mismatch, and that's why Mr. Fujita mentioned there are people worried about over-banking. That's why there are people like me who worry about over-banking. There's no capital in the system.

And so since people are making predictions, like you did, Bob, about being realistic about what's going to happen or not going to happen with GLB, I mean, for what it's worth, my prediction is you're going to see this summer deposit insurance get capped. They are going to implement it after many years of delays.

And the FSA is going to correctly use this as an opportunity to really stomp on the 50 percent of deposits that are in small banks and shut down vast numbers of them that haven't been examined properly for years.

And you're going to end up with three or four hugely too big to fail banks, each with 10 percent, 20 percent, of national deposits in them. And in a sense, it's not going to matter because you're still going to have 50 percent of national deposits in the postal saving system, so who really cares? Because they can't make a profit anyway.

MR. LITAN: Okay. Now back to Dick.

MR. HERRING: I had two quick questions based on some of the results that Tony Saunders presented. One was the looking for where the potential gains were from conglomerating, and there appeared to be absolutely nothing to hope for in terms of economies of scope in production.

There may be some economies of scope in revenue, which leads to the question that it seems you can get most of what there is to be gotten by simply jointly selling rather than actually going through the bother of producing.

Is that perhaps one of the reasons we're seeing one of the main activities under GLBA being insurance agency, basically just producing -- or just selling products that are produced elsewhere.

The second question is, you were looking at diversification benefits from conglomerates. And I'm curious why you didn't also look at what we usually look at when corporations start to diversify, and that is the discount that the market usually applies to conglomerates. Why shouldn't we expect that to happen for financial conglomerates as well?

MR. SAUNDERS: I thought that -- look at a discount indirectly through the M&A normal returns. What happens, he acquires a return when he acquires a target. In most cases, it's negative. So it suggests sort of a loss from acquiring something outside your normal field.

But the question you're saying is, what's the benefits of diversifying versus focusing? Because in the industrial structure, we find almost universally now, the evidence shows that the best-performing firms are those focused both regionally, geographically, and in industry.

So does that hold for banking? Well, there's a very nice paper by Gayle DeLong in the Journal of Financial Economics where she finds exactly the same thing for banking. The best performing banks are geographically specialized and they're totally focused. Retail banking, geographically specialized. So that's sort of very depressing news for believers in universal banking.

And your second question about Allianz is -- yes. I mean, banks don't know about underwriting, really underwriting property/casualty insurance. And I'm pretty sure insurance companies don't know about credit risks. Given their losses on credit derivatives, they have no idea about credit risks.

So I think Allianz is -- they take each other's specialization. It just acts as an agency function, is the way forward.

MR. LITAN: Okay. Is there anybody who wants to make any final comments, or do you want to go drink? I think, by silence, I think you vote for drinking.

We're going to go just next door for cocktail hours, and then we're going to eat at 6:00 downstairs. And before you all leave here and we disperse, I just want to make sure that we thank all of our presenters today. I thought we learned a lot, and I think they deserve a round of applause.

(Applause.)

(Whereupon, at 5:38 p.m., the conference was concluded.)

* * * * *