Exchequer Speech

The Failure of the Gramm-Leach-Bliley Act

December 19, 2001

Some of you in the audience today might have attended a recent AEI roundtable on the Gramm-Leach-Bliley Act. The purpose of that program—which featured representatives of many of the major players in the framing of the Act—was to determine what in the world they had in mind. Writing shortly after the Act was passed, Chairman Leach declared that the Act was the most significant banking legislation since the Federal Reserve Act of 1913. Even allowing for the usual hyperbole with which members of Congress describe their doings, this seemed a bit much, and I thought the roundtable might throw some light on what the various participants thought they had achieved.

Unfortunately, Chairman Leach was unable to attend—having had a family emergency at the last minute—and perhaps the roundtable would have taken a different course had he been there. But my summary of what was said by the participants and the audience would be that—far from the earth-shaking reform the Chairman thought he had accomplished—most people who worked to pass the Act thought of it either as a clean-up measure to bring the law into conformity with what the market was already doing, or as an opportunity to accomplish some relatively minor long-term objective for which the Act was a convenient vehicle.

And these are the views of the Act's proponents!

My own view is that the Act has been a failure. Actually, worse than a failure. It has created a competitive imbalance in the financial services market that is worse than what had existed before.

If the Act had been a true reform, it would have created a level playing field, a two-way street, in which all the participants in the financial services market—securities firms, insurance companies and banks—would be able to enter one another's businesses and compete. Instead, the Act contains a built-in bias in favor of banking organizations, and has in effect frozen out securities firms and insurance companies. There can hardly be any question that this was the Act's effect. The Fed has had hundreds and hundreds of applications by banking organizations to become financial holding companies so they can establish or acquire insurance companies or securities firms, but only a handful of applications by nonbank organizations to become financial holding companies so they can acquire banks.

There is a good reason for this. Banking organizations can extend their activities by becoming financial holding companies, while securities firms and insurance companies are slipping on a strait-jacket that few managements are willing to voluntarily assume. That strait-jacket, of course, is the Fed's authority to determine whether a particular activity is a financial activity—and thus suitable for a financial holding company. From the perspective of a bank's management, becoming a financial holding company is clearly a no-brainer—it opens all kinds of opportunities that did not exist before. But from the standpoint of the management of a securities firm or insurance company it is something else again: a life sentence to live within the narrow range of activities the Fed may in its wisdom categorize as “financial in nature.” Someone at the roundtable called this a “roach motel”—once you enter you never get to leave. It is no wonder that few managements have thought it prudent to take this step.

The sad thing about all this is that it is all so unnecessary. The restriction that is keeping securities firms and insurance companies out of the banking business—the idea that financial activities should be separated from nonfinancial activities—is a vestige of the old idea that banking should be separated from commerce. What the Act did was extend the fence around banking so that it would now separate what the Fed deems to be financial activities from what the Fed deems to be commerce. All the distinctive features of the Gramm-Leach-Bliley Act—the authorization of financial holding companies, the installation of the Fed as “umbrella regulator,” the elimination of unitary S&L holding company—are the result of this idea.

The trouble is, separating banking from commerce—although a faulty idea as a matter of policy—was at least intellectually supportable. Separating financial from nonfinancial activities is not even intellectually or conceptually supportable

I won’t go into why separating banking and commerce is a faulty idea as a matter of policy—although I’d be pleased to discuss it during the question period—but I want to spend the rest of my time on two points that I think illustrate the absurdity that lies at the root of the Gramm-Leach-Bliley Act:

1. By permitting banks to affiliate with securities firms, the Act in effect destroyed the theoretical underpinnings for the separation of banking or financial activities generally from nonfinancial or commercial activities; and

2. There is no objective or principled way to distinguish between financial and nonfinancial activities, and the Act’s effort to do so leaves the Fed in an impossible quandary—where every decision it makes will seem arbitrary.

If you think about the reasons why banking was supposed to be separated from commerce, they come down to only three:

If banks were controlled by commercial firms--

1. they would be compelled to make excessively favorable loans to their affiliates, giving those affiliates a competitive advantage over competitors;
2. they would not make loans to competitors of their affiliates; and
3. they would be compelled to bail out their affiliates if the affiliates got into financial difficulty.

I won't argue the merits of these points, although I certainly have in the past. Suffice it to say that none of them has any validity. For present purposes, however, I simply want to point out that if they have any merit they apply most forcefully to the relationship between banks and securities firms—one of the affiliations that is specifically *permitted* by Gramm-Leach-Bliley.

For example, the classic statement of those who would separate banking from commerce is that if a bank were controlled by an automobile company, all the bad things I mentioned before could occur. That is, the bank would preferentially lend to its affiliate, refuse to lend to other auto manufacturers, and be compelled to bail out its affiliate if car sales fell through the floor.

Well, the same things would be true if a bank were controlled by a securities firm—which is permissible under Gramm-Leach-Bliley. Indeed, it would be worse if a bank were controlled by a securities firm—since securities firms, which carry their trading portfolios with bank financing, make far more use of bank loans than automobile companies.

So by allowing banks to affiliate with securities firms the proponents of separating banking and commerce have completely eviscerated their own arguments. The very things they profess to be worried about are the things they have authorized in Gramm-Leach-Bliley.

So I think I've now shown that there can be no sensible *policy reason* for attempting to separate financial from nonfinancial activities—the very essence of Gramm-Leach-Bliley.

Now I'd like to show that there is no objective or principled way to draw a line between financial and nonfinancial activities, and thus that the Fed—in its eagerness to retain jurisdiction over the banking business through holding companies—has painted itself into a conceptual corner from which there is no escape. Bin Laden apparently had better options than the poor lawyers at the Fed who have to counsel the Board on this issue.

Let's start with the current controversy about real estate brokerage, the Fed's very first venture into this morass. The Fed currently has before it a proposed rule to determine that real estate brokerage is a financial activity. The application has been opposed, of course, by the realtors—who don't want financial services companies competing with them—and favored by banking organizations. The rule was originally proposed in December 2000, and we are now going on a year without a decision.

As an aside, there is no better illustration of why the managements of securities firms and insurance companies do not want to subject themselves to Fed jurisdiction by becoming financial holding companies.

Imagine if you were the management of a securities firm or an insurance holding company and you wanted to go into the real estate brokerage business in order to offer this service to your customers. To do so, you would need no approvals; the only delay would be whatever was required to make the acquisition or establish the brokerage firm *de novo*.

But if you were the management of a financial holding company that also controls a bank you would be subject to the Fed, and a year after you decided to go into the real estate brokerage business you'd still be waiting for the Fed to determine whether real estate brokerage is a financial activity.

But the delay is only part of the problem. It might be that after all the waiting—after paying all the lawyers to press your application and argue with the lawyers representing the people who don't want your competition—the Fed will conclude that real estate brokerage is *not* a financial activity.

Its long delay in deciding this question suggests that the Fed considers it a difficult question. That in itself should be a warning to those who would voluntarily subject themselves to the Fed's jurisdiction.

But in fact a question like this *is* a difficult question—because in fact *there is no way* to distinguish between a financial activity and a nonfinancial activity.

To illustrate this point, let's consider some questions about real estate brokerage.

In what way is real estate brokerage *not* a financial activity? Brokerage is simply bringing together buyers and sellers. No one denies that securities brokerage would be a financial activity. What is it about real estate brokerage that makes it so different from securities brokerage that it's not a financial activity?

One argument might be that the things that are being brokered are not themselves financial items. That seems to be the principal argument of the opponents.

Well, everyone agrees that leasing is a financial activity. If a company leases cars or airplanes, it is in a financial business. Leases, of course, are also bought and sold—leases on cars, airplanes and similar nonfinancial items. If someone is in the business of bringing together buyers and sellers of these leases, is that a financial activity? Most people would agree that lease brokerage is a financial activity, even if the underlying asset is a car or an airplane, which is clearly not a financial asset.

What is a real estate broker doing when he or she brings together the buyer and the seller of a lease on an apartment? How is this different from a lease on a car? When a lease on a car is sold, the new owner becomes the lessor. When an apartment lease is sold, the same thing happens. One involves a car and the other a piece of real estate, but is there any principled basis for distinguishing the two?

Let's take this one step further. We've already determined that brokerage of leases would be a financial activity. A lease is a right to control a tangible asset—like a car or an apartment—for a limited period of time. What if a broker were bringing together buyers and sellers of control over a tangible asset for an *unlimited* period of time? Is that materially different from brokering leases? Does the period of time make the difference?

If the answer is no—and I think it must be—doesn't this mean that a real estate broker who brings together buyers and sellers of real estate is engaged in the same activity as a broker of leases on the same property? And if a broker of leases is engaged in a financial activity isn't the same thing true of a real estate broker who brings together buyers and sellers of homes?

But if the Fed follows this analysis, where can it stop? If bringing together buyers and sellers is a financial activity, so is buying and selling goods and services. I can use the same analysis that I used for brokerage to show that selling a car or a house is a financial activity.

We start again with the lease, and find that if leasing is a financial activity—and it certainly is—there is a continuum between transferring temporary control of a tangible asset and transferring permanent control. There is no place along this continuum where we can defend a line. Why as a matter of policy should an aircraft lease be on the financial side of the line and an aircraft sale on the nonfinancial side?

Of course, the Fed can simply declare that the line is drawn at some arbitrary point, but arbitrary points have no legitimacy. The Fed will be accused—as seems to be the case in the real estate brokerage controversy—of knuckling under to political pressure.

Another example will demonstrate, I think, how arbitrary the distinction can be. Everyone will agree, I suppose, that manufacturing automobiles is not what the drafters of Gramm-Leach-Bliley Act would have considered an activity that is "financial in nature." And it is unlikely that the Fed will ever authorize Citigroup to acquire General Motors. But why not?

GM has a factory, buys raw materials and parts, assembles these items into cars, and sells the cars to dealers. Clearly a nonfinancial activity. However, if I change the hypothetical a bit, it becomes difficult to distinguish this activity from something we would unambiguously regard as financial. What if GM didn't sell its cars but leased them?

Most people would say that merely leasing cars instead of selling them would not make GM a financial company. But what if GM didn't actually manufacture cars, but had them manufactured by Toyota under a contract, and then leased them? This is exactly what a leasing company does—buys a product like a car or an airplane from some independent firm and leases it—a transaction that has always been regarded as financial, as the equivalent of a loan arrangement.

Well, at what point between the manufacturing and sale of cars and the purchase and leasing of cars did the transaction convert from a commercial one to a financial one? Would the leasing company be engaged in a nonfinancial activity if, instead of buying the finished cars from Toyota it specified to Toyota that it wanted a particular chassis, transmission, engine, seats, etc., to be acquired from different manufacturers and assembled by Toyota? What if it had supervisors in Toyota's plant to assure quality? What if—dissatisfied with the quality it was getting from Toyota—it sets up its own assembly plant?

At which point along this continuum—from buying the whole vehicle for purposes of leasing it, to specifying how a third party would create the vehicle that would be leased, to assembling the vehicle itself—did the company's business turn from financial to commercial? How is the Fed supposed to answer this question?

Thus, the Gramm-Leach-Bliley Act—by attempting to make a distinction between finance and commerce and setting the Fed to police this line—has made it necessary for companies to give up their freedom to enter new activities if they want to acquire a bank. This is the reason the Act has largely been a failure for any businesses other than banking organizations, and—worse—the reason that the Act has tilted the competitive playing field unreasonably in favor of banks.

But it is important to note that in pursuing the irrational goal of separating financial from nonfinancial activities the Act has also given the Fed a conceptually impossible task. As I think I have shown, there is no way to distinguish between a nonfinancial—or commercial—activity and a financial activity, and the arbitrary decisions that will eventually begin to emerge from this process—coupled with Act's failure to create a true two-way street in financial services—will eventually require the Act to be repealed or substantially modified.

In a Senate floor colloquy about the Gramm-Leach-Bliley Act on November 3, 1999, Senator Gramm said:

> This is not the end of the process. I believe this is the most important banking bill in 60 years. But there will be another banking bill within 10 years, and it will deal with commerce. Banking and commerce is already a reality. This bill is a pause, and it is only a pause, and it is not going to last very long.

My question is whether the faulty structure created by the Act can last even 10 years.