

**FINANCIAL MODERNIZATION  
LEGISLATION IN THE UNITED STATES**

**Background and implications**

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# FINANCIAL MODERNIZATION LEGISLATION IN THE UNITED STATES

## Background and implications

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### Abstract

*The Gramm-Leach-Bliley Financial Modernization Act went into effect in the United States in 1999. The Act establishes a new framework for affiliations among commercial banks, insurance companies and securities firms through “financial holding companies” and “financial subsidiaries”, and establishes guidelines for entry into merchant banking. It moves financial institutions in the United States towards a system of conglomeration that has long existed in continental Europe and elsewhere in the world. This paper reviews important provisions of the new law, provides some comparisons with other countries, and draws some implications for future developments. The immediate effects of the law are not likely to be great, either in the United States or elsewhere. With respect to the integration of financial activities, it merely supports recent trends. At the same time, it requires a continued “separation of banking and commerce”, precluding the establishment of true universal banks. Longer-run effects are likely to be more important. If the past is a guide to the future, whatever lines are now drawn by law and regulation between financial and commercial activities are likely to erode in the coming years.*

### Introduction

The Gramm-Leach-Bliley Financial Modernization Act of 1999 (GLB) moves financial institutions in the United States towards a system of conglomeration that has long existed in continental Europe and elsewhere in the world. It establishes new types of permissible activities for financial institutions, new corporate organizational arrangements for engaging in these activities, new methods for determining additional activities, and a new regulatory framework. In doing so, it repeals key sections of the Glass-Steagall Act that, for over 60 years, had limited the securities dealings of commercial banks and their affiliates. It also amends the Bank Holding Company Act which in 1970 established standards that restricted the activities of commercial bank affiliates.

This paper reviews important provisions of the GLB that establish the framework for affiliations among commercial banks, insurance companies and securities firms. In section I the background of restrictions on bank activity in the United States and the current law are briefly reviewed; in section II the major provisions of the law are described; in section III some implications for the behaviour and performance of US banking

organizations are discussed; section IV contains some conclusions. Appendix A provides a description of related legislation that has a role in the implementation of the GLB; Appendix B offers a brief commentary on comparative regulatory structures in the United States and other countries.

The GLB is extensive and complex legislation. Throughout, there are numerous exceptions to its general rules, including the grandfathering of some activities otherwise prohibited. Important provisions require elaboration through rules, regulations, determinations and agreements reached by and among the Federal banking agencies: the Office of the Comptroller of the Currency (OCC), Federal Reserve Board (FRB), Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision (OTS), and others. For purposes of selected provisions, the others include the Treasury Department, Securities and Exchange Commission (SEC), National Credit Union Administration (NCUA), Federal Trade Commission (FTC), and state supervisory agencies.

While the full impact of the new law will remain uncertain until the regulatory and rule-making processes it has set in motion are further developed, it clearly establishes a broader range of activities for commercial banks in the United States than previously existed. However, important differences will remain between the more extensive financial organizations permitted under the law and the “universal banks” that have long existed in a number of European countries. The immediate effects of the law, in the United States and abroad, are not likely to be great. Longer-run effects may, however, be more important.

## **I. BANK ACTIVITY RESTRICTIONS IN THE UNITED STATES<sup>1</sup>**

Modelled on the eighteenth century Bank of England, the earliest banks in the United States received limited-purpose charters that permitted them to borrow and lend and to issue notes payable on demand that served as currency, but were restricted in other activities. Non-banking firms were prohibited from providing bank notes. Under the National Banking Act (1863–1865), the “business of banking” was specified to include the acceptance of deposits, issuance of notes, extension of credit, etc., and included an authorization “to exercise ... such incidental powers as shall be necessary to carry on the business of banking”. By regulatory and judicial interpretation, national banks were prohibited from making mortgage loans, dealing in or purchasing corporate stock as an investment, becoming a partner in a business in which they could incur unlimited liability; or engaging in the operation of a business, even if it had been acquired in satisfaction of a debt.

Over the years, the National Banking Act was been liberalized by legislation, and by interpretation. The Federal Reserve Act of 1913 is an early example of liberalizing legislation. It provided for a moderate expansion of national banking powers by permitting national banks to offer real estate loans, time and savings

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<sup>1</sup> This section draws on information and sources in Shull (1994).

deposits, trust services, and to open foreign branches. A more recent example of regulatory and judicial interpretation has involved the sale of insurance by national banks. In 1916, Congress authorized national banks located and doing business in towns with a population of not more than 5,000 to sell insurance. In 1993, a court ruled that a national bank located in a small town could sell insurance anywhere.<sup>2</sup> In 1995, the Supreme Court indicated a broad judicial deference to the OCC's determinations under the "incidental powers" clause of the National Banking Act, and accepted the Comptroller's determination that the brokerage of annuities – a traditional insurance type of business – should be classified as investment, not insurance, and could reasonably be included as an "incidental power."<sup>3</sup> In 1996, the Supreme Court held that a Florida state law that prohibited bank holding companies (BHCs) and bank subsidiaries from engaging in insurance activities could not prevent a national bank, affiliated with a bank holding company, and doing an insurance business through a branch in a small town, from selling insurance through a state-licensed insurance agency.<sup>4</sup>

The Banking Act of 1933 imposed further restrictions on bank activities. The Glass-Steagall provisions, in particular, required the separation of commercial and investment banking. The rationale for this separation is best understood in historical perspective.

By the late nineteenth century, large national banks in New York and Chicago had begun to undertake investment banking activities in their bond departments. The Comptroller of the Currency, faced by adverse court decisions, interpreted the National Banking Act (1863–1865) to preclude some of the investment banking activity undertaken directly. In the early years of the twentieth century, he began to inform national banks that they were not permitted to hold corporate stock.<sup>5</sup> Banks responded by organizing securities affiliates.<sup>6</sup> Principally owned pro rata by bank stockholders and controlled by bank management, the affiliates were state-chartered firms with general powers that permitted almost any kind of activity.<sup>7</sup> Formal and

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<sup>2</sup> *Independent Insurance Agents v. Ludwig*, 997 F.2d 958 (D.C. Cir 1993).

<sup>3</sup> *Nations Bank v. Variable Annuity Life Insurance Co.*, 115 S.Ct. 810 (1995).

<sup>4</sup> *Barnett Bank of Marion County. Nelson*, 517 United States 25 (1996).

<sup>5</sup> See the Comptroller's *Annual Report* for 1915 (pp. 35–36) for references to a letter sent by the Comptroller to a national bank around 1903 drawing attention to a Court decision stating that "[t]he power to purchase or deal in stock of another corporation is not expressly conferred upon national banks, nor is it an act which may be exercised as incidental to the powers expressly conferred".

<sup>6</sup> George Baker, Chairman of the Board, of the First National Bank of New York testified in 1913 that his bank's affiliate, First Security Company, was organized "[f]or doing business that was not specially authorized by the banking act. We held some securities that in the early days were considered perfectly proper, but under some later decisions of the courts the holding of bank stock or other stock was prohibited; at any rate the comptroller prohibited it". *Hearings on the Concentration of Control of Money and Credit*, Subcommittee of the Committee on Banking and Currency (Pujo Committee Hearings), Part 19, p. 20; 1913, p. 1424; see also p. 1432.

<sup>7</sup> Realty, insurance and mortgage company affiliates were also acquired and frequently had their main offices in the same building as the bank.

informal affiliations among investment and commercial banks with securities affiliates, at the beginning of the twentieth century in the United States, constituted the beginnings of universal banking.

At the time, the underwriting of private securities by commercial banks and their affiliates was severely criticized by a subcommittee of the United States House Committee on Banking and Currency, chaired by Congressman Pujo. The Committee had been established to investigate the “concentration of control of money and credit”. Its *Hearings and Report* remain controversial to this day. Nevertheless, it concluded that underwriting by banks, and the affiliation of banking, investment and commercial firms was excessively risky and facilitated concentration. The Committee’s Report (1913) remains a compendium of issues still raised in debates on the dangers of combining banking and commerce.<sup>8</sup>

The Federal Reserve Act of 1913 provided for a moderate expansion of national banking powers by permitting real estate loans, time and savings deposits, trust services and foreign branches. It did not materially disturb the security affiliates of national banks or state banking powers. In 1927, the McFadden Act gave national banks explicit authority to buy and sell marketable debt obligations. The Comptroller ruled that national banks could underwrite all debt securities, and that their affiliates could underwrite both debt and equities.

This arrangement was demolished by the Banking Act of 1933. The Glass-Steagall provisions of the Act revoked the powers that had been granted by the McFadden Act and mandated the divorce of commercial banking and investment banking.<sup>9</sup> Passed in the wake of the stock market crash of 1929, the failures of thousands of banks during that same period and the slide of the US economy into the worst depression of its history were proximate factors influencing this legislation. More specifically, Congress perceived that some commercial banks’ securities activities had helped fuel the stock market speculation of the late 1920s prior to the crash, that some banks had abused their fiduciary responsibilities towards their customers through improper securities activities, and that the failures of some banks were related to their securities activities.

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<sup>8</sup> See USHR (1913 – “Pujo Committee Report”). For example, the *Report* argued, among other things, that bank funds were likely to be used to finance speculative operations (p. 155), that the mistakes of affiliates were likely to impact the bank (p. 155), and that the relationships between banks and the industrial and railway companies they financed would compromise the interests of creditworthy borrowers (pp. 159–160).

<sup>9</sup> The relevant Sections are 16, 20, 21 and 32. Section 16 limits bank dealing and underwriting to specified types of securities, i.e. obligations of the United States and general obligations of states and political subdivisions. Section 20 prohibits banks from having affiliates principally engaged in dealing in securities. Federal Reserve interpretation of Section 20 has permitted holding company affiliates to underwrite otherwise impermissible securities. Section 21 prohibits firms dealing in securities from accepting deposits. Section 32 prohibits interlocks of directors and officers of securities firms and banks. The overseas investment banking operations of US banks were not affected by the Act. Nor did it apply to state-chartered non-members.

In recent years, some researchers have found that the evidence of improper securities activities by banks, and of bank failures attributable to securities activities, to be inadequate.<sup>10</sup> These findings may imply that the United States Congress had no rational basis for passing the Glass-Steagall Act.

In historical perspective, however, the opportunity afforded by Congress's perception of the securities-related problems in 1933 had deeper roots. There had long existed in the United States, as revealed in heightened form in the Pujo *Hearings and Report*, intense political and social, as well as economic, concerns about the concentration of power in the hands of a few private interests and also in the hands of the government. These concerns had, in fact, delayed the establishment of a central bank; and they also explain the unique structural organization of the Federal Reserve, with its 12 Reserve Banks and a Board in Washington.

Most of the legislative proposals of the "Pujo Committee Report" of 1913 were not adopted. Two decades later, in the depth of the Depression, the anti-universal banking views of Pujo prevailed in passage of the Glass-Steagall Act. While concentration was not perceived as a problem in the early years of the Great Depression, the fuller version of these views was that concentration and financial collapse were two sides of the same coin – i.e. if "universal banks" were successful, there would be excessive concentration; and, if they were not, there would be financial collapse that would probably require extensive government intervention.

In this context, the evidence of the securities abuses of the late 1920s and early 1930s, whatever its validity, does not fully explain the basis for passage of the Glass-Steagall Act. Questions on the concentration of financial and non-financial power resulting from relaxed restrictions on bank activities and the role of government intervention in the face of banking problems remain open.<sup>11</sup>

Provisions of the 1933 Banking Act, other than Glass-Steagall, imposed limited restrictions on BHCs, which were understood as an institutional mechanism through which activity restrictions on commercial banks could be circumvented. BHCs were required to register with FRB. Corporations owning more than 50 per cent of the stock of one or more Federal Reserve member banks were required to apply to the Federal Reserve to secure permits to vote their stock.

BHCs, however, could and did find ways to avoid the restrictions, and expanded into a wide variety of non-banking activities in the 1940s and early 1950s. The essentially unrestricted growth of BHCs was terminated with the Bank Holding Company Act of 1956 (BHCA). The Act effectively prohibited BHCs (defined as organizations that controlled two or more banks) from engaging in almost all non-banking activities, as well as restricting their expansion across state lines.<sup>12</sup> The concerns that motivated the bank

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<sup>10</sup> See, for example, Benston (1990) for a recent review of the evidence supporting these claims.

<sup>11</sup> Some of these questions are addressed in Shull and Hanweck (2000).

<sup>12</sup> Under BHCA provisions, commercial bank activities were to be "of a financial, fiduciary, or insurance nature" and "so closely related to *the business of banking* or managing or controlling banks as to be a proper incident thereto" (italics added). The Federal Reserve Board narrowly interpreted the term "the business of banking" to mean a relationship between the



holding company, passed during a period of relative prosperity, were the dangers of concentration of financial power.

In the late 1960s, banks found that they could affiliate with almost any kind of business without legal challenge by reorganizing into one-bank companies that, by definition, were not included under the BHCA of 1956. By 1969, the largest banks had done so. Congress moved to eliminate this loophole in 1970, with amendments to the BHCA focusing more on the impact of one-bank holding companies on concentration than on risk to financial institutions and the financial system.

The amendments redefined “bank holding company” to include organizations that controlled one or more banks. At the same time, activity restrictions were relaxed. The new legislation authorized FRB to permit activities it determined were “so closely related to banking or managing or controlling banks as to be a proper incident thereto” (Section 4(c)(8)). The “so closely related to banking” phrase meant that a new activity would have to be functionally like the existing activities of banks. The “proper incident” phrase established a “net public benefits” test that required a weighing of the benefits of the new activity against costs. The Federal Reserve’s determinations under the Act since its existence have been widely reported.

Despite the restrictions of the Glass-Steagall Act, a number of avenues have been open for banks and BHCs to invest in the equities of non-banking companies. With “control” as its focal point for prohibition, FRB has permitted BHCs to acquire up to 5 per cent of the voting shares, and up to 25 per cent of the total equity of any company without aggregate limit. Investments abroad have been of less concern where investments of BHCs are governed by Section 4(c)(13) of the BHCA rather than Section 4(c)(8); and Edge Act companies (subsidiaries of banks or BHCs) are permitted to acquire 20 per cent of the voting shares and 40 per cent of total equity of non-financial companies outside the United States.

Exceptions to limits in the United States are also made for investments in publicly favoured areas, e.g. through small business investment companies (SBICs), for low-cost housing and community redevelopment. Both banks and BHCs have been authorized to invest in the equity of small businesses through SBICs as long as the aggregate of such investments does not exceed 5 per cent of the bank’s or BHC capital. Further, over the last 15 years, BHCs have expanded their securities activities through Section 20 subsidiaries. These subsidiaries have been permitted, under FRB rules, to deal in and underwrite otherwise “ineligible securities” to the extent that they were not “principally engaged” in doing so.<sup>13</sup> Other avenues for combining banking with other financial and non-financial businesses that have, in recent years, circumvented general restrictions include: (i) the unitary S&L holding company which was not limited in its activities;<sup>14</sup> (ii) the “non-bank bank”

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customers of specific banks and their non-banking affiliates.

<sup>13</sup> The reference is to Section 20 of the Glass-Steagall Act that prohibited banks from having affiliates principally engaged in dealing in most kinds of securities. “Not engaged principally” has been defined by FRB as a maximum percentage of gross revenues provided to the subsidiary by its dealings in ineligible securities.

<sup>14</sup> Such activities were effectively combined with “banking” when S&Ls obtained in 1980 Federal authority to provide checkable deposits and make commercial loans.

that permitted any business to acquire a bank as long as the bank did not offer both demand deposits and commercial loans;<sup>15</sup> and (iii) investments by non-Federal Reserve member, state-chartered banks which have been excepted from Glass-Steagall Act restrictions.<sup>16</sup>

## II. THE GRAMM-LEACH-BLILEY ACT OF 1999

Serious proposals for liberalization of existing limitations on banking activities, including legal and regulatory restrictions on insurance and securities activities, were developed in the 1980s and early 1990s during the Reagan and Bush administrations.<sup>17</sup> Such liberalization was in line with the widespread deregulation efforts of the period, and many felt it was particularly necessary in banking to preserve a seemingly declining industry in which the failure rate had risen substantially, and in which profits were at a low ebb. Notwithstanding the resurgence of bank profits and low levels of failure over the last six years, the United States Congress continued to debate a number of liberalization bills as a necessary competitive measure in an era of “globalization”. So, for example, the House passed a Financial Services Competition Act in 1998 (H.R. 10) that repealed key sections of the Glass-Steagall Act and allowed the affiliation of insurance and securities businesses with banking through financial holding companies. But it was not until November of 1999 that compromise legislation was successful.

One of the several issues that held up passage of the Act involved the organizational structure for new activities. In 1994, the OCC proposed, and in 1996 adopted, a revision of Part 5 (12 CFR) permitting national banks to engage in a variety of activities, permissible to national banks, through operating subsidiaries. Some of the activities, that were not then permitted to the parent bank, could, nevertheless, on application by well-managed and well-capitalized banks, be permitted in such subsidiaries.<sup>18</sup> Debate arose between FRB and the Treasury (OCC) on whether new activities should properly be located in subsidiaries of banks or of holding

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<sup>15</sup> The term “bank” under the 1970 Bank Holding Company Act Amendments was defined as an institution that provided both demand deposits and commercial loans. Beginning in 1980, large conglomerates, securities and insurance firms began acquiring banks that refrained from one or the other. Congress thwarted further acquisitions by redefining “bank” to include all institutions with Federal deposit insurance in the Competitive Equality Banking Act of 1987.

<sup>16</sup> The FDIC determined that the Glass-Steagall Act did not apply to affiliates of non-Federal Reserve member banks, and permitted those that were FDIC-insured to offer securities services. By the early 1990s, roughly half the states had authorized banks to deal in securities beyond the limits established by Federal law and regulation.

<sup>17</sup> For a review of the Congressional bills and other proposals, see Litan (1987: 144). One widely discussed proposal was that of the President of the Federal Reserve Bank of New York, in Corrigan (1987). See also the United States Treasury’s proposals in *Modernizing the Financial System* (UST, 1991).

<sup>18</sup> For a recent review of the advantages and disadvantages of alternative organizational structures see Shull and White (1998).

companies. Subsidiaries of banks would be likely to enlarge the supervisory domain of the OCC at the expense of FRB. Subsidiaries of holding companies would maintain the domain of FRB.

Another key issue involved the role of the Community Reinvestment Act (CRA) as a restraint on non-traditional activities. CRA requires banks to extend credit in their local communities, and has been effectively enforced by prohibitions on mergers, acquisitions and branches for banks that inadequately do so.

Still another issue involved the role of state insurance supervisors and the continued immunization of insurance from Federal regulation.

The GLB, then, reflects a culmination of almost 20 years of debate regarding permissible activities for banking firms. It permits and facilitate the entry of banks into insurance, securities and other activities. It likewise permits and facilitates the entry of other financial organizations into banking.

## ***A. Overview***

Title I of the GLB provides for the affiliation of banks, insurance companies and securities firms. Title II combines “functional regulation” with existing bank regulation. Title III deals with state regulation of insurance, addressing a number of issues including limits on insurance underwriting by national banks, reorganization of mutual insurance companies into holding companies, uniform or reciprocal requirements for the licensing of insurance agents, the role of the National Association of Insurance Commissioners (NAIC) in their development, and the related establishment of a private, non-profit National Association of Registered Agents and Brokers (NARAB). Title IV prohibits new unitary savings and loan holding companies. Title V deals with consumer privacy issues, i.e. the disclosure of non-public personal information by financial institutions. Title VI modifies the Federal Home Loan Bank System, among other things providing for long-term Home Loan Bank advances to “community financial institutions” (insured depository institutions with less than \$500 million in assets). Title VII deals with miscellaneous issues, including automatic teller machine fees, Community Reinvestment Act issues (“sunshine” requirements for disclosure of payments by banking organizations in fulfilling CRA obligations), and clarification of the “source of strength” doctrine closely associated with FRB policy. Several studies are mandated by the GLB, including a study by FRB and the Treasury on the effectiveness of bank issuance of subordinated debentures in augmenting market discipline and by the Treasury on the effectiveness of CRA.

The principal sections of the Act affecting the combination of banking, insurance and securities firms are discussed below.

## ***B. Repeal of Glass-Steagall Act provisions***

The GLB repeals two of the four sections of the Banking Act of 1933 known as the Glass-Steagall Act. It repeals Section 20, that prohibited banks from having affiliates principally engaged in dealing in securities, and Section 32 that prohibited interlocks of directors and officers of securities firms and banks. It does not repeal Section 16 of the Glass-Steagall Act, that limits banks that deal in and underwrite securities to specified type C obligations of the Federal government and general obligations of states and political subdivisions; nor does it repeal Section 21 that prohibits firms dealing in securities from accepting deposits. These sections continue to preclude “universal banking”, in which all investment banking activities may be conducted within the bank itself (Title I, Section 101).

## ***C. Amendments to the Bank Holding Company Act***

The new Act amends Section 4 of the BHCA, adding a series of new subsections that permits new activities (Title I, Section 102). Section 4(c)8 of the old Act is amended to incorporate activities previously determined by FRB through regulation or by order to be “so closely related to banking as to be a proper incident thereto”. A new section is added (4(k)) that permits BHCs that qualify to establish themselves as “financial holding companies” (FHCs). FHCs are permitted to engage in a broader range of activities, including those that are financial in nature, incidental to such activities or, as determined by FRB, “complementary” to financial activities.

The Section 4(k) list of financial activities includes “lending, exchanging, transferring, investing for others, or safeguarding money or securities, insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing in any State”. It also includes securities underwriting, dealing and market making (without revenue limits), sponsoring all kinds of mutual funds and other investment companies, any activity FRB has found, under 4(c)(8) to be permissible, merchant banking, insurance company portfolio investments, and health insurance.<sup>19</sup> Also included as “financial in nature” are activities a bank holding company may engage in outside of the United States and that FRB has determined under Section 4(c)(13) to be “usual” in connection with the transaction of banking or other financial operations abroad (Title I, Section 103).

Congress recognized that insurance and securities firms may have equity interests in businesses engaged in “commercial activities” not authorized by the Act. The GLB provides for their retention indefinitely, or for

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<sup>19</sup> The business of insurance is defined in Section 4(k)(4)(B) as “insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing in any State”.

some period of time, depending on the dates on which the equity interests were acquired and the proportion of a company's revenue they provide.<sup>20</sup>

#### ***D. Structural organization for expanded financial activities***

As noted, the new financial activities can be undertaken through a new type of bank holding company, termed an FHC. With some exceptions, they can also be undertaken through a new type of operating subsidiary of a national or state-chartered bank, termed a "financial subsidiary" (Sections 121 and 122).

##### *1. Financial holding companies*

A bank holding company may become an FHC by notifying FRB. All of its subsidiary banks must be "well capitalized" and "well managed", as defined by the Federal bank regulatory agencies (Appendix A). Any bank holding company electing to become an FHC must also have satisfactory or better CRA ratings on its most recent examinations for all insured depository institution subsidiaries (Appendix A).<sup>21</sup>

An FHC may engage either *de novo* or through acquisition in any activity that has been determined by the Board to be financial in nature, incidental or complementary. An FHC may engage in pre-approved activities that are listed in Section 4(k) of the Act, and any other FRB-approved activity, without prior notice. (Notice must be given to FRB 30 days after the activity is begun or a company acquired.)

##### *2. Financial subsidiaries*

As noted above, beginning in 1996, the OCC permitted national banks to have "special operating subsidiaries" under its Part 5 Rule. These could engage in activities not permissible for the parent bank but which were determined by the OCC also to be "incidental" to "the business of banking". With passage of the GLB, national banks may engage through "financial subsidiaries" in some of the newly authorized activities that are not permitted for a national bank itself and that may go beyond activities incidental to the business of banking.

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<sup>20</sup> Section 4(k)(H) permits FHCs to acquire or control companies or other entities engaged in any unauthorized activity as long as the shares, assets or ownership interests are not acquired or held by a depository institution. Such shares, etc., may be acquired and held by (a) a securities affiliate, or (b) an affiliate of an insurance company that provides investment advice and is registered under the Investment Advisers Act of 1940, or an affiliate of such an investment adviser. Such acquisitions are viewed as an underwriting, merchant banking or investment banking activity. The shares may be held for whatever time is necessary to enable sale consistent with the financial viability of the activities; and as long as the bank holding company does not routinely manage or operate such company or entity, except as necessary to obtain a reasonable return on investment or sale. Section 4(k)(I) permits FHCs to make the same kinds of acquisitions, with the same limits, if the ownership interests are acquired by an insurance company predominantly engaged in underwriting life, accident and health insurance, or property and casualty insurance, or providing and issuing annuities. Insurance companies engaged predominantly in credit-related insurance are not included in this permission.

<sup>21</sup> Failure of a subsidiary bank to have a satisfactory rating after becoming an FHC will result in a prohibition against any new activities, but not divestiture or limits on old activities.

National banks, however, are not permitted, through financial subsidiaries, to engage in all of the activities permitted to FHCs. Activities explicitly not permitted to national banks include: (i) insurance or annuity underwriting (except for underwriting permitted prior to 1 January 1999); (ii) insurance company portfolio investments; (iii) real estate investment and development (except as authorized by law); and (iv) merchant banking.<sup>22</sup>

As in the case of FHCs, national banks must be well-capitalized and well-managed and have a satisfactory CRA rating to operate financial subsidiaries. Additional restrictions include the following: (i) the aggregate consolidated assets of all of a national bank's financial subsidiaries cannot be greater than 45 per cent of the bank's consolidated assets, or \$50 billion, whichever is less; (ii) in meeting its capital requirements, a national bank's equity in its subsidiaries (including retained earnings) must be deducted from its own assets and tangible equity; (iii) large national banks (top 100) must have long-term unsecured debt that is rated in one of the highest three investment grades.

Sections 23A and 23B of the Federal Reserve Act, limiting financial transactions between depository institutions and their affiliates, are made applicable to national banks and their financial subsidiaries (Appendix A). So are the anti-tying provisions of the BHCA (Section 106) (Appendix A). Insured state-chartered banks are permitted to engage in expanded activities through financial subsidiaries on essentially the same basis as national banks.

### 3. *Unitary thrift holding companies*

As discussed, unitary savings and loan holding companies have been permitted for many years to engage through other subsidiaries in almost any activity. With few statutory restrictions, they effectively breached the barrier between banking and commerce. The GLB partially closes this "loophole". It provides that no company can acquire control of a savings association after 4 May 1999 unless the company is only engaged in activities currently authorized for *multiple* thrift holding companies; or in activities permissible for financial holding companies under the BHCA. However, unitary S&L holding companies that existed on or before 4 May 1999 (or that subsequently came into existence as the result of an application that had been pending before the Office of Thrift Supervision [OTS] as of that date) are grandfathered and not subject to GLB activity restrictions. However, such companies may not transfer their grandfathered status through acquisition or merger.

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<sup>22</sup> National banks and their subsidiaries are prohibited from underwriting insurance, except for authorized products. Authorized products include those authorized by the OCC as of 1 January 1999 that have not been overruled by a court. National banks are prohibited from underwriting or selling title insurance, except that they may sell title insurance on the same basis as state-chartered banks in states where the latter are authorized to do so (except if they are so authorized on the basis of "wild-card" provision). Certain title insurance activities are grandfathered, and existing state laws prohibiting sale of title insurance are protected. Other explicit exclusions apply.

## ***E. Determination of new activities***

The FRB has responsibility for determining what activities are financial in nature, incidental to financial activities, or complementary. In determining which activities are financial in nature or incidental, Congress intended FRB to consult with the Treasury. It must notify the Secretary of the Treasury of applications or requests to engage in new activities.

### *1. Complementary activities*

These are a new category established by the GLB (Section 4(j)). By exclusion, they are not “financial activities or “incidental activities”, and therefore must be “commercial activities” that are related to financial activities. A financial holding company may engage in any non-financial activity the Federal Reserve Board determines to be “complementary” to a financial activity. They are to be determined by FRB on a case-by-case basis. The law provides that in making determinations, FRB must find that the “complementary activities” pose no risk to the safety and soundness of insured depository institutions or the financial system in general.

### *2. Merchant banking activities*

These activities are also permissible under the GLB. Prior to passage of the Act, the investments of bank and BHCs in firms engaged in impermissible activities were governed under diverse regulatory standards for different classes of organization. In general, banking organizations could not exercise “control” of such firms. For a bank holding company, for example, control was presumed not to exist if it owned less than 5 per cent of the voting equity in a company, with a rebuttable presumption for shares between 5 and 25 per cent.

Under the GLB, an FHC may invest in the stock or assets of any type of company, in any amount, engaged in any non-financial activity. These are considered “merchant banking” investments and may be retained as long as necessary to dispose of the investment on a reasonable basis consistent with the financial viability of the activity. The FHC may not routinely manage or operate a company held as a merchant banking investment, except as necessary to obtain a reasonable return on the investment. Merchant banking investments include investments acquired and held by affiliates of insurance companies registered as investment advisers and by broker-dealers.

Insurance companies and securities firms with commercial affiliates prior to 30 September 1999 are permitted to keep them as long as they account for less than 15 per cent of the revenue of the FHC. For those commercial affiliates acquired after that date, but before the firm became a bank holding company, it has up to five years to divest. Commercial firms acquired after becoming a bank holding company can only be held under the merchant banking rules.

The Act authorizes the Board and the Secretary of the Treasury to jointly issue regulations to implement merchant banking authority. The regulations may include limits on transactions between insured depository

institutions and their merchant banking affiliates. If the FHC owns 15 per cent or more of a “portfolio company”, it is rebuttably presumed to be an affiliate of the FHCs depository institution.

The FRB and the Secretary of the Treasury recently announced an interim rule governing merchant banking activities of financial holding companies.<sup>23</sup> The rule includes provisions on risk management practices, holding periods for merchant banking investments, and limits on exposure of FHCs to merchant banking investments. It emphasizes Congressional intent to maintain a separation between banking and commerce, and establishes requirements for corporate separateness and limits on FHC involvement in day-to-day management of commercial companies. It also imposes restrictions on interaffiliate transactions (Sections 23A and 23B of the Federal Reserve Act) and cross-marketing restrictions. The Federal Reserve has also proposed for comment a regulation that would impose a 50 per cent capital charge on all merchant banking investments.

#### ***F. Regulatory framework***

The GLB combines functional regulation with traditional bank regulation on the belief that regulators with expertise in supervising specific sets of activities should uniformly regulate those similar activities in all institutions. Bank regulation in the United States is shared at the Federal level by the OCC, FRB, FDIC and OTS. All nationally chartered banks and all state-chartered banks that are members of the Federal Reserve System and that have FDIC insurance are supervised by one or more of these Federal agencies. In addition, each state has authority to regulate state-chartered banks, and typically does so through an office of state bank supervision. Since the Securities and Exchange Act of 1934, securities firms have been regulated by the SEC with an aim to prevent fraud and promote fair practices in securities markets. Public disclosure of all information relevant to the pricing of securities has been the key aim of SEC regulation. In contrast to the Federal regulation of banking and securities firms, insurance firms have been regulated by state authorities. Insurance regulation is implemented by state insurance commissioners, who have authority to limit the prices charged and to insist on adequate service. Functional regulation under the GLB means that, to the extent possible in financial holding companies, banking activities should be regulated by bank regulatory agencies, securities activities by the SEC, and insurance activities by state insurance commissioners.

The FRB, however, is the designated “umbrella regulator” for BHCs and FHCs. It is authorized to examine each holding company and its subsidiaries. It is, however, directed to use examination reports developed by other Federal and state agencies to the fullest extent possible (Title I, Section 111). Its authority, and that of other Federal bank regulators, is restricted with respect to functionally regulated subsidiaries in requiring reports, making examinations, imposing capital requirements and taking any direct or indirect actions (Title I, Section 112).

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<sup>23</sup> Federal Reserve System, 12 CFR Part 225; Department of the Treasury, 12 CFR Part 1500; 17 March 2000.



The FRB may examine functionally regulated subsidiaries of an FHC only if: (i) it believes that the subsidiary is engaged in activities that pose a material risk to an affiliate depository institution; (ii) it believes (after reading reports) that examining the subsidiary is necessary to determine the adequacy of its systems for monitoring risk; or (iii) it has reason to believe that the subsidiary is not in compliance with the BHCA or other Federal law that the Board enforces, and needs to conduct an examination in order to make a final determination. The GLB also prohibits indirect action by the Board against functionally regulated affiliates through rules, restrictions, etc., unless the action is necessary to address a “material risk” to the safety and soundness of the depository institution or the payments system, and it is not possible to guard against the risk through requirements imposed directly on the depository institution. The FDIC’s authority to examine functionally regulated affiliates is preserved for purposes of protecting the deposit insurance funds.

The FRB also retains authority to establish consolidated capital standards for holding companies. However, it is not authorized to prescribe capital requirements for any functionally regulated subsidiary that is in compliance with applicable capital requirements of another Federal regulatory authority, a state insurance authority, or is a registered investment adviser or licensed insurance agent.<sup>24</sup> There are special provisions for broker-dealers whose capital requirement is established by SEC.<sup>25</sup>

The Act also addresses the “source of strength” doctrine implemented in the past by the Board to require other affiliates of a depository institution to support that institution in difficulty. It is prohibited from requiring insurance companies or broker-dealers that are BHCs to infuse funds into a depository institution if the company’s functional regulator determines that such action would have material adverse effect on the broker-dealer or insurance company.

### ***G. Treatment of foreign banks and holding companies***

Foreign banks operate in the United States through subsidiary banks, branches, agencies or commercial lending subsidiaries. Most operate through branches of the foreign bank itself. Whatever the organizational arrangement, the foreign bank is treated as a bank holding company under the BHCA. The GLB authorizes foreign banks to become financial holding companies, just as in the case of domestic banks. However, the requirements for insured depository institutions that they be well capitalized and well managed are not applicable to branches of foreign banks. The Act requires the Federal Reserve Board to apply comparable

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<sup>24</sup> The Act specifically indicates “leverage requirements”.

<sup>25</sup> The Act contains here a prohibition of indirect action by the Board against functionally regulated affiliates similar to that described above.

capital and management standards to foreign bank branches in the United States, “giving due regard to the principle of national treatment and equality of competitive opportunity”.<sup>26</sup>

### III. DISCUSSION

The Gramm-Leach-Bliley Act of 1999 is extensive and complex legislation that liberalizes long-existing activity restrictions in banking. In a sense, it parallels the Riegle-Neal Interstate Banking Act of 1994 that liberalized long-existing geographic restrictions. It provides a general framework for the affiliation of banking, insurance and securities firms that constitutes a moderate extension of existing arrangements. At the same time, it remains more latent promise that radical change.

In line with the position taken by Gerald Corrigan almost twenty years ago, the GLB sustains the traditional position of banks (institutions that offer transactions deposits payable on demand at par) as “special” (Corrigan, 1982).<sup>27</sup> It reinforces existing bank regulation with requirements that FHCs and financial subsidiaries be associated with banks that are “well capitalized”, “well managed”, and have satisfactory CRA ratings. It further emphasizes corporate separateness by extending existing firewalls, in particular Sections 23A and 23B.

The regulatory structure established by the GLB is an extension of the current bank regulatory regime, adding functional regulators to the existing group of agencies with overlapping responsibilities. FRB, as the “umbrella regulator” for FHCs, maintains its principal regulatory position, even with the so-called “Fed-lite” provisions of the law aimed at sustaining the authority of functional regulators. The Comptroller’s Part 5 reforms of 1995 are, in part, implemented through provisions for new financial subsidiaries.

The law breaks some new ground with respect to the provision of insurance, even though recent court decisions had substantially expanded the powers of national banks. The Citicorp/Travellers merger could not have been fully consummated without passage of the GLB. For the most part, the repeal of Glass-Steagall Act provisions is a confirmation of changes that FRB had instituted through Section 20 subsidiaries beginning in 1987.

The GLB does modify the existing line between banking and commerce within a Congressional effort to maintain a separation. The effort is reflected in the closure of the “unitary thrift holding company loophole” that had permitted commercial firms to acquire thrift institutions with banking powers. The new law does not contain a provision – supported by FRB Chairman Alan Greenspan, among others, in 1997 – that would

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<sup>26</sup> The FRB has announced an interim rule regarding procedures for BHCs and foreign banks to elect to be treated as FHCs (12 CFR, Part 225).

<sup>27</sup> Corrigan argues that banks are different from other private, profit-making institutions, because they constitute the core element of the payments system, are a source of liquidity for all other private and public institutions, and are the mechanism through which monetary policy is transmitted.

have permitted commercial banking organizations to invest in a “basket” of non-financial assets up to some percentage of their assets or capital.<sup>28</sup> The recent FRB-Treasury interim rule for merchant banking has made clear a regulatory intention to sustain Congressional intent in this regard. On the other hand, the new law makes numerous exceptions for commercial activities, including grandfathering of some.<sup>29</sup> It permits FHCs to hold commercial investments for very long periods through its merchant banking provisions and, possibly, indefinitely in the form of complementary activities. While management of merchant banking investments on a day-to-day basis is not permitted, interlocking directorates could provide for strategic, if not tactical, decision-making by banking officials.

At a more general level, the GLB provides the bank regulatory agencies in the United States – particularly FRB and the OCC – with Congressional affirmation for the liberalization of banking powers they have managed over the last 15 years. It would seem to encourage further liberalization through regulatory agency interpretation.

Because the changes made by the GLB are minor, at least in the short run, there are few implications for changes in bank behaviour in the United States or in other countries. In the case of the latter, activity restrictions on US banks have, under the BHCA Amendments of 1970, been considerably less severe. It is conceivable that larger, more diversified, financial organizations may behave differently, both in the United States and abroad, as a result of changes in efficiency and/or competition. A more careful examination of changes in Citigroup behaviour after the 1998 combination could be revealing.

What the GLB has not done merits consideration as areas for future legislative deliberations. In facilitating the growth of larger organizations, Congress has done little to deal with the problems associated with the tacit policy of “too-big-to-fail” (TBTF). The law does prohibit the FDIC from assisting non-banking affiliates and subsidiaries of banks. Further, it requires as a condition for engaging in expanded activities through FHCs and financial subsidiaries that the largest 100 banks issue subordinated debentures to create a class of creditors with a strong incentive to monitor and constrain excessively risky activities (it mandates a Treasury-Federal Reserve study on the use of subordinated debt for this purpose). In support of small borrowers, the GLB provides smaller banks (institutions with less than \$500 million in assets) long-term advances, collateralized by loans to small businesses, small farms and small agri-businesses, from Federal Home Loan Banks. This provision simultaneously provides support for smaller banks whose funding costs are likely to be higher than larger banks perceived by the market as TBTF. The quantitative significance of

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<sup>28</sup> Alan Greenspan, Statement before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Banking and Financial Services, United States House of Representatives, 13 February 1997.

<sup>29</sup> For example: (i) insurance companies and securities firms with commercial affiliates prior to 30 September 1999 are permitted to keep them as long as they account for less than 15 per cent of the revenue of the FHC; (ii) unitary thrift holding companies that existed on or before 4 May 1999, or that subsequently came into existence as the result of an application that had been pending before the OTS as of that date, are grandfathered and not subject to GLB activity restrictions; (iii) it provides for a 15-year divestiture period for non-financial holdings of new BHCs.

these measures in offsetting the likely “cost-of-funds” advantage of the largest banking organizations is uncertain.

The law does not address potential problems created by deposit insurance. While the capital regulation and prompt corrective action of the FDIC Improvement Act of 1991 did address moral hazard problems, the changes it undertook have yet to be tested in a period of recession and high rates of bank failure. The importance of the deposit insurance \$100,000 limit established twenty years ago has been eroded by inflation. But the Federal obligation, and its implications, may require further reform.

The law does not address the problems of multiple agencies with overlapping responsibilities, long a subject of Congressional deliberations. The addition of functional regulators to the mix creates an extended regulatory system that requires extensive cooperation among a larger number of independent agencies, and is likely to intensify the need for rationalization.

Finally, the law does not permit an integration of banking and commerce of the type that has long existed in many continental European countries. At this point, it is difficult to imagine Congress sanctioning extended activities within banks themselves. But future legislation, expanding commercial opportunities for financial holding companies and financial subsidiaries, perhaps in confirmation of future regulatory modifications, seems quite possible.

If, over the longer run, the GLB permits extensive integration of commercial and financial activities, its implications for the operations of US banks abroad may be greater. A continued merger movement is likely to result in a relatively small group of very large, globally extended, financial/commercial conglomerates. The implications of such developments merit study.

#### **IV. CONCLUSIONS**

The GLB moves financial institutions in the United States towards financial arrangements that have characterized such institutions elsewhere in the world. But it does not write on a clean slate. It adapts a system that has included distinctive financial institutions that developed independently and have been separated from one another by law and regulation.

One effect of the new law is that US banking organizations will have greater opportunity to grow larger. In extending, rather than reformulating, existing regulatory arrangements, and adding new functional regulators to the existing group of agencies, the problems resulting from overlaps in regulatory responsibility and authority are likely to be compounded. In historically characteristic fashion, Congress has made an effort to maintain a separation of banking and commerce. The GLB does not permit the creation of universal banks in the manner of German and other continental European banks, where all financial and non-financial businesses can be conducted within the bank itself.

The difficulty of maintaining the traditional American separation is reflected in the complex standards and regulations under the GLB with regard to merchant banking and complementary activities. If the past is any guide to the future, whatever line is now drawn between commerce and banking will erode in the coming years.

It seems unlikely that the new law will alter US bank behaviour and performance very much in the United States or in other countries in the immediate future. However, the GLB opens avenues for more significant changes in the longer run.

## **Appendix A**

### **RELATED LEGISLATIVE AND REGULATORY PROVISIONS**

The GLB invokes a number of concepts deriving from related legislative and regulatory provisions in permitting affiliations through FHCs and financial subsidiaries. A number of these are briefly reviewed below.

#### ***Well capitalized***

Minimum risk-adjusted capital requirements were established through international agreement (Basle Agreement) in 1988. The FDIC Improvement Act of 1991 (FDICIA) established several capital categories for purposes of “prompt corrective action”. These were: (i) well capitalized; (ii) adequately capitalized; (iii) undercapitalized; (iv) significantly undercapitalized; and (v) critically undercapitalized. The categories constituted thresholds intended to trigger specific supervisory interventions. The “prompt corrective action” approach is in contrast to the previous approach that Congress believed entailed excessive supervisory discretion. The specific interventions range from the requirement that an undercapitalized bank file a capital restoration plan to placing a critically undercapitalized bank in receivership.

A well-capitalized bank is defined as a bank with at least a 10 per cent ratio of total capital-to-risk-based assets, at least a 6 per cent ratio of tier-1 capital-to-risk-based assets, and at least a 5 per cent leverage ratio of capital to assets; and is not subject to any written agreement, order or directive.

Tier-1 capital is intended to represent the most stable and readily available form of capital for supporting banks’ operations. The principal components of tier-1 capital are common equity, non-cumulative perpetual preferred stock and surplus, and minority interest in equity accounts of consolidated subsidiaries. Goodwill and certain other intangible assets are deducted from tier-1 capital.

In the last half of 1998, over 98 per cent of insured depository institutions in the United States were “well capitalized”. It is likely that roughly the same proportion would be “well capitalized” currently.

#### ***Well managed***

Federal bank supervisors review five characteristics of a bank’s operations and conditions: capital adequacy, asset quality, management and administrative ability, earnings level, and quality and liquidity level; these are summarized by the acronym CAMEL. Banks are rated from 1 (the strongest) to 5 (the weakest) on each of these characteristics. Management ratings are based on managerial knowledge and experience, quality of internal policies and controls, and adherence to regulations. A “well-managed” bank is one that is rated 1 or 2.

### ***CRA ratings***

The Federal banking agencies conduct examinations of depository institutions for which they have primary supervisory responsibility for compliance with the requirements of the Community Reinvestment Act of 1977. Under the Act, depository institutions are required to make an “affirmative effort” to meet the credit needs of low- and middle-income customers in their communities. Each institution defines the local “community” it serves. CRA ratings include “outstanding”, “satisfactory”, “needs to improve” and “substantial non-compliance”. Ratings are made public by the several banking agencies. For example, a recent OCC release of CRA evaluations for 52 national banks found seven were “outstanding”, 43 were “satisfactory”, two were “needs to improve”, and none was “substantial non-compliance”.

### ***Inter-affiliate transactions***

Section 23A of the Federal Reserve Act, originally added as part of the Banking Act of 1933, and Section 23B, of more recent origin, limit inter-affiliate transactions involving depository institutions.

For an insured bank, credit extensions, advances, purchases of assets or investments in a single affiliate, guarantees issued on behalf of an affiliate, and acceptance of the affiliate’s securities as loan collateral is limited to 10 per cent of the bank’s equity capital accounts. The total of such credit extensions to all affiliates is limited to 20 per cent. Each credit extension must be secured by collateral having a market value equal to at least 100 per cent of the extension. In general, these restrictions do not apply to transactions among subsidiary banks of a holding company (Section 23A).

Any transactions between an insured bank and its affiliates must be on terms and under circumstances that are at least as favourable to the bank as comparable transactions with non-affiliated entities, i.e. on an arms-length basis (Section 23B).

### ***Tying agreements***

When Congress permitted BHCs to expand into new activities by amending the BHCA in 1970, it also tailored prohibitions in Section 106 against tying, reciprocal, and exclusive dealing agreements. Section 106 of the BHCA imposes tying restrictions that are, in general, considered to be more restrictive than those imposed by the antitrust laws. They are applicable to depository institutions and their affiliates. Section 106 is amended by the GLB to make them applicable to financial subsidiaries of national banks.

Under Section 106, BHCs and their subsidiaries have been prohibited from extending credit, leasing or selling property, furnishing services or fixing the consideration for such on the condition or requirement:

- (i) That the customer obtain some additional credit, property or service from the bank, the bank holding company or any of its subsidiaries, i.e. a tying agreement. There is an explicit exemption

applicable to banks – but not BHCs or their other affiliates – for loans, discounts, deposits or trust services (“traditional banking services”);

(ii) That the customer provide some additional credit, property or service to the bank, the bank holding company or any of its subsidiaries, i.e. a reciprocal agreement. There is an explicit exemption applicable to banks – but not BHCs or their affiliates – for loans, discounts, deposits or trust services “usually provided”;

(iii) That the customer shall not obtain some additional property, credit or service from a competitor of the bank, the bank holding company or any of its subsidiaries, i.e. an exclusive dealing agreement. There is an explicit exemption for reasonable restrictions to insure the soundness of the credit extended.

In addition to the exemptions indicated, FRB has authority to permit exemptions “as it considers will not be contrary to the purposes of the Section”. The Justice Department is also authorized to enforce the prohibitions by entering suit. Private parties are authorized to sue, if injured, for treble damages. Neither the statute nor its exemptions prevent proceedings under the antitrust laws.



## Appendix B

### NOTES ON COMPARATIVE REGULATORY STRUCTURES

Banking in the United States has been characterized by laws and regulations that have differentiated it from many other countries in the world.<sup>30</sup> These have defined “banking” by restricting activities of banks on the one hand, and “banking” activities of non-banking firms on the other. Until passage of the GLB, a legal and regulatory barrier, attenuated as it had become, existed between banking, securities and insurance firms.

Even with passage of the GLB, there continues to exist in the United States a barrier between banking and commercial firms, i.e. legal and regulatory restrictions have established a separation of banking and commerce.<sup>31</sup> While the future of this separation is uncertain, technological innovation has, in recent years, given non-banking firms, including computer and software companies, the capacity to offer many traditional banking products. While these developments may suggest to some that the combination of banking and commerce in the United States has become economically feasible and profitable, it is likely that it has always been so. Foreign financial companies, affiliated with commercial firms, have long competed in the United States; and affiliates and subsidiaries of US banking organizations abroad, restricted only by the laws of the countries in which they operate, have found commercial activities profitable for some time.

The extent of banking powers permitted in various countries lies along a broad spectrum. In concept, it is possible to classify countries – or at least to group them – from most restricted to least. In practice, however, groupings based on written law and regulation are unlikely to capture informal behaviour manifest in subtle rules, preferred corporate organizational form, moral suasion and tradition. Banking practice in the United Kingdom is more restricted than law and regulation suggest, while in Germany and Japan it is less restricted than law and regulation suggest. Recent formal classification places Germany with those countries affording banks “wide”, but not “very wide powers”; and Japan with those, including the United States, in which powers are restricted.<sup>32</sup> In both cases, the laws and regulations that dictate these classifications are less than meet the eye.

It appears that the historical and continuing differences among countries reflect unique institutional imperatives; and that governments have played a profound role in determining the nature and extent of

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<sup>30</sup> For a more extensive cross-country comparison, including brief histories of the development of differential legal and regulatory structures in several countries, see Shull (1999: 3–20).

<sup>31</sup> Any dividing line between commercial banks and other firms (“commercial firms”) is invariably hazy, though such lines have been repeatedly drawn in banking legislation in the United States. “Commercial banks” may be defined today to include firms offering transactions deposits and generally engaged in “the business of banking”, as defined by law. This “business” has changed over the years in terms of types of loans, deposits and related activities. Banks remain distinguishable, however, from other financial institutions and also from the businesses of manufacturing, distribution, agriculture, communications, transportation and the other activities that compose the “commercial sector”.

<sup>32</sup> See, for example, James et al. (1997, table 5); see also IIB (1995: 12).

restrictions, even though law and regulation do not necessarily provide a realistic picture. In countries like England, first law, and then tradition, dictated a separation of banking from commercial firms. In the United States, an heir of the English tradition, legislatures imposed restrictions early in the country's history, and then formally re-established them from time to time, as required by market changes and innovations over the years. In the United Kingdom and the United States, relatively free capital markets developed to provide the financial resources for industrialization. Capital market developments were associated with a rising mercantile class; government played a limited role. In Germany and Japan, on the other hand, relationships between banks and commercial firms have been intimate from the origin of modern banking in those countries in the last half of the nineteenth century. Germany and Japan were latecomers to industrialization, and their governments adopted policies to "catch up". Private banking organizations provided a substitute for capital markets, and a tool for what is currently called "industrial policy".

Bank powers and activities in developed countries now appear to be converging. For the European Union (EU), the Second Banking directive contains a broad list of securities and commercial banking activities that EU "credit institutions" (firms engaged in deposit-taking and lending) may conduct. Insurance and real estate activities are determined by home country and host country consent based on suitability of the shareholders. In general, however, the universal banking model has been adopted, with bank investments in industrial firms and industrial firm investment in banks permitted with some restrictions (IIB, 1995:10; Barth et al., 1997, table 4). The EU approach has been reflected in changes elsewhere. For example, in Canada banks now offer security and insurance and real estate activities through wholly owned bank subsidiaries. They are permitted up to a 10 per cent interest in industrial firms, with aggregate shareholdings not to exceed 70 per cent of bank capital. Industrial firms are permitted to hold up to a 10 per cent interest in banks (IIB, 1995: 8).

While the separation of banking from commercial firms in the United States continues to be maintained by law and regulation, the GLB does, as noted, open some pathways towards more extensive integration. At the moment this separation continues to differentiate banking in the United States from most of the rest of the world.

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