

The Business of Banking: Before and After Gramm-Leach-Bliley

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I. INTRODUCTION	691
II. BUSINESS OF BANKING: THE ONCE AND FUTURE BANKING INDUSTRY	695
A. <i>The Current Theory of Banking</i>	695
B. <i>A Modification of the Current Theory: Banks as Insurers</i>	697
1. <i>Bank Capital Structure</i>	699
2. <i>Deposit Insurance</i>	699
3. <i>Banks, Narrow Banks, and Mutual Funds</i>	701
a. <i>Money Market Mutual Funds Versus Bank Checking Accounts</i>	701
b. <i>Why Banks Make Loans with Depositors' Funds</i>	703
c. <i>Banks' Unique Role in the Economy</i>	707
III. GRAMM-LEACH-BLILEY ACT: BANKS VERSUS FINANCIAL HOLDING COMPANIES	709
A. <i>Functional Regulation</i>	710
B. <i>Privacy</i>	713
C. <i>The Demand for Financial Services Reform and the Repeal of Glass- Steagall</i>	715
IV. CONCLUSION	719

I. INTRODUCTION

The Gramm-Leach-Bliley Act¹ was enacted with enormous, indeed histrionic fanfare at the end of 1999. The fanfare seems misplaced because Gramm-Leach-Bliley is not a very important statute. Ostensibly, the most important feature of the new law was the repeal of the Depression-era Glass-Steagall Act,² which imposed a legal separation on the commercial and investment banking industries.³ However, over time, banks and investment banks had conspired with compliant regulators to punch giant holes in the statutory restrictions on combining commercial banking and investment banking. In other

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1. Pub. L. No. 106-102, Nov. 12, 1999, 113 Stat. 1338 (1999) (codified in scattered sections of 12, 15, 16, 18 U.S.C.A. (West Supp. 2000)).

2. The Glass-Steagall Act was the popular name for the Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.).

3. Jerry W. Markham, *Banking Regulation: Its History and Future*, 4 N.C. BANKING INST. 221, 236-37 (2000) (outlining the changes that were occurring in banking during the New Deal era).

words, the Glass-Steagall Act was already a dead letter when Gramm-Leach-Bliley was passed. All the Act did was to formalize the death. Glass-Steagall was dead before Gramm-Leach-Bliley because federal regulators, particularly the Federal Reserve Board and the Comptroller, had already eviscerated the "Maginot Line" between commercial and investment banking through liberal regulatory interpretations of the statute long before the Act was passed. Thus Congress, in passing the Act, merely gave formal recognition to the changes that had been taking place in the marketplace over the past twenty years.⁴ One need not look further than the Bankers Trust Company acquisition of Alex Brown, or the Travelers Insurance business combinations with both CitiBank and Salomon Brothers for proof of the fact that, in large part, the new law simply gave formal recognition to changes that had already occurred in the financial markets.

This Article will argue that the Gramm-Leach-Bliley Act was based on a premise about the business of banking that is fundamentally false. The articulated rationale for the passage of the Act was that technological developments had already occurred that eviscerated the traditional distinctions between these two activities. These technological innovations were making traditional commercial banking obsolete. Under this view, if the nation's commercial banks were to survive, they would have to move into new, more profitable areas like investment banking. As Laurence H. Meyer, a member of the Board of Governors of the Federal Reserve put it, "Part of the motivation for the [new] bill was to put US banking organizations in a more competitive position. To the extent that securities and banking are increasingly interconnected activities with power synergies, US banking organizations are better able to play in the global arena than they were before."⁵

In other words, the Gramm-Leach-Bliley Act was, at its core, ostensibly a bailout bill for the banking industry. The justification for the statute was that it was needed to rescue a commercial banking industry that was thought to be obsolete.⁶ Banks were thought to be in a "long downward spiral" caused by "deep structural problems" that threatened the existence of federally insured depository institutions and raised "the specter of ongoing deposit-insurance cases."⁷ The way to save the industry, the Act's proponents maintained, was to allow banks to merge with nonbanking financial firms. Such mergers would serve a variety of purposes. First, such mergers would be cheap substitutes for the costly bank failures that might occur if the industry were to collapse under the weight of its own desuetude. Second, mergers would make the United States financial services industry more competitive, particularly in international competitive markets. Finally, permitting financial services conglomerates to exist would assist the operation of the U.S. managerial labor markets by permitting highly skilled bankers to transfer their talents to other, more valuable activities such as investment banking or insurance.⁸

4. MAYER, BROWN & PLATT, THE FINANCIAL SERVICES REGULATORY REPORT, THE GRAMM-LEACH-BLILEY ACT (1999).

5. James Smalhout, *Winners and Losers of New Finance Law*, EUROMONEY, Dec. 1999, at 68, 68 (discussing the move to make the United States banking industry more competitive).

6. See JAMES R. BARTH ET AL., THE FUTURE OF AMERICAN BANKING 59 (1992).

7. *Id.*

8. See Jonathan R. Macey & Geoffrey P. Miller, *Bank Failures, Risk Monitoring and the Market for Bank Control*, 88 COLUM. L. REV. 1153, 1155 n.9 (1988) (arguing that the number of bank failures could

Alan Greenspan, the Chairman of the Federal Reserve Board was quite explicit about the fact that he was worried about the impending obsolescence of banks. Chairman Greenspan argued that “[p]ublic policy should be concerned with the decline in the importance of banking. . . . The issues are too important for the future growth of our economy and the welfare of our citizens.”⁹ William Isaac, a former chairman of the Federal Deposit Insurance Corporation and a lobbyist for the banking industry, articulated the dominant view when he remarked to a journalist that “[t]he banking industry is becoming irrelevant economically, and it’s almost irrelevant politically.”¹⁰ Prominent academics reflected the views of regulators and politicians, arguing that banks were becoming riskier and less profitable¹¹ and that bank lending was declining as a source of funding for corporations.¹²

This Article will argue that the obsolescence justification for Gramm-Leach-Bliley is wrong in a very interesting way: it fails to understand the economic nature of banking. This Article will articulate a theory of what banks do. This author contends that the business of banking, both in terms of deposit gathering and in terms of commercial lending, is fundamentally different from the business of investment banking. Further, this Article will argue that there will always be a need for the financial services provided by banks (although there will be dramatic changes in the intensity of this demand at different points in the business cycle).

On the deposit (liability) side of banks’ balance sheets, this Article will argue that banks provide depositors with an insurance function that neither money market mutual funds nor any other alleged bank substitute can replicate. Similarly, on the lending (asset) side of banks’ balance sheets, this Article will argue that banks develop unique, relational contracts with borrowers that are not duplicated when those borrowers raise debt and equity in the public capital markets rather than securing bank loans. That is why even large firms with access to the public debt and equity markets do not sever their bank loan relationships and replace banks as funding sources with public equity and debt.

In other words, important differences still exist between commercial banking and investment banking. Moreover, the services that banks provide are still in demand both by those clients who put money in banks (depositors) and by those clients who take money out of banks (borrowers). Banks are unique at least in the sense that commercial banking and investment banking are not perfect substitutes for one another.

I want to emphasize that my argument does not lead to the conclusion that the Gramm-Leach-Bliley Act was a bad idea. Rather, this Article simply argues that the standard justification for the statute is wrong. Banks are not on the verge of extinction now, and they were not on the verge of extinction before the Act was passed. In fact,

perhaps be decreased by changing the procedures that govern a shift in control of a bank) (citing A. Dale Tussing, *The Case for Bank Failure*, 10 J.L. & ECON. 129, 146 (1967)).

9. Kenneth H. Bacon, *The End of Banking as We Know It—Losing Ground: Banks’ Declining Role In Economy Worries Fed, May Hurt Firms*, WALL ST. J., July 9, 1993, at A1 (internal quotations omitted).

10. *Id.*

11. See, e.g., Gary Gorton & Richard Rosen, *Corporate Control, Portfolio Choice, and the Decline of Banking*, 50 J. FIN. 1377 (1995).

12. Frederick S. Cams, *A Two Window System for Banking Reform*, FDIC BANKING REV., June 1995, at fig. 1 (showing commercial and industrial bank lending as a percentage of Gross Domestic Product), <http://www.fdic.gov/bank/analytical/banking/1995sprgr/rbr01a01.html>.

ironically, the Gramm-Leach-Bliley Act was a good idea not because commercial banking is such a bad business to be in, but rather because commercial banking is such a good business to be in. Before the Gramm-Leach-Bliley Act was passed, regulators had construed the Glass-Steagall Act in such a way that commercial bank holding companies were being allowed to establish and acquire investment banking operations, but investment banking firms were not being allowed to acquire commercial banks.¹³ This anomaly would not have mattered very much if the business of commercial banking was not such a profitable and important business. But commercial banking is a profitable and important business and prior to passage of Gramm-Leach-Bliley, investment banks could justifiably claim that they were being discriminated against.¹⁴ Consistent with this argument, it is not surprising that the first merger approved under the Gramm-Leach-Bliley Act was the acquisition by a brokerage firm, Charles Schwab, of a commercial bank, U.S. Trust Corp.¹⁵

This Article will argue that combining commercial banking and investment banking was a good idea. However, the Gramm-Leach-Bliley Act does not permit these activities to be combined in the most efficient way. Under the Act, financial holding companies, which can own both banks and investment banks, will receive all of the economic benefits of the synergies and risk-reduction through diversification that comes from combining commercial banking and investment banking. But, as this Article will argue, there is a much greater public policy interest in promoting the success and stability of commercial banks than in insuring the success and stability of financial holding companies. Thus, the Gramm-Leach-Bliley Act should have permitted banks to acquire investment banking firms directly in order to permit the benefits of combining these two activities to flow to the bank itself, rather than to the shareholders of the financial services holding company that owns the bank.

Part II of this Article reviews the currently received and accepted wisdom about the economic nature of the business of banking.¹⁶ It shows the flaws in this approach and articulates a more coherent theory of the economic nature of banking.¹⁷ Part III of this Article examines the Gramm-Leach-Bliley Act and argues that the statute did not go far enough to liberalize the United States financial services industry.¹⁸ In particular, the Act

13. See, for example., *Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys.*, 900 F.2d 360 (D.C. Cir. 1990); *Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys.*, 847 F.2d 890 (D.C. Cir. 1988); *Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys.*, 839 F.2d 47 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059 (1988); *Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys.*, 807 F.2d 1052 (D.C. Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987); *Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys.*, 468 U.S. 137 (1984) for examples of decisions permitting commercial banks to establish and acquire investment banking operations. Section 21 of Glass-Steagall, by making it unlawful for firms that issue, sell, underwrite, or distribute securities to accept deposits, keeps investment banks out of commercial banking. 12 U.S.C. § 378 (1994).

14. See *Consumer Debt: Hearing Before the House Comm. on Banking and Financial Services*, 104th Cong. 109 (1997) (statement of Ricki Helfer, Chairman, Federal Deposit Insurance Corporation) (stating that commercial banks have been making record profits), available at <http://www.fdic.gov/news/speeches/archives/1996/sp12sept96b.html>.

15. R. Christian Bruce, *Fed. in First Deal Under New Bank Law, Clears Charles Schwab to Buy U.S. Trust*, 68 U.S. LAW WEEK (LEGAL NEWS) 2665, 2665-66 (2000).

16. See *infra* Part II.A.

17. See *infra* Part II.B.

18. See *infra* Part III.

should not merely have allowed financial activities to be combined within financial holding companies.¹⁹ It should have allowed such activities to be combined within commercial banks as well. A conclusion follows Part III.²⁰

II. THE BUSINESS OF BANKING: THE ONCE AND FUTURE BANKING INDUSTRY

A. The Current Theory of Banking

Banks are financial intermediaries that gather funds from depositors and lend them to borrowers, profiting from the spread between the net interest income earned from the repayment on the loans they make and the net interest costs on the deposits they gather. The dominant economic explanation for the persistence of banks is centered around transaction costs. The argument in favor of banks is that it is too costly for people who find themselves temporarily in possession of excess funds to identify and analyze borrowers worthy of entrusting with those funds. Banks economize on transaction costs for depositors in a number of ways.²¹ Banks can lower risk by pooling deposits and making a large number of loans. This allows banks to reduce risks by holding a diversified portfolio of loans, benefiting both depositors and borrowers. Depositors benefit because the consequences of a single loan default are minimized. Borrowers benefit because it is far cheaper for them to collect the funds they need from a single bank than to try to gather the funds from a widely dispersed group of small investors or savers.

In other words, a second economic benefit offered by banks is that they allow borrowers and depositors to exploit economies of scale in investing. Borrowers often borrow millions of dollars from banks. Few individual depositors have this much money to invest, and even fewer are willing to loan it to a single borrower in the form of a commercial loan. But, “[b]ecause financial intermediaries pool funds from numerous investors, they are able to participate in the market for these large scale investments.”²²

Banks also benefit depositors by specializing in identifying and monitoring good credit risks.²³ Banks have a comparative advantage over their depositors in identifying profitable uses for funds, and depositors entrust their savings to banks in order to gain access to this expertise.²⁴ This frees depositors to pursue other activities.

Finally, banks provide what have been called “transformation services” by converting *illiquid* investments into *liquid* investments.²⁵ The literature on transformation services starts with the basic insight that people generally would prefer to be able to cash

19. See *infra* Part III.C.

20. See *infra* Part IV.

21. See JONATHAN R. MACEY & GEOFFREY P. MILLER, *BANKING LAW & REGULATION* 44-45 (2d ed. 1997).

22. *Id.* at 45.

23. Douglas W. Diamond, *Financial Intermediation and Delegated Monitoring*, 51 *REV. ECON. STUD.* 393, 409-10 (1984) (developing a theory of financial intermediation based on minimizing the cost of producing information used to resolve incentive problems).

24. MACEY & MILLER, *supra* note 21, at 44.

25. Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 *J. POL. ECON.* 401, 403 (1983) (describing the economic function of banks in providing transformation services).

in their investments quickly in order to meet sudden demands for funds.²⁶ That is why liquid investments are more desirable than illiquid ones.²⁷ Illiquid investments typically offer greater returns than liquid investments, however, for two reasons. First, rational investors will demand to be compensated for the risks associated with the lack of liquidity itself. This is because all else equal, liquid investments are more valuable than illiquid investments. Second, illiquid investments promise higher returns because borrowers who have the use of investors' funds for a longer period of time have a longer "incubation period" within which to make the funds more valuable. A well-known feature of financial markets is that yield curves are positively sloped.²⁸ This means that investments with longer maturities have higher rates of return than investments with shorter maturities.²⁹ The generally positive slopes of yield curves support the idea that some investments with longer maturities are worth more than the same investments with shorter maturities. In other words, people who borrow from banks invest the proceeds of their loans in illiquid assets. These borrowers need to be able to negotiate loan agreements that deny lenders the right to call the loans at will because borrowers need to have sufficient time to utilize the money so as to maximize the total return. This is one of the principal reasons why there is a mismatch in the term structure of commercial banks' balance sheets. Banks offer deposits that are payable to depositors on demand because that is what the depositors want. Banks make loans that do not have to be repaid for several years because that is what borrowers want.

This analysis indicates, however, that banks are very fragile. Even banks with healthy balance sheets and no loss in the underlying value of their assets (loan portfolios) can be forced into bankruptcy. If all, or even many, of the depositors demand repayment of their funds simultaneously, banks cannot liquidate their assets in such a way as to satisfy the claims of all of its depositors. This is due to the fact that if large numbers of depositors demand repayment simultaneously, the bank will be forced to liquidate its loan portfolio in "fire sale" fashion. This means that assets will be sold at a time when their liquidation value is lower than their long-term value (this is what it means to hold an illiquid asset) and, of course, lower than the value of the claims by depositors seeking the return of their funds.³⁰

Under this view of banking, depositors face a collective action problem akin to a "prisoner's dilemma". Depositors will be better off individually if they could beat their fellow depositors to the bank and reclaim their deposits whenever there is the slightest bit of uncertainty about the value of a bank's assets. But depositors as a group would be

26. MACEY & MILLER, *supra* note 21, at 45.

27. *Id.*

28. A yield curve is the general term for a graph that measures yield to maturity of a particular issuer's securities on the vertical (*Y*) axis and length of time to maturity of those securities on the horizontal (*X*) axis. Yield curves often are drawn on the basis of data on the yields of U.S. treasury obligations because data about the yields of these securities is readily available due to the fact that these securities trade in very thick markets. CHARLES N. HENNING ET AL., *FINANCIAL MARKETS IN THE ECONOMY* 455-460 (4th ed. 1984).

29. *Id.* at 454-57. "[S]hort-term rates, in recent years, usually have been lower but sometimes higher than long-term rates—upward-sloping (yield) curves prevail during most periods of moderate growth and during periods of recession." *Id.* However, "flat and down-ward sloping curves, perhaps with humps, are usually observed during periods of vigorous economic expansion and near peaks of business activity," because during these periods, the central bank will push short term interest rates up. *Id.*

30. Diamond & Dybvig, *supra* note 25, at 402.

better off by not withdrawing funds unless necessary to meet their own needs for short-term liquidity because this would avoid a run on the bank and allow the bank time to collect the full value of their loans, enabling it, in turn, to repay to the depositors all of their funds. This collective action problem leads to destructive, me-first behavior among the depositor population. Regulation is necessary to prevent this from happening.

Under this view, banks are both dangerous and increasingly unnecessary. Banks are dangerous because the mismatch in the term structure of their balance sheets makes them inherently unstable regardless of their economic performance because of their susceptibility to bank loans. Banks are unnecessary because "technological changes . . . have permitted investors to make their own evaluations regarding credit and market risk, thereby allowing investors to lend directly to larger borrowers."³¹ Subsequently, institutions such as insurance companies, pension funds, and mutual funds compete directly with commercial banks on the asset side of the balance sheet by offering borrowers access to funds that they do not have to repay immediately. These firms compete with commercial banks on the liability side of the balance sheet by accepting excess cash from investors.³²

As trading markets have become more liquid, investors have been able to move money out of the commercial banking sector and into the stock market, largely through investments in mutual funds, with more confidence. In particular, open-end money market mutual funds (MMFs), which accept investments from customers and invest the funds in short-term, highly liquid securities, compete directly with banks. These funds not only allow investors to redeem their funds at any time, they also allow investors to make redemptions by writing checks to third parties drawn on their mutual fund accounts.

As Geoffrey Miller and the author have observed elsewhere, as various alternative avenues of financial intermediation develop, the relative importance of banks as financial intermediaries decline.³³ It is now apparent that this analysis is at least partially incorrect because it mistakenly assumes that these other sorts of financial intermediaries perform the same economic function as banks. This analysis fails to comprehend the unique and important economic role that banks play. While the economic function of banks may decline during certain periods in the business cycle, at other times banks will dominate the economic scene. In other words, contrary to current perceptions, the role of banks has not declined, at least not permanently.

B. Modification of the Current Theory: Banks as Insurers

Banks, of course, perform a role similar to that of mutual funds in two ways. First, they provide investors-depositors with immediate access to their cash on demand. Second, both banks and at least some mutual funds provide transaction services. That is, banks and MMFs allow investors-depositors to make transfers directly from their accounts to the accounts of third parties.

31. MACEY & MILLER, *supra* note 21, at 37-38 (citing Alan Greenspan, Remarks at the Federal Reserve Bank of Chicago Bank Structure Conference (May 6, 1993)).

32. Jonathan R. Macey & Geoffrey P. Miller, *America's Banking System: The Origins and Future of the Current Crisis*, 69 WASH. U. L.Q. 769, 772-74 (1991) (arguing that current bank regulation reform proposals will not help rescue banks from a cyclical decline in demand for commercial banking services).

33. Macey & Miller, *supra* note 32, at 772.

The difference between checking accounts and other investments, such as MMFs, is the characteristic of interdependence.³⁴ Bank depositors are interdependent in a way that no other sorts of investors are. When people invest money in MMFs, they are not concerned about the savings and consumption patterns of other investors. Because MMFs invest depositors' funds in assets that match the maturity and liquidity structure of their investors, such investors need not concern themselves with when or whether other investors are seeking access to their investments.

The same is not true for bank depositors. Because of the mismatch in the term structure of banks' assets and liabilities, the behavior of other depositors really does matter because it affects the ability of the bank to meet its creditors' claims as they come due in the ordinary course of business. If, for some reason, all or even many of the depositors in a particular bank want to obtain their funds at the same time, there will be a run on the bank and the bank will be forced into insolvency. This is true even if the bank is solvent in a balance-sheet sense, *i.e.*, in the sense that the present value of the bank's assets is greater than the present value of its liabilities. But these assets are illiquid and opaque, meaning that they cannot be sold or even evaluated easily by outside investors. For this reason, if a bank's assets have to be sold hurriedly, in a sort of "fire-sale" fashion, to meet the liquidity needs of outside investors, these assets cannot be sold at anything close to their fair market value.³⁵ This is why a run on a bank is such a fearful event.

Bank depositors are dependent upon one another. And significantly, bank depositors are dependent on each other in precisely the same way that people who buy standard insurance products such as life insurance are dependent on each other. If everyone who purchased a life insurance policy died immediately after making such a purchase, the life insurance company would be unable to remain in business. Life insurance companies depend on statistical averages derived from actuarial studies that predict mortality and morbidity rates for insured populations. Like all sorts of insurance companies, life insurance companies invest the funds they collect from people and businesses that buy insurance. The maturity structure of these investments coincides with the actuarial predictions about when the company will have to make payments on the policies they have written.

People who buy life insurance are interdependent because they depend on the mortality of the other people who are in the same risk pool as their insurance company. More precisely, in any risk pool, some people will be expected to pre-decease others within the same pool of insured individuals. It is well understood that those who die relatively late subsidize those who die relatively early. Those who have the misfortune to die early should be viewed as "winners" in the insurance lottery because the insurance company's payout to them is subsidized by the "losers" who remain alive to continue paying premiums and supporting the insurance company's investments.

34. See Raghuram G. Rajan, *Why Banks Have a Future: Toward a New Theory of Commercial Banking*, 9 J. APPLIED CORP. FIN. 114, 119 (1996) (arguing that it is economically efficient for commercial banks to take deposits on demand and make nonmarketable loans).

35. Cf. Daniel R. Fischel et al., *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 308-09 (1987) (noting the possibility that the liquidation value of bank's assets may fall short of the value of creditor-depositor's claims where bank depositors "panic" and attempt to withdraw their funds unexpectedly).

Exactly the same dynamic of interdependence works in the context of banking. In banking, making a demand deposit is like buying a life insurance contract. People are “buying” liquidity. Just as people who buy life insurance do not know when they are going to die, people who put money in checking accounts do not know when they are going to need liquidity. Some depositors find that they need liquidity very soon. Other depositors find that they do not need access to their funds as soon as they thought. Those depositors who require liquidity soon after making their deposits are subsidized by those depositors who find that they do not need as much liquidity as they had thought, just as those people with life insurance who die early are subsidized by those people who live a long time after buying their insurance policies.

Several important insights emerge from this analysis. This Article will focus on three. First, this analysis helps explain the strange capital structure of banks.³⁶ Second, this analysis helps explain why government-sponsored deposit insurance is a good idea.³⁷ Finally, and most importantly from the perspective of this Article, this analysis helps explain why MMFs, despite their similarity to banks, will never completely replace the traditional demand deposit.³⁸

1. Bank Capital Structure

The peculiar thing about banks is the existing mismatch in the nature and term structure of their assets and liabilities. By nature, bank assets are illiquid, composed principally of illiquid loans or other sorts of individualized contracts with particular borrowers. Banks profit by loaning money to individuals and firms that do not have access to the securities markets. With respect to term structure, banks’ assets are of longer duration and maturity than their liabilities because their liabilities come mostly in the form of cash deposits payable to depositors on demand, or, at best, relatively short-term certificates of deposit.

This mismatch is understandable if we view banks not as being similar to mutual funds, but to insurers. Banks keep only enough funds in short-term liquid form to meet the expected liquidity demands of depositors. They invest the rest of the money in higher yielding, longer term assets. Life insurance policies would cost considerably more if insurance companies kept all of their clients’ insurance premiums in near-cash assets rather than investing such premiums in higher yielding, longer term assets. Likewise, the checking accounts offered by banks would require substantially higher fees if banks kept all of their clients’ deposits in near-cash assets. While there is asymmetry in the term structure of banks’ assets and liabilities, there is also asymmetry between the term structure of bank assets and the expected term structure of bank liabilities.

2. Deposit Insurance

If the business of offering demand deposit and checking account services to clients is like the business of insurance, then it stands to reason that the banks that offer these services should face the same sorts of moral hazard and adverse selection problems that

36. *See infra* Part II.B.1.

37. *See infra* Part II.B.2.

38. *See infra* Part II.B.3.

plague insurance companies. Moral hazard is the concept that insurance can affect the behavior of the people and firms who are insured in ways that are costly to the insurer.³⁹ Moral hazard problems arise because the people and firms who have insured against certain events have, by definition, reduced the costs associated with the occurrence of those events. People with fire insurance have fewer incentives to take precautions against fires than people with no fire insurance. At the margin, even people with life insurance face moral hazard, as they have fewer incentives to reduce stress, avoid second-hand smoke, and engage in other behavior necessary to prolong their own lives.

In the context of banking, moral hazards produce sudden depositor demand for liquidity. If depositors did not hold their savings in liquid form, they would have stronger incentives to manage their expenditures carefully. In particular, depositors would have incentives to time their expenditures to coincide with the maturity structure of their assets.

Perhaps a more serious problem for banks is the challenge of adverse selection. Adverse selection is the problem that insurance companies have in trying to distinguish among their customers.⁴⁰ In the insurance context, adverse selection arises because an insurance company's most eager customer will be precisely the person that the company most wants to avoid having as customers, *i.e.*, the person who is most susceptible to the risks the insurance company insures against. All else being equal, people with fatal illnesses will have the highest demand for life insurance. This is adverse selection. Bad drivers will seek to have car insurance. Similarly, in the banking context, only people who are likely to have short-term liquidity needs will have checking accounts. Luckily for banks, everybody (or virtually everybody) has short-term liquidity needs. Even better for banks is the fact that people are risk-averse, so they tend to overestimate the amount of money they need to have in their checking accounts at any one time. If this were not the case, banks could not make money.

Exploring the checking account-as-insurance analogy more deeply, one sees that banks, like insurance companies, take various steps to reduce their adverse-selection problems by customizing their products to segregate their clientele. Life insurance companies control adverse selection by charging smokers higher rates and by requiring prospective clients to undergo medical examinations as a condition to obtaining insurance. Automobile insurers control adverse selection by segregating drivers with bad driving records into separate risk pools and charging them higher rates.

In this context, one can conceptualize the standard checking account as pooling a group of high-risk insurance clients. Certificates of deposit are the money market instrument banks offer to deal with adverse selection. Clients unlikely to withdraw their funds immediately obtain benefits by sorting themselves into the separate risk pools represented by certificates of deposit, which offer higher rates of return in exchange for the depositor's promise to permit the bank to maintain control of her funds for a specified length of time.

Minimum balance requirements and higher rates of return (or lower fees for customers who maintain a certain minimum balance) also serve to control the adverse selection problem facing banks. These requirements increase the amount of money that

39. Diamond & Dybvig, *supra* note 25, at 417.

40. See Rajan, *supra* note 34, at 116.

depositors keep on deposit at any particular time. The larger the amount that one has on deposit, the lower the probability that she will need all of her money at any particular time.

3. *Banks, Narrow Banks, and Mutual Funds*

The previous section argues that, in essence, the business of offering checking accounts has the same essential economic features as the business of insurance. Specifically, both of these businesses work because of client interdependence and the ability to make accurate statistical inferences about the future behavior of their customers. Banks use statistical inferences to allow them to make intelligent gambles that all of their customers will not simultaneously demand the return of their funds. Similarly, insurance companies use statistical techniques to allow them to make intelligent inferences about the probable timing of claims for insurance compensation.

Viewing the market for bank deposits as a form of insurance market leads to a number of important practical insights. First, this analysis explains why MMFs will never be complete substitutes for bank checking accounts. Second, the analysis explains the appearance of banks' balance sheets. Finally, the analysis enables better understanding of the nature of certain bank regulations.

a. *Money Market Funds Versus Bank Checking Accounts*

Money market mutual funds differ from banks and thus will not replace bank checking accounts. People put money into checking accounts and MMFs because their demand for cash is uncertain. People simply do not know how much cash they will need and when they will need it. MMFs solve this problem by investing in highly liquid money market instruments characterized by low credit risk and low interest rates.⁴¹ By matching the term structure of their assets with the term structure of their liabilities, MMFs can credibly promise their investors that their money will be there for them when they need it. The problem with this strategy is that it is wasteful. In fact, all depositors will not need to have access to their funds simultaneously on short notice. Statistical inference allows banks to predict with great accuracy what depositors' demands for liquidity will be for MMFs. This allows a bank to invest that portion of a depositor's money that will not be needed for a depositor's short-term liquidity needs in illiquid assets that offer higher rates of return. By contrast, because mutual funds erroneously assume that all depositors will want their funds simultaneously, mutual funds are quite limited in how they can invest their clients' money. Therefore, mutual funds are imperfect substitutes for banks, suggesting that a market niche for banks is likely to remain. Those mutual funds that invest money in high-yielding investments cannot promise investors that all of their principal will be returned. This makes non-money-market mutual funds poor substitutes for checking accounts because investors who need liquidity must be able to know with certainty how much money they will have available at any particular time.

41. Gary Gorton & George Pennacchi, *Money Market Mutual Funds and Finance Companies: Are They the Banks of the Future?*, in *STRUCTURAL CHANGE IN BANKING* 180 (Michael Klausner & Lawrence White, eds., 1993) (evaluating whether alternatives to banks are subject to the same information externalities that have caused panics for United States commercial banks).

MMFs solve this problem by stabilizing the price of their share,⁴² usually at a value of \$1.00. Once this price is fixed, mutual funds strive mightily to make sure that the value of their investments does not decline so as to drive the price per share below \$1.00 (when the price of a mutual fund share declines below \$1.00, the event is called "breaking a dollar").⁴³ The Investment Company Act of 1940,⁴⁴ which regulates mutual funds, permits investors in MMFs to choose whether to fix their share values at a particular level (such as \$1.00) or else to "market-to-market," that is, to adjust the price of their shares each day to reflect changes in the market values of the underlying assets.⁴⁵ When MMFs fix their share prices, they cope with changes in the underlying value of fund assets by adjusting the number of shares owned by each MMF investor, rather than by adjusting the value of each share. It is the ability of MMFs to fix their share prices at \$1.00 that allows them to compete with bank checking accounts.⁴⁶

The point here is that both banks and MMFs compete for a depositor's short-term funds. Banks have one significant advantage over MMFs: They invest a depositor's money in longer-term, higher yielding assets. This allows banks to successfully compete against MMFs for customers.

However, it does not appear that MMFs compete with banks on the basis of price. The interest rates offered customers on MMF accounts and on checking accounts appear to be quite similar.⁴⁷ It seems clear that commercial banks out-compete mutual funds on the vector of customer convenience.⁴⁸ Moreover, many money market funds have only limited checking privileges, allowing checks to be drawn only for limited amounts such as \$250 or \$500 per check. Banks, of course, generally allow customers to write checks

42. See Money Market Funds, 17 C.F.R. § 270.2a-7 (2000). This rule was designed to reduce the volatility of MMFs by restricting the types of securities that they can hold.

43. Revisions to Rules Regulating Money Market Funds, 56 Fed. Reg. 8113, 8115 n.9 (Feb. 27, 1991) (to be codified at 17 C.F.R. pts. 230, 239, 270, 274). Sometimes the event is called "breaking the buck." Henry Dubroff, *Mutual Fund's Failure Teaches a Lesson*, DENV. BUS. J., Jan. 18, 1999, at 1.

44. 15 U.S.C. §§ 80a-1 to -64 (1994).

45. Gorton & Pennacchi, *supra* note 41, at 181.

46. *Id.*:

Relative to other mutual funds whose share price is permitted to fluctuate, a money market mutual fund's fixed share price makes redemption of its shares more convenient and allows the account to resemble a bank demand deposit account. This convenience comes from two sources. First, since a shareholder will usually realize no capital gain or loss when selling shares, the need for tax-related record keeping is reduced. Second, as long as a MMF can maintain a fixed price, a shareholder will be certain of her account's minimum balance, since rates of return will always be non-negative.

47. Richard Pozen, *Comment on Gorton and Pennacchi*, in STRUCTURAL CHANGE IN BANKING 223-24 (Michael Klausner & Laurence White eds., 1993) (evaluating the substitutability of money market funds for bank deposit accounts).

48. *Id.* at 224:

If we look at convenience of withdrawing cash, bank deposits have a significant advantage over MMFs. Banks allow cash withdrawals, not only at a multitude of branches but also through a broad array of ATMs [automated teller machines]. By contrast, most MMFs do not permit cash withdrawals even at investor centers. Investors typically receive a check from the MMF that must be cashed at a bank. While a few MMFs have allowed ATM access, the fees for ATM access to MMFs typically have been higher than those for ATM access to bank deposits.

for any amount, no matter how small, and usually do not charge fees for checks or account fees to customers who maintain the minimum balances described above.⁴⁹

b. Why Banks Make Loans with Depositors' Funds

The above discussion has focused primarily on the liability side of banks' balance sheets. As noted above, the fact that banks perform an insurance function regarding depositors' funds allows banks to use depositors' funds to make longer term investments than MMFs are able to make. There are many long-term investments that banks could make instead of loans. However, banks choose to make loans.

The reason that banks make loans rather than purchasing long-term securities or pursuing other investment strategies is because banks have a comparative advantage over other firms in making loans. Banks enjoy this advantage for two reasons. First, banks play an important economic role in signaling the financial markets with information about the firms to which they loan money. Just as insurance companies face moral hazard problems, banks that lend money to businesses also must confront a variety of moral hazard and adverse selection problems. Adverse selection problems exist because all borrowers—including unstable, high-risk, or untrustworthy borrowers—attempt to masquerade as being stable, low risk, and trustworthy. The adverse selection problem is generated from the fact that it is often difficult to distinguish among the various categories of borrowers.

Moral hazard problems exist in lending relationships because borrowers have incentives to increase the riskiness of their activities after they receive loans. Borrowers can transfer wealth to themselves from fixed claimants like banks by increasing the riskiness of their activities after they have received loans.⁵⁰ Conceptually, borrowers can accomplish this wealth transfer from fixed claimants by engaging in riskier activities because borrowers are residual claimants, while banks and other lenders are fixed claimants.⁵¹ This means that the borrowers get to keep all of the upside gains when investments perform better than expected, but are able to share the downside risks associated with the investment with the lenders. From a lender's perspective, no matter how profitable the borrowers' risky activities ultimately are, the lenders' return is no greater than the contract amount. This is because lenders' claims are fixed. On the other hand, the banks stand to lose if risky investments turn out badly and borrowers cannot repay their loans.⁵² The following example illustrates the problem of moral hazard and the conflict that exists between fixed-claimant lenders such as banks and the residual claimants (owners) who borrow from them.

49. *Id.* at 225. One reason why MMFs discourage check writing more than banks do is that MMFs do not have direct access to the Federal Reserve payment system. However, it appears that "the costs of direct access to that system would probably not be worth the benefits for most MMFs." *Id.* This is largely due to the fact that MMFs are pass-through vehicles that lack the ability to accumulate equity of their own, since earnings in the form of distributions and capital appreciation are immediately passed along to the funds' customers. By contrast, the Federal Reserve requires banks to maintain substantial amounts of equity to guarantee that the clearing function will not be impaired. *Id.*; see also Gorton & Pennacchi, *supra* note 41, at 189-94.

50. Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 STAN. L. REV. 73, 77-81 (1995).

51. *Id.*

52. *Id.*

Suppose that a bank makes a loan to a borrower with a single investment. The term of the loan is tied to the expected cash flows generated by the investment. These cash flows will manifest themselves in the form of a lump-sum payout at the end of one year, which is when the principal and interest on the loan come due. Assume further that a total of \$500 in principal and interest on the loan will be due at the end of the year. Finally, assume that the bank makes the loan on the premise that the borrower's investment has the following risk-return characteristics: (a) a ninety-percent probability that the investor will receive \$1000; (b) a five-percent chance of experiencing a complete default and generating no returns to investors, including the bank; and (c) a five-percent chance that the investor will receive \$2000. As the following table shows, this investment will have an expected return of \$1000.

Investment #1

Probability:	Outcome:	Expected Value:
.05	\$0	\$0
.90	\$1000	\$900
<u>.05</u>	\$2000	<u>\$100</u>
1.0		Expected Return: \$1000

Now, suppose that after the bank makes the loan, the borrower, unbeknownst to the bank, shifts its activities from Investment #1 to another, riskier investment, Investment #2. Investment #2, like Investment #1, has an expected return of \$1000, but unlike Investment #1, has the following risk-return characteristics: (a) a sixty-percent chance of returning \$1000 to investors; (b) a twenty-percent chance of experiencing a complete default and generating no returns to investors, including the bank; and (c) a twenty-percent chance of returning \$2000 to investors.

Investment #2

Probability:	Outcome:	Expected Value:
.20	\$0	\$0
.60	\$1000	\$600
<u>.20</u>	\$2000	<u>\$400</u>
1.0		Expected Return: \$1000

Even though the expected return of these two investments is the same (\$1000), the risks associated with the two investments are quite different. Investment #2 is riskier than Investment #1 because there is a twenty-percent chance that Investment #2 will return

nothing to investors, while there is only a five-percent chance that Investment #1 will return nothing to investors. In technical terms, the variance and standard deviation of Investment #2 are substantially greater than Investment #1 because the probability of deviating from the expected return is significantly greater.

The danger that the borrower will shift from Investment #1 to Investment #2 after it has received its bank loan is a moral hazard. By shifting from Investment #1 to Investment #2 after receiving a fixed claim, such as a loan, the owners of the borrower's business as residual claimants will be able to transfer wealth to themselves from the lender. The gains to the owners of the business, from shifting to Investment #2, come from the fact that Investment #2 has a greater upside than Investment #1.⁵³ As residual claimants, the owners of the business get to keep everything that is left over after the residual claimants have been paid. This means that all of the gains associated with the greater upside potential of Investment #2 are enjoyed by the residual claimant owners, while the losses associated with the downside risks are shared with the bank.

One can observe more precisely the moral hazard associated with lending by disaggregating the expected returns associated with these investments into the expected returns to the residual claimant owners and the expected returns to the fixed claimant banks.⁵⁴ In Investment #1, the expected return to the banks is \$475, while the expected return to banks associated with Investment #2 is only \$400. This is because there is a ninety-five-percent chance that the banks will be repaid in full if the firm pursues Investment #1, while there is only an eighty-percent chance that the banks will be repaid in full if the firm pursues Investment #2. Thus, Investment #1 is unambiguously better for the banks. However, Investment #2 is unambiguously better from the perspective of the equity claimant borrowers. Investment #2 has an expected return to equity claimants of \$600, while the expected return of Investment #1 is only \$525.⁵⁵ It is easy to overlook the fact that the moral hazard problem described above plagues both borrowers as well as lenders. Lenders are concerned about moral hazard for the obvious reason that moral hazard increases the riskiness of the loans they have made. Borrowers are concerned about moral hazard because it increases the costs of obtaining funds. Lenders who are concerned about moral hazard will charge higher rates of interest and impose all sorts of costly restrictions on borrowers' activities in order to alleviate these concerns. If a

53. The greater upside potential is due to the fact that there is a 20% chance that Investment #2 will return the highest possible payout of \$2,000, while there is only a 5% chance that Investment #1 will generate the \$2,000 payout.

54. See ROBERT C. MERTON, *FINANCIAL INNOVATION AND THE MANAGEMENT AND REGULATION OF FINANCIAL INSTITUTIONS*, 10-15 (Div. of Research, Harv. Bus. Sch., Working Paper No. 95-018, 1994).

55. The \$525 expected return to owners associated with Investment #1 results from the fact that there is a 5% chance that the owners will receive zero return, a 90% chance that the owners will receive \$500, and a 5% chance that the owners will receive \$1500. There is a 90% chance that Investment #1 will return \$1000. If this happens, the bank, as a fixed claimant, must be paid before returns can be paid to the residual claimant owners. Thus, with Investment #1, there is a 90% chance that the owners will receive \$500 because if the investment generates \$1000 in cash flows for investors, the bank will receive the first \$500 and the residual claimants will receive the second \$500. Similarly, if Investment #1 produces a return of \$2000, the bank will be repaid the \$500 due to it first, and the residual claimants then will be able to claim the remaining \$1500. Thus, the \$525 in expected returns can be accounted for by $[(\$1000 - \$500) \times .9] + [(\$2000 - \$500) \times .05] = \$525$. Similarly, with respect to Investment #2, which has a 60% chance of returning \$1000 and a 20% chance of returning \$2000, the expected return to owners is $[(\$1000 - \$500) \times .6] + [(\$2000 - \$500) \times .2] = \$600$.

borrower is so untrustworthy that she is not able to make a credible commitment to prospective lenders that she will control her risk-taking proclivities, she will be unable to obtain credit.

The same holds true for firms that have the misfortune of being located in undeveloped legal jurisdictions where it is not possible for borrowers and lenders to make legally enforceable commitments to each other. The moral hazard facing banks and borrowers described above is pervasive. All firms have both fixed claimants and equity claimants. Any time a firm borrows, its lenders face the moral hazard described above, which manifests itself in the form of borrowers shifting their investment strategy *ex post* (i.e., after the loan has been made at fixed terms) to riskier investments that have a higher upside potential from the standpoint of the residual claimant owners. Because the equity claimants elect the boards of directors of the borrowers, there is always the risk that the equity claimants will use their control to install a management team that will pursue high-risk strategies that transfer wealth from the fixed-claimant banks to the residual-claimant owners.⁵⁶

One way that firms deal with the problem of moral hazard is by contract, both explicit and implicit.⁵⁷ Explicit contracts permit lenders to mitigate the problem of moral hazard by forbidding changes in management without the lenders' permission, forbidding dividend payments and other distributions unless certain earnings targets are achieved, and by restricting the sorts of investments that borrowers can make.⁵⁸ In addition, lenders frequently require borrowers to personally guarantee the repayment of loans to corporations that they control. Moral hazard declines when borrowers must return to the capital markets frequently for funds. Unless such borrowers can develop a reputation as a reliable credit risk, they will find the credit markets closed to them.

It is important to emphasize that many forms of moral hazard are difficult to control because they are difficult to detect. This is because borrowers know their businesses better than anyone else and can make their businesses riskier in ways that are often extremely difficult to observe. For example, companies will better understand the risks that are associated with various product design changes. It is hard for lenders to make sure that borrowers do not choose the riskiest designs in order to transfer wealth to themselves from fixed-claimant lenders. Similarly, firms invest in research and development programs. Firms can choose between relatively low-risk, low-return research and development projects and relatively high-risk, high-return research and development projects. It is very difficult for lenders to distinguish among these various programs. For this reason, the most important way that prospective borrowers can make credible commitments to prospective lenders to not succumb to moral hazard is by agreeing to submit themselves to an intensive regime of close and on-going monitoring by the firms that have loaned them money.

56. See Fischel et al., *supra* note 35, at 337-38.

57. Clifford W. Smith & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 124-30 (1979) (examining how debt contracts can help to maximize shareholder and bondholder wealth).

58. See *generally id.* (discussing how dividend and financing policy restrictions are written in a manner that encourages stockholders to follow investment and production policies maximizing firm value).

c. Banks' Unique Role in the Economy

Banks are quite unique because they are the financial institutions that specialize in providing borrowers with the intensive scrutiny necessary to mitigate moral hazard. There are few, if any, competitors for this aspect of the constellation of services that banks provide. Banks, unlike other sorts of providers of capital, face few, if any, collective action problems when dealing with borrowers. This is because when banks make loans they either keep the loan on their balance sheet as an asset, thereby agreeing to internalize all of the costs and benefits associated with making the loan, or they sell all or a portion of the loan by securitizing it or by entering into a syndication agreement with other banks who help to underwrite the loan.

Even in cases where portions of a loan are removed from a bank's balance sheet, banks remain as delegated monitors of the other investors. This distinguishes the role played by banks from the role played by investment banks that underwrite securities. There are several sources of support for the proposition that banks remain as delegated monitors for the other investors in loan securitizations and syndications. First, banks are repeat players in these markets. Hence, if they attempt to trick or deceive their co-investors by offering poor quality loans, banks will suffer consequences in the form of lost future business.⁵⁹ Second, banks often make implicit commitments to repurchase loans when purchasers experience difficulties after the loans are sold. Finally, banks keep a significant portion of the loans they sell on their balance sheet, but it appears that the percentage they retain increases with the risk of the underlying borrower.⁶⁰

In contrast, when firms eschew banks and raise money by selling securities to the public, the individual investors who purchase these securities face significant collective action problems in the form of rational ignorance and free riding. Rational ignorance decries that it is inefficient for securities investors to spend more money to investigate and monitor the firms in which they have invested than the value of the benefits that they are likely to obtain from such investigation and monitoring. For this reason, unlike banks, it is irrational for investors who buy securities to engage in ongoing investigation and monitoring of the firms in which they have invested.

Similarly, free riding occurs because individual investors have disincentives to spend resources to research companies in which they have invested if they think that they can gain the benefits of such research at zero cost by relying on the efforts of others.⁶¹ Free riding and rational ignorance lead to a lack of monitoring of companies that raise money by selling securities rather than by taking out bank loans. For this reason, not all firms enjoy access to the securities markets. The only firms that will have recourse to the securities markets will be those that are so trustworthy that investors can purchase their securities knowing in advance that free riding and rational ignorance will prevent them, as well as other investors, from doing much in the way of monitoring management after the securities are issued.⁶² While the securities are being offered to the public, this

59. See Rajan, *supra* note 34, at 123.

60. See Gorton & Pennacchi, *supra* note 41, at 181.

61. Rajan, *supra* note 34, at 116.

62. The objective of the Securities Act of 1933 is to provide investors with material financial and other information concerning new issues of securities and to prohibit fraudulent sales of securities. RICHARD W. JENNINGS & HAROLD MARSH, JR., *SECURITIES REGULATION, CASES AND MATERIALS* 112 (8th ed. 1998).

scrutiny by investment bankers, market analysts, and sophisticated investors will reduce the adverse selection problems that investors face when they purchase securities. Such due diligence will not reduce the moral hazard that plagues investors later, after the public offering is complete.

Thus, new firms that have unproven track records or that are for other reasons unable to make credible assurances to investors will find that they are unable to raise funds, either equity or debt, by selling securities. These firms must rely on traditional bank financing to meet their credit needs. Banks specialize in providing ongoing, intensive monitoring and in intervening in the business of their clients in order to mitigate the excessive risk-taking proclivities of borrowers that constitute moral hazard.⁶³ Another reason that banks excel at acting as monitor (and delegated monitor) of risky borrowers is because of an "informational economy of scope between lending and checking, in particular [banks'] ability to process checking accounts."⁶⁴ The idea here is simple. When firms who borrow from banks also maintain checking accounts at the banks from whom they have borrowed, banks have access to a wealth of information about their lending clients. The information derived from these checking accounts makes it much easier for banks to monitor the firms to which they have loaned money.⁶⁵ Information from checking accounts allows banks to monitor cash flows in a variety of useful ways. Banks can keep track of their borrowers' sales by looking at the flow of deposits into their accounts.⁶⁶ Banks also can monitor where their borrowers are spending their money to determine whether suppliers are being paid on time and whether payrolls and inventory levels are remaining constant, rising, or falling.⁶⁷ In other words, bank lending to businesses gives banks a unique ability to monitor the firms to which they have made loans.⁶⁸

For all of these reasons, deregulation, advances in technology, and the rapid proliferation of capital markets will not result in the obsolescence of commercial banks. Furthermore, economies that lack strong commercial banking systems are likely to perform poorly, regardless of how strong their capital markets are. The following section of this Article examines the Gramm-Leach-Bliley Act from the perspective of the banking theory articulated here.

Lawyers, investment bankers, issuers, and accountants involved with public offerings must conduct due diligence to ensure that the information contained in the public documents distributed by companies issuing securities is accurate and not misleading. See generally *id.* at 111-13, 882-925.

63. See John H. Boyd & Edward C. Prescott, *Financial Intermediary-Coalitions*, 38 J. ECON. THEORY 211 (1986); Tim S. Campbell & William A. Kracaw, *Information Production, Market Signaling, and the Theory of Intermediation*, 35 J. FIN. 963 (1980) (discussing the resolution of moral hazard conflict in financial markets that arises when there is imperfect information); Douglas W. Diamond, *Financial Intermediation and Delegated Monitoring*, 51 REV. ECON. STUDIES 393 (1984) (outlining a theory of financial intermediation consisting of monitoring information useful for resolving incentive conflict between borrowers and lenders).

64. Leonard I. Nakamura, *Recent Research in Commercial Banking: Information and Lending*, 2 FIN. MARKETS INSTITUTIONS AND INSTRUMENTS 73, 73-74 (1993).

65. Leonard I. Nakamura, *Commercial Bank Information: Implications for the Structure of Banking*, in STRUCTURAL CHANGE IN BANKING 131, 131 (Michael Klausner & Lawrence White eds., 1993) (examining how banks use the information garnered from depositors' account activities).

66. *Id.*

67. *Id.* at 143.

68. Eugene F. Fama, *What's Different About Banks?*, 15 J. MONETARY ECON. 29, 35-38 (1985).

III. GRAMM-LEACH-BLILEY ACT: BANKS VERSUS FINANCIAL HOLDING COMPANIES

The Gramm-Leach-Bliley Act⁶⁹ was passed for the purpose of facilitating mergers and acquisitions and similar affiliations among banks, securities firms, and insurance companies by repealing the Glass-Steagall Act⁷⁰ and by amending the Bank Holding Company Act⁷¹ in order to permit business combinations among these types of entities. Gramm-Leach-Bliley also contains important provisions regarding the privacy rights of consumers of financial services.⁷² Finally, Gramm-Leach-Bliley reflects the core philosophy that financial institutions should be regulated on a functional basis.⁷³

The theory of banking developed in this Article provides important insights on all three of these aspects of Gramm-Leach-Bliley. First, regarding functional regulation, the Act is based on the core premise that financial products can be categorized and regulated as banking, insurance, or securities products.⁷⁴ Some have argued that this premise is obsolete because banking, insurance, and securities products are fundamentally indistinguishable.⁷⁵ The analysis in this Article shows that functional regulation can work because banking, insurance, and securities products are, in fact, distinct. Second, the privacy provisions of Gramm-Leach-Bliley will strengthen banks by making it somewhat more difficult for banks' competitors to obtain the information necessary to compete with banks as monitors of high-risk borrowers. Because lending is an information-intensive business, rules that make it more difficult for banks' competitors to obtain the information that banks receive automatically will make it more difficult for these other entities to compete with banks.

Finally, Gramm-Leach-Bliley repeals the Glass-Steagall Act and permits affiliations between banks and securities firms.⁷⁶ The Act also expands the scope of activities in which bank holding companies may engage pursuant to the Bank Holding Company Act.⁷⁷ This portion of Gramm-Leach-Bliley benefits investment-banking firms far more than it benefits banks. Prior to the passage of the Gramm-Leach-Bliley financial services reform, bank holding companies could move into investment banking by acquiring companies engaged in investment banking, as long as the companies acquired were not "engaged principally" in investment banking.⁷⁸

69. Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified in scattered sections of 12, 15, 16, 18 U.S.C.A. (West Supp. 2000)).

70. Banking Act of 1933, ch. 89, 48 Stat. 162 (codified in scattered sections of 12 U.S.C.).

71. 12 U.S.C. §§ 1841-1849 (1994 & Supp. IV 1998).

72. See MAYER, BROWN, & PLATT, *supra* note 4, at 1.

73. Markham, *supra* note 3, at 264.

74. See Bert Ely, *Functional Regulation Flunks: It Disregards Category Blurring*, AM. BANKER, Feb. 21, 1997, at 4.

75. *Id.*

76. Memorandum, Weil, Gotshal & Manges LLP, Financial Services Modernization Act 1 (Nov. 23, 1999) (on file with author).

77. *Id.* at 2.

78. *Id.* (stating that one must consider four factors in determining whether an activity is "financial in nature:" (1) purpose of Gramm-Leach-Bliley Act and the BHCA; (2) any foreseeable changes in the financial holding company's marketplace; (3) foreseeable changes in technology for delivering financial services; and (4) whether the activity is necessary for a financial holding company or its affiliates to effectively compete in the financial services industry).

In the debates surrounding Gramm-Leach-Bliley, a key issue was whether the new law should allow banks, as well as bank holding companies, to enter the securities business.⁷⁹ The forces for more radical liberalization were defeated. Significant restraints on bank securities activities remain.⁸⁰ The fact that these restrictions remain represents a major flaw in the new statute because these restrictions prevent the emergence of “universal banks” that can offer customers a diversified array of financial services products.⁸¹

A. Functional Regulation

One of the most important features of the new financial services legislation is a shift in the direction of the principle of “functional regulation” of financial institutions. Prior to passage of Gramm-Leach-Bliley, financial institutions were regulated along industry lines. Under this “entity approach,” the Comptroller of the Currency regulated national banks.⁸² The Federal Reserve regulated state banks that were members of the Federal Reserve System and regulated bank holding companies.⁸³ State regulators, along with the Federal Deposit Insurance Corporation (FDIC), regulated state banks that were not Federal Reserve members.⁸⁴ The Securities and Exchange Commission (SEC) and the National Association of Securities Dealers regulated broker-dealer firms.⁸⁵ State insurance commissioners regulated insurance companies.⁸⁶

Gramm-Leach-Bliley changed the way that regulatory authority is allocated among regulators. Prior to Gramm-Leach-Bliley, entity regulation generated a significant amount of competition among regulators. For example, before the financial services reform legislation was passed, state regulators regulated the insurance activities of stand-alone insurance companies. The Comptroller of the Currency regulated the insurance activities carried out by national banks. Regulations promulgated by restrictive state insurance regulators could be avoided by carrying out those activities within a national bank. This put heavy pressure on insurance regulators to refrain from being too restrictive.

Under a system of functional regulation, regulatory authority is allocated on the basis of the nature of the activity being performed, rather than on the basis of the institutional identity of the firm conducting the activity.⁸⁷ The legislative history of Gramm-Leach-Bliley pays substantial lip service to the principle of functional

79. MILTON R. SCHROEDER, FINANCIAL SERVICES REFORM, ANALYSIS, AND GUIDELINES ON THE GRAMM-LEACH-BLILEY ACT OF 1999, at 1-2 (1999).

80. *Id.* at 1-2 to 1-3.

81. See George J. Benston, *Universal Banking*, 8 J. ECON. PERSP. 121, 131-34 (1994) (pointing out that the development of universal banks theoretically reduces institutional and consumer costs without stifling competition from smaller or specialized institutions).

82. See 12 U.S.C. § 93(a) (1994) (allowing the Comptroller of the Currency to file suit against bank directors for violations of the national banking laws).

83. Smalhout, *supra* note 5, at 69.

84. *Id.*

85. *Id.*

86. *Id.*

87. Linda Birkin Tigges, Notes & Comments, *Functional Regulation of Bank Insurance Activities: The Time Has Come*, 2 N.C. BANKING INST. 455, 475 (1998) (arguing that banks should be allowed to enter the insurance industry under a functional regulatory system).

regulation.⁸⁸ Gramm-Leach-Bliley allocates to the SEC regulatory authority over the activities of each “functionally regulated subsidiary” of a financial holding company.⁸⁹ Broker-dealer firms, investment advisers, investment companies, insurance companies (with respect to the insurance-related activities of companies that fall within the regulatory authority of a state insurance authority), and entities regulated by the Commodity Futures Trading Commission will be regulated along functional lines.⁹⁰

Some view functional regulation with suspicion on the grounds that with individual financial institutions being regulated by several regulators simultaneously, some of the myriad of activities of these complex financial institutions might not receive the appropriate level of scrutiny.⁹¹ Similarly, one might be concerned that a single regulator should shoulder the responsibility for the overall safety and soundness of a financial institution.⁹² This latter concern was particularly germane in light of the requirements of statutes such as the Foreign Bank Supervision Enhancement Act of 1991,⁹³ which stipulates that no applications from foreign banks to open lending operations or branches in the United States may be granted unless the foreign bank making the application receives “comprehensive supervision or regulation on a consolidated basis in its home country.”⁹⁴ Citing concerns about comprehensive supervision similar to those raised in the provisions of the Foreign Bank Supervision Enhancement Act quoted above, it appeared that “[s]ome foreign regulators and supervisors have apparently been reluctant to allow US securities and insurance companies to enter their markets because they were not subject to safety and soundness regulation by a recognized US supervisor.”⁹⁵

Gramm-Leach-Bliley responds to these concerns (and to considerable political pressure exerted by the Federal Reserve Board) by allocating to the Federal Reserve regulatory responsibility for overseeing all financial services organizations from a safety and soundness perspective.⁹⁶ The stated ground for ceding such massive power to the Federal Reserve was the perceived need “for oversight of the [financial services] organization as a whole as well as subsidiaries not subject to functional regulation.”⁹⁷

The problem with establishing the Federal Reserve as the umbrella agency for the financial services industry is that this change threatens to reduce or eliminate the healthy regulatory competition that existed previously among the Comptroller of the Currency, the Federal Reserve, the FDIC, and numerous state regulatory authorities. To the extent

88. See S. REP. NO. 106-44, at 9-10 (1999); H.R. REP. NO. 106-74, pt. 1, at 97-98 (1999); H.R. REP. NO. 106-74, pt. 3, at 187 (1999). The Commerce Committee explained that the allocation of regulatory authority among administrative agencies was designed “to facilitate functional regulation of the operative components of a financial services holding company. Specifically, the preeminent authority of the insurance regulators over securities firms and the business of insurance, respectively, is preserved.” H.R. REP. NO. 106-74, pt. 1, at 71.

89. Gramm-Leach-Bliley Act § 111, 12 U.S.C.A. § 1844 (West Supp. 2000) (amending Bank Holding Company Act § 5(c)(5)).

90. *Id.*

91. S. REP. NO. 106-44, at 9-10.

92. See Tigges, *supra* note 87, at 476.

93. 12 U.S.C. §§ 3109-3111 (1994).

94. 12 U.S.C. § 3105(d) (1994).

95. Smalhout, *supra* note 5, at 69.

96. Carter H. Golembe, *Reform of the Financial Regulatory Structure*, 2000-2 & 3 GOLEMBE REP. 1, 3 (2000).

97. S. REP. NO. 106-44, at 16. “[T]he bill establishes the Federal Reserve Board . . . as the umbrella regulator of bank holding companies engaged in expanded financial activities.” *Id.* at 7.

that the Federal Reserve is not required to compete for regulatory turf with other regulatory agencies, its incentives to innovate and to adjust to competitive concerns will diminish. This concern is particularly acute in light of the argument that "the Fed has a history of suppressing innovation, very conservative management and a readiness to take on board requests from Congress for restricting new activities."⁹⁸

Another concern about the concept of functional regulation is that technological innovation and market developments have so blurred the lines between banking, securities, and insurance that functional regulation is a practical impossibility. The idea is that the once-distinct financial products involved in banking, securities, and insurance are becoming indistinguishable to customers and to regulators. For example, a consumer may view a bank checking account and a MMF as close substitutes, or even as interchangeable. Annuities offered by banks and by insurance companies are likely viewed by consumers in the same way. Consumers are indifferent to minor, legal differences among these products. They care only about price and service when comparing these products.

As suggested above, however, it is possible to distinguish banking, securities, and insurance.⁹⁹ Thus, functional regulation is possible. The distinguishing features of commercial banks are that they are financial intermediaries that provide transaction services to clients. Banks are financial intermediaries:

because they occupy a position between the investor and the ultimate investment. The investor in a financial intermediary has a claim only against the intermediary and not against the firms or other ventures in which the intermediary invests. In this respect financial intermediaries are to be distinguished from institutions such as securities brokerage firms, which do not act as intermediaries but rather assist the customer in making direct investments. Financial intermediaries include depository institutions, life insurance companies, mutual funds, and pension funds.¹⁰⁰

Banks' role as financial intermediaries helps to distinguish them from other financial institutions. But the real reason that banks are special intermediaries is because they combine financial intermediation with transaction services.¹⁰¹ No other entity does that. Transaction services permit clients to transfer wealth among people easily. Moreover, banks are entirely unique in their use of interdependency among depositors to enable them to use short-term deposits to provide borrowers with medium- and long-term funds.

The point is that functional regulation can work in the financial services industry. It is, indeed, possible to distinguish banking from securities and insurance. From a common sense perspective, customers know when they are doing banking business and when they are dealing with securities and insurance. Financial institutions and regulators are also aware of these distinctions.

This is not to say that there will not be turf wars among ambitious regulators hungry to expand their regulatory domain. There undoubtedly will be such conflicts. In

98. Smalhout, *supra* note 5, at 69 (citing Peter Wallison, a Washington attorney and director of the American Enterprise Institute's program on financial market deregulation).

99. See *supra* text accompanying notes 75-81.

100. MACEY & MILLER, *supra* note 21, at 44.

101. *Id.* at 46.

particular, when new banking products are developed, conflicts among regulators will likely emerge. The new statute attempts to deal with this issue by giving the SEC authority to regulate any "new hybrid product."¹⁰² A new hybrid product is a product the SEC has determined a security, but that (1) the SEC has not treated as a security before, (2) is not "an identified banking product," and (3) is not an equity swap.¹⁰³ The SEC must consult with the Federal Reserve Board before grabbing jurisdiction over these products by categorizing them as securities.¹⁰⁴ The Federal Reserve may then challenge the SEC's determination in the U.S. Court of Appeals for the District of Columbia Circuit.¹⁰⁵

The above discussion leads to an important observation about the efficacy and desirability of the functional regulation of financial institutions. First, the issue of whether functional regulation is possible is conceptually distinct from the issue of whether functional regulation is desirable. Functional regulation may, in fact, be possible, as this author has argued above, even though it is undesirable for some as yet unarticulated reason.

Oddly enough, even if functional regulation were, as some maintain, impossible to implement in a coherent way, this form of regulation may still be desirable. The reason for this seemingly strange result is simple. Critics of functional regulation argue that such regulation is feasible because it is no longer possible to make principled distinctions between the services provided by insurance companies, securities firms, and banks. But, if it were true that it is not possible to make these sorts of distinctions, the consequence would be that activities that were economically indistinguishable (*i.e.*, banking, securities, and insurance) would be regulated by different agencies. This, in turn, would produce regulatory competition. Innovating and competing regulatory agencies would be more likely to respond quickly to changing market and industry conditions in order to maintain market share against rival regulatory agencies seeking to grab regulatory turf.

B. Privacy

Consumer privacy issues were among the most important and most controversial aspects of the new financial services legislation.¹⁰⁶ Most people, understandably, view privacy issues as the expression of concern about individual rights against the domain of "Big Brother" financial services companies. They fear that companies will exploit their privileged access to information that falls into their grasp in the ordinary course of their business relations with consumers.

The analysis presented in this Article suggests that while privacy issues are important in their own right, they also have important competitive implications. It is important to look at the competitive consequences of the privacy provisions of Gramm-Leach-Bliley. As noted above, banks inevitably obtain a plethora of information about their depositors as a result of maintaining control over their accounts.¹⁰⁷ There are

102. See Gramm-Leach-Bliley Act § 205, 15 U.S.C.A. § 78o(i)(6)(A) (West Supp. 2000).

103. *Id.*, 15 U.S.C.A. § 78o(i)(6).

104. *Id.*, 15 U.S.C.A. § 78o(i)(1).

105. *Id.*, 15 U.S.C.A. § 78o(i)(5).

106. Memorandum from Weil, Gotshal & Manges LLP, *supra* note 76, at 7.

107. See *supra* text accompanying notes 63-68.

economies of scope between maintaining checking accounts and engaging in bank lending because the information gleaned while administering these checking accounts can be used to monitor the moral hazard problem facing borrowers that maintain checking accounts at the banks from which they take loans.

If one were unconcerned about privacy issues, one might argue that banks should be allowed (perhaps even required) to share information with rival nonbank lenders in order to level the competitive playing field between firms like commercial finance companies and commercial banks. Needless to say, Gramm-Leach-Bliley does not take this approach. The approach taken in the new statute, however, is almost as interesting. Gramm-Leach-Bliley restricts the ability of banks that are part of a financial holding company from sharing customer financial information with nonaffiliated third parties.¹⁰⁸ The Act does not restrict the ability of banks that are part of a financial holding company from sharing customer financial information with affiliate companies within the holding company organization.¹⁰⁹ In other words, consumers can choose not to have confidential information about themselves disclosed to unaffiliated third parties. They cannot choose to restrict the disclosure of such information to affiliate companies within the bank holding company structure.

The ostensible justification for this rather peculiar distinction between information-sharing with holding-company affiliates (which cannot be avoided) and information-sharing with non-holding-company affiliates (which can be avoided) is that "the integrated products and services today's consumer expects from his or her financial institutions require information sharing, especially among affiliates. After all, in the eyes of the consumer, what are affiliates other than different departments of the same company that they are dealing with."¹¹⁰ A more plausible explanation for the way that privacy issues are treated in the statute is that banks, insurance companies, and securities firms doing business (or anticipating doing business) in financial services holding companies are far more politically powerful than the finance companies, regional financial intermediaries, and others expected to remain independent after the statute was passed.

From a human rights perspective, the privacy provisions of Gramm-Leach-Bliley will not do much to protect the spread of confidential consumer information. The large-scale financial services conglomerates that are expected to emerge in the wake of the statute will be freely able to share all the confidential consumer information they want without even the mild inconvenience of obtaining their customers' permission.¹¹¹ It is ironic that those who designed Gramm-Leach-Bliley thought it would be possible to restrict the scope of federally sponsored deposit insurance protection to the confines of the FDIC-insured banks within the holding company structure, and also thought it would be impossible to restrict the scope of consumers' privacy in precisely the same way. Apparently, consumers understand that federal deposit insurance protection is restricted

108. Bob Curley, *Opting In on Compliance*, INS. & TECH., Jun. 2000, at 30.

109. However, the statute does require that this issue be "studied." See 145 CONG. REC. H5317 (daily ed. July 1, 1999) (adopting Amendment 11 by a vote of 427 to 1); see also 145 CONG. REC. H5310-5316 (daily ed. July 1, 1999) (debating this amendment). A motion to include provisions restricting the sharing of information with affiliate companies (as well as some amendments on medical privacy that related to insurance companies) failed by a vote of 198 to 232. 145 CONG. REC. H5322 (daily ed. July 1, 1999).

110. 145 CONG. REC. H5310 (daily ed. July 1, 1999) (statement of Rep. Oxley).

111. Curley, *supra* note 108, at 29.

to the bank within the holding company, but that information about themselves can be transferred anywhere within the holding company.

The privacy provisions of Gramm-Leach-Bliley will make it difficult for firms to remain independent of the financial services conglomerate form envisioned by the statute. Firms who try to remain independent will find that their inability to obtain useful information about their clients will hamper their ability to compete.

C. The Demand for Financial Services Reform and the Repeal of Glass-Steagall

The Gramm-Leach-Bliley Act did not come out of thin air. People had been analyzing the United States financial services industry and clamoring for reform for decades.¹¹² Over the years, there were many attempts to reform the banking industry. Until Gramm-Leach-Bliley, these efforts had ended in failure.¹¹³ In light of the fact that there was no sudden, tangible event to cause the political zeitgeist to change in favor of financial services reform, a somewhat more subtle analysis of the interest group dynamic that gave rise to passage of the statute is required.

As prominent banking expert Ed Kane has observed, the new law was the outcome of a "struggle between two groups: those willing to pay Congress to leave the restrictions on the financial services industry in place, and those willing to pay Congress to delete the restrictions."¹¹⁴ This analysis appears correct. The question is, what made the forces of reform finally able to outbid the forces in favor of stasis?

In a nutshell, the answer to this question is that the Glass-Steagall reform came about when, and only when, securities firms found that the Depression-era legislation was imposing more of a burden than a benefit on the securities industry. For much of Glass-Steagall's history, the statute provided benefits and costs to both banks and securities firms. When this was the case, there was little demand for Glass-Steagall reform. In particular, because the securities business generally has been more profitable than the banking industry in recent years, securities firms have been unwilling to pay much, if anything, for Glass-Steagall reform.

Commercial banks have been extremely interested in entering the investment banking industry. Rather than obtaining entry through legislative reform, however, the banking industry has obtained regulatory relief through "loophole lawyering," which was done with the help of supportive regulators who shared the industry's view that

112. For a smattering of the more prominent studies suggesting that the U.S. financial system should be overhauled, see generally FED. DEPOSIT INS. CORP., MANDATE FOR CHANGE: RESTRUCTURING THE BANKING INDUSTRY (1987); TASK GROUP ON REGULATION OF FIN. SERV., BLUEPRINT FOR REFORM: REPORT OF THE TASK GROUP ON REGULATION OF FINANCIAL SERVICES (1984); U.S. DEP'T OF TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS (1991); WORKING GROUP OF THE CABINET COUNCIL ON ECON. AFFAIRS, RECOMMENDATIONS FOR CHANGE IN THE FEDERAL DEPOSIT INSURANCE SYSTEM (1985);

113. See H.R. REP. NO. 106-74, pt. 1, at 105 (1999).

114. Smalhout, *supra* note 5, at 68.

commercial banking was a dying business and that banking firms would only survive if they could enter more lucrative lines of business, such as investment banking.¹¹⁵

The Glass-Steagall Act created a “legal Maginot Line” between commercial banking and investment banking.¹¹⁶ Glass-Steagall was comprised of sections 16, 20, 21, and 32 of the Banking Act.¹¹⁷ Section 16, which is still in force, approaches the intended separation between commercial banks and investment banks from the commercial banking perspective.¹¹⁸ Section 16 prohibits national banks from underwriting, selling, or dealing in securities.¹¹⁹ Section 21, also left intact by Gramm-Leach-Bliley, approaches the problem from the investment banking perspective by prohibiting investment bankers from offering checking or savings accounts.¹²⁰

While sections 16 and 21 of Glass-Steagall remain in force after Gramm-Leach-Bliley, the financial services reform legislation repealed the remaining two sections of Glass-Steagall—sections 20 and 32. Section 20 forbade affiliations between banks and firms “engaged principally” in the investment banking business.¹²¹ Section 32 prohibited people involved “in any aspect of the investment banking business” from serving as an officer, director, or employee of a bank that was a member of the Federal Reserve System.¹²²

The passage of Gramm-Leach-Bliley can be traced directly to the Federal Reserve’s liberal interpretations of section 20. These interpretations altered the political equilibrium that kept Glass-Steagall in place for so many years because they gave bank holding companies a competitive advantage in the financial services marketplace.¹²³ This, in turn, increased the investment banking community’s demand for repeal of Glass-Steagall.¹²⁴

As the statutory language makes clear, while sections 16 and 21 of Glass-Steagall contain “flat,” unambiguous prohibitions on securities activities by banks and restrictions on commercial banking by securities firms, section 20 permits commercial banks’ *affiliates* to engage in investment banking so long as the affiliate is not “engaged

115. Jonathan R. Macey & Geoffrey P. Miller, *Nondeposit Deposits and the Future of Bank Regulation*, 91 MICH. L. REV. 237, 273 (1992) (chronicling the increase of the nondeposit deposit and its impact on the commercial banking industry).

116. Jonathan R. Macey, *Special Interest Groups Legislation and the Judicial Function: The Dilemma of Glass-Steagall*, 33 EMORY L.J. 1, 5-7 (1984) (examining the Glass-Steagall Act and concluding that special interest groups helped to secure its passage).

117. Note, *A Banker’s Adventures in Brokerland: Looking Through Glass-Steagall at Discount Brokerage Services*, 81 MICH. L. REV. 1498, 1501 n.12 (1983) (arguing for the separate incorporation of bank discount brokerage services).

118. Jonathan R. Macey et al., *The Glass-Steagall Act and the Riskiness of Financial Intermediaries*, 14 RES. L. & ECON. 19, 21 (1991).

119. 12 U.S.C. § 24 (Seventh) (1994).

120. Section 21 of Glass Steagall defines investment bankers as those “engaged in the business of issuing, underwriting, selling or distributing . . . stocks, bonds, debentures, notes or other securities.” 12 U.S.C. § 378(a)(1) (1994).

121. 12 U.S.C. § 377 (repealed 2000).

122. 12 U.S.C. § 78 (repealed 2000).

123. See Macey et al., *supra* note 118, at 22-23 (citing William B. Hummer, *Driving the Final Nail Into Glass-Steagall’s Coffin*, BANK’S MONTHLY, Feb. 1989, at 9).

124. Macey et al., *supra* note 118, at 22-23.

principally" in this business.¹²⁵ For years, section 20 remained moribund as litigation involving Glass-Steagall revolved around sections 16 and 21.¹²⁶ The federal courts interpreted Glass-Steagall rather restrictively. These interpretations did not upset the extant political equilibrium between investment banks and commercial banks: investment banks were kept out of commercial banking and commercial banks (and their affiliates) were kept out of investment banking.¹²⁷

The situation began to change in 1987 when the Bankers Trust Company sought approval from the Federal Reserve to engage in certain investment banking activities through a holding company subsidiary.¹²⁸ The Federal Reserve Board permitted Bankers Trust to go forward into the investment banking business as long as its subsidiary was not engaged principally in any prohibited investment banking business and the subsidiary met two further conditions.¹²⁹ First, the subsidiary had to restrict its gross revenues from investment banking to five percent of its total revenues.¹³⁰ Second, the Federal Reserve claimed that Bankers Trust Company's securities affiliate could not attain more than a five percent market share of the amount underwritten domestically by all firms for the investment banking activity in each particular type of ineligible security in which it dealt. Thus, for example, with respect to dealer-placed commercial paper, the Federal Reserve ruled that Bankers Trust could not underwrite more than five percent of the average amount of commercial paper outstanding during the previous calendar year.¹³¹

The securities industry's chief trade group challenged the Federal Reserve in this case¹³² and every time regulators agreed to allow commercial banks to enter the domain of investment banking.¹³³ The Federal Reserve prevailed in its view that Bankers Trust

125. See Bankers Trust New York Corp., Order Approving Application to Engage in Commercial Paper Placement to a Limited Extent, 73 Fed. Res. Bull. 138, 141 (1987).

126. See, e.g., Bd. of Governors of Fed. Reserve Sys. v. Investment Co. Inst., 450 U.S. 46, (1981) (holding, in part, that sections 16 and 21 do not wholly prohibit banks from providing investment adviser services); Investment Co. Inst. v. Camp, 401 U.S. 617, (1971) (concluding that a bank's operation of a collective investment fund to be in violation of sections 16 and 21).

127. See Macey et al., *supra* note 118, at 21-22.

128. See Orders Issued Under Section 4 of the Bank Holding Company Act, Citicorp, J.P. Morgan & Co. Incorporated, Bankers Trust New York Corporation, Order Approving Applications to Engage in Limited Underwriting and Dealing in Certain Securities, 73 Fed. Res. Bull. 473, 485 (1987) [hereinafter Bankers Trust Order].

129. *Id.*

130. *Id.* at 485-86.

131. *Id.* at 486.

132. Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys., 839 F.2d 47 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059 (1988) (permitting bank holding companies to underwrite and deal in securities via nonbank subsidiary corporations).

133. See, e.g., Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys., 468 U.S. 137 (1984) (challenging Bankers Trust Company's plan, approved by the Federal Reserve, to sell commercial paper); Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys., 900 F.2d 360 (D.C. Cir. 1990) (challenging the Federal Reserve Board's order permitting J.P. Morgan & Co., Inc., the Chase Manhattan Corporation, Banker's Trust New York Corporation, Citicorp, and Security Pacific Corporation to deal in debt and equity securities through a nonbank subsidiary); Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys., 839 F.2d 47 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059 (1988) (challenging the Federal Reserve Board's determination that Citicorp, J.P. Morgan & Co., Inc. and Banker's Trust New York Corporation could engage in securities activities through subsidiaries); Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys., 847 F.2d 890 (D.C. Cir. 1988) (challenging the Federal Reserve Board's decision to allow a subsidiary of the Chase

could enter the investment banking industry through a section 20 subsidiary.¹³⁴ Indeed, the bank received more favorable results from the Second Circuit than before the Federal Reserve because the court of appeals struck down the Federal Reserve's requirement that Bankers Trust keep its market share to five percent.¹³⁵

The banking industry's entry into the securities business received a considerable boost from the way the Federal Reserve interpreted its requirement that subsidiary companies limit their gross revenues from investment banking to five percent of their total revenues. The Federal Reserve decided that so-called "bank-eligible securities," which are securities like general obligation municipal bonds and United States government securities that banks were expressly allowed to deal in under section 16 of Glass-Steagall, would not count as securities for the purpose of calculating section 20's five percent revenue limitation.¹³⁶ Moreover, because these bank-eligible securities were not considered securities for purposes of section 20, they were counted in the denominator of the revenue calculation. This meant, of course, that the more bank-eligible securities a subsidiary underwrote, the more bank-ineligible securities would be permitted.¹³⁷ This also meant that, by dealing in both bank-eligible and bank-ineligible securities, a so-called section 20 subsidiary could be exclusively engaged in the securities business, but not "engaged principally" in the securities business.

As time passed, the Federal Reserve became increasingly more liberal, thus increasing the gross revenue limit from its original five-percent level to ten percent, and, ultimately, to twenty-five percent.¹³⁸ As a result of the Federal Reserve's actions, prior to the passage of Gramm-Leach-Bliley, a bank holding company could own an investment banking business that engaged in every conceivable aspect of the business of investment banking, subject only to the twenty-five percent gross revenue test and some modest "firewall" restrictions on interactions between the bank and its investment banking affiliate.¹³⁹ These rules led to transactions such as Bankers Trust Company's acquisition of Alex Brown, and CitiCorp's acquisition of Salomon Brothers.

Thus, the Federal Reserve, through its interpretation of Glass-Steagall's section 20, permitted commercial bank holding companies to enter the investment banking industry. However, the Federal Reserve's rulings did nothing to permit large investment banks from acquiring commercial banks or other firms engaged in the business of receiving

Manhattan Corporation to deal in commercial paper); *Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys.*, 807 F.2d 1052 (D.C. Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987) (challenging the Federal Reserve Board's determination that Banker's Trust Company could sell commercial paper as "an agent" for its customers).

134. See Bankers Trust Order, *supra* note 128, at 485.

135. See *Sec. Indus. Ass'n v. Bd. Of Governors*, 839 F.2d 47, 68 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059 (1988).

136. See *id.* at 51; see also *Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys.*, 847 F.2d 890, 893 (D.C. Cir. 1988).

137. In other words, a bank could deal in \$5 million in bank-ineligible securities for every \$100 million in bank-eligible securities it dealt. A bank that dealt in \$200 million in bank-eligible securities could deal in twice as many bank-ineligible securities as a bank with only \$100 million in bank-eligible business.

138. Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 68,750, 68,752 (Dec. 30, 1996).

139. Review of Restrictions on Director, Officer and Employee Interlocks, Cross-Marketing Activities, and the Purchase and Sale of Financial Assets Between a Section 20 Subsidiary and an Affiliated Bank or Thrift, 61 Fed. Reg. 57,679, 57,683 (Nov. 7, 1996).

deposits. Thus, while the Federal Reserve accomplished its objective of allowing commercial banks to enter the investment banking industry, investment banks who wanted to enter commercial banking on a large scale were at a disadvantage. This, in turn, diminished the investment banking industry's political support for retaining Glass-Steagall and finally created the political conditions necessary for major legislative reform.

IV. CONCLUSION

The business of banking is alive and well. Indeed, if banking were not an attractive business, then the financial services industry would not have spent hundreds of millions of dollars galvanizing special interest groups into an effective political coalition to reform the laws regulating the financial services industry so as to permit investment banking firms to participate.

Firms see borrowing money from banks and selling stocks through investment banks as interchangeable methods of raising capital. Likewise, consumers perceive the choice of making a deposit in a commercial bank and purchasing shares in a MMF as involving very similar choices. However, deeper economic analysis reveals that banking and investment banking are fundamentally different. On the liability side of the balance sheet, banking is different because of the interdependence of depositors which results in depositors entering a risk-pool with one another. This, in turn, allows the bank to rely on the law of large numbers to estimate that only a fraction of depositors will demand the return of their funds at any one time. Commercial banks are then able to invest depositors' funds in high-yielding investments not available to investors in MMFs.

On the asset side of the balance sheet, banks specialize in close, continued, and textured monitoring of their borrowers. More expertise is needed to monitor a bank loan made by a commercial bank than a security underwritten by an investment bank because there is no public market for bank loans. This means that bankers, unlike investors in securities, cannot rely on the anonymous price-setting of markets to inform them of how the borrowers' actions are affecting the underlying value of their investment.

Gramm-Leach-Bliley can be viewed from both a public interest perspective and from a public choice perspective. From a public interest perspective, the statute is properly interpreted as a sophisticated bailout bill for the banking industry. The Federal Reserve, along with many other industry observers, took the view that the financial industry had to be reformed in order to put the United States banking industry on a competitive footing with local and international rivals.¹⁴⁰ The statute sought to accomplish this legitimate public policy objective by permitting the formation of financial services holding companies that could own both commercial banks and investment banks. Since commercial banking was perceived as a dying industry and investment banking as a vibrant, lucrative business, the idea was that the financial services holding company would thrive by gradually expanding its investment banking activities and shrinking its commercial banking activities.

This Article has argued that the public interest premise behind Gramm-Leach-Bliley was misguided. This is true for two reasons. First, commercial banking is not a

140. See Smalhout, *supra* note 5, at 68.

technologically obsolete business. Commercial banking is an important, profitable part of any economy, whether advanced or developing. Commercial bank loans will not be displaced by the securitization of credit allocation. Indeed, securitization is only possible where the issuers selling the securities have access to traditional commercial banking services such as lines of credit.

The public choice or interest group-based explanation for Gramm-Leach-Bliley is more convincing. Gramm-Leach-Bliley clearly served the private interests of large financial services firms, particularly investment banks, who wanted to enter the business of commercial banking, but were prohibited from doing so by the Glass-Steagall Act.¹⁴¹ When the Federal Reserve punched large loopholes in Glass-Steagall for commercial banks by its liberal interpretations of section 20, the demand for legislative reform on the part of the investment banking community became sufficiently strong to overcome the natural inertia of the political process that had kept Glass-Steagall on the books for almost seventy years.

However, the fact that the public interest explanation for Gramm-Leach-Bliley is more convincing than the private interest explanation for the Act does not mean that the statute was a bad idea. Permitting investment banking and commercial banking to combine is a good idea, although not for the publicly articulated reason that commercial banking is obsolete. Rather, permitting large, diversified financial services conglomerates to emerge is a good idea precisely because commercial banking and investment banking are so different. Diversified financial services holding companies that carry out both sorts of activities will be far stronger than their more specialized, less well-diversified rivals. Unlike today's commercial banks, the diversified financial services conglomerates that emerge in the wake of Gramm-Leach-Bliley will survive and flourish when the business cycle favors investment banking as well as when the business cycle favors commercial banking.

Consistent with this view, there is a wealth of historical and empirical evidence showing that bank involvement in the securities business makes financial institutions and the economy safer.¹⁴² In particular, a careful study by Eugene White found that securities activities of commercial banks prior to Glass-Steagall did not impair bank stability.¹⁴³ Banks in the securities industry were not riskier (as measured by earnings variance) and did not have lower capital than banks without any securities operations.¹⁴⁴

More importantly, banks involved in the securities business were less likely to fail than banks that were not involved in the securities business.¹⁴⁵ Five thousand banks failed in the 1920s, but virtually none of these were the city banks that had securities

141. *See id.*

142. *E.g.*, GEORGE J. BENSTON, THE SEPARATION OF COMMERCIAL AND INVESTMENT BANKING: THE GLASS-STEAGALL ACT REVISITED AND RECONSIDERED 20-32 (1990); VINCENT P. CARUSO, INVESTMENT BANKING IN AMERICA 242 (1970); EUGENE WHITE, THE REGULATION AND REFORM OF THE AMERICAN BANKING SYSTEM (1983); Benston, *supra* note 81, at 124; Randall S. Kroszner & Raghuram G. Rajan, *Is the Glass-Steagall Act Justified? A Study of the U.S. Experience with Universal Banking Before 1933*, 84 AM. ECON. REV. 810 (1994); Eugene White, *Before the Glass-Steagall Act: An Analysis of the Investment Banking Activities of National Banks*, EXPLORATIONS IN ECON. HISTORY, Jan. 1986, at 33, 33-35.

143. WHITE, *supra* note 142, at 40-42.

144. *Id.*

145. CARUSO, *supra* note 142, at 242.

affiliates.¹⁴⁶ Moreover, in the bank failures at the height of the Great Depression (between 1930 and 1933), although more than twenty-five percent of all national banks failed, less than ten percent of the national banks with large securities operations closed.¹⁴⁷

This important empirical evidence strongly suggests that the banking system will be stronger as a result of financial services reform. But these results raise another, distinct public policy issue. In light of the overwhelming theoretical and empirical support for the proposition that combining commercial banking and investment banking in a single entity makes that entity stronger, rather than weaker, why does Gramm-Leach-Bliley retain Glass-Steagall's prohibition on commercial banks' entry into investment banking? After all, because most of the liabilities of commercial banks are insured by the federal government, it seems clear that public interest dictates that we allow (if not require) FDIC-insured commercial banks, and not just their holding companies, to enjoy the benefits of diversification that come from combining commercial banking and investment banking.

However, public choice theory applies a ready explanation for why commercial banks were not given the power to engage in investment banking directly and why investment banks were not permitted to enter directly into the commercial banking industry. Simply put, the analysis above indicates that the drafters of Gramm-Leach-Bliley clearly understood that there were major competitive advantages to be gained from combining investment banking and commercial banking. As such, the drafters of the statute were faced with the choice of whether one hundred percent of those advantages should inure to the shareholders of the financial services holding company, or whether such advantages should be shared with the government. Allowing banks to conduct securities activities directly would allow the competitive benefits, particularly the benefits which come in the form of risk reduction through diversification, to be shared with the public through a reduction in the contingent liabilities of the federally sponsored FDIC insurance funds.

Rather than take this approach, however, Gramm-Leach-Bliley, by requiring that financial services holding companies keep their commercial banking and investment banking activities cabined in separate subsidiaries, creates a structure in which all of the benefits of diversification go to the shareholders of the holding company. The activities of the commercial bank do not change. Indeed, because the privacy provisions of Gramm-Leach-Bliley permit the bank within the financial services holding company to share confidential customer information with securities affiliates without first procuring the customers' permission, the statute provides a benefit to the investment banking industry without a corresponding benefit to the commercial banking industry.

Thus, Gramm-Leach-Bliley will provide substantial benefits to consumers and will, as its proponents claim, generate substantial competitive benefits for the United States financial services industry. The statute, however, does not go as far as it should because it does not permit true universal banking, which would allow financial institutions to take deposits, make loans, sell and underwrite insurance and securities, carry out securities transactions on behalf of others, and own and vote shares in the companies in which they

146. *Id.*

147. WHITE, *supra* note 142, at 40.

have invested. This is the European universal banking model. It is not likely to come into the United States anytime soon.