FEDERAL RESERVE BANK OF DALLAS

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Southwest Economy

Region Lags Nation in Education Gains

The average American became better educated in the 1990s. The number of U.S. adults with at least a bachelor's degree jumped 38 percent between 1990 and 2000, while the number without a high school diploma fell. Entering the 21st century, the average American had more than a year of postsecondary education.

The average education of the adult population increased in every state and the District of Columbia. However, as Chart 1 shows, some states improved much more than others. Intriguingly, gains in average educational attainment were systematically lower in the West and Southwest. In particular, Alaska, California and Nevada posted less than half the national gain. California, which ranked 14th in the nation in terms of average educational attainment in 1990, slipped to 29th by 2000. Texas dropped seven places to 42nd.

Why did the West and Southwest lag the rest of the nation? There are two key factors: The adult population without a diploma did not decline, and the share of the population with at least a bachelor's degree did not rise as rapidly as elsewhere in the country.

(Continued on page 2)

Slow but Steady Progress Toward Financial Deregulation

After almost 20 years of trying, in late 1999 Congress finally repealed the Glass–Steagall Act and parts of the Bank Holding Company Act, which had separated traditional banking, insurance and securities underwriting into three, nonoverlapping industries.[1] The Financial Services Modernization Act of 1999, also known as Gramm–Leach–Bliley, was hailed as a major step toward ending government regulation that was initially imposed following the stock market collapse in the late 1920s and the ensuing Great Depression. Proponents claimed that eliminating the artificial barriers that divided the financial sector into distinct industries would increase competition, thus generating greater efficiencies and economies of scale and benefiting consumers and the economy.

(Continued on page 6)

INSIDE:

Chilean Accord Extends U.S. Free Trade Universe by One

Slow but Steady Progress Toward Financial Deregulation

(Continued from front page)

On the third anniversary of Gramm–Leach–Bliley's passage, the media are focused on the fact that many of its touted benefits have yet to be realized.[2] Large-scale mergers and consolidations in the financial services industry have not occurred, expanded product lines and one-stop financial shopping have not developed, and prices for financial services have not fallen substantially. In addition, banks have been accused of conflicts of interest between their commercial lending and investment banking divisions. This has emboldened consumer advocates and some in Congress to call for reestablishing some of the barriers Gramm–Leach–Bliley eliminated.

This article explores three primary reasons the benefits of Gramm–Leach–Bliley have yet to be fully realized. First, the Glass–Steagall restrictions that separated commercial and investment banking had been slowly eroded over the last 20 years. Thus, Gramm–Leach–Bliley was not as sweeping a piece of legislation as often billed. Second, the recent economic downturn and corporate accounting and governance scandals have inhibited the industry's ability to realize some of the gains from the recent legislation. Third, the writing of regulations fleshing out Gramm–Leach–Bliley has also taken time.

Those who anticipated fast, extensive changes in the financial sector landscape had unrealistic expectations. Despite the slow progress of reform, however, benefits from Gramm–Leach–Bliley have begun to materialize and are likely to increase as the economy improves and banks determine how to best take advantage of their newfound freedom.

Historical Perspective

To understand the impact of Gramm–Leach–Bliley, it's useful to trace the history of Glass–Steagall and examine how the banking industry evolved during the 1990s.

The Banking Act of 1933, often referred to as the Glass–Steagall Act in the popular press, did three important things.[3] First, it established the Federal Deposit Insurance Corp. Second, it gave the Federal Reserve's Federal Open Market Committee the authority to conduct open market operations. (Monetary policy was previously conducted via the discount window.) Third, and most important for this article, the act erected barriers separating commercial and investment banking. (It is only this part of the Banking Act that technically constitutes Glass–Steagall.) Specifically, commercial banks were barred from underwriting or even dealing with corporate, but not government, securities. This division kept banks and investment firms from competing with each other.

Glass–Steagall's passage was largely a result of the public's misconception that commercial banks were chiefly responsible for the stock market crash. This idea gained considerable support after congressional hearings (by the Pecora Committee) documented numerous abuses by banks with regard to their investment dealings—not unlike the current scrutiny of bank lending to corporations such as Enron Corp.[4]

More recently, the 1990s were an extremely good period for the banking sector. Although the decade's strong economic growth is often attributed to technology, the New Economy and government spending restraint, an often overlooked, but crucially important, contributor to that prosperity was a sound and effective banking sector. The decade started with the winding down of the cleanup of the savings and loan crisis, which had begun in the 1980s. As the economy embarked on its historic growth streak, the banking sector also grew and prospered.

Congress passed significant reform legislation in the 1990s. In 1994, the Riegle–Neal Interstate Banking and Branching Efficiency Act repealed the McFadden Act of 1927 and Douglas Amendments of 1970, which had curtailed interstate banking. In particular, the McFadden Act, seeking to level the playing field between national and state banks with respect to branching, had effectively prohibited interstate branch banking.[5] Starting in 1997, banks were allowed to own and operate branches in different states. This immediately triggered a dramatic increase in mergers and acquisitions. The banking system began to consolidate and for the first time form true national banking institutions, such as Bank of America, formed via the merger of BankAmerica and NationsBank.

The decade ended with the passage of Gramm–Leach–Bliley in November 1999. The impact of this legislation was not felt until 2000, as the Federal Reserve Board and the Treasury Department required time to finalize some of the regulations necessary to implement it. Thus, the 1990s were characterized by prosperity and historic deregulation of the banking sector.

Expectations for Financial Deregulation

Proponents of Gramm–Leach–Bliley had argued that a number of benefits would result from deregulating the financial sector and tearing down the artificial barriers erected by Glass–Steagall and the Bank Holding Company Act.

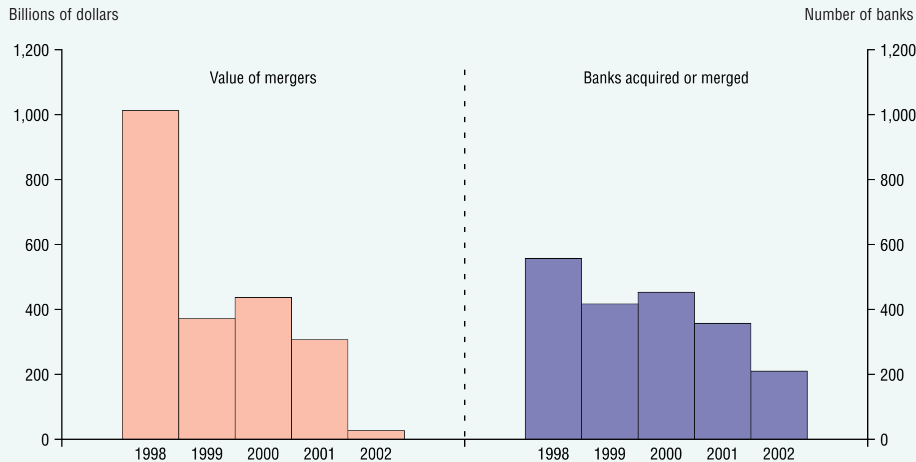
By eliminating the barriers between commercial banking and investment banking, the two sectors would provide greater competition for each other. This would lower prices as banks aggressively competed to underwrite securities and investment banks offered deposit and lending services currently offered by commercial banks.

Proponents also expected considerable consolidation in the financial sector. As banks, investment companies and insurance companies expanded into each other's territory, it was thought that much of this expansion would occur through mergers because companies would find it more cost-efficient to buy existing firms than to start new divisions from scratch. This consolidation would also benefit the economy as these new, large firms achieved economies of scale and passed these efficiency gains on to consumers and businesses. It would also be beneficial to the financial companies because their expanded service offerings would provide greater diversification of assets and risks.

Finally, by allowing banks to offer products such as brokerage services and

Chart 1

Merger Activity Declines



NOTES: 2002 data are for the first three quarters. Dollar value of mergers is for the 50 largest bank holding companies.

SOURCES: Federal Reserve Board; Federal Deposit Insurance Corp.

insurance, new one-stop financial companies would be created. These new financial supermarkets would benefit consumers and businesses by reducing the costs associated with obtaining a variety of services from a diverse group of providers.

Financial Deregulation Reality

Three years after Gramm–Leach–Bliley's passage, many of these expected gains are still largely unrealized. In particular, the mergers and consolidation have not materialized and the creation of one-stop financial centers has been limited. However, as detailed in the next section, it was somewhat unrealistic to expect large gains this quickly.

The lack of consolidation within the financial services industry is evidenced by the general absence of large-scale mergers across industry boundaries. The most notable exception is Citigroup—formed in 1998 from a merger of Citicorp, a bank holding company, and Travelers Group, an insurance company.[6] However, in mid-2002 Citigroup spun off Travelers' property-casualty insurance business.

In general, though, much of the recent merger activity is due to the 1994 repeal of branch banking restrictions and other competitive forces rather than Gramm–Leach–Bliley. Mergers peaked (in dollar terms) in 1998 at $1,013 billion, with only $27 billion in the first three quarters of 2002 (*Chart 1*).[7] The number of mergers displayed a similar pattern. In the mid-1990s, 600 banks per year were acquired as a result of mergers. More recently, that number has dropped to around 350 banks per year.[8]

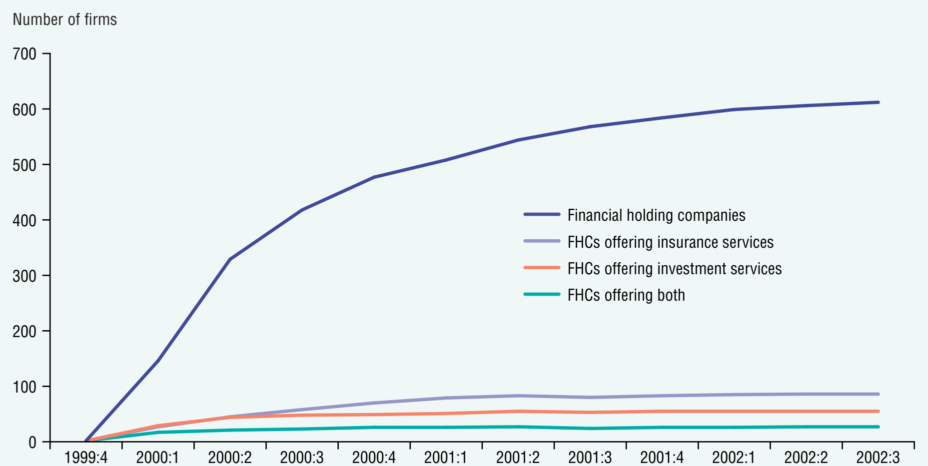
This lack of merger activity between industries has also slowed the creation of one-stop financial centers. Citigroup, by virtue of its merger prior to Gramm–Leach–Bliley, is perhaps the furthest along in terms of having banking, insurance and investment banking under one roof. Other large firms—such as J.P. Morgan Chase & Co., FleetBoston Financial Corp. and State Farm—have succeeded in marrying investment, commercial banking and insurance in a more limited fashion. As of September 2002, 145 investment companies were part of larger financial holding companies. However, only 55 of 612 financial holding companies—a new category of financial services providers explained below—had investment subsidiaries (*Chart 2*). Although these companies represent some of the largest financial companies, the fact that only the largest firms are testing the integration waters—and only to limited degrees—indicates the slowness with which one-stop financial centers are being developed (*Chart 3*).

Why Progress Is Slow

Although the benefits from Gramm–Leach–Bliley seem to be slow in coming, the sluggish pace should not be attributed to a failure of deregulation. There are three key reasons the effects of this legislation have been muted: (1) the barriers between banking, insurance and securities had slowly eroded over time, (2) the recent economic downturn and corporate scandals have hampered banks', insurance companies' and investment banks' ability to take advantage of the recent legislation, and (3) the issuance of regulations has taken time and is, in fact, not yet complete.

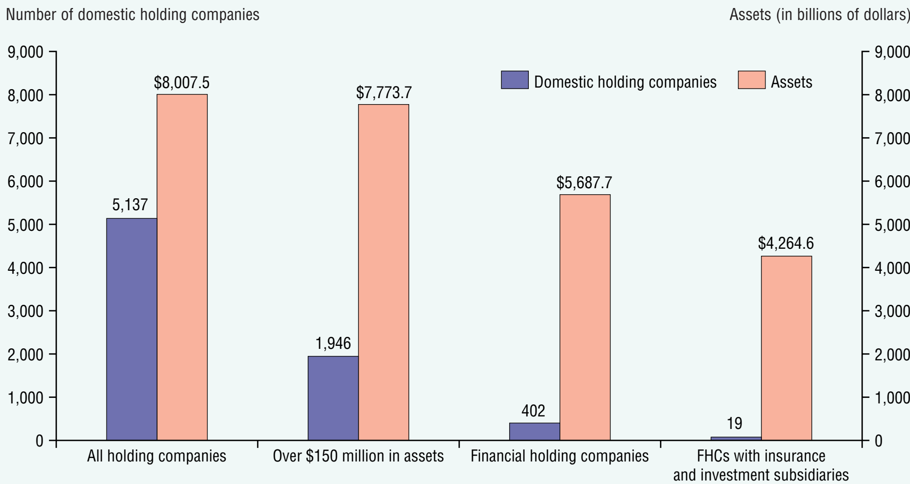
Chart 2

Few Financial Holding Companies Offer All Products



NOTE: A financial holding company (FHC) is the legal structure required for a bank or other institution to engage in brokerage services, insurance services or other financial activity under Gramm–Leach–Bliley.

SOURCE: Federal Reserve Board.



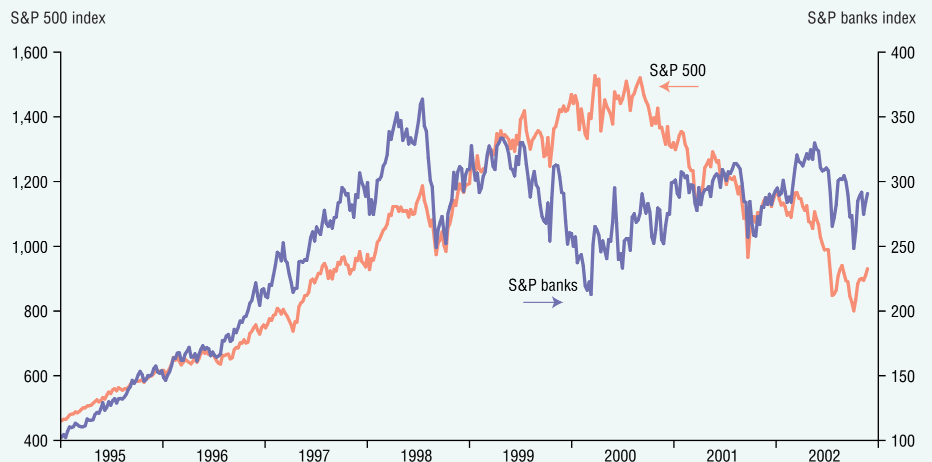
Although proponents hailed Gramm–Leach–Bliley for breaking down artificial barriers that had stood for over half a century, the reality is that decisions by the Federal Reserve Board of Governors had slowly chipped away at those barriers over the previous two decades. In 1987 the Board allowed subsidiaries of bank holding companies to do limited securities underwriting. This activity was initially limited to 5 percent of the securities subsidiary's revenues but was increased to 10 percent in 1989 and then 25 percent in 1996. In addition, banks slowly expanded into related areas, such as mutual funds and insurance.

Under Gramm–Leach–Bliley, the first step to offering a diverse portfolio of financial products is receiving the new designation of financial holding company (FHC). In the past, the least restrictive designation for banks was bank holding company.[9] Current bank holding companies or other institutions seeking the new designation must pass basic reviews of financial soundness. As of September 2002, 584 domestic banks and 28 foreign institutions had been designated as financial holding companies. This compares with 5,137 total domestic bank holding companies and 18 partly or wholly owned foreign institutions. Although the number of financial holding companies represents about 12 percent of bank holding companies, it is unlikely to grow dramatically in the near future. Of the 612 financial holding companies, approximately 477 were granted this status during the first year after Gramm–Leach–Bliley's passage and only 135 have obtained this designation in the last two years (*Chart 2*). It should be noted, however, that institutions that have received financial holding company status represent the country's largest banks and financial companies.

The second reason the full ramifications of Gramm–Leach–Bliley have not been felt is the current spate of corporate scandals and the recent economic downturn, which have reduced mergers and slowed the expansion of products. Overall, however, the banking sector has weathered the slowdown remarkably well.

As with the rest of the economy, the stock market's woes have affected the value of bank stocks, albeit to a lesser degree lately (*Chart 4*). Bank stocks experienced a dramatic run-up in the mid-1990s and then fell significantly between late 1998 and early 2000. It is no coincidence that within the last half decade, stock prices and the dollar value of mergers peaked in the same year, 1998. As with many industries, banks used highly valued stocks to acquire other banks (as opposed to issuing debt to pay cash). Thus, when stock prices came off their highs in 1998, banks were less able to afford mergers and acquisitions.

The economic slowdown has also caused a deterioration in loan quality. The number of delinquencies (missed payments) and charge-offs (uncollectible loans) on loans to commercial and industrial businesses and consumers has risen dramatically since 1998 (*Chart 5*). This loan deterioration has prompted banks to set aside larger reserves to cover expected losses. Given the situation, banks are understandably much more leery of mergers and acquisitions and of expansion into highly volatile areas such as insurance and investment banking.



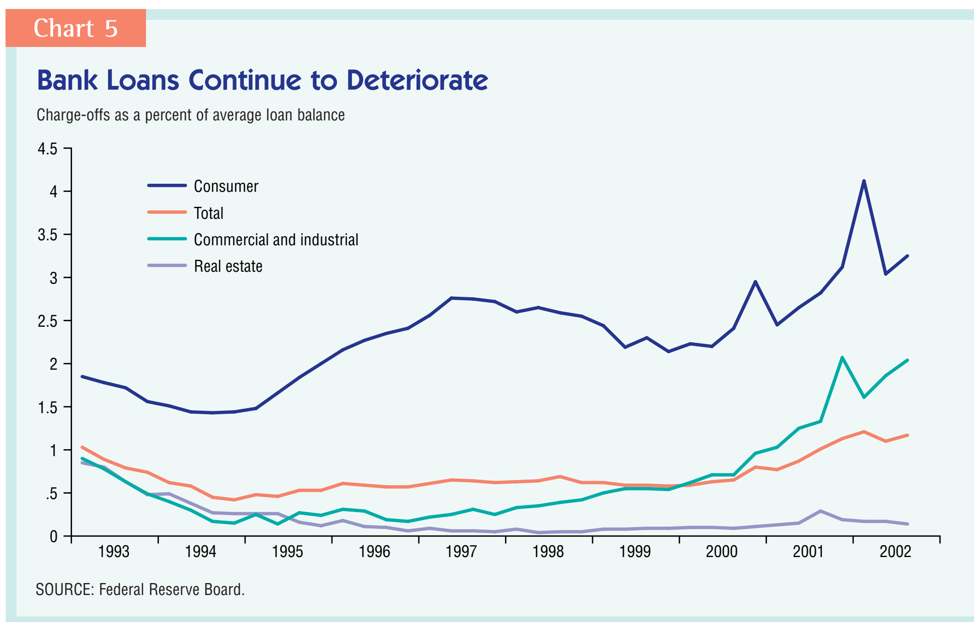
The recent rash of corporate governance scandals has also ensnared the banking industry. Given that Glass–Steagall was a response to alleged abuses by commercial banks with respect to investment banking, it is rather foreboding that only a few years after its repeal, the industry finds itself with similar problems. Large banks have been under attack on several fronts. On the accounting side, Citigroup and J.P. Morgan Chase have been accused of dubious lending deals with Enron. Commercial banks have come under scrutiny for tying loans to investment banking activities and for alleged conflicts of interest between research reports and investment banking opportunities. The latter has resulted in some banks, such as Citigroup (and its investment arm, Salomon Smith Barney), and some investment companies, such as Merrill Lynch, paying large fines. In addition, these companies are considering the degree to which they should make their research departments more autonomous or even independent.

The economic downturn and scandals have led banks to severely curtail or even reverse recent expansion beyond their traditional banking boundaries. As mentioned above, Citigroup has already spun off part of its insurance business. FleetBoston Financial recently closed its investment banking division, Robertson Stephens, because of the nonexistent market for initial public offerings. Bank of America eliminated its auto leasing and subprime mortgage lending divisions because of the weak economy. But although many banks are refocusing on their core business rather than expanding into new territories, once the economy gains momentum, they are likely to test the waters of expansion more aggressively.

The final reason Gramm–Leach–Bliley has taken time to implement is that some provisions are being phased in and others have been delayed while various government agencies create and refine regulations to carry out the law. Since different agencies (for example, the Federal Reserve, the Treasury Department, and the Securities and Exchange Commission) have oversight responsibility for commercial banks, insurance companies and investment banks, the task was further delayed as the agencies coordinated their regulations.

Chart 5

Bank Loans Continue to Deteriorate



SOURCE: Federal Reserve Board.

As previously discussed, the first step to offering a diverse portfolio of financial products is being designated a financial holding company. Although satisfying the requirements is not onerous, companies could not apply for this status until the end of the first quarter of 2000, when the applicable regulations were finalized. In addition, several layers of regulations govern the various subsidiaries of financial holding companies. For example, financial holding companies are allowed to engage in merchant banking, which involves directly investing in companies, but the relevant regulations were not finalized until early 2001.[10] And Gramm–Leach–Bliley gives the Federal Reserve and Treasury until 2004 to decide whether banks, in addition to financial holding companies, may engage in merchant banking.

The Treasury still has to decide whether to allow banks to engage in real estate brokerage.[11] Gramm–Leach–Bliley states that banks should be allowed to engage in any activity that is "financial in nature." However, the legislation does not define this term, leaving it to the Federal Reserve Board and the Treasury to jointly determine an appropriate list of activities. So some activities, such as real estate brokerage, must go through the arduous and time-consuming process of first being designated as financial in nature before banks are allowed to engage in them.[12]

Insurance is one of the few markets in which banks have expanded more aggressively. Here again, however, there are regulatory barriers, primarily reflecting the hodgepodge of state-by-state regulations. Thus, although Gramm–Leach–Bliley requires that states permit banks to sell insurance, banks must still adhere to the same regulations as all other insurance companies in each state.

Deregulation Taking Hold

The three years since the passage of Gramm–Leach–Bliley have seen steady but slow progress toward reintegrating the many distinct industries that make up the financial sector. Although some expected immediate, large-scale changes in the commercial banking, insurance and investment banking industries, that has not been the case.

The mergers and consolidation some anticipated have not occurred, and financial supermarkets offering all financial products under one roof have not developed. However, the lack of progress in these areas does not indicate a failure on the part of deregulation. There are many solid economic reasons for the slow pace.

One of the key reasons Gramm–Leach–Bliley did not cause a flurry of activity across traditional banking, insurance and brokerage boundaries is that the barriers separating the three had already begun to fall. Banks did not suddenly

(Continued on page 12)

Slow but Steady Progress

(Continued from page 9)

achieve the ability to sell stocks and bonds; their securities subsidiaries were now allowed to generate more than 25 percent of their revenue from such activities. Consequently, the industry has seen slow expansion across boundaries, as opposed to wholesale changes in products and services.

The recent economic downturn, coupled with accounting and investment scandals, has also dampened banks' ability and desire to create and support new products in which their expertise is limited. Finally, the removal of barriers was not intended to be accomplished over a relatively short period. Congress used general language in much of the legislation to give regulators the flexibility to adapt to ever-changing market forces. However, this flexibility has a price—the time it takes different agencies to develop and agree on regulations.

As regulations and their interpretations are made clear and the economy revives, financial companies that fulfill the promise of Gramm–Leach–Bliley are likely to be formed, furthering competition in the financial sector.

—Mark G. Guzman

Guzman is an economist in the Research Department of the Federal Reserve Bank of Dallas.

Notes

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[1] The Glass–Steagall Act separated commercial banking from investment banking. Restrictions on insurance sales were the result of the Bank Holding Act of 1956 and subsequent amendments.

[2] For example, see "In Focus: Rethinking the Business Case Behind Some of GLB's Changes," *American Banker*, Nov. 8, 2002.

[3] See Frederic S. Mishkin, *The Economics of Money, Banking, and Financial Markets*, 5th edition, Addison-Wesley, New York, 1997, for more detailed explanations regarding important banking legislation.

[4] It is not clear, in hindsight, that banks did anything wrong. See Randall S. Kwoszner and Raghuram G. Rajan, "Is the Glass–Steagall Act Justified? A Study of the U.S. Experience with Universal Banking Before 1933," *American Economic Review*, September 1994, for a more detailed look at the impact of banks' securities underwriting on the stability of the financial system.

[5] Not all interstate branching was eliminated, as various states entered into regional pacts that allowed some interstate branching or holding companies.

[6] This merger occurred prior to Gramm–Leach–Bliley and was one of the primary forces in getting the legislation through Congress. If not for Gramm–Leach–Bliley, Citigroup would have been required to divest itself of its insurance underwriting.

[7] These dollar figures are for the 50 largest bank holding companies in the United States.

[8] Standard & Poor's Industry Surveys: Banking, Nov. 7, 2002.

[9] Bank holding companies themselves were largely the result of banks attempting to circumvent the interstate branching restrictions imposed by the McFadden Act.

[10] See Kenneth J. Robinson, "Banks Venture into New Territory," Federal Reserve Bank of Dallas *Economic and Financial Policy Review*, vol. 1, no. 2, 2002, for a more detailed exposition of merchant banking and how banks have pursued this new authority since Gramm–Leach–Bliley's passage.

[11] See Karen Couch, Robert Mahalik and Robert R. Moore, "Banks as Real Estate Brokers—Letting Free Enterprise Work," Federal Reserve Bank of Dallas *Southwest Economy*, May/June 2001, for a more detailed overview of the banking industry's struggle to obtain permission to engage in real estate brokerage services.

[12] Bills were introduced in the newly convened 108th Congress (in both the House and Senate) to prohibit banks from engaging in real estate brokerage.

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