

Brooklyn Journal of International Law

Volume 19

Issue 1

SYMPOSIUM:

Global Trends Toward Universal Banking:
Comparative Bank Regulation/Meeting The
Regulatory Challenge

Article 10

9-1-1993

COMMENTARY

Robert E. Litan

Follow this and additional works at: <https://brooklynworks.brooklaw.edu/bjil>

Recommended Citation

Robert E. Litan, *COMMENTARY*, 19 Brook. J. Int'l L. 229 (1993).

Available at: <https://brooklynworks.brooklaw.edu/bjil/vol19/iss1/10>

This Article is brought to you for free and open access by the Law Journals at BrooklynWorks. It has been accepted for inclusion in Brooklyn Journal of International Law by an authorized editor of BrooklynWorks.

COMMENTARY

*Robert E. Litan**

It's a pleasure to comment on the paper by John Macey. He always writes provocative and interesting stuff, and this paper is no exception.

I should say at the outset that Macey has succeeded in disarming me from giving any major criticism since he's cited my work in many places. Very clever, John. Nevertheless, I have to say something to earn my airfare, so here it goes.

Macey's paper advances two major points. First, that regardless of the legal niceties, market forces are driving the United States banking system toward the universal banking model. And second, that because of the current legal niceties — which John persuasively argues are not likely to change any time soon due to the weakened political power of the banking industry — banks, as we know them today, ironically, will not participate in the trend toward universal banking. Instead, the universal banks of today and tomorrow are and will be the non-banking giants, such as General Motors (GM), General Electric (GE), Sears, Ford Motor — not Citicorp, Bank of America or Nationsbank. There are elements of truth in these two propositions but I have a few reservations.

I want to start out, however, with a brief digression on what we mean by "universal banking." Macey says it means expanded powers for banks, and that is literally true; universal banks in the German model actually can use deposits to fund investments in other non-banking activities. But elsewhere in the paper, Macey seems to imply that universal banking can also be carried out by bank holding companies or non-banking parents that may own a bank-type, deposit-taking enterprise, such as a thrift. Thus, it is in this broadened sense that Ford Motor is a univer-

* Robert E. Litan is a Senior Fellow at the Economic Studies Program of the Brookings Institution, where he also directs the Institution's Center for Law, Economics, and Politics. He has received a B.S. in Economics from the University of Pennsylvania, and a J.D. and Ph.D. from Yale University.

sal bank because it owns First Nationwide. A similar claim can be made for GM or GE, which own their own credit card banks.

In short, under the narrow definition of universal banking, the bank is directly involved with the non-banking activity; whereas under the broader definition, the bank is affiliated with the non-banking enterprise.

To those who believe in the "one happy family" theory of corporate enterprise, this is a legal distinction without a practical difference. That is, if firewalls are useless or ignored, then it doesn't matter whether the non-banking activity is inside or outside the bank. Either way, the bank may be adversely affected by the failure of the non-bank, or benefited if the non-bank does well.

However, for those who believe that firewalls can be effective, it does make a difference whether the non-banking activity is located inside or outside the bank. In particular, if you believe in firewalls and are concerned about the possibility that problems at non-banks may infect the bank, then you would prefer the affiliation version of universal banking over the German model of direct bank participation in non-bank enterprises. This is also true if you believe, as I do, that a safe version of universal banking is the "narrow banking" model, whereby banks narrowly investing in safe, liquid securities are given the right to affiliate with any other type of non-banking enterprise. Incidentally, it is still possible in the narrow bank model for the overall organization to benefit from economies of scope, since the narrow bank and the affiliates could use the same offices and personnel and cross-market each others' services.

Now, I want to turn to a couple of comments on Macey's basic thesis that universal banking is inevitable. Again, definitions are important. If by universal banking Macey means bank participation in just securities underwriting, then he certainly is correct. Bank holding companies already have Section 20¹ powers to carry out this activity, with some restrictions. I predict that, while Congress is unlikely during the Clinton Administration to repeal Glass-Steagall, we will see the Federal Reserve further relaxing the current restrictions on the Section 20 affiliates in the next couple of years.

1. The Glass-Steagall Act is the name commonly used to refer to the Banking Act of 1933, ch. 89, 48 Stat. 162 (1933). Section 20 of the Act is codified, as amended, at 12 U.S.C. §377 (1988).

Moreover, such a move would be in the public interest. Macey makes clear — crystal clear — that securities finance is replacing bank-dominated finance, not just in the United States, but to an increasing degree in Japan and Europe as well.² And equally important, the skills in extending a loan and underwriting a securities issue are virtually identical. Thus, it makes little sense to preclude banks from underwriting securities.

Let's get a little more ambitious and ask whether we are likely to see banks affiliated with the full range of financial service activities — such as insurance agency, underwriting, real estate agency and development. This is the so-called "one-stop" shopping model much talked about in recent years.

There is no question that many of the non-banking companies I have mentioned have already engaged in aspects of banking. But the jury is still out on whether one-stop shopping makes economic sense, as Helen Garten suggests in her paper.³ In fact, several recent developments suggest that many American consumers may not want one-stop financial shopping. Sears, a company that Macey cites in his article as an example of American-style universal banking, has just announced its intention to divest its financial divisions.⁴ American Express, another aspirant to universal banking, also has had its share of troubles. And while a number of European banks have rushed into the arms of insurance companies, and vice versa, it is still far from clear whether these marriages will prove financially fruitful.

Incidentally, Macey seems to think that the skills for succeeding in banking and insurance are transferable.⁵ While a banking organization can certainly benefit from sharing customer lists for the two activities, it is not true that selling or underwriting insurance requires the same skills as attracting depositors and making loans.

In short, we still don't know to what extent banks and non-banks will want to diversify broadly into each others' businesses and what combinations will prove most economically attractive.

2. On this point, see the excellent analysis in International Monetary Fund, *International Capital Markets: Developments, Prospects and Policy Issues* (Washington, D.C., 1992).

3. See Helen A. Garten, *Universal Banking and Financial Stability*, 19 BROOK. J. INT'L L. 159 (1993).

4. Suzanne Bilello, *Sears to Spend \$4B to Remake Stores*, NEWSDAY, February 12, 1993, at 50.

5. Jonathan R. Macey, *The Inevitability of Universal Banking*, 19 BROOK. J. INT'L L. 203 (1993).

Presumably, Macey would answer that this is an issue we should let the market decide, and, fundamentally, I would agree with him.

At the same time, however, there is danger in mixing banking, finance, and commerce, more so than is true today. The risk is that the federal safety net will thereby get extended to cover not just banks, but a much broader sector of the economy. I continue to believe that the best way of preventing this from happening is to allow only the narrow banking version of universal banking, which would insulate banks and the federal insurance fund from any financial difficulties experienced by non-banking activities. One missing element in Macey's excellent paper is a statement as to which universal banking model *he* would prescribe for the United States, and whether any of the models actually matter.

Finally, I have a couple of observations on the three policy reforms that Geoffrey Miller recommended in his comments on Professor Lichtenstein's paper.⁶ First, I question the willingness of banks to issue "double-liability" or "assessable" common stock. This is particularly true at the present time when many large banks have been reluctantly selling their non-assessable common stock in order to bring themselves safely into compliance with stiffer capital requirements.

Second, I also question the advisability of scaling back deposit insurance. In my view, depositors are highly unstable sources of discipline because they can run on a moment's notice. Holders of longer-term subordinated (and uninsured) debt provide a much more stable source of discipline precisely because they *cannot run*, but instead must wait until their debt matures to recover their investment.

For this reason, I strongly favor requiring all large banks — perhaps those with assets above \$1 billion that currently have access to the capital markets — to meet part of their capital requirement by issuing subordinated debt. For example, two percent of the eight percent Tier II risk-weighted capital requirement could be made up of subordinated debt. Such a requirement would mean that any large bank that wanted to expand its deposit base would constantly have to go to the market

6. See Cynthia C. Lichtenstein, *International Standards for Consolidated Supervision of Financial Conglomerates*, 19 BROOK. J. INT'L L. 137 (1993); Geoffrey P. Miller, *Universal Banking and Financial Stability*, 19 BROOK. J. INT'L L. 197 (1993).

to sell its subordinated debt. That market, in turn, would discourage large banks from taking many of the risks they became accustomed to taking during the 1980s.

Finally, I fully agree with Geoffrey Miller and Jonathan Macey that nationwide interstate branching and banking is long overdue. There is no rational reason for the current geographic restrictions, which only have contributed to the weakness of the United States banking system.

