given to the Chinese authorities by the Hong Kong Police will be a less controversial subject than the matter of rendition of wanted persons: China is unlikely to make requests of the Hong Kong Police which threaten its own sovereignty or law and order and vice versa. How will China reassure Hong Kong citizens or place procedural safeguards in the way of the exercise of its own sovereign power?

In contrast with extradition to third countries, it is not to be expected that the sovereign power would permit its requests to its dependent jurisdiction to be challenged in Hong Kong courts on the basis of an overriding political motive. Would China also seek to avoid in any future arrangement to avoid the 'double criminality' requirement that has been for so long a safeguard in the field of extradition and which is expressly maintained in the *Fugitive Offenders Ordinance*? The safeguard tests the conduct complained of against the criminal law of the requested jurisdiction. This is the practical minimum that China should offer in any legal arrangements for the rendition of suspects, though such a safeguard may thereby offer the possibility that a Hong Kong court might need to examine the substantive criminal law of the People's Republic. Extradition also requires proof, normally in documentary form, of a prima facie case: this again could lead to a Hong Kong court examining the means of proof relied upon by the Chinese authorities, possibly exposing fundamental differences of approach in the ways in which evidence is gathered, what is regarded as evidence and how such matters are to be weighed by the courts.

Future arrangements for rendition and assistance would (presumably) operate alongside the long-established Hong Kong administrative practice of deporting those persons who enter illegally from China. Keeping this in mind, it should be possible, in typical instances of flight after violent crime or crimes of dishonesty, for the authorities to deal with the fugitive by deportation where the person has entered Hong Kong illegally. A similar approach, employing Hong Kong's *Immigration Ordinance*, might be adopted for a Chinese citizen suspected of offences in China who has overstayed in Hong Kong or whose right to residence has been cut short by administrative means. Should such practices continue if and when China introduces a legal framework by which fugitives are rendered from Hong Kong?

Future rendition arrangements will be brought into critical focus should an incident arise whereby China requests the rendition of a Hong Kong permanent resident to face a serious criminal charge which may carry the possibility of the death penalty. Chinese penal provisions are harsh by western standards. The local business community will watch developments with concern. To imagine a further example, if a charge of fraud flowed from a joint venture, Hong Kong investment in Chinese projects might be slowed. Joint ventures in China often involve state organs or are backed by politically powerful individuals.

CONCLUSION

Despite great progress, it has not yet been fully demonstrated that China maintains a clear line between the exercise of executive power and those matters which are expressed by its substantive law and constitution to be within the proper realm of legal remedy. It is for this reason above all that any purely administrative system of rendition or co-operation for mutual legal assistance would be suspect. Most local concerns would be met by a Hong Kong ordinance covering the subject of rendition and co-operation with China with the same safeguards that are available to meet requests from or co-operation with third jurisdictions – but excluding the possibility of questioning the political motive of Chinese requests. The future under such arrangements would still present the judiciary in China and Hong Kong with great challenges, but challenges that can be met and from which both systems may emerge beneficially. Any course which avoids such challenges would demonstrate a lack of confidence by China's political leadership in both legal systems.

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Glass-Steagall on life support

by Kimberley Anne McCoy

Spring – a time of rebirth and the renewal of hope. But for commercial bankers, those hopes are typically crushed, as Spring represents a time of annual Congressional angst over the future of the *Glass-Steagall Act* 12 USC. The Spring of 1997 was no different. While Congress debated whether the 64-year-old legal division between commercial and investment banking should continue, federal regulators presided over a dramatic end-run around the lawmakers. The board of governors of the Federal Reserve System, through an order effective from 6 March 1997, increased the revenue limits allowed for a s. 20 subsidiary of a bank holding company from 10% to 25%. Consequently, the past five months witnessed a flurry of acquisition activities as commercial banks took advantage of the new regulation.

The recent regulatory reform efforts go some way towards dissolving the barrier between commercial and investment banking. But despite the success and global influence of the US banking industry, our banking laws remain anachronistic in comparison with other commercial centres. This article focuses on one of those antiquated laws, the *Glass-Steagall Act*. Although the regulators' reform efforts have been welcomed by commercial bankers, the *Glass-Steagall Act* will remain in its moribund state so long as Congress is unable to make the difficult legislative choices necessary to modernize our financial services system. The regulator-led piecemeal reform avoids the inevitable march of market and technological progress, ultimately impacting on the continuing vibrancy of our banking industry. This article will examine the *Glass-Steagall Act*, the regulatory efforts to respond to the banking industry's calls for reform and the economic price of maintaining the status quo.

HISTORICAL CONTEXT

Over 60 years ago, the US was in the throes of a major economic catastrophe. The stock market crash of 1929, the widespread banking panic of 1932 and 1933, leading to over 1,500 bank failures and the ensuing Great Depression number as some of this country's darkest days. President Franklin D Roosevelt's administration and Congress responded to the financial crises by promulgating the *Banking Act* 1933, of which four provisions constituted the *Glass-Steagall Act*.

Popular consensus in the early 1930s was that commercial banks' securities activities resulted in unsound stock market speculation, causing the failures of numerous banks and the Great Depression. The *Glass-Steagall Act's* legislative history indicates that Congress believed that the nexus between commercial and investment banking produced conflicts of interest and jeopardized bank safety. In an attempt to insulate the banking system from the risks associated with securities activities, the *Glass-Steagall Act* partitioned commercial and investment banking functions by prohibiting national and state-chartered banks that were members of the Federal Reserve System from conducting investment banking activities and from being affiliated with investment banks. The most important provision for purposes of this article is s. 20 of the *Glass-Steagall Act* which proscribes affiliations between national and state member banks and firms:

'... engaged principally in the issue, flotation, underwriting, public sale, or distribution . . . of stocks, bonds, debentures, notes, or other securities'

Three other provisions of the *Glass-Steagall Act* addressed Congressional concerns. Section 16 of the Act prohibits national and state member banks from underwriting, selling and dealing in securities. Section 21 complements s. 16 by forbidding investment banks from accepting deposits, an activity regarded as engaging in commercial banking. It should be noted that the prohibitions in s. 16 and s. 21 contained exceptions for 'bank eligible securities' (primarily government securities) in which national and state member banks could deal. Finally, s. 32 prohibits officer, director or employee interlocks between national and state member banks and securities firms primarily engaged in underwriting and dealing.

RECONSIDERATION NEEDED?

The prohibitions imposed by the Glass-Steagall Act should be re-considered for two reasons. First, since the Glass-Steagall Act's enactment in 1933, the American financial services landscape has changed dramatically. The complexity of financial regulation, the structure of American capital markets, technological progress and the tremendous growth of the economy all point to the appropriateness of re-examining the separation of commercial and investment banking.

Secondly, empirical evidence indicates that the assumptions used by the 1933 Congress in promulgating the *Glass-Steagall Act* were based on incorrect data. With the benefit of hindsight, economists are able to conclusively demonstrate that the link between commercial banks' securities activities and the stock market crash, bank panics and the Great Depression is tenuous. In *A Monetary History of the US 1857–1960* (1963), Milton Friedman and Anna Schwartz argue that restrictive monetary policy and protectionist trade measures contributed to the numerous bank failures.

Other economists point to additional alternative explanations. For example, technological advances in communications and transportation in the 1920s rendered superfluous small banks located in remote areas. In addition, dismal agricultural output in the late 1920s led to a number of mostly small bank failures when credit defaults occurred. Finally, poor supervision of undercapitalized small banks, coupled with the changing economic climate, inevitably produced some bank failures as well. Thus, research indicates that, contrary to Congress' view at the time, commercial banks' securities activities were not responsible for the economic malaise in the late 1920s and early 1930s. In fact, the majority of commercial banks with securities affiliates survived the Great Depression.

The separation of commercial and investment banking activities was not challenged for 50 years. In the 1980s, however, the undeniable dynamics of a globalized financial system and the nearly unanimous concurrence among economists that the rationale underlying the separation was incorrect prompted commercial bankers to urge Congress and federal regulators to reform the law. Several Congressional attempts to reform the law followed, but ultimately it was the regulators who answered the commercial bankers' pleas. Alan Greenspan, Chairman of the Federal Reserve, commented in 1987 that Glass-Steagall represented:

'... perhaps the single most important anomaly that now plagues our financial system'

The 1980s were a difficult decade for commercial bankers. In *Banking Law and Regulation* (1992), Jonathan Macey and Geoffrey Miller note that, in 1970, eight US banks occupied the list of the world's top 25 banks in terms of assets. By 1980, the number dropped by half and in 1990 only one US bank held on to a spot on the list. American banks' share of the financial services market diminished as consumers and businesses turned in greater numbers to the securities market as an alternative way to invest and to raise capital. It was in this environment that Citicorp petitioned the Federal Reserve in 1984 to allow one of its subsidiaries to engage in underwriting and dealing. Citicorp argued that 'engaged principally' (s. 20) was equivalent to a bank holding company's subsidiary earning revenues of 20% or less from bank-ineligible securities activities. The Federal Reserve responded negatively and Citicorp withdrew its application.

Regulators eventually became more receptive. In 1987, Bankers Trust petitioned the Federal Reserve to allow it to engage in private placements of commercial paper. Commercial bankers' lending profits dwindled in the 1980s as businesses turned to the commercial paper market for their short-term financing needs, rather than entering into traditional lending arrangement with commercial banks, and this phenomenon spurred Bankers Trust to file its application. The Federal Reserve determined that affiliates could engage in bank-ineligible securities activities such as the private placement of commercial paper, so long as the s. 20 subsidiary's revenues from such activities did not account for more than 5% of the bank holding company's revenues. Shortly thereafter, the Federal Reserve approved Citicorp, J P Morgan and Bankers Trust's applications to establish s. 20 subsidiaries to underwrite and to deal in commercial paper, municipal revenue bonds and mortgage-backed securities. Two years later, the Federal Reserve expanded the bank-ineligible securities activities to include corporate debt and equity underwriting and increased the revenue limit to 10%, an increment contemplated in the 1987 Citicorp order.

It should be noted that throughout this period of regulatory activity, a series of measures called 'firewalls' were imposed. The firewalls were intended to address bank safety and soundness issues, as well as potential conflicts of interest and risk management controls. The term 'firewall' derives from Adam Smith's *Wealth of Nations*, wherein he analogized the regulation of issuing bank notes to the construction of walls to prevent the spread of fire. In essence, then, the term connotes the prevention of financial risks that may spread within a banking entity.

INCREASED ROOM FOR GROWTH

After achieving a measure of regulatory relief in 1989, commercial bankers re-visited the revenue test with the Federal Reserve. Commercial bankers discovered that their eligible securities activities, such as underwriting and dealing in government securities, carried a shorter term than their newly obtained bank-ineligible securities activities so that when the yield curve steepened, the revenues derived from the bank-eligible securities activities declined relative to the revenues derived from bank-ineligible securities activities. Accordingly, commercial bankers petitioned the Federal Reserve for additional assistance. In 1993, the Federal Reserve adjusted its revenue test in order to take account of fluctuations in the level and structure of interest rates and permitted an adjustment by indexation to the 1989 interest rate structure.

The Federal Reserve recognized that the new indexation method would entail significant compliance costs for the commercial banks, so it provided an option for banks to use the previous, non-indexed test. Two Federal Reserve governors disagreed with the optional structure and concluded that the 10% revenue limit should be increased to accommodate the banks' pushing against the revenue cap. The commercial bankers agreed and, in 1994, 30 banks suggested an increase in the revenue limit to 25%. Several Federal Reserve governors commented at the time that they would consider raising the revenue limit, but not until Congress had been given the opportunity to enact reform legislation.

Congressional efforts to pass legislation failed and in 1996 the regulators stepped into the breach. A series of dynamic steps were taken by federal regulators. First, the Federal Reserve announced in September 1996 that interest earned on debt securities qualified as eligible revenue. By this time, though, the Federal Reserve was not the only regulator willing to push reform efforts on behalf of the commercial banks. In November 1996, the Office of the Comptroller unveiled a new rule allowing national banks to conduct bank-ineligible securities activities without needing the bank holding company structure, a necessary component for s. 20 subsidiaries. Under the new rule, applications would be reviewed on a case-by-case basis by the Comptroller of the Currency and national banks could potentially engage in a variety of new activities, such as the establishment of insurance subsidiaries.

Despite the seemingly broad mandate, only two banks, Nations Bank and Zion's Bank, actually filed applications with the Office of the Comptroller. Following the Comptroller of the Currency's announcement, the Federal Reserve quickly acted upon its August 1996 proposal and increased the revenue limit for a s. 20 subsidiary's bank-ineligible securities activities from 10% to 25%. This was effective from 6 March 1997. During these months of heightened regulatory activity, the Federal Reserve also modified or eliminated some of the firewalls imposed in 1987 and 1989.

Commercial bankers responded immediately. On 7 April 1997, Bankers Trust announced that it would acquire Alex Brown & Sons in a stock swap valued at $1.7 billion. Three other significant deals followed. In mid-May, Swiss Bank Corporation acquired Dillon Read for $600m and on 9 June, Bank America Corporation, the third largest commercial bank in the US, announced its plan to purchase Robertson, Stephens & Co for $540m. The most recent proposed acquisition was Nations Bank Corporation's $1.2 billion combined cash-stock offer for Montgomery Securities.

So far, only niche market investment banks have been gobbled up by the commercial banks. Alex Brown & Sons is one of the oldest and most respected investment banks but its franchise is primarily focused on the US equity market in a limited number of industries. Dillon Read, an investment bank with a blue-chip client list, was once one of the most powerful and influential Wall Street firms but today it remains primarily an advisory boutique. Robertson Stephens and Montgomery Securities are also regional, San Francisco-based investment banks that capitalized on the tremendous expansion of a selected number of industries, such as technology and healthcare, but have yet to achieve a national franchise or to expand beyond more than a handful of industries.

It is too early to determine if these acquisitions will return a healthy profit for the acquiring commercial banks. What is likely, though, is that other commercial banks will take advantage of their new growing room. The golden opportunity for any commercial bank is the acquisition of a bulge bracket investment bank, boasting an array of financial services both nationally and internationally. However several obstacles to a profitable union exist. For example, the marriage between a commercial bank and an investment bank would entail many difficult integration decisions, such as operational control and streamlining overlapping product areas. In addition, cultural clashes on issues such as compensation are likely. There are certain to be some profitable and some not-so-profitable unions. What is most significant, however, is that the gradual dissolution of artificial barriers between sectors of the financial system will result in the more efficient use of capital, decreased costs for consumers, diversification of risk for financial institutions and a shot in the arm for commercial banks competing against international banks for capital.

Commercial banks' prosperity depends on the retention of a comparative advantage over other entities in assembling capital and investing in profitable lines of business. Regulation, by design, closes some opportunities or increases the costs of finding a substitute opportunity. The commercial banks' comparative advantage is damaged and capital simply moves on in search of another intermediary.

STRUCTURE AT ODDS WITH MARKET

The banking regulatory structure in the US developed largely as a response to real or perceived crises or emerged as a result of a political compromise between competing sectors of the financial system. This inchoate approach translates into a banking regulatory structure at odds with economic theory and market practice. For example, modern portfolio theory conclusively demonstrates that diversification of investments is the best way to minimize risk. It is ironic, then, that the *Glass-Steagall Act* achieves the opposite of its purported objective, the promotion of bank safety and soundness. By restricting the types of investments and securities activities commercial banks may engage in, legislators actually increase commercial banks' risk rather than decrease it. Moreover, the absence of commercial bank competition in certain securities markets results in a greater concentration of entities in those areas, another antithetical result. Not only have the rationales behind the *Glass-Steagall Act* been contorted, but the fears of legislators in 1933 have never been realized. Research indicates that the investment banking activities of US commercial banks doing business abroad have been conducted without significant loss. Moreover, in the ten years since commercial banks have been able to conduct a limited amount of bank-ineligible securities activities, no significant adverse consequences have occurred.

A variety of empirical studies conclude that a number of economic benefits are obtainable if the barrier between commercial banking and investment banking disappears. This article will not attempt to engage in an extensive analysis of the economic studies undertaken to date. Apart from the recognized economic benefits of the portfolio theory and the efficient capital markets theory, some of the more obvious benefits should, however, be mentioned. For example, natural synergies between commercial and investment banks, such as credit assessment, are capable of producing economic benefits. Credit evaluation is an important element of both traditional lending and underwriting securities, and loan syndication among commercial banks is functionally similar to an underwriting arrangement. A certain economy of scale can be reached if credit assessment information is secondarily utilized when a borrower wants to issue debt. In a broader context, the largest banks in the world are able to compete more effectively for capital since they are not precluded from consolidating commercial and investment banking activities. In essence, US commercial banks have been fighting for capital and growth with one hand tied behind their back.

Notwithstanding the economic advantages involved in dismantling the *Glass-Steagall Act*, those benefits must be weighed against possible disadvantages. One of the most frequent concerns voiced in the debates over the *Glass-Steagall Act*, then and now, is the potential for conflicts of interest. The *Pecora* hearings in the 1930s highlighted some of those conflicts, most notably the worry that a commercial bank, in its eagerness to promote the securities it underwrote, would eschew a balanced presentation of relevant facts and inadvertently (or advertently, if the commercial bank were less scrupulous) mislead its depositor-customers who might be persuaded to invest in such securities. As mentioned above, regulators designed firewalls to prevent these conflicts of interest. If, in fact, the established firewalls have prevented conflicts of interest, it is expected that no difference in the initial yields of similar s. 20 subsidiaries and investment bank underwritings should exist. In 'Repealing Glass-Steagall: The Past Points the Way to the Future' *Federal Reserve Bank of Philadelphia Business Review* vol. 37 (July/August 1996), Amar Gande, Manju Puri, Anthony Saunders and Ingo Walter, in a study undertaken in 1995, found no significant statistical differential in the yields of similar issues underwritten by four s. 20 subsidiaries and those underwritten by investment banks.

WHO BENEFITS FROM REFORM?

Another economic cost, infrequently noted in the journalistic accounts of the regulatory and legislative debate, but of potentially great significance, involves regulatory turf battles. Even if the *Glass-Steagall* Act is eventually abandoned, who will regulate what in the new structure? In his 'The Theory of Economic Regulation' in the *Bell Journal of Economic and Management Science* (Spring 1971), Nobel Prize economist George Stigler argued that regulators do not always guard the public's interests, but rather serve the interests of the regulated. In essence, Stigler theorized that suppliers, such as regulators and legislators, sell power over the wealth of a regulated industry. Various groups compete for access to the supplier's power and ultimately the more cohesive group wins. Stigler stated that the public typically lost these battles because of the perceived defused benefits, their weak incentives to collect information and the difficulties in organizing. The groups most directly affected by regulation, on the other hand, typically won because of their ability to organize and to bring pressure on the political process. Thus, consumers lose to the more organized and well-informed 'producer' groups as a result of their informational and organizational disadvantages.

In the case of the recent regulatory developments discussed above, it is interesting to observe that Stigler's theory has application here as well. While it is certain that the Federal Reserve and the Office of the Comptroller are well-intentioned in their efforts to reform the banking regulatory structure and bank regulations appear to be lessening, the regulators are not presiding over a concomitant decrease in their numbers. Even before the *Glass-Steagall Act* is history, federal regulators are staking out their claims to new regulatory territory. The Federal Reserve advocates a system in which an 'umbrella' regulator would have authority over all aspects of the new consolidated businesses. The Office of the Comptroller and the Securities and Exchange Commission, on the other hand, contend that functional regulation is the best approach, whereby each regulator will remain in charge of its traditional area of authority. Regardless of which regulatory view succeeds, the cost that consumers pay is high. Tax dollars feed large regulatory staffs while regulation ultimately increases the cost of financially-related services to the consumer. It would seem prudent to ask for a good, old-fashioned cost-benefit analysis of our banking regulations.

Only Congress can pull the plug on the *Glass-Steagall Act*. So far, though, Congress has been reluctant to do so, choosing instead to remain on the sidelines while regulators assumed responsibility for the most far-reaching reforms yet. The regulatory reforms promulgated by the Federal Reserve and the Office of the Comptroller are certainly welcome but they are not a panacea for the burdens imposed by the *Glass-Steagall Act*. The selective unwinding of particular restrictive Depression-era laws is not a substitute for the development of comprehensive structural reform of the banking industry. A modern regulatory structure is essential if the US is to continue its pre-eminent position in the global financial market. Our financial services system cries out for deliverance.

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