

**EXPANDING THE  
LIMITS OF POWER:  
The Federal Reserve  
and the  
Implementation  
of Functional  
Regulation in the  
Gramm-Leach-Bliley  
Era**

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## ABSTRACT

*Research on bureaucratic behavior suggests that agencies are more likely to use the implementation process to extend their power and influence under particular circumstances. I argue that when an agency has been delegated considerable power by Congress, but provided only vague guidance on how to implement this authority, an atmosphere of uncertainty and competition is created. Under such a circumstance the agency will feel pressured to further extend its power in order to defend its regulatory turf against competitors and protect the authority it was delegated. I test this proposition by examining the behavior of the Federal Reserve as it implements the functional regulation provisions of the Gramm-Leach-Bliley Act. Evidence from the Federal Reserve's dealings with the Securities and Exchange Commission during the approval of the Schwab – U.S. Trust merger provides evidence that the Fed is indeed acting to extend its power and influence.*

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Research over the last decade on the capacity of legislatures to shape the way administrative agencies implement policy has invigorated the study of bureaucratic behavior. Once assumed to have the upper hand in most dealings with legislatures, new theories suggest that the lack of frequent oversight may actually mean bureaucrats are obedient agents to the congressional principal (Weingast and Moran 1983; McCubbins and Schwartz 1984). But unless agencies are populated by automatons programmed to carry out legislative will, these utility maximizing theories must concede that the choices of bureaucrats, like those of legislators, further their own notions of what policy should be. If the process of implementation provides an opportunity for agencies to engage in policy shaping, then under what circumstances will an agency use such an opportunity to further its preferences? In other words, what political conditions encourage agencies to extend their power and influence?

I argue that the condition most conducive to political behavior by an agency, thereby creating the greatest chance of policy deviation, is when a legislature delegates extensive power but provides little guidance on its use. Not only does the agency have the opportunity to take advantage of the situation to extend its power, but may even feel pressured to do so due to the uncertainty it faces regarding the final outcome of the implementation process. Furthermore, competition with other parties, including other agencies, also trying to take advantage of this circumstance to circumscribe the agency's new authority may pressure it into acting aggressively to protect its regulatory turf. In

order to test this proposition I examine the first full year of implementation of provisions in the Gramm-Leach-Bliley Act directing the Federal Reserve to act in concert with other regulatory agencies to collectively regulate banking, finance and insurance companies. I find evidence that the Federal Reserve has indeed taken advantage of the highly political and uncertain atmosphere created by this landmark law to extend its power beyond its traditional banking domain at the expense of these other agencies.

## **POLICY IMPLEMENTATION AND THE POLITICAL BEHAVIOR OF EXECUTIVE BRANCH AGENCIES**

Two cornerstones in our understanding of policy implementation are that the process is often political and the parameters of this politicization are variable. In their study of the Economic Development Administration, Pressman and Wildavsky (1973) demonstrated how policy implementation often becomes politicized when government officials and organized interest groups involved in legislative battles shift their fight into the regulatory arena. This follows Schattschneider's (1960) argument that interests unsuccessful in one decision making arena may look for another in which they can continue their struggle on more favorable terms.

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Certainly, executive agencies themselves are not above pursuing their own self-interest during times of political uncertainty. Downs (1967) and Niskanen (1971) demonstrated that bureaucrats often act politically to further their personal policy goals and the power of their agencies during implementation. Yet, positive theorists modeling the relationship between the legislature and the bureaucracy argue that the capacity of agencies to use implementation to expand their own power beyond legislative intent is conditioned on the breadth of the distribution of preferences in the enacting legislative coalition (Weingast and Moran 1983; McCubbins, Noll, and Weingast 1987; 1989). They suggest that if legislators with substantially different policy preferences are forced to compromise in order to pass a bill, then it is more likely that the bill will delegate broad responsibilities to the agency, but provide it with few specifics on how to implement the policy. This suggests that it is under this type of implementation circumstance that the agency will have the greatest discretion space in which it may engage in political behavior.

There remains considerable debate in the scholarly community as to the extent of a legislature's real capacity to constrain the bureaucracy (see Moe 1987; Wood 1988; Balla 1998) and I do not attempt to further this debate. Rather, given a circumstance where the legislature has chosen to delegate authority and empower an agency, will that agency necessarily engage in political behavior to further extend this power? John Brehm and Scott Gates (1997) suggest that agencies are by no means only looking out for their own self-interest. They often desire to faithfully interpret legislative intent and respond to public desire. Assuming they are correct, and there is variation in how agencies respond when the opportunity to engage in political behavior arises, what pressures might push an agency to exceed its legislative mandate and extend its influence? I suggest that uncertainty and competition provide the necessary pressure.

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Students of legislatures over the last decade have used the uncertainty government officials face over how the policies they vote for will impact their constituents as a primary motivating factor in models of decision making. For example, Krehbiel (1991) and Cox and McCubbins (1993) theorized that uncertainty over potential policy outcomes sparked the development of a committee system populated by experts but held accountable to either the entire chamber or the majority party. Wright (1996) and Austen-Smith (1993) use uncertainty to explain why legislators grant access to, and build long term relationships with, interest groups. Interest groups, they argue, act as providers of the critical information regarding policy impacts on constituents that legislators need in order to cast votes furthering their political careers.

When diverse legislative coalitions delegate substantial authority but provide little guidance on implementation to an agency, then it is reasonable to assume that the role the agency is expected to play has not been well defined. With the scope of the agency's power still open to interpretation and change, competitors, be they other agencies or organized interests, may attempt to restrict this power, increasing the atmosphere of uncertainty for the agency. The logical response for the agency to adopt under such a circumstance is to take advantage of the implementation process to extend and entrench this new power to preserve its gains and resist its opponents. Furthermore, it is those agencies granted the most authority by the legislature who should most aggressively engage in such behavior—for they have the most to lose.

Their uncertainty as to the final outcome as the implementation process slowly solidifies into a more institutionalized regulatory structure provides a strong incentive to place themselves in the best position possible while the opportunity permits. In other words, due to the uncertainty effect, those agencies delegated the most authority by the legislature are the ones most likely to use it to further their influence. And, when an agency perceives other agencies as its competitors, it will extend its power at their expense.

## **FUNCTIONAL REGULATION AND THE “UMBRELLA REGULATOR”**

This theoretical framework provides a basis by which the first couple of years of implementation of the Financial Modernization Act of 1999 may be evaluated. Better known as the Gramm-Leach-Bliley Act (GLB),<sup>1</sup> this bill is almost certainly one of the most important milestones in the history of national banking, investing and insurance policy. Although a variety of regulatory and legislative actions over the last fifty years have contributed to the erosion of the legal barriers set up by the Glass-Steagall Act of 1933 separating the banking, investing and insurance industries, GLB took the decisive step of formally erasing such Depression Era laws. More importantly, it set the foundations of a new regulatory structure through which banks, Wall Street brokerage firms and insurance companies can enter into each other's lines of business through the creation of multi-purpose financial holding companies (FHCs). Even more than the enactment of financial deregulation in 1982 and the Riegle-Neal Interstate Banking Act of 1994, GLB is expected to fundamentally alter the shape of the financial industry by permitting the blurring of these three sectors into one-stop shopping, multi-service conglomerates. Citigroup, the colossus created through the union of Travelers Insurance and Citicorp, serves as the proto-type for what these new firms may look like.

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The politics surrounding the enactment of GLB are documented elsewhere (see Perkins 1971; Indick and Domenici 1996; Williams and Jacobsen 1995; Holyoke 2001). Although a variety of issues polarized interests representing different sectors of this new finance industry, the most contentious issue, and one of the last to be resolved, was the provision establishing the Board of Governors of the Federal Reserve System as the “umbrella regulator” over the new FHCs. Although not granted complete regulatory authority over an FHC, GLB did give the

Federal Reserve the power to oversee the consolidated operations of companies containing investment subsidiaries traditionally regulated by the Securities and Exchange Commission, and insurance subsidiaries regulated by state insurance departments. Through vigorous lobbying, Fed Chairman Alan Greenspan was able to provide his agency with what on paper appears to be the lion's share of the regulatory pie, a powerful position to oversee the future of the financial industry. As others have pointed out, such behavior has characterized much of the Fed's history (Kettl 1986; Greider 1989).

100 So intense were the political battles over Greenspan's new authority that lawmakers and interest groups could only agree to grant this power after limits were set in place. Although provided the authority to oversee the safety and soundness of the parent financial holding company, the Federal Reserve was not permitted to regulate the specific banking, investing, or insurance subsidiaries within that company. These would continue to be regulated by traditional state and federal agencies. But so difficult were the details involved in crafting what has become known as "functional regulation", and so diverse were the preferences of the legislators and interest groups backing the final bill, that very little guidance on how this system should work was provided. Instead, without articulating any line of demarcation, the Federal Reserve and the traditional regulators were left to figure it out for themselves.

In sum, the functional regulation provisions of GLB were established by a broad coalition of legislators who delegated considerable power to the Federal Reserve. Unable to develop precise statutory guidelines without shattering their coalition, legislators left the details of implementation to the involved regulatory agencies. Although this created a wide discretion space for the Fed to act in, the requirement to coordinate its oversight with other agencies that might view the Fed as an intruder in their traditional regulatory turf created intense competition and an atmosphere of uncertainty. In this environment implementation of GLB's functional regulation provisions may be evaluated by answering the following questions:

1.) How extensive is the Federal Reserve's actual new authority as measured by the number of conversions to multi-service FHCs? Have traditional investment, securities brokerage, or insurance companies been willing to submit themselves to Federal Reserve oversight by converting to FHCs, or are most FHCs emerging from the banking sector?

## **Holyoke: Expanding the Limits of Power**

2.) To the extent these conversions have been occurring, are there appearing patterns of service disparities by FHCs, creating variation in the Federal Reserve's regional authority vis a vis other regulators?

3.) How has the Federal Reserve implemented the functional regulation statutory directive in its dealings with traditional regulators? Has it used implementation as an opportunity to extend its power deeper into the FHC structure at the expense of traditional regulators?

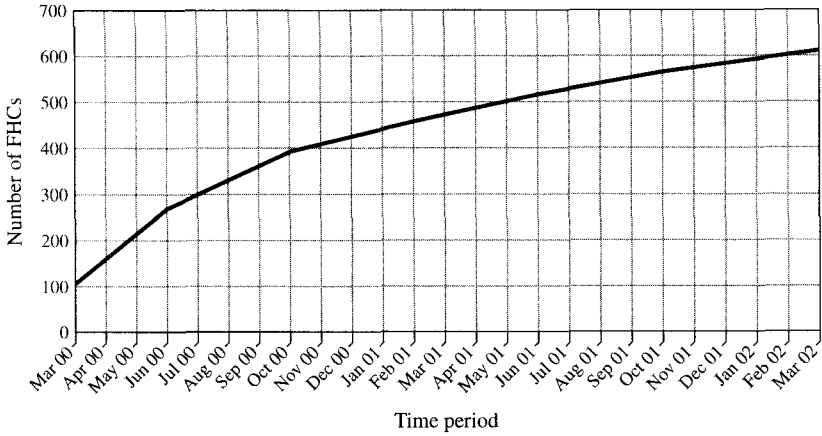
Questions one and two evaluate the real extent of the new authority granted to the Federal Reserve by Congress through its position as the umbrella regulator of FHCs. If FHCs are few and far between, or highly concentrated geographically, then the Fed is less likely to be concerned with protecting its new power from competitors. There would simply be less at stake. Question three examines the extent to which the Federal Reserve, from this pre-eminent position, is using the implementation of functional regulation as an opportunity to reduce uncertainty regarding its future power by further extending its authority to regulate FHC subsidiaries at the expense of traditional financial regulators.

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## **TRENDS IN THE FINANCIAL INDUSTRY AFTER GRAMM-LEACH-BLILEY**

Question one can be addressed by examining trends in conversions by bank holding companies and non-bank companies into FHCs. Periodically the Federal Reserve publishes a list of all current FHCs and their geographic location which can be linked to data on total holding company assets provided by the Federal Deposit Insurance Corporation.<sup>2</sup> The overall rate of entry into the multi-services world is shown in Figure 1 where the trend in conversions to FHC status are plotted beginning with the first conversions approved on March 11, 2000.<sup>3</sup> As the graph demonstrates, the number of conversions continues to rise with the slope of the line holding more or less constant from June of 2000 to the present, indicating that the FHC sector is growing at a healthy pace. As of March, 2002, there were 611 FHCs, with approximately \$5,677 billion in assets, representing 10% of all bank holding companies and 16% of financial sector assets.<sup>4</sup> If this trend continues, by the end of 2002 nearly a quarter of all assets in the financial system would be held in the FHC sector.

Figure 1: FHC Conversion



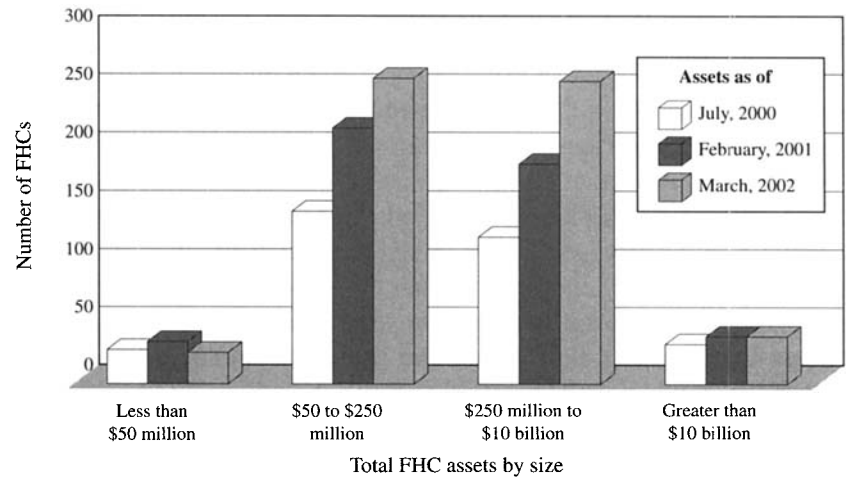
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Breaking up these aggregated data by asset levels it is possible to explore the reach of the Federal Reserve's new power in more detail. Is the community of multi-service FHCs limited to the largest financial firms, such as Citigroup and Morgan Chase, or does it extend to smaller corporations as well? The extent to which smaller institutions have chosen to enter the FHC community as compared to larger corporations is displayed in Figure 2. This graph shows that the vast majority of FHCs are tending towards the middle range, between \$50 million and \$10 billion in total assets, neither behemoth nor mom-and-pop operation.<sup>5</sup> Furthermore, it is these middle classes of FHCs that have exhibited the most growth while the high end has remained relatively stable and the low end has actually fallen slightly.

Geography may constrain the Federal Reserve's new power, and permits an answer to question two on disparities in the range of services offered to consumers. If the new FHCs are concentrating on the coast, then more rural communities in middle America may not have access to the touted convenience of one-stop financial shopping many interest group advocates promised, and the extent of the Federal Reserve's power may be limited geographically.<sup>6</sup> In order to examine geographic dispersion by asset size, Figure 3 displays the number of FHCs and total assets for each of the twelve Reserve Bank Districts breaking out assets by large and small institutions.<sup>7</sup> With the exception of the Cleveland District on the one hand, and the Atlanta District on the other, all of the non-coastal Reserve Districts have greater numbers of smaller

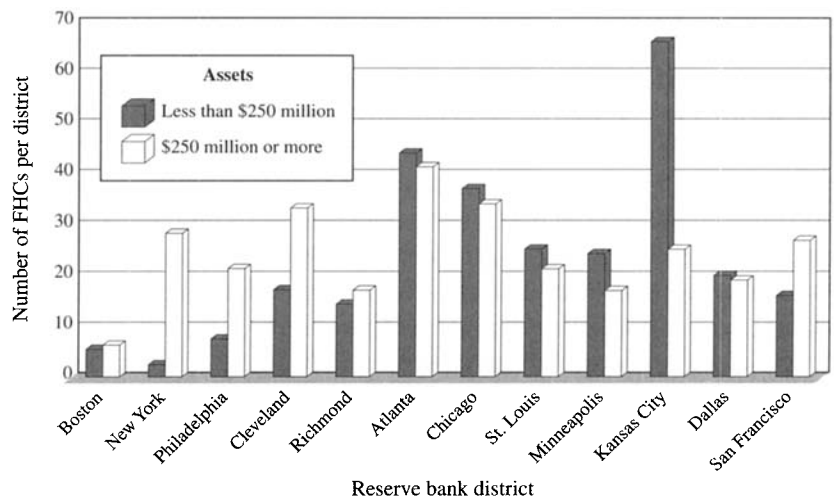


Figure 2: FHCs Grouped by Total Assets



FHCs than larger. Most likely this is because, historically, most of the great money-center banks have tended to cluster towards the east and, to a lesser extent, west coasts. Smaller banks in rural America, on the other hand, are more likely to expand into the insurance and investment business because there may not be other convenient local providers of

Figure 3: Distribution of FHCs by Reserve Bank Districts as of March, 2002



such services, encouraging rural community banks to diversify.<sup>8</sup> In terms of FHC assets, the coastal Reserve Districts hold \$4,389 billion, with \$1,289 billion held in the non-coastal districts.<sup>9</sup> Yet the data shows that no part of the country is conspicuously low in FHCs; the Federal Reserve's power over the new financial industry extends to both the big and the small all across the nation.

Question one also asks if non-bank firms from the insurance and investment industries have been willing to submit themselves to Federal Reserve oversight by choosing to enter the banking business as FHCs, expanding the Fed's authority across several industry sectors instead of just banking. At first glance the answer would appear to be a resounding "no", for to date only nine firms, including Charles Schwab and Metropolitan Life, have chosen to convert. Yet according to reports in the trade press, pressure is slowly building on non-banks to convert and diversify their lines of business, although recent economic downturns may have dampened this pressure somewhat.

104 Banks have been forced to be more aggressive in expanding their range of services. Under pressure by investors to increase earnings during a time when the value of bank stock has been falling, coupled with the threat of diminishing market share, banks are largely looking to expand as acquirers of investment companies or to offer themselves up for acquisition.<sup>10</sup> Although published accounts of the industry's expansion has been dominated by the great banks, such as Chase-Manhattan's acquisition of venerable J.P. Morgan, this pressure to diversify is falling on the small institution as much as, if not more than, the money-center banks. For example, Rawlins National Bank in Wyoming, with only \$155 million in assets, recently purchased the insurance agency across the street because the only direction they could grow was laterally (Reich-Hale 2000).

But pressure may be building in other sectors to follow the lead of the banking industry. Although some investment firms claim there is not enough demand from customers for traditional banking services to warrant conversion (Weidner and Mandaro 1999), the incursions of the great Swiss financial institutions UBS and Credit Suisse into domestic markets through their acquisitions of Wall Street stalwarts PaineWebber and Donaldson, Lufkin & Jenrette, respectively, suggest that the key to future viability is diversification. Combined with pressures at home from emerging on-line investment competitors, such

as e-Trade, Ameritrade, and Datek, once proudly independent Wall Street firms may be forced to link with other types of financial service providers. Schwab admitted as much in its ambitious move to expand into the banking sector through its acquisition of U.S. Trust Company through which it may now market the latter's high-end financial products out of Schwab's nationwide network of offices (PR Newswire 2000). In order to stay out of the "acquired" box on merger and acquisition score sheets, firms such as Morgan Stanley Dean Witter, Goldman Sachs and Merrill Lynch may have to diversify widely, requiring conversion to FHC status.

The insurance industry has been less active in service diversification, leading some analysts to doubt that the industry has the capital to acquire banks and investment firms. Others argue that there is less need for these companies to acquire banks because many are already engaging in some form of banking through unitary thrifts.<sup>11</sup> The major exception is the de-mutualized Metropolitan Life Insurance Company that not long ago acquired Grand Rapids Bank of New Jersey in an effort to move deeper into the commercial banking field and recently opted for FHC status. Other large insurers, such as Prudential Financial, with recently completed IPOs may have enough capital to consider taking steps deeper into the world of banking as FHCs.

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The reason the investment and insurance sectors have not been as quick to take advantage of GLB may not only be the fact that pressure to diversify is building more slowly, although recent economic uncertainties have probably not created an atmosphere conducive to risk taking. Other perspective problems may be giving firms cold feet as well. These include the complicated process of integrating the front and back office operations of firms that have evolved in different markets. Unequal levels of technology between potential partners may also act as a disincentive, knowing that the computer systems of one partner would have to be upgraded and then integrated into a single system. In many cases the professional working cultures of banks, investment firms and insurance companies may simply be too different to function as one corporation. Establishing subsidiaries *de novo* also has its share of disincentives as institutions may end up pushing into new markets that are already well saturated with better known brand name products. Finally, entering the insurance business means complying with multiple state insurance codes, often considered more trouble than it is worth.

If the diversification of the banking sector through FHCs continues, and if expectations regarding the inevitable expansion of the insurance and brokerage industries are born out, then it appears that Chairman Greenspan was indeed farsighted in his maneuvering for the title of umbrella regulator. The Federal Reserve has a great deal of new territory to defend against other financial regulators and interest groups unfriendly to the Fed and who might use the implementation process to circumscribe this new power. It now remains to answer question three and see if this uncertainty has motivated the Federal Reserve to respond by using implementation as way to further expand its power and defend its new turf.

### **IMPLEMENTING FUNCTIONAL REGULATION: THE CASE OF THE CHARLES SCHWAB – U.S. TRUST COMPANY MERGER**

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The act of conversion into a financial holding company creates an excellent opportunity to observe the behavior of the Fed as it learns to deal with other financial regulators in the new GLB environment. Although both bank holding companies and non-banking firms may apply for conversion to FHC status, I will examine the process for non-banks. Unlike bank holding companies, which they already regulate, conversion brings non-bank corporations under the eye of the Fed for the first time. Furthermore, non-bank firms already have a traditional regulator, providing an opportunity to observe how the Fed behaves when the location of the line of demarcation between umbrella regulator and functional regulator is unknown. As it has no history of overseeing the company, and no experience working with its people, the Federal Reserve is also more likely to require more detailed examinations of that company. To do so it must coordinate its efforts with the traditional regulators, in this case the Securities and Exchange Commission (SEC), to establish a procedure, providing an opportunity for the Federal Reserve to push its authority deeper into the FHC at the SEC's expense. The analysis focuses on the conversion of Charles Schwab, a discount brokerage firm, so that it could acquire U.S. Trust Company, a New York based private bank.

The analysis is essentially qualitative in that I am using a single case, although I do quantify elements of the order approving the Schwab conversion in order to compare it to three other mergers. The

justification for using a single case is twofold. The first is practical. Schwab is the only non-bank FHC conversion for which there is any detailed information available on the procedures the Federal Reserve developed. Second, and more importantly, Schwab is the trend setter. As with most bureaucratic systems, once a procedure is established it normally remains as the standard operating format. Therefore it makes sense to focus on the case that established the procedure, for how the staff and board members of the Fed proceeded in the Schwab case is a good indication of how they will approach similar cases. The analysis is largely based on publicly available documents from the Federal Reserve regarding the conversion and merger. A couple of interviews were conducted with staff at the Board of Governors but they were purely for help to place the documents in context, not for the gathering of additional data.

The first part of the analysis requires the establishment of a baseline indicating what functional regulation would look like if the Federal Reserve did not choose to use the opportunity to enhance its authority. Although the language in GLB on functional regulation is vague, it remains the logical starting point to use in building this baseline. Under §§111(B)(i) and (iii)(I), GLB states:

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“For purposes of compliance with this paragraph [on functional regulation], the Board shall, to the fullest extent possible, accept – (I) reports that a bank holding company or any subsidiary of such company has provided or been required to provide to other Federal or State supervisors or to appropriate self-regulatory organizations... In the event that the Board requires a report under this subsection from a functionally regulated subsidiary of a bank holding company of a kind that is not required by another Federal or State regulatory authority or an appropriate self-regulatory organization, the Board shall first request that the appropriate regulatory authority or self-regulatory organization obtain such report.”

The intent of Congress appears to be that the Federal Reserve is not to go directly to the subsidiaries of the holding company for information on operation and safety procedures unless it absolutely must. Rather, the functional regulators are to either provide the requested information, or request it from the holding company subsidiary themselves.

The stated Federal Reserve policy on functional regulation appears to support this position. On August 15, 2000, the Division of Banking Supervision and Regulation at the Federal Reserve released a supervisory letter spelling out how they intend to interact with other agencies responsible for FHC subsidiaries.<sup>12</sup> In the letter the Fed asserted its responsibility for overseeing an FHC “on a consolidated or group-wide basis with the objective of ensuring that the holding company does not threaten the viability of its depository institution subsidiaries.” In other words, the traditional safety and soundness approach espoused in the past regarding bank holding companies was to drive their approach to FHC oversight as well. The letter goes on to specify that it will examine risk management procedures and performances at the “consolidated level” and all of the risk and performance assessments of the individual entities will be solely the responsibility of the traditional regulator. Furthermore, to obtain its information on the safety and soundness of the functionally regulated entities, instead of directly requiring non-bank entities to report information, Federal Reserve staff will rely on those reports submitted to the functional regulator.

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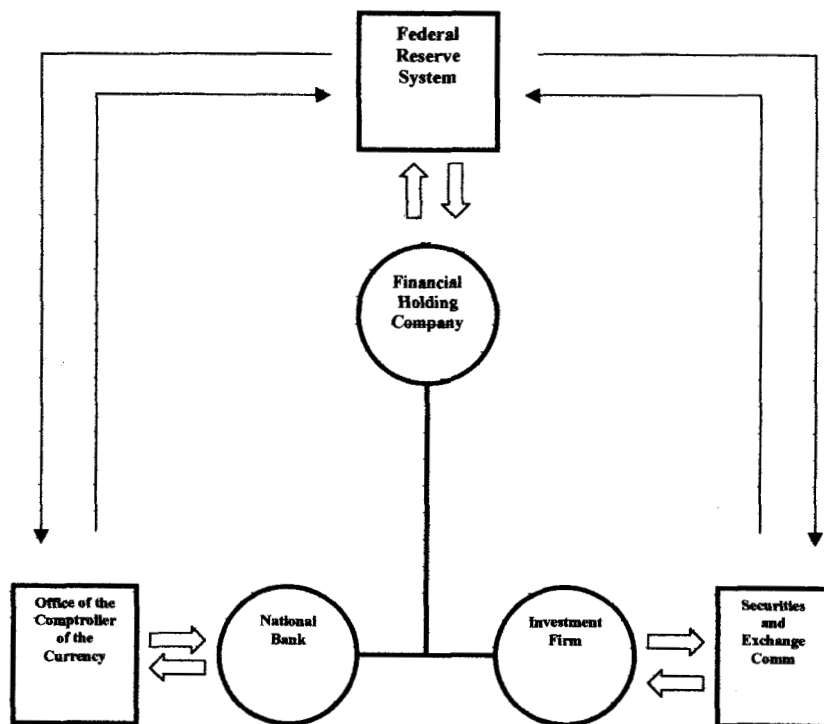
This suggests two criteria to construct a baseline on how the Federal Reserve ought to approach the implementation of functional regulation:

- The Federal Reserve will only concern itself with risk management practices and corporate performance as it effects the entire holding company, not the performance of the specific non-bank entity;
- The Federal Reserve will not request additional materials from the non-bank entities themselves, but will instead obtain what information they require from the functional regulator.

Figure 4 provides a diagram of the relationship between various regulators and the different parts of the new Schwab FHC as would be expected given this baseline. It now remains to determine what the Federal Reserve actually did in Schwab.

One method of examining the Federal Reserve’s behavior in the Schwab – U.S. Trust conversion and merger is to compare the issues discussed by the Board of Governors, as indicated in the published order approving the merger, with those of other mergers. In order to capture different kinds of variation I compare elements of the Schwab

**Figure 4**  
**Functional Regulation Flow of Information**  
**For the new Schwab Under Gramm-Leach-Bliley**  
Arrows Represent the Flow of Information and Communication



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– U.S. Trust merger order with the approval orders for three different kinds of other mergers. I select the Citicorp – Travelers merger because it is the most similar to Schwab, the acquisition of a banking corporation by a non-banking firm. This merger, however, took place prior to the passage of GLB and the Federal Reserve was not required to comply with functional regulation and clearly went directly into the subsidiaries of both companies to obtain information needed to evaluate the merger.<sup>13</sup> If the Federal Reserve is implementing functional regulation in a manner that cuts into the territory of other agencies, then there should be considerable similarity between the issues discussed in Schwab and those in Citigroup.

TABLE 1  
COMPARISON OF HOLDING COMPANY MERGERS BY TOPICAL AREA

Category	Schwab - U.S. Trust	Citicorp – Travelers	Bank of America - NationsBank	Regions – First Commercial
Post Merger Assets (000)	\$34,300,000	\$751,000,000	\$580,000,000	\$31,800,000
Words in Approval Order	5,761	30,736	24,198	5,211
CRA Assessment Performed	Yes	Yes	Yes	Yes
Total Words on Convenience and Needs Factors	2,295	11,737	11,299	2,460
Public Hearings Held	No	Yes	Yes	No
Number of Comments	1	425+	1,600+	3
Total Public Comment Period	21 days	48 days	65 days	27 days
Words Describing Negative Comments	609	5,170	2,859	111
Words Describing Positive Comments	0	828	459	0
Words on Anti- Competitive Impacts and Market Concentration	463	1,448	5,767	467
Interstate Analysis Conducted	No	No	Yes	Yes
Herf-Hirsch Index Increase	None listed	None listed	Average of +137 points in 17 markets	+15 points to 1885 in one market
DOJ Consulted on Anti-Competitive Impact	Not indicated	Yes	Yes	Not indicated
Divestitures Required	No	Conditional	Yes	No
HMDA Analysis Performed	Yes	Yes	Yes	Yes
Community Reinvestment Commitment Made	No	Yes	Yes	No
Words on Nonbanking Activities	816	10,167	2,171	516
Examined Competitive Impacts of Nonbanking Activities	Yes	Yes	Yes	Yes

Source: Orders issued by the Board of Governors of the Federal Reserve System approving these mergers.  
Word counts performed by the author.

I also compare Schwab to the acquisition of Bank of America by



NationsBank in 1998. Although this merger dealt with two banking firms, both engaged in a degree of non-banking activity and both had extensive markets similar to Schwab's. Again, there should be some similarity between the issues discussed in these mergers if the Federal Reserve is truly extending its power. Finally, I also include a comparison with a routine, randomly selected pre-GLB merger between two smaller companies. The merger selected was between Regions Financial Corporation and First Financial Corporation of Little Rock, Arkansas, in April, 1998.<sup>14</sup> If the Federal Reserve is looking beyond the parent company level and into the non-bank subsidiaries of Schwab, then there should emerge clear differences from the Regions merger. In conducting the comparison I read through each merger approval order and identified the issue discussed in each paragraph. In many cases I counted the number of words to measure the extent of the discussion and its importance to the Board of Governors. Sections on similar topics in each order were consolidated into single categories. The results are provided in Table 1.

In terms of change in the Board's behavior as measured by what it openly considered, Schwab - U.S. Trust looks surprisingly more like the standard Regions - First Commercial merger. The fact that the former is a cross-industry merger and not a traditional bank holding company transaction appears to be largely irrelevant. Although every line in Table 1 provides comparative information on these mergers, to ascertain whether or not the Board of Governors used Schwab as an opportunity to intrude into issues that may be the turf of the traditional subsidiary regulators requires only looking at a few categories. The results do not provide evidence to support a claim of the Fed extending its own prerogatives through functional regulation implementation. Even though the competitive impacts of Schwab's non-banking activities, arguably the province of the SEC, were considered, the amount of discussion as measured through word counts in the "Words on Anti-Competitive Impacts and Market Concentration for Banking and Non-Banking Entities" was smallest for Schwab. More importantly, the amount of discussion on non-banking activities at the new Schwab was quite small, considerably less than for either Citigroup or the approval of the new Bank of America.

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At this stage it appears that the Federal Reserve took a conservative approach to functional regulation, restricting its consideration to issues surrounding the parent company and elements of the banking law under

its traditional jurisdiction. Had the Fed been inclined to push its authority deeper into the holding company to oversee the brokerage dealings of Schwab there should have been more evidence of discussion on these topics. Yet considering the final results of the Federal Reserve's examination of the Schwab – U.S. Trust merger as published in the approval order may mask other critical information. Federal Reserve staff may have conducted a detailed analysis of risk management and operation structures at the subsidiary level, and not finding any particular problem worth reporting, did not highlight non-banking activities in the subsidiaries as major issues worth the Board's time. In fact, this may be what happened.

112 Although the extensive staff discussion memos and correspondence available to the public on the Schwab – U.S. Trust merger have been too heavily edited by Federal Reserve legal staff to allow systematic comparisons with the other mergers, the information that is available is revealing. A considerable amount of the documentation Schwab submitted for the merger came from the Form 8-K Current Reports they are required to file with the Securities and Exchange Commission regarding the current status of the company and expectations of future performance and risk.<sup>15</sup> Two reports filed by U.S. Trust with the SEC in January and February 2000 were also submitted with the application. Most of the information contained in these reports dealt with the performance and risk management structures of the parent Schwab company, its major component company, Charles Schwab, and U.S. Trust Corporation. These documents should have provided Federal Reserve staff with the information necessary for analyzing the procedures of the new company at the “consolidated” level.

However, in March the Federal Reserve sent a letter to the law firm representing Schwab in the merger requesting considerable additional information. The 27 questions (not including any confidential questions that may have been asked) requested a wide variety of information, but the lion's share focused on risk management for each line of business the new company would be engaging in. In particular, the letter requested information regarding a large number of specific risk management committees at the subsidiary level, including information on specific management positions and, where possible, the names of the individuals who would be filling those positions in the subsidiaries. Although the intent of the request appears to have been an effort to trace the processing of information as it is aggregated

up to the parent company level, the Fed was none the less directly requesting Schwab to provide detailed information on its subsidiaries. Not only does this indicate that the Fed was looking further downstream in the FHC than the consolidated parent level, it was also requesting the information directly from the company instead of being content to rely on the more general information provided through the SEC.

Federal Reserve staff also requested additional information on many of the business activities of ten subsidiaries in the new holding company structure, ranging from banking, to software development, to consulting services. Although they may have felt that such information was essential for evaluating the combined performance outlook for the company and its combined risk management structure, the request nevertheless digs deep into the activities of the subsidiaries. Again, these requests were made directly to Schwab instead of relying on information regarding these subsidiaries provided in the reports they had received from the SEC or directly contacting SEC for the information.

The evidence is not clear cut, and no information is available on how the traditional regulators reacted to these information collection efforts. Although interviews with staff at the Federal Reserve and the SEC did not reveal any direct complaints regarding the interaction of these two regulators during Schwab, Fed staff did emphasize that Schwab was serving as a template for developing a “process” that would be used in future non-bank conversions. In other words, it appears that this deviation from the baseline of working through the functional regulator for information on the non-banking subsidiaries intends to become the Federal Reserve’s standard process. Additional supporting evidence comes from a speech given by Board Governor Laurence Meyer. At a conference of bank examiners, Governor Meyer stated that the Board “needs to know more about...large insured depository institutions than can be derived from...the reports of the primary bank supervisors.” The remarks leave the impression that the Federal Reserve intends to be aggressive in its role as umbrella regulator and expand their sphere of influence under functional regulation.<sup>16</sup>

## CONCLUSION

Although the literature on legislative control of the bureaucracy is nearly two decades old, there is little existing work looking into agency response to the different types of implementation environments that may emerge given the level of delegation of power and how politically charged the particular policy is. Given the opportunity to do so when considerable authority is delegated and statutory guidance on the use of this authority is vague, what types of pressures may drive an agency to exceed legislative intent and further expand its authority? In this article I argue that when the policy being implemented is highly political and the final outcomes are uncertain, agencies have an incentive to stretch their authority in order to defend the power they were delegated. Furthermore, when potential rivals, such as another agency, are present in such an uncertain atmosphere, agencies have an incentive to enhance their own power by hamstringing these rivals.

114 Enactment of the Gramm-Leach-Bliley Act was a milestone in the development of financial policy in the United States and many compromises were made between legislators and interest groups in order to get a final bill enacted. These not only required a broad delegation of power to the Federal Reserve, but an articulation of only the broadest of constraints on the use of that power – that the Fed should respect the territory of traditional regulators when implementing functional regulation. The vagueness of the statute and the politics still boiling beneath the issue produced an atmosphere of uncertainty for the Federal Reserve, and the requirement to work in tandem with other agencies created competition. Responding to these pressures, the Federal Reserve used the Schwab conversion and acquisition of U.S. Trust to implement functional regulation in a way that stretched out its new power at the expense of the SEC.

Although future work should be done to see if other agencies respond in the same manner given similar circumstances, or if there are other kinds of responses we might expect given different circumstances, bureaucrats are often inclined to behave politically during policy implementation as any other legislator or interest group. The reasons for this behavior, and the extent to which it occurs, may vary, but researchers who study the separation of powers or implementation should keep in mind that choices made by actors at one stage of the game to delegate creates pressures to expand the scope of political conflict and politicize the implementation process.

## **ENDNOTES**

<sup>1</sup> The legislation is named for the chairmen of the three relevant congressional committees the legislation was developed in. Original author Rep. Jim Leach (R-IA) chaired the House Banking Committee, Senator Phil Gramm (R-TX) the Senate Banking Committee, and Rep. Tom Bliley (R-VA) the House Commerce Committee.

<sup>2</sup> Lists of all existing financial holding companies are posted and periodically updated by the Federal Reserve at <http://www.federalreserve.gov/generalinfo/fhc/>. The Federal Deposit Insurance Corporation provides information on bank and financial holding company assets at <http://www2.fdic.gov/idasp/>, but the information used here does not include assets held outside of the U.S. by foreign firms. The Financial Markets Center links FHCs to FDIC data on a regular basis at <http://www.fmcenter.org/>.

<sup>3</sup> Under the provisions of the law any corporation may form a bank holding company as long as it is well capitalized, has a sound risk management procedure in place and intends to conduct a significant amount of its work in the business of banking. Only after a company has made this conversion may it opt to become a financial holding company.

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<sup>4</sup> The 13% figure is provided by the Financial Markets Center. The 8% figure is calculated by using the National Information Center database maintained by the Federal Reserve at <http://www.ffiec.gov/nic/> to generate the total number of assets for all banking holding companies and then finding the financial holding company percentage.

<sup>5</sup> Out of the 495 FHCs in existence on January 26, 2001, I only have total asset data for 483 because the FDIC does not collect this form of data on foreign corporations.

<sup>6</sup> As Paulson (1987) notes, many rural communities may suffer from lack of access to financial services than urban areas.

<sup>7</sup> I classify as coastal districts the Boston, New York, Philadelphia, Atlanta, Richmond and San Francisco Districts. This leaves the Minneapolis, Kansas City, Dallas, Chicago, St. Louis, and Cleveland Districts classified as “non coastal”.

<sup>8</sup> First Busey Corporation, parent of Busey Bank, in Urbana, Illinois, for example, began offering mutual funds even before it became an FHC because customers started demanding the service and there was no alternative provider (Monahan 2000).

<sup>9</sup> The individual District asset levels broken out by amount is available on the Internet site of the Financial Markets Center at <http://www.fmccenter.org>.

<sup>10</sup> A recent study conducted by the Federal Reserve Bank of New York found that the market share of the 50 largest banks in the United States has declined, even though banks themselves have grown. From 1990 to 1999 their market share fell from 71% to 68% while only growing 2.3% over the same time period. The study also noted that out of the 50 largest bank holding companies in 1990, only 23 of them remain independent entities, the rest have been acquired. See Stiroh and Poole (2000).

<sup>11</sup> A unitary thrift is a particular type of savings bank or savings and loan association. Under the law prior to Gramm-Leach-Bliley mutual insurance companies were permitted to establish a single thrift in their corporate structure through which they could offer financial services to customers.

<sup>12</sup> The text of this letter can be viewed at <http://www.federalreserve.gov/boarddocs/SRLETTERS/2000/SR0013.HTM>.

116 <sup>13</sup> Technically the merger of Citicorp and Travelers Insurance was probably not even legal prior to the passage of Gramm-Leach-Bliley on a permanent basis. A provision of the old law permitted temporary unions of banking and insurance companies in a holding company structure, but the intention was to simply provide the corporation time to spin off the insurance subsidiaries until it complied with the law.

<sup>14</sup> The text of the Schwab order can be found at <http://www.federalreserve.gov/boarddocs/press/BHC/2000/20000501/attachment.pdf>. The Citicorp-Travelers order can be found at <http://www.federalreserve.gov/boarddocs/press/BHC/1998/19980923/19980923.pdf>. The NationsBank – Bank of America approval order can be found at <http://www.federalreserve.gov/boarddocs/press/BHC/1998/19980817/default.pdf>. The Regions – First Financial approach order can be found at <http://www.federalreserve.gov/boarddocs/press/BHC/1998/19985132>.

<sup>15</sup> This information is only available directly through the Board of Governors of the Federal Reserve System by request through the Public Information Office.

<sup>16</sup> The text of this speech may be found at [www.federalreserve.gov/boarddocs/speeches/2000/20000531.htm](http://www.federalreserve.gov/boarddocs/speeches/2000/20000531.htm).

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