Banking on Free Markets

Catherine England

Congress is currently considering changing or repealing the 1933 Glass-Steagall Act that separated commercial from investment banking. That reconsideration is six decades overdue. But misunderstanding about the banking sector could cause policymakers to opt for a halfway reform, leaving in place controls that could continue to hamper the efficiency of a sector that is essential to a competitive economy.

In mid-May the House Banking Committee passed a Glass-Steagall reform bill sponsored by Banking Committee chairman James Leach (R-Iowa). The Leach bill, which passed by a surprisingly wide 29 to eight margin, would allow full-service securities firms and commercial banks to be jointly owned by new financial services holding companies. Only holding companies owning banks that regulators designate as "well-managed" and "well-capitalized" would be allowed to acquire securities firms. The pending legislation would also require that holding companies have satisfactory community-lending ratings before being permitted to acquire securities subsidiaries.

In a controversial move, Representative Leach's bill named the Federal Reserve as the primary regulator of the newly refigured holding companies, thus expanding the Fed's regulatory powers. The Federal Reserve currently regulates bank holding companies, but the Securities and Exchange Commission has always been the primary regulator of securities firms. The Banking Committee approved an amendment that would allow commercial banks to underwrite municipal revenue bonds, and it voted to allow grandfathered "nonbank banks"—which were established before 1987 and allowed to continue to operate after new banks of that sort were banned—to issue corporate credit cards in addition to the personal (consumer) credit cards they currently issue. The House Commerce Committee is also reviewing the bill. The Senate will consider its own version of such a bill.

The 1933 Banking Act, passed during a period of widespread bank failures, contained two especially far-reaching provisions. The bill created the federal deposit insurance system, and in the section called the "Glass-Steagall Act," it forced the separation of commercial and investment banking. (Commercial banks take deposits and make loans, while investment banks aid firms and governments in selling securities to the public.) Banks were still allowed to underwrite U.S. government securities and municipal general obligation bonds. Not all commercial banks were involved in investment banking activities before the Glass-Steagall Act, but those banks that did offer both commercial and investment banking

Catherine England directs the Insurance Reform Project for the Competitive Enterprise Institute and is a visiting assistant professor in the School of Business at George Mason University.

activities had to choose which lines of business to pursue and which to abandon.

Following World War II, owners of banks sought ways around the restrictions on their activities. They formed bank holding companies through which one corporation owned other corporations, including commercial banks and other subsidiaries engaged in nonbanking activities. With the Bank Holding Company Act, passed in 1956 and amended in 1970, Congress closed the loophole and reinforced the commercial banking/investment banking split. In broad terms, the Bank Holding Company Act declared that what a bank could not do internally, its holding company could not do either.

In recent years the wall separating commercial and investment banking has been eroded. U.S. banks have long been allowed to operate investment banking affiliates or subsidiaries in other countries. But within the United States, the Federal Reserve and other bank regulators initially interpreted as a prohibition the provision of the Bank Holding Company Act that subsidiaries of bank holding companies should not be "principally engaged" in nonbanking activities. Then in 1986 the Federal Reserve decided that an investment banking affiliate of a well-capitalized commercial bank would not be considered "principally engaged" in prohibited activities if no more than 5 percent of the investment bank's revenues came from those activities, primarily underwriting corporate securities and municipal revenue bonds. Those so-called section 20 bank holding company subsidiaries can now derive as much as 10 percent of their revenues from otherwise prohibited investment banking activities.

In 1987, with the Competitive Equality Banking Act, Congress closed a legal loophole that allowed the establishment of "nonbank banks." Those were created when companies such as Sears purchased banks that the companies restricted to making consumer loans only, and not commercial or business loans, which would have made them regular banks. Existing nonbank banks were grandfathered in, allowed to continue to operate. But new nonbank banks could not be established.

Several questions face Congress during this session, as it considers Glass-Steagall reform. In addition to the central issue about whether the 62-year-old separation of commercial and investment banking should be abandoned, there are other problems for which the answers will determine the impact of repealing the Glass-Steagall prohibitions. For instance:

- Federal deposit insurance did not exist when banks engaged in securities activities at the turn of the century. Congress must decide what difference federal deposit insurance should make now, if banks are once again allowed to provide investment banking services. This is the "firewalls" issue.
- The extent to which banks' powers should be expanded is another question raised by the possible repeal or revision of Glass-Steagall. Should banks or bank holding companies be allowed to sell insurance or real estate, for example?
- Should banks be allowed to underwrite insurance?
- Finally, who can own a bank? Public policymakers in the United States have long insisted on a separation between banking and commerce. Nonfinancial firms such as retailers and manufacturers are not allowed to own banks, even though they may own other financial firms. (The exceptions are nonbank banks that were established before the 1987 ban on nonbank banks took effect.) The congressional debates about the repeal of Glass-Steagall will also cause that issue to be revisited.

Each industry would prefer legal and regulatory changes that would allow its member institutions to expand the services they offer, while preventing members of other industries from encroaching on their own markets.

Before turning to the arguments for and against Glass-Steagall, it is important to identify the players in the debate. There are the several industry players: the banking industry, the securities industry, and the insurance industry, to name the principal participants. In broad terms, each industry would prefer legal and regulatory changes that would allow its member institutions to expand the services they offer, while preventing members of other industries from encroaching on their own markets. But there are important divisions within every industry. Small banks are much less interested in securities powers than large banks, but small banks are more interested in being able to market insurance. Similarly, large securities firms and small securities firms have different interests. Finally, there

is an important distinction between insurance agents, who do not want banks selling insurance at all, and insurance companies, that could view banks as another marketing outlet as long as banks do not underwrite their own insurance products.

This article will examine briefly the debate over the desirability of banks providing investment banking services. There are strong arguments for removing current restrictions on the financial products banks can offer. Finally, the article will discuss criteria for assessing the current reform efforts.

The Glass-Steagall Act passed because Congress wanted to blame some specific, identifiable group of villains for the financial crisis and the economy's troubles. With banks failing in large numbers, bankers were a convenient group to blame.

Some Background on Glass-Steagall

The Glass-Steagall Act was the result of congressional efforts during the Great Depression to be seen as doing something about widespread bank failures. No less a banking authority than Paul Volcker, former chairman of the Federal Reserve Board of Governors, has observed that "congressional hearings on the securities practices of banks disclosed that bank affiliates had underwritten and sold unsound and speculative securities, published deliberately misleading prospectuses, manipulated the price of particular securities, misappropriated corporate opportunities to bank officers, engaged in insider lending practices and unsound transactions with affiliates. Evidence also pointed to cases where banks had made unsound loans to assist their affiliates and to protect the securities underwritten by the affiliates." The problem is that none of that is true. Banks were certainly accused of all those things, but during three different sets of congressional hearings held over four years during the 1930s, none of the accusations of conflicts of interest, improper banking activities, or excessive risk attached to banks' securities activities was proved. George Benston, in researching his book *The Separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered,* returned to the original hearings records and the reports written during the 1930s and found that there was never any evidence to support the charges brought against the banking industry.

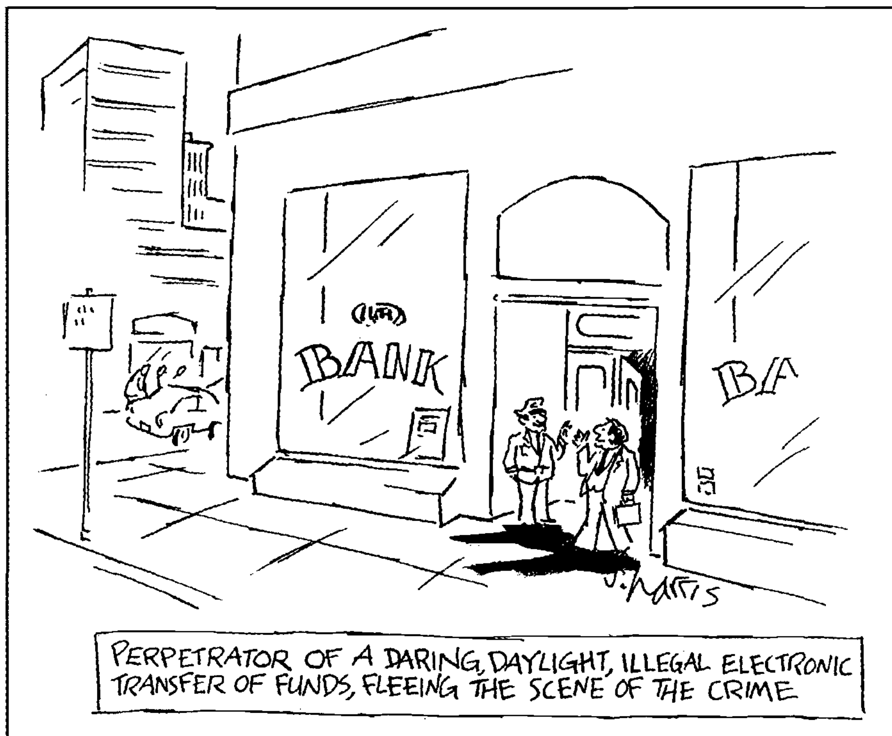
The Glass-Steagall Act passed anyway, for several reasons. First, Sen. Carter Glass believed strongly in the "real bills doctrine." He had long argued for legislation limiting banks to making short-term "self-liquidating" business loans that used inventory as collateral. Senator Glass thought that banks' engaging in securities activities reduced the effectiveness of the Federal Reserve and was contrary to sound banking laws. With the collapse of the stock market and widespread failures among banks, Senator Glass was the man with the plan when his congressional colleagues were ready to do something or anything.

The Glass-Steagall Act passed because Congress wanted to blame some specific, identifiable group of villains for the financial crisis and the economy's troubles. With banks failing in large numbers, bankers were a convenient group to blame. Furthermore, during the 1930s many observers believed that the nation's economic ills resulted from "excessive competition." Legislation affecting several industries during the 1930s was designed to reduce competition and allow for more coordination among producers. In short, much legislation promoted government-sanctioned cartels. In the financial markets, as elsewhere, Congress took steps to provide individual financial institutions with well-defined, protected markets. Restrictions against geographic expansion were reinforced for banks and savings and loan associations. The business of banking, the activities of thrifts, the purview of investment banks and insurance companies were all defined in ways designed to limit interindustry competition.

Finally, policy analysts during the 1930s clearly understood "moral hazard." The Congress that passed the Banking Act of 1933 and created the deposit insurance system was amply warned that federal guarantees for all bank deposits would relieve banks of the need to compete for customers on the basis of their financial strength and stability. By making deposits in all banks equally safe, federal deposit insurance freed bankers to take on more risk in pursuit of higher profits. By strictly circumscribing the range of services banks could provide, 1930s policymak-

ers no doubt hoped to limit the risk embodied in bank portfolios.

The Abusive Power Argument



PERPETRATOR OF A DARING, DAYLIGHT, ILLEGAL ELECTRONIC TRANSFER OF FUNDS, FLEEING THE SCENE OF THE CRIME

It is helpful to understand why the Glass-Steagall Act became law, but the desirability of retaining or abandoning existing restrictions on banks' activities must be evaluated given today's market conditions. Among the common arguments for retaining limits on banks' powers are concerns about banks' possible abuse of concentrated market power if they are allowed to expand their activities. Opponents of expanded bank powers worry about possible conflicts of interest if commercial banks were again allowed to engage in investment banking activities.

Opponents of Glass-Steagall reform who express concerns about possible conflicts of interest offer several hypothetical scenarios. Suppose a bank has loaned money to a firm whose financial condition has deteriorated. Could the bank help the firm float a bond issue, use the proceeds to repay the loan, and shift the default risk to unsuspecting investors? Or suppose the investment banking firm had purchased newly issued securities that it could not sell. Perhaps the trust department of the bank could be induced to purchase the securities at inflated profits, thus protecting the bank's investment banking affiliate. Or a bank's depositors might be pressured to invest in overpriced securities underwritten by the bank's securities affiliate.

Any of those things could happen, but there is no historical evidence that such obvious abuses did in fact occur before investment and commercial banking were separated. It is not difficult to understand why. Any customer who learned of such behavior on the part of a commercial or an investment bank would no doubt take all of his or her business elsewhere. In fact, a bank or banking organization selling a broader range of financial services to its customers would have more to lose than a narrower bank if it lost customers' trust in any one area. Financial institutions interested in remaining profitable over the long term cannot afford to risk their reputations for potential short-term gains.

Concerns that repealing Glass-Steagall restrictions would lead to banks abusing their concentrated market power are also misplaced.

Financial institutions interested in remaining profitable over the long term cannot afford to risk their reputations for potential short-term gains.

Consumers are best protected from market abuses by competitive markets, and there is ample evidence that the financial markets, both domestic U.S. markets and world financial markets, are becoming more competitive, not less so. Where pockets of market power remain, the culprit is generally government-sponsored barriers to entry. Observers concerned about too little competition among banks might ask, for example, why the interstate branching law that passed last year still prohibits banks from entering new markets by opening new branches. Well-capitalized

banks should be allowed to decide for themselves where and when they will open new banking offices.

The False Analogy to S&Ls

Despite the evidence that abusive banking practices were not and are not likely to be a problem, there are still widespread concerns that banks offering a wider range of services will face more risk and be financially more fragile than they are now. Fueling that fear are widespread reports that deregulation caused the savings and loan (S&L) losses during the 1980s. But while safety and soundness are valid concerns, banks' financial stability may be undermined by retaining limits on the financial products they can offer.

Advances in financial theory since the 1930s have clearly demonstrated that the old warning against putting all your eggs in one basket is as valid for bankers as it is for farmers.

First, the charge that the S&L industry lost billions of dollars because of deregulation is misleading at best. The S&L industry was insolvent by the late 1970s, before there was any financial deregulation, because federal law required S&Ls to fund their 30-year, fixed-rate mortgage loans with short-term savings deposits generally paid on demand. Interest rates that S&Ls and banks could pay on deposits were held artificially low by the government. When federal fiscal and monetary policies led to high rates of inflation and high market interest rates during the 1970s, S&Ls lost deposits to the unregulated money market mutual funds, and many institutions became insolvent. Because political decisionmakers were reluctant to close half the savings and loan industry, Congress granted S&Ls new powers without requiring that thrift owners recapitalize their institutions. Thrift owners and managers were allowed to offer new and unfamiliar financial products without putting their own money at risk. Allowing S&Ls to offer a broader line of financial services was not the mistake; continued federal support for decapitalized institutions was the mistake.

The proper lesson from the thrift debacle is that financial institutions should be allowed to offer new products only to the extent that the new ventures are adequately backed by private owners' capital. There is no question that bank owners should have money at risk before their banks take on new activities.

It is also argued that securities underwriting is too risky for depository institutions. The stock market is clearly more volatile on a day to day basis than are the loans traditionally held by commercial banks. Many observers argue that U.S. banks do not have the expertise to assess and manage properly the risks associated with investment banking.

There is a valid distinction between "more risk" and "different risk." Securities underwriting involves different risks than decisions about how much money to lend to whom. In underwriting stocks or bonds, securities firms often buy the new issue from the corporation or government borrower before selling the newly issued securities to the public. If financial markets reevaluate for the worse either the individual entity issuing the new securities or the economy as a whole between the time the securities firm buys the securities and the time it sells the stocks or bonds to the public, the securities firm may lose a great deal of money. Banks embarking on that new line of business would certainly want to make sure to employ individuals who understand underwriting risk.

But underwriting risk exposure is counted in days, while loans are held by banks for years. A successful bank faces the challenge of evaluating loan default risk several years down the road. Loan values may be every bit as volatile as stock prices, but the information about loans' values is simply not as readily available. Stock prices are reevaluated and publicly reported every day, while loans are generally carried on the books of banks and other lenders at their historic value.

There is no evidence that the combination of commercial and investment banking causes increased bank failures. During the 1930s only 15 of the 207 nationally chartered banks with securities affiliates failed. That was a much lower rate of failure than for the banking community as a whole. Banks with securities affiliates also tended to be larger banks, and failures were concentrated among smaller banks during the 1930s. Nor do banks in countries that currently allow the mixing of commercial and investment banking fail at a higher rate than banks in countries that restrict banks' activities.

One reason for that record may be diversifica-

tion. Advances in financial theory since the 1930s have clearly demonstrated that the old warning against putting all your eggs in one basket is as valid for bankers as it is for farmers. Commercial banks, limited to making loans, began to lose their best corporate customers to the commercial paper market in the 1960s. That trend has continued. The most creditworthy borrowers, among consumers and among businesses of almost all sizes, have found better terms offered by financial institutions with more direct access to the securities markets. Banks' ability to innovate and compete has been circumscribed by their inability to offer a broader range of financial services. As long as the returns from commercial and investment banking do not rise and fall exactly together, banks may stabilize their income streams by offering a wider range of financial products.

Finally, it is argued that allowing banks to expand the range of financial services they offer is unacceptably risky because the failure, for example, of a bank's investment banking affiliate might spill over to the commercial bank. There is nothing wrong with that. Bank customers' refusing to deal with a bank whose securities affiliate has failed or engaged in some unfair trading practice is a valid form of market discipline. No threatened regulatory action will have as much impact as the threat that large numbers of customers will walk away from banks with tarnished brand-name capital. The threat of a run will focus the attention of financial institution managers on protecting their reputations for fair dealing and financial stability—and that protects bank customers' interests.

Evaluating Current Proposals

In a 1991 Cato Institute Policy Analysis, "Judging the 1991 Reform Effort: Do U.S. Banks Have a Future?" I identified four questions that might be used to judge any broadly based reform effort. Two of those questions are useful in identifying principles with which to judge current reform proposals:

1. Does the proposed reform address both federal deposit insurance and structural issues?
2. Does the proposed reform promise to improve service to bank customers?

A lot has changed in four years. In 1991 the bank insurance fund was depleted, and banking experts were concerned that further bank failures would force the FDIC to borrow from the Treasury Department. Banks were losing market share in all their traditional lines of business, and banks' search for profits was leading them to increase the risk in their loan portfolios. A favorable interest rate environment coupled with further consolidation and restructuring has improved the overall health of the banking industry since 1991.

In the 1991 article, I identified three broad issues with which banking reformers needed to deal. Those were deposit insurance reform, interstate branching restrictions, and powers restrictions. Rather than addressing all three issues in a single bill as the Bush Treasury Department had suggested, Congress passed deposit insurance reform legislation in 1991 and an interstate branching bill in 1994. Current proposals for Glass-Steagall reform can be put in better context when considered with the two earlier pieces of legislation.

But if Congress is debating the extent to which potted plants dividing a suite of offices represent adequate "separation" of securities and banking affiliates within an office building, the government is still too involved in the details of banking.

1. Does the proposed reform address both federal deposit insurance and structural issues?

The fact that U.S. depository institutions (banks, S&Ls, and credit unions) receive federal deposit guarantees clearly makes them different than other financial institutions without such guarantees. The existence of federal deposit insurance raises important questions: how can insured deposits be invested? If a bank fails, how will a healthy securities affiliate or subsidiary be treated? If a securities firm becomes financially distressed or fails, what impact will that have on an affiliated bank? Those types of questions are part of the broader issue of institutional "firewalls."

Firewalls are legal separations between various activities performed by banks and/or bank holding companies. They are designed to protect

the deposit insurance fund from nonbank losses and to protect bank customers from the illusion that nonbanking activities receive federal deposit insurance protection. Current regulations that allow bank holding companies to engage in limited securities activities through section 20 subsidiaries also establish very specific firewalls. Banks cannot make loans to their section 20 affiliates, for example. Bank employees cannot sell the products of section 20 affiliates, nor can employees of the securities firms market their products on the banks' premises. The two firms cannot cross-market their products.

Current proposals to remove the remaining Glass-Steagall restrictions again raise the question of firewalls. Without federal deposit insurance, there would be no reason for government officials to concern themselves with the way financial institutions conduct their business. There is no clear evidence that indicates it is more efficient or safer to offer expanded financial services through a bank holding company and subsidiary structure rather than through a single expanded bank. The former structure may protect the bank from the losses experienced by other holding company affiliates, but it also prevents the isolated bank from benefitting from the economies of scope and the more stable profits that might result from expanded operations.

To the extent that there are markets with inadequate financial services in the United States, it is primarily because of legislative and regulatory mindsets that think in terms of drawing lines around different financial institutions.

The 1991 Federal Deposit Insurance Corporation Improvement Act (FDICIA) was widely promoted as the solution to the flaws identified during the 1980s with the federal deposit insurance system. With FDICIA, Congress directed regulators to (1) close banks or S&Ls when their capital fell to 2 percent of assets; and (2) to use the least-cost failure resolution method in closing depository institutions. As expected, the latter requirement is leading to more liquidations and fewer mergers of failed banks. Those FDICIA-mandated changes are designed to protect both uninsured depositors and the deposit insurance funds from losses, because if a depository institution is closed while it still has some capital, all creditors' claims can be satisfied.

A broad range of banking experts agree that the efficacy of the FDICIA reforms will depend on the expertise and the resolve of the regulators in enforcing the new requirements. FDICIA has not yet been tested in a way that provides much evidence regarding the success of the 1991 efforts to reform the federal deposit insurance system. FDIC chairman Ricki Helfer's recent statements regarding the inadequacy of the S&Ls' insurance fund are certainly a cause for concern. If regulators promptly close S&Ls when their financial capital falls to 2 percent, there is presumably no reason the Savings Association Insurance Fund will be tapped except for administrative costs. If Chairman Helfer expects larger losses, policymakers should be talking about—and fixing—the problems with FDICIA.

In short, the need for government-mandated firewalls is an indication of continuing problems with the federal deposit insurance system. Ideally, policymakers should leave the organization of financial institutions to the owners of the banks and securities firms. The market is the best arbiter of the organizational structure; it serves the needs of both financial institution owners and their customers. Indeed, the ideal organization will probably be different for different institutions. Given that federal deposit insurance still exists, limiting what can be done with insured deposits is necessary, and banks should be absolutely clear about what is insured and what is not. But if Congress is debating the extent to which potted plants dividing a suite of offices represent adequate "separation" of securities and banking affiliates within an office building, the government is still too involved in the details of banking. Restrictions on cross-marketing and innovative packaging of financial services must by definition harm potential consumers to the same degree they harm the firms that would sell such products.

2. Will the proposed reforms improve service to bank customers?

The most important reason for banking reform is to increase the efficiency of the financial sector and thereby improve service to households and businesses. Consumers of financial services are best served by minimizing the restrictions facing well-capitalized banks, S&L associations, securi-

ties firms, and insurance companies. Restrictions on the services that any particular type of institution can offer create artificial barriers to competition and reduce the pressures financial service providers face to improve their products.

In short, commercial banks should be allowed to offer investment banking services as well as insurance and real estate services, if they so choose. But securities firms and insurance companies should be able to provide demand deposits and offer other commercial banking services as well. Growth limits and restrictions on commercial lending should no longer be applied to nonbank banks.

Finally, expansion of well-capitalized commercial banks into other lines of business should not be held hostage by the Community Reinvestment Act. That act gives bank regulators the power to force banks to make certain portions of their loans available to minorities or open a certain number of branches in particular locations, to better serve the community in ways defined by bureaucrats and local interest groups. To the extent that there are markets with inadequate financial services in the United States, it is primarily because of legislative and regulatory mindsets that think in terms of drawing lines around different financial institutions. Less wealthy consumers will be better served in the long run by freeing financial institutions to innovate in serving the needs of particular market segments, and then subjecting financial service providers to competition, thus forcing them to reach out to new customers.

Would a handful of firms come to dominate the financial markets of the United States under such conditions? That is extremely unlikely. The United States today has one of the most unconcentrated financial systems in the world. As long as the government focuses on maintaining and expanding open market entry, including entry from foreign financial providers, the development of dominant firms could occur only because those firms were serving consumers and businesses better than alternative providers. Market share won by serving customers well is market share we should all applaud.

Conclusion

The forced separation of commercial and investment banking addressed no real problems or abuses in the 1930s, and concerns about removing those restrictions today are overblown. There is no evidence that institutions that combine commercial and investment banking activities are more likely to fail or more likely to abuse their customers' trust. Indeed, relaxing restrictions on the services banks can offer would create an opportunity for some banks to better diversify their income streams and better serve their customers.

The existence of federal deposit insurance is the only possible justification for restricting banks' activities. It is no accident that the Banking Act of 1933 introduced both federal deposit insurance and the Glass-Steagall Act restrictions on banks' securities activities. It is important to be clear about what part of the debate over Glass-Steagall reform today is a holdover from unresolved federal deposit insurance issues and to press forward with needed deposit insurance reforms. If FDICIA addressed the deposit insurance problems, as its proponents claim, policymakers should be comfortable allowing banks to expand the services they offer. If FDICIA did not address the problems, then Congress should take steps by amending that legislation to address remaining deposit insurance concerns. It is time to move the U.S. financial markets out of the 1930s and into the 21st century.

Selected Readings

Benston, G. *The Separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered.* New York: Oxford University Press, 1990.

England, C. "Judging the 1991 Reform Effort: Do Banks Have a Future?" Cato Institute Policy Analysis No. 149, March 12, 1991.

England, C. and T. Huertas, eds. *The Financial Services Revolution*. Washington: Cato Institute, 1988.

Horowitz, S. and Selgin G.A. "Interstate Banking: The Reform That Won't Go Away." Cato Institute Policy Analysis No. 97, December 15, 1987.

Timberlake, R. *Monetary Policy in the United States.* Chicago: University of Chicago Press, 1993.