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GLASS-STEAGALL ACT:

COMMERCIAL VS. INVESTMENT BANKING

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GLASS-STEAGALL ACT: COMMERCIAL VS. INVESTMENT BANKING

SUMMARY

Debate over reform of the Nation's financial structure in the 100th Congress includes re-examination of "the separation of banking and commerce." This separation was mandated by the Glass-Steagall Act (part of the Banking Act of 1933); and was carried forward into the Bank Holding Company Act of 1956, as amended in 1970 and thereafter. The resulting isolation of banking from securities was designed to (1) maintain the integrity of the banking system; (2) prevent self-dealing and other financial abuses; and (3) limit stock market speculation. By half a century later, the "wall" it created seemed to be crumbling, as bankers created new financial products resembling securities, and securities firms innovated new financial products resembling loans and deposits. The ongoing process of "financial deregulation" has evoked calls for Congress to give depository institutions new powers, especially in the securities field. Financial deregulation in the United Kingdom, Canada, and Japan has put additional pressure on Congress to re-examine this Act. Concerns over a seemingly fragile system of depositary institutions persist, however, tending to place counter-pressure on Congress to maintain the Act.

ISSUE DEFINITION

Should "banking" be separated from "commerce", especially, the investment banking (securities) business? The 100th Congress has been asked to reconsider this underlying intent of the Glass-Steagall Act in view of: (1) the need to maintain competition in national and world-wide financial markets, and (2) the need to maintain customer confidence in the safety of depository institutions. The Administration and many depository institutions seek to relax this Act somewhat; other parties seek to retain its separation of banking and commerce.

BACKGROUND AND ANALYSIS

In the nineteenth and early twentieth centuries, bankers and brokers were sometimes indistinguishable. Then, in the Great Depression after 1929, Congress examined the mixing of the "commercial" and "investment" banking industries that occurred in the 1920s. Hearings revealed conflicts of interest and fraud in some banking institutions' securities activities. A formidable barrier to the mixing of these activities was then set up by the Glass-Steagall Act. It consists of four sections of the Banking Act of 1933. Its language makes it a felony for anyone -- banker, broker, dealer in securities, or savings institution -- to engage in the deposit-taking and securities businesses at the same time. For Federal Reserve member banks, it included reinforcing language designed to separate the two activities directly and through corporate affiliation or interlocking directorates. As exceptions, banks could underwrite and deal in obligations of the United States and many of its instrumentalities, along with obligations of States and their subdivisions -- for example, cities, countries, and school districts -- only if supported by the full faith and credit of the issuer. Banks were also permitted to provide securities brokerage services at the request of customers in the 1933 Act, as amended in 1935 to allow stock purchases and sales in an "agency" capacity as well.

Much of the intent of this Act was carried forward into the regulation of firms controlling banks known as bank holding companies. They became subject to Federal Reserve control through the Bank Holding Company Act of 1956, as strengthened in 1970.

Although Glass-Steagall seemed to maintain the barriers between "banking" and "commerce" for half a century, depository financial, industrial, and securities firms have increasingly blended the businesses of banking and brokerage, using "loopholes" in the Act and other statutes (such as those governing savings institutions). Since 1982, as a result, banks and the financial arms of non-depository firms have become competitors to some extent. A conspicuous case is that of depository institutions and their holding companies entering the securities business as "discount brokers." By only taking customers' orders, they avoid offering advice or sponsoring new security issues, and thus (as customers' "agents") appear to be operating within the literal language of the Glass-Steagall Act.

Another way banking institutions have blended the commercial and investment banking businesses is by expanding abroad. The international operations of many large United States banking organizations include the underwriting, distribution, and brokerage of securities in countries such as Britain, whose financial markets are more "deregulated" than ours. And back in the United States, the Federal Reserve has just let the gigantic Sumitomo Bank of Japan (which owns large U.S. banking interests) buy into the profits of Goldman, Sachs -- a leading full-service Wall Street securities dealer. U.S. banks consequently view their U.S. operations as being at a competitive disadvantage, from an international perspective, despite the prevention of foreign banks' maintaining depository and security services within our borders legislated in the International Banking Act of 1978.

U.S. banks and their holding companies are thus seeking to obtain regulatory and/or congressional authority to expand their financial services into new securities areas. In the fixed-income area, they seek to underwrite and deal in: commercial paper, municipal revenue bonds, and bonds backed by mortgages and consumer loans. In the equity area, they seek to sponsor, run, and distribute mutual funds ("investment companies"). Such powers would leave less than one-quarter of the Nation's dollar volume of financing restricted to traditional stock and bond dealers only, according to industry estimates. Many non-bank providers of financial services, however, question whether the institutions can operate in these areas well, because they have experienced large loan losses in their basic business of lending.

The case for preserving the Glass-Steagall Act includes the following arguments.

(1) Conflicts of interest characterize the granting of credit -- lending -- and the use of credit -- investing -- by the same entity, which led to abuses that originally produced the Act.

(2) Depository institutions possess enormous financial power, by virtue of their control of other people's money; its extent must be limited to ensure soundness and competition in the market for funds, whether loans or investments.

(3) Securities activities can be risky, leading to enormous losses. Such losses could threaten the integrity of deposits. In turn, the Government insures deposits and could be required to pay large sums if depository institutions were to collapse as the result of securities losses.

(4) Depository institutions are supposed to be managed to limit risk. Their managers thus may not be conditioned to operate prudently in more speculative securities businesses. An example is the crash of real estate investment trusts sponsored by bank holding companies a decade ago.

The case against preserving the Act -- that is, for relaxing its restrictions -- includes the following counter-arguments.

(1) Depository institutions now operate in "deregulated" financial markets in which distinctions between loans, securities, and deposits are not well drawn. They are losing market shares to securities firms that are not so strictly regulated, and to foreign financial institutions operating without much restriction from the Act.

(2) Conflicts of interest can be prevented by enforcing legislation against them, and by separating the lending and credit functions through forming distinctly separate subsidiaries of financial firms.

(3) The securities activities that depository institutions are seeking are both low-risk by their very nature, and would reduce the total risk of organizations offering them -- by diversification.

(4) In much of the rest of the world, depository institutions operate simultaneously and successfully in both banking and securities markets. Lessons learned from their experience can be applied to our national financial structure and regulation.

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