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Glass-Steagall Act Modernization?

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GLASS-STEAGALL ACT MODERNIZATION?

SUMMARY

Debate over reform of the Nation's financial structure in the Congress includes reexamination of the banking and securities industries. The two were divided by the Glass–Steagall Act (part of the Banking Act of 1933), as carried forward into the Bank Holding Company Act of 1956. 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. The "wall" it created seems to be crumbling, as bankers create new financial products resembling securities, and security firms innovate new financial products resembling loans and deposits.

This 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, Japan, and the European Union has put additional pressure on Congress to reexamine this Act. Concerns over a seemingly fragile system of depositary institutions persist, however. They tend to place counter–pressure on Congress to maintain the Act. Securities markets may also become somewhat unsettled: problems with "derivatives" based on securities raise questions as to the desirability of liberalizing the Act.

The 104th Congress has been revisiting these issues, following earlier congressional considerations in 1984, 1988, and 1991. Legislation has been marked up to reformulate the Act, and the Administration supports "reforming" it as well. Hearings have examined financial industries and potential changes in their regulation, both with respect to this Act and more broadly as to the role of depository and securities–based institutions in a competitive marketplace.

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Congress is reexamining the pace at which federally insured commercial banking institutions should trade in less–protected, less–regulated securities, directly or indirectly. Whereas New Deal legislation isolated the two, recent trends suggest their convergence is occurring despite the 1933 legislation. Should Congress encourage this tendency, leave it to be determined by market forces, or discourage it?

BANKERS AS BROKERS

The business of banking in the United States had long emphasized "banking," not "business." Public policy has generally held that the integrity of the payments mechanism and the nature of competition for funds would be compromised if banks undertook the risks inherent in commercial ventures, or had conflicts of equity interest that involved favorable treatment for some customers. This tradition in America followed that of England's dating back to the seventeenth century. Breaches in this separation occurred occasionally in the nineteenth and twentieth centuries, but were filled in by laws. Thus, in contrast to the open–ended powers provided by the charters of most non–financial corporations, the domestic activities of commercial banks tended to be limited to deposit–taking, lending, and very closely related fields. They did not resemble the "universal banking" systems of countries such as Germany, in which a few large banks seemed to control financial markets including the securities business.

Banks were originally chartered by specific legislative acts of Congress or State legislatures. Special provisions mandating investments in quasi-public-purpose activities were occasionally made part of their charters. Most of their charters continued the English tradition of forbidding transactions in merchandise, but allowed loan contracting services — transacting investment-type businesses of buying and selling loans — prior to the development of organized markets in securities.[1]

By the 1830s, many State–chartered banks were underwriting securities and making investments generally. Most notable was the U.S. Bank of Pennsylvania

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[1] Krooss, Herman E., and Martin R. Blyn. *A History of Financial Intermediaries* New York, Random House, 1971. p. 31; Shull, Bernard. The Separation of Banking and Commerce: Origin, Development, and Implications for Antitrust. In: U.S. Congress. House. Committee on Banking, Finance and Urban Affairs. *How the Financial System Can Best be Shaped to Meet the Needs of the American People*. Hearings. Washington, U.S. Govt. Print. Off., 1984. p. 754-769. (Serial no. 98-83); and, Blair, Christine E. Bank Powers and the Separation of Banking from Commerce. *FDIC Banking Review*, Spring 1994. p. 29.

— successor to the Second Bank of the United States. It bought, sold, and sponsored public and private securities and lent money against these securities. In the Depression after 1837, it collapsed, as did other State banks associated with non–banking investments. Yet, many State banks, especially those chartered under more financially prudent "free banking laws," continued in the securities business. Their competitors in this activity were unincorporated private bankers, outgrowths of general merchants' financing activities. Private bankers did not have to disclose their financial condition to anyone, nor suffer examinations by Government authorities. By the Civil War, they had become active financial institutions.[2]

At that time, desires for a uniform national currency, financing the War, and a sound banking system converged to favor incorporated banks once more. Overriding "States' Rights," Congress specified the conduct of banking in legislation. The resulting National Bank Act[3] specifically forbids National banks from investing in commercial and industrial ventures. The current version of this authority generally restricts the investments of a National bank to specified high–grade debt securities. It mandates that:

> Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the [National banking] association for its own account of any shares of stock of any corporation.[4]

An important provision of this authority allows National banks "to exercise . . . all such incidental powers as shall be necessary to carry on the business of banking."[5] The determination of incidental powers is made by their regulator, the Office of the Comptroller of the Currency, which is a bureau of the U.S. Treasury Department.

Among the possible incidental powers was that of the securities business. With the rise of State banks and private banks again in the later nineteenth and early twentieth centuries, National banks as well sought to capture the investment banking profits to be earned from new corporations and economic growth. Banks — especially State banks — conducted such activities through their bond departments, which provided many of the facilities of private banks in the underwriting and brokerage fields. The Comptroller of the Currency, disapproving of such activities more strongly as the 1890s turned into the new century, restricted them. The bankers' response took the form of bank

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[2] Carosso, Vincent P. *Investment Banking in America*. Cambridge, Harvard University Press, 1970. p. 2-23, 80-81.

[3] Originally R.S. §5136, 1864, successor to the National Currency Act, 1863.

[4] 12 U.S.C. §24.

[5] Ibid.

securities affiliates. A National bank would sponsor a State–chartered corporation, whose ownership was often the same as that of the National bank. (If it was expected to be very profitable, its owners might be the directors and officers of the bank!) The affiliate, beyond the Comptroller's reach, could thus engage in securities activities anywhere in America, as a securities house. Likewise, trust companies — chartered by States — could accept deposits and engage in most commercial and investment banking fields.[6]

In the early twentieth century, few barriers prohibited financial institutions from engaging in commercial or investment banking activities. By the 1920s, bank security affiliates had gained perhaps half of securities distribution, including that of investment companies (ancestors of mutual funds).[7] In 1927, the McFadden Act[8] specifically "reaffirmed" the authority of National banks to underwrite investment securities (bonds), following liberalization of the Comptroller's position and approval of bank underwriting by the Federal Reserve. The McFadden Act did not directly authorize National banks to buy and sell stocks, but did nothing to restrain bank securities affiliates.

THE NEW DEAL

In another Depression after 1929, Congress examined the mixing of the commercial and investment banking industries. Hearings seemed to reveal conflicts of interest and fraud in some commercial and investment banking securities activities.[9] Direct involvement of bank lenders with corporate securities was believed to be detrimental to the financial system. As a corrective, the resulting Glass–Steagall Act (GSA):

> . . . had three objectives: discouragement of speculation, prevention of conflicts of interest, and promotion of bank soundness. Regarding speculation, the Act's proponents argued that if banks were affiliated with brokers, the former would have an incentive to lend money to customers of the latter. These customers might, in turn, invest their borrowings in securities rather than in what were believed to be more productive investments, such as hard assets. The conflicts of interest

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[6] Carosso, *Investment Banking*, p. 97-98; and, Blair, *Bank Powers*, p. 30-31.

[7] Krooss and Blyn, *Financial Intermediaries*, p 157, 161-168; Bloch, Ernest. Multiple Regulators: Their Constituents and Policies. In: Amihud, Yakov, et al. *Market Making and the Changing Structure of the Securities Industry*. Lexington, Mass., D. C. Heath, 1985. p. 168; and, Peach, W. Nelson. *The Security Affiliates of National Banks*. New York, AMS Press, 1983. (Reprint of 1941 edition.) p. 83.

[8] P.L. 69-939.

[9] Peach, *Security Affiliates*, p 113-179; and, Carosso, *Investment Banking*, p. 330-335, 346-348. The spectacular "failure of the Bank of the United States in December 1930 was attributed to speculative excesses of management operating through a securities affiliate." Sametz, Arnold W., Michael Keenan, Ernest Bloch, and Lawrence Goldberg. Securities Activities of Commercial Banks. *Journal of Comparative Corporate Law and Securities Regulation*, November 1979. p. 159.

> rationale hinged on the fear that commercial banks that had underwritten a firm's securities might then make imprudent loans to the firm to buttress the firm's financial structure while the bank had an equity interest. Perhaps most important was the soundness objective. Proponents of Glass–Steagall feared that banks' soundness could be threatened both by direct losses on securities held by a bank and by adverse effects on the public's confidence should a banks' securities affiliate falter. The Glass–Steagall Act was intended to respond to some of the glaring abuses that had encouraged, some thought, the bank failures and depression of recent years.[10]

GSA is part of the Banking Act of 1933.[11] Other parts of this Act provided for the Federal Deposit Insurance Corporation (FDIC) and banking safeguards. The GSA portion nominally prevents anyone — bank, broker, dealer in securities, or savings institution — from engaging in both the deposit–taking and securities businesses. For Federal Reserve member banks, it includes reinforcing language covering corporate affiliation and interlocking directorates. As exceptions, banks can 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, counties, and school districts — that are supported by the taxing power of the issuer. Banks could provide securities brokerage services at the request of customers — to allow stock purchases and sales in an "agency" capacity as well.

More precisely, in GSA: Sections 16 and 5(c) limit a National bank and a State–chartered Federal Reserve member bank to "purchasing and selling such securities and stock without recourse, solely upon the order and for the account of customers, and in no case for its own account" except for dealing in and underwriting U.S. Treasury and municipal general obligation securities.[12] Section 20 prevents affiliations between member banks and organizations "engaged principally in the issue, flotation, underwriting, public sale or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities."[13] Section 21 prohibits securities firms from engaging in "the business of receiving deposits."[14] Finally, Section 32 prohibits officer, director, or employee interlocks between member banks and organizations "primarily engaged in" securities activities.[15]

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[10] Hayes, Samuel, *et al.* *Competition in the Investment Banking Industry*. Cambridge, Harvard University Press, 1983. p. 21.

[11] P.L. 73-66.

[12] 12 U.S.C. §§24, 335.

[13] 12 U.S.C. §377.

[14] 12 U.S.C. §378.

[15] 12 U.S.C. §78.

The key Section 20 of GSA on its face forbids affiliation of any Federal Reserve member bank (through a holding company as noted below) with any business entity engaged principally in investment banking activities. Thus, for half a century thereafter, bankers could not underwrite most securities (be as the original seller to investors). Underwriting these "bank ineligible" corporate debt and equity issues is often viewed as the most profitable securities activity.

GSA forced private banks to become either incorporated banks or securities firms. GSA and companion legislation in the securities field became well accepted by commercial and investment bankers.[16] New Deal legislation in the investment banking sector consisted of the Securities Act of 1933,[17] the Securities and Exchange Act of 1934,[18] followed by the Investment Company and Investment Advisers Acts of 1940.[19] All of the latter stressed investor protection and regulation by information and fraud prevention. GSA in contrast stressed protection by prohibition. The result was to remove each industry from the other's businesses: compartmentalization. Only a few pockets of finance remained in which they could go one–on–one, such as being "primary dealers" in U.S. government securities as recognized by the Federal Reserve.[20]

Contrary to some impressions, GSA did not separate the banking from the insurance or real estate industries. Neither is mentioned in it. New York State had broken up combinations of banking and insurance earlier. Other States followed to prevent banking–insurance combinations.[21]

Banking of all kinds shrunk in the Depression, remaining subdued for two decades thereafter. Since then, bankers have continued to push the boundaries of the business further through companies owning banks.

Bank holding companies own ("hold") stock of commercial banks, thereby controlling them — and often "hold" the stock of other nonbanking firms. GSA is applied to these banking companies under their governing statute: the Bank Holding Company Act of 1956, as amended in 1970.[22] The Federal Reserve

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[16] Benston, George J. *The Banking and Securities Industries in Historical Perspective.* 37 p.; and, Krozner, Randall S. *The Evolution of Universal Banking and its Regulations in Twentieth Century America.* 33 p. Both presented at the Conference on Universal Banking, New York University, Salomon Center, February 23-24, 1995.

[17] P.L. 73-22.

[18] P.L. 73-291.

[19] Both P.L. 76-768.

[20] U.S. Library of Congress. Congressional Research Service. *Primary Dealers: Domestic and Foreign Buyers of Treasury Deficit Financing Securities Under the Iran and Libya Sanctions Act of 1996.* Report No. 96-591 E, by William Jackson. Washington, 1996. 5 p.

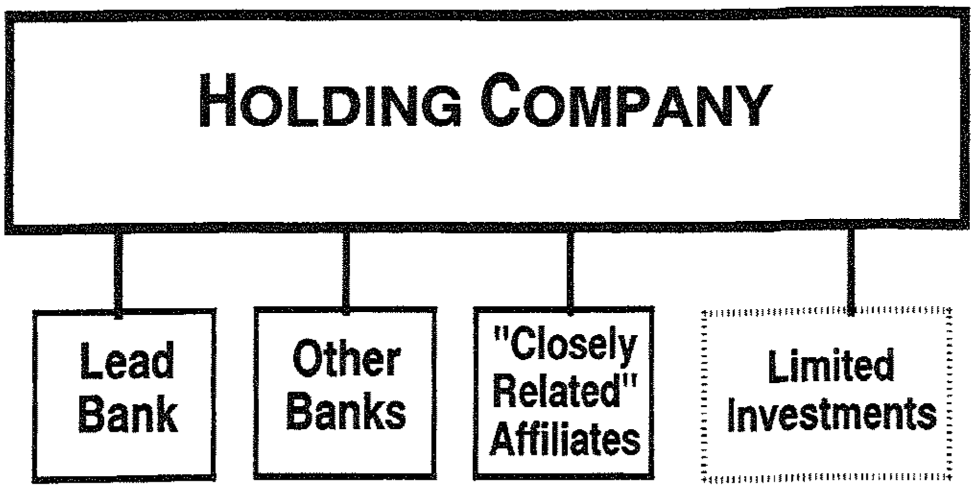
[21] Carosso, *Investment Banking*, p. 112-127.

[22] P.L. 84-511 and P.L. 91-607.

administers this Act.[23] Operations of a bank holding company that are not banks are covered by the GSA "affiliations" language of Section 20, if the company includes a Federal Reserve member bank. The 1956 Act was aimed at large banking organizations with insurance and securities components. It sought to prevent concentrations of financial power and conflicts of interest somewhat as the Public Utility Holding Company Act of 1935[24] had done for that regulated sector. The Banking Acts of 1933 and 1935[25] seemingly had not prevented any such undesirable tendencies any more than the Clayton Act had done via antitrust language since 1914. All of the latter three Acts had nominally given the Federal Reserve some control over banking companies.[26] This time, the Fed received explicit control over them.

Under the Bank Holding Company Act, the Fed allows affiliates that are only "closely related to banking" in its sole view. A picture of a bank holding company's structure appears as figure 1 (below). The heart of the company is the largest ("lead") bank. The controlling holding company often holds other investments. They can be other banks; securities–related, lending, advising, etc. companies allowed by the Federal Reserve — the third box from the left; but only minor shares of other businesses as limited investments. The spaces between the boxes indicate that they are separate entities.

FIGURE 1. Bank Holding Company Structure



Source: Prepared by the Congressional Research Service.

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[23] Under its "Regulation Y:" 12 C.F.R. Part 225.

[24] P.L. 74-333.

[25] P.L. 74-305.

[26] Carosso, *Investment Banking*, p. 177, 371; and, Fischer, Gerald C. *The Modern Bank Holding Company: Development, Regulation, and Performance*. Philadelphia, Temple University School of Business and Management, 1986. p. 25-36.

THE NEW FINANCIAL COMPETITION

Bankers and the financial arms of non–depository and even non–financial firms have increasingly become competitors. The financial asset market share of commercial banks has fallen, while that of securities and related businesses have risen since the 1970s.[27] Most financial institutions have come to offer overlapping products. Notable examples include money market mutual funds accessible by check and annuities invested in stocks and bonds. Nonbanks have always been able to offer loans or their equivalents; they have come to add deposit equivalents.[28] Figure 2 (on the next page) conceptually illustrates competitive convergence. GSA issues are one aspect of the debate as to whether further transition to the rightmost panel is in the public interest.

GSA barriers have become eroded significantly in that banks, directly, and their holding company affiliates have entered the securities business as "discount brokers." By only taking customers' orders, they avoid offering advice or sponsoring new security issues. Thus, as customers' "agents," under GSA, they offer transactions–based activities converging on those of insurance and securities companies. Bankers thus may be retaining much of their historical shares of total financial activity — although selling these "investment products" results in non–interest income and does not generate banking assets. Since the mid–1970s, bank holding company affiliates have also markedly increased their involvement in mutual funds activities.[29]

Banking institutions have blended the commercial and investment banking businesses abroad for years. The international operations of many large U.S. banking organizations include the underwriting, distribution, and brokerage of securities in many other countries[30] whose internal financial markets are more deregulated than the United States.[31] Japan may be the only country with strict isolation of banking from securities along GSA lines. Even its corresponding Section 65 of the Securities and Exchange Law — dating from the U.S. Occupation — has been somewhat deregulated.[32] In particular, U.S. bankers may mix securities activities with banking in the European Union. It

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[27] U.S. Library of Congress. Congressional Research Service. *Universal Banking.* Report No. 95-579 E, by William Jackson. Washington, 1995. p. 3, A1-A3.

[28] Eaton, David M. The Commercial Banking-Related Activities of Investment Banks and Other Nonbanks. *Emory Law Journal*, Summer 1995. p. 1200-1214.

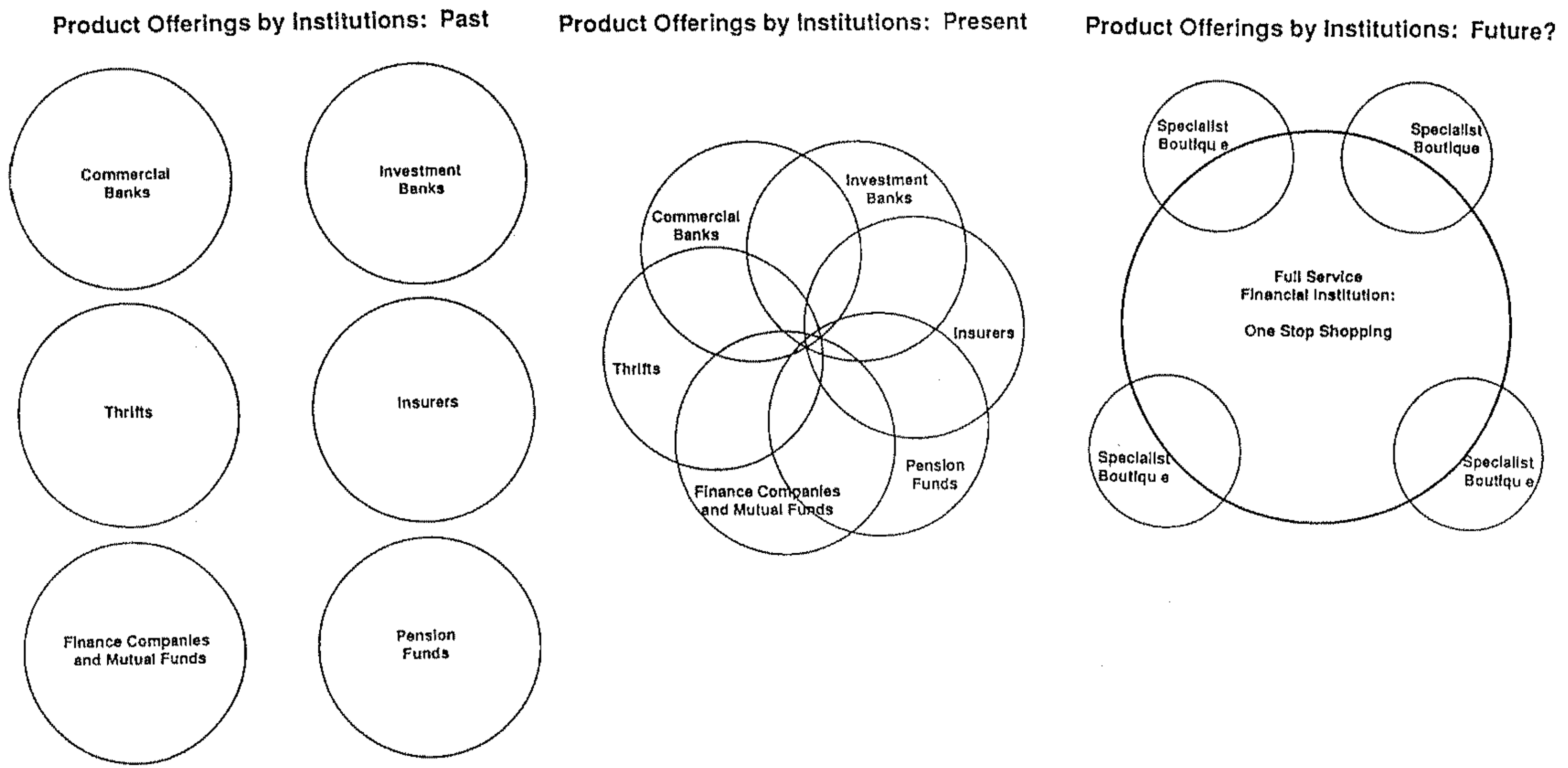
[29] Golter, Jay W. Banks and Mutual Funds. *FDIC Banking Review*, Summer 1995. p. 10-20.

[30] Under the Federal Reserve's "Regulation K:" 12 C.F.R. Part 211.

[31] Institute of International Bankers. *Global Survey 1995*. New York, 1995. p. 7-16. See table 2, below.

[32] Brown, J. Robert. Japanese Banking Reform and the Occupation Legacy. *Denver Journal of International Law and Policy*, Winter 1993. p. 390, 398; and, Smith, Charles. Where Does the Japanese Securities Industry Go from Here? *Institutional Investor*, December 1995. p. 128-134.

FIGURE 2. Product Offerings by Financial Institutions Over Time



Source: Statement of Anthony M. Santomero in: U.S. Congress. House. Committee on Banking and Financial Services. Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises. *Current State and Future of the Financial Services Markets*. Hearings. Washington, 1995. p. 111. (Serial No. 104–6) allows "universal banks[33]" throughout its fifteen nations: combining lending, stock and bond dealings, with money management.

U.S. banks still view securities operations within our borders as being at a competitive disadvantage from an international perspective. Foreign banks are not supposed to combine most depository and security services in America, according to the International Banking Act of 1978.[34] Yet, the Federal Reserve let the Sumitomo Bank of Japan (which owns large U.S. banking interests) buy into Goldman, Sachs — a leading full-service Wall Street securities dealer. It allowed the Credit Suisse banking organization to control CS First Boston, the First Boston investment house.

THE LAST DECADE

Congress passed the Competitive Equality Banking Act of 1987[35], to, among other things, strengthen GSA. The measure placed a "moratorium" until March 1, 1988 on approval of securities, insurance, and real estate activities of banks or bank holding companies. The law stated that the moratorium may not be renewed. It has not been. The 1987 Act also permanently prevented securities (and other commercial) companies from offering insured deposits and other bank services through new "non-bank banks." It thus isolated banking and commerce from a reverse direction.

Later in 1987 came a large stock market decline. The 500-point fall-off in the Dow Jones Industrial Average suggested to many observers that mixing "banking" and "commerce" might not be desirable. Among other things, giant losses at the First Options securities subsidiary of the Continental Illinois bank holding company — itself having received massive Federal aid in 1984 — were covered by Continental's bank.

On its own — without congressional directive — the Federal Reserve in 1987 approved new bank holding company securities activities. Bank holding companies' non-banking affiliates could underwrite commercial paper, municipal revenue bonds, and securities backed by mortgages or consumer credit. This was done in light of Section 20 of the Glass-Steagall Act prohibiting them from being "engaged principally" in investment banking functions. The Fed initially limited the new activities to 5 percent of an individual affiliate's gross revenues. This creative interpretation of <u>engaged principally</u> allows securities underwriting by large bank holding companies.

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[33] Saunders, Anthony and Ingo Walter. *Universal Banking in the United States*. New York, Oxford University Press, 1994. 276 p.; and, U.S. Library of Congress. Congressional Research Service. *Universal Banking, op. cit.*

[34] P.L. 95-369.

[35] P.L. 100-86.

Federal Reserve orders in 1989 allowed specific bank holding companies, through "Section 20" affiliates, to underwrite and deal in corporate debt securities. The Fed doubled its percentage limits on the four groups of affected private and municipal securities to 10 percent of revenues of affiliates authorized to underwrite them. And, just as National banks may package their own loans into securities and underwrite them, so can bank holding companies package bank loans into self-underwritten securities. The latter must be given a quality rating by a national rating agency comparable to the ratings of corporate bonds.

The Federal Reserve approved equity (stock) underwriting by bank holding companies beginning in 1990. It liberalized its "Regulation K" limits on banks' securities activities beyond U.S. borders. It also granted applications of foreign banks to underwrite corporate debt and other securities in this country directly. U.S. bankers have to use affiliates for underwriting.

About the same time, the Comptroller of the Currency approved further securities powers. Its regulatees, the National banks, may sell mortgage-backed securities they originate, and offer investments in pools of futures commodities (speculative commodity funds). National banks still lack full-service securities underwriting and brokerage authority.

The majority of States continue to allow long-standing or new securities powers for their State-chartered banks. (See figure 3, on the next page.) Their authority to do so is not restricted by GSA — unless the State banks belong to the Federal Reserve System. The FDIC may veto these State authorities, but, as is noted below, has generally not done so.

The thrust of the deregulation of the 1970s and 1980s is summarized in table 1 (on p. 12). It generalizes bank-related securities activities. Most of them were attained only after much skirmishing involving regulatory interpretations. They may not be available to some institutions. It is not necessary to specify the many bank-like products of unregulated investment bankers and nonbank firms. The latter are not generally limited by law.[36] The present framework of GSA thus was in place by the beginning of this decade.

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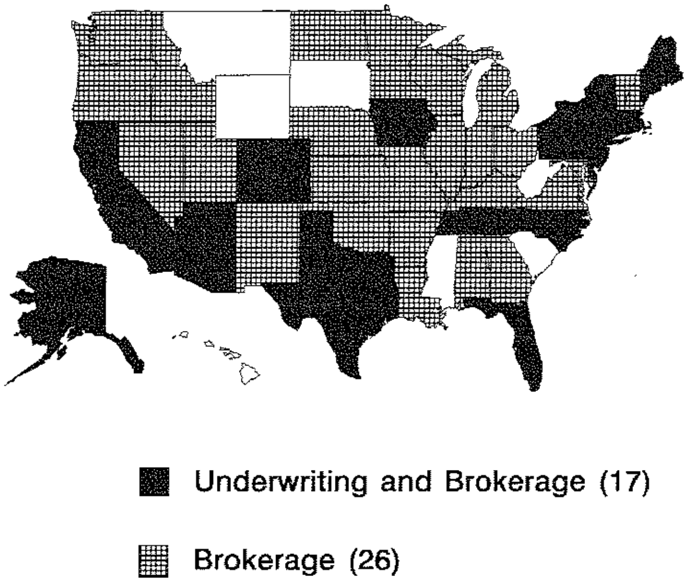
[36] Emory, Commercial-Banking-Related Activities, *op. cit.*

FIGURE 3. Securities Activities Authorized
For State–Chartered Banks, April 17, 1995



Source: Conference of State Bank Supervisors. *State of the State Banking System 1995.* Washington, 1995. p. 13. Chart prepared by CRS.

MORE CURRENTLY

In the late 1980s and early 1990s, the securities industry had problems resulting from tight money and a recession. Full–line brokerage firms lost money as a group in 1987, 1988, 1989, and 1990.[37] The (largest) commercial banks had lost money only in 1987 and 1989.[38] Collapse of the venerable leading securities house, Drexel Burnham Lambert — which had helped finance the Civil War — reminded policymakers of risks that dragged down the healthy parts with its bad operations. Its experience created concerns that internal firewalls proposed to insulate subsidiaries of financial holding companies from each other and affiliated banks could be too weak to contain financial fires within holding companies. Some U.S. bankers closed their London offices, which had the securities powers they were seeking in America.

In the 102d Congress, the Treasury Department had sponsored legislation[39] that sought to allow well–capitalized banks to affiliate with

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[37] Siconolfi, Michael. Full-Line Brokers Take Profit Prize. *Wall Street Journal*, December 21, 1995. p. C1, C14.

[38] English, William B., and Brian K. Reid. Profits and Balance Sheet Developments at U.S. Commercial Banks in 1994. *Federal Reserve Bulletin*, June 1995. p. 563.

[39] H.R. 1505, S. 713.

TABLE 1

SECURITIES ACTIVITIES OF DOMESTIC COMMERCIAL BANK HOLDING COMPANIES (JANUARY 1994)

Permissible	*Year Started*[a]
Underwriting, distributing, and dealing	Always
U.S. Treasury securities	Always
U.S. federal agency securities	Various years
Commercial paper	1987
Mortgage and other asset-backed securities	
Collateral originated by other banks	1987
Collateral originated by issuing bank	1989
Municipal securities	
General obligation	Nearly always
Some revenue bonds	1968
All revenue bonds	1987
Corporate bonds	1989
Corporate equity	1990
Financial and precious metal futures brokerage and dealing	1983[b]
Private placement (agency capacity)	Always
Sponsor closed-end funds	1974
Underwrite deposits with returns tied partially to stock market performance	1987
Offshore dealing in Eurodollar securities	Always
Mergers and acquisitions	Always
Trust investments	
Individual accounts	Nearly always
IRA commingled accounts	1982
Automatic investment service	1974
Dividend investment service	Always
Financial advising and managing	
Closed-end funds	1974
Mutual funds	1974
Restricted	Always
Brokerage	
Limited customer	Always
Public retail	1982
Securities swapping	Always
Research advice to investors	
Separate from brokerage	1983
Combined with brokerage	
Institutional	1986
Retail	1987
Nonpermissible	
Mutual funds sponsorship and underwriting	

[a]After the Civil War. Different dates may apply to national and state banks and among state banks. With some exceptions, the earliest date is shown. Regulatory rulings frequently concluded that a specific activity was permissible before the date of ruling. If the activity was halted by enactment of the Glass-Steagall Act, the date of renewed activity is given.

[b]Restricted to futures contracts for which banks may hold the underlying security or that are settled only in cash.

Source: Kaufman, George G. *The U.S. Financial System.* Englewood Cliffs, Prentice-Hall, 1995. p. 395.

securities firms through common control by "financial services holding companies." To isolate the nonbanking (securities, insurance), parts of these entities from the federally insured banks, the proposed structure would have provided separate capitalization, disclosure and funding firewalls, and regulation of affiliates by function (that is, the SEC would oversee the securities operations directly). All parts of these companies might, however, share personnel, and cross–market each others' offerings to customers.

A key element in this debate was the extent to which securities and other non–banking businesses would be removed from direct banking operations. The height and depth of firewalls — barriers to mixing the federally protected deposit and lending bank operations with riskier and noninsured activities — were much debated. The Bank Holding Company and Federal Reserve Acts had already provided firewalls restricting informational and monetary transfers to affiliates of bank holding companies from insured banks.[40]

> "Firewalls" are the legal and economic barriers that are intended to prevent inappropriate flows of capital, funds and information between affiliates. They facilitate the segmentation of functions within an organization, and are designed to prevent the transmission of losses from one area of an organization to another. Banking firewalls have been implemented for the purpose of isolating the insured depository from nonbank activities of the bank or its affiliates. The so–called "Chinese wall" that separates the trust function from the depository function of a bank is an example of a common banking firewall. Another is the set of restrictions on interaffiliate transactions in bank holding companies contained in the Federal Reserve Act.[41]

But their rigidity under stress has continued to be questioned. And they are not common in worldwide finance. Only the U.S.A., Japan, and two other countries seem to place firewalls between commercial banking and securities operations of the same company. See table 2 (on the next page).

The major banking legislation Congress actually passed[42] was the Federal Deposit Insurance Corporation Improvement Act of 1991.[43] Despite much debate, this measure did not mention GSA. The new law was actually restrictive: it gave the FDIC veto power over State bank securities powers

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[40] Sections 23A and 23B of the Federal Reserve Act, most recently from the Garn-St Germain Depository Institutions Act of 1982 (P.L. 97-320), and the Competitive Equality Banking Act of 1987 provide especially relevant firewalls. They extend to nonmember State banks and their affiliates under P.L. 102-242, noted below.

[41] Blair, Bank Powers, p. 28.

[42] After conference on H.R. 3768, S. 543.

[43] P.L. 102-242.

TABLE 2. Forty–Six Nation Survey of Firewalls* Applicable to Securities Underwriting and Dealing Activities

Securities Activities Permissible Without Firewalls			Securities Activities Subject to Firewalls
Securities Activities Permissible in the Bank		Securities Activities Permitted Only in a Non–Bank Affiliate	Securities Activities Permitted Only in a Non–Bank Affiliate
Argentina[a]	Luxembourg	Bolivia	Japan[e]
Australia	The Netherlands	Brazil	Korea[f]
Austria	New Zealand	Canada	Singapore[g]
Bahrain	Norway	Chile	United States[h]
Belgium[b]	Pakistan	China[d]	
Bermuda	Panama	Colombia	
Cayman Islands	Peru	Indonesia	
Denmark	Philippines	Thailand	
Dominican Republic	Portugal		
Finland	South Africa[c]		
France	Spain		
Germany	Sweden		
Greece[a]	Switzerland		
Hong Kong	Turkey		
India[a]	United Kingdom		
Ireland	Uruguay		
Italy[a]			

* These "firewall" restrictions do not include so–called "chinese walls" which restrict the dissemination of non–public, confidential information between banking and securities operations.

[a] Trading securities on the exchange limited to stockbrokerage subsidiary.

[b] Trading securities on the exchange limited to stockbrokerage subsidiary until December 31, 1995.

[c] As of November 8, 1995 when authorizing legislation goes into effect. Whether firewalls will be imposed is not yet resolved.

[d] Whether firewalls will be imposed is currently under consideration by the Peoples' Bank of China.

[e] There are a number of firewalls in Japan, the most significant being that a securities subsidiary is prohibited from being a lead manager for a company with assets less than 500 billion yen if the bank is or has recently been the trustee on that or similar issues. In addition, loans by the bank to purchase securities underwritten by the securities subsidiary are prohibited, tie-in-sales are prohibited, sharing space in the same building is regulated, joint sales visitations are restricted unless requested by the customer and director and personnel interlocks are restricted.

[f] Personnel interlock restrictions.

[g] Banks cannot extend unsecured credit in excess of S$5,000 to their securities affiliate. Non-domestic banks can engage in securities activities through their branch operations without firewalls.

[h] U.S. and non-domestic banks are subject to extensive firewalls between their banking operations and their section 20 securities subsidiaries under applicable Federal Reserve Board orders. See J. P. Morgan & Co. Incorporated, 75 Fed. Res. Bull. (1989); Canadian Imperial Bank of Commerce, 76 Fed. Res. Bull. 158 (1990).

Source: Institute of International Bankers. *Global Survey 1995.* New York, 1995. p. 17.

shown in figure 3 (p. 11). Yet it gave the Federal Reserve authority to lend to securities firms in need of emergency liquidity — a reaction to the 1987 stock market crash. The Fed's "discount window" lending had been reserved for banks and other depository institutions.

In 1992, the Federal Reserve Board further weakened GSA. It allowed bank holding companies to offer investment advisory and security brokerage services to large (institutional) customers on a combined basis. It relaxed restrictions on key personnel overlaps between banks and affiliated securities firms.

Bankers joined in the securities surge of the 1990s not only as discount brokers but also as providers of mutual funds — which have increased to almost equal bank deposits.[44] They can sponsor or distribute mutual funds: although generally not both for the same funds. They can "advise" portfolios. Their Section 20 underwriting grew rapidly. Their rapid expansion has not been without consumer and regulatory problems, however.[45] Difficulties have arisen in bank–related sales of many securities. Questions remain as to whether buyers of mutual funds and other "investment products" sold through banks view them as if they are deposits or similar federally–guaranteed investments.[46]

Risk has persisted, as well. Some bank holding companies have covered investor losses in funds they advised. Large investment bankers specializing in underwriting lost money in 1994.[47] Losses in derivatives may require further payouts. The spectacular implosions of Kidder, Peabody and Company — formed in 1865 — and of Barings in Britain/Singapore — formed in 1763 — as derivatives trading ended their long existence, are recent reminders that years of successful operation and financial sophistication in securities activities cannot always overcome riskiness. More recently, spectacular trading losses ended the gigantic Daiwa Bank's operations in New York — through one uninsured and one federally–insured entity.[48] The collapses of these three institutions came

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[44] U.S. Government Accounting Office. *Mutual Funds: Impact on Deposits and Credit Availability.* Report No. GAO/GGD-95-230. Washington, 1995. 18 p.

[45] Statement of Arthur Levitt in U.S. Congress. House. Committee on Banking and Financial Services. *H.R. 1062, the Financial Services Competitiveness Act of 1995, Glass-Steagall Reform, and Related Issues (Revised H.R. 18) -- Part 2.* Washington, U.S. Govt. Print. Off., 1995. p. 259–286.

[46] U.S. General Accounting Office. *Bank Mutual Funds: Sales Practices and Regulatory Issues.* Report No. GAO/GGD-95-210. Washington, 1995. 145 p.; *Banks' Securities Activities: Oversight Differs Depending on Activity and Regulator.* Report No. GAO/GGD-95-214. Washington, 1995. 116 p.; and, U.S. Library of Congress. Congressional Research Service. *Banks' Sale of Mutual Funds: Legislative and Regulatory Issues.* Report No. 94-875 E, by Gary W. Shorter. Washington, 1994. 34 p.

[47] Siconolfi, Full-Line Brokers, p. C14.

[48] U.S. Library of Congress. Congressional Research Service. *The Daiwa Bank Problem: Background and Policy Issues.* Report No. 95-1164 E, by Dick Nanto, William Jackson, and F. Jean Wells. Washington, 1995. 20 p.

from only one trader in each. Some believe that this pattern suggests caution in amending GSA.[49]

Several recent research papers suggest that GSA was, however, targeted at what were really only isolated, misperceived, or even common, securities market practices not specifically identifiable with commercial banking. Overreaction may have unduly removed competitors from both the commercial and investment banking fields. In this view, market convergence of financial services implies relaxing GSA.[50]

LEGISLATION?

Prominent banking companies generally, and their regulators, seek to modify or repeal GSA. The Administration agrees. Many bank holding companies are especially interested in gaining mutual funds sponsorship and distribution. Securities underwriting is most attractive to the larger bank holding companies. (A banking company may need over $1 billion in assets to enter the full–line securities business successfully.[51]) Several securities firms would like to own banks. They seek access to the banking system's Federal payment clearing and support mechanisms without becoming regulated bank holding companies. Other securities firms may view themselves as merger buyout targets at high prices to be paid by domestic and foreign banking companies. Opponents include many smaller banks,[52] other securities firms, and some consumer groups. The momentum to relax GSA is largely industry–driven. Few customers are actively petitioning Congress to allow one–stop financial shopping. Questions as to regulatory oversight of diversified financial firms and responsibilities for bailing them out directly, or closing them, if they encounter losses also remain subjects for debate.

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[49] Wilke, John R. Daiwa Scandal Spurs a Review of Banking Bill. *Wall Street Journal,* December 6, 1995. p. A4.

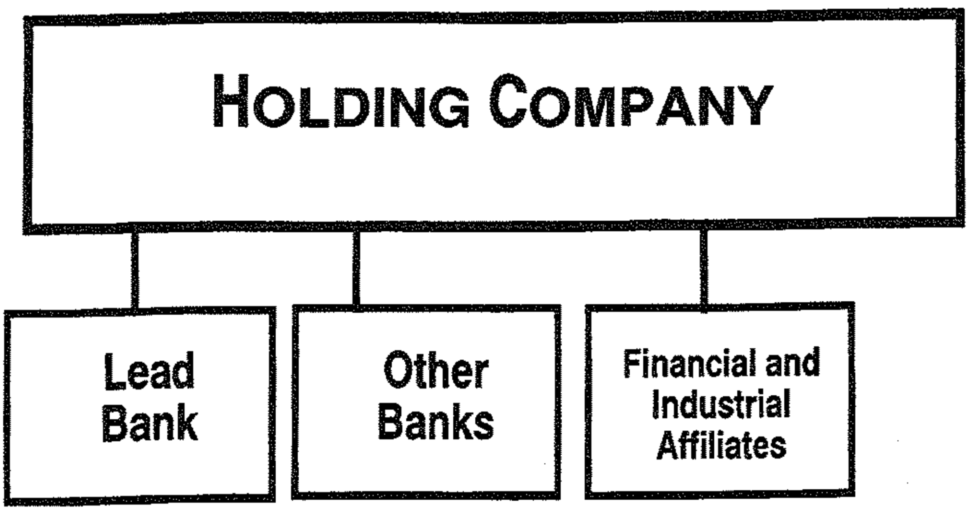
[50] White, E. N. Before the Glass-Steagall Act: An Analysis of the Investment Banking Activities of National Banks. *Explorations in Economic History,* 1986. p. 33-55; Benston, *The Separation of Commercial and Investment Banking.* New York, Oxford University Press, 1990. 263 p.; Ang, James S. and Terry Richardson. The Underwriting Experiences of Commercial Bank Affiliates Prior to the Glass-Steagall Act. *Journal of Banking and Finance,* March 1994. p. 351-395; Puri, Manju. The Long-Term Default Performance of Bank Underwritten Security Issues. *Ibid.,* p. 397-418; Krozner and Raghuram G. Rajan. Is the Glass-Steagall Act Justified? *American Economic Review,* September 1994. p. 810-832; Benston, *The Banking and the Securities Industries in Historical Perspective,* p. 29-32; and, Mester, Loretta J. Repealing Glass-Steagall: The Past Points the Way to the Future. *Federal Reserve Bank of Philadelphia Business Review,* July 1996. p. 3-15.

[51] Goldberg, Lawrence G., Gerald A. Hanweck, Michael Keenan, and Allan Young. Economies of Scale and Scope in the Securities Industry. *Journal of Banking and Finance,* Spring 1991. p. 91-107.

[52] Expanded securities powers for small banks are a low-priority legislative goal, in a survey of community bankers. Grant Thornton LLP. *Annual Survey of Community Bank Executives.* Chicago, 1996. p. 15.

In the 104th Congress, H.R. 1062, the successor to H.R. 18, was marked up by the Committee on Banking and Financial Services. Following controversies over insurance–related and other issues, much of this measure was combined with parts of H.R. 1815, a banking compliance regulation relief measure, into H.R. 2520.[53] In particular, the proposal would have allowed "wholesale financial institutions": non–insured full–service banking affiliates of investment banking companies regulated by the Federal Reserve.[54] Other measures, numbered H.R. 814 and S. 337, would allow even more diversified financial services holding companies owning subsidiaries in the banking, securities, and insurance and, perhaps, the trade and industrial sectors: universal banks and the like of Europe. The approach of H.R. 2520 could have been viewed as much of the framework of figure 4 (below); while that of H.R. 814/S. 337 would be fully like this figure. H.R. 2520 would have left out the industrial affiliates and limit the financial affiliates. Both financial services holding company approaches would go beyond the existing structure of figure 1 (p. 6). The former would seek to expand the Federal Reserve's regulatory reach; the latter would not necessarily do so. Firewalls exist in both approaches, reflecting the governmentally–supported role of commercial banks in the Nation's credit and payments systems.

FIGURE 4. Possible Financial Services Holding Company Structure



Source: Prepared by the Congressional Research Service.

[53] U.S. Library of Congress. Congressional Research Service. *Banking and Insurance Amendments in the Financial Services Competitiveness and Regulatory Relief Act of 1995*. Report No. 95-1168 E, by William Jackson. Washington, 1995. 6 p.

[54] Harrell, Alvin C. Commentary: Is There A Woffie In Your Future? *Consumer Finance Law Quarterly Report*, Winter 1995. p. 67, 138, 152.

Prospects for this legislation continue to depend on reactions of securities, banking, and, especially insurance entities. The insurance sector (which now also contains prominent securities businesses despite their earlier isolation) might again prevent passage of legislation liberalizing GSA, as it did in 1984, 1988, and 1991.[55] Insurance issues prevented a vote on H.R. 2520 in committee as is noted below.

Favorable stock prices might also be required to encourage deregulatory legislation. The general bull market in stocks — like that of the 1920s — has lasted for years as of this writing. Transformation of National financial processes and economy–wide industrial structures has also resembled that of the 1920s.[56] Although no 1930s Depression–like reversion seems likely, the financial future may not always be rosy.[57] In times of financial market trouble, Congresses have mainly focused on tightening, rather than liberalizing, financial regulation.[58]

Legislative efforts, spearheaded by Representative Leach, continue to be proposed to relax GSA as the 104th Congress is coming to an end. GSA and banking "regulatory relief" could be jointly addressed in any legislation proposed to succeed H.R. 2520.

Increases in banks' securities activities could, unexpectedly, come from the measure H.R. 3448 commonly known as the minimum wage bill: the Small Business Jobs Protection Act. It provides for banks to transfer common trust fund assets into mutual funds on a tax–free basis, and for financial asset securitization investment trusts to package auto and credit card home equity, etc. loans into pools resembling those for mortgages.[59] The measure awaits the President's signature as of this writing.

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[55] LaRocco, Larry R. Same Old Story Keeps Glass-Steagall Alive. *American Banker*, December 11, 1995. p 26.

[56] Krozner, *The Evolution of Universal Banking, op. cit.*

[57] Peters, Edgar E. *Chaos and Order in the Capital Markets: A New View of Cycles, Prices, and Market Volatility*. New York, John Wiley, 1991. 240 p.

[58] Most notable was the Depression that evoked GSA and companion securities measures. More recent examples contained a re–regulatory philosophy stressing banking safety and soundness. The Garn–St Germain Depository Institutions Act of 1982 (P.L. 97-320, Title VI) restrained insurance activities of bank holding companies. Savings and loan association losses produced cleanup and loss prevention legislation: the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (P.L. 101-73). It was soon followed by the Federal Deposit Insurance Corporation Improvement Act of 1991, when the banking sector appeared to be following savings institutions. All three measures occurred after weakness in stock prices. Conversely, a strong stock market preceded recent bank regulatory relief and nationwide operation measures: the Community Development and Regulatory Improvement Act of 1994 (P.L. 103-325) and the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994 (P.L. 103-328).

[59] Hensley, Scott. Law Seen Sending Trust Assets Flooding Into Funds. *American Banker*, August 12, 1996. p. 13, 21; and, Senate Overwhelmingly Endorses Small Business Tax Breaks. *BNA's Banking Report*, July 15, 1996. p. 83.

NO LEGISLATION NEEDED?

Further deregulation of GSA might well occur without any legislation, through bank holding company and/or National bank regulations.

The Comptroller of the Currency has had pending for some time a potential regulation that would allow National banks to form subsidiaries.[60] Their "operating subsidiaries" would offer financial services that the National banks are prohibited from marketing directly. Real estate brokerage, insurance underwriting, and securities underwriting are examples. The House has already rejected one legislative pre–emptive strike against the unissued regulation: it voted down an amendment to this effect to the Treasury–Postal Service appropriations measure H.R. 3756 in July 1996.[61]

The Federal Reserve Board, at the urging of Representative Leach, the American Bankers Association, the Bankers Roundtable, and the Institute of International Bankers, has recently proposed liberalizing Section 20 underwriting noted above. The Fed could perhaps more than double the underwriting business of the Section 20 affiliates of bank holding companies. They might receive up to 25% of revenues from underwriting bank–ineligible debt and equity securities. They might also face fewer firewalls restricting management and marketing interlocks and cross–selling to other affiliates (i.e. banks) and customers. Indeed, the Fed could redefine the revenue base of the Section 20 affiliates — so that they could have even more securities activities now offered by full–service broker/dealers. The effect would be that Section 20 affiliates would become more profitable. Their number would be expected to increase beyond the current less–than–40, especially as more foreign banking companies would seek them.[62]

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[60] 59 *Federal Register* 61034-61067 (November 29, 1994). The proposed revision would be to 12 CFR §5.34.

[61] House Rejects Solomon Effort to Hang OCC Rider on Treasury Bill. *BNA's Banking Report*, July 22, 1996. p. 121-122.

[62] Banks' Expansion in Securities Business is Unlikely to Spark Wave of Big Mergers. *Wall Street Journal*, August 2, 1996. p. A4; Mester, Repealing Glass-Steagall, p. 7; Seiberg, Fed Proposes Boosting Cap on Securities Units' Income. *American Banker*, August 1, 1996. p. 1, 2; Padgett, Tania. Bond Rally, Plan to Ease Cap on Securities Units Help Boost Bank Stocks. *Ibid.*, August 2, 1996. p. 20; Dunaief, Daniel. Investment Banking Profits Seen Near Glass-Steagall Cap. *Ibid.*, July 31, 1996. p. 24; Dunaief, Fed Plan Could Expand Investment Banking Ranks. *Ibid.*, August 6, 1996. p. 1, 24; Seiberg, Jaret, Fallout Fears Kept Fed from Further Easing Securities Units' Reins. *Ibid.*, August 5, 1996. p. 2; Dunaief, Banks Seen as Acquirers of Investment Banks Soon, *Ibid.*, August 13, 1996. p. 1, 32; and, Fed Proposes Easing of Restrictions on Section 20 Securities Subsidiaries. *BNA's Banking Report*, August 5, 1996. p. 197. crsphpgw