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NO GOING BACK: WHY WE CANNOT RESTORE GLASS-STEAGALL'S SEGREGATION OF BANKING AND FINANCE[1]

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Introduction

Recently, a number of authoritative voices have called for a return to the New Deal Glass-Steagall legislation as the most appropriate response to the 1999 Financial Services Modernization Act's failure to provide stability of the financial system. However, a clear understanding of the 1933 Banking Act, along with subsequent regulatory interpretation and legislation, suggests that this would be difficult, if not impossible. A new Glass-Steagall Act would have to be substantially different from the original, and some of the internal structural contradictions that led to its demise remedied.

What Was Glass-Steagall Trying to Do?

First, it is important to note that the legislation, produced in slightly less than three months, was considered a stopgap measure that was enacted following three years of crisis. It drew extensively on reform proposals that had been under discussion since the establishment of the National Monetary Commission in 1908 and the subsequent creation of the Federal Reserve System. Indeed, the main

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proposal—the separation of banking and finance—had been put forward by Louis D. Brandeis (1914) in his famous condemnation of the turn-of-the-century financial system.

The Senate Committee on Banking and Currency report on the Act emphasized the intention to construct a bill to correct the "immediate abuses" rather than prepare a completely comprehensive measure for the reconstruction of the U.S. banking system. A good summary[2] of these "immediate abuses" is contained in the decision of the District of Columbia Circuit Court of Appeals: *A.G. Becker, Inc. v. Board of Governors of the Federal Reserve System* (1982). The basic abuses were deposit-taking banks' underwriting of and investment in securities, lending to finance the acquisition of securities, and margin lending to retail clients for the purchase of securities. The integrity of the public's holding of deposits in banks was to be ensured by prohibiting deposit-taking banks from these activities, and by preventing any financial institution engaged in these prohibited activities from taking deposits from the public.

The Comprehensive Measures

While the Constitution forbids states the right to issue debt or currency, it does not prohibit them from chartering banks. The Civil War–era National Bank Act sought to reduce the role of state banks by limiting the issue of national bank notes to federally chartered banks. But state banks responded by offering clients checkable deposits, and by the turn of the 20th century, state banks were dominant. This was partly due to a 1902 ruling by the Comptroller of the Currency limiting investments by national banks to any single borrower and curtailing the right of the large New York national banks to deal in and underwrite securities. State banks were not subject to these restrictions, and national charter banks formed state-chartered affiliates to evade them. It was the activities of these security affiliates that produced most of the fraud and malfeasance during the 1920s stock market boom and that many experts considered to be the cause of the Great Crash.

To remove this abuse, section 20 of the 1933 Act specified that "no member bank shall be affiliated in any manner . . . with any corporation, association, business trust, or other similar organization 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" (FRB 1933, 398). Thus, the more "comprehensive measures" referred to by the Senate committee involved the elimination of this dual system of regulation by state governments and the federal government. In particular, the prohibition applied by most states to branch banking, and the decision of federal regulators to respect this rule, produced a predominance of small "unit" banks in the United States. This was often thought to be a contributory factor in the instability of the U.S. system as compared to the Canadian, which had a small number of large banks and emerged from the 1930s without major financial crisis. To remedy these more fundamental problems would require unifying regulation at the federal level, possibly along the lines of "a constitutional amendment or some equally far-reaching measure necessitating a long postponement of action" (*A.G. Becker* 1982).

Correcting the Manifest Abuses Produces a Financial Structure

Although considered stopgap measures, the restrictions on the immediate abuses had very clear consequences for the structure of the financial system. One set of financial institutions would be responsible for taking deposits from the public and making short-term loans to commercial and industrial borrowers through the creation of credit in the form of new deposit accounts. A second set of institutions would be charged with the long-term financing of capital investment through the initial underwriting and secondary distribution and trading of securities: bonds and equity.

Section 21 of the 1933 Act simply formalized this difference between the short-term and long-term forms of finance for the private sector. It provided member banks with a monopoly on deposit business, subject "to periodic examination by the Comptroller of the Currency or by the Federal reserve bank of the district" and to the requirement that each bank "make and publish periodic reports of its condition" (FRB 1933, 398).

Following Brandeis's admonition, the intention was to shield public deposits from exposure to or use in any securities market activities, and, in particular, to prevent member banks from owning or dealing in equity or forming affiliates to do so. Thus, the operational difference between commercial and investment banks rests on the former's ability to receive deposits and the limiting of their investments to short-term, self-liquidating business loans.

However, H. Parker Willis's (1921) analysis of the activity of commercial banks notes that their most important function is not the simple receipt of public deposits but rather the creation of liquidity for its borrowers through the acceptance function. He notes that this allows the bank to earn income in the form of a net interest margin, less charge-offs for bad loans. Banks not only receive and preserve deposits but also create liquidity through leverage, and they are recompensed for this by the premium on their deposits relative to their assets and by their ability to scrutinize the solvency of borrowers.

Thus, while the 1933 Act limited the "receipt of deposits" to member banks, it also limits banks' ability to use and create deposits to create liquidity for their clients to particular types of investments—what are generally called commercial and industrial (C&I) loans.

However, commercial banks are not unique in the creation of liquidity. While a commercial bank creates liquidity by insuring that its liabilities have a higher liquidity premium than its assets and thus can always be exchanged for currency, investment banks also provide liquidity by ensuring that the liabilities they underwrite have a higher liquidity premium than the capital assets they finance and thus can be bought or sold in organized markets without a great variation in price. They do this by ensuring an active and liquid secondary market for securities through their broker-dealer activities as market makers. The 1933 Act provided monopoly protection for a particular means of providing liquidity through deposit creation, but it did not give commercial banks a monopoly on the creation of liquidity.

The Viability of the Commercial-bank Business Model under the 1933 Banking Act

National banks suffered from competition from alternative forms of liquidity creation even before their operations were restricted to short-term commercial and industrial loans in the 1933 Act—and had already begun to expand their lending into longer–term maturities. The financial system also evolved beyond the simple structure envisaged by the Banking Act as a result of a process of innovation and competition between regulated and unregulated banks. In any event, both the protected deposit business and the creation of liquidity based on deposit creation were eroded by competition from nonmember investment banks that were not restricted to a particular business model. Indeed, it was not the receipt of customer currency deposits that had to be protected but rather liquidity creation, or the acceptance function, if the separation of commercial and investment banks was to be sustainable. Once investment banks could provide these liquidity-creating services more cheaply than regulated banks, the latter's business model became untenable, and with it the logic of the Glass-Steagall separation of commercial and investment banking.

Glass-Steagall Created a Monopoly That Was Bound to Fail

For supporters of free-market liberalism, the decline of member banks as the providers of liquidity through insured deposit creation was simply an expression of the inefficiencies of a de facto cartel on deposit taking. For example, Kenneth E. Scott (1981) notes that the 1933 Act undertook to create a buyers' cartel among banks, restraining competition among them for demand deposits and for time and savings deposits. And, according to George G. Kaufman (1988), the Act was blatantly anticompetitive, and economists generally agreed that most of its restrictions were no longer necessary, at least for restricting risk.

However, the erosion of the protections afforded member banks' deposit business was as much due to the conscious decisions of regulators and legislators to weaken and suspend the protections of the Act—thus providing explicit support for the competitive innovations of nonmember banks—as it was to the triumph of market forces over monopoly. Indeed, Glass-Steagall gave unregulated investment banks a monopoly over securities market activities, some of which could be made functionally equivalent to the deposit business and liquidity creation of regulated banks with the introduction of financial innovation.

Challenges to Monopoly Protection: Thrifts and Asset Securitization

An initial challenge to member banks' monopoly on the receipt of deposits came from savings and loan banks. Savings banks were considered investment banks, so they were excluded from the 1933 Act and the Regulation Q limits on deposit interest rates for insured member banks. When interest rates started to climb along with inflation, thrifts were provided a means of competing with member banks for insured deposits—but with fewer constraints as a result of deregulation. The end result was the savings-and-loan crisis, which led to the collapse of the industry.

But the real challenge to member banks' monopoly on liquidity creation came from the extension of asset securitization to encompass loans to businesses at lower financing spreads through risk reduction and redistribution. First, corporate issue of commercial paper displaced borrowing from commercial bank loans, and the guaranteed one-dollar net asset value of liabilities of money market funds provided a substitute for member bank deposits. Legislators in 1933 could not have foreseen the rise of commercial paper as a substitute for C&I loans or money market mutual funds (MMMFs) as a substitute for retail deposits, and member banks could not respond by entering those markets.

However, in 1984 the Supreme Court ruled that the Federal Reserve had the authority to allow regulated banks to acquire brokers as a subsidiary in a bank holding company (see *Securities Industry Association* 1984), and in 1985 the Fed ruled that bank holding companies could acquire as subsidiaries firms that offered both brokerage and investment advice to institutional customers. Subsequent interpretations further relaxed the Act's section 20 restrictions, and then expressly allowed regulated banks to engage in securitization via affiliation with companies underwriting commercial paper, municipal revenue bonds, and securities backed by mortgages and consumer debts—as long as the affiliate did not principally engage in those activities.

The basic concept used by MMMFs was generalized in asset-backed securitization.[3] This concept was soon extended to the securitized financing of a wide range of corporate liabilities. The remuneration from this activity comes from identifying any market mispricing of risk (i.e., "riskless arbitrage"). Instead of a spread between borrowing and lending rates determined by the bank's ability to assess credit risk and thus ensure the liquidity of its liabilities, riskless arbitrage requires just the opposite process. Here, it is the pooling, diversification, and structuring of the special purpose entity's assets that reduces risk, along with the distribution of the assets into a large and active market that increases liquidity and converts high-rate, risky assets into lower-rate, less risky assets. In addition to the income generated from the interest spread between long-term assets and shorter-term liabilities, fees and commissions result from the origination of the loan, the underwriting of the securities, and the servicing of the structure itself.

The decision by the Securities and Exchange Commission (SEC) to exempt securitization structures from reporting as stand-alone financial institutions opened an alternative pathway for member banks to organize and operate affiliates that were neither regulated nor consolidated for financial reporting purposes. Again, regulators could have halted the development of asset-backed securities, but instead chose to suspend regulations in order to allow member banks to participate in their origination and sale.

The Response to Challenges from Nonmember Banks

To remedy the competitive disadvantages, member banks were allowed extensive exemptions from the section 20 and 21 interdictions against dealing in securities and with security affiliates, eroding the strict segregation provided by the original 1933 legislation. The combined impact of money market funds, exemptions for securities affiliates, and structured securitization is to provide liabilities with a higher liquidity premium than assets. The impact of these structures was to allow noninsured institutions to challenge the monopoly given commercial banks to make their liabilities more liquid than their assets through the use of deposit insurance and balance sheet regulation. They also increased system liquidity without the same regulatory prudential measures imposed on banks to ensure the liquidity and price of deposit liabilities. Under the U.S. regulatory system, money market deposit accounts and regulated bank deposits are considered equivalent, yet the former are regulated by the SEC and issued by investment banks, while the latter are regulated by the Fed and the Office of the Comptroller of the Currency (OCC) and issued by commercial banks.

The Liberalizing Power of "Incidental Powers"

Although competitive innovation played an important role in breaking down the segregation of deposit taking and securities activities, it was the legal and administrative interpretations of section 16 that ultimately eviscerated Glass-Steagall and the protections it provided to the business model envisaged for commercial banks. Section 16 accorded regulated banks "all such incidental powers … necessary to carry on the business of banking" (FRB 1933, 396). Most of the exceptions that enabled commercial banks to meet the competition from noninsured banks and caused the progressive erosion of Glass-Steagall came in later interpretations of the phrase "incidental powers," especially by the OCC.[4]

The overall impact of these rulings laid the basis for the creation of proprietary trading by banks for their own account, as well as derivatives dealing and the provision of structured derivative lending—both of which led to the rapid growth of the over-the-counter market in credit derivatives. Paradoxically, the justification was to provide regulated institutions, which were supposed to have a monopoly advantage, a level playing field with investment banks.

The Regulatory Dynamic of Innovation and Protection

The regulatory dynamic in the postwar period was one in which nonregulated investment banks devised innovations that were more competitive than those that could be offered by regulated commercial banks. In this environment, the monopoly protections placed on deposit business by the 1933 Act became a hindrance to the commercial banks' survival. Regulated institutions argued for the elimination of regulations until there was virtually no difference in the activities of FDIC-insured commercial banks and investment banks. As a result, the basic principles of the Act were eviscerated even before the Financial Services Modernization Act formally suspended Glass-Steagall's protections in 1999.

This de facto suspension of Glass-Steagall had another consequence for the stability of the financial system. Liquidity creation was increasingly transferred from deposit creation by commercial banks subject to prudential regulation, to securitized structures that were exempt from reporting and regulation because they were considered capital market activities and (usually) exempt from even SEC oversight—each one of these structures could be considered a ghost or "shadow" bank. Thus, the liquidity crises in 1998 and 2008 produced, not a run on banks, but a collapse of security values and insolvency in the securitized structures, and the withdrawal of short-term funding from the shadow banks. The safety net created to respond to a run on bank deposits was totally inadequate to respond to a capital market liquidity crisis.

The challenge that this new system of liquidity creation raises for those who would restore Glass-Steagall is twofold: how can commercial banks compete with investment banks in providing finance for business borrowers if they cannot deal and trade in securities, and how can regulations be written to prevent a repeat of the collapse of restrictions on securities trading? In particular, the question of "incidental powers," the real Achilles heel of the 1933 Act, must be resolved. And even if these problems could be resolved, it would still leave open the fundamental reform that was bypassed by the original Act—the relation between state and national charters and regulations.

If There Is No Way Back, Is There a Way Forward?

A return to Glass-Steagall thus presents a conundrum. Since the activities that currently provide the least costly method of short-term business financing are fundamentally linked to securities market activities, they would be prohibited to regulated banks. In addition, it would appear impossible to legislate monopoly protections similar to those of 1933 for deposits without active monitoring and the prohibition of competitive innovations by nonregulated institutions. Similarly, a separation of short-term bank financing activity from long-term funding in securities markets would require prohibiting the structured financing and derivatives that have largely eliminated this distinction by converting long-term assets into liquid, short-term liabilities. Thus, an alternative source of revenue would have to be found for regulated banks, requiring regulators, legislators, and the judiciary to agree on the precise definition of permissible banking activities and the incidental powers required to carry them out.

Resolving this problem will not be easy. Neither a restoration of the current system, with better regulation, nor a return to 1933 will suffice. One approach would be to recognize the activity of deposit taking as a public service and to regulate it as a public utility, with a guaranteed return on regulated costs. This approach would probably involve increased costs for transaction services or some form of government subsidy. Alternatively, a tax on nontransaction banks could provide this subsidy, rather than using it as a fund to bail out unregulated failed banks. Another possibility would be to define the business of banking as the creation of liquidity through the acceptance function of client liabilities. The expertise of banking would then be returned to minimizing charge-offs by improving the credit assessment of borrowers. All other forms of liquidity creation would fall within the realm of investment banking. Here, expertise would be in arbitraging market imperfections; that is, risk, interest rates, exchange rates, and so forth. Under such a division, MMMFs would be a permissible commercial bank activity.

A further approach would recognize that the Constitution reserves the provision of currency to the government, and there is no reason for the major part of this obligation to be outsourced to the private sector.[5] The safekeeping of wealth and transaction services could thus be provided as a public service by a regulated utility—say, through a national giro payments system—eliminating the need for deposit insurance and the lender-of-last-resort function of the Federal Reserve. Both short- and long-term finance and funding could then be provided by private investment funds or trusts monitored by securities regulations, but without the need for a government guarantee. Private savings would then limit investment financing, and the benefits of the banks' acceptance function would be lost. The conundrum noted above remains unresolved.

Notes

1. This brief should be read in conjunction with Policy Note 2009/11 (Kregel 2009), which argues that the main problem facing the U.S. financial system is not only banks that are too big to fail, but that are multifunctional. Comments from Thomas Ferguson, Rainer Kattel, and Mario Tonveronachi, not all of which could be incorporated, are gratefully acknowledged, without implicating them in the final result.
2. This source has been chosen not because it is considered correct but rather because it is representative of what the courts have considered to be the essence of the New Deal legislation and thus the basis for legal interpretation.
3. This is an issue that Minsky considered crucial but did not discuss in great length in his published work; see Minsky 2008.
4. This language was originally introduced in section 8 of the National Bank Act of 1863 granting national associations "all such incidental powers as shall be necessary to carry on the business of banking" but made no reference at all to securities; see Krooss 1969, 2:1386. There has been extended debate concerning whether these powers are restricted to those expressly mentioned in the law or are subject to interpretation. In practice, the decision is left with the OCC, created in the same legislation. A 1995 Supreme Court decision (*NationsBank of North Carolina, N.A. v. Variable Annuity Life Insurance Co.*) affirmed the OCC's full power to interpret section 8.
5. Indeed, many economists have seen this as the major source of instability in the financial system. For example, Henry Calvert Simons (1948 [1934], 54–55) notes the "usurpation by private institutions (deposit banks) of the basic state function of providing the medium of circulation (and of private 'cash' reserves). It is no exaggeration to say that the major proximate factor in the present crisis is commercial banking.… Chaos arises from reliance by the state upon competitive controls in a field (currency) where they cannot possibly work."

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