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Reforming Banking in 1995
Repeal of the Glass Steagall Act
Some Basic Issues

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Outline

1. OVERVIEW.
2. THE FINANCIAL STRUCTURE AS A LEGACY OF THE GREAT
DEPRESSION
3. THE MEANING OF REPEALING GLASS STEAGALL
3. THE SIGNIFICANCE OF MONEY MARKET AND OTHER FUNDS
4. INITIAL CONDITIONS
5. MONEY MANAGER CAPITALISM
6. 100% MONEY
7. MANAGING AND FINANCING CADRES OF LOAN OFFICERS.

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I.. OVERVIEW.

The most important single fact about the behavior of the American Economy over the fifty years since the end of World War II is that there has not been a serious depression such as was common over the prior 150 years of the Republic. This important fact indicates that we have to assume that there are significant differences between the American Economy of 1788 - 1933 and the American Economy of 1945 - 1994.

However the performance of the economy over 1945 - 1995 has not been homogeneous. Over the first post war era (1946-68 or so) the performance of the United States economy can be taken as a practical best i.e. the performance was not perfect but it was as good as any reasonable person can expect. Over the second part of this era the performance of the United States economy was not up to the high standards of the first part: there were bouts of inflation and the business cycles became more severe. Unemployment rates trended upwards and there were episodes in which the integrity of the financial structure was threatened. Nevertheless this second episode was inferior to the first, it remained better than the cyclical behavior that had characterized the earlier long sweep of 150 years.

There is one striking difference between the two periods. Over the first twenty two years of the post war period there were no significant threats to the financial

structure of the United States and the Bretton Woods international payment mechanism, which evolved into a system with the United State's dollar as the reserve currency of much of the world, reigned supreme. Over the second period there were threats to the financial stability of the United States that required central bank intervention and the dollar's role as the center of the international monetary system was abandoned as flexible exchange rates replaced the fixed exchange rates of the earlier period. As 1995 rolls on it is clear that the United States dollars role as the preeminent reserve currency is in question.

Given the length and the depth of the recent world wide recession the question of whether the post war record can be preserved or whether, now that Communism has been demonstrated to be a failed economic system, American Capitalism will revert to its behavior prior to World War II so that once again it will be from time to time a failed economic system.

2. THE FINANCIAL STRUCTURE AS A LEGACY OF THE GREAT DEPRESSION

The banking/financial system of the successful post war era (1945-68) was the segmented or compartmentalized system that had been put in place by the legislation that reacted to the great contraction of the economy between 1929 and 1933. This great contraction culminated in the utter

collapse of the financial and economic system over the winter of 1932-3.

As winter was coming to a close in 1933 American Capitalism was a failed economic system. A flurry of emergency legislation was enacted. Restructuring of the failed banking and financial system was among the emergency legislation of 1933 and the reform legislation that was enacted over the next two years.¹

This banking and financial system legislation aimed to create

1. a safe and sound payments system,
2. financial institutions that would facilitate the capital development of the economy and
3. agencies and structures which would foster public confidence in the soundness and integrity of the banking / financial system.

Three aids to the restoration of the public's confidence in the integrity of the banking and financial system can be identified:

1. the insurance, by agencies of the Federal Government, of small and modest deposits in banks and savings and loan associations,
2. the examination and supervision of insured institutions by either the insuring organization, the Office of the

1. The key legislative acts were emergency banking and securities acts during 1933, the 1935 Banking Act and the 1935 Securities and Exchange Act.

Comptroller of the Currency or the Federal Reserve System.

3. the institution by the Securities and Exchange Act of rules for corporate reporting, the behavior of securities markets and the operations of investment banking firms.

The performance of the American Economy over the second post war period (1970 to 1994) has not lived up to the high standards set by the first post war period, but it

As a result of the dismal performance of many holding companies during the great contraction of 1929-33, holding companies in general were in bad repute. This foreclosed the possibility of using holding companies to integrate various aspects of finance within one holding company organization.

It was believed that the safety and soundness of banks and savings and loan association were promoted by narrow definitions of their permissible activities. In particular the scope of permissible activities by a depository institution was to be limited to what examiners and supervisors could readily understand. This objective of examinability and supervisability supported the separation of commercial and investment banking: it was not so much the differences in riskiness as it was the ease of understanding the operations that led to the separation of investment and commercial banking. Commercial bank and Savings and Loan operations were deemed to be relatively simple and not given to rapid changes, whereas the activities of investment banks were flexible and complex. Furthermore

investment banking was inherently innovative and entrepreneurial in contrast to the staidness and routine commercial and savings banking activities.²

In much of the thinking of the economists and thinkers about banking of the time the business of commercial banks was to make short term *self liquidating* loans to business. It was argued that the making of commercial loans was not only sound business practice but that if banks made only such loans then the economy would have the right amount of money. This view of banking was incorporated in the original Federal Reserve Act in the form of the doctrine of eligibility for access to the discount window.

The regulation of margins for the purchase and holding of securities was designed to close off an area of financing from bank lending which did not conform to the commercial loan theory of banking.

The effect of the 1930's legislation was to make banks specialists in soliciting, structuring and supervising opaque loans. The underlying philosophy of the securities and exchange legislation of the New Deal, as modified over the years, has been that transparency, as to the operations of public corporations, the prospects of issuers of new securities, the regulation of financial markets, and

2. Lawrence J White "The Proper Structure of Universal Banking: "Examinability and Supervisability" are the Key Words. February 1955: To appear in Financial System Design: The case for Universal Banking edited by Anthony Saunders and Ingo Walter makes examinability and supervisability the key to the extent of the activities permissible by a "Universal Bank"

transactions on financial markets was to assure that portfolio owners could make an informed choice among issues. Investment banking organizations were to be specialists in arranging for the financing of organizations whose "credit worthiness" could be determined by the information that the securities and exchange laws required to be publically available.

Savings and Loan Associations became specialists in originating and servicing local real estate loans: with primary emphasis upon loans to finance mortgages on 1 to 4 family homes. The Saving and Loan Associations and the Mutual Savings Banks, became instruments in the social policy of promoting home ownership.

The deposit liabilities of banks and savings and loan associations were to be protected by

1. the equity of these organizations,
2. deposit insurance and examination and supervision of both nationally and state chartered banks.

For the first fifty plus years of deposit insurance it rarely was necessary to call upon the insurance to validate deposit liabilities of banks and savings and loan associations. Appropriate bonding of bank officers could have preempted the role played by deposit insurance during that period.

In the late 1980's early 1990's - fifty years and more after deposit insurance was put in place - deposit insurance for commercial banks and savings and loan associations was

tested for the first time: the cause was the explosion of non performing assets in the portfolios of savings and loan associations and commercial banks. The reserves of the specialized insurance fund for the savings and loan associations proved inadequate to meet the payouts needed to offset the negative net worths of savings and loan associations. It was necessary to fall back upon the full faith and credit commitment of the Federal Government to support the insurance funds in order to fulfill the obligations of the deposit insurance fund. Massive amounts of government money was needed in order to pay off the insured deposits at face value.

The insurance fund for commercial banks was also tested, as clusters of banks failed in response to declines in asset values. However the offsetting of the negative net worth of the failed banks by the deposit insurance corporation did not exhaust the reserves of the commercial bank insurance fund: no Treasury Funds were needed to contain the crisis in banking.

In the late 1980's and early 1990's deposit insurance was a critical part of the policy regime that succeeded in preventing the debt deflation that the failure of banks and S & L's would likely have triggered. As the accumulated reserves of the S & L insurance fund proved to be insufficient to meet commitments the Federal Government had to step in and validate the obligations of the insurance fund. The full faith and credit of the Federal government,

made relevant by the government's ability to go into debt to meet its commitments, contained the repercussions, upon the net worth of households, the availability of financing for households and businesses, and the flow of profits, that would have taken place in the absence of the protection that S&L and commercial bank liabilities enjoyed from deposit insurance.

The standard press and political - demagogue statement is that the taxpayer paid for the failure of the Savings and Loan associations. This is true enough, but the "payment" was to avoid the catastrophe of a serious depression. Prevention and containment of catastrophies - as well as picking up the pieces after a catastrophe - is a proper function of government. The deposit insurance agencies, bank examiners and regulators, and the Congress were amiss in not constraining the entry of the on the whole poorly managed savings and Loans into the riskier business of financing construction and land development. The Savings and Loan crisis to a great extent and the Commercial bank crisis to a somewhat smaller extent took place because in the heady days of the early 1980's no agency was looking out for the interests of the insurance funds when the institutions were given the go ahead to enter new lines of business.

In particular during the interest rate explosion of 1979-1982 short term interest rates rose mightily relative to the interest rates on Savings and Loan Association asset.

This stripped the Savings and Loans of their net worth. As a result of the loss of this layer of protection for deposits the regulators should have tightened their control of the S & L's. Instead the response to the problem was to free S & L's to engage in hitherto forbidden activities such as land development and construction financing and the taking of positions in so called "junk bonds".

Even though the banking legislation of the early 1930's formally separated commercial and investment banking activities, these activities had been largely separated prior to the legislation. Some Comptrollers read the National Banking Act of 1863/64 as requiring such separation. In the 1920's national banks usually used an affiliate, that was organized under more permissive state laws, to engage in investment banking activities.

Even as the establishment of the compartmentalized banking system with restrictions on bank activity as well as deposit insurance was going through the legislative process, an alternative proposal of 100% money, identified with Henry Simons of the University of Chicago and Irving Fisher of Yale University, received a hearing in both the administration and the Congress. In the light of the limited success of deposit insurance, it is worth considering the 100% money proposal as one possible approach to the reform of the banking structure that is now on the agenda.

The 100% money position holds that the two functions of banking, the supply and processing of instruments used in the payments mechanism and participating in financing the capital development of the economy, are separable.

The operation of the payments mechanism has undergone and is continuing to undergo rapid changes due to the electronic revolution in communicating, record keeping and computing on one hand and the emergence of money market funds which pay market determined interest rates on liabilities which essentially are available on demand on the other hand. Because of the competition from money market accounts banks are forced to pay market determined interest rates on their customer's balances, even as they charge impose fees on account activity. Operating the payments mechanism can well become a fee for service profit center for specialized banking organizations.

Financial institutions with wider scopes than the Glass Steagall act allows are likely to emerge in the aftermath of a repeal of Glass Steagall. The evidence from history indicates shows that such wider scope institutions are not necessary for the United States' economy to do well.

The most important economic event of the post world war II era is something that has not happened: there has not been any recession or depression that compares in either its length or its intensity with the depressions and recessions of the era that stretches from the inauguration of George Washington to the beginning of the Second World War.

Whereas the performance of the economy over the first post war epoch (1946-68) can be taken to be a practical best, the performance of the economy over the second post war era (1968 to date) is while poorer than over the first is nevertheless appreciably poorer than over the first post war era. Nevertheless it compares favorably with any prior period of such length (27 years) in our economic history. The United States had been plagued with serious recessions and depressions from its founding until the second world war.

Advocates of universal banking need to show that the current American and world economies are sufficiently different from the United States economy of the 1948-1970 period, so that the historical record of doing very well with a banking and financial system that is compartmentalized is no guide to what is now needed.

I believe that the repeal of the Glass-Steagall Act, in itself, would neither benefit nor harm the economy of the United States to any significant extent. The American financial system, *as it stands*, offers a multitude of financing options for businesses and households as well as a rich array of financial instruments (contracts) for households. In addition the check, wire transfer and ATM based payments mechanism *as it stands* is safe and secure. In the aggregate, any improvements in either investment financing, portfolio options or the payments system from repealing Glass Steagall will be marginal at best.

Due to modern electronics, the monopoly power due to location, which was important when the Glass Steagall Act was passed, has been much diminished. A financial institution need not have an office or agent in any location for it to serve as a source of supply of either business financing or assets for household portfolios. Even now the interface between major financial institutions and their household clients are by way of an 800 number or an ATM machine, rather than by face to face interactions.

The importance of the "repeal" will depend upon the scope permitted to institutions chartered as commercial banks and bank holding companies and the extent to which liabilities of bank and non bank financial institutions will be protected by government agencies or the Federal Reserve.

At one time banks were special because

1. their bank notes and demand deposit liabilities were the dominant part of the payments mechanism and
2. their contacts within the community of bankers

provided the mechanism for making payments at a distance.

In those times banks also served as

1. rating agencies, informing banks and merchants at a distance, in other towns and countries, of the credit worthiness of local merchants and manufacturers,
2. suppliers of funds for enterprises and
3. trustees for estates.

Protection was extended to banks because banks were special in these numerous ways. Today banks are special only because their liabilities serve as part of the money supply and it is believed that any serious disruption of the ability of banks to meet their commitments on that part of their liability structure that is part of the money supply would lead to serious disruptions of the economy. The model of the economy that underlies the treatment of banks as something special, both in their chartering and in the government's protection of the value of their deposit liabilities, needs to hold that if some banks fail and their deposit liability holders are not "made whole" by government intervention then a serious depression is a likely consequence. In other words financial instability such as we experienced between 1929 and 1933 is a necessary and perhaps even a necessary and sufficient condition for a great depression.

If we go down the list of why banks were special in the past the only reason that still holds is that their deposit liabilities subject to check are part of the "ultimate" payment system within economies (the proximate payment mechanism now is often a credit card). Furthermore as these deposits are guaranteed to trade at par the transaction deposits also serve as nominal value safe assets for portfolios. The list no longer states properties which are "monopolies of banks. There are now alternatives to banks for all but the provision of the ultimate payment mechanism

function. Banks are not as special now as in the past and the need to prevent all non-equity liabilities of banks to go to a discount is not as vital as in the past.

Because banks operate the ultimate payments mechanism, those liabilities of banks which serve as the 'medium of exchange' also serve as the standard in which domestic public and private debts are denominated. These bank liabilities also serve as an asset whose nominal value cannot be compromised by market events. Because the nominal value of bank transaction liabilities are presumed to be safe from market vagaries, these instruments also function as a safe and secure assets in portfolios. This safety and security of transaction balances enables portfolio holders to tailor the riskiness of their portfolios to their preferences by combining risk free and risky assets.

The nominal value of the transaction liabilities of banking institutions are protected by guarantees from the government and the Federal Reserve by way of special relations that banks have with government agencies. One special relationship of banks is that they can access the Federal Reserve's discount window, another is that selected deposit liabilities are insured (guaranteed) by government agencies. In order to get these guarantees there are limitations upon the assets that the qualifying institutions can hold.

In the monetary history of the United States the nominal values of transaction balances were guaranteed

during the National Bank era by limiting the asset offsetting National Bank Notes to government bonds, by having a lending window at The Federal Reserve Banks at which banks could acquire reserve deposits by discounting eligible paper at rates fixed by the Federal Reserve Banks, and by deposit insurance. Although the National Banking act system had no trouble maintaining the value of the currency, the system broke down in the late 19th century, early 20th century because of a shortage of government debt. The first Federal Reserve Act (1913) provided bank access to liquidity through discounting eligible private paper. The first Federal Reserve System was unable to contain the debt deflation which ultimately led to the value of liabilities for many banks exceeding the value of their assets.

The second Federal Reserve Act (1935) opened the way to a Federal Reserve System whose assets were almost exclusively government debt: this Federal Reserve System operated upon the available reserves of commercial banks through open market operations in government debt. The liabilities, up to a total which Congress regularly adjusted, were also insured.

THE MEANING OF REPEALING GLASS STEAGALL

As a minimum "repeal of the Glass Steagall Act" means that the line between investment banking and commercial banking will be erased. This will open the way for American banks to underwrite, trade and make markets in equities and

debts. In the United States the repeal is likely to take the form of allowing bank holding companies to own a variety of subsidiaries, each with a separate balance sheet. Inasmuch as capital/output relations are now the principle way banks are regulated, each company held by the holding company will have its own capital/asset or capital/liability ratio.

The February 1995 Baring PLC bankruptcy is an argument for the broader powers of banks that the repeal of the Glass Steagall restrictions will allow to be exercised within a holding company structure rather than by a unitary universal bank. A bank holding company will allow banks and other businesses to be joined in an enterprise which has a wide range of subsidiaries, each subsidiary having its own assigned capital. A failure of a particular subsidiary would not impair the capital and the ability of other subsidiaries to operate.

THE SIGNIFICANCE OF MONEY MARKET AND OTHER FUNDS.

One major development over the period since the Glass Steagall act is the emergence of Mutual funds and Money Market mutual funds. These funds have three characteristics:

- 1.. The value of a position in the fund is determined by market prices of assets in the fund and will vary with market conditions.

2. The prospectus of the fund states the type of assets the fund will purchase i.e. the assets offsetting the liabilities are determined in the contract between the purchaser-holder and the manager of the fund.

3. There is no manager's "equity" which shields the owner of liabilities from price changes of the instruments that are in the corpus of the fund.

Mutual funds with their assets that offset liabilities being determined by contract and the pass through of changes in asset values to liability holders of stand in sharp contrast to banks where the contours of the composition of assets are set by regulations and which have an owners capital that protect liability owners against market declines in asset prices. Bank failures happen when the decline in asset values wipe out the protection offered depositors by bank capital.

Within a holding company framework a bank can offer liabilities that are tied to the financing of a variety of different activities. A holding bank company may have separate subsidiaries with different asset and liability structures.

One such subsidiary can be a narrow bank which has transaction balances as liabilities and government debt as its assets. This narrow bank does not need deposit insurance: the government can keep the issues at a set value by adjusting the interest rate. Because of the nature of its portfolio and the government's commitment to reprice

bonds held by banks so that they never fall to a sharp discount deposit insurance is redundant. There is no need for a limit to the amount of the transaction balance that is guaranteed not to fall to a discount from its nominal value.

Another subsidiary could be business loan fund which uses only short term Certificates of Deposit to fund its activities. These certificates of deposits will be protected by assigned equity. A government insurance fund for 80% of the face value of the liabilities will be part of the package. One convention in the use of CD"s is that once a CD"s initial period runs out it can be continued on a day to day basis, becoming a call loan. The oversight agency will need to monitor to see to it that the liability structure does not become too heavily dependent upon short term financing.

The narrow bank and the short term business financing subsidiary will carry on the transaction and short term business financing banking functions. Another subsidiary will carry on the investment banking function. Insurance subsidiaries can carry out the underwriting and sales of insurance products.

The merchant banking operation will be financed by own capital as well as commercial paper and certificates of deposit. Because of the high risk these activities will be financed to a larger extent than the other functions by capital: the special liabilities of this subsidiary may well carry some equity kicker. The creation of large

denomination "participation deposits" to finance merchant banking activities which carries some of the pains even as it shares in the gains from merchant banking activities.

As the "division of labor is determined by the extent of the market" the growth of finance relative to industry and trade indicates that specialized institutions will exist and prosper even as universal banking is permitted. Using modern communicating and record keeping techniques, financial organizations that are specialized by function and location should be able to survive and prosper. Very much depends upon the legal restrictions to entry that will be part of the legislation that formally permits universal banking.

INITIAL CONDITIONS

The great collapse of banking, the financial structure and the economy over 1929-33 constitutes the initial condition for the current legislated structure of banking and finance. The legislation that aimed to put Humpty Dumpty together again after the great fall included not only the emergency legislation of 1933 but also securities and exchange legislation, housing and agriculture financing institutions, rural electrification financing authorities, a government investment bank (The Reconstruction Finance Corporation) and a revised Federal Reserve System. (The second Federal Reserve System, of 1935 to date, is

significantly different from the failed first Federal Reserve System, of 1913-1933.) The segmented structure is a horses for courses approach to the provision of assets and the financing of activity whereas the universal banking approach is a one size fits all.

The concepts underlying the reconstruction of the financial system in the 1930's emphasized the role of the banking and financial structure in

1. providing a safe and secure means of payments and
2. financing the capital development of the economy.

One aspect of this reconstruction was the shift from tying the reserve base of banks and the supply of currency to the monetization of private paper (the 1913 act) to allowing the reserve base of banks and the supply of currency to be linked to the Federal Reserve's holdings of government debt. (the 1935 act). This government debt based structure gave the Federal Reserve rather than the needs of trade control over the amount of currency and bank reserves.

The premises of the securities and exchange legislation of the 1930's are

1. that for the foreseeable future the United States is going to be a capitalist economy in which the corporate form is the dominant way of organizing business and
- 2 active markets for the purchase, sale and underwriting of corporate equities exist and the value of business organizations as going concerns are set in these markets.

Another premise underlying the legislation of the 1930's was that the dominant public interest in overseeing the corporate form of organizing business was to assure the rights of stockholders. Ever since the New Deal American capitalism has had a stockholder centric bias. The critical elements in this stockholder centric structure for publicly held companies are that the results of current corporate operations and the structure of corporate balance sheets shall be transparent and that the markets on which corporate securities are floated and traded shall be both transparent and trustworthy.

One distinction between commercial and investment bank financing is that commercial banks specialize in opaque transactions while investment banks and the markets in which financial instruments are issued and traded specialize in transparent transactions. Merchant banking activities, in which banking firms commit their capital by taking positions in firms, parts of firms and instruments which manage risk, are often hybrid transactions. While each particular deal is "opaque" the public has to be kept informed that these transactions are taking place.

Merchant banking activities also include making markets and taking positions in what is euphemistically called the managing of risk. Today merchant banking activities are carried out by organizations which are chartered as banks as well as by organizations which are not so chartered.

Every universal bank will need to set a precise limit to the equity it allocates to merchant banking activities. Given the size of the possible capital losses and gains in such merchant banking, some means of "insulating" commercial banking activities from merchant banking activities of conglomerate organizations chartered as universal banks will be necessary.

MONEY MANAGER CAPITALISM

The development of what can best be called money manager capitalism, in which mutual and pension funds are the dominant proximate "owners" of the equity and debt liabilities of corporations is a major change in financial arrangements since the 1930's reconstruction of the financial system. These mutual and pension funds presumably act for the benefit of the households who are the ultimate owners of the assets these organizations have in portfolio: they stand in a fiduciary relation with the owners of their liabilities.

There is ample evidence that the ethics that guides many operators in the financial services industry, including some in our most prestigious outfits, is summarize by a remark cited in The Economist in April 1994: "If God had not meant them to be sheared, He would not have made them sheep".

In the further development of the banking and financial structure the relations between banks, commercial, investment, and merchant, and the management of mutual and pension funds needs to be considered . Given the evolution of institutions over the past decades I would like to suggest that those institutions which manage money and are in a fiduciary relation with households be separated from institutions whose primary focus is upon trading and investing for the benefit of the owners of the firm's capital and their staff whose compensation is based upon performance. Universality may well exclude pension and mutual funds.

Thus even as the wall between investment and commercial banking that found expression in the Glass Steagall separation in the 1930's we may need a new separatism as the 21st century approaches, one that separates investment banking and the managing of mutual and pension funds. Managers of mutual and pension funds are presumably in a fiduciary relation with the owners of positions in the funds. The personnel of a broad post Glass Steagall "Bank" are guided by profit maximizing and own income. The fiduciary and the merchant banker - trader are different personality types and have quite different objectives. Thus a Bank holding company may well be forced to choose between having an investment bank or a mutually fund management affiliate.

then a serious fall in the market value of assets, in current output prices and in employment will follow. The initial reactions will it is believed trigger a system wide break down and is likely to trigger a deep and long depression. (In other words bank liabilities are special because the possibility that a debt deflation leading to a great depression will follow a systemic decline in the value of bank deposits and currency below par.)