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## Would Repeal of the Glass Steagall Act Benefit the US Economy

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Would Repeal of the Glass Steagall Act  
Benefit the U/S Economy?:

Statement prepared for Hearings on  
Repeal of the Glass Steagall Act.

Committee on Banking and Financial Services  
United States House of Representatives

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## !. OVERVIEW.

The performance of the United States economy over the first post war era (1946-68 or so) was in many ways a practical best i.e. the performance of the economy was not perfect but it was as good a performance as any reasonable person can expect. The banking/financial system of this era was the segmented or compartmentalized system that was put in place by legislation <sup>between 1933 + 1966, following</sup> ~~in the aftermath of~~ the great collapse of the financial and banking systems between 1929 and 1933. ~~The banking and financial system legislation that was enacted between 1933 and 1936~~ aimed to create a safe and sound banking system, to create financial institutions that would facilitate the capital development of the economy and to put in place agencies and structures which would help the public regain confidence in the soundness and the integrity of the banking / financial system.

One aid to the restoration of the public's confidence in the integrity of the banking and financial system was the insurance, (by agencies of the Federal Government), of small and modest deposits in banks and savings and loan associations. Inasmuch as holding companies in general were in bad repute, as a result of the dismal performance of many holding companies during the great contraction of 1929-33,

the safety and soundness of banks and savings and loan association was promoted by narrow definitions of their permissible activities. In particular this narrow definition took the form of separating what were believed to be higher risk investment banking activities from presumably lower risk commercial banking activities. In much of the thinking of the time commercial banking was still largely to take the form of short term self liquidating loans to business: the regulation of margin requirements for the holding of securities was designed to close off an area lending to banks.

Banks and savings and loan associations were to specialize in opaque loans and the deposit liabilities of banks and savings and loan associations were to be protected by the equity of these organizations and deposit insurance. 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. <sup>rarely</sup> The role played by deposit insurance could have been covered by

*Approximate* the bonding of bank officers *could have covered the role played by deposit insurance*

In the late 1980's early 1990's the deposit insurance facilities for commercial banks and savings and loan associations were tested. ~~In the case of the~~ <sup>the</sup> savings and loan associations the reserves of the insurance fund proved

inadequate to ~~meet the commitments due to~~ <sup>fully meet the</sup> negative net worth savings and loan associations. There was a need to fall back upon the full faith and credit guarantee of the Federal Government. <sup>II</sup> Although the commercial bank insurance fund was tested as banks failed in various parts of the country, the negative net worth of the failed banks did not exhaust the reserves of the commercial bank insurance funds. <sup>no</sup> Treasury Funds were needed to contain the crisis in banking. ~~The judgement of~~ <sup>D</sup> deposit insurance is that it did prevent a debt deflation from happening, but ~~that~~ this required the full faith and credit of the government. <sup>Government debt was issued to acquire the funds needed to make deposits whole.</sup>

One aspect of the banking legislation of the early 1930's was the separation <sup>Glass Steagall Act which boardedly</sup> of commercial and investment banking activities. ~~In many ways~~ <sup>largely</sup> these activities were separated prior to the legislation: some readings of the National Banking Act of 1863/64 hold that such separation was required by the National Banking act. National banks usually used an investment bank affiliate, organized under ~~the~~ more permissive state laws, to engage in investment banking activities.

Even as the establishment of the compartmentalized banking system with deposit insurance was going through the legislative process, an alternative proposal, the so called 100% money proposal 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, <sup>in the 1970-1980's</sup> it is worth considering the 100% money proposal <sup>for inclusion in</sup> ~~as one facet~~ of the reform of the banking structure.

Fundamentally 100% money position holds that two functions of the banking and financial structure, the supply and processing of instruments used in the payments mechanism and participating in the financing in the capital development of the economy, are separable. The operation of the ~~ultimate~~ payments mechanism is now undergoing rapid changes due to both the electronic revolutions, <sup>the ever expanding use of credit cards</sup> and the emergence of money market funds, which pay market determined interest rates on funds which are available essentially on demand. If organizations chartered as banks are to remain the central actors in the payments mechanism then they will have to <sup>compete by</sup> paying market rates on their customers balances even as they charge fees for deposits and payments on customers accounts. Operating the economy's payments mechanism can well become a fee for service profit center for banking organizations.

~~a the financing of the~~

This evidence from history indicates that financial institutions with a wider scope than now exists, such as are

likely to emerge in the aftermath of a repeal of Glass Steagall, are not necessary for a capitalist economy to do well.

The performance of the economy over the second post war era (1968 to date) is 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. 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.

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.

*II Repealing Glass Steagall*

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 <sup>act</sup> importance of the "repeal" will depend upon the scope permitted to institutions chartered as commercial banks <sup>OR</sup> ~~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.

*Protection was extended to banks because of a belief that Banks were special in a number of ways*

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.

*was special because they*  
~~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 <sup>still</sup> 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, <sup>lead to propositions which assert that</sup> 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 to occur 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 <sup>and Central bank and Treasury intervention are warranted if they about serious recessions and depressions.</sup>

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. <sup>The Bank as special business there are other risks</sup> ~~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 <sup>may</sup> ~~is~~ not <sup>be</sup> 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.

Over

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

*During the brief Federal Reserve System*  
*the discount window was to assume the responsibility of*  
*financing as well as a primary supply*  
 responsive to the needs of banks. During the past 60 years the availability of deposit expansion has been maintained through the availability of F.R. credit in support of the nominal value of deposits.

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 <sup>per customer</sup> 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/<sup>asset ratio</sup>~~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<sup>s</sup>/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 a 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 <sup>as well as</sup> and Money Market <sup>as well as</sup> 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 <sup>held by the unit holders</sup> 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.

*in a Mutual 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.

*subsidies*  
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. *In principle there is no reason why a bank's liabilities cannot have value per investment unit which depend upon market value of assets*

One such subsidiary <sup>of the bank</sup> 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 <sup>an</sup> assigned equity. A government insurance fund

for 80% of the face value of the liabilities <sup>could well</sup> ~~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 <sup>h</sup> <sub>↑</sub> baking functions. Another subsidiary will carry on the investment banking function. Insurance subsidiaries can carry out the underwriting and sales of insurance products.

*invest from* *large denomination investments by "highly liquid"*  
 The merchant banking operation will be financed by own <sup>carry high risk</sup> ~~own~~ <sub>bank activities could</sub> ~~commercial paper and certificates of~~ <sup>be carried</sup> ~~deposit~~. Because of the high risk <sup>invest from</sup> these activities will be financed to a larger extent than the other functions by ~~own~~ <sup>debt</sup> 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 <sup>with the</sup> <sub>wide</sub>

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 <sup>board structure holding companies</sup> ~~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.

A possible adverse effect of universal banking is that the number of independent banking institutions will decline even as their equity bases are likely to increase. The natural financing habitat of a banking institution is given by its capital accounts and a prudential limit on its exposure to any one account. This natural habitat will increase as the consolidation of banking into fewer but larger institutions takes place. This evolution would leave unsatisfied pockets of potential bank clients. Any formal move towards universal banking will need to meet such unsatisfied fringes by allowing ~~ready~~<sup>ready</sup> into banking to be relatively unrestricted.

The elimination of Glass Steagall does not guarantee that either the safety and security of the payment mechanism will improve or that the financing of the capital development of the economy will be done any better than under the old regime. Perhaps it is of greater importance to think through how the emergence of the new dominant player in

finance, the pension and mutual funds, affects the capital development of the economy.





great depression will follow a systemic decline in the value of bank deposits and currency below par.)