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Would Universal Banking Benefit the U.S. Economy?

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INTRODUCTION

Significant policy questions related to universal banking are:

1. the scope of universal banking

2. the extent to which particular institutions, instruments and usages are protected by the Federal Reserve or the Treasury and

3. whether universal banking will increase the number of "financial" and mixed "financial and industrial" institutions that are *too big to fail.*

4. does the proliferation of institutions that are *too big to fail* have adverse effects beyond the "moral hazard" that arises from such protection.

The banking legislation that is on the agenda for 1995 which will change the limits to bank activities and redefine the legal structure of banks will take place under the rubric of repealing Glass Steagall. We need to specify what banks do that affects the performance of the economy if we are to discuss the possible gains and losses from eliminating Glass Steagall. A well functioning banking system provides and operates *a safe and secure payments system* and actively participates in *financing the capital development* of the economy.[1]

The various proposals in the legislative hopper indicate that the repeal of Glass Steagall is being defined rather narrowly. The extension of what an organization holding a bank charter can do is being limited to the integration of investment and commercial banking and opening some insurance activities to banks. It seems likely that repeal of Glass Steagall will take the form of an expansion of what subsidiaries bank holding companies can have and what they can do. The bank holding company format means that acquisitions and divestitures of subsidiaries will be possible, which implies that the profitability of different combinations of operations will largely determine the structure of post Glass Steagall banking institutions.[2]

True universal banking, with a close integration of financial and commercial operations, is not on the agenda. This means that the repeal of Glass Steagall will have relatively little overall effect upon the economy's operation. If the legislation were to allow a holding company to own not only a wide variety of financial institutions, including banks, but also ordinary industry and trade operations then the structure of industry could change dramatically.

THE SCOPE OF POST GLASS STEAGALL BANKING

We posit that a post Glass Steagall bank holding company will be a collection of private profit seeking subsidiaries, some of whom have *liabilities which function as money*, even as others have liabilities which may be liquid to their owner but which are not money.[3] The rules of prudent banking, which evolved over the years and which are enforced by chartering and supervising agencies, will still limit the scope of assets for subsidiaries. In particular the rules, which forbids banks to own equity assets and which require that assets inappropriate for bank portfolios be disposed of expeditiously after they are acquired, will still rule for bank subsidiaries of banking holding companies.

One or more subsidiaries of a post Glass Steagall bank holding company will have monetary liabilities. These subsidiary institutions will enjoy protections from the central bank and treasury which guarantee that their monetary liabilities will not fall to a discount from their face value. These protections take the form of assuring the liquidity of the assets offsetting monetary liabilities and providing capital infusions whenever the value of the assets supporting monetary liabilities fall below that of the monetary liabilities.[4] In exchange for this protection the assets they can own will be restricted.

A representative post Glass Steagall bank holding company will have specialized financial subsidiaries which include not only a combination of commercial, investment and merchant banking subsidiaries but also a sampling of more specialized financial institutions such as credit card operations, payment operations, finance companies and the brokering and underwriting of insurance. Each subsidiary will have a dedicated equity, which protects the holders of the liabilities of the subsidiary.

The equity / asset ratio assigned to each subsidiary will vary with the perceived riskiness of the assets. The liabilities of these financing subsidiaries would be somewhat analogous to the liabilities of mutual funds. The difference is that the bank liabilities will have a face interest rate and a protective buffer due to bank equity, between market losses and the value of their liabilities. For a mutual fund the return on liabilities is contingent upon the performance of its portfolio and there is no protective buffer between the value of the assets and the value of the liabilities. The liabilities of the bank holding company subsidiaries other than the payments mechanism subsidiary will not enjoy the protection of the central bank and the treasury.

THE DISSONANCE BETWEEN PRACTICE AND THEORY

Public policy in regard to banking institutions is driven by the proposition that the monetary liabilities of banks cannot be allowed to become non performing assets to their

holders: an issuer of monetary liabilities is not allowed to clear its debts through a bankruptcy procedure which can lead to paying some small percentage of the face value of its monetary liabilities. This is so because it is believed that if deposit liabilities of banks become non performing assets (fall to a discount from face value), then an avalanche in the form of falling market values of financial instruments and capital assets will follow. The concern is that such avalanches have disastrous consequences for output prices, national output, wages, and employment: the disastrous consequences in turn set conditions for additional avalanches. Such interactive processes among the "financial and the real" dimensions of the economy lead to serious depressions.

In other words, monetary liabilities of banks are protected because a debt deflation model of great depressions underlies our views of the dynamics of capitalist economies.[5] There is a dissonance between the felt need to have in place central banks, deposit insurance and governments which protect the economy against debt deflations and the orthodox economic theory which envisages economies as being guided "**as if by an invisible hand**" to seek and sustain an equilibrium. If the economic theory is valid then central bank and fiscal policy interventions are at best of no use and more likely counterproductive: if central bank and fiscal policy interventions are productive then orthodox economic theory is a misleading guide to economic policy.

Because of the special position of bank liabilities as money and the way bank finance enters into the scenarios of both debt deflation and inflations, the public wisdom limits the assets that banks can hold and requires banks to be adequately capitalized. The laws that guide the post Glass Steagall banking structure need to force a clear separation of the assets and the capital allocated to the monetary liability business of bank holding companies from the assets and capital allocated to activities other than the monetary liability business.

In a holding company structure this is likely to lead to the development of special payments operations subsidiaries. These subsidiaries will be *well defined separate*

entities, with their own equity which hold restricted classes of assets (most likely government debt): the liabilities of this subsidiary will be money. As a result of this asset selectivity the required capital can be a low ratio to the liabilities.

PAYMENTS AND FINANCING

In the United States in the aftermath of the great collapse, a compartmentalized banking and financial system was put in place. The performance of the United States economy over the immediate post World War II era, 1946-70 (or so), was *a practical best* as measured by the growth of GDP per capita, the maintenance over an extended period of a close approximation to full employment, and the extent to which that prosperity was spread through the population. This practical best was achieved with the segmented or compartmentalized banking/financial system that had been set up in the 1930's: a banking/financial structure without universal banks is compatible with a capitalist economy doing well.

Great changes in both the payments system and the way the financing of activity is carried out have taken place since the 1930's. The growth of finance relative to industry and trade has meant that specialized financial institutions have arisen and prospered. If the playing field is level for bank holding companies with different composition of subsidiaries then even after Glass Steagall is repealed many financial organizations that are specialized by function and location will survive and prosper .

The structure that will emerge after the formal repeal of Glass Steagall depends upon what restrictions the reform legislation places upon entry into banking. If entry is relatively free then, after the dust settles from the wave of mergers that are likely to follow the broader domain allowed to bank holding companies, new entrants can prevent the larger financial organizations that emerge from acquiring and exploiting market power.

THE FINANCIAL RECONSTRUCTION OF THE 1930'S

The great collapse of banking, the financial structure and the economy over 1929-33 is the initial condition for the compartmentalized financial system of the United States. The legislation that followed the great fall included not only the emergency banking legislation but also legislation which regulated securities and exchanges, created specialized financing for housing, agriculture, and rural electrification, and increased the powers of the government investment bank (The Reconstruction Finance Corporation). Furthermore the Federal Reserve System was thoroughly revised.[6]

The reconstruction of the financial system in the 1930's shifted the determination of the reserve base of banks and the supply of currency from the monetization of private paper to the Federal Reserve's holdings of government debt. This government debt based structure gave the Federal Reserve's view of what was good for the economy, rather than the needs of trade as reflected by the demand for bank credit, 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,
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 and
3. the dominant public interest in overseeing the corporate form of organizing business is to assure the rights of stockholders.

American capitalism has had a stockholder centric bias ever since the New Deal. The critical elements in this stockholder centric structure 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 of activities 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 assets to the taking of positions in firms, parts of firms and instruments which manage risk, are often hybrid transactions. In the financing of merger and acquisition activities each particular deal is "opaque", the transparency requirement means that the public has to be informed when such activity occurs. 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. Given the size of the possible capital losses in merchant banking every bank holding company will need to set a precise limit to the equity it allocates to merchant banking activities. In particular as modern merchant banking activities are risky and their link to the financing of economic activity is rather tenuous, the liabilities financing this activity should be excluded from the protection provided by central banks and treasuries.

The emergence of *money manager capitalism* is a major change in United States capitalism over the past decades. In this capitalism funds, both mutual and pension, are the dominant proximate "owners" of the equity and debt liabilities of corporations. These mutual and pension funds presumably act for the benefit of the households who are the ultimate owners or beneficiaries of the assets they own.

The organizations that manage these funds stand in a fiduciary relation with the owners of their liabilities. In the development of the post Glass Steagall banking and financial structure the relations between the newly allowed wide spectrum bank holding companies and the management of mutual and pension funds needs to be carefully considered. I 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. Organizations with bank charters may well be excluded from simultaneously managing pension and mutual funds and engaging in underwriting and merchant banking.

PAYMENTS BANKS

Those bank subsidiaries whose liabilities are money and therefor are protected by central bank and treasury guarantees will not only handle the economy's payments but will also supply liquid and assured nominal value assets for the accounts of the public. In order for payment banks to be eligible for this protection capital requirements and restrictions on their assets will need to be set. One simple solution is to restrict the assets to be held to offset monetary liabilities to government debt. Payment banks would hold only government debts as assets. Their profitability would be derived from the interest earned on government debt, fees charged for account activity and the low capital requirements. Because their assets are restricted to government debts, deposit insurance becomes redundant.

The payments and the financing of the capital development of the economy functions will therefor be separated in a post Glass Steagall banking structure. Business and household lending by banks will be financed by the sale of non-insured certificates of deposits and commercial paper by subsidiaries and the holding company.[7]

The coexistence of post Glass Steagall bank holding companies and mutual and pension funds means that three types of not money private debt paper will be available for portfolios. One will be the direct debt of particular companies, another will be certificates of deposits of banks and a third will be positions in a wide variety of non equity pension and mutual funds. In addition monetary liabilities, government debt, equity mutual funds, direct ownership of equities and the ownership of real estate will be available for portfolios.

This rich menu of available assets combined with the an assured nominal value money supply will facilitate household asset selection.

TOO BIG TO FAIL

We should expect that a consolidation of disparate financial institutions will take place after Glass Steagall is repealed. This, together with the breaking down of the barriers to interstate banking, will lead to a decline in the number of independent banking institutions and an increase in the average equity of a bank holding company. As the preferred lending per client of a bank is given by the equity of the bank, some financing advantages are likely to accrue to larger units. Adverse effects upon the economy may follow:

1. The market power of banks may increase.
2. The preferred size of financing transactions may increase.
3. Banking institutions may become too big to fail.

The increase in the market power and the preferred size of financing transactions of banks can be overcome by removing barriers to entry into banking. As bank holding companies will be collections of specialized operating units a particular holding company need not engage in all functions. For example a "community development" bank may specialize in providing payment services, small savings deposits, and highly localized financing of small business. A holding company which has its roots in wholesale banking may withdraw from the provision of household payment services.

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. Entry is a preferred solution to this problem.

The consolidation of banks into larger units will also have an impact upon the structure of industry and trade. The merger of commercial and investment banking organizations together with the low capital absorption ratios of the payments subsidiaries will free capital for specialized banking activities such as merchant banking. To the extent that an increase in merchant banking capital leads to an increase in the availability of financing for entrepreneurial smaller units, the economy will benefit. If the increase in merchant banking activity leads only to an increase in merger and take over activity then the benefits will be minimal.

The removal of central bank and treasury protection from all but the payment subsidiaries means that no other subsidiary is deemed to be too big to fail. The maintenance of clear and well defined capital for each subsidiary means that there will be barriers that constrain contagion of a healthy subsidiary by a failing one. Even as protection by the central bank and the treasury of liabilities of the non-payments subsidiary is not guaranteed, the central bank can engage in open market operations and discounting when it is deemed necessary to provider liquidity to markets. Furthermore the treasury. through both its automatic and discretionary fiscal policies can prevent an avalanche of falling profits from taking place.

Too big to fail disappears as an issue if the post Glass Steagall banking system takes the form of a allowing interstate bank holding companies with a wide variety of specialized subsidiaries.

CONCLUSION

Once the distinction between the payments and financing operations of banks is recognized, it follows that post Glass Steagall banking firms will be structured as bank holding companies in which the payments subsidiary is

clearly separated from the financing subsidiaries. The liabilities of the payments subsidiary will be protected by the central bank and the treasury. In exchange for this protection the assets of the payments subsidiary will be limited to government debt and interest earning accounts at the Federal Reserve: the assets of the payments banks will not include business and household liabilities. The payments bank will pay interest on deposits based upon the interest rate it earns on government debt. Households and firms that use payment facilities will pay fees based upon the activity of their accounts. Payments banks should be profit centers for bank holding companies.

The financing subsidiaries of bank holding companies will be financed by bought moneys, such as federal funds, certificates of deposit and commercial paper, and the assigned capital of the subsidiary. It is envisaged that a bank holding company can have a number of financing subsidiaries. The liabilities of the financing subsidiaries will not be protected by either the Federal Reserve, the treasury, or agencies of the treasury such as a deposit insurance fund. Bank capital will "protect" these liabilities against the first tranches of losses on assets: the codicil of the financing subsidiary will determine the deterioration of the bank capital that leads to the liquidation of the portfolio and a distribution of the proceeds to liability holders.

A holding company structure of post Glass Steagall banking will quite naturally lead to 100% money. In the 1930's a 100% money proposal, most clearly identified with Henry Simons of the University of Chicago and Irving Fisher of Yale, was actively considered as an alternative to the banking structure that was put in place in the legislation of 1935 and 1936.[8]

There were two aspects to the Henry Simons version of the 100% money proposal. One was the offset of the publics money, both currency and demand deposits, by government debts.

The second was the development of specialized banks and mutual funds, whose liabilities would not be money, which would finance activity. In the mid 1930's the non bank institutions for the financing function of banking were not available. Since the mid 1930's institutions compatible with 100% money have developed. In mid year 1984 the assets of the Federal Reserve were almost exclusively government debt, transaction deposits at commercial banks were about one third of total deposits, bought money are about 2/3 of commercial bank deposit liabilities. In addition the holdings of government debt by commercial banks just about equal the transaction deposits. In the aggregate it would take very little juggling of assets and liabilities to introduce specialized bank subsidiaries who offset their deposit subject to check liabilities with holdings of

government debt. For the United States 100% money is now feasible.

By itself the repeal of Glass Steagall will not change much in the way banking and finance operates. There will be a lively period in which the investment banking community does well in reorganizing the commercial and investment banking industry. However in the light of our experience during the late 1980's and early 1990's a more meaningful reorganization of banking could be undertaken under the rubric of eliminating Glass Steagall by reviving the deep reforms embodied in 100% money, reforms that for a brief moment were on the agenda in the 1930's. By eliminating the link between the money supply and the performance of private liabilities such reforms could dampen, even as they cannot eliminate, the instabilities inherent in a market economy that follow from the linking of the quantity of money and the financing of activity to the performance of private liabilities.

ENDNOTES

1. *"The Bank of England performs two operations of banking, which are quite distinct, and have no necessary connection with each other: it issues a paper currency as a substitute for a metallic one; and it advances money in the way of loan, to merchants and others. That these two operations of banking have no necessary connection, will appear obvious from this - that they might be carried on by two separate bodies, without the slightest loss of advantage, either to the country, or to the merchants who receive accommodation from such loans."* David Ricardo, Plan for the Establishment of a National Bank, cited by R.J. Phillips footnote 7, p. 3.

2. At this writing (end of March 1995) House Senate and Administration proposals are being advanced. Only the Senate version allows commercial companies to be owned by a bank. All three seem to be advancing a holding company structure.

3. Negotiable certificates of deposit are the model for a market liquid term liability of a bank.

4. "Capital infusion" by the government can take the shape of the acquisition by a government agency or corporation of equity in a bank (as the Reconstruction Finance Corporation did) or government refinancing of a deposit insurance fund (as was done in the failure of the Federal Savings and Loan Insurance Corporation).

5. Irving Fisher *The Debt-deflation Theory of Great Depressions*, Econometrica, 1933

6. The second Federal Reserve System, of 1935 to date, is significantly different from the failed first Federal Reserve System, of 1913-1933. The first Federal Reserve System mainly interfaced with commercial banks through the discount window of the District banks. In the first Federal reserve System the liabilities of the Federal Reserve banks were mainly offset by gold and discounted eligible paper. In today's Federal Reserve System the liabilities of the Federal Reserve are mainly offset by government debt.

7. At present the stylized facts are that the monetary liabilities of the Federal Reserve System are offset by government debts and the holding of government debts by and transaction deposits of commercial banks are just about equal. It takes very little "juggling" of balance sheet items to achieve a banking system of bank holding companies in which the balance sheet of the payments system function of banking is separated from the financing economic activity function of banking.

8. Ronald J Phillips "The Chicago Plan & new Deal Banking Reform", M.E. Sharpe, 1995 is a comprehensive study of the origins and the political history of 100% money banking.