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The question of solvency If BHCs are special, given that their activities are highly interdependent, then the government should provide the public with a "safety net" to ensure the liquidity of the banking system. Currently, this safety net consists of deposit insurance and the Federal Reserve Bank as a lender of last resort. But, if the banking business were completely deregulated, could we expect to be cushioned from the harmful effects of a failed bank or group of banks? How would financial deregulation affect the public's trust in this safety net in financial crises?

If Glass-Steagall were reformed, the role of deposit insurance in the financial system also must be examined. As legislatively mandated by Garn-St. Germain, the deposit insurance agency submitted reports to Congress recommending methods of injecting more market discipline into the deposit insurance system. Reform of the deposit insurance system would enable further financial deregulation. But without such reform, even if banks were given additional product powers, it is likely that the regulatory agencies would realize the risks that banks incur.

Conclusion Garn-St. Germain and the Mone-
tary Control Act unquestionably represent major steps in deregulating the banking system and in loosening the restraints imposed by Glass-Steagall and the BHCA. Yet, Congress should reappraise existing financial legislation, including the extent to which banking and commerce should mix. If the competition for deposits continues to circumvent Glass-Steagall's barriers, Congress ought to consider seriously the merits of imposing a moratorium on encroachments by banks and non-banks into each other's areas. Without a moratorium, it is likely that the financial services industry would be restructured in the future, more to avoid legislative restrictions than to respond to market incentives.

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Banking and Commerce: To Mix or Not to Mix? by Thomas M. Buynak

In the late 1970s, commercial banks and thrifts experienced an unprecedented diversification as they sought funds to less regulated institutions. Particularly in reaction to this massive outflow of deposits, in 1982, U.S. Congress passed two separate, fairly comprehensive deregulatory measures—the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St. Germain Depository Institutions Act of 1982.1 Because of these two acts, banks and thrift institutions can more freely pay whatever interest rates they choose in order to attract deposit funds.

Financial concerns such as Merrill Lynch and insurance firms, retailers, and money market funds are competing more and more with banks. Their most recent incursion into the banking business involves acquisitions of "nonbank banks"—entities that function as banks but escape the legal definition of banks under the Bank Holding Company Act of 1956 (BHCA), as amended. The BHCA defines a bank as an institution that both accepts demand deposits and engages in commercial lending. If an institution engages in only one of these activities, it is not classified as a bank for purposes of the BHCA. In response to this competition, banks are doing more than accepting deposits and extending loans. Increased permitted diversification is seeking their presence in securities, real estate, and insurance businesses.

Concern about exploitation of the BHCA's definition of a bank recently prompted the Federal Reserve Board to update its definition to include negotiable order of withdrawal (NOW) accounts. In response to these nonbank bank acquisitions, the Office of the Comptroller of the Currency (OCC), the regulator of national banks, imposed a temporary moratorium on nonbank acquisitions involving de novo national charters. Other broader moratorium proposals, including one by the Federal Reserve Board, are pending before Congress. Such moratoriums would allow Congress more time to investigate proposals for restructuring the financial services markets. 1. In 1982, Congress also passed the Export Trading Act, which authorizes limited bank involvement in financing and developing export trading companies.

Federal Reserve Bank of Cleveland
December 5, 1983

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9. See statement by Paul A. Volcker, p. 6, testimony of September 13, 1983.

Economist Thomas Buynak analyzes bank structure and consumer issues for the Federal Reserve Bank of Cleveland.

The views stated herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Governors of the Federal Reserve System.
Congress is considering a financial deregulation bill, sponsored by the Treasury Department, which has sought to expand banks' product powers since 1961. At issue in this bill is the degree to which banks should engage in other businesses, including real estate, securities, and insurance and the degree to which these businesses should be involved in banking. This Economic Commentary explores the implications of mixing banking and commerce and poses questions about the effects of this trend on banks, nonbank institutions, and the banking system as a whole. It also focuses on the Glass-Steagall Act, its roots in the Depression, and its role in the current tension between a regulated financial environment and the "level playing field" that the Garn-St Germain and Monetary Control Acts attempt to establish.

Ensuring safety and soundness of banks

During the financial turmoil of the 1930s, it seemed that excessive competition and risk-taking in banks contributed to the collapse of the banking system. Congress responded by passing major legislative measures affecting the financial and securities businesses. The Banking Act of 1933, popularly known as the Glass-Steagall Act, separated commercial and investment banking from the securities business, limited rates paid on deposits (Regulation Q), and authorized federal deposit insurance. In addition to these measures, Congress enacted the 1970 Act, continued to regulate bank holding companies (BHCs), required the divestment of a BHC's nonbanking activities, and confined a BHC's activities to the business of banking. The FRB also is considering a proposal that would allow new bank holding companies to enter or expand insurance, real-estate brokerage, limited real-estate investment and development, and thrift ownership. Also, a BHC would be authorized to underwrite government bonds and to advise, sponsor, and manage investment companies. Further, a BHC could engage in any other activities authorized by the FRB. The FRB would determine to be of "financial nature or closely related to banking." Finally, this proposal would restructure the "one-bank holding company" into a "financial institution that has or is eligible for FDIC insurance, or an institution that both accepts deposits that can be withdrawn by check or other arrangement that could not be withdrawn by check or other arrangement." Each offers products or services that are fundamentally different from other providers of financial services, such as securities, thrift, insurance, and banking.

Glass-Steagall and recent relaxing trends

The drafters of Glass-Steagall apparently contemplated a system of specialized financial institutions, as the act sets limits on the extent to which these businesses may mix. Today, these boundaries are becoming less clear as banks and securities firms enter the space traditionally forbidden to the other.

The Glass-Steagall Act stipulates that commercial banks may underwrite and deal in municipal and international obligations but not municipal revenue bonds and, through their trust departments, may purchase and sell stock and securities. Specifically excluded, however, is the underwriting and dealing of corporate long-term debt and stock. The act has historically prevented securities firms from engaging in these activities. Under the act, banks have historically engaged in these activities, as the act permits banks to underwrite corporate securities. The FDIC later relaxed restrictions on bank activity in corporate securities. In another proposal, the FDIC solicited comments on a proposal to relax, and possibly remove, certain corporate securities. In another proposal, the FDIC solicited comments on a proposal to relax, and possibly remove, certain corporate securities. In another proposal, the FDIC solicited comments on a proposal to relax, and possibly remove, certain corporate securities. In another proposal, the FDIC solicited comments on a proposal to relax, and possibly remove, certain corporate securities. In another proposal, the FDIC solicited comments on a proposal to relax, and possibly remove, certain corporate securities.
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The Glass-Steagall Act stipulates that commercial banks may underwrite and sell obligations but not municipal revenue bonds and, through their trust departments, may purchase and sell stock and securities. Specifically excluded, however, is the underwriting and dealing of corporate long-term debt and stock. The act has historically prevented securities firms from encroaching on markets served by commercial banks.

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The drafters of Glass-Steagall apparently contemplated a system of specialized financial institutions, as the act sets limits on the extent to which banking and commercial banking activities may mix. Today, these boundaries are becoming less clear as banks and securities firms enter new product and service markets.

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Glass-Steagall also prohibits affiliations between securities firms and commercial banks. Increasingly, however, regula-tory agencies are removing product restrictions on their constituent institutions. The FRB recently added discount brokerage activities and securities lending to the list of permissible nonbanking ac-tivities. In reaching this decision, however, the FRB specifically proscribed line brokering and the dealing and underwriting of long-term corporate debt or equities. The FRB also is considering a proposal that would permit banks to engage in underwrit-ures for adding new nonbanking activities for BHCs.

The OCC and the Federal Depos-Ition Corporation (FDIC), the regulator of state-chartered nonmember banks, also are easing traditional product restrictions on their constituent institutions. The OCC recently authorized a national bank, via a bank subsi-dary, to offer investment advisory services.

The OCC also has authorized banks to engage in underwriting and underwriting of long-term government bonds and to advise, sponsor, and manage investment companies. Further, BHCs could engage in any activities allowed state banks, although the Federal Reserve would determine to be of “financial nature or closely related to banking.” Finally, the current proposal would permit commercial banks to serve as depositories for mutual savings banks, to sell whole-life insurance, and to offer investment advice through an operating subsidiary.

The Treasury proposal

The Treasury Department fa-vors reform of Glass-Steagall and since 1981 has been advocating, on behalf of the Reagan administration, fewer restrictions on banks’ product decisions. The Treasury’s latest proposal would permit banks and bank holding com-panies to enter or expand insu-rance, real-estate brokering, limited real-estate investment and development, and thrift ownership. Also, a BHC would be authorized to under-write government revenue bonds and other industrial development bonds and to advise, sponsor, and manage investment companies. Further, BHCs could engage in any activities allowed state banks, although the Federal Reserve would determine to be of “financial nature or closely related to banking.” Finally, the current proposal would permit commercial banks to serve as depositories for mutual savings banks, to sell whole-life insurance, and to offer investment advice through an operating subsidiary.

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This Economic Commentary explores the implications of mixing banking and commerce and poses questions about the effects of this trend on banks, nonbank institutions, and the banking system as a whole. It also focusses on the Glass-Steagall Act, its roots in the Depression, and its role in the current tension between a regulated financial environment and the "level playing field" that the Garn-St Germain and Monetary Control acts attempt to establish.

Ensuring safety and soundness of banks

During the financial turmoil of the 1930s, it seemed that excessive competition and risk-taking by banks contributed to the collapse of the banking system. Congress responded by passing major legislative restrictions affecting the banking and securities businesses. The Banking Act of 1933, popularly known as the Glass-Steagall Act, separated commercial banking from securities, and the Federal Deposit Insurance Corporation (FDIC), authorized by the banks and insurance, and the passing from real estate, securities credit lending to its constituent institutions. The OCC recently authorized a Full-line brokering and the proposed Full-line brokering and the FRD has opposed proposals that fail to take into account the special role that banks play in providing financial services. The OCC and the Federal Deposit Insurance Corporation (FDIC), the regulator of state-chartered and national banks, also are easing traditional product restrictions on their constituent institutions. The OCC recently authorized a national bank, via a bank subsidiary, to offer insurance brokerage services.

Steagall also prohibits affiliations with personal or management interlocks between securities firms and commercial banks.

Increasingly, however, regulators are being faced with product restrictions on their constituent institutions. The FRB recently added discount brokerage activities and securities credit lending to its list of permissible nonbanking activities. In reaching this decision, however, the FRB specifically proscribed full-line brokerage and the dealing and underwriting of long-term corporate debt or equities. The FRB also is considering a proposal that would permit banks holding companies, to enter or expand into real estate-broking, limited real-estate investment and development, and thrift ownership. Also, a BHC would be authorized to underwrite and sell government revenue bonds and to advise, sponsor, and manage investment companies. Further, BHCs could engage in any activity that the Federal Reserve Board would determine to be of "financial nature or closely related to banking." Finally, this proposal would define the term bank as an institution that has or is eligible for FDIC insurance, or an institution that both accepts deposits that can be withdrawn by check or other instrument—that could not, in the past, be identified with the bank itself. One of these prescribed approaches would have to be used to minimize the risks undertaken by the bank. Limits on the type of activities that the bank engages in, or the extent to which it underwrites securities for its customers, could also be taken into consideration.

The Treasury's proposal

The Treasury Department favors reform of Glass-Steagall and since 1981 has been advocating, on behalf of the Glass-Steagall administration, fewer restrictions on banks' product decisions. The Treasury's latest proposal would permit bank holding companies, to enter or expand into real estate-broking, limited real-estate investment and development, and thrift ownership. Also, a BHC would be authorized to underwrite and sell government revenue bonds and to advise, sponsor, and manage investment companies. Further, BHCs could engage in any activity that the Federal Reserve Board would determine to be of "financial nature or closely related to banking." Finally, this proposal would define the term bank as an institution that has or is eligible for FDIC insurance, or an institution that both accepts deposits that can be withdrawn by check or other instrument— that could not, in the past, be identified with the bank itself. One of these prescribed approaches would have to be used to minimize the risks undertaken by the bank. Limits on the type of activities that the bank engages in, or the extent to which it underwrites securities for its customers, could also be taken into consideration.

The FRB generally supports the current Treasury proposal. While favoring additional financial deregulation, the FRB has opposed proposals that fail to take into account the special role that banks play in the economy—that is, as serving as the "natural supplier of credit, and as depository institutions for most of the public's liquid savings." Also, banks are the channels through which monetary policy is implemented. It is the FRB's position that the current Treasury deregulation process proposes changes sufficiently between banks and other financial and nonfinancial producers.

Commerce and finance

Glass-Steagall's relaxation might mean that any barriers to competition are not significantly different from other providers of financial services, such as securities firms, insurance brokers, real estate agents, and bank holding companies. Each offers products or services that are substitutable for one another. Proponents of deregulation hold that any barriers preventing financial firms from entering the other's businesses should be dismantled, enabling all financial suppliers to compete on a "level playing field." Those who oppose Glass-Steagall's relaxation of nonbank should be distinguished from other financial and nonfinancial providers and that the government, through its role in the banking system, should assure their safety and soundness. Since financial markets are highly integrated, the government's role in protecting the public against the risks of the banking system as a whole. According to this line of thought, regulations imposed on banks would affect and restrict other suppliers of financial services, although banks must offer competitive services. Evaluating the merits of these two views involves a re-examination of the purposes of financial regulatory policy. Questions must be asked that focus specifically on the extent to which banking and securities activities should mix. Do other regulations exist to protect suppliers from potentially abusive tie-in credit arrangements? Would investors be adequately protected without the stipulations of Glass-Steagall? Would current anti-trust laws guard against concentrations of economic power?

Glass-Steagall's relaxation might have a more profound effect on the concentration of financial resources of banks, securities firms, and other financial suppliers than on banks alone. The current Anti-trust laws have a more profound effect on the concentration of financial resources of banks, securities firms, and other financial suppliers than on banks alone.
Economic Commentary

Federal Reserve Bank of Cleveland

December 5, 1983

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Banking and Commerce: To Mix or Not to Mix?

by Thomas M. Buynak

In the late 1970s, commercial banks and thrifts experienced an unprecedented wave of deregulation that permitted them to seek new nontraditional products and services. As a result, banks were able to offer new products but only on restrictive terms, which they chose in order to cushion the harmful effects associated with a failed bank or group of banks. How financial deregulation affects the public's trust in this safety net in financial crises if Glass-Steagall were reformed, the role of deposit insurance in the financial system also must be examined. As legislatively mandated by Garn-St Germain, the deposit insurance agencies submitted reports to Congress recommending methods of injecting more market discipline into the deposit insurance system. Reform of the deposit insurance system would enable further financial deregulation. But without such reform, even if banks were given additional product powers, it is likely that the regulatory agencies would require the banks to incur additional costs, such as paying higher premiums and maintaining reserves that do not pay interest.

If we adopt a deregulation measure such as the Treasury's banking bill, which would allow banks to engage in businesses previously prohibited while allowing nonbank firms to enter the banking business, would banks be granted a competitive advantage? Perhaps the FRB's implementation of the BHCA can provide insight on these issues. To date, the FRB has authorized 15 "permissible" nonbanking activities for BHCs. Each new activity is evaluated in terms of whether, when coupled with a bank's credit-granting powers, a bank would have a competitive advantage over other producers in the industry. In: what cases the FRB either disallows or restricts the FRB's involvement in the nonbanking activity. Restrictions on nonbanking activities in effect, neutralize the potential for credit abuse.

In considering a relaxation of Glass-Steagall's barriers, we should also identify and quantify what economic effects might predictably occur if the securities and commercial banking businesses were reconceived. Would an increase in the number of potential competitors significantly affect the prices of banking and securities products or services, other things being equal? Could we realize significant cost savings by co-producing securities and commercial banking products? And, if banks are allowed to offer new products but only on restrictive terms, we should evaluate whether, and to what degree, such restrictions would have on negating any "synergies" of cooperation? A principal objective of banking regulation is to preserve the safety and soundness of banks. If we allow banks into other business activities, we must face the question of what new risks would be incurred. Investment bankers can incur substantial losses if markets fluctuate adversely, or if the marketability of the issue are poorly judged. On the other hand, securities discount broking involves virtually no market risk, but the participants were permitted to take on such risks, then is it possible to isolate banking activities from the risks associated with nonbanking activities? Those who advocate a deregulation proposal in which a BHC's nonbanking activities are conducted in separate subsidiaries are argued principally by the forces that encourage the BHC to be financially structured so that potential parent-company problems cannot be transmitted to affiliated banks. Some individuals have expressed doubt about this assumption. Recent research, which shows that a BHC operates as an integrated firm, provides a basis for these reservations. Deregulation proposals, therefore, that attempt to separate a BHC's banking and nonbanking

9. See statement by Paul A. Volcker, p. 6, testimony of September 13, 1983.

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"An Alternative Approach to Regulating Bank-
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11. See Robert A. Eisener, "How Should Bank
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Conclusion
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Partly in reaction to this massive
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Increased
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Concern about exploitation of
the BHCA's definition of a bank
recently prompted the Federal
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tion of "mixed businesses" to
exclude nonbank banks and demand deposit. A commercial loan
now includes the purchase of com-
mmercial paper, certificates of
deposits, and bank and bankers' accepting
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