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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 diversion of their funds to less regulated institutions. Partly in reaction to this massive outflow of depositories' funds, the 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. Increasingly, banks are seeking a larger 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 definitions of a commercial loan and a demand deposit. A commercial loan now includes the purchase of commercial paper, certificates of deposit, federal funds, and bankers' acceptances; the definition of a demand deposit has been amended 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 bank 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 industry.

1. In 1982, Congress also passed the Export Trading Act, which authorizes limited bank involvement in financing and developing export trading companies.

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Congress is considering a financial deregulation bill, sponsored by the Treasury Department, which has sought to expand banks' product powers since 1981. 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 by banks contributed to the collapse of the banking system. Congress responded by passing major legislative reforms affecting the banking and securities businesses. The Banking Act of 1933, popularly known as the Glass-Steagall Act, separated commercial banking from the securities business, limited rates paid on deposits (Regulation Q), and authorized federal deposit insurance. All three measures were viewed as essential to restoring the public's confidence in banks and to assuring the safety and soundness of banks in the future. The Bank Holding Company Act of 1956, as amended in 1970, imposed additional limits on banking. This act, among other things, set controls for the formation and expansion of bank holding companies (BHCs), required the divestment of a BHC's nonbanking activities, and confined a BHC's activities to the business of banking.[2] One exception permitted bank holding companies certain "closely related" nonbanking activities, subject to approval by the Federal Reserve Board (FRB). In 1970, the act was amended to eliminate the exemption of the one-bank holding company—i.e., a holding company that owned only one bank, thus completing product restrictions on banks.

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 securities and commercial banking activities may mix. Today, these boundaries are becoming less clear as banks and securities firms enter markets traditionally forbidden to the other.

The Glass-Steagall Act stipulates that commercial banks may underwrite general obligation bonds 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 stocks. The act also has historically prevented securities firms from encroaching on markets served by commercial banks. Glass-

2. A significant provision of the 1956 act, known as the Douglas Amendment, effectively prohibited interstate banking by requiring a host state specifically to authorize the entry of out-of-state banking organizations.

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

Increasingly, however, regulatory agencies are loosening product restrictions on their constituent institutions. The FRB recently added discount brokering activities and securities credit lending to its list of permissible nonbanking activities. In reaching this decision, however, the FRB specifically proscribed full-line brokering and the dealing and underwriting of long-term corporate debt or equities. The FRB also is considering a proposal that would relax its procedures for adding new nonbanking activities for BHCs.[3]

The OCC and the Federal Deposit Insurance 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 subsidiary, to offer investment advisory services.[4] In the past, banks have offered such services through their trust departments; this authorization makes them available to the general public. Two even more far-reaching proposals are now being considered by the FDIC. One would permit FDIC-regulated banks, via bank subsidiaries, to underwrite corporate securities.[5] In another proposal, the FDIC solicited comment on whether, and to what degree, controls or limits should be placed on the nonbanking activities of FDIC-insured banks.[6] Under consideration are real estate, third-party data processing, travel agency activities, and insurance brokerage and underwriting.

The Treasury's proposal

The Treasury Department favors 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, through bank holding companies, to enter or expand insurance, real-estate brokering, limited real-estate investment and development, and thrift ownership. Also, a BHC would be authorized to underwrite government revenue bonds and certain industrial development bonds and to advise, sponsor, and manage investment companies. Further, BHCs could engage in any activity that the Federal Reserve would determine to be of "financial nature or closely related to banking." Finally, this proposal would redefine 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-

3. Proposed Revision of Regulation Y, "Bank Holding Companies and Change in Bank Control," June 3, 1983.

4. The OCC approved an application by American National Bank of Austin, Texas, to provide investment advice through an operating subsidiary.

5. Proposed rule by the FDIC, May 9, 1983; see *Federal Register*, vol. 48, no. 96 (May 17, 1983). pp. 22, 155-64.

Under the FDIC plan, a bank would underwrite corporate securities in a separate subsidiary—that could not, in name, be identified with the bank itself. One of three prescribed approaches would have to be followed to minimize the risks undertaken by the bank. Limits on the bank's credit extensions would cover companies for which it underwrites securities and customers who purchase its underwritten securities.

6. Advance notice of proposed rulemaking by the FDIC, August 30, 1983; see *Federal Register*, vol. 48, no. 177 (September 12, 1983), pp. 40, 900-02.

wise accessed by third-party payment) and that engages in commercial lending.

Before approving other nonbank activities, the FRB would evaluate the proposed business activity to ensure that the impartiality of a bank's credit extensions was not adversely affected. The FRB would also ensure that these activities would not jeopardize the safety and the soundness of a BHC's banking affiliates.

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, serving as operators of the payments system, as important suppliers of credit, and as depository institutions for most of the public's liquid savings.[7] Also, banks are the channels through which monetary policy is implemented. It is the FRB's position that the current Treasury deregulation proposal distinguishes sufficiently between banks and other financial and nonfinancial producers.

Commerce and finance

Glass-Steagall opponents argue that depositories are not significantly different from other providers of financial services, such as securities brokers, investment bankers, and insurance companies. Each offers products or services that complement or are substitutable for one another. Proponents of deregulation hold that any barriers preventing financial firms from entering each other's businesses should be dismantled, enabling all financial suppliers to compete on a "level playing field."[8]

Those who oppose Glass-Steagall's repeal argue that banks should be distinguished from other financial and nonfinancial providers and that the government, through the regulatory agencies, should assure their safety and soundness. Since financial markets are highly integrated, the government should assure the solvency of the banking system as a whole. According to this line of thought, regulations imposed on banks would exceed those levied on other suppliers of financial services, although banks must offer competitive products to survive.

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 individuals or corporations from potentially abusive tie-in credit arrangements? Would investors be adequately protected without the stipulations of Glass-Steagall? Would current antitrust laws guard against concentrations of economic power?

Glass-Steagall's relaxation might have a more profound effect on the concentration of financial resources if banks, securities firms, and other financial suppliers did not compete fairly in a deregulated financial environment. Glass-Steagall proponents allege that because banks

7. See statement by Paul A. Volcker, before Committee on Banking, Housing and Urban Affairs, U.S. Senate, April 26, 1983; see also testimony of September 13, 1983.

8. See, for example, E. Gerald Corrigan, "Are Banks Special?" in *1982 Annual Report*, Federal Reserve Bank of Minneapolis.

possess advantages such as entry restrictions, deposit insurance, and access to the FRB's discount window, they would have a competitive advantage over other suppliers of financial services unless reciprocal entry is allowed. Those who favor relaxing Glass-Steagall contend that banks also bear some unique costs, such as paying insurance premiums and maintaining reserves that do not pay interest.[9]

If we adopt a deregulation measure such as the Treasury advocates, allowing banks to engage in businesses previously prohibited while barring nonbank firms from operating a bank, 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 that industry. In such a case, the FRB either disallows or restricts the bank's involvement in the nonbanking activity. Restrictions on the 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 recombined. 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 security 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 co-production.

A principal objective of banking regulation is 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 simply if the marketability of the issue were poorly judged. On the other hand, securities discount brokering involves virtually no market risk. If banks 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 and regulated principally by market forces assume that the BHC can be financially structured so that potential parent-company problems cannot be transmitted to affiliate banks.[10] Some individuals have expressed doubt about this assumption.[11] 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.

10. See Robert J. Lawrence and Samuel H. Talley, "An Alternative Approach to Regulating Bank Holding Companies," in Proceedings of a Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, April 27-28, 1978, pp. 1-10.

11. See Robert A. Eisenbeis, "How Should Bank Holding Companies Be Regulated?" *Economic Review*, Federal Reserve Bank of Atlanta, January 3, 1983, pp. 42-7.

activities would probably achieve limited success.

The question of solvency

If banks 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 crisis?

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 restrict the risks that banks incur.

Conclusion

Garn-St Germain and the Monetary 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 nonbanks 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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