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Glass–Steagall and the Regulatory Dialectic

by João Cabral dos Santos

The Glass–Steagall Act, passed a few years after the Great Depression, prohibited U.S. commercial banks from engaging in investment banking activities. This has led to the same costly cat-and-mouse game as did the prohibition against interstate banking. Bankers often develop financial innovations aimed at exploiting gray areas in the law, and regulators respond by successively closing each loophole. Hence, in designing regulations, it seems sensible to take banks' incentives into account.

Congress, the Administration, and the bank regulatory agencies are considering various proposals to usher the U.S. banking system into the twenty-first century. The pace of financial innovation—spurred by advances in information technology, globalization of the economy, and competition from other financial institutions—has made this reform seem long overdue. However, any clear understanding of the causes and consequences of the reform movement must recognize that some of the financial innovations that have sprung up over the last three decades were specifically designed to avoid regulations that current reform efforts may repeal.

Like any other industry, banks are in business to earn profits by supplying the products that their customers demand. Similarly, the factors that motivate innovation in the nonfinancial industry—changes in technology and in the market environment—also motivate innovation in banking. But, because of their central place in creating money and credit, banks are considerably more regulated than are firms in the nonfinancial sector, and so have an extra incentive to innovate: Often, bankers aim to avoid regulations that prevent them from exploring profitable opportunities as they arise.

Although some financial innovations eventually become accepted practices, others are blocked by new regulations. These regulations motivate banks to develop other innovations, which in turn prompt further action by the regulators. This interaction sometimes resembles a cat-and-mouse game, or what Professor Edward Kane has termed the "regulatory dialectic."[1] That is, prohibiting banks from adopting a specific path to achieve one of their objectives creates an incentive for them to find an alternative route to the same goal.

Financial innovations are generally introduced by larger and more aggressive banks, and then are successively adopted by other banks until regulators eventually intervene. The nature and timing of this intervention are in turn influenced by interactions among the institutions that make up the bank regulatory system and that are ultimately responsible to Congress, which makes the laws.[2]

The last four decades have provided ample evidence of how banks attempt to circumvent regulations. In general, they either develop new financial products or change their organizational structure. Banks avoided deposit-rate ceilings by making implicit interest payments (for example, they offered gifts to depositors when market interest rates rose above the regulatory ceiling). They attempted to overcome the prohibition on interstate branching by creating bank holding companies (BHCs) with banks in multiple states. And they circumvented the Glass–Steagall Act by developing new financial products, like MID (market-indexed deposit) accounts.

The first half of this *Economic Commentary* presents a brief review of the interactions among banks and regulators as banks attempted to expand their activities across state lines. The second half discusses whether any lessons from those interactions can be applied to the ongoing debate over reforming the Glass–Steagall Act.

Interstate Banking and the Regulatory Dialectic

Banks' efforts to circumvent the regulations that prohibit interstate banking—and regulators' subsequent reactions—are a classic example of the regulatory dialectic. Since the 1950s, banks have tried to exploit the loopholes in these regulations by changing their organizational structure or by altering their portfolio of activities. Regulators, on the other hand, have adjusted the regulations in reaction to each innovation.

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Branching conditions for state banks (those chartered by the states) have always been a matter of state discretion. Passage of the McFadden Act in 1927, and its amendment in 1933, gave national banks (chartered by the Comptroller of the Currency) branching capabilities identical to those of state banks. But because no states allowed interstate branching for state banks, the McFadden Act effectively imposed the same restriction on national banks.[3]

During the two decades following passage of the McFadden Act, banks seemed to lack the incentive (or the means) to profitably circumvent the prohibition on interstate branching. That changed in the 1950s, perhaps because of a perceived increase in economies of scale, additional competition from other U.S. financial institutions and foreign banks, and improvements in technology, all of which encouraged banks to find profitable ways around the branching prohibition.

Bankers first attempted to overcome the interstate branching restrictions by developing multibank holding companies with banks located in various states. Once lawmakers recognized bankers' intent, they responded with the Douglas Amendment to the Bank Holding Company Act, which prohibited BHCs from acquiring banks in other states without the home state's authorization. This provision, passed in 1956, effectively stopped the interstate banking movement, because no states permitted out-of-state acquisitions.

Banks' next step was to expand their activities across state lines by forming one-bank holding companies. These were parent corporations that owned a single bank plus other nonbank subsidiaries (such as mortgage companies and finance companies), which could be located in one or more states. This organizational structure allowed banks to circumvent the Bank Holding Company Act, which defined BHCs as corporations that controlled two or more banks. Again, Congress stepped in and closed this loophole in 1970 by revising the Act to cover one-bank holding companies.

The government's actions did not stop banks from further attempts to engage in interstate banking. The 1970 amendment to the Bank Holding Company Act defined a bank as any firm that accepted demand deposits *and* made commercial loans. The industry's answer was to develop "nonbank" banks—institutions that offered only one of these services. Some nonbanks chose to offer money market deposit accounts instead of transaction deposits. Others continued to offer transaction deposits, but restricted the extension of credit to the purchase of money market instruments, like commercial paper, or to consumer credit. Not surprisingly, Congress went into action again, closing this loophole in 1987 by redefining a bank as any institution that had deposit insurance or that offered demand or transaction deposits and engaged in commercial lending.

Banks' continuing attempts to expand their services across state lines finally met with some success in the early 1980s, when the regulatory barriers to interstate banking began to be dismantled. The first step in this movement was taken by a few states that began permitting out-of-state BHCs to acquire home-state banks. Since then, every state except Hawaii has passed legislation allowing either nationwide entry (with or without reciprocity) or regional entry (with reciprocity). However, interstate branching was still forbidden to most banks because states generally did not allow acquired banks to be converted into branches, and only a few states permitted entrance through a de novo branch.[4]

Another important development came in 1994, when Congress passed the Interstate Banking and Branching Efficiency Act. This legislation defined nationwide standards for BHCs' acquisition of a bank in any state, implying that state laws governing out-of-state acquisitions were no longer applicable. Furthermore, beginning on June 1, 1997, BHCs will be allowed to convert their bank subsidiaries into a single network of branches, provided that their home states have not enacted legislation opting out of the Act's branching provision.[5]

This latest regulatory change, though welcome among the nation's bankers, has left intact one potentially important barrier to the development of a full nationwide banking system: It does not provide for de novo branching across state lines. That is, in a state where a bank has no branches, it can set up a new branch only if the host state has passed legislation specifically allowing for de novo branching.

■ Lessons from the Movement to Interstate Banking

The regulatory back and forth described here has been—and will continue to be—costly. Besides the resources involved in developing innovations and enacting legislation to prohibit them, further costs will be incurred once the regulatory barriers that inspired these innovations have been repealed. The reason is that some of these innovations will become inefficient.

For example, as a result of last year's regulatory change allowing interstate branching, most of the BHCs that were specifically created to undertake interstate banking will convert their organizational structure into a network of branches. This setup avoids the need to maintain separate banks with separate boards of directors and reduces the cost of complying with other existing regulations, like capital requirements. The conversion will improve the efficiency of the financial system, but its costs would not have been incurred if such BHCs—a product of the regulatory dialectic—had not been developed in the first place.

As the history of the movement to interstate banking shows, the cost-benefit analysis of a regulation is incomplete unless it considers the costs of the regulatory cat-and-mouse game it might engender. This is a timely issue given the ongoing debate over reforming the Glass–Steagall Act. Its importance is further enhanced by the continuous increase in financial market competition and the constant progress in information technology, which together make innovation easier and more attractive.

Reforming the Glass–Steagall Act

Following the 1929 stock market crash, the U.S. economy went into recession and a large number of banks failed. In 1931, the Pecora Commission was established to study the causes of the crash. Its conclusions pointed to banks' securities activities as a major reason that many institutions had to close their doors—a view disputed by recent research.[6]

Partly because of the Commission's findings, in 1933 Congress passed the Glass–Steagall Act, which forced the separation of commercial banking (accepting deposits and making loans) from investment banking (underwriting, issuing, and distributing stocks, bonds, and other securities).

Between the enactment of Glass–Steagall and the beginning of the 1960s, both commercial banks and securities firms seemed to lack the incentive (or the ability) to explore some of the gray areas of that Act. Commercial banks, for example, limited themselves to the few securities activities left open to them, namely, trading and underwriting U.S. Treasury securities and municipal general obligation bonds, and participating in private placements of corporate securities.[7] Since then, however, commercial banks and securities firms have attempted to expand their activities into one another's historical strongholds. This movement has engendered many interactions among these institutions, their regulators, and the courts. For instance, the growing outflow of certain deposits from banks and the rapid increase in mutual fund investment gave commercial banks a strong incentive to enter this line of business. But there was a hitch: The Glass–Steagall Act had been interpreted as prohibiting commercial banks from underwriting and distributing mutual funds.

Bankers found a way around this restriction by entering into joint-venture-type agreements with investment companies in order to create mutual funds that were bought and sold by these companies, but managed and advertised by the banks. More recently, some banks have introduced MID accounts as another way of circumventing the restriction on their mutual-fund activities. MIDs are fixed-term deposits whose return is one part guaranteed and one part connected to the Standard & Poor's 500 stock index. Being treated as a deposit, the principal plus the guaranteed interest are insured up to $100,000 by the Federal Deposit Insurance Corporation. This resembles an indexed stock mutual fund with two exceptions: First, MIDs have a fixed maturity. Second, the price the investor pays for a minimum guaranteed return is that the account receives only a partial gain when the stock index rises.

Commercial banks' successive attempts to enter the securities business led to a certain amount of deregulation. Using a more flexible interpretation of the Glass–Steagall Act, regulators began allowing banks to undertake some additional investment banking activities, such as discount brokerage services and the underwriting of commercial paper, municipal revenue bonds, and, more recently, corporate bonds and equities. Some important conditions were attached to this permission, however. For instance, most of these activities had to be undertaken by an independent affiliate of the BHC, and their collective revenue could not exceed 10 percent of the affiliate's total revenue.

The proposal under discussion in the House of Representatives to reform the Glass–Steagall Act continues the deregulatory path initiated in the 1980s. If implemented in its current form, it would end some of the actual investment banking restrictions faced by commercial banks. However, some bankers have opined that the deregulation does not go far enough. At stake are the exclusion of certain businesses (such as insurance) from the set of activities that banks would be allowed to undertake, and, to a lesser extent, the degree of choice regarding the organizational structure that banks could adopt if they chose to enter the investment banking business.

Given the incentives already expressed by the nation's bankers, and the continuous technological progress that drives the development of financial innovations, it would seem sensible for Congress to evaluate whether the benefits from certain provisions of the proposed regulation are worth the costs of another round of the regulatory dialectic that might ensue.

Conclusion

Deposit-rate ceilings were implemented to restrict banks' competition for deposits, so banks turned to implicit interest payments. The prohibition on interstate banking was introduced to protect small local banks and to limit banks' growth, so banks changed their organizational structure and adjusted the set of activities they undertook. Investment banking was closed to commercial banks because of potential conflicts of interest with their lending activity and its perceived risks, so banks entered into joint-venture-type agreements and developed new financial instruments.

Each of these cases demonstrates bankers' ability to innovate when regulations prevent them from exploring potentially profitable opportunities. However, these innovations are costly to develop, and they often become inefficient once the regulation that drove them is repealed.

A regulation that on its surface may contribute to the banking system's efficiency and stability can also harbor hidden costs and perverse outcomes if it fails to factor in banks' incentives and reactions. This issue is particularly timely because of the ongoing debate over reforming the Glass–Steagall Act. When the original legislation was enacted in 1933, it had a limited impact on commercial banks because investment banking was a relatively small business. The situation is now very different. Investment banking, as well as the competition, are far more important, and banks' ability to innovate has improved considerably.

Given the history of the regulations discussed here, it would seem prudent for lawmakers to consider banks' incentives when hammering out the final provisions of the reform bill. Otherwise, we should not be surprised to see banks challenging the new regulation with yet another round of cat and mouse.

Footnotes

[1] See Edward J. Kane, "Accelerating Inflation, Technological Innovation, and the Decreasing Effectiveness of Banking Regulation," *Journal of Finance,* vol. 36, no. 2 (May 1981), pp. 355–67.

[2] The bank regulatory system includes the Comptroller of the Currency, the Federal Reserve System, and the Federal Deposit Insurance Corporation, among others. This *Economic Commentary* refers to the regulatory system as a whole, and not to any particular institution.

[3] The fundamental reasons why the interstate branching prohibitions were introduced remain unclear. Some believe that these restrictions were intended to protect small local banks from competition with out-of-state banks, while others point to the public's distrust of large banks.

[4] See Donald T. Savage, "Interstate Banking: A Status Report," *Federal Reserve Bulletin,* vol. 79, no. 2 (December 1993), pp. 1075–89.

[5] As of December 1995, only Texas had opted out of the branching provision, while 25 other states had opted in. Of the latter group, only eight have opted into the de novo branching provision.

[6] For a critique of the Pecora Commission's conclusions, see George J. Benston, *The Separation of Commercial and Investment Banking: The Glass–Steagall Act Revisited and Reconsidered,* New York: Oxford University Press, 1990.

[7] See, for example, Larry R. Mote and George G. Kaufman, "Securities Activities of Commercial Banks: The Current Economic and Legal Environment," *Research in Financial Services,* vol. 1, Greenwich, Conn.: JAI Press, Inc., 1989, pp. 223–62.

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