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FRBSF Weekly Letter

Glass-Steagall

In the past decade, distinctions have become blurred between commercial banks and other depository and nondepository institutions. Financial and Congressional figures thus have begun to debate the half-century-old piece of legislation which put those distinctions into practice—the Glass-Steagall Act (the Banking Act of 1933). Several bills now before Congress would modify the Act in different ways—for example, by permitting banks, either directly or through bank holding-company subsidiaries, to underwrite municipal-revenue obligations and to offer money-market funds. Such proposals also would permit commercial banks to enter certain restricted or prohibited areas—such as investment advice, leasing, insurance, data processing, and real-estate development and brokering. Other issues arising from the Glass-Steagall Act are also coming under scrutiny—such as interstate banking, payment of interest on demand deposits, and the structure of the Federal Reserve System. For all these reasons, it would be worthwhile to review the principal provisions of the Act and the circumstances which led to their adoption.

Genesis of Act

President Roosevelt signed the Banking Act of 1933 into law on June 16, 1933, after a two-year-long period of Congressional hearings and studies. The Act was authored by Senator Carter Glass (D. Va.) and Congressman Henry Steagall (D. Ala.), the chairmen of the Senate and House Banking Committees.

Glass-Steagall was a child of the Great Depression, and specifically reflected a Congressional response to the demise of some 10,000 banks between the crash of 1929 and the imaginatively-named Bank Holiday of 1933. In their reports, however, the Congressional Banking Committees blamed these problems primarily upon developments arising out of the prosperous 1920s. These included an excessive increase in bank credit for speculative purposes, especially loans to brokers and the public for carrying securities, which had been facilitated by a substantial buildup of surplus reserves resulting from large gold imports and Federal Reserve operations. The Committees also blamed the breakdown upon the growth of bank affiliates ("the greatest danger"), which "devote themselves in many cases to perilous underwriting operations, stock speculation, and maintaining a market for the banks' own stock, often largely with the resources of parent banks."

Key provisions

In an attempt to assure the safety and soundness of the banking system, Congress through Glass-Steagall provided a clear separation between commercial and investment banking—and between banking and commerce generally. Specifically, Section 16 stipulated that nationally-chartered banks be limited to purchasing and selling investment securities "solely upon the order, and for the account of, customers and in no case for their own account". That section, however, imposed no restrictions on underwriting and dealing in U.S. government obligations, Federal agency issues, and *general* obligations of state and local governments. (Section 5 extended the Glass-Steagall prohibitions from nationally-chartered banks—which must be Federal Reserve members—to state-chartered member banks as well.) On the other hand, Congress excluded municipal-revenue obligations from the laundry list of securities eligible for acquisition, and the courts have interpreted that exclusion as an implicit prohibition of such activities—thereby complicating life for many institutions today which would like to deal in such securities.

Regarding boundary lines between institutions, Section 11 of the Act prohibited any member bank from acting as an agent for any non-banking entity in making loans to brokers or dealers in stocks, bonds, and other investment securities. To resolve any doubts, Section 20 further stipulated that no member bank could be affiliated "with any corpor-

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ation, association, business trust, or similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail, or through syndicate participation, of stocks, bonds, debentures, notes, or other securities." The bill's authors recognized the difficulty of separating member banks completely from financial affiliates of various types, but required that the examination of remaining affiliates be carried out in a manner "as consistent as possible" with the examination of parent banks. Congress subsequently expanded these restrictions considerably by bank holding-company legislation.

Further, Section 21 prohibited anyone in the securities business from receiving deposits subject to check "or repayment upon presentation of a passbook, certificate of deposit, or evidence of debt." This constraint may raise questions about the activities of today's money-market mutual funds, which hold about $185 billion in customer accounts with check-writing privileges. These accounts, however, technically represent shares and not deposits, and thus do not come under Glass-Steagall restrictions.

Payment of interest

In another move to enhance the "safety and soundness" of the banking system, Glass-Steagall's Section 11 provided that no member bank "directly or indirectly, by any means whatsoever, shall pay any interest on any deposit which is payable on demand." (Congress later extended this restriction to non-member banks under the Banking Act of 1935.) NOW accounts and "other checkable deposits", which amount to about $75 billion today, do not fall under this prohibition because most such accounts technically are considered savings deposits under the terms of the Monetary Control Act of 1980.

The authors of the Glass-Steagall Act utilized several different arguments in supporting a prohibition on demand-deposit interest. They believed that large banks' payment of interest on "bankers' balances" in the 1920s had siphoned funds from rural areas. Again, they believed that the prohibition, by reducing costs, would induce banks to avoid risky high-yielding investments, and would also make them better able to pay the premium on deposit insurance required under another provision of the Act. However, many studies have questioned the argument that payment of interest on demand deposits had contributed to the widespread bank failures of the early 1930s. The siphoning-of-funds argument, for example, overlooked the fact that the typical rate on bankers' balances, at about two percent in the 1920s, was less than the 5-to-5½ percent average rate of return on bank portfolios at that time.

Geographic restrictions

Finally, Glass-Steagall got into an area which even now, a half-century later, is a matter of intense controversy—interstate banking. The Act specifically amended the McFadden-Pepper Act of 1927 to allow (national and state-chartered) Federal Reserve member banks to branch wherever state-chartered nonmember banks could do so. Ironically, the McFadden Act had been considered a liberalizing measure, since it eased certain branching restrictions on member banks. Nonetheless, until 1933, it still prohibited any member bank, even in states which permitted state-wide branching, from establishing new branches outside the parent (home office) city, and it required any new member to divest itself of any branches established outside of the home-office city after passage of the Act.

The period between the passage of the McFadden and Glass-Steagall Acts provided a good laboratory experiment of the health of branch-banking systems. The best example came from the San Francisco (Twelfth) Federal Reserve District, where branch banking was quite common and where several states permitted statewide branching. This district accounted for less than five percent of the 10,000 bank failures of the 1929-33 Depression, and only a few of the Western branch systems succumbed during this period. (In 1929, only 64 of the 1,333 Western banks were branch systems, but they

accounted for over 40 percent of all banking offices in the district.)

In view of the relative strength of branch-banking systems during the Depression era, several Congressmen included a provision in an early draft of the 1933 bill that would have permitted a national bank to establish branches in an adjacent state within 50 miles of its home office. However, Congress deleted the provision in the final mark-up of the measure because of the strong opposition of unit bankers and most state banking authorities. Congress also rejected a similar provision in the Banking Act of 1935 that would have allowed branch banking on a regional or economic-area basis.

Remaining issues

A number of important issues still remain. Perhaps the basic issue is simply—what is a bank? (See the *Weekly Letters* of January 22 and January 29, 1982.) In the past, we could argue that only banks through their deposit-taking and lending activities created deposits. Today, however, that distinction between bank and nonbank firms no longer applies, especially with the sharp increase in checkable deposits at thrift institutions, and with non-depository institutions (such as securities brokers and dealers) offering money-market mutual funds.

Another issue involves the measure of competition—i.e., the number of competitors in the financial industry, or the scope, pricing and convenience of the services which they offer. Related to this is the question of when size becomes socially undesirable, regardless of economies of scale and other considerations of economic efficiency. If we substitute the word "success" for "size," we can perhaps understand the nature of the dilemma more clearly.

Other questions concern the appropriate dividing line between competition and cooperation in financial markets. For example, the pioneering BankAmericard found its most effective competitor in a rival vehicle developed by a group of *other* large banks acting *together*. The consumer clearly benefitted from this competition between giant concerns. Moreover, through the cooperative mechanism of franchising, such cards and their successors have become important marketing tools for small depository institutions which are unable to support the heavy costs of developing and marketing cards on their own. Today, with electronic transfers of funds growing rapidly, the implications of anti-trust policy regarding joint ventures assume great significance for the competitive viability of financial institutions offering payments-related services.

Another unresolved issue concerns the question of Federal versus state and local control. Congress is now under pressure to assert an overriding Federal interest in certain areas, such as in proposed legislation for a Federal preemption of state usury laws and of state legal rulings regarding mortgage "due on sale" clauses. In the opposite direction, Congress is under pressure to remove earlier Federal controls on state actions, such as in legislation to repeal the McFadden Act. In that case, Congress a half-century ago specifically delegated authority to the states to regulate interstate commerce in a specific industry; i.e., to allow the states to utilize state lines as barriers to the expansion of interstate banking businesses. These conflicting pressures seem likely to continue, despite the approach under the New Federalism toward expanding the scope of state and local control.

With the second session of the 97th Congress now convening, the House and Senate Banking Committees will resume deliberations on both "emergency" and comprehensive "restructuring" legislation—just as they did in 1933. Thus, it may be worth noting at this time what the authors of the Glass-Steagall Act had to say about this basic problem: "the United States will never have a completely strong banking system until such time as it should succeed in fully harmonizing and adjusting state and federal laws on banking matters." Forty-nine years later . . . .

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/20/82	Change from 1/13/82	Change from year ago Dollar	Percent
Loans (gross, adjusted) and investments*	156,170	– 161	9,222	6.3
Loans (gross, adjusted) — total#	135,001	– 288	10,556	8.5
Commercial and industrial	41,458	– 231	4,498	12.2
Real estate	55,912	24	5,221	10.3
Loans to individuals	23,712	– 48	– 81	– 0.3
Securities loans	2,038	– 40	564	38.3
U.S. Treasury securities*	6,031	194	– 771	– 11.3
Other securities*	15,138	– 67	– 542	– 3.5
Demand deposits — total#	40,398	–1,613	– 1,556	– 3.7
Demand deposits — adjusted	28,042	–1,943	– 2,129	– 7.1
Savings deposits — total	30,754	– 280	1,477	5.0
Time deposits — total#	90,077	528	14,457	19.1
Individuals, part. & corp.	81,059	483	15,095	22.9
(Large negotiable CD's)	35,953	218	6,334	21.4

Weekly Averages of Daily Figures	Week ended 1/20/82	Week ended 1/13/82	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	83	56	47
Borrowings	21	131	312
Net free reserves (+)/Net borrowed(–)	62	– 75	– 265

* Excludes trading account securities.
# Includes items not shown separately.

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