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FRBSF ECONOMIC LETTER

1997-08 | March 21, 1997

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Cracking the Glass-Steagall Barriers

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Introduction

Since 1933, the Glass-Steagall Act has stood as a wall between commercial banking and investment banking in the U.S. financial system. But the wall is not perfectly solid. The act does allow commercial banks to underwrite and deal in certain classes of securities, the so-called “bank eligible securities.” Furthermore, it states only that commercial banks cannot be affiliated with any organization that is engaged *principally* in underwriting and dealing in securities, without giving a clear indication of the degree of integration that would be permissible. As a result, commercial banking organizations have made inroads into investment banking via their so-called “Section 20 subsidiaries,” which are bank holding company subsidiaries authorized by the Federal Reserve to engage in a limited amount of bank-ineligible securities activities. In this *Economic Letter*, I discuss the creation of Section 20 subsidiaries, their economic role in the financial markets, and the latest developments and future outlook for banking organizations’ securities activities.

Creation of Section 20 subsidiaries

The provisions of the Glass-Steagall Act that separated commercial banking from investment banking are in Sections 16, 20, 21, and 32 of the Act. Section 16 bars national banks from investing in shares of stocks, limits them to buying and selling securities as an agent, and prohibits them from underwriting and dealing in securities. Section 20 prohibits Federal Reserve member banks from being affiliated with any organization that is “engaged principally” in underwriting or dealing in securities. Section 21 makes it unlawful for securities firms to accept deposits. Section 32 prohibits officer, director, or employee interlocks between a Federal Reserve member bank and any organization “primarily engaged” in underwriting or dealing in securities.

Certain securities are exempted from the act. They include municipal general obligation bonds, U.S. government bonds, private placement of commercial paper, and real estate bonds, which collectively are referred to as bank eligible securities. All other securities are deemed “bank ineligible.” More importantly, since the terms “engaged principally” and “primarily engaged” were not defined in the Act, both the courts and the regulators have had to determine the meaning of these terms in enforcing the law.

In 1986, the Federal Reserve made a new ruling on Section 20 of the Act. It allowed securities subsidiaries of bank holding companies to underwrite and deal in certain bank ineligible securities for the first time. To comply with the Glass-Steagall concept of not “engaging primarily” in ineligible securities, the initial limits on revenues from these activities were set at no more than 5% of the subsidiary’s total gross revenues on an eight-quarter moving average basis. The securities affiliates established under this authorization are commonly referred to as Section 20 subsidiaries.

On several occasions, the Fed has expanded the securities power of Section 20 subsidiaries, including enlarging the set of permissible bank ineligible securities, increasing the revenue limit on ineligible securities activities, and allowing an alternative method to calculate ineligible revenues. Today, the classes of ineligible securities that are permissible in Section 20 affiliates include corporate debt and equity, commercial paper, municipal revenue bonds, mortgage-backed securities, and asset-backed securities. The ineligible revenue limit was raised to 10% in 1989 and further increased to 25% recently. Furthermore, Section 20 subsidiaries have been given the option to index the revenue test for interest rate changes.

In requiring all ineligible securities activities to be conducted in a subsidiary of the holding company that is separate from the commercial bank, the Fed also erected a number of “firewalls” between the securities subsidiary and the bank owned by the same holding company. For example, a bank may not make loans to securities issuers to support or enhance the securities underwritten by its securities affiliate, or to finance the purchase of securities underwritten by its securities affiliate; a bank may not purchase financial assets from, or sell such assets to, its securities affiliate; the securities and bank affiliates may not have common officers, directors, or employees, nor may they cross-market each other’s financial services; the securities affiliate may not have full access to customer records of the commercial bank. These firewalls are aimed at preventing conflicts of interest between the securities subsidiary and the commercial bank, the primary concerns that led to the passage of the Glass-Steagall Act in the first place. By restricting transactions, information flows, and shared management between the securities subsidiary and the commercial bank, the firewalls also safeguard the banking system and prevent securities affiliates from tapping the safety net that is available exclusively to commercial banks.

Economic role of Section 20 subsidiaries

To date, 40 bank holding companies have Section 20 subsidiaries. Banking organizations have traditionally been major competitors in the underwriting of municipal securities. Once their securities affiliates were allowed to deal in and underwrite bank ineligible securities, a number of Section 20 subsidiaries successfully challenged the corporate underwriting market, despite the limit on ineligible revenues. For example, during the first six months of 1996, two of the top ten underwriters of U.S. corporate debt by dollar volume and two of the top ten underwriters of municipal bonds are affiliated with banking organizations.

Banking organizations have been fairly successful in entering the market for corporate bond-underwriting partly because of their expertise in providing credit services. Both bond-underwriting and loan-making involve credit analysis and pricing. The main difference is that in providing credit, banks hold and fund the loans until they mature, whereas in underwriting, the underwriters hold the bonds for a very short

period of time and quickly resell them in the open market. Hence, in order for banks to be successful in underwriting, they must be able to set up their own distribution channel and network of potential buyers. This is exactly what banks have been practicing when they securitize their loans. As banks become more prominent in underwriting corporate securities, the ability to provide both credit and underwriting services within the same organization allows banking firms to offer one-stop shopping in corporate finance. Bank customers may even enjoy lower prices when the efficiency gains from scope economies are passed on to them.

Although banking firms have acquired a significant share of the bond underwriting market, they have not been able to capture much of the action in equity underwriting, which garners much higher fees than bond underwriting. The infrastructure for underwriting equity securities is not the same as that for underwriting bonds, because it requires different expertise in the areas of research, client contact, and sales support. While building up an equity underwriting department involves substantial investment by the holding company, the most active Section 20 subsidiaries were operating close to the 10% then ineligible revenue limit (see [Figure 1](#)), which could have hindered their expansion into equity underwriting.

Recent developments and future outlook

Following the recent failure to repeal the Glass-Steagall Act by the Congress, the Federal Reserve submitted proposals to ease some of the restrictions on Section 20 subsidiaries. Based on the responses, in October 1996, the Fed relaxed three firewalls between securities affiliates and their banks. First, officers and directors may work for both the Section 20 subsidiary and the bank, provided that the directors of one may not comprise more than 49% of the board of the other. Also, the CEO of the bank may not be a director, officer or employee of the securities affiliate, and vice versa. Second, the restrictions on cross-marketing between the bank and its Section 20 subsidiary are repealed. Third, intercompany transactions between a bank and its Section 20 affiliate are expanded to include any assets that have a readily identifiable and publicly available market quotation.

In addition to liberalizing the above restrictions, in December 1996, the Fed lifted the ineligible revenue limit on Section 20 subsidiaries from 10% to 25%. From a capital budgeting perspective, raising the revenue cap can lower the hurdle in recovering the initial investment in the Section 20 subsidiary, thus enticing more banking firms to enter the securities business. By the same token, it also encourages existing securities affiliates to make capital investments in the equity underwriting business. To the extent that the previous 10% revenue cap represented a binding constraint on active Section 20 affiliates and hence limited their ability to expand into equity underwriting, the recent ruling allows banking organizations to launch a serious challenge at equity underwriting. Furthermore, under the 10% revenue cap, banking firms had little choice but to build up their securities affiliates from scratch. Entering the securities business by acquisition was either infeasible due to the cap, or unattractive because of limited growth potential. The boost in permissible ineligible revenues makes the acquisition of an established securities firm a more viable alternative.

In January 1997, the Fed submitted for public comment another proposal that further relaxes the restrictions between Section 20 subsidiaries and their bank affiliates. Since 1987 when the original Section 20 firewalls were prescribed, the Fed implemented Section 23B of the Federal Reserve Act, which requires all inter-affiliate transactions to be on arm's-length terms. Also, Section 23B prohibits representing that a bank is responsible for a Section 20 affiliate's obligations, and prohibits a bank from purchasing certain products from a Section 20 affiliate. Thus, Section 23B makes many of the firewalls specifically designed for the securities affiliates redundant. In addition, as the Fed has gained experience in regulating banks' securities affiliates, it has become apparent that some of the Section 20 firewalls are too conservative and impede their ability to operate efficiently and effectively. Modifying these restrictions would allow the bank and the securities affiliate to maximize synergies, enhance services, and possibly reduce costs.

Nevertheless, important policy questions remain to be addressed. While policymakers seem to be in general agreement that the Glass-Steagall Act should be repealed, there is vigorous debate on how to integrate commercial and investment banking. At issue are: How can the financial services industry be modernized without compromising the safety and soundness of the banking system? What degree of integration among financial services providers, and between financial and non-financial firms, would be socially desirable? How should the new financial services firms be organized and regulated?

Conclusion

Although the Glass-Steagall Act, which separates commercial banking from investment banking, has been targeted for repeal for many years, the reform effort has failed each time. However, in enforcing the law, banking regulators have some leeway in providing limited relief for banking firms to engage in ineligible securities activities through their Section 20 subsidiaries. Despite being hamstrung by numerous restrictions, banks' securities affiliates have been able to foster meaningful competition in the somewhat concentrated investment banking market. As financial services customers are benefiting from banking firms' penetration into the securities market, the restrictions on Section 20 securities affiliates are being gradually relaxed. Nevertheless, true financial modernization can be accomplished only by reforming the Glass-Steagall Act, rather than by loosening banking regulations. The success of banks' securities affiliates should be viewed as convincing economic evidence to support such reform.

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