Our Perspectives:
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A Brief Note on Why Glass-Steagall Was Repealed*

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Sections 20 and 32 of the Glass-Steagall Act were repealed in 1999 when the Gramm-Leach-Bliley Act was passed.[1] In light of the discussions that have been generated recently about the role of that repeal in the downturn our economy had this past decade, perhaps the question should be asked — why were they repealed.

In short, they were repealed because, in effect, they had already been repealed by action of various regulators and new business practices, and their formal repeal would make activities already being done easier to do. It also would formalize the recognition that financial services had changed so dramatically over the decades that walling off commercial banking from activities that in a more pristine age one might think should only be done by non-banking companies would lead to a marginalization of commercial banking within the scope of financial services, and leave most significant financial activities to be carried on by unregulated or sparsely regulated entities — a shadow financial services world. Finally, it would put U.S. banks in a decidedly inferior position vis–vis foreign banks.

Here's how we got there.

1. In 1933, Congress decided that banks had competed too hard on rates offered to depositors, so imposed a regulatory scheme that would address this problem: they denied banks the right to pay interest on demand deposits, and directed the Federal Reserve to impose ceilings on rates on other kinds of deposits — This established Regulation Q.

   Reg Q created credit crunches when rates rose, leading some banks to assist their best customers by enabling them to reach the capital

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

[1]These are the sections that prohibited affiliations between commercial banks and companies dealing in or underwriting and distributing securities. Section 21 prohibits banks themselves from underwriting securities. That was never repealed.

markets directly through commercial paper. Those corporations would never return to normal commercial lending thereafter.

Banks also introduced other banking products, such as residential mortgages, to the capital markets through securitization. Depositors found those securities more appealing than rate-restrained deposits.

Increasing rates and the inability of banks to meet those rates for deposit customers resulted in a new industry — the money market fund industry — caused directly by the rate restrictions imposed on commercial banks by Regulation Q. The industry was here to stay. Merrill Lynch created a cash management account in 1977; six years after the Reserve Fund had been created. Consumers realized they could get market rates from that kind of account and use redemptions like checks.

Meantime, in 1966 Congress decided to include savings and loan associations under the Regulation Q restrictions, but in doing so, gave a rate advantage of 25 bp to thrifts. That gave the lobbying arm of the industry, the Savings and Loan League a reason for existing, and through its — lets' say "exuberant" — lobbying, assured the continuation of Regulation Q much longer than normal political economics would have permitted.

Finally, commercial banks were limited by the McFadden Act to branches within a state, while thrifts could collect deposits nationwide.[2]

2. President Johnson decided to fight the Vietnam War, introduce the Great Society of social entitlements, and not pay for either with taxes or reduced spending elsewhere. Inflation necessarily followed. President Nixon decided he liked full employment more than restrained inflation, so he installed Arthur Burns as Chairman of the Fed and encouraged the continued Keynes-like creation of easy money. Inflation reached 14 percent by 1980.[3]

   The U.S. left the gold standard in 1971 and other nations then decided to float their currencies in the market rather than tying them to the dollar. Oil producing nations found that their real income then

[2] The final vestiges of that limitation were not removed until passage of the Dodd-Frank Act in 2010.

[3] Paul Volcker and his fellow Board members at the Fed finally stopped that precarious ride by raising the federal funds rate very high in 1981 until the inflation pressures eased. Of course, at one point this drove the prime rate to 20 percent, and was not well received by members that wanted to be reelected. Nevertheless, the Board held its course and that anti-inflation attitude has since prevailed at the Fed ever since.

fell dramatically as the value of the dollar depreciated since the price of oil worldwide was tied to the dollar. In 1973, they also decided to fight Israel again, so launched the Yom Kippur war, fully intending to use the production of oil as a weapon in the war. They limited production of oil (the notorious oil embargo), thus causing oil's price to rise quickly and dramatically, leading to increase prices throughout world economies because of the central roll oil plays. Bill Simon was appointed Energy czar, and long lines at gas pumps became standard. Big heavy fancy cars were no longer desirable. The U.S. stock market lost 40 percent of its value in the 1973-74 nosedive in the aftermath of these events.

Monetary policies contributed to inflation. President Carter defetaed President Ford and his campaign slogan — "Whip Inflation Now."

3. In the midst of this turmoil, commercial banks were fighting for their lives. Money market funds were siphoning off deposits, thrifts still had a deposit rate advantage, the earlier efforts of Comptroller Saxon to free the banks from these restraints were thrown out in court or on the Hill — things weren't going well for commercial banks.

   Banks had had some small victories, however. Banks were permitted to underwrite general obligation bonds in the late 1960s. They were authorized to privately place commercial paper in the late 1970s. Their customers could permit banks to regularly withdraw funds from deposit accounts to purchase identified securities. But these were small victories.

   In 1974, NOW accounts were created by a small bank in Massachusetts, offering negotiable orders of withdrawal to permit payments on near-checking accounts at banks. They spread like wildfire, and in 1980, were permitted for all institutions, with rate ceilings eliminated in 1986.

   In 1982, the FDIC decided that state non-member banks could underwrite securities in subsidiaries, since GS only restricted affiliations of member banks. In the same year, the OCC, under Todd Conover, approved the application of Dreyfus Corporation to charter a national bank that would accept demand deposits but not make commercial loans. Non-bank banks avoided the Bank Holding Company Act restrictions by offering either commercial loans or insured deposits, but not both, and those institutions could be owned by anyone. The list of companies that became owners of non-bank banks was lengthy, including Dreyfus, Sears, Aetna, Control Data, Merrill Lynch, Prudential Bache, and Gulf & Western. Five years later, Congress restricted chartering any new such affiliations, but grandfathered the existing ones.

In addition, another loophole appeared as non-banking companies realized that they could engage through a unitary thrift holding company in all kinds of financial services and non-financial services. Sears ended up with not only all of the hard goods and soft goods sold in their stores, but also the Discover credit card, All State Insurance, Dean Witter brokerage, and Coldwell Banker real estate products and services — all operating out of the same store. Others such as Ford, JC Penney, IT&T and Transamerica did the same, although perhaps not so grandly as Sears.

4. One of the results of all of this fragmentation in the U.S. was the decline in relative size of U.S. institutions as compared with those of other countries. In 1960, six of the largest 10 banks in the world were U.S. banks, while 20 years later, in 1980, not a single U.S. bank was among the largest 25 banks in the world. In fact, over a dozen foreign banks were unrestrained by GS in the U.S. because they had established foreign branches here before GS was expanded to include foreign banks. And to top it off, U.S. banks could underwrite securities in Europe but not in the U.S. Europeans were creating the "universal bank."

   In 1988, the EU (not yet so named) proposed a directive that permitted the combination of commercial and investment banking in a single company throughout the European Economic Community, thus creating the Universal Bank. At about this point, only the U.S. and Japan (influenced by Gen. MacArthur's occupation after WWII) hewed to the GS restrictions.

5. By this time, Congress and the agencies had seen the writing on the wall, the financial services marketplace had become worldwide, deregulated, filled with different kinds of entities that were not well-regulated, and had created a decided competitive disadvantage to the traditional regulated commercial banks and bank holding companies. There was concern that bank holding companies might drop their commercial banks and utilize the provisions being utilized by the other companies engaged in financial services. Distinctions between loans and deposits and securities products had become cloudy at best, and deposits at

commercial banks no longer provided a near-monopoly on funds raised from consumers.

The situation was further complicated by the development of section 20 subsidiaries. Fighting back against the competition, commercial BHCs had concluded through a tight reading of section 20 of GS that if the subsidiaries were not principally engaged in underwriting securities not eligible for banks to underwrite, the banks could be affiliated with them. The regulators agreed and the larger banks that underwrote large portfolios of bank eligible securities immediately began operating out of section 20 subsidiaries.

Notwithstanding that it seemed to want to pass a repeal of GS, Congress did not move swiftly. The first inklings were a financial services reform bill by Chairman Proxmire in the late 70s, but that didn't advance. Chairman Garn attempted to reform the system on the margins by restricting what FDIC-insured banks could do in underwriting, but permitting all bank affiliates to underwrite a limited variety of securities. It received overwhelming support in the Senate, but failed to be acted upon in the House.

In 1987, Congress passed CEBA, which restricted underwriting activities of non-member banks until 1988 and eliminated the non-bank bank loophole, while grandfathering all of the non-bank banks that were in existence. In 1988, the Senate again passed a modernization bill, the Proxmire Financial Modernization Act of 1988, by a nearly unanimous vote, but it was stopped in the House. That bill contained much of what later became the law that repealed GS, but again, the House failed to act.

As time passed, banks became more interested in having commercial powers as well as financial services powers, pointing to the large number of grandfathered non-bank and unitary thrift companies, many of which had in their structure major commercial companies such as General Motors. The Fed opposed that successfully, however.

What the repeal needed was something to push it over the line in Congress. That came when the Federal Reserve approved the merger of Traveler's Insurance and Citicorp to create Citigroup, a full service financial services firm. While it was hailed as the icebreaker that was needed to repeal GS, the only activity in that merged institution that did not fit within already existing authorities was the insurance underwriting activities of Travelers; Salomon Smith Barney was a very large securities firm, but less than 25 percent of the securities that it underwrote were bank ineligible, and the Fed had raised the limit for section 20 affiliates to 25 percent before the merger. GLBA also permitted national banks themselves to underwrite municipal revenue bonds.[4]

In 1998, it appeared that both houses would finally pass the repeal of sections 20 and 32 when the House voted to pass such a bill immediately after the announcement of the Citi-Travelers merger. Since the Senate had passed similar bills twice before, passage seemed a formality. That didn't happen, however, as Senators Gramm and Shelby prevented the bill from coming to the floor.

The next year, however, when Senator Gramm had become Chairman of the Senate Banking Committee (hence "Gramm-Leach — Bliley Act"), the bill passed both houses and became law upon the signature of President Clinton.

Summary

Therefore, the sections were repealed because the commercial bank franchise had dramatically declined in value, both as to gathering funds and to funding businesses. The decline in value and prestige of that charter raised fears over a 30 year period that foreign banks and foreign banking centers would become the world hubs for major financial activity, and there was evidence that this was the case.[5]

Attempts had been made by clever lawyers and by hard-pressed regulators to find ways for commercial banks to compete, but at the end of the day, existing laws and regulations had diminished commercial banks and ad hoc regulatory decisions and creative interpretations of old laws had to be

[4]Someone sometime should write the unexpurgated story of the successful resistance of the securities industry to all attempts by commercial banks to underwrite municipal revenue bonds. While not the best of the story that could be told, one part would have to be the year that two respected congressmen from Ohio, Messrs. Stanton and Ashley, managed to obtain signatures of well over half the Members of the House of Representatives as co-sponsors of a bill to permit commercial banks to do so, only to find that Chairman St Germain refused to even schedule a hearing on the bill in the Banking Committee.

[5]Prior to passage of GLBA, it was assumed that one or more major U.S. banks had constructed and reviewed plans for moving their headquarters to London because of the better regulatory atmosphere there and the real concern that they would permanently lose their role in the hierarchy of world financial institutions if they remained bound by U.S. laws and regulations.

made to keep them competitive. It became a conglomeration of patches all over the regulatory system and the franchises.

So sections 16 and 20 were repealed and a new financial services holding company franchise was created. It is not clear what would have happened to the commercial bank franchise had the law not been changed.[6]

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[6] It is doubtful, however, that the origination of residential mortgage loans would have been more prudently made, or that the infrastructure that permitted them to be securitized and passed on to investors would have changed, or that rating agencies would have rated the bonds differently, or that any other parts of the chain (including the government and GSEs) would have reduced their financial leverage to more prudent levels, or that the very large institutions that failed would not have been rescued by merging them into other large institutions.