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GLASS-STEAGALL REVISITED

The functional separation of the financial sector mandated by the Glass-Steagall Act of 1933 has been one of the primary features of the U.S. financial system since the 1930s. As with so much "reform" legislation of the past 65 years, however, its passage was achieved mainly as an expedient to relieve a perceived "crisis" and reflected little regard for its possible long-term unintended consequences. As a result, this politically popular attempt (described in box on next page) to restore stability to and reestablish the public's trust in the banking system sowed the seeds of long-term weakness in the banking industry.

Banking Before Glass-Steagall

Historically, the relationship between commercial and investment banking in the U.S. has been an on-again off-again affair. After the Civil War, America's banking system mirrored the British practice of separating commercial and investment banking. Commercial banks collected deposits from the public and made short-term, self-liquidating loans for commercial purposes.

Investment banks, however, under the guidance of men like Pierpont Morgan and Jakob Schiff, merged and reorganized railroads, mining companies, and manufacturers into new firms whose prospects were bright enough for their debt to be marketable in the large financial centers. Houses such as J.P. Morgan & Company and Kuhn, Loeb & Company underwrote and distributed the new firm's securities, typically placing a partner on the board of directors to ensure that the firm honored its obligations to security holders and remained a customer of the underwriting bank. Interlocking directorships among the Wall Street banks also were characteristic of the time. This practice became one of the focuses of the famous Pujo committee hearings in 1912, which sought to prove a Money Trust in a strict conspiratorial sense but, to its dismay, only uncovered gentlemanly rules of conduct among bankers.

Recognizing the advantage of being able to underwrite and distribute securities, state-chartered banks lobbied for and won such powers. Although the National Bank Act of 1864 did not grant these powers, nationally chartered banks undertook these activities by establishing separate state bank affiliates. Commercial banks significantly increased their securities activities as a result of World War I. Earlier experience and success in buying and selling war bonds combined with weak loan demand and a declining depositor base spurred bankers to expand into corporate bond and equity underwriting, distribution, and brokerage services during the 1920s. By 1930, the separation of commercial and investment banking had been bridged; commercial banks and their affiliates were the principal players in investment banking.

The Banking Crisis of 1930-33

From the beginning of the Depression in 1929 to the time the economy hit bottom in 1933, real GDP had plunged nearly 30 percent while unemployment soared to 25 percent. The nation's banking system was also in shambles. Of the 25,000 banks doing business before the economy's collapse, only 14,000 remained in business by 1933 — a failure rate of more than 40 percent. Most of the failures — roughly 90 percent — were so-called unit banks with under $2 million in assets. Failures were most prevalent among state chartered banks, especially those in the midwest, southeast, and southwest that catered to the agricultural sector of the economy.

What were the sources of the banking industry's implosion? Although the answer is complex, it begins with the failure to preserve free banking. Free banking (and sound banking) began to erode when first states and later the federal government began to regulate bank activities. Typically, this regulation was based more on opportunistic politics than sound economics. By the 1930s, the fundamental elements of free banking — a decentralized, market provision of specie money and credit; a network of private clearing houses; an absence of geographical restrictions; and a reliance on sound interbank lending of reserves — had been legislated away. What remained was a legal monopoly on note issue, a centralized reserve system, and policy-determined interest rates.

The regulated construct of the banking industry made it impossible for many depositories to cope with the Federal Reserve's inflating and subsequent deflating of money and credit during the 1920s. Banks, now solely dependent upon the Fed for system liquidity, were dealt an excruciating blow by the Fed's mismanagement of the discount window. Regulatory restrictions on branching limited portfolio diversification, thus exacerbating the already grim situation, especially for the smaller unit banks serving agriculture.

The hobbled economy and wrack and ruin in the financial sector spurred overwhelming public discontent and vociferous demands for policy action. What followed was not a dispassionate evaluation of the structure, conduct, and performance of the banking system but rather a textbook example of poor public policy formulation.

THE GLASS-STEAGALL ACT

The 'Glass-Steagall' Act refers to the sections — namely, 16, 20, 21, and 32 — of the Banking Act of 1933 dealing specifically with banks' securities activities. The Act is named after its co-sponsors, Senator Carter Glass of Virginia and Representative Henry Steagall of Alabama. Glass, a major sponsor of the legislation creating the Federal Reserve System in 1913, had long been a vociferous proponent of the separation of commercial and investment banking; Steagall authored the deposit insurance provisions of the Act.

Section 16 mandates that banks can neither underwrite securities and stock nor act as dealers in the secondary market for securities and stock. An exception to section 16 permitted banks to continue to underwrite and deal in U.S. government obligations and "general obligations of any state or political subdivisions thereof." Banks could also continue to purchase and sell securities and stock without recourse upon the order and for the account of their customers. Section 16 restricts only the activities of commercial banks in the United States, not overseas.

Section 20 prohibits a Federal Reserve member bank from affiliating with any organization, 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.

Section 21 forbids any person, firm, corporation, association, business trust or similar organization that accepts deposits — so-called depository institutions — from engaging in the securities activities proscribed in Section 16.

Section 32 disallows interlocking directorates between Federal Reserve member banks. It further prevents depositories from circumventing the securities activities banned in Section 16 by barring interlocking directorates between banks and securities firms. This firewall is designed to restrain banks from obtaining indirect, yet effective control over an affiliate engaged in the activities described in Section 16.

Subsequent legislation, court rulings, and regulatory decisions have somewhat eroded the original Glass-Steagall provisions. However, to this day, commercial and investment banking remain functionally separate.

The Genesis of Glass-Steagall

As early as 1929, President Herbert Hoover had advanced the notion of separating commercial and investment banking. The idea spread quickly — first appearing in banking legislation introduced by Virginia Senator Carter Glass in 1930 and later in 1932 as a part of the Democratic party platform. Momentum continued to build as a result of the famous Pecora hearings of the U.S. Senate in 1933. That spring, newly elected President Roosevelt urged the Senate Banking Committee to adopt a more sweeping mandate to investigate "all the ramifications of bad banking." In the end, bankers — summarily declared guilty of disreputable, dishonest, and dubious dealings and a gross misuse of the public's trust — would be held culpable for the country's misfortune. The passage of the Banking Act came shortly thereafter on June 16, 1933. The specific provisions separating commercial and investment banking are outlined in the box above.

The Arguments

Supporters of the Act, especially Senator Glass, believed that bank involvement with securities led to the misuse of borrowing privileges at the discount window, a perversion of good banking practices, and increased bank risk. Other proponents alleged that banks that underwrote and marketed securities were guilty of widespread breaches of fiduciary responsibility. Such allegations, revealed during the Pecora hearings, included misrepresentation of securities' risks to investors, the sale of excess or low-grade securities to bank trust accounts, the sale of illiquid loans to bank-sponsored mutual funds, and trading in the bank's stock by an affiliate.

One widely held belief of the time was that bankers fueled the wild speculation in the stock market via brokers' loans. Bankers were accused of inappropriate borrowing at the discount window — that is, borrowing for purposes other than to meet the needs of commerce and industry — and then lending to brokers who in turn used the funds to finance their own customers. Such loans, the argument alleged, provided a major source of leverage in the stock market, fueling higher prices and further speculation.

An examination of the "Bills discounted" during the period 1918-30 as reported in Table 1 shows that discounting at the peak of the stock market frenzy was consistent with historical borrowing by banks from the Fed before the market run-up. However, it is possible — as Senator Glass believed — that bankers channeled this credit to brokers in lieu of using it to fund the needs of commerce and industry. The data in Table 2 dispel this notion as well as shed light on actual events.

Contrary to Glass's belief, banks did not significantly alter their lending to brokers during this period, although nonbank sources apparently did. Firms awash in cash found it more profitable to direct their surpluses to brokers in the form of so-called call loans instead of investing the money in more traditional ways such as commercial paper securities. In October 1929, 78 percent of the nearly $8.5 billion in brokers' loans reported that month poured in from nonbank sources. If the market was driven by speculation fueled by brokers' loans, most of the responsibility resides outside the banking community.

A second accusation maintained that securities activities increased risk and the probability of bank failure. In hearings held by Senator Glass during 1931 and 1932 before a Subcommittee of the Senate Committee on Banking and Currency, the failure of the Bank of United States in 1930 was offered as *prima facie* evidence of the damage bank affiliates could inflict upon their parent. In fact, the failure was the only example of affiliate related problems discussed at the hearings. Furthermore, the event would be improperly considered indicative of the peril inherent in combining banking and securities activities.

Testimony revealed that none of the bank's dozens of affiliates were engaged in underwriting or distribution (other than the bank's own stock). The bank's failure was attributed to rapid overexpansion, concentration in real estate loans and holdings, unsecured loans to officers of the bank, and fraud by its principals. There is no reference in the hearing's record that specifically tied the bank's use of affiliates or collapse to securities activities.

The current evidence contradicts the view that securities activities increase bank risk, regardless of whether the activities were conducted in a separate securities affiliate or an in-house department. Of the 207 national banks with securities operations in 1929, only 15 — or 7.2 percent — failed during the years 1930-1933. Fewer than 8 percent of the 145 banks with bond departments failed while fewer than 7 percent of the 62 national banks operating separate securities affiliates crumbled. By contrast, roughly 26 percent of all national banks toppled between 1930 and 1933.

Clearly, banks that engaged in securities activities experienced a smaller incidence of failure than ones that did not conduct such operations. Why? These banks were typically larger and better diversified than smaller banks that relied on deposit taking and lending. By curbing bankers' ability to diversify risk, the passage of Glass-Steagall actually may not have reduced bank risk but increased it.

A final argument justifying the separation of depositories and investment banks involved the gross conflicts of interest perceived to permeate the industry. In large part, this belief was fostered by the Pecora hearings in 1933. These hearings focused on Charles Mitchell, chairman of National City Bank and its brokerage affiliate, National City Company. Pecora would later admit to purposefully targeting that bank on account of its prominence in the public's eye. Like the failure of the Bank of United States, the indiscretions of Mitchell and National City would wrongly be touted as representative of the industry as a whole.

Table 1
BILLS DISCOUNTED, 1918-1930

Year	*Bills discounted*	*Year*	*Bills discounted*
1918	$1,720	1925	$1,195
1919	2,623	1926	1,257
1920	3,390	1927	1,174
1921	2,202	1928	1,504
1922	1,226	1929	952
1923	1,205	1930	272
1924	996		

Source: Federal Reserve Bulletin; data are averages of daily figures (in millions of dollars).

Of the dozen or so allegations levied against Mitchell and his bank, many, such as Mitchell's avoidance of personal income taxes, high salaries and bonuses showered on the bank's top executives without shareholder knowledge, and special borrowing privileges provided exclusively for the bank's officers, had little or nothing to do with securities activities. Regardless, these revelations fueled the public discontent needed to pave the way for major financial "reform." With respect to its securities operations, National City stood accused of failing to disclose material facts to its clients with respect to bond and equity issues, using high-pressure sales tactics, steering its depositors to its own securities affiliate, trading in its own stock, and using its affiliates to hide bad loans from its shareholders. The point is that, however sordid these practices may have been, they were never shown to weaken the bank, its affiliate, or the banking system.

Were conflicts of interest an industry-wide problem as believed? Studies that examined the 1920s and early 1930s suggest that they were not. The general consensus is that issues underwritten by commercial banks defaulted less often and had lower initial yields than issues underwritten by investment banks.

Table 2
BROKERS' LOANS, 1923-30
(in thousands of dollars unless otherwise indicated)

Year	*Total*	*NYC Banks*	*Outside Banks*	*Nonbanks*	*Percentage Nonbank*
1923	$1,580	$720	$410	$450	28.5%
1924	2,230	1,150	530	550	24.7
1925	3,550	1,450	1,050	1,050	29.6
1926	3,290	1,160	830	1,300	39.5
1927	4,430	1,550	1,050	1,830	41.3
1928	6,440	1,640	915	3,885	60.3
1929	4,110	1,200	460	2,450	59.6
1930	2,105	1,280	215	610	29.0

Source: Federal Reserve Bulletin; loan data reported as averages of daily figures.

Commercial banks also were more likely to underwrite issues of larger, older, and less-leveraged firms, firms listed on the stock exchange, and senior securities — not the type of firms and issues most suitable for abuse.

Potential conflicts of interest exist with nearly all financial transactions. Glass-Steagall does not guarantee disinterested advice from either commercial or investment banks. It may, however, work to the contrary. A potential borrower might get better advice from a bank than an investment bank about whether to take a loan, sell equity, or issue bonds if the bank could do all three. The same would hold for savers seeking advice on investment alternatives. In addition, bankers have an incentive to maintain their reputation for integrity and prudence.

Conclusion

Without question, the banking industry had foundered during the early 1930s, leaving financial hardship and distrust in its wake. But, in the fervid attempt to restore stability and faith in the industry, policymakers turned to prejudiced allegations, half-truths, and erroneous generalizations instead of rational analysis to win over the public. There was no mention of the Federal Reserve's unsound monetary policy or its mismanagement of the discount window. Instead of considering restricting the Fed's powers, the only talk was of expanding them. There was no discussion of repealing the McFadden Act, which outlawed branch banking and severely restricted portfolio diversification.

The provisions of the Banking Act of 1933 separating commercial and investment banking, commonly known as the Glass-Steagall Act, failed to restore the public's faith in depositories, securities firms or the economy. Indeed, full confidence in the banking industry has yet to be restored, and for good reason. Almost surely, the politicians' deliberate campaign then (and since) to sow distrust of financial institutions in general has contributed. But the larger consequence is that banks and bankers for decades have been hobbled by restrictions that discourage or prohibit prudent banking practices.

ONLINE COST-OF-LIVING CALCULATOR

As a service to our readers, we now maintain a Cost-of-Living calculator at our web site. Anyone with access to the World Wide Web can use this calculator to adjust any dollar amount for price inflation. Use it to see if your house, your wage, or anything else has retained its *real* value over time or to see what a dollar in 1940 would be "worth" today. This calculator uses the same data we use in our popular *Economic Education Bulletin, The AIER Cost-of-Living Guide*. The advantage of the new calculator is that it will employ the latest available data. We hope you find it useful. To access the calculator go to our web site at http://www.aier.org/ and click on the Cost-of-Living calculator link.

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