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THE SENATE'S NEW BANKING BILL: A TIMID REFORM

INTRODUCTION

Outdated federal banking regulations are undermining seriously the international competitiveness of the United States banking industry. Increasingly, U.S. corporations are raising funds by issuing their own bonds and other securities in the capital markets, rather than by using the services of U.S. banks -- an accelerating trend resulting from recent developments in information and communications technology. Yet under the 1933 Glass-Steagall Act, U.S. commercial banks are prevented from underwriting and dealing in securities. Consequently, they are unable to serve their customers in new developing markets. And these customers are turning to foreign banks and to investment banks, which traditionally have provided such underwriting and securities services.

Harming Competitiveness. U.S. banks are not losing just their corporate customers. American families increasingly prefer institutions that can offer them a broad package of financial services, including money market funds, mutual funds and other investment alternatives, advisory services, insurance, credit lines, and real estate services. But because federal regulations prevent banks from affiliating with nonbanking commercial business enterprises, U.S. banks effectively are prohibited from offering many of the key services desired by consumers. Consequently, savers and investors are turning to securities firms and other nonbanking institutions, which can offer a broader range of services.

Restrictions on diversification threaten the safety of U.S. banking. These rules also hurt American competitiveness, since U.S. banks are losing customers not only to domestic U.S. underwriters and securities firms but also to foreign banks, which are not subject to the same onerous federal restrictions on the services they are allowed to provide.

The erosion has been dramatic. Two decades ago, six of the ten largest banks in the world ranked by deposits were American. Today, seven of the top ten banks in deposits are Japanese, and the highest ranking American bank is only 17th worldwide. As recently as 1984, U.S. banks controlled over one-quarter of the international banking market, but by

1986 this share had dropped to below 20 percent, while Japanese banks over the same period grew from 23 percent to 32 percent of the market, bypassing the U.S. Large U.S. corporations now borrow $4 from foreign banks for every $10 they borrow from major U.S. banks. Moreover, recent wide-ranging banking deregulation in Britain threatens to boost London past New York as the premier city for international finance. Unless outdated U.S. regulations are removed, U.S. banks will fall further behind.

Privileged Market. These same regulations, however, protect investment banks from the competition of commercial banks, which are prohibited from engaging in investment banking. As a result, investment banks enjoy a privileged, government-restricted market. And because of reduced competitiveness, American business faces unnecessarily high costs of capital. This artificial separation between banking and commerce also protects insurance companies and real estate brokers from competition by banks, and it reduces competition in banking as well, since commercial businesses cannot enter banking.

By maintaining such artificial walls of separation, federal rules reduce competition throughout the U.S. financial services industry. This reduces the stimulus for improved efficiency.

The U.S. Senate voted overwhelmingly last month for new banking legislation introduced by Senators William Proxmire, the Wisconsin Democrat, and Jake Garn, the Utah Republican, the Chairman and ranking Minority Member respectively of the Senate Banking Committee. This legislation (S. 1886) would eliminate elements of Glass-Steagall's separation between commercial and investment banking. It proposes long overdue reform. Yet it still would leave many barriers intact. Other proposals, such as that offered by the Federal Deposit Insurance Corporation, would provide more comprehensive and beneficial deregulation by completely repealing Glass-Steagall as well as the prohibitions on bank affiliations with general commercial business. These proposals deserve serious consideration by the House.

OUTDATED RESTRICTIONS ON U.S. BANKS

The Glass-Steagall restrictions were enacted as part of the Banking Act of 1933. These rules sought to separate commercial banking, which involves accepting deposits and making loans, from investment banking, which involves underwriting and dealing in securities such as stocks and bonds. "Underwriting" means the investment bank pays an agreed price to the company issuing the stocks or bonds and then resells them to the general public to gain its profit. The underwriter takes the risk that the market price will be sufficient to yield a profit. "Dealing" in securities means the investment bank purchases securities and holds them for sale to investors or issues and sells its own securities.

Section 16 of the Banking Act provides that national banks may not underwrite or deal in any securities other than general obligation government bonds.

Section 20 prohibits banks that are members of the Federal Reserve System (the vast majority of commercial banks) from having any affiliation with a company "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 bars any company engaged in these activities from accepting deposits.

And Section 32 prohibits Federal Reserve member banks from employing officers, directors, or employees who are also employed by an investment bank or an organization engaged in underwriting.

These provisions essentially prevent commercial banks from engaging in investment banking and underwriting and dealing in most securities. At the same time, investment banks are generally prohibited from engaging in the key function of commercial banking – accepting deposits – although investment banks and other underwriters can still make loans.

Ill-Considered Prohibitions. This legislation was an outgrowth of the Great Depression. Its primary objective was to increase the safety and soundness of commercial banks by prohibiting their participation in supposedly high-risk investment banking, underwriting, and securities activities. But as the Federal Deposit Insurance Corporation (FDIC) points out in a recent study, scholarly investigations of the matter consistently find that the investment banking activities of commercial banks played no role in causing the widespread bank failures during the Depression, the 1929 stock market crash, or the Depression itself.[1] Thus the Glass-Steagall prohibitions not only are outmoded today, they were ill-considered even at the time of their enactment.

Besides this separation of commercial banking from investment banking, commercial banks are prohibited more broadly from engaging in nonbank activities or businesses. Under federal and state law, banks are empowered to engage only in the "business of banking," a term that has been construed narrowly as limiting banks to traditional commercial banking activities. Consequently, banking is said to be separated from commerce generally.

Closing a Loophole. Historically, banks could avoid this restriction by affiliating with nonbank businesses in a holding company arrangement. Under this structure, the bank became the subsidiary of a parent holding corporation or company, which was permitted to engage in any nonbank business. The holding company then could run the bank and its nonbank businesses as a joint enterprise. But the 1956 Bank Holding Company Act (BHCA) effectively closed this loophole by prohibiting parent corporations or companies owning two or more bank subsidiaries from engaging in any business activities except those "so closely related to banking...as to be a proper incident thereto." These holding companies also were prevented from owning subsidiaries engaged in any of the banned activities. In 1970, these same restrictions were extended to parent corporations or companies owning only one bank subsidiary.

The 1970 legislation, however, created a new loophole by defining a bank under the BHCA as an institution that both accepts deposits payable on demand and makes commercial loans to businesses. Under this provision, any nonbank company could own a bank that accepted federally insured deposits if it did not make commercial business loans, but perhaps focused instead on consumer loans, mortgages, auto financing, credit card operations,

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1 Federal Deposit Insurance Corporation, *Mandate for Change: Restructuring the Banking Industry* (Washington, D.C.: FDIC, 1987), pp. ix, 37.

education loans, and other loans to individuals. Alternatively, any company could own a bank that made commercial loans but placed withdrawal restrictions on its depositors.

Many major commercial companies, including Sears, Roebuck and Co. and American Express Co., have acquired such "nonbank banks" and integrated allowable banking activities into their overall operations, offering consumers an attractive package of services. But last year, as part of the Competitive Equality Banking Act, Congress extended the BHCA restrictions to such nonbank banks as well, closing this loophole. The existing nonbank banks owned by nonfinancial companies, however, were allowed to continue to operate, subject to restrictions on their growth.

THE PROXMIRE-GARN BILL

On March 30, 1988, the U.S. Senate, by a vote of 94 to 2, approved the Financial Modernization Act of 1987 (S. 1886), introduced by Senators Proxmire and Garn. This legislation essentially would eliminate the Glass-Steagall separation between commercial and investment banking. Under the bill, commercial banks can be owned by parent holding companies, which also own firms that underwrite and deal in securities, and can engage in investment banking.

However, the bill bars bank holding companies from underwriting, distributing, or dealing in stocks and bonds unless Congress enacts a joint resolution authorizing this activity. The joint resolution is to be voted on sometime before April 1991. In addition, bank holding companies with more than $30 billion in assets cannot acquire investment banking firms with more than $15 billion in assets. A commercial bank owned by a parent holding company also cannot extend loans to an underwriting firm owned by the same holding company. Another provision of the Proxmire-Garn bill would bar bank holding companies from issuing insurance through bank subsidiaries located outside the state in which the holding company has its principal business.

The Financial Modernization Act is an important step in the modernization of America's banking laws. Yet it fails to provide the full scope of reform that is badly needed.

THE CHANGING BUSINESS OF BANKING

This reassessment of bank regulation is taking place amid a revolution in domestic and international banking. At the heart of this revolution is the "securitization" of credit. Thanks to advances in computer and communications technology in recent years, commercial firms wishing to raise capital can now more easily sell bonds and other securities directly in the

credit markets rather than take loans from banks. Savers and investors are purchasing such securities through money market funds, pension funds, mutual funds, and directly, rather than placing their savings in bank deposits.[2] As one House subcommittee report on banking issues put it recently, "short term credit flows from savers to borrowers are increasingly bypassing the banks."[3] Because Glass-Steagall's outdated regulations prevent banks and their affiliates from underwriting and dealing in securities, banks cannot adapt to this changing market.

Direct Issues. This trend toward securitization is seen most clearly in what historically has been the core business of commercial banking – lending to commercial business enterprises. Large enterprises now routinely sell bonds, or short-term commercial paper, directly to investors in the credit markets, rather than turning to banks to raise capital. Increasingly, mid-size firms are joining this pattern. By issuing such commercial paper directly, many firms obtain funds at lower interest rates than is possible from a bank. This is especially true for large firms with good credit ratings. Relying on their own commercial paper also allows firms more control over the terms and conditions of their credit.

Because of this development, commercial banks are losing a major share of commercial business debt, traditionally their most important market. Two decades ago, commercial banks provided 85 percent of funds borrowed by corporations.[4] Today, banks provide only 60 percent of such funds, and the percentage is likely to decline even further under current conditions.[5] In 1966, the ratio of outstanding bank commercial loans to outstanding commercial paper issued directly by the firm was 99 to 1.[6] By 1976, this ratio had fallen to about 13 to 1, and by 1986 it had dropped almost to 6 to 1.[7] With these prime corporate borrowers turning away from banks, the banks are having to lend more of their funds to riskier, less stable and secure borrowers.

The securitization revolution is reflected in another recent financial practice – pooling many small loans and selling these packages on the credit markets as interest-bearing securities. This process increases the liquidity of small loans for the lender. Banks often originate the pooled loans, but Glass-Steagall prevents them from underwriting and dealing in the securities representing shares of the pool.

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2 *Ibid.*, pp. ix., 33, 44.

3 Commerce, Consumer, and Monetary Affairs Subcommittee, Committee on Government Operations, U.S. House of Representatives, *Modernization of the Financial Services Industry: A Plan for Capital Mobility Within a Framework of Safe and Sound Banking*, H.R. Doc. No. 324, 100th Cong., 1st Sess. (1987), pp. 1-9; see also *Mandate for Change*, *op. cit.*, pp. 1-16; E. Gerald Corrigan, *Financial Market Structure: A Longer View* (New York: Federal Reserve Bank of New York, 1987), pp. 6-11; Robert E. Litan, "Reuniting Investment and Commercial Banking" in Catherine England and Thomas Huertas, eds., *The Financial Services Revolution: Policy Directions for the Future* (Washington, D.C.: Cato Institute, 1987), pp. 269-287.

4 Sarah Bartlett, "Are Banks Obsolete?" *Business Week*, April 6, 1987, pp. 74-82.

5 *Ibid.*

6 *Mandate for Change, op. cit.*, p. 6.

7 *Ibid.*

Home mortgages are now routinely packaged in pools with shares sold to the credit markets. Such pooled mortgages have grown from less than 8 percent of total outstanding mortgage debt in 1976 to over 32 percent in 1986.[8]

Auto loans, general consumer credit, and student loans are increasingly packaged and sold in a similar way. In addition, the major auto manufacturers now raise funds directly in the markets through their own bonds and use the money to finance car purchases through their own auto finance companies. As a result, auto financing by banks declined from 60 percent of the market in 1977 to 41 percent in 1986, while finance companies increased their share from 18 percent to 38 percent over the same period. These trends are sure to continue.[9] Glass-Steagall, of course, prevents commercial banks from adapting to this change in the loan market, since it prohibits them from engaging in the securities business.

THE ERODING COMPETITIVENESS OF U.S. BANKING

As major corporations and other enterprises increasingly turn to the securities markets rather than bank loans, they tend to take much of their other financial business to institutions that can provide the underwriting and related services. The underwriting institutions generally can provide such customers with most of the important financial services they need. For example, these institutions can offer insurance and real estate brokerage services, and banks cannot. They also can offer money management accounts, which provide unrestricted access to the entire possible range of private investments, while the ability of banks to offer stock-related investments is subject to disabling regulations. They can provide any foreign exchange services that banks can and can even act as deposit brokers, handling the placement of a company's funds among a diversified group of banks.

U.S. banks are also losing ground in the market for family savings and deposits. Money market funds have soared from a total of $4 billion in deposits in 1976 to $292 billion in 1986.[10] And while banks now offer money market accounts, their competitors are able to combine them with an attractive package of services, many of which banks are not permitted to offer. The nonbank firms, moreover, can offer services, such as credit lines and deposit broker services, that make the nonbank accounts close substitutes for bank deposits. In addition, the nonbank firms can offer these services at any number of convenient locations across the country. Banks, on the other hand, are subject to interstate banking and branch banking restrictions. As a result of these artificial disadvantages in competition imposed on them by unnecessary, outdated regulations, banks are losing more and more of the market for savings and deposits. From 1976 to 1986, the share of private financial assets held by commercial banks fell from 37.9 percent to 31.5 percent.[11]

The Inroads of Foreign Banks

Thanks to federal regulation, U.S. banks are losing customers through this process to foreign banks as well as domestic underwriters. The reason is that banks in many foreign

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8 *Ibid.*, p. 9.
9 *Ibid.*, pp. 7-9.
10 *Mandate for Change*, *op. cit.*, p. 7.
11 *Ibid.*

countries are allowed securities and underwriting activities. As a result, American corporations and businesses increasingly are turning to European and Japanese banks to underwrite their securities for sale around the world. And U.S. banks are losing jobs and income to foreign competitors.

London Gaining on New York. Some world financial centers are now using their more attractive system of regulation to draw business away from New York. In 1986, for instance, as part of a general program of banking deregulation, Britain allowed foreign banks to affiliate with London securities firms and underwrite securities in the London market. This has resulted in a surge of securities and underwriting activity in London. Financial industry expert Robert Litan of the Brookings Institution notes that employment by foreign banks and securities firms in London jumped 26 percent in 1986, the largest single-year increase in the last two decades.[12] Clearly, if the U.S. regulatory straitjacket is not removed, London may surpass New York as international finance's premier city.

The combination of all these factors is leading to the decline of the U.S. commerical banking industry. While six of the ten largest banks in the world in terms of deposits were American twenty years ago, today the largest American bank ranks only 17th worldwide.[13] Currently, seven of the top ten are Japanese. Ranked by assets, only one American bank is now in the top ten.[14] The share of international lending by U.S. banks declined from over 25 percent in 1984 to less than 20 percent in 1986.[15] During this period, Japanese banks bypassed U.S. banks, growing from 23 percent of the market to 32 percent, an increase of almost 40 percent. Large U.S. corporations themselves now borrow 40 percent as much from foreign banks as they do from major U.S. banks.[16]

How Glass-Steagall Fails the Banking Industry

The Glass-Steagall regulations, separating commercial banks from investment banking, underwriting, and general commercial enterprises, were of course intended to promote the safety and soundness of banks. But by hampering diversification and preventing banks from adapting to a radically changing market, the regulations are having the opposite effect. Said Comptroller of the Currency Robert L. Clarke before the House Commerce, Consumer and Monetary Affairs Subcommittee:

> The banking industry's vitality [is] threatened by outdated laws and regulations . . . [that] have a direct and adverse affect on the safety and soundness of the banking system.[17]

Clarke continued:

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12 Litan, *op. cit.*, p. 279.

13 Clemens P. Work and Douglas Stanglin, "Is Bigger Better in Banking," *U.S. News and World Report*, October 12, 1987, p. 52.

14 Diedre Fanning, "Set Us Free," *Forbes*, February 23, 1987, p. 94.

15 David Fairlamb, "The Bleak Picture Abroad," *Business Month*, April 1987, p. 40.

16 Bartlett, *op. cit.*

17 Commerce, Consumer and Monetary Affairs Subcommittee, *Modernization of the Financial Services Industry*, p. 11.

> As the primary supervisor of national banks, I have a duty to see that they are operated in a safe and sound manner. However, it is ironic that Glass-Steagall prohibitions are supported in the name of bank safety and soundness when those very prohibitions have caused the level of risk in the banking system to increase.[18]

"Serious Adverse Consequences." Former Federal Reserve Board Chairman Paul Volcker, testifying at the same hearing declared that the present regulatory structure for banking is "untenable," noting that "new technology and changing markets simply can't be rationally accommodated in the structure of law passed years ago."[19] The subcommittee concluded in its report on the hearings that today's regulatory restrictions on bank activities have produced "serious adverse consequences for the soundness of banks, the stability of the banking system, and the efficiency and competitiveness of the entire U.S. financial sector."[20]

Similarly, the Federal Deposit Insurance Corporation states in a recent report,

> It has become increasingly apparent that our banking system is in need of major reform. The rapidly changing financial environment, in combination with the existing restrictions on banking activities, has resulted in the inability of banks to remain competitive players in our financial system. This has been characterized as a new form of banking crisis — not like the type that occurred during the early 1930s, but one that will slowly erode the viability of banks and ultimately lead to a weak and noncompetitive system....
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> The result for banking is declining market share, and it remains questionable whether banks will be able to remain profitable in the future.[21]

Indeed, the FDIC notes that in 1987 banks had their worst earnings performance since the Great Depression. The weakness extended across the board in both large and small banks.[22]

Certain Exceptions. Despite the general restrictions placed on banks by Glass-Steagall, there always have been certain exceptions to the prohibitions. These have been expanded by both the regulatory agencies and the courts in recent years in response to the economic pressures on banks caused by the securitization revolution. Significantly, banks have engaged in limited underwriting and securities activities under these exceptions without any threat to their safety and soundness.

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18 *Ibid.*, p. 12.
19 *Ibid.*, p. 11.
20 *Ibid.*, p. 33.
21 *Mandate for Change*, *op. cit.*, pp. 1, 4.
22 *Ibid.*, pp. 11-12.

Glass-Steagall, for instance, always has allowed banks to underwrite federal government bonds and general obligation bonds of states and municipalities. Even more striking, Glass-Steagall does not restrict what U.S. banks may do abroad, and several U.S. banks have substantial investment banking operations overseas, even though precluded from such business at home. The prohibition on affiliation with underwriting and securities firms does not apply to those state-chartered banks in the U.S. that are not members of the Federal Reserve System, to existing, grandfathered, nonbank banks, and to thrift institutions such as savings and loans and savings banks.

Slow Reform

Federal regulatory authorities recognize the problems associated with Glass-Steagall, and within the constraints of the law, have instituted modest regulatory reforms. In the early 1980s, regulatory authorities ruled that banks and bank holding companies could offer discount brokerage services for the purchase of stocks and bonds as directed by customers without any investment advice from the bank. And in 1986, the Federal Reserve Board approved plans for banks to offer investment advice along with brokerage services to larger institutional clients and to offer mutual funds by having an investment bank market the fund under contract with the commercial bank. Also in 1986, the Federal Reserve approved a plan to allow banks for the first time to offer mutual funds by having an investment bank market them under contract with the commercial bank.

Recent Federal Reserve Board rulings allow banks to "privately place" commercial paper issued by corporations. This means banks can provide the service of finding buyers to purchase the commercial paper directly from the corporate issuers. But the banks would not be buying the paper themselves and reselling it, as with traditional underwriting. Early last year, the Federal Reserve also ruled that bank holding companies could, through subsidiaries, underwrite shorter term commercial paper, municipal revenue bonds, mortgage-backed securities, and securities backed by consumer installment debt, such as automobile loans and credit card debt. This new authority, however, still does not allow banking affiliates to underwrite stock and standard corporate bonds.

With these wide-ranging exceptions, the Glass-Steagall prohibitions have become incoherent. If banks can engage in these underwriting and securities activities without threats to their safety and soundness, then the remaining prohibitions on such activities can be removed as well. The remaining prohibitions simply undermine the ability of banks to compete in the new and rapidly changing financial markets and threaten their economic foundation.

BARRIERS TO COMPETITION

By preventing commercial banks from entering investment banking, Glass-Steagall protects investment banks from potentially stiff competition from the commercial banks. Such competition is badly needed. Investment banking is a very concentrated industry. In 1985, the top five investment banks underwrote 70 percent of all corporate securities and 96

percent of all commercial paper.[23] In the first half of 1987, nearly all securities in pools of debt instruments, such as mortgages, were underwritten by just five securities firms.

Removing the Glass-Steagall restrictions would greatly increase competition in investment banking by allowing commercial banks to enter the field. This would have several important benefits, including:

1) Lower capital costs for U.S. industry.

The increased competition would substantially reduce the fees charged to American businesses to raise capital, benefitting the overall economy. The biggest beneficiaries would be small to medium sized companies who now pay relatively higher fees for investment banking services. These businesses would enjoy wider availability of services from more and closer outlets, as well as lower prices.

2) Cheaper bond financing for cities.

Cities and towns would benefit from the increased competition. In the market for general obligation bonds of municipalities, where banks are permitted to compete with securities firms, the underwriting fees are about half those for underwriting municipal revenue bonds, where banks are barred by Glass-Steagall. In 1979 alone, by best estimates, this translated into $150 million to $300 million in extra financing costs for cities and towns.[24] Municipal revenue bonds account for nearly 75 percent of state and local bond issues. Removing Glass-Steagall would allow banks to compete in the market for municipal revenue bonds as well, resulting in large annual savings for cities.

3) Stronger commercial banks.

Glass-Steagall reduces competition in commercial banking, since investment banks and finance corporations are prohibited from entering that field. Indeed, the separation of banking and commerce generally means that no corporation other than an existing bank or bank holding company can purchase a bank or start a new bank.

Besides reducing competition in commercial banking, this also means that the potential sources for new investment in the undercapitalized banking industry are sharply limited. Financially troubled banks thus have far fewer potential buyers who can restore them to health with an infusion of new capital investment. Moreover, banks cannot enter closely related fields, such as insurance and real estate brokerage services, which would allow them to diversify income sources. As a result, the safety and soundness of banking is further undermined.

Removing Glass-Steagall restrictions, however, would increase competition in commercial banking. Further, it would provide new sources of badly needed capital and diversified income for banks.

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23 Litan, *op. cit.*, p. 275.
24 *Ibid.*, p. 275.

4) Less expensive services for the consumer.

The consumer ultimately loses from all these restrictions on competition. He or she must bear higher insurance premiums, higher real estate broker fees, higher banking charges, and ultimately higher investment banking fees built into the prices of goods and services generally. The consumer is also denied the potential savings due to economies of scale in jointly provided financial services. The greater competition from removing Glass-Steagall would reverse these adverse effects.

PROPOSALS FOR REFORM

The Proxmire-Garn Bill

By allowing commercial banks to affiliate with firms that underwrite and deal in securities, the Proxmire-Garn bill essentially eliminates the Glass-Steagall separation between commercial and investment banking. But the bill fails to complete the task. It would deny banks the authority to underwrite stocks at least until April 1991, when a further congressional vote of approval would be needed for stock underwriting power to go into effect. Moreover, the bill would even further restrict the power of banks to offer insurance services. And it does nothing to remove the restrictions preventing banks from offering other financial and commercial services.

The Corrigan Proposal

A broader but still limited proposal was offered recently by E. Gerald Corrigan, President of the Federal Reserve Bank of New York.[25] Under this alternative, bank holding companies would be allowed to own any firm providing one or more financial services, including commercial banks, thrifts, insurance companies, securities firms, underwriters, and investment banks. But banks and thrifts still could not be owned by a commercial business firm or a parent holding company which owned a commercial business firm. Nor could banks or thrifts own any such holding firm directly. Thus the proposal would repeal Glass-Steagall completely but maintain the separation between banking and commerce. Legislation (S. 1891) providing for a similar regulatory framework has been introduced recently by Senators Timothy Wirth, the Colorado Democrat and Robert Graham, the Florida Democrat.

The FDIC Proposal

The FDIC recently has proposed more comprehensive deregulation.[26] Under the FDIC proposal, banks can own or be owned by firms that engage in any legal business activity, including nonfinancial activities. This would repeal both Glass-Steagall and the separation of banking from general commercial business activities. The FDIC argues that possible conflict of interest abuses between a bank and its affiliates could be prevented through proper oversight by the regulatory authorities. The FDIC would require banking activities to be

25 Corrigan, *Financial Market Structure*, *op. cit.*, pp. 37-46.

26 *Mandate for Change*, *op. cit.*, pp. 86-102.

provided through a separate corporation distinct from affiliates engaging in other financial and nonfinancial activities.

According to the FDIC, current regulations and proper use of the existing supervisory and oversight authority of bank regulators would be sufficient to ensure that the banking corporations would be insulated from the financial risks of their nonbank affiliates, and hence that FDIC deposit insurance guarantees need not be extended beyond the bank. This is very significant, given that the FDIC is the major agency responsible for bank safety.

Legislation providing for similar regulatory reform (S. 1905) was introduced by Senators Alan Cranston, the California Democrat, and Alfonse D'Amato, the New York Republican. Under this bill, banks could affiliate with firms engaged in other financial and nonfinancial activities through a parent holding company which would own these other firms as well as the bank.

The House Subcommittee Proposal

Another appealing proposal recently has been offered in a report from the House Subcommittee on Commerce, Consumer Protection and Competition of the Committee on Energy and Commerce.[27] Under this proposal, any bank or thrift could be owned by a financial services holding company which also owned other companies engaged in such financial services as insurance, securities activities, and underwriting. The financial services holding company could itself be owned by any firm engaged in any general commercial business activity or owning any such firms.

This proposal effectively would repeal both Glass-Steagall and the legal separation between banking and commercial business. As in the case of the FDIC proposal, the subcommittee's plan would provide for enhanced regulatory authority to prevent conflict of interest abuses in transactions between a bank and its affiliates. Similarly it would mandate that banking activities be provided through separate corporate entities legally distinct from affiliates engaged in nonbanking activity.

Essential Step. Any of these latter proposals would be superior to the Proxmire-Garn legislation. A strong consensus exists among analysts and federal banking officials that Glass-Steagall is badly outdated and must be completely repealed. An essential further step would be the repeal of the mandated separation between banking and general commerce, as the FDIC, Cranston-D'Amato, and the House subcommittee proposals provide. This would greatly increase competition by allowing nonbank firms to enter banking and commercial banks to enter fields related to their expertise, such as insurance and real estate brokerage. Such deregulation would increase bank safety and soundness by allowing banks to diversify their sources of income and by allowing nonbank firms to invest new capital in the banking industry.

The House will now have the opportunity to go beyond the modest Proxmire-Garn bill. But meanwhile, the draft of a bank bill being circulated by House Banking Committee Chairman Fernand St. Germain of Rhode Island offers even less reform than the Senate

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27 *Modernization of the Financial Services Industry, op. cit.*, pp. 73-83.

bill. St. Germain's bill would leave most of Glass-Steagall in place, although it would permit banks to underwrite municipal revenue bonds, commercial paper, and asset-backed securities. And where the Senate version permits banks to underwrite corporate debt and sponsor mutual funds as well as calling for a congressional vote on whether banks may underwrite corporate equity, the St. Germain bill is silent. As currently configured, this bill is anti-consumer and anti-competition.

Democratic Representative Doug Barnard of Georgia is distributing a second draft bill which follows the Senate version more closely. As such, it recognizes the need for more comprehensive reform than that offered in the St. Germain proposal.

CONCLUSION

Outdated, unnecessary federal regulation is undermining the safety and soundness of American banks and reducing the competitive position of the entire U.S. banking industry. Foreign banks, particularly the Japanese, are taking advantage of this situation and seizing international preeminence from U.S. banks. Unnecessary regulation is also limiting the availability of services to consumers.

There is a clear consensus among experts that Glass-Steagall should be repealed. Congress has failed yet to do so only because it is unwilling to challenge large and powerful investment banking firms who lobby heavily to maintain government protection against competition from commercial banks. In failing to act, Congress is harming the interests of all segments of the U.S. economy.

Small Step. The Senate Banking Committee has at least taken one small step, by voting overwhelmingly for legislation that ultimately could repeal Glass-Steagall. But better proposals and legislation have been offered by others involved in banking policy. The FDIC, in particular, has offered a proposal that would repeal Glass-Steagall and the regulations prohibiting banks from affiliating with general commercial businesses through holding companies. The Comptroller of the Currency, who along with FDIC, plays a major role in ensuring bank safety and soundness, has supported such reforms.

Congress should give urgent and serious consideration to these more fundamental proposals. They would allow U.S. banks to be competitive once again, both in the U.S. and abroad, thereby giving U.S. banks an opportunity to regain the international preeminence they are rapidly losing.

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