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GLASS-STEAGALL:
THE MAGINOT APPROACH TO REGULATION

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In 1930, with memories of the Great War still fresh, France determined to concentrate its defense efforts on building a protective line on its northeast frontier to prevent another German attack. The idea for this concrete and steel barrier grew out of the success which certain modern fortresses had enjoyed in withstanding German artillery a decade before, as well as the savings in manpower it produced. In 1940, now well-prepared to fight World War I, France paid the price for its tactical rigidity and lack of foresight. When Germany attacked, France's Maginot Line was outflanked by tanks in four hours; within a week the Germans had made their way across France to the English Channel.

In 1933, with fresh memories of banking excesses and abuses which contributed to the Great Depression, Congress enacted a far-ranging program of corrective legislation designed to regulate the financial marketplace of the time. Portions of that program -- the securities laws are a proud example -- have proved to have an enduring flexibility. One notable exception was that portion of the Banking Act of 1933, commonly known as the Glass-Steagall Act, which sought to erect an unyielding and permanent barrier between commercial banking and certain investment banking practices -- most notably the underwriting of securities.

The Glass-Steagall Act served its immediate purpose well by restoring public confidence in our banking system -- a confidence which had been severely eroded by the Crash and the subsequent failure of over 7,000 banks.

Today, Glass-Steagall is embattled, facing challenges no less difficult or important than those it faced at the outset. The seemingly irresistible pressures of inflation atop the sweeping social and economic changes of the last 50 years have radically redrawn the neat divisions which in 1933 distinguished competitors and their products in the financial markets. The results are revolutionary, with major new

* The views expressed in this paper are my own and do not necessarily represent those of the Commission or my fellow Commissioners.
developments seeming to arrive almost daily. Lest there be any doubt that today's financial landscape would be a truly alien experience for Senator Glass and Representative Steagall, let me briefly describe some notable landmarks:

-- money market funds, which accept what some would call "deposits," pay the functional equivalent of "interest" and provide check cashing privileges, today hold aggregate investments of over $160 billion, or three times the gross national product for 1933.

-- Merrill Lynch's Cash Management Account, which looks, smells, feels and tastes so much like the product of a commercial bank that it has been called "the bank of the future," holds $10 billion in assets without so much as a nod to the bank regulators.

-- Private pension funds -- virtually non-existent in 1933 -- today control assets of over $360 billion.

-- Commercial banks -- the "slow growth giants" of the 1930's and 1940's -- are vigorously marketing a wide range of corporate finance and retail investment services and products including the packaging of securities offerings for private placement, the underwriting of commercial paper domestically and of corporate securities outside the United States, and the sponsoring of closed-end investment companies and automatic investment plans.

-- Insurance companies -- which have already expanded into new products, including variable life policies, guaranteed insurance contracts, and universal life policies -- are beginning to enter into direct competition with securities firms through acquisitions such as that of Bache, Halsey, Stuart by Prudential.
Sears -- that friendly giant which publishes farm equipment catalogues -- has committed to establish a money market fund, acquire a major broker-dealer, Dean Witter, and the nation's largest real estate brokerage firm, Coldwell, Banker; in short, to become the nation's largest financial services supermarket.

Thrift institutions -- those traditional sources of home mortgage credit and 5-1/2 % interest on deposits -- are offering retail repurchase agreements collateralized by U.S. Government securities, with returns two to three times the maximum levels permitted for their savings accounts, and some are seeking authority to organize a nation-wide brokerage firm.

In this fusillade of change, will the Glass-Steagall line hold? When the smoke clears, will it have been outflanked and overtaken by developments, like Minister Andre Maginot's Line? Some, most notably the major banks, have suggested that this already is the case -- and that the Act should be rescinded as an unnecessary barrier to the operation of a freely competitive market. Others, especially from the investment banking industry, seek Congressional reaffirmation of the Act, declaring it essential to avoid the banking excesses of the 20's, and to continue, incidentally, the protection from bank competition afforded by the Act's restrictions. Thus goes the debate, before a public audience, 70% of whom weren't even born when Glass-Steagall was signed into law. The issue is now joined in the Congressional forum, where Senator Garn has introduced a bill to "enhance the competitiveness of depository institutions, to expand the range of services provided by such institutions, to protect depositors and creditors of such institutions and for other purposes."

Although the highly complex issues clustered about Glass-Steagall have received extensive and intelligent attention through testimony before Congress and a number of studies over the years, clear solutions remain marvelously elusive. As the landmarks just noted suggest, the principal difficulty in reaching solid judgments about Glass-Steagall is that the game being played, the field on which it is played, and the players, are constantly changing.
Let me try to illustrate this point by reference to the Hunt Commission. In 1970, President Nixon formed a "blue ribbon" Commission, charged with the broad mandate to "review and study the structure, operation, and regulation of the private financial institutions in the United States for the purpose of formulating recommendations that would improve the functioning of the private financial system." With the benefit of hindsight, it is nothing short of amazing that the Commission did not study investment banking or other facets of the securities industry, did not reflect the competitive or anti-competitive effects of Glass-Steagall in its recommendations, and did not include, in the Blue Ribbon panel, a single representative from the investment banking or brokerage industries.

Of course, we cannot just throw up our hands and walk away from the problems because solutions remain elusive. There are continuing pressures for legislative change, as seen most recently in the form of Senator Garn's bill, which would, among other things, legalize bank underwriting of investment company shares and municipal revenue bonds. These types of changes should be undertaken only with an adequate understanding of the overall regulatory structure, its effect on the underlying markets and the role played in these matters by Glass-Steagall.

For the balance of this talk, I would like to share with you some observations on the Glass-Steagall Act, and the conclusions to which they point. I will then briefly apply these conclusions to the Glass-Steagall legislation now pending. In so doing, I hope to describe some neutral principles that can be applied to analyze any issue arising under Glass-Steagall.

The Purpose and Limitations of the Act

The purpose of Glass-Steagall was simple enough. As explained by Representative Steagall in 1933:

"The purpose of this legislation is to protect the people of the United States in the right to have banks in which their deposits will be safe. They have a right to expect of Congress the establishment and maintenance of a system of banks in the United States where citizens may place their hard earnings with reasonable expectation of being able to get them out again on demand."
This purpose was achieved in part by prohibiting commercial banks from underwriting and otherwise dealing in securities and in part by providing federal insurance for deposits. The concerns of Congress were thus quite broad -- anything that threatened the stability or security of the banking system. But viewed against the backdrop of the federal deposit insurance program, the barrier against investment banking was somewhat narrow.

Thus, although Glass-Steagall was interpreted by the Supreme Court "to prohibit commercial banks from going into the investment banking business," a number of the activities carried on by investment bankers were left open to commercial banks as well. For example, the Act specifically contemplated direct involvement by commercial banks in the underwriting of certain government and municipal securities, and in agency securities transactions for retail customers. Moreover, when operating in their trust capacity, commercial banks were permitted to offer pooled investment funds whose real world economic distinction from mutual funds was, at best, elusive. Commercial banks were also free to render a variety of financial services to corporate issuers, including the packaging of offerings for private placement, and investment advice to customers. These are all securities activities, and each puts the banks in direct competition with segments of the securities industry.

The Glass-Steagall barrier was intended to stamp out a number of evils which Congress found banks to have engaged in prior to the Great Depression. These included:

-- self-dealing by bank officers,
-- unsound lending practices,
-- conflicts of interest, and
-- fraud in the marketing of securities.

Each of these abuses was seen as having its root in the temptations and pressures created by the diversion of commercial banking facilities into speculative operations fostered by the aggressive and promotional character of the investment banking business. Of course, today, each of these abuses could be dealt with more flexibly than through the
construction of a rigid barrier such as Glass-Steagall. A combination of state law, federal securities and banking laws, and bank regulatory agency oversight and rulemaking, could hold these abuses in check. Concepts such as the "Chinese Wall," developed by the banks and securities firms themselves to deal with inside information and other conflicts within a single firm or group of affiliated firms, afford creative solutions to accommodate diversification of function within a single enterprise.

The Glass-Steagall Act and Competition

The Glass Steagall Act reflected a clear Congressional determination that avoidance of the "hazards" and "financial dangers" to banking that arise when commercial banks engage in investment banking, outweighed the advantages of competition, convenience, or expertise which might support bank entry into investment banking. In the words of Justice Harlan, "if anything, the Act was adopted despite its anticompetitive effects rather than because of them."

This bright line approach and the underlying Congressional balancing of interests served well for more than 30 years -- as long as the markets were willing to cooperate. In recent years, however, the realization has grown that the balance may have to be restruck -- that changes in the financial marketplace have so heightened the effects of Glass-Steagall on competition that the original concerns which prompted Congress to act might no longer be viewed as dominant.

To take one aspect of the debate -- money market funds -- the banks argue that, far from protecting the banking system, the Glass-Steagall barrier is weakening that system by blocking the banks' ability to compete, as depository institutions, for the public's funds through sponsorship of such investment companies. On the other side, the Investment Company Institute argues that Glass-Steagall is essential to avoid giving unfair competitive advantages to the banks and fostering undue concentrations of economic power in their hands. While these concerns may be legitimate ones to weigh in today's debate, they were not, as the ICI suggests, among the original concerns underlying Glass-Steagall.
Conclusions Drawn From Experience With The Act

Nearly 50 years of experience with Glass-Steagall prompts two important conclusions:

First, many of the concerns underlying the Act remain as valid today as they were in 1933; and

Second, the Maginot line approach to dealing with those concerns should give way to more flexible regulatory solutions.

Allow me to expand briefly on these conclusions.

1. The REIT Experience

The temptations and conflicts which were thought to arise when commercial banks engage in investment banking were confirmed as recently as the 1970's by the history of bank-sponsored REITS, where most if not all of the perils predicted for the joinder of investment banking with commercial banking occurred when bank holding companies sponsored REITS bearing their names and sold them to the public, through investment bankers to be sure, but on the basis of bank expertise and commitment.

Among the principal concerns underlying the Glass-Steagall line of defense were the following:

. Congress feared that banks and their financial affiliates would be closely associated in the public's mind, with the result that, should the affiliate fare badly, public confidence in the bank might be impaired.

. To avoid such a loss of confidence, the bank might be tempted to shore up the affiliate through unsound loans or other aid.

. Congress feared that the promotional pressures on the bank to make its financial affiliate successful would cause it to make its credit facilities more freely available to its affiliate, even to the point of making unsound loans.
A few highlights from the REIT debacle should suffice to show how brilliantly that experience validated these Congressional concerns.

At the peak of REIT activity, in 1976, there were 39 bank-sponsored REITS out of 216, accounting for some $6 billion of invested assets or 30% of the industry total. At least 30 of the bank-sponsored REITS used their bank names, including Chase Manhattan Mortgage and Realty Trust, the largest of all the REITS. The public was led to expect that the bank's reputation for prudence, safety and solvency would shelter its sponsored REIT. As one Miami banker, William Duncan, was quoted as saying:

"Because it was the Chase, the implication was the project had to be good. Nothing could go wrong, and even if it did go wrong, the bank was there to back it up."

The record suggests that banks extended excess credit to their REITs, both to earn high returns on their loans and to generate large profits for the affiliated adviser to the REIT, whose fee was based on size of assets under management.

Some commentators suggest that banks directed the riskier loan applications to their sponsored REITS, who were obvious candidates for such loans in view of their need to charge a higher return on their loans than was charged by the bank or other suppliers of capital to the REIT.

The record is also clear that, as their sponsored REITs developed problems, the banks engaged in unsound asset swaps and other transactions with their REITs in order to shore them up. The Chase bank, for example, after purchasing about $160 million of its REIT's loans to help stave off that REIT's bankruptcy -- loans that no other purchaser would buy on comparable terms -- had a loan exposure to its REIT of 140% of its total reserve for all loan losses. In 1976, the Washington Post reported that the Chase Bank was included on the Comptroller of the Currency's confidential list of "problem banks."
Now, if the REIT experience validated the underlying concerns which gave rise to the Glass-Steagall barrier, why didn't that barrier work? The barrier didn't block the REIT abuses because it was outflanked by the banks. Its rigidity -- intended as a strength -- was also its weakness. Neither the sponsorship of REITs, nor their use of bank names, nor the rendering of investment advisory and management services to the REITs, nor the making of loans to them constituted activities proscribed under the Act. This leads to my second conclusion.

2. The Maginot Line approach should give way to more flexible regulatory solutions.

While its purposes remain viable today, the Glass-Steagall approach to achieving them, as not so subtly suggested by the Maginot Line metaphor, is too rigid to serve the needs of our rapidly changing financial environment. If the goal is protection of a sound banking system, flexible regulation by agencies charged with implementing that goal through rule-making to condition or prevent bank diversification will better serve the public interest. What was intended as a "bright line" distinction between commercial and investment banking has spawned much litigation, several Supreme Court decisions, and line drawing of the most delicate sort. Thus, by a split decision in Investment Company Institute v. Camp, the Supreme Court traced the thinnest of lines between

(a) that which is **lawful**:
management, by way of pooled or common trust arrangement, of separate funds held as fiduciary in the technical sense, and management of separate agency accounts of whatever size, and

(b) that which is **unlawful**:
the pooling of those separate agency accounts for common management.

Or consider the super-refined application of Glass-Steagall by the Supreme Court this year, when it construed the Act to prevent bank sponsorship, organization and control of open-end investment companies but to permit such activities as applied to closed-end investment companies.
In short, despite its rigidity, the Glass-Steagall line is not bright. Despite the soundness, today, of the concerns which cast it in concrete almost a half-century ago, its effectiveness is impaired by its inflexibility. For the future, then, a regulatory approach to those concerns will best serve our needs.

I do not mean to suggest that the regulatory solution always works. Indeed, in the REIT case, the Bank Holding Company Act probably afforded the bank regulatory agencies sufficient power to address most, if not all, of the conflicts and temptations which ripened into financial problems for the banks who had sponsored REITs. In fact, in 1972 the Federal Reserve Board issued a rule permitting bank holding companies and their non-banking subsidiaries to act as investment advisers to "closed-end" investment companies, subject to precisely the kinds of safeguards that would have been invaluable to the bank-sponsored REITs. That rule prohibited:

- advisory services to an investment company having a name similar to the holding company or any subsidiary bank;
- bank holding company or affiliate purchases of the investment company's securities, either for its own account or as a fiduciary; and
- loans to the investment company.

Now, with these thoughts in mind, I will briefly consider that portion of Senator Garn's bill that would modify Glass-Steagall to permit banks to underwrite investment company shares and municipal revenue bonds.

Brief Comments On The Garn Bill

In considering the Garn Bill, one is faced with two basic questions:
1. Whether the Glass-Steagall barrier should be lowered to permit either of these two activities; and

2. If so, how it should be done?

First, as to whether, I think one can usefully look separately at the underwriting of (a) municipal revenue bonds, (b) money market fund shares, and (c) other investment company shares.

(a) Municipal revenue bonds can reasonably be viewed as a natural extension of the kind of underwriting activity expressly approved for commercial banks by Glass-Steagall. Moreover, this type of financing -- which represented an insignificant 2.5% of state and local issues when Glass-Steagall was enacted into law -- has grown to represent more than 70% of the current new issues.

While legal differences certainly exist between the two, revenue bonds can -- and often do -- present about equivalent degrees of security for the investor.

Thus, subject to appropriate safeguards to assure that banks do not assume undue risks, it would seem that the Glass-Steagall concerns need not continue to stand in the way of this activity.

(b) As noted earlier, money market funds compete head-on with commercial banks for funds. And, because of the legal ceilings on interest payable by banks to their depositors, the money market funds are whipping the banks in this scuffle, despite the fact that federal insurance is available only for bank deposits. Under these circumstances, it is reasonable to view assets invested in money market funds, especially those investing exclusively in paper issued or guaranteed by the federal government, as the functional equivalent of bank deposits, and, therefore, more a commercial banking, than an investment banking activity. Under this line of analysis, it would seem that Glass-Steagall concerns need not, and perhaps should not, stand in the way of bank sponsorship, underwriting, and advising of money market funds, subject to appropriate safeguards for both banks and investors.

(c) To go beyond money market funds, however, as the Garn Bill would do, to permit sponsorship, underwriting and
advising of all types of investment companies, raises broader and more difficult questions of policy, which, I for one, have not yet worked out. I do feel, however, that before the Glass-Steagall barrier is lowered to permit bank entry into the investment company field generally, a broad review of the financial services industry should be essayed, focusing on the respective roles of competition and regulation in benefiting the consumer of financial services.

In this regard, it is often said that, when different segments of the financial services industry compete, they should compete on an equal regulatory footing. However impeccable in its logic and compelling as an expression of fairness, I submit that this notion is an ideal beyond the reach of a system that has been evolving for over 200 years. This is not to say that the "level playing field" idea is without merit. I simply believe it is an important, rather than overriding, principle, to be weighed in the legislative debates along with other principles, such as stability in both the banking and investment banking industries, and preservation of vigorous and effective competition.

Thus, I do not believe that bank deposits and money market fund shares should be regulated in the same way, even though they now often compete for the same dollar and will do so even more as interest ceilings are phased out. However, I do feel that, if banks are permitted to sponsor money market funds, the bank regulators should be given ample authority to protect bank safety and soundness and, in addition, banks and their funds should be subject to the same regulation as other money market funds and their sponsors.

2. Now, to my second question. Assuming Congress decides to lower the Glass-Steagall barriers to permit some or all of these activities, how should it be done? On this question, I have a clearer judgment, which flows logically from the two conclusions reached earlier about our experience with Glass-Steagall.

As I read the Garn Bill, it would not empower the bank regulatory agencies to establish standards for the entry of commercial banks into the underwriting of municipal revenue bonds and investment company shares. I view this omission as a mistake.
The REIT experience demonstrates that (a) the concerns underlying Glass-Steagall remain valid today, and (b) they are not easily dealt with by the Maginot approach of rigid legislation. Thus, I would urge that, if Congress proceeds to lower the barriers, it be done by empowering the appropriate bank regulatory agencies to permit these activities, subject to appropriate regulatory safeguards designed to protect the banking system from such self-inflicted wounds as occurred with bank-sponsored REITs.

In addition to these Glass-Steagall issues, it is important to consider the concerns of investor protection and competition which would arise if banks were granted entry into these fields. Although the Garn Bill would enable banks to sponsor, underwrite and advise investment companies, it would not subject banks to those provisions of the federal securities laws which regulate brokers, dealers, and investment advisers with a view to the protection of investors. The Bill would require bank regulatory agencies to set standards of training, experience and sales practice on the part of those selling investment company shares. However, I am not convinced that asking those agencies to establish such standards is the most effective way to protect investors in an area where Congress has established a comprehensive scheme of regulation involving the Securities and Exchange Commission and the self-regulatory organizations.

The Garn Bill would also permit banks to underwrite municipal revenue bonds, subject to certain restrictions designed to protect the soundness of banks and prevent conflicts of interest. Since the municipal securities activities of banks are fully regulated, this provision would not raise investor protection concerns. The Bill, however, does not take into consideration the tax advantage enjoyed by banks which allows them to carry tax-exempt securities with borrowed funds while at the same time deducting the interest paid on those borrowings -- an advantage not available to investment bankers conducting identical activities.

The Administration has considered these issues and favors a bill that would allow banks to enter these new fields, but only through securities affiliates, subject to the same federal securities and tax laws as investment bankers.

I support this approach as a means of addressing the investor protection and competitive concerns which would arise if banks were permitted entry into these fields. As for
Glass-Steagall's fundamental concern with the stability of the banking system, however, I remain convinced that, if Congress is going to permit these activities, it should assign to the appropriate bank regulators the power to condition entry upon compliance with rules designed to insure bank safety and soundness.