FINANCIAL MODERNIZATION LEGISLATION IN THE UNITED STATES

Background and implications

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CONTENTS

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Abstract

The Gramm-Leach-Bliley Financial Modernization Act went into effect in the United States in 1999. The Act establishes a new framework for affiliations among commercial banks, insurance companies and securities firms through "financial holding companies" and "financial subsidiaries", and establishes guidelines for entry into merchant banking. It moves financial institutions in the United States towards a system of conglomeration that has long existed in continental Europe and elsewhere in the world. This paper reviews important provisions of the new law, provides some comparisons with other countries, and draws some implications for future developments. The immediate effects of the law are not likely to be great, either in the United States or elsewhere. With respect to the integration of financial activities, it merely supports recent trends. At the same time, it requires a continued "separation of banking and commerce", precluding the establishment of true universal banks. Longer-run effects are likely to be more important. If the past is a guide to the future, whatever lines are now drawn by law and regulation between financial and commercial activities are likely to erode in the coming years.

Introduction

The Gramm-Leach-Bliley Financial Modernization Act of 1999 (GLB) moves financial institutions in the United States towards a system of conglomeration that has long existed in continental Europe and elsewhere in the world. It establishes new types of permissible activities for financial institutions, new corporate organizational arrangements for engaging in these activities, new methods for determining additional activities, and a new regulatory framework. In doing so, it repeals key sections of the Glass-Steagall Act that, for over 60 years, had limited the securities dealings of commercial banks and their affiliates. It also amends the Bank Holding Company Act which in 1970 established standards that restricted the activities of commercial bank affiliates.

This paper reviews important provisions of the GLB that establish the framework for affiliations among commercial banks, insurance companies and securities firms. In section I the background of restrictions on bank activity in the United States and the current law are briefly reviewed; in section II the major provisions of the law are described; in section III some implications for the behaviour and performance of US banking organizations are discussed; section IV contains some conclusions. Appendix A provides a description of related legislation that has a role in the implementation of the GLB; Appendix B offers a brief commentary on comparative regulatory structures in the United States and other countries.

The GLB is extensive and complex legislation. Throughout, there are numerous exceptions to its general rules, including the grandfathering of some activities otherwise prohibited. Important provisions require elaboration through rules, regulations, determinations and agreements reached by and among the Federal banking agencies: the Office of the Comptroller of the Currency (OCC), Federal Reserve Board (FRB), Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision (OTS), and others. For purposes of selected provisions, the others include the Treasury Department, Securities and Exchange Commission (SEC), National Credit Union Administration (NCUA), Federal Trade Commission (FTC), and state supervisory agencies.

While the full impact of the new law will remain uncertain until the regulatory and rule-making processes it has set in motion are further developed, it clearly establishes a broader range of activities for commercial banks in the United States than previously existed. However, important differences will remain between the more extensive financial organizations permitted under the law and the "universal banks" that have long existed in a number of European countries. The immediate effects of the law, in the United States and abroad, are not likely to be great. Longer-run effects may, however, be more important.

I. BANK ACTIVITY RESTRICTIONS IN THE UNITED STATES[1]

Modelled on the eighteenth century Bank of England, the earliest banks in the United States received limited-purpose charters that permitted them to borrow and lend and to issue notes payable on demand that served as currency, but were restricted in other activities. Non-banking firms were prohibited from providing bank notes. Under the National Banking Act (1863–1865), the "business of banking" was specified to include the acceptance of deposits, issuance of notes, extension of credit, etc., and included an authorization "to exercise … such incidental powers as shall be necessary to carry on the business of banking". By regulatory and judicial interpretation, national banks were prohibited from making mortgage loans, dealing in or purchasing corporate stock as an investment, becoming a partner in a business in which they could incur unlimited liability; or engaging in the operation of a business, even if it had been acquired in satisfaction of a debt.

Over the years, the National Banking Act was been liberalized by legislation, and by interpretation. The Federal Reserve Act of 1913 is an early example of liberalizing legislation. It provided for a moderate expansion of national banking powers by permitting national banks to offer real estate loans, time and savings

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[1] This section draws on information and sources in Shull (1994).

deposits, trust services, and to open foreign branches. A more recent example of regulatory and judicial interpretation has involved the sale of insurance by national banks. In 1916, Congress authorized national banks located and doing business in towns with a population of not more than 5,000 to sell insurance. In 1993, a court ruled that a national bank located in a small town could sell insurance anywhere.[2] In 1995, the Supreme Court indicated a broad judicial deference to the OCC's determinations under the "incidental powers" clause of the National Banking Act, and accepted the Comptroller's determination that the brokerage of annuities – a traditional insurance type of business – should be classified as investment, not insurance, and could reasonably be included as an "incidental power.[3] In 1996, the Supreme Court held that a Florida state law that prohibited bank holding companies (BHCs) and bank subsidiaries from engaging in insurance activities could not prevent a national bank, affiliated with a bank holding company, and doing an insurance business through a branch in a small town, from selling insurance through a state-licensed insurance agency.[4]

The Banking Act of 1933 imposed further restrictions on bank activities. The Glass-Steagall provisions, in particular, required the separation of commercial and investment banking. The rationale for this separation is best understood in historical perspective.

By the late nineteenth century, large national banks in New York and Chicago had begun to undertake investment banking activities in their bond departments. The Comptroller of the Currency, faced by adverse court decisions, interpreted the National Banking Act (1863–1865) to preclude some of the investment banking activity undertaken directly. In the early years of the twentieth century, he began to inform national banks that they were not permitted to hold corporate stock.[5] Banks responded by organizing securities affiliates.[6] Principally owned pro rata by bank stockholders and controlled by bank management, the affiliates were state-chartered firms with general powers that permitted almost any kind of activity.[7] Formal and

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2 *Independent Insurance Agents v. Ludwig,* 997 F.2d 958 (D.C. Cir 1993).

3 *Nations Bank v. Variable Annuity Life Insurance Co*., 115 S.Ct. 810 (1995).

4 *Barnett Bank of Marion County. Nelson,* 517 United States 25 (1996).

5 See the Comptroller's *Annual Report* for 1915 (pp. 35–36) for references to a letter sent by the Comptroller to a national bank around 1903 drawing attention to a Court decision stating that "[t]he power to purchase or deal in stock of another corporation is not expressly conferred upon national banks, nor is it an act which may be exercised as incidental to the powers expressly conferred".

6 George Baker, Chairman of the Board, of the First National Bank of New York testified in 1913 that his bank's affiliate, First Security Company, was organized "[f]or doing business that was not specially authorized by the banking act. We held some securities that in the early days were considered perfectly proper, but under some later decisions of the courts the holding of bank stock or other stock was prohibited; at any rate the comptroller prohibited it". *Hearings on the Concentration of Control of Money and Credit,* Subcommittee of the Committee on Banking and Currency (Pujo Committee Hearings), Part 19, p. 20; 1913, p. 1424; see also p. 1432.

7 Realty, insurance and mortgage company affiliates were also acquired and frequently had their main offices in the same building as the bank.

informal affiliations among investment and commercial banks with securities affiliates, at the beginning of the twentieth century in the United States, constituted the beginnings of universal banking.

At the time, the underwriting of private securities by commercial banks and their affiliates was severely criticized by a subcommittee of the United States House Committee on Banking and Currency, chaired by Congressman Pujo. The Committee had been established to investigate the "concentration of control of money and credit". Its *Hearings* and *Report* remain controversial to this day. Nevertheless, it concluded that underwriting by banks, and the affiliation of banking, investment and commercial firms was excessively risky and facilitated concentration. The Committee's Report (1913) remains a compendium of issues still raised in debates on the dangers of combining banking and commerce.[8]

The Federal Reserve Act of 1913 provided for a moderate expansion of national banking powers by permitting real estate loans, time and savings deposits, trust services and foreign branches. It did not materially disturb the security affiliates of national banks or state banking powers. In 1927, the McFadden Act gave national banks explicit authority to buy and sell marketable debt obligations. The Comptroller ruled that national banks could underwrite all debt securities, and that their affiliates could underwrite both debt and equities.

This arrangement was demolished by the Banking Act of 1933. The Glass-Steagall provisions of the Act revoked the powers that had been granted by the McFadden Act and mandated the divorce of commercial banking and investment banking.[9] Passed in the wake of the stock market crash of 1929, the failures of thousands of banks during that same period and the slide of the US economy into the worst depression of its history were proximate factors influencing this legislation. More specifically, Congress perceived that some commercial banks' securities activities had helped fuel the stock market speculation of the late 1920s prior to the crash, that some banks had abused their fiduciary responsibilities towards their customers through improper securities activities, and that the failures of some banks were related to their securities activities.

[8] See USHR (1913 – "Pujo Committee Report"). For example, the *Report* argued, among other things, that bank funds were likely to be used to finance speculative operations (p. 155), that the mistakes of affiliates were likely to impact the bank (p. 155), and that the relationships between banks and the industrial and railway companies they financed would compromise the interests of creditworthy borrowers (pp. 159–160).

[9] The relevant Sections are 16, 20, 21 and 32. Section 16 limits bank dealing and underwriting to specified types of securities, i.e. obligations of the United States and general obligations of states and political subdivisions. Section 20 prohibits banks from having affiliates principally engaged in dealing in securities. Federal Reserve interpretation of Section 20 has permitted holding company affiliates to underwrite otherwise impermissible securities. Section 21 prohibits firms dealing in securities from accepting deposits. Section 32 prohibits interlocks of directors and officers of securities firms and banks. The overseas investment banking operations of US banks were not affected by the Act. Nor did it apply to state-chartered non-members.

In recent years, some researchers have found that the evidence of improper securities activities by banks, and of bank failures attributable to securities activities, to be inadequate.[10] These findings may imply that the United States Congress had no rational basis for passing the Glass-Steagall Act.

In historical perspective, however, the opportunity afforded by Congress's perception of the securities-related problems in 1933 had deeper roots. There had long existed in the United States, as revealed in heightened form in the Pujo *Hearings* and *Report*, intense political and social, as well as economic, concerns about the concentration of power in the hands of a few private interests and also in the hands of the government. These concerns had, in fact, delayed the establishment of a central bank; and they also explain the unique structural organization of the Federal Reserve, with its 12 Reserve Banks and a Board in Washington.

Most of the legislative proposals of the "Pujo Committee Report" of 1913 were not adopted. Two decades later, in the depth of the Depression, the anti-universal banking views of Pujo prevailed in passage of the Glass-Steagall Act. While concentration was not perceived as a problem in the early years of the Great Depression, the fuller version of these views was that concentration and financial collapse were two sides of the same coin – i.e. if "universal banks" were successful, there would be excessive concentration; and, if they were not, there would be financial collapse that would probably require extensive government intervention.

In this context, the evidence of the securities abuses of the late 1920s and early 1930s, whatever its validity, does not fully explain the basis for passage of the Glass-Steagall Act. Questions on the concentration of financial and non-financial power resulting from relaxed restrictions on bank activities and the role of government intervention in the face of banking problems remain open.[11]

Provisions of the 1933 Banking Act, other than Glass-Steagall, imposed limited restrictions on BHCs, which were understood as an institutional mechanism through which activity restrictions on commercial banks could be circumvented. BHCs were required to register with FRB. Corporations owning more than 50 per cent of the stock of one or more Federal Reserve member banks were required to apply to the Federal Reserve to secure permits to vote their stock.