EXPLORING THE RATIONALE BEHIND GLASS-STEAGALL

Readers, who have basic knowledge of the U.S. financial system history, have certainly heard about the famous "Glass-Steagall" Act, which was one of the measures enacted in response to the financial collapse experienced during great Depression. Due to conflict of interest concerns and due to incompatibility of high risk inherent in the business of underwriting and other activities in the securities market with commercial banking, the Act provided for a strict separation between retail and investment banking. To clarify, the separation not only included a general prohibition over direct engagement by commercial banks in the business of securities market (with some limited exceptions, such as purchasing US obligations), it also forbade affiliation with any entity carrying out such business activities. However, a number of acclaimed scholars cast doubt on whether those were the real motivation behind the act. For example, in his well-known treatise "Law and Economics", Richard Posner raised the suspicion that perhaps the real purpose of the Act was not to deter banks from engaging in the risky business of underwriting and to protect the federal deposit insurance scheme but instead to protect the securities underwriters from the threat arising from the competition with banks. One of his main arguments was that the issue could be solved by requiring banks to conduct underwriting and other similar activities in separate corporations.[1]

Although over the years the strict separation between commercial and investment banking had eroded through provisions of various exceptions from the separation requirement by regulators as well as through lenient interpretation of the legislative act by the courts and was finally and formally lifted by the Gramm-Leach-Bliley Act in 1999, a new debate has sparked whether the Glass Steagall Act should be returned. The debate has been triggered by the collapse of Silicon Valley Bank and Signature Bank in US and forced merger of Credit Suisse in Switzerland and is far from being purely academic. In fact, certain countries have bills on separation awaiting their debate in parliament. For example, in March of 2023 the Italian ruling party has submitted a draft bill to the Parliament, which if turns into law will grant Italian banks 12 months to choose between being a retail or an investment bank.[2] In the U.S., Congresswoman Marcy Kaptur is actively advocating for restoration of key Glass-Steagall Act provisions and in April of 2023 has introduced the Prudent Banking Act for that purpose.[3]

Amid the re-sparked debates on the necessity of separating retail banking from investment, we are interested in delving deeper into the claim asserted by Posner and figuring out what was the rationale behind the Glass-Steagall Act. For this purpose we shall take the following steps: a) analyze the Pecora report, a study carried out by a Congress Committee following the 1929 Stock Crash and which justified the separation between retail and investment banking b) analyze the 1987 Congressional Research Service Report that preceded the repeal of the Act and explored pros and cons for keeping the Act c) Reach a conclusion on the evaluation of harms and benefits of commercial banks being engaged in investment banking.

Arguments for separation between retail and investment banking outlined in the Pecora Report

The roughly 400 page Pecora report contains a section dedicated to abuses arising from affiliation between commercial and retail banking. The main abuses detected were as follows:

1. Leveraging the large depositors base to sell securities sponsored by the affiliate investment houses: At the time around and/or preceding the 1929 Stock crash, a number of

[1] Richard Posner, Economic Analysis of Law (1986), p. 426

[2] https://www.reuters.com/business/finance/italy-pms-party-presents-bill-split-retail-investment-banks-2023-03-29/

[3] https://twitter.com/RepMarcyKaptur/status/1649045659826233345

US commercial banks had investment service provider affiliates. For example, National Citi Bank of New York had an investment company affiliate under the name National City Co and similarly Chase National Bank had its investment affiliate Chase Securities Corporation. All shareholders of each bank were simultaneously and in the same proportion shareholders of the investment company and special arrangements were in place to ensure that this always remained the case.[4] One major issue with the affiliation, as claimed by Pecora report, was that often depositors of the banks sought disinterested investment counsel from banks, whereas instead of providing such disinterested advice they took advantage of their clientele and misleadingly promoted securities that were sponsored by their affiliates, the sale of which resulted in profits for such affiliates as well as directly for the bank. In sum, the investment companies used the wide network of branches of their bank affiliates to sell securities sponsored by them.[5]

While the concern raised in this argument is understandable, in our assessment, this finding alone does not justify for strict separation between commercial and investment banking as it is not in line with the disclosure philosophy of securities market regulation. The idea of the disclosure philosophy can be summarized as follows: instead of interfering with the decision of market participants and "deciding the good or bad for them", the primary objective of securities law is to ensure that the investors are sufficiently informed when dealing with securities. As published by the Securities Exchange Commission, the primary act regulating the US capital market, the Securities Act of 1933, has two basic objectives: a) require that investors receive financial and other significant information concerning securities being offered for public sale; and b) prohibit deceit, misrepresentations, and other fraud in the sale of securities[6]. Now, the goal of ensuring informed decisions by investors could be achieved by requiring the banks to disclose to their clients that when offering securities sponsored by their affiliates they are not acting as an investment advisor providing disinterested advise but rather as an agent of the investment affiliate, as well as to disclose the fact that the securities are sponsored by the affiliate and any profit schemes related to such sale of securities.

2. Using Investment affiliates to trade with the bank's stock: The second abuse stemming from intertwinement between commercial and investment banking was active trading with the bank's stock by their investment affiliates. This allegedly caused the prices of shares of the bonds to skyrocket and subsequently plummet in the 1929 stock crash causing many-fold losses to the investing public. The Pecora report unravels circumstances surrounding the sudden and rapid collapse of share prices of two major banks: National Citi Bank and National Chase Bank.

In 1928 National City Co., the investment affiliate of Citi Bank, launched an intensive campaign for distributing National City Bank's stock. Initially the shares of the bank were sold below market price to attract as many buyers as possible. As the interrogation contained in the reports suggests, the primary motive behind this practice was creating a stable client base for distributing other securities in the future. Instances, where National City's dealers advised their clients to sell the stock and use the proceeds for purchasing other stock, were also documented.

The demand for City Bank's stock was so high that at times National City had to borrow the stock from others. A practice, which Pecora characterized as short sale. However, during the

[4] Pecora Commission Report - Stock Exchange Practices Report 1934, pp. 156-163
[5] Id. pp. 163-168
[6] https://www.sec.gov/about/about-securities-laws

interrogations President of City Co. H. Baker refused to label those operations as short sales due to the fact that they were expecting to receive those securities in the future based on relevant contracts.

In 1930 National City granted an option to one of the members of NYSE, Dominick and Dominick. The option was not limited in time and no premium was charged for the option. Subsequently, the investment firm, that received the option, took the opportunity to exercise it when the market price was significantly higher than the price granted by the option. As a result, the said investment firm reaped solid profits.

The hype that was created in the stock market caused the City Bank's stock to reach a high of 580$ per share, whereas approximately at the same time its highest book value was only 70$ per share. No wonder that in 1933 the same stock was traded at 40$ per share.

Similarly, in 1927 Chase National Bank, the investment affiliate of Chase National Bank, started opening a series of trading accounts with other investment firms to trade with the shares of Chase National Bank. Shares of the bank were purchased and sometime later resold at a higher price. Such operations continue over a period of 4-5 years. In 1929 the stock of Chase National Bank reached a high of $1325 per share, whereas in 1933 the number dived to 88.75$ per share.[7]

If we summarize the issues surrounding the trades with shares of banks by their investment affiliates outlined in the report, we can come up with the following break down:

- Sale of securities at below market prices for the purpose of acquiring customers
- Engagement in and promotion of speculation in the stock market
- Short selling of bank shares by their investment affiliates
- Granting stock to NYSE member investment firms on excessively favorable conditions for the latter

We shall now analyze whether the root cause of the enumerated issues was affiliation between investment and commercial banks.

Sale of shares at a below market price: Selling securities at below market price and using them as "candies" to attract clients for the purpose of selling other securities to them is indeed a deceptive practice. Having received the obvious benefits from purchasing stock at below market price, many investors might expect the same trend to continue with other investments. And likely that was what the investment affiliate was hoping for. At least, that is what the following extract from the Pecora report implies: "Hugh B. Baker admitted that the purpose in obtaining this new bank stockholders was to create a fertile field of potential customers for other securities that the investment company owned and wanted to sell."[8]

The question to raise here is not whether the practice was deceptive as such but whether the affiliation between commercial and investment banks caused the issue. In our opinion, the response to this question is negative for the following reason: the practice of selling securities at a price below market value arose from an incentive to acquire a larger client base to sell them other securities in the future. Such incentives are not unique to financial institutions that is why antitrust laws have been long dealing with price dumping and predatory pricing practices. The reason it was easier to engage in such practices with a stock of an affiliate was

[7] Pecora Commission Report - Stock Exchange Practices Report 1934, pp. 168 - 183

[8] Id. p. 169

that naturally a non-affiliate would not be keen about its stock being traded at below market price. Nevertheless such incentives were not born due to the affiliation between investment companies and commercial banks specifically, they could be present in the case of the affiliation with other major entities, e. g. Rail Road companies. What difference would it make from the point of view of investors if instead of selling Citi Bank's stock, National City Co sold shares of "XYZ" rail road company below market price for the motives outlined above.

Promotion of Speculation: Just like the previous issue it would be difficult for one to dispute the fact of harmful effects of speculative bubbles, nor do we intend to do so. Although not admitted as a motive behind active trades with securities by the leaders of National and Chase, essentially the active trade in the shares of the two banks created high demand for them. However, Pecora report does not establish how the affiliation between commercial and investment banks specifically prompted speculation in stock of the banks. The same issue could persist with respect to any market making activity. In addition, speculation with stock of myriad other non-bank entities were documented. For example, on the Black Monday (October 28 of 1929) the Dow Jones Industrial Average, an index that did not include a bank entity as a component, declined around 13%.

Short Sale: At one episode during the Committee hearing on abuses arising from affiliation between commercial banks and investment houses, there was one transaction that Pecora was desperately trying to qualify as a short sale. The transaction at issue was borrowing of 15.000 National City Bank share by National City Co. from Mitchell in order to deliver them to their customer. Just because the transaction constituted a borrowing of shares with their subsequent return to the initial owner, Pecora was alleging the transaction to be a short sale.[9] While technically and in form both short selling and the transaction specified above involve a sale of security that a seller does not own, there is a significant difference in substance between a short sale and the transaction specified above. Generally speaking, short selling is an investment strategy whereby a person trading with securities borrows securities and sells them with the hope that the price will fall subsequently and they will buy them back at a cheaper price and return them to the lender. Whereas, the report states the following: "The National City Co. not only took a substantial long position in National City Bank capital stock but also during the months of April and May 1929, this affiliate sold the capital stock of that bank short.".[10] The statement contradicts itself for the following reason: during the short sale the trader or investor expects the stock price to decline whereas in this case if National City Co was short selling shares in National City Bank with the expectation that the price would decline, it is not clear why it would hold substantial long positions in the National City Bank's stock.

The report also mentions that "In order for the investment company to make deliveries of the stock that it had sold to customers it had to borrow from Charles E. Mitchell 15.000 shares during the month of April 1929 and an additional 15.000 shares during the month of May 1929."[11] This statement implies that the purpose of the transaction was to meet the excess demand for the National City Bank stock by National City Co. President of National City Bank Hugh Baker also clarified that at the time of borrowing the securities they already had contractual arrangements in place whereby they would receive the stock in the near future. It is not clear why dealing with timing mismatches through borrowing securities per se was deemed as a short sale.

[9] Id. pp. 170 - 171
[10] Id. p. 170
[11] Id. p. 171

Granting excessively favorable stock to NYSE investment firms: The report does mention that National City granted a stock option to Dominick&Dominick, a NYSE member firm, to purchase National City Bank stock, and the terms of the option, as specified in the report, are excessively favorable for Dominick&Dominick[12]. However, the report does not further elaborate on the influence the transaction had on the stock crash and its relation to abuses stemming from interrelation between commercial and investment banks.

Arguments for and against the Glass-Steagall Act, as specified in the Congressional Research Service Report of 29th June 1987

Between 1960s and 1980s investment firms gradually developed and offered products that closely resembled traditional bank products such as mortgages and automobile loans. Thus, investment firms were able to compete with banks, whereas the latter were legally prohibited from entering the business of securities market. This turn of events prompted banks to seek permission from regulators to engage in a broader spectrum of activities in the securities market. During this time period the strict separation between commercial and investment banking, as enacted by the Glass-Steagall Act, entered into gradual erosion through certain statutory amendments broadening the list of securities that banks could own and empowering the OCC and the FED to implement and interpret the scope of activities that were deemed as "closely related" to banking activities and therefore could be carried out by certain bank affiliates, as well as through judicial interpretations and administrative interpretations by the bank regulators. Further, in 1980s, a number of draft bills on repealing the Glass-Steagall Act were introduced to Congress.[13]In 1987, the Congressional Research Service carried out a study and published a summary report on pros and cons of preserving the Glass-Steagall Act. The said report stipulates the following arguments for and against keeping the act:

"The case for preserving the Glass-Steagall Act includes the following arguments.
(1) Conflicts of interest characterize the granting of credit -- lending -- and the use of credit -- investing -- by the same entity, which led to abuses that originally produced the Act.
(2) Depository institutions possess enormous financial power, by virtue of their control of other people's money; its extent must be limited to ensure soundness and competition in the market for funds, whether loans or investments.
(3) Securities activities can be risky, leading to enormous losses. Such losses could threaten the integrity of deposits. In turn, the Government insures deposits and could be required to pay large sums if depository institutions were to collapse as the result of securities losses.
(4) Depository institutions are supposed to be managed to limit risk. Their managers thus may not be conditioned to operate prudently in more speculative securities businesses. An example is the crash of real estate investment trusts sponsored by bank holding companies a decade ago.

The case against preserving the Act -- that is, for relaxing its restrictions -- includes the following counter-arguments.
(1) Depository institutions now operate in "deregulated" financial markets in which distinctions between loans, securities, and deposits are not well drawn. They are losing market shares to securities firms that are not so strictly regulated, and to foreign financial institutions operating without much restriction from the Act.
(2) Conflicts of interest can be prevented by enforcing legislation against them, and by separating the lending and credit functions through forming distinctly separate subsidiaries of

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[12] Id. pp. 171-172
[13] Congressional Research Service, The Glass-Steagall Act: A Legal and Policy Analysis, January 19, 2016; pp. 8-14

financial firms.
(3) The securities activities that depository institutions are seeking are both low-risk by their very nature, and would reduce the total risk of organizations offering them -- by diversification.
(4) In much of the rest of the world, depository institutions operate simultaneously and successfully in both banking and securities markets. Lessons learned from their experience can be applied to our national financial structure and regulation."

Let's first turn to the arguments outlined in the report that are in favour of preserving the Act. The first argument raises a conflict of interest issue between lending and use of credit (investment). There, indeed may be a conflict of interest issue, where the same entity decides on lending and investment matters. Both lending and investment are financing products and depending on the given circumstances one means of financing might be more suitable for a particular client as compared to other means. Whereas, the financial institution providing both services might be inclined to push the client to elect the service that is more profitable for the institution. However, the Pecora report was not raising a conflict of interest issue between lending and investing, instead it was raising an issue of misleading depositors, mishandling their funds and mistreating banks' stock. Therefore, it is not clear how such conflicts of interest led to abuses that originally produced the Act.

As for the second argument, depository institutions indeed possess large powers by pooling other people's money, but it is not clear how their engagement in securities activities will limit competition for funds. Firstly, depository institutions are competing among each other. Secondly, the act of prohibiting depository institutions to engage in securities activities because they may offer better solutions and services than investment firms and outperform them, is an act of limiting competition in itself.

Regarding the third argument, although on average securities activities present more risks as compared to lending, the risk of losses arising from engagement in securities activities can be limited by restricting the scope, manner and volume of such activities. In addition, depending on specific activity, circumstances and the way the particular activity is organized within the financial institution, certain securities activities can prove to be of less risk than certain lending activities.

As for the forth argument, the issue outlined therein could be resolved by having distinct business lines (one for commercial banking and the other for investment) within the organization and appointing a talent that possesses the necessary qualities and is best positioned for managing that particular business line.

We shall now briefly look into the arguments outlined in the report for repealing the Glass-Steagall Act. The first argument validly recognizes the competitive disadvantages the already heavily regulated depository institutions were facing. The second argument makes it challenging to agree with. Resolving a conflict of interest by separating functions in two distinct subsidiaries is usually not viable, as subsidiaries form part of the same group and operate based on common and often coordinated economic interests. At the same time, separating functions in to different subsidiaries is indeed useful for decreasing risks. The third argument is very straightforward and self-explanatory. The forth argument is evidence-based and convincing. In addition to the four specified arguments the followings could be added:

- Convenience for customers: It would be convenient for customers to receive a diverse set of financial products from the same institution.

- Lack of motivation to form large investment banks in certain markets: In regions with underdeveloped capital markets or limited demand for securities services, there's little incentive to establish and operate large investment banks. It's difficult to envision entities other than commercial banks stepping in to offer these services either directly or through affiliated.

Conclusion

In conclusion, both lending and investment activities may pose dangers for depository institutions, if remain unregulated. At the same time, investment activities inherently carry more risk than the business of lending, therefore the volume of investment activities for such institutions shall be more limited and if the investment activities are carried out through a separate, then the volume concern becomes insignificant. Nevertheless, it is hard to find justifications for introducing a complete ban on affiliation between investment and commercial banking.