

The Demise of The Glass-Steagall Act: Recent Developments in U.S. Banking and Public Policy Issues

1. Introduction

At their 1989 annual meeting in Boca Raton the Securities Industry Association (SIA) - the trade group representing the large Wall Street investment banks - voted to end their opposition to large U.S. commercial banks expanding their securities activities. With this vote, the final nail has probably been placed in the Glass-Steagall Act which has sought to separate US commercial banks from investment banks these last 56 years. In the future the U.S. banking system will increasingly come to resemble the universal banking systems of Switzerland and Germany, as the large money center banks, such as Citicorp, move into new areas of securities dealing and underwriting. In this paper I look briefly at historical developments leading up to the momentous decision of the SIA. This is then followed by an analysis of the public policy issues and concerns that are raised by the erosion of the Glass-Steagall Act, including the international implications of such developments.

2. Historical Background

The history of the U.S. banking system has been one of almost continuous tension between the investment banking industry and commercial banking industry. This tension has been compounded by Federal law that has switched back and forth be-

tween requiring separation and allowing integration i.e., between the traditional "English Model" of separation and the German-Swiss model of universal banking.

Indeed, the first piece of national bank regulation, the National Bank Act of 1864 explicitly sought a separation between investment banking and commercial banking. However, this intent was side tracked by the large commercial banks establishing separately capitalized State Chartered affiliates to undertake investment banking. So successful were these affiliates that by 1927 they were underwriting approximately 30% of all domestic corporate securities issues. In 1927 the McFadden Act passed control of commercial banks' securities activities to the Comptroller of the Currency who decided to formally end the separation. As a result, the share of commercial banks, of total US securities underwriting, dramatically expanded in the two years leading up to the 1929 Crash.

The Crash of 1929 was disastrous for the U.S. banking system leading to 10'000 bank failures, a bank holiday being declared and the ultimate establishment of the FDIC and deposit insurance. In the aftermath of the Great Crash, Congress and regulators sought out a scapegoat to blame for the tumultuous events of 1929-31. Specifically a commission was established (the Pecora Commission) to investigate the causes of the crash. During its hearings a number of serious abuses and conflicts of interest by the large U.S. commercial banks were identified

(especially those by today's Citibank) and the securities activities of commercial banks were singled out as a cause of instability in the financial system and a major cause of the Crash. While today no serious scholar believes this to be true, in the heated atmosphere immediately following the crash this causal factor gained considerable credibility in Congress. Consequently, as a direct result of the Pecora findings, the Glass-Steagall Act of 1933 was passed. The 4 main clauses of the Act are shown in Table 1.

As can be seen the Act was very restrictive prohibiting all securities underwriting and dealing by banks with the explicit exceptions of: (i) government securities, (ii) general obligation municipal bonds, (iii) private placements and (iv) real estate loans. Thus it returned the US to the separation model. For the first thirty years, until 1963, commercial

banks appeared willing to abide by the general spirit of the Glass-Steagall Act. However, beginning in that year they began challenging the Glass-Steagall Act by undertaking securities activities where the laws interpretation was "grey" or vague. Consequently, the last 26 years has been littered with cases of commercial banks undertaking securities-type activities and being challenged in Court, by the S.I.A., as being contrary to Glass-Steagall. These activities have included: municipal revenue bond underwriting, commercial paper underwriting, discount brokerage, advising open and closed-end Mutual Funds, underwriting mortgage backed securities and managing corporate and individual pension plans.

By 1987 this defacto or homemade deregulation, by the commercial banks, had gone so far that the Federal Reserve allowed large US money center

Table 1: Exempts From Banking Act of 1933 Relating to Securities Activities.

Section 16:

The business of dealing in securities and stock by the (national) association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issues of securities or stock: Provided (specifies securities qualified for the association's own investment account) ... The limitations and restriction herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to (specifies securities exempted) (Section 5 extends these restrictions to Federal Reserve member banks.)

Section 20:

No member bank shall be affiliated in any manner ... with any corporation, association, business trust, or other similar organization engaged principally in the issue, floatation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities.

Section 21:

It shall be unlawful ... for any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stock, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business or receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt or upon request of the depositor.

Section 32:

No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities shall serve the same time as an officer, director, or employee of any member bank except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service by general regulations when in the judgement of said Board it would not unduly influence the investment policies of such member bank of the advice it gives its customers regarding investments.

banks to establish separate affiliates in which to collect together all their Commercial paper, Municipal Revenue Bond and Mortgage Backed Securities (MBS) investment banking activities. To limit the applicability of Section 20 of the Glass-Steagall Act (see Table 1) that restricts commercial-investment bank affiliations, the scale of these activities were capped by a revenue restriction. Specifically, the three activities (commercial paper, municipal revenue bonds and MBS) can account for no more than 10% of the affiliates revenues.

In January 1989 the list of permitted activities of Commercial banks securities affiliates was expanded to include corporate bond underwriting (with J.P. Morgan being the first US commercial bank for 56 years to underwrite a domestic bond issue) and in 1990 a decision will be made on Corporate equities underwriting. Thus history has almost come full circle back to 1927 again.

Because of these dramatic developments a number of public policy issues and concerns have been raised. These include: (i) the safety and soundness of the U.S. banking system, (ii) conflicts of interest that may arise, (iii) the effects on domestic financial service competition, (iv) who should regulate a bank's securities activities, (v) the scope and access to deposit insurance and the "Federal Safety Net" and (vi) international competition.

These issues and concerns are analyzed in the next section of the paper.

3. Public Policy Issues and Concerns

3.1. Safety and Soundness Issues

With respect to banks securities underwriting two questions arise: (i) how risky is underwriting relative to traditional banking activities and (ii) if the investment banking affiliate gets into trouble (makes losses) will it bring the bank down? The latter is of particular concern to the FDIC since it insures a significant proportion of deposits.

As to the first question, whether underwriting is more risky than lending, both evidence and theory

are unclear. The major risk of underwriting is taking a "big hit" due to "over-pricing" an issue. By comparison, a bank that originates and holds loans to maturity, faces a large potential downside default risk (loss of principal plus interest) in return for a limited upside return - repayment of principal plus interest. Thus, it is likely that many banks, with loan portfolios heavily invested in LDC loans, farm loans and oil and gas loans, would view bank lending as far more risky than securities underwriting.

Notwithstanding the above, the second issue concerns the fear that a separately capitalized bank might be adversely impacted if its securities affiliate takes a "big hit" or loss from underwriting? At least two possible mechanisms exist, one direct the other indirect that could threaten the bank. The direct mechanism is when the bank is induced to make additional loans to the failing affiliate to keep it afloat. This would only serve to weaken the bank at the expense of the securities affiliate. A second, indirect mechanism, is that holding company management may have an incentive to "upstream" funds from the bank to the holding company, via excess dividend payments and fees, and "downstream" these funds as a capital infusion into the failing securities affiliate. This would serve to weaken the bank by draining it of earnings and capital.

Of course, regulators are aware that such potential conflicts already exist, among banks and their holding company affiliates (consumer finance, leasing etc.). Consequently, Section 23A of the Federal Reserve Act limits loans by a bank to any single affiliate to 10% of bank capital and to all affiliates (collectively) to 20% of capital. While Section 23B limits the ability of the holding company to upstream funds, through excessive fees and dividends. The problem, however, is that the penalties for violation of such restrictions are unclear. That is, without criminal or civil penalties there may be no incentive for managers and directors to avoid violating these regulations when things get tight. An excellent example of the incentives to overlook regulations was the Continental Illinois - First Options Inc., case. When faced with the potential failure of

its First Options subsidiary following the 1987 crash Continental Illinois violated its 23A type agreements with the Comptroller of the Currency [1]. This suggests that in any future legislation the safety of the bank may only be fully secured by making Section 23A and 23B type restrictions incentive compatible. This might require very strict civil and/or criminal penalties on managers and directors who are found to have violated such regulations.

A third potential risk to a bank from a securities affiliate failure (and vice-versa to the securities affiliate from a bank failure) comes from adverse information contagion effects. Suppose that there are virtually no direct transactional relationships (e.g., loans) among the bank and its securities affiliate. However, suppose both shared a similar corporate name or logo e.g., Citybank and City Investment bank (fictitious names). Suppose that huge losses were announced in the press for City Investment Bank. Would these losses lead to a decline in confidence, among large (uninsured) depositors, regarding the safety of Citybank and would this lead them to engage in a run on the bank's deposits? Or would it, at the very least, lead to major reassessment of the quality of Citybank's management and an increase in the required risk premiums on Citybank's debt and equity? Note also that a reverse example of this contagion effect is also potentially possible. For example, financial problems (loan losses) or runs at the bank may create adverse information leading customers and investors of the securities affiliate to revise downward their expectations regarding its management's quality and reputation. In such cases customers may have incentives to shift their securities business elsewhere. To date there is little evidence regarding the potential size of, or risk of, inter-affiliate contagion effects. Perhaps the best known and most quoted case of such a contagion is that of the Beverly Hills Bank and its real-estate investment trust (REIT) affiliate in the 1970's. Problems at the REIT were extensively publicized in the Southern California media. This, created a minor panic among the bank's depositors and to a decline of approxi-

mately 15% in its deposits. Eventually the bank was taken over by Wells Fargo.

However, it is not clear how destabilizing or important inter-affiliate contagions would be in a macro-sense. The most likely effect would be to cause a flight to quality, from problem organizations to organizations perceived to be safe, with perhaps marginal effects on interest rate levels in the form of higher risk premiums being demanded on loans to lower quality securities affiliates or on deposits to lower quality banks. This unsystematic inter-affiliate informational contagion problem should be clearly distinguished from any potential problems resulting from systematic runs and failures e.g. where the failure of one bank or banking organization leads to a crisis of depositor and investor confidence in all other banking organizations, and eventually, to a general financial panic that encompasses all financial markets.

One possible solution to the inter-affiliate informational contagion effect would be to require the bank and its securities affiliate to use separate corporate names or logos (e.g. Citybank and Town Investment bank). However, commercial bankers believe that such a move would place them at a severe marketing disadvantage compared to existing investment banks as well as for smaller commercial bank affiliates seeking to compete with larger commercial bank affiliates (since only the latter's names or logos are likely to be widely known among investors).

Finally, while the above analysis has concentrated on increased (safety and soundness) risk aspects from securities firm-bank affiliations, there are also some potential risk reducing aspects to consider. Indeed, allowing banking organizations to move into securities activities creates a potential opportunity for them to diversify their business risk. The gains from such diversification, and the potentially enhanced earnings stability of the banking organization, depend on the correlation of earnings among securities activities and banking activities. This of course assumes that a more stable holding company is a "source of strength" to the bank subsidiary. Some quite important evidence suggests that such

activities may have low (or even negative) correlations and thus provide good opportunities for diversification (see SAUNDERS, 1985a and EISENBEIS/WALL, 1984). For example, the recent growth of the commercial paper market from \$187 billion in December 1983 to \$418 billion in June 1988 (or by 223%) has occurred at a time of comparatively slow growth in business loans. Thus these potential product diversification benefits need to be offset against any potential risk increasing costs.

3.2. Conflicts of Interest Issues

A second major issue regarding the extension of banks underwriting powers is the potential for new and more formidable conflicts of interest. These potential conflicts have been extensively documented by SAUNDERS (1985b) and are those that were raised in the Pecora hearings preceding Glass-Steagall and/or have been raised since by securities firms opposing the expansion of bank securities activities into areas such as mutual funds, etc. Potential conflicts include (i) the ability of a bank to tie customers to its affiliate by using its lending powers (such as credit rationing) as a lever, (ii) exploiting information advantages (and ignoring "Chinese" walls) in acting as both a lender and underwriter (iii) giving biased advice in financing decisions, (iv) using bank loans to support or rig the price of a new issue and (v) dumping "bad" issues in those trust accounts where the bank has strong discretionary investment powers [2]. While such potential conflicts have been frequently touted the question remains as to when or if a potential conflict becomes an actual (exploited) conflict?

There are at least three important safeguards limiting banks incentives to exploit potential conflicts of interest. These are information availability, market competition and bank reputation. The ability to exploit a conflict of interest depends heavily on the degree of information imperfection among contracting parties. For example, dumping securities in bank trust departments is infeasible if trust owners actively monitor and receive information about the

structure and performance of their bank-managed funds. The more efficient or perfect information flows are in securities markets, in terms of making more information publicly available at lower cost, the smaller the potential for banks to profitably exploit conflicts of interest. In reducing information imperfections technology has a very important role to play. For example, the SEC's information system EDGAR (Electronic Data Gathering and Retrieval System), put into effect in 1985, requiring companies to file quarterly and annual reports electronically, with terminal access by investors to such files, increases the timeliness of information diffusion for large investors. Admittedly, small investors or trustees may gain little from such technological innovations. Moreover, since information production is costly for firms the SEC has recently proposed reducing disclosure requirements. Such a move would clearly make monitoring more costly and difficult.

The second control over potential conflicts of interest is the degree of market competition. Thus, for example, a bank would be unable to successfully use its credit granting powers to tie a customer to the underwriting services of its affiliate if the loan market is highly competitive [3]. In such a case a credit rationed borrower would simply switch business to another bank.

The third control is the value of reputation as a business "asset". As the recent tribulations of the Chicago Futures Exchanges, BCCI and Drexel Burnham suggest any questions, or adverse publicity, regarding conflicts of interest do severe harm to the future business prospects of a bank or a securities firm. Indeed, it is hard to believe ex-post that any one time profits earned from adversely exploiting existing business relationships could ever outweigh the future costs of lost reputation resulting from discovery and prosecution. Of course, from an ex-ante, or before the act, perspective the potential conflict exploiter (rule violator) would weigh the expected probability of getting caught from violating explicit or implicit rules (and Chinese walls). Thus for reputational effects to matter (or be effective) as conflict controls it is important for regula-

tors to be stringent in their monitoring and enforcement actions. As long as the expected cost of reputation loss are high, the market for bank products remains competitive and the quality, access, and amount of information being disseminated increases, systematic bank exploitation of potential conflicts of interest due to increased underwriting powers remains problematic. However, if information dissemination should weaken and regulators fail to actively monitor and punish rule violators conflict of interest concerns will continue to influence the debate regarding banks' permitted securities activities.

3.3. Domestic Competition

An important argument made in favor of allowing banks to underwrite corporate securities is the potential pro-competitive effect it will have on the cost of raising new equity. For example, allowing banks into discount brokerage has clearly eaten into the ability of full service brokers to charge excessive (oligopolistic) commissions beyond the elimination of fixed commissions [4].

The pro-competitive effects on the cost of equity relate both to the geographic distribution and ownership of capital and the cost of new issues. Geographic distribution and ownership concerns relate to the fact that most existing investment banks have a large proportion of their resources located in the North East. Thus many small firms that might potentially come to the market (say in the mid-west), to raise new equity capital tend to get overlooked - resulting in a regional misallocation of capital (see H. STOLL, 1984). It is argued that banks, because of their larger size and wider regional coverage, either through branching, subsidiaries or correspondents, would use their regional knowledge and resources to make it easier for smaller firms to gain access to national capital markets. Moreover, they would have the regional distribution networks to feed and attract a wider array of new investors to IPO's. This would serve both to even out any regional misallocation of capital (i.e.

equating regional costs of capital) as well as potentially expanding the size of the securities market and improving its liquidity. That is, bank underwriting could help expand capital formation rather than simply competing with investment bankers to underwrite the issues of existing firms.

The cost of new issues argument relates to the "high" costs of new issues for firms. These costs comprise two parts (i) the degree of "underpricing" of new issues (initial public offerings or IPO's) and (ii) the spread, fees and commissions charged by underwriters to bring a new issue to market. Extensive evidence exists which shows that new equity issues in the U.S. are significantly underpriced. These studies show that new issues have been underpriced on average [5] over all periods of the market cycle (bull versus bear or "hot" versus "cold") and adjusting for either market risk or systematic (beta) risk. Specifically, the "offer" price at which the investment banker sells an IPO to the market (which, in turn, is above the bid price actually received by the issuer) is usually between 5% and 48% below the price that is observed during the first week (or first day) in which the stock trades (see the review by LIM/SAUNDERS, 1990). This implies that on average issuers get less capital per share than is implied by the market valuation of the stock when the issue starts trading. It could be argued that in the absence of competition an underwriter will always have an incentive to underprice since it increases the probability that he will be able to sell-out the whole issue to outside investors and therefore earn his maximum return on the issue (the bid-offer spread times the number of shares plus fees and commissions). If banks were to be allowed to underwrite it should have the potentially pro-competitive effect of reducing the average degree of underpricing (thereby leaving more money on "the table" for small issuing firms) as well as narrowing the spread between the bid and offer prices.

In a recent paper TINIC (1988) presented evidence that showed that the degree of underpricing of new equity issues prior to 1929 was less than in a period

after 1934 (this was a period in the 1960's and 1970's). TINIC attributes this lower degree of underpricing pre-1929 to the absence of a fear of "due diligence suits" from investors. Such fears only arose with the passage of the Securities Acts of 1933 and 1934 and the establishment of the SEC. However, the evidence of a lower degree of underpricing pre-1929 is also consistent with the competition hypothesis since in the 1927-1929 period constraints on commercial bank-investment bank competition for securities underwriting were lifted (i.e. this period pre-dates Glass-Steagall) [6].

3.4. Who Should Regulate?

A further public policy concern is who should regulate a banking organization with expanded securities powers. Should the Federal Reserve, the current regulator of bank holding companies, be the only regulator examining the securities arm of the holding company, or, should regulation and examination be shared with the SEC. That is, should the SEC have (predominant) regulatory and examination powers over the securities affiliate with the Fed Reserve having regulatory primacy over the rest of the holding company including the bank? The advantage of having just one regulator, such as the Federal Reserve, is that it may be better able to monitor potential conflicts of interest within the holding company - especially between the bank and its securities affiliate. On the other hand, bank examiners are poorly trained in securities laws and may not have a full grasp of securities regulations. Perhaps a better alternative would be to give the SEC primary regulatory powers over the securities affiliate and the Federal Reserve over the rest of the holding company but with a strong degree of coordination among examiners and regulators. Such coordination is already in existence, among bank regulators such as the Comptroller of the Currency, the Federal Reserve and the FDIC through the Federal Financial Institutions Examination Council (FFIEC). It might be noted that among the Group of 10 countries (G-10) [7] it is quite common for a

single supervisor to be responsible for both banking and securities firms. Thus in Belgium, France, Germany, Sweden and Switzerland the primary regulator is a bank commission while in Italy and the Netherlands it is a Central Bank. In the U.K., Canada and Japan there is less supervisory integration. In the U.K., the Bank of England regulates banks while the Securities and Investments Board (SIB) is primarily responsible for securities firm regulation. In Japan separate departments of the Ministry of Finance oversee bank and securities firm activities. In Canada, bank owned securities subsidiaries are regulated by provincial securities authorities. Thus, in general, internationally there appears to be the belief that coordination is best achieved by a high degree of concentration of supervisory authority and relatively limited functional regulation (i.e. a low degree of separation between security activity regulators and bank activity regulators).

3.5. The Federal Safety Net and its Limits

The Federal Safety net encompasses access to deposit insurance and the Federal Reserve's discount window. Should a securities affiliate of a bank fail and endanger the solvency of the banking organization either the Federal Reserve or the FDIC may feel compelled to intervene and extend the safety net (e.g., cheap discount window loans or liability guarantees) to the securities affiliate. This results in, perhaps, an unwelcome and undesirable extension of the limits and boundaries of the safety net and raises important competitive equity issues. Specifically, should this safety net then be extended to all (non-bank affiliated) securities firms or even to all financial firms? If it is not, does this give bank securities affiliates a built in competitive advantage. There is no easy answer to this question. Either banks and their services are unique or special (e.g., the payments systems and lending) in which case this specialness might best be preserved by severely limiting their non-bank activities, or else their specialness or uniqueness is small - in which case it is

difficult to justify special safety net subsidies for this group of institutions. Unfortunately there is wide disagreement among both academics and regulators as to the degree of bank uniqueness. Finally, although not explicitly discussed, it is generally believed that the Swiss and German Central banks stand ready to support their large bank institutions. Since these banks are universal banks it implies the extension of the safety-net in these countries not only to securities activities but also to their real sector (commercial) activities. This again raises the issue of a level playing field for international financial services.

3.6. International Competitive Considerations

The Glass-Steagall Act only defines the permitted securities activities of banks domestically. By going abroad and establishing separately capitalized affiliates, US banking organizations make themselves subject to the securities and banking laws of the sovereign state in which the subsidiary is located. In general the financial systems of the G-10 countries can be broken down into universal banking systems: such as France, Germany, Italy, Netherlands and Switzerland in which bank and securities activities take place under one roof (and there is a high degree of integration of these activities) and "blended" systems in which securities activities are carried out by a separate subsidiary of the bank (rather than the holding company as in the U.S.). Even in blended systems such as the U.K., Belgium, Canada and Sweden there is a high degree of integration within the corporate whole - specifically there is an absence of 23A and 23B type restrictions on inter-affiliate loan transactions and cross-selling. As a result the U.S. (due to Glass-Steagall) and Japan (due to Article 65) have traditionally had the greatest bank-securities activities separation in their financial systems [8]. US commercial banks' international securities activities have certainly been enhanced by exploiting more liberal laws on bank-securities firm affiliations abroad. Thus the "Big Bang" in the U.K., in

October 1986, not only eliminated fixed commissions and single capacity dealing (i.e separation between brokers and jobbers) but more importantly allowed U.S. banking firms to own up to 100% of British securities firms (in the run-up to the big bang the maximum ownership share was limited to 29.9%). As indicative of the effects of the big-bang, consider the bank, securities and insurance activities of Citicorp in the U.K. Specifically, Citicorp bought two leading stockbrokers: Scrimgeour Kemp-Gee and Vickers da Costa. The latter firm already had access to a seat on the Tokyo Stock Exchange thereby giving Citibank indirect access (via London) to that market. Citicorp was appointed as one of the 29 market-makers in the new gilt-edged (government) securities market - a power recently relinquished due to losses. It also gained a specialist money market "discount house" - Secombe, Marshall and Campion, a 40 branch retail banking network, and two credit card schemes (run jointly with National Westminster and the department store Marks and Spencer). In addition it owns a general insurance company - Citibank General Insurance - and Brandt's an insurance broker. These activities are then linked globally via Citicorp's two satellites and its "global" telecommunications network to offices in over 80 countries including its head office in New York.

On the face of it US banking organizations also appear to have had greater access to Japanese securities markets than domestically. In particular, while large Japanese City bank securities activities are limited by "Article 65", the Japanese equivalent of the Glass-Steagall Act (and modeled on the US legislation), US bank holding companies have been allowed to establish a presence on the Tokyo Stock Exchange through special purpose companies such as 50% owned affiliates (joint ventures) or nonbank banks. Moreover, a number of foreign and US banks have been granted Trust banking licenses, a \$177 billion portfolio management activity (as of March 1988) prohibited to the Japanese City banks [9].

Despite their greater access to international securities markets, the importance of U.S. commercial

banks (measured globally) continues to decline. For example, in 1969 U.S. banks had 33.5% of the assets of the 100 largest banking organizations (measured by asset size) in the world compared to 17.1% for Japanese banks. In 1986, the comparative figures [10] were 12.0% US and 39.7% Japan with the top four size slots being taken by Japanese City banks [11]. While four very important reasons for this are the appreciation in the yen to dollar exchange rate over the period, the growth in Japanese international trade, the absence of inter-state type branching restrictions in Japan and the lower capital requirements imposed on Japanese banks, a further possible reason is that Glass-Steagall at home has constrained US banks' ability to compete abroad. Since expertise and knowledge plays an important role in providing a high quality of investment banking service, this knowledge and skill has been severely limited by Glass-Steagall restrictions. Thus eliminating Glass-Steagall at home should give U.S. banks an additional competitive push abroad and possibly allow them to recapture some market share.

4. Summary and Conclusions

This paper has documented the demise of the Glass-Steagall Act in the U.S. and the six major public policy concerns that this has aroused. The major advantages of a "universal" type U.S. banking system is that it should provide greater access to domestic securities markets for smaller firms and allow U.S. banks to compete more effectively overseas - especially against other universal banks. Against these potential benefits have to be set the fear that new and more serious conflicts of interest will arise, and the banking system might become more unstable with renewed threats to the deposit insurance system. However, if the experience of Germany and Switzerland with universal banking are models for the future, U.S. bank regulators have little to fear.

Footnotes

- [1] In actual fact, First Options was a subsidiary of the bank rather than the holding company.
- [2] It is also arguable that existing investment banks face an analogous set of potential conflicts. For example, an investment bank tying its customers to its trading systems by its provision of custody and stock-loan business.
- [3] For example, Japanese banks have a significant cost of funds advantage relative to domestic banks. Moreover, such borrowers usually have ready access to the commercial paper market.
- [4] While a number of independent discount brokers did enter the brokerage market after 1975, they were generally poorly capitalized and relatively small. It was Bank America's acquisition of Schwab and the wave of bank discount brokerage services that followed which really affected full service broker's profitability (see SAUNDERS/SMIRLOCK, 1987).
- [5] While it is true that some IPO's fall in price after issue the evidence shows that on average underpricing dominates.
- [6] Of course competition should also work to reduce the cost of issuing seasoned (or secondary public offerings) as well as increasing the rate of innovation (or packaging) of security offerings whether equity or debt. However, there is a significant body of research, which argues that underpricing is due to information imperfections rather than competitive reasons.
- [7] The G-10 countries in fact includes 11 countries: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.
- [8] Although it should be noted that Article 65 was directly modeled on Glass-Steagall during the period of post-World War II reconstruction.
- [9] However, it is now proposed that Japanese banks should be allowed to enter this market through affiliates (see, *The Economist*, February 4, 1989).
- [10] Source: *The Banker*.
- [11] It is also unclear that large size of assets is strongly correlated with high return on capital or assets. Indeed, empirical evidence on economies of scale and scope in banking (such as MESTER, 1987) show little support for the existence of such effects in the U.S.

References

- EISENBEIS, R. and L.D. WALL (1984): "Risk Considerations in Deregulating Bank Activities", *FRB of Atlanta, Economic Review*, May, pp. 6-19.

- LIM, J. and A. SAUNDERS (1990): "The Underpricing of IPO's in Singapore: Public Policy Issues and Possible Solutions", forthcoming, *Journal of Banking and Finance*.
- MESTER, L. (1987): "Efficient Production of Financial Services: Scale and Scope Economies", *FRB of Philadelphia Review*, Jan/Feb, pp. 15-25.
- SAUNDERS, A. (1985a): "Bank Safety and Soundness and the Risks of Corporate Securities Activities", in I. Walter (ed): *Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market*, John Wiley and Sons New York.
- SAUNDERS, A. (1985b): "Conflicts of Interest: An Economic View", in I. Walter (ed): *Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market*, John Wiley and Sons New York.
- SAUNDERS, A. und M. SMIRLOCK (1987): "Intra- and Interindustry Effects of Bank Securities Market Activities: The Case of Discount Brokerage", *Journal of Financial and Quantitative Analysis*, Vol 22, Nr 4, pp. 467-482.
- STOLL, H. (1984): "Small Firms Access to Public Equity Financing", in: *Sources of Financing for Small Business*, (pt. B), P. Horvitz and R.R. Pettit (ed), Greenwich, Conn: JAI Press.
- TINIC, S.M. (1988): "Anatomy of IPO's of Common Stock", *Journal of Finance*, pp. 789-822.