# A Public Choice Perspective of the Banking Act of 1933

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Against a background of an unprecedented number of commercial bank failures, the Banking Act of 1933 laid out the basic framework of modern banking regulation in the United States. Among its other provisions, the legislation established federal deposit insurance, reaffirmed the restrictions on branch banking imposed in 1927 by the McFadden Act, authorized the Federal Reserve to set ceilings on the interest rates payable on savings and time deposits at member banks, and prohibited the payment of interest on demand deposits. The Banking Act of 1933 also contained four provisions, commonly referred to as the Glass-Steagall Act, that effectively separated commercial and investment banking in the United States.[1] This was accomplished by prohibiting banks from engaging in the activities of underwriting, promoting, or selling securities either directly or through an affiliated brokerage firm. For their part, securities dealers were precluded from engaging in the business of deposit banking.

The Glass-Steagall Act is typically viewed as a public-spirited attempt by Congress to protect depositors against several problems alleged to arise when the activities of commercial and investment banking are combined. It is suggested that commercial bank security

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[1] I am well aware that the names of Glass and Steagall are more properly associated with legislation enacted in 1932 that allowed the Federal Reserve to use U.S. government securities as collateral for note issues. However, because "Glass-Steagall Act" is widely used in the literature to refer to the 1933 act, I have chosen to perpetuate the error in this paper.

holdings raise concerns about the liquidity and, hence, soundness of banks' asset portfolios. This is because the relatively long terms to maturity of marketable securities may not match up well with the short-term nature of banks' deposit liabilities. Moreover, security holdings make banks' asset portfolios vulnerable to unanticipated capital losses caused by fluctuating market securities prices.

In addition, combining commercial and investment banking activities is thought to create a conflict of interest that may increase the riskiness of banks' loan portfolios. Of particular concern is that banks will make loans on preferential terms to customers who purchase securities underwritten by the bank or that such securities will be accepted as collateral for loans. In short, if banks both purchase securities for their own accounts and make loans to customers who use securities underwritten by banks as collateral, a downturn in the securities market will simultaneously lower the value of banks' asset portfolios and increase the likelihood of default on their loan portfolios. If a deposit outflow occurs at the same time, the banking system's ability to meet the cash demands of its customers will be impaired. This vulnerability to failure is thought to be greater for a combined commercial-investment banking system than for a system in which the two activities are kept separate.

Indeed, a large measure of the blame for the banking crisis of late 1932 and early 1933 was placed on the then fairly common practice of commercial banks underwriting the sale of securities through their bond departments or through separate but affiliated securities firms. Hearings on the bill that would eventually be enacted in 1933 produced testimony on a wide variety of abuses in the securities activities of commercial banks, including insider trading and outright fraud.[2] Senator Glass himself went so far as to claim that the activities of the securities affiliates of commercial banks were a major cause of the Great Depression: "These affiliates, I repeat, were the most unscrupulous contributors, next to the debauch of the New York Stock Exchange, to the financial catastrophe which visited this country and was mainly responsible for the depression under which we have been suffering since" (Kelly 1985, p. 53).

The public-interest explanation for the Glass-Steagall Act suggests that the members of the 73d Congress, which convened in March 1933, successfully set aside political considerations to impose a series

[2]Many of these horror stories surfaced during hearings before the Senate Banking and Commerce Committee (often referred to as the Pecora hearings, after the committee's counsel, Ferdinand Pecora). See Kennedy (1973, pp. 108–28) for a description of the practices of one of the committee's main targets, National City Bank and its securities affiliate, National City Company.

of regulations that would restore safety and soundness to a banking system badly battered by the great crash and ensuing depression. In particular, the formal separation of commercial and investment banking required by the Glass-Steagall Act protected depositors by removing a risky asset from banks' portfolios and by eliminating the conflict of interest between the business of accepting deposits and making loans on the one hand and that of underwriting securities on the other.

The remainder of this paper examines these arguments in more detail. First, some historical background is provided through discussions of the growth of commercial banks' securities activities prior to 1933, the role of securities activities, if any, in precipitating the banking panic of 1929–33, and the main events in the legislative debate on the Glass-Steagall Act. Then comes a summary of the available evidence supporting an alternative, private-interest explanation for the legislation that separated commercial and investment banking. After that, some concluding remarks are presented.

## Historical Background

Alleged securities market abuses by commercial banks and their affiliated brokerage firms played a large role in creating an environment conducive to the regulation of investment banking in the United States. The following is a brief review of the events leading up to the enactment in June 1933 of the bill cosponsored by Senator Glass and Representative Steagall.

### *Commercial Bank Securities Activities before 1933*

The involvement of commercial banks in the securities business predates the 1920s. Indeed, one of the principal motives behind the establishment of a federal chartering option for banks by the National Banking Act (1863) was to create a convenient outlet for U.S. government securities by allowing member banks to issue notes (currency) against collateral in the form of Treasury bonds. These activities expanded rapidly during World War I and the years immediately thereafter when a large number of banks participated heavily in the distribution of Liberty Bonds issued to finance the war effort (Flannery 1985, pp. 67–68).

Although national banks were encouraged to deal in U.S. government securities, they were prohibited from underwriting corporate securities prior to the McFadden Act (1927). Many of the larger commercial banks were able to avoid this restriction, however, by establishing separate but affiliated securities firms to apply to private

securities issues the experience they had gained in purchasing and selling Treasury bonds.[3] The creation of these securities affiliates boosted the involvement of commercial banks in the underwriting business during the 1920s, but the fact that federal regulations continued to restrict national banks from participating directly in such activities raised concerns about the banks' ability to compete effectively with state-chartered institutions that were not so constrained. These concerns were given weight by the development of a trend in which member banks either established state-chartered affiliated banks to deal in corporate securities or simply dropped out of the Federal Reserve System. The McFadden Act attempted to arrest this trend by "reaffirming" the authority of member banks to underwrite certain corporate securities. National banks' underwriting activities were limited initially by the Comptroller of the Currency to debt securities, but were later expanded to include certain equities as well (Flannery 1985, p. 68; Kelly 1985, pp. 42–43).

The establishment of securities affiliates and the lifting of some of the federal restrictions on underwriting activities by the McFadden Act enabled commercial banks to become prominent actors in the securities business by the end of the 1920s. In 1929, for example, 459 U.S. banks were underwriting securities directly through their bond departments and an additional 132 were sponsoring securities issues through an affiliate (Flannery 1985, p. 68). (See Table 1 for data on the growth of commercial banks' securities activities beginning in 1922.) By 1930, commercial banks were underwriting 54.4 percent of all new securities issues (Kennedy 1973, p. 212).

The increased involvement of commercial banks in underwriting activities was reflected to an extent in their own securities holdings. Table 2 reports on the composition of banks' securities portfolios from 1920 to 1933, showing a slight trend during the period toward larger holdings of "other" securities—obligations of domestic corporations, those issued by government agencies but not guaranteed by the United States, and foreign securities. Securities holdings were somewhat more important to member institutions of the Federal Reserve System. By the end of 1933, for instance, U.S. government bonds and other securities accounted for 21.41 percent and 15.5 percent, respectively, of member banks' total assets (Flannery 1985, p. 73).

[3]The owners of the bank and the securities affiliate were often the same. Kennedy (1973, p. 111) notes that the stock of National City Company was printed on the opposite side of the shares of its parent, National City Bank.

*TABLE 1*

SECURITIES ACTIVITIES OF NATIONAL AND STATE BANKS, 1922–33

| | National Banks | | State Banks | | |
|---|---|---|---|---|---|
| Year | Directly Engaged in Securities Business | Operating Securities Affiliates | Directly Engaged in Securities Business | Operating Securities Affiliates | Total |
| 1922 | 62 | 10 | 197 | 8 | 277 |
| 1923 | 78 | 17 | 210 | 9 | 314 |
| 1924 | 97 | 26 | 236 | 13 | 372 |
| 1925 | 112 | 33 | 254 | 14 | 413 |
| 1926 | 128 | 45 | 274 | 17 | 464 |
| 1927 | 121 | 60 | 290 | 22 | 493 |
| 1928 | 150 | 69 | 310 | 32 | 561 |
| 1929 | 151 | 84 | 308 | 48 | 591 |
| 1930 | 126 | 105 | 260 | 75 | 566 |
| 1931 | 123 | 114 | 230 | 58 | 525 |
| 1932 | 109 | 104 | 209 | 53 | 475 |
| 1933 | 102 | 76 | 169 | 32 | 379 |

SOURCE: Peach (1975, p. 83).

*Securities Affiliates and the Panic of 1929–33*

The panic that swept the U.S. banking system following the stock market crash of October 1929 is well documented.[4] From 1929 through 1933, nearly 10,000 banks failed as depositors and bank owner-managers scrambled for liquidity; 4,000 banks closed their doors in 1933 alone. Considered in context, however, depositor losses were not of sufficient magnitude to threaten the survival of the entire commercial banking industry. Mergers and other forms of reorganization transferred the deposit liabilities of many failed banks to institutions on sounder footing. When this was not possible, depositors received some compensation from the liquidation of bank assets. Even at the height of the panic, therefore, only a little more than 2 percent of total commercial bank deposits were irretrievably lost. (Details concerning the effects of the crisis on banks and depositors are shown in Table 3.)

Hardest hit were small, state-chartered banks located away from major financial centers. Eighty-eight percent of the banks that suspended operations between 1921 and 1929, for example, had capital

[4]See, especially, Friedman and Schwartz (1963, pp. 299–419).

*TABLE 2*

SECURITIES HOLDINGS OF COMMERCIAL BANKS AS PERCENTAGE OF TOTAL ASSETS, 1920–33

| Year | U.S. Government Obligations | Obligations of State and Local Governments | Other Securities[a] |
|---|---|---|---|
| 1920 | 7.66 | 1.99 | 8.03 |
| 1921 | 7.47 | 2.39 | 9.29 |
| 1922 | 8.72 | 2.60 | 9.90 |
| 1923 | 9.73 | 2.50 | 9.59 |
| 1924 | 8.50 | 2.76 | 10.05 |
| 1925 | 8.19 | 2.81 | 10.61 |
| 1926 | 7.77 | 3.03 | 10.72 |
| 1927 | 7.62 | 3.24 | 11.46 |
| 1928 | 8.01 | 3.25 | 12.24 |
| 1929 | 7.80 | 3.13 | 10.98 |
| 1930 | 7.60 | 3.29 | 11.55 |
| 1931 | 10.19 | 4.12 | 12.27 |
| 1932 | 13.50 | 4.97 | 12.37 |
| 1933 | 18.50 | 5.60 | 10.65 |

[a]Includes obligations of domestic corporations, those of government agencies not guaranteed by the United States, and foreign securities.
SOURCE: U.S. Department of Commerce (1975, p. 1021).

of less than $100,000 (Kelly 1985, p. 44).[5] This is the pattern that continued into the 1930s. The institutions that failed over the next four years were similarly smaller, on average, than those banks able to weather the storm (see Table 4).

What role did the securities activities of commercial banks play in the crisis of 1929–33? Although a definitive answer to this question is not possible, most of the available evidence points to the conclusion that factors other than securities dealings were more important in explaining the wave of bank failures that followed the crash. Despite the fact that congressional hearings on the subject generated much rhetoric on the harm to the safety and soundness of commercial banks allegedly caused by their investment banking activities, securities affiliates were identified as a proximate cause of failure only in the case of the Bank of the United States (Flannery 1985, p. 75). More-

[5]Burns (1974, p. 5) reports that over half the banks that failed between 1921 and 1929 were located in communities with populations of 2,500 or less and that more than 50 percent of the failures occurred in banks each having a capital stock of not more than $25,000.

*TABLE 3*

BANK SUSPENSIONS, 1921–33

| | Banks | | Deposits | | Depositors | |
|---|---|---|---|---|---|---|
| Year | No. of Suspensions | Failed Banks as Percent of All Banks | Deposits of Failed Banks ($ '000) | Deposits of Failed Banks as Percent of All Banks | Losses of Depositors ($ '000) | Losses of Depositors per $100 of All Banks' Deposits |
| 1921 | 506 | 1.16 | 172,806 | 0.62 | 59,967 | 0.21 |
| 1922 | 366 | 1.15 | 91,182 | 0.30 | 38,223 | 0.13 |
| 1923 | 646 | 2.10 | 149,601 | 0.46 | 62,142 | 0.19 |
| 1924 | 775 | 2.58 | 210,150 | 0.61 | 79,381 | 0.23 |
| 1925 | 617 | 2.08 | 166,937 | 0.44 | 60,799 | 0.16 |
| 1926 | 975 | 3.28 | 260,153 | 0.66 | 83,066 | 0.21 |
| 1927 | 669 | 2.39 | 199,332 | 0.49 | 60,681 | 0.15 |
| 1928 | 498 | 1.84 | 142,386 | 0.34 | 43,813 | 0.10 |
| 1929 | 659 | 2.47 | 230,643 | 0.54 | 76,659 | 0.18 |
| 1930 | 1,350 | 5.29 | 837,096 | 2.01 | 237,359 | 0.57 |
| 1931 | 2,293 | 9.87 | 1,690,232 | 4.42 | 390,476 | 1.01 |
| 1932 | 1,453 | 6.94 | 706,187 | 2.43 | 168,302 | 0.57 |
| 1933 | 4,000 | 20.53 | 3,596,708 | 14.23 | 540,396 | 2.15 |

SOURCES: Flannery (1985, p. 77) and Friedman and Schwartz (1963, p. 438).

*TABLE 4*

AVERAGE SIZE OF FAILED BANKS VERSUS SURVIVING BANKS, 1929–33

| | Deposits per Bank ($ '000) | |
|---|---|---|
| Year | Failed Banks | All Banks |
| 1929 | 349.99 | 1,977.77 |
| 1930 | 620.07 | 2,165.08 |
| 1931 | 737.13 | 2,183.29 |
| 1932 | 486.60 | 1,903.38 |
| 1933 | 899.18 | 2,257.90 |

SOURCES: Friedman and Schwartz (1963, p. 438) and U.S. Department of Commerce (1975, pp. 1021–22).

over, although the collapse of the Bank of the United States in December 1930 was spectacular and contributed greatly to a weakening of public confidence in the banking system, it was due less to the operations of the bank's securities affiliate per se than to inept management and outright fraud (Kennedy 1973, pp. 1–5).

Systematic evidence in this regard has recently been reported by White (1986, p. 40). He notes that while 26.3 percent of all national banks failed between 1930 and 1933, "only 6.5% of the 62 banks which had affiliates in 1929 and 7.6% of the 145 banks which conducted large operations through their bond departments closed their doors." More importantly, using data for 1931, the year when the largest number of banks with securities affiliates failed, White (p. 41) finds that holding other things equal, the presence of an affiliate appears to have reduced the probability of bank failure.

Friedman and Schwartz (1963, p. 354) observe that "if there was any deterioration at all in the ex ante quality of loans and investments of banks, it must have been minor, to judge from the slowness with which it manifested itself." Simply put, banks would have failed at a much higher rate as the economy moved into depression if the composition of the asset and loan portfolios they had built up during the 1920s had been a major contributor to impaired safety and soundness. Further evidence against the culpability of securities affiliates in precipitating the pre-1933 banking crisis is that it was the smaller, rural institutions that accounted for the majority of bank failures throughout the 1920s and early 1930s, and virtually none of these were likely to have been much involved in underwriting activities.

There remains the question of whether the securities affiliates of the larger banks contributed in any way to the collapse of smaller

institutions. In fact, Senator Carter Glass charged that "great banks in the money centers choked the portfolios of their correspondent banks from Maine to California with utterly worthless investment securities" (Flannery 1985, p. 72). "Country" (non money center) banks did indeed hold larger proportions of their assets in the form of private bonds, stocks, and securities than did the average member bank—19.50 percent of total assets at the end of 1929 versus 6.90 percent for banks located in New York City (Flannery 1985, p. 73). There is little to go on in assessing how important the quality (or lack thereof) of these securities was in explaining the failure of the smaller banks, however. A competing explanation deserving of at least as much consideration is that these small, rural banks were hurt severely by the effects of depression on agricultural activity. Falling farm prices caused the default rate on agricultural loans to be sufficiently high that many of these institutions would have failed in any case.

*Legislative History of the Glass-Steagall Act*

The separation of commercial and investment banking in the United States became a public policy issue soon after the October 1929 stock market crash—President Hoover called upon Congress to consider such a measure in his first State of the Union message in December 1929—but it would take almost three years of legislative maneuvering before the Glass-Steagall bill became law. In response to the president's request, the Senate passed a resolution in May 1930 directing the Committee on Banking and Currency to conduct a "complete survey" of the Federal Reserve System; one month later, Senator Glass introduced the first bill, which provided only for the regulation of commercial banks' securities affiliates and to which the origins of the Glass-Steagall Act can be traced (Kelly 1985, p. 43).

The hearings conducted under the auspices of the Senate's resolution (chaired by Glass himself) convened in early 1931 and produced testimony on a number of ways in which the operations of a securities affiliate could adversely affect the safety and soundness of its parent bank. Most of the problems identified by the subcommittee centered on the conflict of interest between the two businesses. It was basically alleged that the existence of a securities affiliate would induce the bank to make a variety of ill-advised managerial and investment decisions that it would not otherwise undertake, including lending money to the affiliate or its customers on preferential terms and purchasing securities from the affiliate to relieve it of excess holdings. For their part, securities affiliates were charged with such practices as being less cautious in their investment decisions

because of their access to the parent bank's resources and with manipulating the market for the bank's own stock (Kelly 1985, pp. 46–47).

No specific legislative action followed the Senate hearings. In January 1932, though, Senator Glass introduced a new bill that would have separated commercial and investment banking by the device of prohibiting corporations from depositing funds in any institution except a chartered commercial bank. This proposal quickly foundered on nearly unanimous opposition, including that of the president of the Federal Reserve Bank of New York, who argued that the bill would essentially divorce "the banking system and the capital market" (Kelly 1985, p. 48). Glass then revised his bill introducing in April 1932 a measure that with some amendment, would eventually become the Glass-Steagall Act (Kelly 1985, pp. 48–49).

More hearings were held, but again no action was taken for the remainder of 1932. Increasing pressure for investment banking regulation was brought to bear, however, by revelations of stock-exchange abuses in testimony before another Senate subcommittee and by the deepening of the banking crisis.[6] The logjam was broken in March 1933 by the announcement of Winthrop Aldrich, the newly appointed chairman of Chase National Bank, that his bank would divest its securities affiliate so that Chase would no longer be tainted with "the spirit of speculation" (Kennedy 1973, p. 212). Aldrich went on to propose that the separation of commercial and investment banking be brought about by prohibiting securities dealers from accepting deposits (Kelly 1985, p. 53). The Aldrich plan was quickly incorporated into the new legislative initiative introduced by Senator Glass when the 73d Congress convened later that month. After a short debate in which a few changes in language were adopted, the bill was passed by the Senate in May. Its provisions were written into the House version of the bill sponsored by Representative Henry Steagall, and the Congress approved the conference report on June 13. President Roosevelt signed the measure into law three days later (Kelly 1985, p. 54).

## Private Interests at Work

The conventional wisdom is that the Glass-Steagall Act resulted from action of a public-spirited Congress moving to restore safety and soundness to an industry badly weakened by commercial banks' involvement in the business of investment banking. As in the case of most public interest justifications for government intervention in

[6]The abuses of National City Bank and its securities affiliate, National City Company, were especially important in creating a climate favorable to regulation. See footnote 2.

the private economy, the conventional wisdom about the Glass-Steagall Act cannot be taken seriously. The notion that depositors were the main beneficiaries of the purging of securities from commercial banks' asset portfolios overlooks the critical fact that most banks that had securities affiliates survived the wave of panic that swept the banking system during the early 1930s. Even if this were not true, however, the creation of federal deposit insurance by other provisions of the Banking Act of 1933 made the separation of commercial and investment banking redundant from the point of view of depositors. Simply put, if a customer's deposit is insured, the composition of his bank's asset portfolio becomes irrelevant to him; his account is protected even if a collapse in asset values causes the bank to fail.

The public interest argument that a separation of commercial and investment banking was needed to prevent an owner-manager from compromising his bank's liquidity by purchasing unnecessarily risky assets or making unnecessarily risky loans similarly fails on the historical evidence of the ability of institutions having securities affiliates to survive the 1933 panic. The argument also fails in terms of the incentives faced by commercial bank owner-managers to minimize downside risk. A profit maximizing commercial bank undertakes investments in such a way that the ex ante risk-adjusted rate of return on its asset portfolio is at a maximum. Such forces would induce the bank not to overinvest in any asset, including any securities it may have underwritten. The market value of equities can fall unexpectedly, but this is true of all other assets that the bank may hold. It is therefore disingenuous to accuse bankers of bad management after the fact when unanticipated events have caused the realized rate of return on a particular asset to be less than expected.

Clearly, the public interest argument does not hold up well under close scrutiny. What follows here is a brief description of an alternative explanation based on identifying whose interests were served by the separation of commercial and investment banking.

First, the legislation benefited brokerage firms by eliminating an important competitor from the business of underwriting, promoting, and selling securities. Some support for this proposition is provided by the fact that by 1930, the securities affiliates of commercial banks were sponsoring over 54 percent of all new securities issues (Kennedy 1973, p. 212). Second, commercial bankers were the beneficiaries of the Glass-Steagall regulations precluding securities dealers from entering the business of deposit banking. Given that successful brokerage houses develop experience in making loans by managing their customers' margin accounts, commercial bankers may have been concerned with the possibility that securities firms not affiliated

with commercial banks could use their expertise to provide other cash-management services, including checkable deposits, blurring the distinction between stock brokering and banking. Under this interpretation, the Glass-Steagall Act represented an early attempt by commercial bankers to block the kinds of innovations in the financial services industry that ultimately did appear in the 1970s and that provided the impetus for recent deregulation legislation.

In addition to the private interests identified above, the Glass-Steagall Act may also have provided an important benefit to the U.S. Treasury. By purging private securities from banks' asset portfolios, the legislation helped expand the market for U.S. government securities by eliminating a competitor to the Treasury for banks' loanable funds.

*The Interests of Commercial and Investment Bankers*

One way of interpreting the Glass-Steagall Act is in terms of a government-sponsored market-sharing agreement for the financial services industry. Under the regulations enacted in 1933, commercial bankers would specialize in the business of accepting deposits and making loans, and investment bankers would specialize in the business of underwriting, promoting, and selling securities. Simply put, the Glass-Steagall Act erected barriers that prevented any direct competition between commercial and investment banking. Such an agreement on how a market is to be divided is a classic example of a dimension of collusion through which the members of a cartel can maximize their joint profits.

Some support for explaining the Glass-Steagall Act as a cartel market-sharing agreement is given by the fact that the new regulations allowed bankers one year to choose between the two businesses (Kennedy 1973, p. 213). Those institutions having a comparative advantage in accepting deposits and making loans thereby had an opportunity to divest their securities affiliates and become members in good standing of the commercial banking industry. Similarly, the grace period allowed those institutions having a comparative advantage in underwriting securities to choose to become investment banking firms by dropping out of the business of accepting deposits. Thus, the Glass-Steagall Act did not require any institution to give up what it thought to be its most profitable line of business.

The legislation enacted in 1933 gave the force of law to a division of the financial services market that benefited both commercial and investment-banking interests. Investment bankers benefited by having an important competitor eliminated from the securities under-

writing business.[7] As mentioned earlier, this was of consequence because securities affiliates of commercial banks were sponsoring over half of all new securities issues by 1933 (Kennedy 1973, p. 212). The emerging success of commercial banks as securities dealers has been traced by White (1986) to significant complementarities in the production of financial services. Economies of scope allowed banks to become "the contemporary equivalents of 'discount brokers' with fees of about one-quarter the New York brokerage commission" (White 1986, p. 36).

The hypothesis that the Glass-Steagall separation decree solely benefited investment bankers at the expense of commercial bankers has been put forth by Macey (1984). His argument is based in part on a 1971 Supreme Court decision striking down a ruling by the Comptroller of the Currency that authorized commercial banks to operate mutual funds.[8] Specifically, Macey (1984, p. 17) reports that Justice John Marshall Harlan's dissenting opinion recognized that in granting standing to the Investment Company Institute's challenge to the Comptroller's decision, the Court was in effect concluding that Congress intended to protect investment bankers against competition from commercial bankers.

Controversy over what constitutes a "security" has plagued efforts to enforce the Glass-Steagall Act since its passage.[9] This is because borrowing funds from a commercial bank and selling stock are interchangeable methods for firms to raise capital. That the Glass-Steagall Act created a dichotomy between two businesses that is more apparent than real provides further support for the legislation's private interest basis (Macey 1984, p. 7). There was also a substantial cost imposed on investment bankers (and a corresponding benefit to commercial bankers) associated with the Glass-Steagall Act's provision excluding them from the business of accepting deposits, however.[10]

[7]The protection against new competition would soon be made more secure by the Securities Act of 1933 and the Securities Exchange Act of 1934.

[8]Investment Co. Institute v. Camp, 401 U.S. 617 (1971).

[9]In contrast to *Camp*, the decision rendered in Board of Governors v. Investment Co., 450 U.S. 46 (1981) held that the Glass-Steagall Act does not prohibit a commercial bank or its affiliate from offering a closed-end mutual fund. The "subtle hazards" that arise when commercial and investment banking are combined have been held to prohibit banks from underwriting commercial paper, but not to prevent a commercial bank affiliate from engaging in securities brokerage (Securities Industry Ass'n v. Board of Governors, 104 S.Ct. 2979, 3003 (1984)). See Fischel, Rosenfield, and Stillman (1986).

[10]Evidence of the profitability of deposit banking is provided by the ability of state-chartered banks to survive despite being taxed out of the business of issuing notes by the National Banking Act. See Perkins (1971, p. 488).

The suggestion that commercial banks may also have benefited from the Glass-Steagall Act is borne out by recent events leading to the banking deregulation initiatives of the early 1980s. Deregulation was precipitated by an innovative cash management service offered to the market by a brokerage firm, Merrill Lynch, which allowed customers to withdraw funds deposited in securities accounts on demand using a financial instrument identical to a bank check in all respects except name. This innovation was soon copied by other brokers, putting securities firms in direct competition with commercial banks for short-term deposit liabilities. Moreover, because the securities industry was not constrained by regulations limiting either their entry into other lines of business (insurance, real estate, and so on) or the interest rates they could pay on customers' accounts, commercial banks were increasingly at a competitive disadvantage. The resulting shift of deposits from banks to brokerage firms created calls for reform that were resolved ultimately in the form of deregulation of commercial banking.

Thus, the Glass-Steagall Act may have represented an early attempt by commercial bankers to forestall the kinds of innovations in the financial services industry that in recent years have caused a breakdown of their market-sharing agreement with investment banking firms. Commercial bankers may have been concerned in 1933 with the possibility that unaffiliated securities firms could use their cash management expertise to offer financial services that would compete directly with commercial bank deposits. The elimination of this potential competition would have been particularly important in view of the provisions of the Banking Act of 1933 authorizing the Federal Reserve to limit the interest rates payable on deposits at member banks.

In this regard it is noteworthy that in 1933,

> [m]any . . . affiliates were . . . in process of liquidation, or had been previously dissolved, either because final passage of the Glass bill was anticipated or because banks welcomed the opportunity to rid themselves of affiliates which they had thought necessary or highly desirable during the twenties (Peach 1975, p. 158).

The data in Table 1 indeed suggest that commercial banks were leaving the securities business prior to the passage of the Glass-Steagall Act—more than 200 institutions did so between 1929 and 1933. The implication is that the cost to commercial banks of giving up their underwriting activities was less than the benefit gained by eliminating a potential competitor from the business of accepting

deposits.[11] This observation helps explain Winthrop Aldrich's announcement of his willingness to divest Chase National Bank's securities affiliate, a decision that lent crucial support to the bill introduced by Senator Glass.[12]

Evidence that can be gathered from congressional hearings concerning the relative benefits and costs of the Glass-Steagall Act to commercial and investment bankers is mixed. Eight witnesses testified in favor of a complete separation of the two businesses during the 1931 Senate hearings conducted under the auspices of the resolution passed in May 1930. Of these, four were members or former members of government regulatory agencies, two were bankers from the Midwest, one represented a New York commercial bank that had not engaged in investment banking activities, and one was a Harvard economist. Most of the sixteen witnesses who opposed the separation were representatives of large commercial banks (Perkins 1971, pp. 506–10). Both the Investment Bankers Association of America and the American Bankers Association issued statements in late1932 and early 1933 criticizing the Glass proposal (Perkins 1971, pp. 521–22). It is difficult to tell, however, how much of this opposition was to the idea of separation per se rather than to specific elements of the plan as it then stood, such as the length of the grace period the various institutions would be given to comply with the separation decree.

By April 1933, the American Bankers Association had apparently been won over. The Association's Economic Policy Commission issued a report recommending immediate enactment of the Glass bill (Burns 1974, p. 82). It is important to note, however, that on the eve of the bill's final passage, the controversy over the provision requiring separation of commercial and investment banking had subsided, with most of the debate now focusing on the issue of deposit insurance and on the nature and extent of the increased regulatory powers to be given to the Federal Reserve System, especially as they related to state-chartered institutions.[13] Thus, the many and diverse

[11]Perkins (1971, p. 522) claims that by 1933 the investment banking business was "dormant."

[12]Fear of a new congressional investigation into the practices of other bank affiliates may also have played a role (Perkins 1971, p. 523).

[13]Indeed, deposit insurance, the legislative brainchild of Rep. Henry B. Steagall, may have been the most controversial provision of the Banking Act of 1933. President Roosevelt's opposition to the idea nearly killed the entire bill. See Golembe (1960) for details. Benston (1982) highlights the role of several provisions of the Banking Act of 1933 in providing a "horse-trading" explanation for the bill's passage. Specifically, he cites deposit insurance as a victory for small unit banks, the prohibition of interest payments on demand deposits as a compensating payoff to large banks, and the Glass-Steagall separation decree as the act's main benefit for securities dealers.

motives that were ultimately responsible for the passage of the separation decree itself cannot be completely disentangled.

What is clear, though, is that the Glass-Steagall Act did provide significant private benefits to both the commercial and investment banking industries. As Perkins (1971, pp. 524–25) has put it,

> Perhaps in the end the bankers themselves . . . were relieved to have the assurance that no competitive pressures would be allowed to emerge in the future, as they had in the past. . . . Certainly, the older investment banking firms welcomed relief from aggressive commercial bank competitors. Hereafter, competition would be contained within the narrow functional banking fields of commercial and investment banking.

*The Treasury's Interests*

Whether intentional or not, the U.S. Treasury also obtained a substantial benefit from the Glass-Steagall Act. By 1940, as Friedman and Schwartz (1963, p. 452) observe, 70 percent of commercial bank investments were in the form of U.S. government securities. Part of the explanation for the sharp increase in commercial banks' holdings of Treasury obligations during the period immediately following the passage of the Glass-Steagall Act lies in the continuation of a trend, dating back to as early as 1929, toward greater liquidity in banks' asset portfolios. Less than 40 percent of banks' investments in 1929 were in the form of U.S. government securities, and nearly three-quarters of these were relatively long-term Treasury bonds. By 1933, U.S. government securities accounted for over 50 percent of investments and the average term to maturity of Treasury obligations held by banks had fallen by nearly one-half. This shift in the composition of banks' asset portfolios was a rational response to the increased cash demands of depositors. Indeed, "the banks that survived understandably placed far greater weight on liquidity than the banks in existence in 1929" (Friedman and Schwartz 1963, p. 449).

The increased demand for liquidity on the part of commercial banks is also reflected in Table 5 (basically a continuation of the data in Table 2), which shows the securities holdings of banks as a percentage of total assets from 1934 to 1940. In 1933, banks held 18.5 percent of their assets in the form of U.S. government securities. This figure jumped to nearly 23 percent in 1934, rose again in both 1935 and 1936, and then stabilized at around 25 percent for the remainder of the decade.[14] A portion, but certainly not all, of the increase in

[14]The decline in U.S. government securities holdings between 1936 and 1937 can be partly explained as a reaction by member banks to the fact that the Federal Reserve's Board of Governors doubled reserve requirements during this period.

*TABLE 5*

SECURITIES HOLDINGS OF COMMERCIAL BANKS AS PERCENTAGE OF TOTAL ASSETS, 1934–40

| Year | U.S. Government Obligations | Obligations of State and Local Governments | Other Securities |
|---|---|---|---|
| 1934 | 22.95 | 5.25 | 9.49 |
| 1935 | 26.13 | 5.50 | 8.73 |
| 1936 | 27.61 | 5.17 | 8.75 |
| 1937 | 25.63 | 4.92 | 8.36 |
| 1938 | 25.06 | 4.95 | 7.56 |
| 1939 | 25.63 | 5.35 | 6.48 |
| 1940 | 24.48 | 5.32 | 5.29 |

SOURCE: U.S. Department of Commerce (1975, p. 1021).

commercial banks' U.S. government securities holdings came at the expense of "other" securities, which declined steadily as a proportion of total assets throughout the period.

A shift in the liquidity preferences of banks no doubt accounts for most of the shift in the composition of asset portfolios that began in 1929.[15] However, it seems reasonable to assign to the Glass-Steagall Act at least some of the responsibility for the increase in the banking system's U.S. government securities holdings between 1933 and 1934. Simply put, the 5 percentage point rise in commercial banks' purchases of Treasury obligations, which equaled the largest single-year jump between 1929 and 1940, may have been driven in part by a need to replace the private securities purged from their portfolios by the new banking regulations. As such, the Glass-Steagall Act caused an increase in the demand for Treasury securities. Although the bill would probably not have been enacted had its sole purpose been to eliminate a competitor to the Treasury for banks' investment funds, such considerations may have played a role in pushing through the separation of commercial and investment banking.

In sum, the conventional wisdom that the separation of commercial and investment banking served the public interest does not hold up well under close scrutiny. There were private interests at work, and these were successful in giving the force of law to a market-sharing agreement in the financial services industry that virtually eliminated competition between commercial and investment banks for roughly

[15]This is the major factor identified by Friedman and Schwartz (1963, p. 453). They discount the importance of changes in the demand for or supply of assets.

40 years. That the distinction between commercial and investment banking is now in the process of breaking down may be taken by some as evidence that the Glass-Steagall Act has outlived its usefulness and should therefore be repealed. The evidence presented herein suggests, however, that the Glass-Steagall bill should never have been enacted in the first place.

## Conclusion

This paper has argued that the private interests of commercial and investment bankers were the driving force behind the regulations imposed on the financial services industry by the Glass-Steagall Act. The principal alternative justification for the law, which suggests that the separation of commercial and investment banking was necessary to protect the public against the speculative activities of commercial banks' securities affiliates, is particularly ironic in view of the creation of federal deposit insurance by separate provisions of the Banking Act of 1933. Such insurance made the equity-ownership and underwriting ban redundant from the point of view of depositors. Thus, the Glass-Steagall Act generates no apparent benefits for depositors but it clearly entails costs. Allowing commercial banks to purchase equities would simply give them an extra degree of freedom, an additional asset over which to spread downside risk. Prohibiting them from doing so precludes commercial banks from holding an efficient asset portfolio and this may have raised, not lowered, the probability of bank failure.[16]

The development of futures markets has further eroded the public interest basis for regulating the activities of commercial and investment banks. Futures and options contracts are now available on a number of equity market indexes, as well as on a wide range of financial assets, including Treasury securities, commercial paper, and foreign currencies. Such contracts allow asset holders to shift downside risk to other market participants, creating a hedge against unanticipated reductions in the values of these assets. Empirical evidence suggests that even the losses from equity underwriting can be reduced to a relatively low level by participation in the options market (Giddy 1985). Thus, the argument that securities are inherently more risky than other assets that commercial banks may hold is simply not valid.[17] There is no reason to believe that allowing

[16]This point is also made by Macey (1984, p. 12). Prohibiting banks from purchasing securities would lower the probability of failure only if all stocks are inherently more risky than all other assets banks may hold. This is clearly not the case.

[17]The opportunity for self-insurance provided by futures markets also raises questions about the continued need for federal deposit protection.

commercial banks to deal in securities—or allowing investment banks to accept deposits—would materially increase the riskiness of either type of institution. More importantly, however, breaking down the barrier between commercial and investment banking would further increase the by now widely apparent benefits that would accrue to depositors through deregulation of the financial services industry.

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# New Deal Monetary Legislation for the Welfare of the Government

*Richard H. Timberlake*

William F. Shughart II's paper discusses the public choice aspects of the Banking Act of 1933, which was passed by Congress on June 16 of that year.

This act had its origins in the second of two bills proposed by Sen. Carter Glass of Virginia and Rep. Henry B. Steagall of Alabama to regulate commercial banking and the Federal Reserve System. The first bill, passed on February 27, 1932, and called the Glass-Steagall Act, allowed the Federal Reserve Banks to use government securities as collateral for the issue of Federal Reserve notes. Because this legislation was named the Glass-Steagall Act, the second act could not be identically labeled, so it was simply titled the Banking Act of 1933 (a more formal, if not better, choice than, say, the Carter-Henry Act, based on their first names).

Besides separating commercial banking from investment banking (the provision Shughart analyzes), the Banking Act of 1933 also granted additional powers to the Federal Reserve Board and Federal Reserve Banks to oversee loans and investments of member banks. The idea was to discourage speculative trading activity in securities, real estate, and commodities. The act also contained several other provisions, including prohibition of interest on demand deposits and Federal Reserve authority to set ceiling rates of interest on time deposits.

Shughart notes immediately the security overdose in the 1933 act: If deposit insurance was a general requirement for banks—including as it subsequently did 98.4 percent of all deposit accounts—the separation of investment banking from commercial banking was an unnecessary flourish as far as the safety of depositors was concerned. They were already well protected. Shughart then looks at the two

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special interest groups that might have benefited from the cartel-like separation of the two banking functions. He finds that commercial banks probably benefited more than investment banks. The evidence for this conclusion is the current direction taken by deregulation; that is, investment houses and others have again gone into the manufacture of demand deposits.

Shughart also notes that the U.S. Treasury received substantial benefits from the 1933 Act. The act encouraged banks to invest in U.S. government securities, both because of the conditioned need for liquidity the banks felt after the recent liquidity debacle, and because of the purging of private securities from the banks' portfolios in accordance with the provisions of the new act. For the nonbank public, ceiling rates of interest on time deposits and zero interest rates on demand deposits also tended to make commercial bank deposits appear less attractive than, say, holding U.S. government securities. Interest rate ceilings on bank deposits, therefore, had the effect of holding down market interest rates on government securities.

Shughart's paper has persuasive arguments. By picking up this one bit of legislation and showing that it was written and passed to further the special interests of at least one of two private groups—or both—in alliance with the government, his investigation opens the door for the same question about other "critical" legislation passed at that time. What follows is the legislative pattern that developed between 1932 and 1934—the years during which congressional acts regulating the monetary, banking, and financial services industry abounded.

The legislation that began the federal government's monetary and banking activities during the early 1930s was the act to form the Reconstruction Finance Corporation (RFC), passed on January 22, 1932. This government corporation was capitalized by the U.S. Treasury with $500 million from general taxpayer revenues. The RFC could then issue its own bonds, debentures, and notes to raise an additional $1,500 million. Its mission was to lend to banks, other corporations, and government agencies that could not get help from conventional sources (Harris 1933, pp. 685–87; White 1935, pp. 697–702).

In the pre-RFC era the most "conventional" source, of course, had been the 12 Federal Reserve Banks. They were the touted lenders of last resort, the legalized descendants from the "extralegal" and illegal clearinghouse associations. However, the Federal Reserve Banks had turned out to be lenders of next-to-last resort. Their managers' concept of "eligibility" for the collateral paper on which they made loans to banks had proven to be procyclical; it had effectively

sterilized the vast amount of lending power that the Federal Reserve Banks had at their disposal throughout the early 1930s.

Congress and the administration, unable to persuade the Fed to promote an extensive and consistent lending policy either for the banks or for the government, decided to create an even more fundamental lender of last resort. The RFC was that institution. After two and three-quarter years of operation (up to November 1, 1934), the RFC had loaned $6.3 billion. Banks received 41 percent of total loans made, and government agencies and state governments came next, with a combined 27 percent (White, p. 699).

The absurdity of this burgeoning of institutions is immediately apparent. Why was an RFC necessary to make loans to needy banks when the elaborate Federal Reserve System has been put in place 20 years earlier to do just that? The RFC, at best, had no net leverage on the monetary system. It could not create monetary base materials. It was similar to a commercial finance corporation in that it borrowed from the securities market after its first endowment of taxpayers' money, and then made loans with the proceeds. True, it made loans to commercial banks when the Federal Reserve Banks would not. It could do so because it was allowed to broaden the eligibility concept to include assets that, although not eligible where the Fed was concerned, were sound and acceptable backing for RFC loans (Harris, p. 686; White, p. 699).

The Glass-Steagall Act of 1932 made an attempt to go in the same direction as the RFC. It relaxed collateral security requirements for member bank discounts at Federal Reserve Banks. It also allowed Fed Banks to use government securities as collateral for the issue of Federal Reserve notes, thereby establishing a formal basis for the government seigniorage operations that were to occur within the next two years. By the end of 1933, as a matter of fact, eligible paper plus government security holdings of member banks were over $7 billion, or 10 times the amount of Federal Reserve lending to member banks at that time (White, p. 703).

The Emergency Banking Act was signed into law on March 9, 1933. It allowed President Roosevelt to declare a banking holiday. More important, it gave the executive branch through the Treasury Department the power to call in all gold coin and gold certificates owned domestically, thereby setting the stage for further seigniorage operations (White, p. 705).

In May 1933, Congress passed the Thomas amendment to the Agricultural Adjustment Act. This "inflation bill," as it was dubbed, allowed the Federal Reserve Banks to buy $3 billion more in government securities on the basis of which they could issue an equiv-

alent amount of new Federal Reserve notes. In addition, it gave the president the power to reduce the gold content of the gold dollar by as much as 60 percent (White, pp. 709–10).

Next, on June 5, 1933, Congress passed the act that abrogated all gold clauses in contracts, including those made by the government in the bonds financing the Liberty and Victory loans (White, pp. 712–13). The Banking Act of 1933 was then passed on June 16. This act was advertised as antispeculative, but it pointedly exempted all security issues of the federal government, state governments, municipalities, and government agencies from the class of investment securities denied to commercial banks (White, p. 718).

The federal government now had the path cleared for expropriating a large fraction of the monetary system's real gold stock. By his authority under the Gold Reserve Act passed January 30, 1934, President Roosevelt raised the price of gold to $35.00 per ounce. He then called in all the gold to the U.S. Treasury, but paid for it at the old price of $20.67 per ounce (White, pp. 720–21). Because all gold clauses had been nullified, the government did not have to share its seigniorage profits of $2.8 billion with private speculators and other "malefactors of great wealth." Two billion dollars of this total was put into the Exchange Stabilization Fund to fix exchange rates, but was used to buy government securities until the money was needed for exchange-control purposes.

Finally, the Silver Purchase Act of 1934 concluded the government's extensive housekeeping revenue-accruing operations. By this act, the Treasury could buy silver at $0.50 per ounce or less, and it could then issue silver certificates as though its silver was worth $1.29 per ounce—the historic fixed price for monetization of silver. During the next two years, the Treasury realized silver seigniorage worth over $300 million (Friedman and Schwartz, pp. 465–70).

All of these congressional acts taken together suggest a pattern of incentives and strategies that is consistent. First, the evil that provoked the Great Contraction and ensuing depression was unchecked speculation. The evidence for this opinion was the dramatic stock market boom. The need, therefore, was to rein in speculation through the Federal Reserve System's imposition of its version of the "moral" use of credit. Unfortunately, in depriving the Speculative Devil of his sustenance, the Federal Reserve also starved the innocent banking institutions it was supposed to nourish. In doing so, it likewise deprived the government of its ability to generate tax revenues.

In the presence of a Federal Reserve System that had so bungled, government policy was to intervene in the financial markets to ensure that its own inflow of resources was secure. By this time, tax revenues

were not manipulable. Seigniorage from gold and silver expropriation, however, provided at least a one-time bonanza. The government's "profit" of $2.8 billion from the revaluation of the gold was, by one pen-stroke, almost the equivalent of one year's ordinary tax revenues. That same federal government almost 100 years earlier, in 1835–37, had returned its fiscal surplus to the states. The government of 1934 legislated the revenue into existence and kept all of the proceeds for itself.

The second source of government revenue, especially on account of the cyclical dearth of taxes, was the sale of U.S. Treasury (and other government agency) securities. Almost all of the new laws encouraged or stimulated a demand for securities from all levels of government, and from government agencies. Commercial banks, Federal Reserve Banks, the RFC, the 12 regional banks of the Federal Home Loan Bank System, the Exchange Stabilization Fund—all were induced to purchase government securities by a number of legislative devices. That some of these purchases might have helped revive the private sector was largely irrelevant to government spokesmen, although they professed otherwise as part of their political rhetoric. As it was, most of the legislation that established government corporations, such as the RFC, simply bled off resources from the private sector that private institutions could have used more efficiently.

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