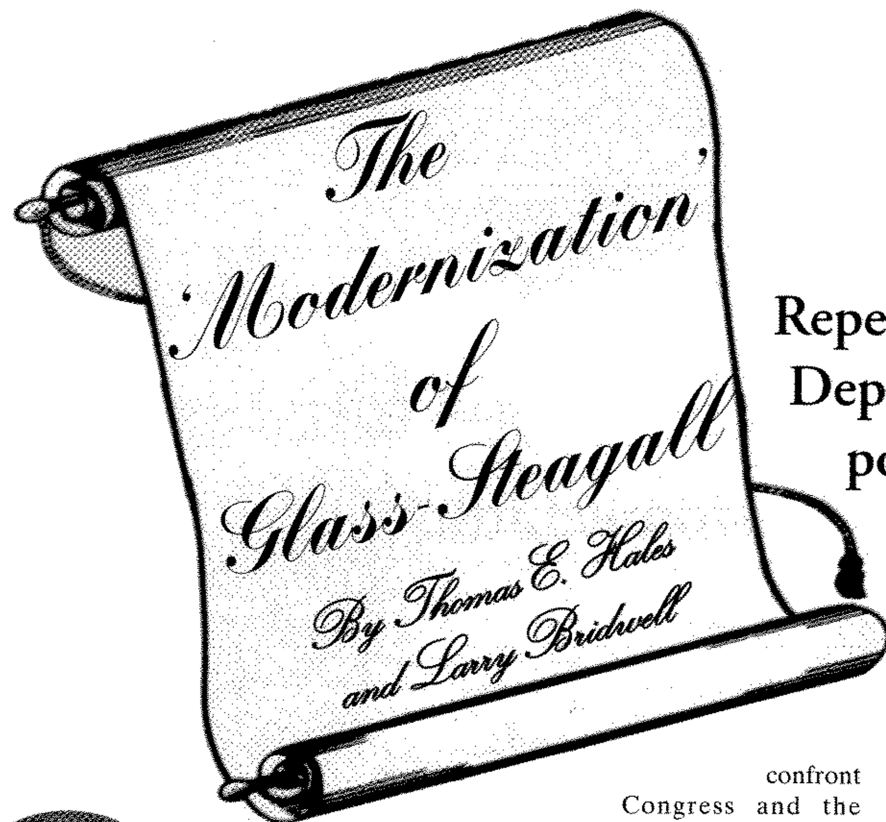


Repealing the Depression-era law portends dangerous consequences.

Over the years, various proposals have been floated to modify or repeal provisions of the Glass-Steagall Act. The basic protections built into the Depression-era law are even more important today, given the proliferation of exotic derivatives and the lightning-fast computerized transfers of vast financial resources.

The need to be extremely careful in modernizing the Glass-Steagall Act is underscored by the potential for financial instability as evidenced by the savings and loan bailouts of the 1980s, the restructuring of Continental Bank and the near financial disaster of Citicorp and Bank of America. The overriding principal that should guide the modernization of the Glass-Steagall Act or the alteration of the Bank Holding Company Act must be to preserve the strength of the Federal Deposit Insurance Corp. and the belief of depositors that their savings are fully protected.

An Overview

To understand the issues that confront Congress and the banking industry, it is worthwhile to review Glass-Steagall. The act is composed of four sections:

1. Commercial banks are limited to purchasing and selling securities for customers.
2. Member banks of the Federal Reserve System cannot affiliate with an investment banking firm.
3. Commercial banking (deposit taking) and investment banking (underwriting) cannot be conducted in the same institution.
4. Director and officer interlocks between investment banks and member banks are prohibited.

Before the declaration of the eight-day banking holiday in 1933, some 8,000 banks had failed, thus prompting then-Senate Banking Committee Chairman Carter Glass to call for the legislative separation of banking and securities. The Glass bill was joined with a bill sponsored by House Banking Committee Chairman Henry Steagall, whose bill established the FDIC. President Roosevelt signed this package into law, thus establishing the Glass-Steagall Act as the law of the land.

The Bank Holding Company Act, enacted in 1956, prohibited the affiliation of banks with commercial firms. Congress determined that this type of affiliation could lead to monopolization through the development of huge banking-industrial firms. Other concerns included conflicts of interest that involve impartially granting credit.

In 1982, Congress amended the Bank Holding Company Act by excluding insurance activities. Exceptions were provided for credit-related insurance and the sale of general insurance in small towns of less than 5,000 people. In the 1980s, the Federal Reserve made concessions that allowed some very large banks to engage in limited security activities.

Deregulation Fever

While the repeal of Glass-Steagall has been a long-term priority of the large money-center banks, deregulation has become a high-profile issue in the 104th Congress. Prompted by the 1994 Interstate Banking and Branching Efficiency bill, the banking industry is in the midst of an historic period of mergers. The repeal of Glass-Steagall would extend to mergers of large banks and securities firms.

Proponents of repealing Glass-Steagall cite the following reasons:

• The share of the financial services market held by banks has shrunk from two-thirds in the mid-1940s to less than one-third today.

• Glass-Steagall is a relic of the Depression. Regulation is in place to control the abuses covered by the act.

• U.S. banks are not among the largest in the world.

• Banks already conduct many securities-related activities in their Section 20 subsidiaries, while their edge banks conduct international business. Therefore, the law is effectively dead.

• Financial products will be more efficiently distributed to the public following the act's demise.

From 1929 to 1932, 11,000 U.S. banks failed (44 percent of the 1929 total) and about $2 billion in deposits left the system. Industrial stocks lost 80 percent of their value, the Gross National Product (GNP) declined by 10 percent annually, and farm prices fell by 53 percent. Millions of Americans lost their jobs, savings and homes. The enactment of Glass-Steagall helped to restore the public's confidence in a devastated banking system.

When members of Congress propose wholesale changes in our banking systems, it appears that few remember the recent thrift industry crisis. A debate of this issue should consider more than market share, global competitiveness, bank size and the relevancy of Glass-Steagall. Rather, there should be a thorough analysis of the consequences of repealing Glass-Steagall. For example, can America's financial institutions withstand tidal wave shocks from rapidly shifting global events? Should the federal government assume the risks of weakening the banking system and making itself vulnerable to multi-billion dollar bailouts? To avoid these disasters, how would the federal government regulate multi-faceted financial giants?

Various Proposals Floated

If Glass-Steagall were repealed, it would most likely occur in one of the following ways:

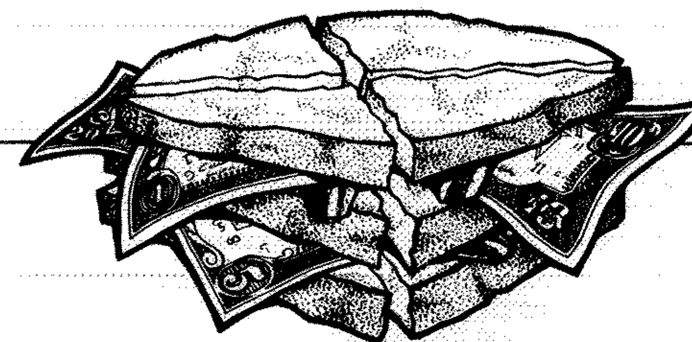
1. Banks could affiliate with investment banking firms (Leach bill).
2. Commercial banks, investment banks and insurance companies could affiliate with each other (Baker amendment).
3. Financial services holding companies could own banks, insurance companies, investment banks and commercial or industrial companies (D'Amato bill).

Advocates of the D'Amato and Baker proposals tout the "firewall" theory. These proposals rely on the premise that a set of regulations and a subsidiary structure can be put in place to prevent losses in a commercial business, insurance company or an investment banking business from affecting the Bank Insurance Fund (BIF).

The BIF is funded by the banking industry to protect depositors and is guaranteed by the federal government. Therefore, under each of the proposals and only limited to the extent of the repeal, the final guarantor of business failures would be the U.S. government.

The use of firewalls to protect this guarantee is unrealistic. To protect against a financial catastrophe, systems need to exist that can measure risk and exposure in "real time." Such systems must be capable of controlling and responding to that risk.

In today's world, trading losses in exotic derivatives can sink an institution and, when leveraged, could wipe out the entire FDIC fund in only a few hours. Computer-driven technology can make fortunes in seconds and destroy a 233-year-old institution in two weeks. Therefore, to control or react



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The concentration of financial resources could devastate the FDIC fund.

to risk, it is essential to have a "real-time risk management system" in place. No such system exists.

Clearly, the financial entities that seek these powers are not ready to manage the risk. It is essential that in any debate about the repeal of Glass-Steagall, considerations regarding the concentration of power and the risk of human behavior cannot be excluded. It should be noted that the savings and loan crisis resulted from the cumulative effect of many smaller failures. No single thrift or bank failure has the potential impact posed by a Merrill Lynch, Chemical-Chase, Citicorp or Bank of America. The concentration of financial resources that will occur with the repeal of Glass-Steagall and the attendant risk could devastate the FDIC fund.

Can the government that guarantees these conglomerates' risk capably regulate and monitor this risk? The answer is, quite frankly, no. It would take years to establish a regulatory agency to monitor a multi-state, inter-national full-service institution.

Agendas and Consequences

In any discussion regarding Glass-Steagall repeal, the true agenda of some of those promoting the repeal has to be considered; that agenda is the elimination of FDIC insurance. In 1991, President Bush, working closely with the big bank lobby, unsuccessfully pushed for deposit insurance reduction. The push continues and has new and powerful advocates in the Congress. This has been the goal of the money-center banks for the past 62 years—elimination of FDIC insurance.

Repeal of FDIC insurance results in the following scenario:

- Ten thousand commercial banks and 2,500 thrifts will close when customers flee to financial services providers (non-banks) that are perceived to be safer.
- Ten major financial institutions will control the payment system.
- Small business lending will be handled by lenders whose cost of funds will be around prime; therefore, loans below $1 million for building construction and small business lending will be 3 to 4 hundred basis points over prime for top credit risks. Customers who are not top credit risks will pay far more, assuming credit is even available.
- Consumer fees will be substantially higher as competition is reduced. Fees will grow, without limit, to assure profit on all bank services.
- The public will buy products from sales reps and financial planners rather than local bankers, in whom many customers have justifiably placed their trust.
- There will be no investment products available that will assure the depositor (investor) the return of principal. Senior citizens and the investing public will need to educate themselves or pay for that service. The new investor or one who is purchasing government securities (Treasuries) will need to hold them until maturity or be subject to market fluctuations. Therefore, a large number of funds will be placed in short-term yields. Yields to traditional bank investors will then decline and income for the ever-expanding mature market will be reduced, resulting in greater demands on the Social Security system.
- Community investment will be substantially reduced because the remaining institutions will be national or super-regionals.
- The U.S. banking system will resemble Japan's, in other words, large banks with major losses. Glass-Steagall has helped create the most diversified and safest financial system in the world, and the act's repeal would concentrate, rather than diversify, financial assets.

In the banking industry, consolidation has involved small banks, money-center banks and super-regional banks. Some consolidation proponents say the United States should have the world's largest banks, as if bigger is better. In the banking industry, however, large means a consolidation of financial power, which can reduce opportunities to finance new enterprises and exclude the small business market, which relies on community banks for its credit needs.

According to the *Wall Street Journal*, 47.7 percent of all business loans under $1 million were made by banks with less than $1 billion in assets.

By allowing consolidation among insurance, securities and industrial firms, there is, in effect, an extension of the guarantee issued through the FDIC insurance fund, which is backed by the federal government. If an alliance involving Merrill Lynch, Prudential Insurance, General Motors and a bank occurred and that consolidated entity were to go bankrupt, it would quickly deplete the BIF or any similar insurance fund. Because such an entity would jeopardize the entire U.S. economy, the federal government would be compelled to bail it out.

FDIC's Future

It is likely that following the repeal of Glass-Steagall, the securities industry would consolidate with the banking industry. Later, the insurance component would come under the control of a financial services holding company. Congress probably would never allow a General Motors to control the capital markets; large firms controlling capital could stifle the growth of smaller competitors. The consolidation of the three major distributors of financial products—banks, securities and insurance—would lead to the elimination of FDIC insurance. Why? Because even with firewalls, the risk posed by major failures would be unacceptable.

The elimination of a well-supervised banking system would probably result in less-supervised, less-capitalized distributors of financial products. There would be a re-creation of the community banking industry that existed in the 1940s and 1950s; in other words, states would begin forming their own deposit insurance funds. After the first state fund fails, the federal government would create another FDIC-type fund. Money-center and national banks that had expanded into riskier portfolios would be excluded from that fund.

Glass-Steagall has provided a solid foundation for independent banks that have served and invested in their community. When the calls for repeal of Glass-Steagall resonate on Capitol Hill, Congress must consider the potential damage.

Years ago, a memorable television commercial featured Joe DiMaggio on behalf of Bowery Bank. The slogan: "Nothing feels better than money in the bank." That commercial echoes the confidence of depositors in our banking system, the foundation of which is an effective Glass-Steagall Act and a strong FDIC. With all the turmoil in today's global financial markets, Congress should be very careful not to overturn the cornerstone, set decades ago, of our strong banking system. IB

Thomas E. Hales is chairman and CEO of Union State Bank, Orangeburg, New York. Larry Bridwell is department chairman, Graduate Management Program at the Lubin School of Business, Pace University, White Plains, New York.

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