competitors significantly affect the

activities would probably achieve
limited success.

If we adopt a deregulation measure

should also identify and quantify
barring nonbank firms from operat-

simply if the marketability of the
banks, would banks be granted a
competitive advantage? Perhaps the
FRB's implementation of the BHCA
can provide insight on these issues.

To date, the FRB has authorized 15
"permissible" nonbanking activities for
BHCs. Each new activity is evaluated
in terms of whether, when coupled with a bank's credit-granting powers, a bank would have a competitive advantage over other producers in the industry. In evaluating applications, the FRB either disallows or restricts the bank's involvement in the nonbank
activity. Restrictions may bar
nonbanking activities, in effect, neutralize the potential for credit abuse.

In considering a relaxation of Glass-Steagall's barriers, we should also identify and quantify what economic effects might predictably occur if the securities and commercial banking busi-
nesses were recongruent. Would an increase in the number of potential competitors significantly affect the prices of banking and securities products or services, other things being equal? Could we realize signifi-
cant cost savings by co-producing
security and commercial banking
products? And, if banks are allowed to offer new products but only on restrictive terms, we should evaluate
whether, and to what degree, such restrictions would have on negating any "synergies" of co-production.

A principal objective of banking
regulation is to maintain the safety and
commercial banking business.

If banks were permitted to take on
risks associated with
erasing involves virtually no market
risk. If banks were permitted to take
such risks, then is it possible to
isolate banking activities from the
risks associated with nonbanking
activities? Those who advocate a
deregulation proposal in which a
BHC's nonbanking activities are
conducted in separate subsidiaries and isolated principally by legal and capital control measures
force us to consider seriously the
merits of imposing a moratorium on
corporations. If Glass-Steagall were reformed, the role of deposit insurance in the
financial system also must be exam-
ined. As legislatively mandated by
Glass-Steagall, the deposit insur-
ance agencies submitted reports to
the Federal Reserve Board as a basis for these reservations.

1. In 1982, Congress also passed the Export
Trading Act, which authorizes limited bank
involvement in financing and developing export
trading companies.

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Economic Commentary
ISSN 0428-1276
Banking and Commerce: To Mix or Not to Mix?
by Thomas M. Buynak

in the late 1970s, commercial
banks and thrifts experienced an unprecedented outflow of depositories' funds to less regulated institutions. Partly in reaction to this massive outflow of depositories' funds, the U.S. Congress passed two separate, fairly comprehensive deregulatory measures—the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982.1 Because of these two acts, banks and thrift institutions can more freely pay whatever interest rates they choose in order to attract deposit funds.

Financial concerns such as Mer-
ril Lynch and insurance firms,
retailers, and money market funds are competing more and more with banks. Their most recent incursion into the banking business involves acquisitions of "nonbank banks"—entities that function as banks but escape the legal definition of banks under the Bank Holding Company Act of 1956 (BHCA), as amended. The BHCA defines a bank as an institution that both accepts demand deposits and engages in commercial lending. If an institu-
tion desires in only one of these
activities, it is not classified as a bank for purposes of the BHCA. In

response to this competition, banks are doing more than accepting de-
posits and extending loans. Increas-
ingly, banks are seeking greater
presence in securities, real estate,
and insurance businesses.

Concern about exploitation of
the BHCA's definition of a bank
recently prompted the Federal Reserve Board to update its defini-
tion of bank. Under its new

ISSN 0428-1276
December 5, 1983

1. Economist Thomas Buynak analyzes bank struc-
ture and consumer issues for the Federal Reserve Bank of Cleveland.

The views stated herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.
Congress is considering a financial deregulation bill, sponsored by the Treasury Department, that has sought to expand banks' product power since 1981. At issue in this bill is the degree to which banks should engage in other businesses, including real estate, securities, and insurance, and the degree to which these businesses should be involved in banking. Economic Commentary explores the implications of mixing banking and commerce and poses questions about the effects of this trend on banks, nonbank institutions, and the banking system as a whole. It also focuses on the Glass-Steagall Act, its roots in the Depression, and its role in the current tension between a regulated financial environment and the "level playing field" that the Garn-St Germain and Monetary Control Acts aim to establish. Ensuring safety and soundness of banks

During the financial turmoil of the 1930s, it seemed that excessive competition and risk-taking by banks contributed to the collapse of the banking system. Congress responded by passing major legislative actions affecting the banking and securities businesses. The Banking Act of 1933, popularly known as the Glass-Steagall Act, separated commercial banking from securities. Specifically excluded, however, is the underwriting and dealing of corporate long-term debt and stock. The act has historically prevented securities firms from encroaching on markets served by commercial banks. Glass-Steagall also prohibits affiliations between securities firms and commercial banks. Increasingly, however, regulators are relaxing product restrictions on their constituent institutions. The FRB recently added discount brokering activities and securities lending to the list of permissible nonbanking activities. In reaching this decision, however, the FRB specifically proscribed full-line brokering and the dealing and underwriting of long-term corporate debt or equities. The FRB also is considering a proposal that would permit banks to have subsidiaries for adding new nonbanking activities for banks. The OCC and the Federal Deposit Insurance Corporation (FDIC), the regulator of state-chartered nonmember banks, also are easing traditional product restrictions on banks.

Glass-Steagall and recent trends

The drafters of Glass-Steagall apparently contemplated a system of specialized financial institutions, as the act sets limits on the extent to which commercial banks, insurance, and banking activities may mix. Today, these boundaries are becoming less clear as banks and securities firms enter markets heretofore traditionally forbidden to the other. The Glass-Steagall Act stipulates that commercial banks may underwrite and deal in obligations but not municipal revenue bonds and, through their trust departments, may purchase and sell stock and securities. Specifically excluded, however, is the underwriting and dealing of corporate long-term debt and stock. This act and its historical predecessors have served to insulate the public's interest in banks and to assure the safety and soundness of banks in the future. The Bank Holding Company Act of 1956, as amended in 1970, imposed additional limits on banking, including various securities. A proposal to remove the barriers was dropped in 1980, and the FDIC has been granted the power to require additional capital. Proposals to remove other restrictions have been made in 1974 and 1979, and the Treasury Department has sponsored a bill that would permit commercial banks to enter the underwriting and dealing of corporate securities. The OCC has opposed the bill, citing the potential for increased risk-taking by banks.

The Treasury's proposal

The Treasury Department favors reform of Glass-Steagall and since 1981 has been advocating, on behalf of the Glass-Steagall administration, fewer restrictions on banks' product decisions. The Treasury's latest proposal would permit banks holding companies to enter or expand into real estate, limited real estate investment and development, thrift ownership. Also, a bank would be permitted to provide investment advice through an operating subsidiary. In another proposal, the FDIC solicited comments on the extension of its power to accept and regulate bank subsidiaries. The FDIC noted that new rules and regulations of banks and other financial institutions would not jeopardize the safety and soundness of a bank's banking activities. The FRB generally supports the current Treasury proposal. While favoring additional financial deregulation, the FRB has opposed proposals to permit banks to underwrite corporate securities. The FRB's position is that the current framework of the Glass-Steagall reforms is sufficient. However, the FRB is concerned about the potential for increased risk-taking by banks and about the safety and soundness of the banking system as a whole. According to this line of thought, regulations imposed on banks would have to be relaxed in concert with other suppliers of financial services, although banks must offer competitive services.

Evaluating the merits of these two views involves a re-examination of the purposes of financial regulatory policy. Questions must be asked that focus specifically on the extent to which banking and securities activities should mix. Does the public benefit from having banks and securities firms compensate for one another? Do barriers prevent banks and other financial institutions from competing on a "level playing field" that the Garn-St Germain and Monetary Control Acts aim to establish.

7. SeeEastman and Puckler, before Committee on Banking, Housing and Urban Affairs, 98 Cong., 1st sess., 1983, at 8.

8. See, for example, R. Gerald Corrigan, "Are Banks Special?" in 1982 Annual Report, Federal Reserve Bank of Minneapolis.