Interest Groups and the Glass-Steagall Act

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Introduction[3]

Banks are regulated and supervised according to technical criteria, and banking contracts are enforced according to abstruse laws, but those criteria and laws are not created and enforced by robots programmed to maximize social welfare. They are the outcomes of a political process – a game, as it were – whose stakes are wealth and power. There is, in fact, no getting politics out of bank regulation, because public officials have inherent and unavoidable conflicts of interest when it comes to the banking system. First, governments simultaneously regulate banks and look to them as a source of finance. Second, governments enforce the credit contracts that discipline debtors on behalf of banks (and in the process assist in the seizing of debtor collateral), but they rely on those same debtors for political support. Third, governments allocate losses among creditors in the event of bank failures, but they may simultaneously look to the largest group of those creditors – bank depositors – for political support.

The implication is inescapable: the property-rights system that structures banking is not a passive response to some efficiency criterion but rather the product of political deals that determine which laws are passed and which groups of people have licenses to contract with whom, for what, and on what terms. These deals are guided by the logic of politics, not the logic of the market.

The Glass-Steagall Act of 1933 is not an exception to this general rule about bank regulation. Not only were its specific provisions the product of a political deal, the structure of the banking system that it was designed to protect was also the product of a political deal. That prior deal had given rise to a system that was fragile by design. The purpose of Glass-Steagall was not to modernize or replace that inherently fragile system, it was designed to prop it up by discouraging competition. There were a number of mechanisms by which Glass-Steagall accomplished this goal, but one of these was an innovation that was later copied by scores of governments around the planet, government-run deposit insurance.

The US banking system prior to Glass-Steagall: fragile by design

In order to understand the origins and effects of the Glass-Steagall Act, one first has to understand the inherent fragility of the US banking system prior to its passage. The United States had a banking system like no other country in the world: In 1914 there were 27,349 banks in the United States, 95 percent of which had no branches! The banks that did have branches tended to be small, with fewer than five branches on average (Calomiris and White 1994, 145–88; Davis and Gallman 2001, 272). The reason for the preponderance of these so-called "unit banks" was that most states maintained laws that prevented branch banking, even by banks that had charters from the national government. States that did not explicitly forbid branch banking typically had no provision in their laws for branches, and this lack effectively limited the creation of branching banks.

This peculiar organization of the banking system imposed significant losses on the rest of society. The high cost of obtaining information meant that bankers needed to be able to obtain "soft knowledge" about potential borrowers (knowledge of the borrower's "character," business relationships, and personal history) and that could only be obtained locally. The inability to open a branch in a local market required a banker to establish an entirely new, stand-alone unit bank, but doing so entailed significant fixed costs: the accounting and administrative operations of the bank could not be spread across multiple branches; they all had to be located with-

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in a single office. The combination of high information costs and high fixed costs constituted a barrier to entry.

As a result, the United States essentially had a system composed of unstable, segmented monopolies. Indeed, the United States had no less than 10 major banking crises *before the Great Depression:* 1814–16, 1825, 1837–39, 1857, 1861, 1873, 1893, 1896, 1907, and the mid-1920s. These periodic crises reflected three key weaknesses of unit banking: the lack of diversification of risk within banks (as was possible in branch-banking systems); the pyramiding of the banking system's reserves in New York City (which made the entire system vulnerable to the securities-market-related shocks that affected New York's banks); and the difficulty of coordinating banks' responses to liquidity crises.

These segmented monopolies were also inefficient allocators of credit. The barriers to entry implied by unit banking prevented productive competition among banks, especially in rural areas. In addition, unit banking inhibited financial integration across regions. Nationwide branching banks can easily move funds across regions to accommodate differences in demand and thereby equalize interest rates. In the absence of branching, large interest-rate differences across regions persisted well into the twentieth century. Finally, unit banking also promoted a growing mismatch between the size of banks and the needs of their prospective borrowers: small banks could not lend the sums needed by large industrial firms. The scale of industry grew substantially during the nineteenth century as steel and chemicals replaced textiles and shoes as the fastest-growing manufacturing sectors – but the scale of banks did not keep up. Thus, although banks had been important sources of funds for the industrial enterprises of the early nineteenth century, they played a much less important role in industrial finance by the end of the nineteenth century (Calomiris 1995; Giedeman 2005).

Unlikely partners: small bankers and agrarian populists

This peculiar competitive and geographic structure of the banking system was the product of sustained lobbying by an unlikely coalition of local bankers, who were opposed to the creation of large, branching banks that would put them out of business, and farmers who disliked and distrusted big corporations of any type. They benefited from unit banking as borrowers (despite its higher interest rates) because unit banking made banks locally captive – they could not withdraw credit from funding local activities during lean times because they had no other lending opportunities. Beginning in the 1810s, this unit banker-agrarian populist coalition gradually undermined an earlier system based on a small number of very large banks, which had been the brainchild of Alexander Hamilton. President Andrew Jackson's successful veto of the re-chartering of the Second Bank of the United States in 1832 signaled the hegemony of this populist-unit banker coalition.

The coalition of unit bankers and agrarian populists was able to impose its preferences because of the strongly federal nature of the US political system. The 13 colonies went to war against Great Britain as allied but separate entities, and when they won, they initially constituted themselves as 13 sovereign states joined in what was little more than a customs union. Drawing them together into a single nation, with a national government and constitution, required that the states retain considerable autonomy. Any power not specifically enumerated in the US Constitution as the province of the national government was left to the states – and the Constitution was silent about the regulation of banking. This meant that agrarian populists and unit bankers did not have to win legislative fights at the national level until the twentieth century: they only had to win local contests, which was a far easier task.

State governments responded to the problem of bank instability with actions of their own. State legislatures basically had two options: stabilize existing unit banks by creating mandatory deposit insurance, or allow banks to consolidate by permitting them to open branches. These strategies are mutually exclusive. In a mixed system of unit banks and branch banks, the unit banks will find it difficult to survive unless there is deposit insurance, because depositors will move their funds to the inherently more stable banks with branch networks that can spread risk across regions and transfer funds from one branch to another to head off runs (Economides, Hubbard and Palia 1996). A deposit insurance system undermines these advantages of branch banks, because it subsidizes the unit banks by providing them with access to deposits at low cost in spite of their higher underlying risks. As a result, in a mixed system that includes both unit banks and branch banks, the unit banks tend to favor state-run deposit insurance, because it allows them to compete with the branching banks, while banks with branch networks tend to oppose state-run deposit insurance because it undermines their competitive advantage over unit banks.

Between 1908 and 1917, eight states created mandatory deposit-insurance systems, and these demonstrate why the government-run deposit-insurance option should have disappeared in favor of the branch-banking option. World War I was good for American agriculture, as worldwide food shortages pushed up prices. Those shortages, however, were short-lived. As world output grew, agricultural prices collapsed, and unit banks in rural areas of the United States began to fail in unprecedented numbers: in the years 1921–29, 5,712 banks failed. All eight of the state deposit-insurance systems failed as well, and the banking collapses in the systems with mandatory deposit insurance coverage of all state-chartered banks were the most extreme examples of loan loss in the United States.

As a result of these failures, popular support both for unit banking and deposit insurance began to crumble. By 1930, eight states, primarily in the West and South, permitted unrestricted, statewide branching. An additional 13 states permitted branching, but tightly restricted the geographic extent of branch networks in order to protect unit bankers in rural areas from competition.

The Glass-Steagall Act: a lifeline for unit bankers

The wave of bank failures in the 1920s became a torrent during the Great Depression and threatened to completely undermine political support for unit banking. Between 1930 and 1933 more than 9,100 banks (38 percent of all banks) suspended operations. Depositors came to view unit banks (correctly) as more prone to failure. Moreover, the collapse of so many unit banks left thousands of agricultural communities, and even some suburbs of major cities, without any banks at all. The widespread contraction of credit that was associated with so much bank distress magnified the severity of the Depression (Calomiris 1993). By 1933, to many observers, it seemed as if the days of unit banking were numbered. In response to the severe banking distress of the early 1930s, states further relaxed their branching laws. By the end of 1935, 13 of the 27 states that had prohibited branching entirely in 1930 had repealed the prohibition, and seven states passed legislation allowing state-wide branching (Abrams and Settle 1993, 687–88).

A depression of the magnitude that hit the United States from 1929 to 1932 required a policy response by the national government. Among those responses was the Glass-Steagall Act of 1933. One component of Glass-Steagall was the separation of investment banking from commercial banking, because some contemporaries (most particularly, Senator Carter Glass, who chaired the Senate Banking Committee) believed that allowing deposit-taking banks to underwrite and trade in securities distracted banks from their proper business of funding commerce, and in doing so exposed the financial system to the speculative actions of Wall Street bankers. That view had no empirical basis, and has subsequently been disproven by the research of numerous financial economists in the 1980s and 1990s, who found that banks that combined underwriting and lending prior to 1933 were better diversified, and that the debts they underwrote performed as well as the debts underwritten by specialized investment banks (White 1986; Kroszner and Rajan 1994; Ramirez 1995, 1999, 2002; Neal and White 2012).[4]

Glass-Steagall went far beyond the divestment of investment banks; it became a mechanism to preserve unit banking by removing the economic advantages of branch banks. It did so by actively discouraging competition among banks. The key to this was the establishment of federal deposit insurance: depositors had no incentive to move their funds to inherently more secure, better run (and often larger) banks: their deposits were guaranteed by the government, regardless of which bank they chose. Although the civics textbooks used by just about every American high school portray deposit insurance as a necessary step to save the banking system, all of the evidence indicates otherwise: it was the product of lobbying by unit bankers who wanted to stifle the growth of branch banking, and it was instituted in spite of the widespread understanding of its adverse consequences. First, the banking crisis of 1932–33 ended months before the establishment of FDIC (Federal Deposit Insurance Corporation) insurance. Second, President Franklin Roosevelt, as well as his secretary of the treasury and his comptroller of the currency, *opposed* deposit insurance: they were all familiar with the disastrous experience of state-level experiments with deposit insurance during the early 1920s. As then-candidate Franklin Roosevelt wrote in a 1932 letter to the *New York Sun*, deposit insurance, "would lead to laxity in bank management and carelessness on the part of both banker and depositor. I believe that it would be an impossible drain on the Federal Treasury" (Prins 2009, 139). Third, Senator Carter Glass and the Senate

[4] Benston (1989) criticizes the nature of the evidence presented in the hearings leading up to the passage of the 1933 prohibition on combining investment banking and commercial banking.

Banking Committee, who drafted the initial legislation, were also opposed to deposit insurance. They allowed it to be added to the Glass-Steagall Act only at the eleventh hour, in order to gain the support of Henry Steagall. In fact, that eleventh-hour deal limited coverage to small deposits; it was broadened to include larger deposits several years later, well after the banking crisis had ended. Fourth, even with this initial limitation of coverage, the American Banker's Association lobbied Roosevelt to veto the bill after it was log-rolled through Congress.

The inclusion of deposit insurance in the 1933 act ended the long history of failed attempts by unit bankers and their allies to push through deposit-insurance legislation in Congress. Unit-bank supporters had tried on 150 separate occasions between the 1880s and the 1930s to create a federal deposit-insurance system. They succeeded this time not because the facts were on their side but because they had an able advocate in the person of Steagall, an Alabama populist who, as chairman of the House Banking Committee, held enough blocking power to force the addition of his legislative priority to the agenda of reforms.

Competition was further limited by other provisions of the Glass-Steagall Act (under section 5144), which were designed to make it more difficult for "chains" or "groups" of unit banks to become organized within a holding company. Chains and groups were not fully integrated corporate entities and thus were imperfect substitutes for nationwide branch banking. They had evolved as a second-best means of bank consolidation. The Glass-Steagall reined them in by requiring Federal Reserve Board approval for any voting of share interests in a bank by a bank holding company and by attaching costly burdens to that approval.

The Glass-Steagall Act further discouraged competition by regulating deposit interest rates. Regulation Q prohibited banks from paying interest on demand deposits. It also limited the interest rates that could be paid on time deposits. Regulation Q, like the new limits on bank involvement in securities underwriting, also reflected Senator Glass's desire to break the links between the commercial banking system and the securities markets; prohibiting interest on interbank deposits would discourage the pyramiding of reserves in New York (which funded New York's call money market) and encourage banks to use Federal Reserve Banks, not commercial banks, as their main repositories of funds.

Once the federal government guaranteed deposits by creating the FDIC and regulated deposit interest rates through Regulation Q, state legislatures faced reduced pressure from voters to allow branch banking. What possible benefit could now accrue to a client from moving his or her money from one bank to another: all deposits were safe, because they were insured by the government; and all banks paid essentially the same interest rate. Only four states relaxed their branching laws between 1939 and 1979 (Calomiris 2000, 67). In fact, as late as the early 1970s, only 12 states allowed unrestricted intrastate branching, and no states allowed interstate branching.

It is also interesting to note what the Glass-Steagall Act did *not* do. Most of the banks that failed during the 1920s and 1930s were located in agricultural areas, and the evidence indicates that bank distress during the 1920s and 1930s was primarily due to declines in agricultural income and land values both in rural areas and in cities.[5] Nevertheless, Carter Glass made sure that real estate lending continued to be allowed. Loans collateralized by land had proven to be risky, but Glass wanted to maintain the incentives of rural banks with state charters, whose main business was lending to local farmers, to stay in the Federal Reserve System. After all, he had been one of the architects of the Fed in 1913 (Neal and White 2012, 109). Understandably, he opposed policies that might undermine support for it. Thus, even though it made the US banking system less stable than it would have been otherwise, the Glass-Steagall Act did nothing to limit lending on real-estate.

All of these steps did, in fact, produce a stable banking system, and that stability endured for decades. But that stability came at a cost. Given this collection of regulatory barriers, America continued to be a country of "unit banks." It was illegal for banks to branch across state lines, and the vast majority of states (38 out of 50, to be exact), limited the ability of banks to open branches even within the state. As a result, banks did not compete very hard against one another in loan markets. Financial economists generally agree that this system raised the cost of credit to small and medium business enterprises and households, thereby limiting economic opportunity and social mobility (Jayaratne and Strahan 1996; Kroszner and Strahan 1999; Black and Strahan 2001, 2002; Correa 2008; Beck, Levine and Levkov 2010). As bankers in those "good old days" joked, banking was a 3-3-3 business: borrow at three percent, lend at three percent more, and be on the golf course by 3:00.

[5] See the review in Calomiris and Mason (2003).

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