THE RISE AND FALL OF GLASS-STEAGALL

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ABSTRACT

The passage of the Financial Services Modernization Act in 1999 was said to have finally repealed the Glass-Steagall Act. In 1933, Congress enacted a set of bank regulations entitled of The Banking Act of 1933 (more commonly known as the Glass-Steagall Act) which created an array of new bank structures and restrictions, including: 1. the prohibition and limitations of deposit interest payments, 2. the separation of commercial from investment banking, and 3. the creation of FDIC. Furthermore, the new legislation chose to reaffirm the restrictions on interstate branch banking. The composite of these four provisions formed an environment in which banks operated for decades, until one after another these restrictions were stripped away until the passage of the FSMA left only FDIC as the last major component still standing. This paper examines the four provisions and reviews the literature in terms of: a. the rationale behind each provision, b. the theoretical and empirical evidence about the wisdom of the rationale, c. the ultimate impact of the provision on the banking industry, and d. the reason why all but FDIC have been repealed.

Introduction

When Congress passed the Financial Services Modernization Act in 1999 and ended the separation of commercial banking and investment banking, media reports universally described this action as the repeal the Glass-Steagall Act, one of the longest-lasting legislative legacies of the Great Depression. Sixty-six years earlier, in response to the banking crisis that culminated in the bank holiday of 1933, Congress had enacted a set of bank regulations entitled of The Banking Act of 1933. This wide-ranging banking-reform law has been more commonly, and sometimes confusingly, known as the Glass-Steagall Act, after its principal architect Senator Carter Glass and his colleague and ally in the House, Representative Henry Steagall.[1] Like much of what was done by the federal government during the Depression, these bank regulations were born in an atmosphere of emergency and uncertainty at a time when the true sources of the bank crisis, as well as the Depression itself, were not fully known or well understood. Nevertheless, guided by the principle premise that it was the reckless actions of bankers that precipitated the crisis, Congress imposed a set of restrictions on banking that was designed to prevent a recurrence of a bank crisis by significantly limiting what banks could do. Glass-Steagall created an array of new bank structures and restrictions, arguably the most important of which were: 1. the prohibition and limitations of deposit interest payments (often simply called Regulation Q), 2. the separation of com-

mercial banking from investment banking (which we will later abbreviate as SCIB), and 3. the creation of the Federal Deposit Insurance Corporation (hereafter, called FDIC). In addition, the new legislation chose to reaffirm and keep intact the restrictions on interstate branch banking found in the McFadden Act of 1927. The composite of these four provisions formed an environment in which banks operated for decades. One after another, these restrictions have been stripped away until the passage of the Financial Services Modernization Act has left only FDIC as the last major component of Glass-Steagall still standing.

Such an historic change calls for an historical study. First we will return to period when Glass-Steagall was written in order to review briefly the process that led to its passage. Then we will examine each of the four provisions, and review the literature in terms of: a. the rationale behind the provision, b. the theoretical and empirical evidence about the wisdom of the rationale, c. the ultimate impact of the provision on the banking industry, and d. the reason why all but FDIC have been repealed.

Passage of Glass-Steagall

On March 6, 1933, the newly inaugurated President Roosevelt declared a bank holiday and called for a special session of Congress to convene on March 9 to deal with the bank crisis.[2] In that session, Congress passed and sent to the President the Emergency Banking Act, which was designed to get the banks back open again as soon as possible (Chandler 1970, 145). On the same day, Senator Carter Glass introduced a bank reform bill. This multi-faceted plan was designed to correct the flaws that led to thousands of bank failures throughout the 1920s and had ultimately triggered and propelled the debilitating bank crisis from 1930 to 1933. In the House, Representative Henry Steagall offered essentially the same bill (Kennedy 1973, 204). These two names had shared top billing a year earlier on the Glass-Steagall Act of 1932, a piece of legislation concerning the gold backing of the money supply. Glass was by far the more prominent of the two, having been the co-author of the Federal Reserve Act in 1913, the Secretary of Treasury under Woodrow Wilson, and the preeminent expert on banking on Capitol Hill. He had been proposing bank reform legislation throughout the three years of the banking crisis to little or no avail. But now with fellow-Democrat, Roosevelt, in the White House, chances for passage of his reforms increased substantially. Glass's bill would become part of Roosevelt's one-hundred-day blitz of legislation that attacked the Depression from all angles. Steagall, the chairman of the House Banking and Currency Committee, was a staunch supporter of farmers and rural banks (Schroeder 1998, A6). His support was always necessary for the passage of any banking bill. Eventually, the names of Glass and Steagall would be immortalized by the passage of this most sweeping and consequential of bank reform bills. There may have been more than one Glass-Steagall Act, but the one passed in 1933 became the Glass-Steagall Act.

Senator Glass had begun pushing for banking reforms almost as soon as the banking crisis began. The greater sense of urgency caused by the 1933 bank holiday and the alliance with Steagall helped push this bill through Congress. But the path was still a contentious one, as will be discussed in more detail in later sections. The plan to separate investment and commercial banking was fueled in part by the inflammatory Pecora hearings (held earlier in the year) into the security dealings of commercial banks (Huertas 1984, 151; Kennedy 1973, 103-28) and was assured of passage. But efforts to expand branch banking by national banks were met with a firestorm of protest from the supporters of small unit state banks. And the ultimate passage and signing of the entire bill was held hostage up to the last minute by the debate over deposit insurance (Kennedy 1973, 207-23). In the end, the bill was flawed and incomplete – another "Banking Act" was needed in 1935. Nevertheless, following its passage, the financial markets were left with a set of four restrictions whose merits and life histories will be the targets of our attention.

Deposit Interest Rate Ceilings

If there was one central theme behind the bill Senator Glass introduced, it was that banks had too often violated the standards of "sound banking," by acquiring too many risky assets. Furthermore, it was Glass's belief that too much of this asset money had flowed from the interior banks into the major banks of New York City. Once there, that money had been channeled into particularly risky loans in the securities market. This theme was the basis for limiting the payment of interest on deposits. In the simplest of terms, the deposit interest payment restrictions were justified by the contention that part of the difficulty banks had encountered over the previous decade had been caused by the intense competition among banks for deposits. This competition had manifested itself in high deposit interest rates and a predilection to loans that were relatively more risky, motivated by the need to cover the costs of those high rates. By eliminating interest on demand deposits and limiting the rates on time deposits, it was hoped the regulation would reduce this unhealthy competition among the bankers to the betterment of the banking system (Linke 1966, 460-68).

In fact, in the 1920s, banks were competing so hard to attract and retain deposits that they were paying lofty rates of interest on savings deposits – e.g., from 4% to 7% in 1926, at a time when inflation was negligible. Then, so the argument goes, faced with the high costs of acquiring funds, the banks were pushed to seek out higher rates of return on their uses of funds in order to protect their profit margins. This quest for higher asset returns pushed them into more and more risky assets, thereby increasing their capital-to-risky-assets ratios and increasing their chances of insolvency (Benston 1964; Gambs 1977, 13; Gilbert 1986, 22-24; Linke 1966, 462-65). The prescription was a ceiling on time deposit interest rates to prevent banks from getting carried away in their competition for depositors.

There was a second rationale behind this provision of the bill, and it had to do with interbank deposits. It was quite common for hinterland banks to maintain deposits in New York City banks that served at least two purposes. These deposits acted like secondary reserves in that they paid attractively competitive rates of interest while being, at the same time, highly liquid. And as a further attraction, these interbank deposits offered the interior bank the feature of allowing it to connect its customers to the financial activities in New York City through the banks there. Kansas depositors' money could be invested in the big-city markets just as easily as Wall Street money. The problem with this arrangement was that it all too well resembled the pyramid deposit system that had made the national banking system so crisis prone before the creation of the Federal Reserve. Even without a panic, the seasonal draining by rural banks of the funds from their deposits in the New York City banks to satisfy depositors needs back in the rural communities left the latter banks highly susceptible to liquidity difficulties. Hence liquidity crises could spread throughout the banking system in the same manner they did in the latter nineteenth century. The suggested solution would be the elimination of any interest on interbank demand deposits. This would cause interior banks to reduce their correspondent deposits and keep more of their funds back home. There the funds would either stay in the vault where it would improve their liquidity position or they would be directed toward "productive" loans in the local community where they supposedly belonged.

But is there any empirical truth to the theory that interest payments on deposits contributed to the bank crisis? That is, was there a correlation between deposit interest rates and bank failures? Not according to Benston (1964) or Cox (1966). Neither found a statistical relation between the rates of interest paid by bank to depositors and the likelihood of bank failure. For example, Benston concluded that the rationale for the prohibition of the payment of interest on demand deposits had "no basis in fact" during the banking crisis period (Benston 1964, 449). While it may sound plausible that high deposit interest rates will force bankers to seek higher rates of return on loans, bankers will testify that their loan portfolio choices are made independent of the level of the interest rates they pay on deposits. On the other hand, given how this regulation, at first glance anyway, made banking so much easier, one cannot help but suspect that bankers did not protest this provision very hard for good reason. What banker would fight against a free source of funds? Indeed, the provision passed through committee consideration with barely a ripple of debate, as this provision became conceptually tied to the provision that separated commercial and investment banking (Linke 1966, 465-69).

As it turned out, Regulation Q had very little effect on bankers, actions during the first twenty-five years of its existence. In fact, instead of reducing their holdings of interbank deposits, small banks actually significantly increased them during the remainder of the 1930s (Gilbert 1986, 24). In that respect, the prohibition on demand deposit interest was totally ineffective in achieving its purpose. Similarly, the ceilings on time deposit rates were virtually meaningless until the rise of interest rates in the

1960s. It was then that the banking community realized how harmful these restrictions could be.

The ceiling on savings deposits was set at 2.5% from 1933 right up to the late 1950s. During that period, banks and thrifts had virtually no competition for short-term deposits, given that the rates on securities like Treasury Bills were well below those ceilings. However, money market interest rates creeped upward until, in 1956, the return on T-Bills exceeded the Regulation Q ceiling for the first time. This led to the first elevation of the ceiling since its inception, when the Federal Reserve raised it to 3% in 1957. As the rate of inflation began to climb in the in the 1960s, interest rates rose with it, and several ceiling hikes followed. Money market rates eventually topped 7%, over three percent above the Regulation Q ceiling. This differential was too attractive. Many depositors withdrew their funds from banks and simply purchased T-Bills directly. The banking industry (along with thrifts) suffered from "financial disintermediation."

What followed for the next decade was a series of stopgap measures and financial innovations – a lengthy story in itself that we will touch on only briefly.[3] The days of Regulation Q were numbered. As money market rates reached the double-digit level, banks and thrifts could not retain their depositors. Funds flowed out in search of better returns through direct purchase of securities and through the new intermediaries on the block, money market mutual funds, who offered check writing services from accounts that paid money-market rates. Banks could not compete for funds with Regulation Q tying their hands and preventing them from offering comparable rates of return on both checking and savings accounts. A regulation designed to safeguard banks by keeping them from competing too hard with one another for depositors was endangering their survival by stopping them from competing with other financial intermediaries. A new banking crisis had developed with a new form of bank run.

Forced to act in the face of this new banking crisis, Congress passed the Depository Institution Deregulation and Monetary Control Act in 1980. Among its many provisions, this legislation repealed Regulation Q by eliminating the prohibition of paying interest on individual checking accounts and by phasing out the ceiling on savings account interest payments over a six-year period. Bank interest rate ceilings on individual deposits, whose rationale was flawed to begin with and which never did what they were designed to do anyway, became unworkable and were thrown on the regulatory junk pile by 1986. However, the prohibition of interest payments on inter-bank deposits was retained.

Separation of Commercial and Investment Banking

Senator Glass's concerns about banks violating the standards of "sound banking" were even more pronounced when it came to the involvement of banks in the underwriting of securities – the realm of investment banking. As Huertas (1984, 149-50) and Benston (1996) have indicated, Glass was a disciple of the "real bills doctrine" as

far back as his work on the Federal Reserve Act. In the briefest of terms, the real bills doctrine holds that banks should strictly limit their assets to short-term commercial loans for the purpose financing a commercial borrower's acquisition of raw materials or inventory. These real assets would supposedly lead to sales revenues for the commercial borrower to be used to pay back the loans in short order. Or lacking the sales revenue, the real assets themselves could be sold to pay back the loan. In this respect the loans were said to be "self-liquidating" and relatively safe. Moreover, since these loans were directly connected to economic activity, they could be declared "productive," which means that they led to "real" activities rather than "speculative, such as the purchases of securities (White 1983, 115-25).

From Glass's point of view, banks simply were not following the standards of the real bills doctrine when they made loans that were secured by financial assets, and this practice had become far too common during the 1920s. In order to encourage banks to follow the real bills doctrine, the Federal Reserve Act had established that rediscount loans from the Fed to banks at the discount window would be based upon only real bills. It was hoped that this provision would provide banks with enough incentive to upgrade and maintain the quality of their portfolio of assets to the standard of the real bills doctrine. Even though the recommendation of the famous Pujo Committee in 1912 was to separate commercial and investment banking, Congress did not do so (Huertas 1984, 150). In fact, the McFadden Act of 1927, better known for its impact on branch banking, certified the practice of underwriting for national banks. It limited the banks themselves to underwriting debt issues, but it allowed the underwriting of equity through bank affiliates. In short, the McFadden Act authorized exactly what the Glass-Steagall Act would annul six years later. Banks commonly participated in the field of investment banking as the economy approached the crisis years of 1929-33 (Mester 1996, 4; Benston 1990 and 1996). As the financial crisis unfolded, Glass became progressively more convinced that part of the "unsound banking" problem could be traced to bank involvement in speculative activity in the underwriting area.

The banking bills Glass began offering at least as early as 1932 included the separation of commercial and investment banking (hereafter abbreviated as SCIB). The stock market crash and the mountains of rumors and anecdotes about speculative and fraudulent activities associated with both the crash and the ongoing banking crisis fueled a growing public suspicion about activities on Wall Street (Mester 1996, 4-5). Much of these suspicions were directed toward the transactions that were occurring behind the stone columns of the major banks that were heavy players in the debt and equity markets. Hearings into these practices were initiated in the Senate Banking and Currency Committee in 1932, but they drew little attention. That changed when the committee reconvened in January 1933 in the midst of another serious bank crisis. The newly appointed chief counsel, Ferdinand Pecora initiated a series of what would be described today as McCarthy-like hearings into the practices of the leading banks and their bankers to prove his contention that the bank crisis was the result of their speculative activities (Huertas 1984, 151; Kennedy 1973, 103-28). Pecora's hearings

never proved any connection between bank failures and speculative activities associated with underwriting (Benston 1990, Chapters 3 and 4). In fact, the provisions of the Securities and Exchange Commission Act of the same year addressed most of the questionable transactions Pecora did expose. Nevertheless, with Pecora acting as prosecutor and the banking committee acting as jury, the verdict reached was that commercial banking and investment banking needed to be separated.

After March 1933, SCIB was a certain ingredient in the Glass-Steagall Act, much to the satisfaction of Senator Glass. Investment bankers, who had felt all along that commercial bankers had an unfair advantage in the underwriting field, were glad to see such a provision. Congress was essentially going to eliminate commercial bankers as their competitors. But even the commercial bankers – particularly those not active in underwriting – were persuaded by the tidal wave of public opinion that SCIB would be good for their industry. Thus, Sections 16, 20, 21, and 32 (the sections of the Glass-Steagall Act that have become commonly known as "the" Glass-Steagall Act) of the Banking Act of 1933 address SCIB. Technically, the SCIB sections did not completely separate commercial and investment banking. Nevertheless, the SCIB sections virtually prohibit banks and their affiliates from underwriting or owning corporate equity and drastically limit the same activities with respect to corporate debt.[4]

Once again, we ask the empirical question: Does evidence exist to support the claim that the underwriting activities of commercial banks contributed to the bank failures during the bank crisis of the Great Depression? The answer is a resounding No. A number of empirical studies have looked at the question from a variety of angles – excessive risk-taking, conflicts of interest, etc. – during the pre-1933 era. None has found evidence to support the rationale for SCIB (Ang and Richardson 1994: Kroszner 1996; Kroszner and Rajan 1994 and 1995; Puri 1994 and 1996; Rajan 1996; and White 1984).

One notices that a surge of research on the subject came in the 1990s. That is because during the late 1980s and early 1990s, the firewall that had been separating commercial and investment banking since the passage of Glass-Steagall had been eroding. In one step after another banks chipped away at SCIB as regulators, primarily at the Federal Reserve, allowed banks more and more leeway in the underwriting of debt and equity. Eligibility restrictions were relaxed, and Section 20 limits were nudged upward. J.P. Morgan offered the first publicly-issued corporate bond underwritten by a commercial bank affiliate in 1989, and followed that with the first equity issue underwritten in a bank holding company subsidiary in 1990. By 1996, the Fed had raised the revenue limit for underwriting activities from 10% to 25% of a bank's total revenues. And in 1997, the purchase of Alex. Brown (an investment bank) by Bankers Trust (a commercial bank) bridged a chasm that had existed since 1933. With commercial banks offering mutual funds and annuities and investment banks providing certificates of deposits and loans, it was getting difficult to tell commercial banks from investment banks. Each had invaded the other's turf to such an extent that it had become apparent that the days of SCIB were numbered. After a merger by Travelers

Group and Citibank forced Congress to act sooner than it might have, the Financial Modernization Act was passed in 1999. Now one "financial holding company" may offer all of the services of commercial and investment banking, although the activities are still kept somewhat separated in different affiliates. A second major plank of the Banking Act of 1993 had been declared flawed and obsolete.

Deposit Insurance versus Branch Banking

The third major banking provision of the Banking Act of 1933 was deposit insurance. In retrospect, of all of the stipulations of the Act, this one probably did the most to make the banking system panic proof and, thereby, far less prone to failures. During the 1920s, an average of over six hundred banks failed annually, and over the four-year period of the crisis from 1930 to 1933, another 9,000 banks failed. But after the creation of FDIC, panics and banks runs virtually disappeared. Moreover, bank failures plummeted to 61 in 1934, and never exceeded 82 for the rest of the decade (Friedman and Schwartz 1963, 438). FDIC data tell us that annual failure rates would not exceed twenty-five again until the 1980s, when failure rates topped one hundred and two hundred for eight straight years. This history tells us that, on one hand, FDIC has greatly reduced the likelihood of bank failures by eliminating the bank panic as a source of difficulties. But on the other hand, the experience of the 1980s indicates that FDIC has not eliminated other reasons for bank failures, like bad management and risky lending. FDIC may make the system panic-proof, but certainly not failure-proof.

What has become clear over the years is that FDIC has been a *sufficient* measure to ward off bank panics. Furthermore, Friedman and Schwartz contend that had FDIC been in existence in 1930, "it would very likely have prevented ... the tragic sequence of events" that caused the catastrophic decline in the money supply over the subsequent three years (Friedman and Schwartz 1963, 441). They are convinced the nationwide bank crisis never would have gained momentum had deposit insurance been in existence, since most, if not all, of the bank runs would not have occurred had depositors had the assurance of knowing their funds were safe.

Whether federal deposit insurance was actually *necessary* is another question. Many have wondered whether the American banking system could have been spared many of the failures, and the panics they spawned, during the 1929-33 period had nationwide branch banking been the norm. Canada had only ten banks – nine of which possessed numerous branches nationwide – and none had failed (Drummond 1991; Friedman and Schwartz 1963, 352; White 1984, 132). That comparative result leads one to the question: Would banks that were part of a nationwide branching system have been far less susceptible to failure? With bank failures, and therefore bank panics, far less common in a banking system that is dominated by nationwide branch banking, the need for deposit insurance may have been obviated. Either deposit insurance or branch banking can ward off bank panics. The choice of the former over the latter by Senator

Glass *et al* in 1933 has an interesting story, and the ramifications of that choice have certainly been the grist for a great deal of debate and research.

In earlier years, Senator Glass had been opposed to the establishment of a nation-wide banking system because of his general support of the interests of smaller banks. But the plight of the small unit banks and their depositors over the last decade had persuaded him that his overriding goal of achieving "soundness" in the banking system was being sabotaged by the many small bank failures. The failure of small banks had spread like an infection throughout the entire banking system. In conjunction with his plans to strengthen the Federal Reserve, Glass suggested an enhancement of the national banking system by allowing national banks to branch in all states (regardless of the individual states' restrictions concerning branching) and even to extend those branches across state borders where urban market areas reached from one state to another. As it had before, this idea was met with a storm of protest from the supporters of state and unit banking (Kennedy 1973, 207-08).

In order to understand this controversy, one must review a bit of the historical background on branch banking. As Mengle (1990, 5) points out: "The history of banking in the United States is characterized not simply by the lack of interstate branching, but by the longtime lack of interest in branching within a state as well." Branching had really only started to catch on at all at the turn of the century. The concept had gained some popularity, as a means of getting banks into smaller communities that could not support a unit bank. At this point, the American banking structure was at an important fork in the road. Congress did not choose the branch-banking route. Instead, in the Currency Act of 1900, it made it easier for small towns to get their own banks by authorizing a reduction in the minimum capital requirement for new bank charters. This decision would come back to haunt the banking system. What followed was an explosion of new bank charters as the number of banks in the United States rose from 13,000 in 1900 to 25,000 in 1910 and finally to a peak of 30,000 in 1920. The groundwork for the bank crisis had been laid. The majority of these banks would not survive the next thirteen years because they were too small, too illiquid, and too non-diversified (Mengle 1990, 6).

With all of these small, unit banks now dotting the countryside, the opposition to branch banking had gained a cadre of supporters. Each of these unit banks considered the concept of branch banking a threat to its survival. Nevertheless, branching of state banks was becoming more common in a few states. At the same time, however, it was not clear whether national banks were actually allowed to branch. The issue kicked around the courts until it was finally settled after much debate by a provision of the McFadden Act of 1927. This is the law commonly known for prohibiting interstate branching, but what it really did was make it legal for national banks to branch, albeit only within cities. While that provision cracked open the door to branching for national banks, it also codified the limitation of branching within state borders (Mengle 1990, 7).

While the multitude of bank failures led some to the conclusion that a nationwide banking system might be an idea whose time had come, the state banking faction was intransigent. Glass settled for the inclusion of a small liberalization of the McFadden Act in the Glass-Steagall Act. National banks were permitted to branch to the same extent as their state counterparts in each state. Interstate banking was not to be one of the reforms in included in Glass-Steagall. The stability of the banking system would have to be accomplished in another manner (Kennedy 1973, 208).

Many look back at this period and rue this lost opportunity, because they believe the true source of instability in the American banking system was the preponderance of small, unit banks (Ely 1988; White 1983). Several studies of bank failures in the United States in the 1920s and 1930s have found that they were highly concentrated in two ways: 1. geographically, particularly in rural areas in non-diversified markets, and 2. structurally, among the small unit banks that made up the overwhelming majority of the banks that failed. In his studies of bank failures in the 1920s, Wheelock concludes that branch-banking restrictions increased the likelihood of bank failures by limiting bank market size and diversification opportunities (Wheelock 1992b and 1993). Agricultural problems in a community could mean the death of a small unit bank, where the branch of a much larger more-diversified bank could sustain the same losses without bringing down the entire bank. Other studies by Mengle (1990), Calomiris (1993b), and White (1984) reached similar conclusions. It is not that banks that had branches did not fail. Indeed, possibly the most famous single bank to fail, Bank of United States, had fifty-seven branches. Its failure was used as ammunition by the anti-branching forces. But the bank failures among banks with branches were a small percentage of the total. Furthermore, since branching at this time was almost entirely confined to the city in which the primary banks were located, the branched banks that did fail – like Bank of United States — hardly fit the model of being diversified over a wide geographic area.

Comparative studies of the United States and Canada by Kryzanowski and Roberts (1993) and Drummond (1991) conclude that the nationwide branching system clearly increased stability. It did so by enhancing the flow of funds from one geographic area to another. This made the Canadian banking system far less likely to turn a local liquidity problem into a nationwide crisis. Grossman's (1994) comparative study of many countries and their experiences during this period found a general theme that branch banking was a source of stability – as was a good lender of last resort, something else sorely lacking in the United States. Without the Federal Reserve doing its job of adding and shifting liquidity, the American banking system was left with no nationwide conduit system for moving liquidity to where it was needed most, as was done automatically among the branches of Canadian banks.

But there was no persuading the unit-banking supporters in 1933 that branch banking was not a threat to their survival. Stability for the entire system would have to be found somewhere else. To Steagall and Vice President John Nance Garner, the only answer was to insure deposits. But Congress and the White House did not come easily to this answer.

The deposit insurance debate had a long and rocky history even before the Depression, too long to address here (Calomiris and White 1994; Golembe 1960). Those supporters of the unit banking system we discussed above gravitated to deposit insurance as a far more attractive alternative to the creation of a more unified and regulated national banking system. But opponents of deposit insurance were many. Representatives of the country's larger banks were against a system that had them bailing out their risky brethren. Franklin Roosevelt was a hard-core opponent, threatening to veto any bill that included it, and even Senator Glass was unconvinced of its merits. But while congressional debate had focused over the years on the costs and benefits of deposit insurance from a more technical point of view, public perception was what really mattered at this juncture. Garner warned Roosevelt that it was all well and good to reform the banking system and reopen the banks, but people were not going to put their money back in the banks without some form of guarantee (Kennedy 1973, 214). Even though the creation of a deposit insurance system would not pay back a single dollar of previous lost deposits, it was deemed crucial to the reestablishment of public confidence in the banks. In answer to our earlier question, under the circumstances that existed in 1933, deposit insurance was necessary.

But if deposit insurance was both a necessity and inevitability in 1933 from the point of view of reestablishing public confidence in the banking system, does it also contribute to sound banking? Many are still not convinced. It had long been argued that in a deposit insurance system, the sound banks would subsidize the unsound ones, much as safe drivers pay higher insurance fees because of the wrecks of the bad drivers. Depositors of poorly-run failed banks would be paid off from funds collected primarily from the well-run banks. Given this perspective, it is easy to understand that most of the opposition to deposit insurance came from the large banks that were least likely to fail. As a corollary, support came from the smaller, higher-risk banks. Deposit insurance allowed them to attract more depositors than they would have otherwise, since their risky balance sheets would have likely repelled depositors. Bank runs do serve a purpose in that they send a message from depositors to bankers about the perceived degree of risk-bearing in their operations. The fear of a run would act to rein in a bank's tendencies toward adverse selection of assets (Calomiris 1990, 290-93; Kaufman 1988, 23-25). Not surprisingly, high-risk banks tended to gravitate toward the state-run deposit insurance systems that existed prior to FDIC, and they took advantage of the protection it provided them. It is not hard to guess which banks would join a voluntary deposit insurance system. That means deposit insurance also increased the chances that moral hazard would plague the banking system.

These kinds of fears are borne out in the conclusions of a number of studies that looked at the pre-FDIC actions of banks. In a series of studies, Wheelock (1992a, 1992b, 1993, and 1995) found that the existence of state deposit insurance plans was associated with an increase in risk-taking and failures. He also argues that in a deposit insurance system, the larger banks subsidize the smaller, less-stable banks. Calomiris (1989) found higher rates of bank failure among the insured banks, and he also con-

cluded that the incidence of adverse selection and moral hazard increased in the presence of deposit insurance (Calomiris 1990). Thies and Gerlowski (1989), consistently found the following pattern of events: risky lending, losses that exceeded assessments, and the exit of the less risky banks from the system. This left, through adverse selection, an increasingly risky group of banks. Finally, Alston, Grove, and Wheelock (1994) reached a conclusion that is particularly germane here: deposit insurance limits the number of bank failures due to bank runs but increases failures due to risk taking.

This last observation of the practices of banks during the 1920s is perfectly applicable to the actions of savings and loans in the 1980s. Given the confidence that federally insured deposits generate, the existence of FSLIC ensured that no runs occurred on insured savings and loans (or even the uninsured ones). But deposit insurance, combined with the changes in regulations and enforcement, encouraged the managers of many savings and loans to act just like their banker counterparts in the 1920s. They were guilty of committing both adverse selection and moral hazard. The savings and loan crisis provides more recent evidence that deposit insurance generates incentives that work against the goals of sound banking (White 1998). Rather than give up on the premise of deposit insurance, Congress has worked to reform and revise it with FIRREA in 1989 and FDICIA in 1991. We keep patching up FDIC rather than abandoning it. This likely is because it is as hard to imagine depositors using our banking system today without FDIC as it was for Vice President Garner to imagine them putting their funds back into the banks without it in 1933.

What is ironic is that back in 1933, in the search of ways to make the banking system more sound, FDIC was the alternative to nationwide branch banking. With the passage in 1994 of Riegle-Neal, Congress finally came around to the acceptance of interstate banking by repealing most of the branch banking restrictions that dated back to the McFadden Act of 1927 and the Glass-Steagall Act of 1933. As nationwide banking gradually becomes the norm, the banking system should become progressively more sound and safe. FDIC may actually become as unnecessary as it could have been in 1930 had the United States had nationwide banking at that time (White 1983).

Conclusion

Both political laws and economic theories are often products of their times and the contemporary view of the workings of the economy. The reforms and regulations of the Glass-Steagall Act of 1933 are classic examples. Many, in looking back, have concluded that the collapse of the economy and the banking system had as much or more to do with the Federal Reserve's actions and/or failure to act as did flaws in the banking system (Benston 1975; Calomiris 1993a; Friedman and Schwartz 1963; White 1984). But that was not the consensus in 1933. It was widely held at that time that both the economy and the banking system were highly flawed and in need of major changes. Time was too limited to study the issues carefully; immediate action was needed. There can be no doubt that the legislative measures in the Glass-Steagall Act of 1933 succeeded in getting the banking system up and operating again. What is not so obvious,

however, is which measures truly deserve the credit for the revival and which simply spawned a financial system with as many or more flaws than before.

There was no solid evidence before or since the passage of Glass-Steagall to support the inclusion of the two provisions that limited interest payment on deposits and separated commercial and investment banking. Experience over the years proved that the deposit interest rate restrictions served no purpose but to make banks temporarily more profitable at the expense of their depositors and competing financial intermediaries. Regulation Q eventually threatened the survival of depository institutions. For its part, the separation of commercial from investment banking accomplished little other than to make investment bankers more profitable at the expense of banks and to make life far more inconvenient for financial services customers. While FDIC was undeniably successful in restoring public confidence in the banking system, it may have been attacking the symptom in the form of bank runs rather than the cause of disease, bank failures. In fact, deposit insurance may have actually contributed to the disease. The one reform that the banking system truly needed in 1933, nationwide branch banking, it did not get. It would be sixty years before Congress corrected that omission.

Notes

1. Even though the Banking Act of 1933 is named after its co-authors, the portion that deals with only with the separation of commercial banking from investment banking is often referred to the Glass-Steagall Act – witness any of the many news articles like Schroeder (1998) or even Federal Reserve publications such as Mester (1996).

2. In addition to the sources that will be cited later in reference to the specific sections of the Banking Act of 1933, the following sources deal with the causes and consequences of the bank failures during the bank crisis period: Benston (1975); Gambs (1977); Keehn and Smiley (1993); Stauffer (1981); and Wicker (1980).

3. One measure taken in 1970 was an increase in the minimum price for Treasury Bills from $1,000 to $10,000. This was meant to discourage depositors from disintermediating. While the measure did slow the small depositors who had less than $10,000 to shift, it had far less effect on major institutions. In this respect is discriminated heavily and unfairly against those with less wealth. In time, money market mutual funds arose to offer money market returns for investments that were much smaller than $10,000.

4. For a thorough analysis of the legal quirks of the SCIB provisions, their interpretations, and their track record over the years, see Benston (1990), as well as Jonathan Macy and Geoffrey Miller. *Banking Law and Regulation.* Boston: Little, Brown, 1992.

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