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Statement of the Shadow Financial Regulatory Committee

On

The Latest Round of Bills on Financial Modernization

April 26, 1999

Both the House and Senate Banking Committees have now passed financial modernization legislation, and while neither bill is what anyone should reasonably call "modernization" or "reform," both contain modest improvements over last year's weak effort.

Real banking modernization would require no more than a single sentence: "The Bank Holding Company Act of 1956 and the Glass-Steagall Act of 1933 are hereby repealed." That would remove the artificial constraints imposed by law. These bills run to several hundred pages of intricate compromises among interest groups and the banking agencies. On balance, the Shadow Financial Regulatory Committee still believes the nation's financial system would be better off with no bill.

The House Banking Committee bill has yet to run the gauntlet of the House Commerce and Rules Committees, and if the past is any guide these committees will make substantial changes in the Banking Committee's product. However, in its current form, by accepting the idea that subsidiaries of national banks can engage in investment banking as well as merchant banking—and by permitting merchant banks to control nonbanking businesses in the ordinary course of their activities—the House Banking Committee's bill is superior to the bill adopted by the whole House last year.

The bill also improves last year's H.R. 10 by working out a division of responsibility between the Treasury and the Federal Reserve Board. Under the

bill's language, national bank operating subsidiaries would be able to engage in securities underwriting and merchant banking, but not insurance underwriting or real estate development, which would have to be carried on in holding company subsidiaries. In order to engage in these new activities through subsidiaries, national banks with more than $10 billion in assets would be required to be subsidiaries of holding companies and thus subject to Fed supervision. Although the Fed has not approved this approach, and continues to argue—incorrectly, we believe—that activities in bank subsidiaries pose a greater danger to the safety net than in holding company subsidiaries, the House bill at least suggests a way to avoid a veto over what is essentially a false issue.

Similarly, the Senate Banking bill, by continuing unitary S&L holding companies, and allowing them to transfer ownership to commercial companies in the future, is a major improvement over last year's bill. It opens another channel to permitting the scope of the firm to be determined by the market.

In the bitter dispute over the Community Reinvestment Act, Chairman Gramm has raised questions which deserve thorough review. If the rest of the bill were acceptable, we would urge Congress to put the CRA issue aside for separate consideration in greater depth and to proceed to pass this much-delayed legislation.

But the rest of the bill is not acceptable as financial modernization or reform. Congress continues to be in thrall to the idea of maintaining the "separation between banking and commerce," even though this concept continues to search for some adequate policy justification. While Congress now seems finally to have accepted the idea that banks can be affiliated with securities or insurance underwriters, no one has drawn a principled distinction between those firms and a commercial company. Every danger that supporters of continued separation purport to see in banks affiliating with, say, software manufacturers, would also be present when banks affiliate with securities or insurance firms. That is not, of course, an argument against banks having such affiliations; it is an argument against allowing a false distinction to drive the current legislation.

The same can be said of the idea that bank subsidiaries pose a greater danger to the safety net than the subsidiaries of holding companies. As long as the capital invested in the subsidiary is subtracted from the bank's capital, and as long as the bank supervisors oversee transactions between the bank and its subsidiary, these subsidiaries are not functionally different from holding company subsidiaries. Indeed, their success would strengthen the financial condition of the bank.

The Committee has consistently opposed any legislation that implements a policy of separating banking and commerce, or which appears to place any store in the policies underlying the Glass-Steagall Act. (See Statements No. 56, May 7, 1990; No. 115, December 12, 1994; and No. 118, May 22, 1995.) While we find some of the changes between last year and this year to be small steps in the right direction, there is no reason at this point to believe that the current House and Senate Banking Committee bills will result in a better financial services environment than the status quo.