Volume 31 | Issue 2 Article 6

January 1986

Drafting a New Regulatory Scheme: A Congressional Perspective

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DRAFTING A NEW REGULATORY SCHEME: A CONGRESSIONAL PERSPECTIVE*

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At the outset, I would like to thank New York Law School for the opportunity to participate in this distinguished forum. A symposium to discuss the issues underlying the Glass-Steagall debate is indeed timely. These issues are going to influence America and the world far more in the future than in the past, and I think it is altogether appropriate to pull together such a distinguished panel, myself excluded of course, to address this topic. As an advocate, on the House Banking Committee, for the preservation of Glass-Steagall, I will try to temper my remarks, but only somewhat, so you'll have to see through some of the advocacy here to determine how much is Congress' view, and how much is simply my view.

One thing is clear, the world of banking has changed dramatically over the last decade. To look at banks and financial institutions in general today, and to look at them in 1976, one would not know that they were actually the same institutions. A dramatic revolution has already occurred and now the question is: (a) what caused this revolution; (b) how does the financial system adapt; and (c) how does the government, in particular, react to these changes.

The first dramatic change has been in the area of technology. Money can move around with the blink of an eye, the touch of a button. The days of paper transfers, of billions of dollars of little notes and papers being transferred from airplane to airplane are gone, and that of course speeds up everything and creates new competition where it has not existed before.

A second important change involves the rules governing the banking industry. Deregulation of money has occurred at least on the deposit side, which bankers in their arcane lingo refer to as the liabilities side. It is sort of ironic that on the day that interest rate regulation finally expired,[1] the average money market deposit account interest

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* This article is an expansion upon remarks made by Congressman Schumer at the New York Law School Symposium on Financial Regulation Under The Glass-Steagall Act, held on April 4, 1986.

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1. *See* Depository Institutions Regulation Act of 1980, 12 U.S.C. §§ 3501-3509 (1982). The Act provided that the authority to impose limitations on maximum interest rates would expire on March 31, 1986. On that date the statutory authority of the Depository

rate was a little over six and one-half percent. If that rate had prevailed between 1978 and 1980, we would probably still have Regulation Q,[2] because the impetus behind deregulation was: first, that interest rates had skyrocketed to the fifteen, sixteen and even twenty percent range; and second, non-banking institutions had begun to siphon off depositors' money by offering investment vehicles that would realize these profitable interest rates. Banks quite naturally became very frightened. All of their depositors did not want to stay at five and one-half and five and one-quarter percent money, and so they started investing in the money market funds and everything else. While being denuded, the banks clamored for legislative action; and Congress responded.

One problem with Congress' response is that the long-range impact of deregulation on the national interest was largely overlooked. How much real interest rates are permanently affected by deregulation is another matter altogether, but what Congress intended to look at was simply the competition among competing institutions. Congress considered: "Well, the banks are doing this and the securities firms are doing that—how can we equalize it?" This is not what I conceive to be my role as a Congressman, nor should it be Congress' role. Congress ought to determine what is in the national interest and if certain financial institutions prosper and others suffer hardships, as long as the national interest is prospering, we ought to go ahead and do what is best.

One thing that has not changed—and this probably underlies my beliefs more than anything else—is that the banking system is fundamentally based on one thing, confidence. If you look at the economic history of the United States between 1789 and 1929, far more hardships and cycles in the economy were invoked by an unstable banking system, in which people did not have confidence, than by just about anything else. The panic of 1873[3] and the panic of this year[4] were both

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Institutions Deregulation Committee, established by the Act to provide for the orderly phase-out and ultimate elimination on maximum interest rates which could be paid on deposits, expired. *Id.* §§ 3502-3503.

2. Regulation Q—Interest on Deposits, 12 C.F.R. pt. 217 (1986). Effective April 1, 1986, Regulation Q was amended to eliminate those sections that governed withdrawals from time deposits and savings deposits, set early withdrawl penalties, and established account characteristics and interest rate ceilings. 51 Fed. Reg. 9636 (1986).

3. For a discussion of factors which contributed to the failure of state banks during the panic of 1873, see J. WHITE, BANKING LAW 6-18, 23-24 (1976).

4. *See, e.g.*, N.Y. Times, Apr. 10, 1986, at D8, col. 4 (banking regulatory agencies seek new powers to aid insolvent banks in the southwest and midwest); N.Y. Times, Apr. 5, 1986, at A35, col. 2 (announcement that Mainland Savings Association, a one billion dollar institution, was closing; apparently the largest failure ever of a thrift institution in the United States); Barron, *Financial Scandal Lingering in Ohio*, N.Y. Times, Apr. 4, 1986, at A15, col. 1 (discussing the closing of Home State, Ohio's largest privately-insured thrift institution).

caused by banking failures. The depression of 1929 may have had many root causes, but certainly the instability of the banking system prolonged, exacerbated, and may have even caused the Great Depression.

Confidence is the foundation of stability in banking, and the point of departure in determining the national interest. What I find so strange—indeed, contradictory—about the deregulators, is that they risk impairing the very confidence that regulation has built up over the past fifty years. We have not had a single panic, we have not had any rocking of the financial and economic system because of lack of confidence in the banking system, mainly because Franklin D. Roosevelt effected a number of changes—regulatory changes—that allowed the financial system, the banking system, and the American economy to grow and prosper.[5] Before we start thinking about dismantling those changes, we ought to think about whether or not we are destroying the very plateau—banking and financial confidence—from which the deregulators are ready to jump. They think they will soar, I fear they may fall, and this dispute is the essence of the debate.

I think the proponents of eliminating Glass-Steagall emphasize the first two changes but they don't give enough emphasis to the level of confidence engendered by prudent regulation. Also, of course, they talk about the desirability of maximum competition within the banking industry. I would submit that there is plenty of competition right now. We have over 14,000 banks,[6] maybe a thousand securities firms, tons of insurance firms, and all sorts of hybrids in between. There is no lack of competition, and I think the general view of Congress is: Yes, free market open competition is desirable, but only when it serves the long run national interest. If by increasing an already competitive system we seriously erode confidence in the system, we would be doing the country a disservice.

In Congress, we are beginning to see a stepping back from the deregulation philosophy and that is quite natural because deregulation has caused some fallout in the financial services area, and in other areas as well. What are members of Congress thinking about? Well, they are thinking about how Glass-Steagall and deposit insurance instilled confidence in the banking system following the Great Depression. There is also a maxim: If it ain't broke, don't fix it. We have the

5. I am referring here, of course, to the Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.), which provided for the Glass-Steagall prohibitions, *see id.* §§ 16, 20, 21, 32 (codified as amended at 12 U.S.C. §§ 24, 377, 378, 78, respectively (1982)), as well as the Federal Deposit Insurance Corporation, *id.* § 8 (current version at 12 U.S.C. § 1811 (1982)).

6. A 1984 government report stated that there were 14,467 commercial banks in the United States. TASK GROUP ON REGULATION OF FINANCIAL SERVICES, BLUEPRINT FOR REFORM: THE REPORT OF THE TASK GROUP ON REGULATION OF FINANCIAL SERVICES 20 (1984).

strongest financial markets in the world, far stronger than any other country's. That is one of the advantages that even the Japanese admit we have over them. So if it ain't broke, why monkey around with it.

Finally, we have to set the whole banking area in context. Most members of Congress do not study these issues on a daily basis. When I go to O'Halloran's bar on Clinton Road in my district—not to drink of course, just to shake hands with the patrons—Joe Timothy doesn't come over to Chuck Schumer and say: "Hi, Charlie, what's going on with Glass-Steagall down there in Washington?" Only because I am a member of the House Banking Committee do I devote a lot of time to these issues. Although it is not part of today's theme, it is very important to understand that oftentimes it is hard to get comprehensive legislation. Most members of Congress are not thinking about these issues nor are their constituents. So if a single little industry group—for instance, the local Sears manager who is a powerful and important person in your town—lobbies for consumer banks, members of Congress think: "Why not?" A lot of legislation is passed or conversely Congress gets paralyzed, because there are so many of these interest groups asking—quite naturally, and quite correctly, as part of our democracy and as part of the American way—for their own little provisions. At this point, however, Congress isn't convinced, in my opinion, that deregulation and elimination of Glass-Steagall are the way to go, even though there are far more industry interest groups pushing in that direction.

A number of events have created cause for concern. We have experienced a series of banking calamities. I suppose calamity is much too strong a word, but the confidence in the banking system has been rocked to a certain extent. Additionally, we have experienced problems with real estate investment trusts in the middle 1970's,[7] third world loans, Continental Illinois and the oil and gas loans,[8] thrifts' direct investment in securities,[9] speculation, and fraud all impinging on financial stability. When Americans see people lined up at a bank, that is when things start to crystallize in the minds of most legislators.

7. The severe real estate recession in the mid-1970's caused several prominent real estate investment trusts to fail. *See* Durnham & Rowland, *Real Estate Investment Trusts Win New Attention*, Nat'l L.J., Apr. 15, 1985, at 13, col. 1. For the statutory definition of real estate investment trusts for tax purposes, see 26 U.S.C. § 856 (1982 & Supp. III 1985).

8. *See Inquiry into Continental Illinois National Bank: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 98th Cong. 2d Sess. 1 (1984) [hereinafter cited as *Hearings on Continental Illinois*]; Nash, *Bank Regulators Seek New Powers*, N.Y. Times, Apr. 4, 1986, at A1, col. 6 (agencies fashion solutions to revitalize banks paralyzed by outstanding loans to oil and gas companies); Nash, *Woes Seen at 'Energy Banks,'* N.Y. Times, Mar. 27, 1986, at D9, col. 1 (assessment of the magnitude of problems faced by banks which have granted large loans to oil and gas companies).

9. For some recent examples of the thrift problem, see *supra* note 4.

We are now about to experience another problem in the banking industry. Oil and farm loans are being hit with a double whammy due to rapidly dropping commodity prices following over-investment when times were good. So we have got a whole lot of problems, and every time one of these problems arise people say: "Wait a minute! Why should we be allowing banks into newer and risker areas when they are having enough trouble in the general and traditional areas of banking?" That's a pretty common sense view, and I would submit that it is not too far off the mark.

My general view of what is happening in the banking world is that the deregulation of interest rates has forced banks into riskier businesses to begin with. If you have got to pay eight, nine, or ten percent on deposits with falling interest rates on loans, then you are going to seek higher yield and higher risk investments. Why did the banking system become so over-committed in the Third World? In my opinion, banks were seeking higher interest rates; they got them from Third World countries and became a little less prudent in the process.

In an environment in which confidence in the system is beginning to be eroded, the bottom line is that ownership interests in securities, insurance and real estate are inherently more risky than non-ownership. Sure there are certain commercial loans that might be even more risky than certain underwriting or real estate investments, but by and large the history of the industry indicates that commercial loans, particularly those that have collateral and are properly invested, tend to be far less risky than other kinds of ventures. If we allow our banks, already in such a precarious state, to get into new and more risky kinds of businesses, you are going to find new problems, a new lack of confidence, and additional failures.

Something that has had a major influence on the House Banking Committee is how the pressure to find new higher yield investments impacted on one bank, Continental Illinois. We held hearings after Continental Illinois failed,[10] and we discovered two serious deficiencies. Continental Illinois had no loan documentation for twenty-five percent of its oil and gas loans and fifty percent of these loans were extended without collateral.[11] In other words, they were in such a frenzy, pushed by a rapid growth mentality and by the need to find a greater rate of return, that it was crazy. Now with real estate investments, securities underwriting, and certain kinds of insurance ventures, the problems are going to be even worse.

Let me try to outline three potential problems with allowing banks

10. *See generally Hearings on Continental Illinois*, *supra* note 8.

11. *Hearings on Continental Illinois*, *supra* note 8, at 56 ("Significant credit quality and loan documentation deficiencies in Continental's oil and gas lending were spotlighted by the Penn Square National Bank failure in July 1982.").

into these kinds of businesses. One is tie-ins. I have yet to find an antitrust lawyer who will admit privately that Congress or the Justice Department can prevent tie-ins. Conceptually, tie-ins are quite simple. If you want to borrow money from a bank, you allow them to underwrite your securities. Tie-ins also arise in the context of separate subsidiaries. The Chase Manhattan Securities Corporation is certainly going to have an implicit, if not explicit, tie-in to the Chase Manhattan Bank; you cannot avoid that, and I do not think separate subsidiaries solve that problem. A second problem is going to be conflicts of interest. Could a bank make an objective assessment of credit-worthiness when it underwrites the securities of, own stocks in, and recommends the stock of that company? A third problem arises from over-concentration of power. America's financial system has worked because entrepreneurialism bubbles up in all sorts of different places. I shudder to think of America evolving to resemble the German system which has six large banks that do everything. They do the risk stuff and they do the lending. When German entrepreneurs need to find risk capital, guess where they come? They come to the United States of America; and Glass-Steagall, I would submit, has played an important role in making that happen.

Perspectives on Policy Formation

In my opinion, the fundamentals have not changed. I think there ought to be two pools of money. There ought to be a low-risk pool of money, in which the widow or orphan can place their savings and know that they are going to receive a reasonable rate of return without risking the loss of their money. For this reason, there should be an insured pool of money. There should also be a risky pool of money, in which an individual can invest and either become a millionaire or go broke under free market conditions without any insurance. If one pool of money shrinks relative to the other, so be it. There ought to be these two distinct pools, and my guess is that the vast majority of American investors and depositors will still opt to keep their money in the low-risk, insured pool of money. Banks should deal in the low-risk insured area, brokers ought to be in the high-risk uninsured area. We ought to keep that rule as best we can.

There are a few other points that I'd like to make. First, there is the question of non-bank banks.[12] How do they fit in? I'm against them. I think the line between banking and commerce ought to be

12. Non-bank banks are "institutions that offer services similar to those of banks but which until recently were not under [Federal Reserve] Board regulation because they conducted their business so as to place themselves arguably outside the narrow definition of 'bank' found in § 2(c) of the [Bank Holding Company Act of 1956]." Board of Governors of the Fed. Reserve Sys. v. Dimension Financial Corp., 106 S. Ct. 681, 683 (1986).

kept. When Dean Witter or Allstate takes a bath somewhere, their non-bank bank is going to be affected. For example, a Swiss investor with large amounts of institutional deposits in Sears' non-bank bank reads that Dean Witter Securities is having real trouble; don't you think those deposits will be affected? The purported benefits of non-bank banks need to be carefully examined. Sears has hired a number of consumer experts and consumer advocates, who contend that a primary benefit will be greater competition. These claims, however, are questionable. Take credit card interest rates—an area in which I have been particularly interested—for example. The cost of money today is about six percent, but credit card interest rates are still at nineteen percent. This is outrageous in my opinion, but guess what the new Sears Discover card is charging as an interest rate? In order to bring more competition to the consumer banking industry, Sears is charging 19.8 percent. Some competition!

The issue of expanded bank powers must also be addressed. Banks are looking for new ways to combat outside competition and the question arises: If you are not allowing banks into the securities area, what are they to do? One thing they ought to be doing, in my opinion, is going interstate.[13] There is nothing wrong with a New York bank making loans in Alabama. Interstate banking does not require a change in the fundamental two pools of money approach. We have a national economy in every other way, and I think sooner or later interstate banking will occur one way or another. Another area that I think we ought to pause and think about—even a purist like myself on these Glass-Steagall issues—is the commercial paper area. Commercial paper has traditionally been a banking area with respect to making large stable loans to large corporate borrowers, so you may want to keep that on the other side of the ledger.[14]

What do I see as the biggest problem with Glass-Steagall? Not all of the stuff the Reagan Administration and the deregulators bring up. The biggest problem is internationalization. American banks can go to London or Tokyo, where they do not have the Glass-Steagall prohibitions, and they can do all of the things that they are not allowed to do

13. Federal statutes considerably restrict interstate banking. *See* McFadden Act of 1927, § 7(c), 12 U.S.C. § 36(c) (1982) (limiting authority of national banks to establish branches outside home states); *see also* 12 U.S.C. § 1842(d) (1982) (prohibiting bank holding companies from acquiring banks in another state unless the state law of the target bank explicitly authorizes such acquisitions). For a general discussion of the inexorable pressures toward interstate banking, see Dunnan, *The Wild World of Interstate Banking,* 71 A.B.A. J., Nov. 1985, at 54-57.

14. *See* Hurley, *The Commercial Paper Market,* 63 FED. RES. BULL. 525 (1977) ("commercial paper is an important substitute for bank credit"). *But see* Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 468 U.S. 137 (1984) (holding that commercial paper is a security subject to the prohibitions of the Glass-Steagall Act).

here in America. Does building a wall in America make any sense when you can fly over that wall on the Concorde to London. I have yet to come up with a good answer to this question, but I think that if internationalization obliterates Glass-Steagall, both American and international financial institutions will end up in more and more hot water, with national and international economies suffering as a result. So I think it behooves us to try, in this new internationalized market, to find some mechanism that will apply some restraint. Banking, as I alluded to earlier, is a psychological game. Often the least common denominator prevails. Diminished confidence in certain institutions pervades the entire industry. The task of intelligent legislation and prudent regulation is to prevent this phenomenon.