



The Erosion of the Glass–Steagall Act: Winners and Losers in the Banking Industry

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This paper studies stock price reaction to increased investment banking powers for commercial banks using Seemingly Unrelated Regressions. Market participants react favorably to the announcement of increased Section 20 powers to the Glass-Steagall Act both with and without a risk-shift variable. When the sample is split, abnormal returns are significantly higher for Money Center Banks, banks with prior Section 20 subsidiaries, and Large Regional commercial banks as compared to Small Regional banks. Cross sectional analysis suggests that banks with prior Section 20 subsidiaries have higher abnormal returns and Small Regional banks have lower abnormal returns than the average bank in the sample. © 2000 Elsevier Science Inc.

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I. Introduction

This paper studies the effects of increased investment banking powers in the commercial banking industry. Section 20 of the Glass–Steagall Act, as amended on December 20, 1996, allows commercial bank affiliates to underwrite up to 25% of revenue in previously ineligible securities of corporate equity or debt. Commercial banks are tested for overall and differential reaction across groups of banks to increased investment banking powers and share price reaction is compared in cross sectional models.

Bhargava and Fraser (1998) study the proposed increase in the Section 20 loophole, along with other prior Section 20 events, and find that the 1996 action had few wealth effects. However, Bhargava and Fraser only studied the market reaction to the initial proposal by the Federal Reserve to increase the loophole to 25% of subsidiary revenue. One of the contributions of this paper is that the interim events and subsequent adoption of the increase in the Section 20 revenue limits is explicitly studied along with the reaction of competing Small Regional banks.

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Results show that share prices react favorably to the adoption of increased Section 20 powers to the Glass–Steagall Act in models both with and without risk-shift variables. Abnormal returns are significantly higher for Money Center Banks, banks with prior Section 20 subsidiaries, and Large Regional commercial banks as compared to Small Regional banks. Cross sectional analysis shows that banks with prior Section 20 subsidiaries have higher abnormal returns and Small Regional banks have lower abnormal returns than the average bank in the sample.

II. Background on the Glass–Steagall Act

The Glass–Steagall Act was passed in 1933 to prohibit National and Federal Reserve member banks and bank holding companies (BHCs) from underwriting corporate equity and debt.¹ The Act was passed due to perceived conflicts of interest between banking and underwriting and actions related to the findings of the Pecora Committee.² Many advocates of the Glass–Steagall Act claim the potential conflicts of interest between commercial and investment banking are too severe and these enterprises should remain separate. Conflicts of interest arise if banks underwrite equity and bank customers use the proceeds to repay bank loans. Conflicts can also arise if banks make loans to customers who purchase other bank underwritten securities, or additionally if banks use proprietary customer lending information to direct underwriting. In addition, many claim the presence of deposit insurance negates the incentive for monitoring the investment activities in a combined entity.

Commercial banks can underwrite eligible securities, such as Treasury securities, general obligation municipal securities, and privately placed equities. Beginning in 1986, the Federal Reserve also allowed BHCs to underwrite previously ineligible debt and equity through related bank affiliates or subsidiaries under Section 20 of the Glass–Steagall Act. BHC subsidiaries could have up to 10% of total subsidiary revenues in “ineligible” corporate debt and equity. On December 20, 1996, the Federal Reserve modified Section 20 of Glass–Steagall, increasing the limit from 10% of subsidiary revenue to 25% and making the demise of Glass–Steagall more likely.

Banks desire the ability to underwrite corporate debt and equity for many reasons. Securities underwriting can offer corporate customers “one-stop shopping,” and allow for informational synergies between the commercial and investment banking subsidiaries. Because commercial customers are issuing commercial paper and foregoing short-term loans, the investment bank subsidiary could strengthen customer loyalty and secure more traditional bank activity. Mester (1997) reports that the average return on equity for investment banks was about 17.5% and 11% for commercial banks from 1990 to 1993. With narrowing commercial bank spreads and increased nonbank competition, higher performance is very lucrative for commercial bank stakeholders. If underwriting activities lower bank risk through diversification, the industry would experience a risk reduction and the deposit insurance fund would be safer. Other benefits include greater presence in global markets, technology and innovation among affiliates, and others.

The majority of research of the potential repeal of Glass–Steagall has focused on the conflict of interest inherent in commercial banking and investment banking or perfor-

¹ The term bank is used to denote bank holding company throughout the paper with all variables aggregated at the holding company level where appropriate.

² For a discussion of the Act and the Pecora Committee, see Kroszner and Rajan (1994).

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