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Statement of the Shadow Financial Regulatory Committee

On

Glass Steagall, Tying and Conflicts of Interest

February 24, 2003

The corporate scandals of 2002 have given rise to questions about whether Congress should revisit those portions of the Gramm-Leach-Bliley Act that repealed the Glass-Steagall Act restrictions on affiliations between banks and securities firms. In addition, even before the corporate scandals, there had been renewed interest in strengthening the anti-tying provisions of the Federal Deposit Insurance Act that apply to banks. The arguments of those who would re-impose Glass-Steagall restrictions are based on the belief that affiliations between commercial banks and securities firms encouraged imprudent lending and conflicts of interest by banks hoping to obtain securities business from Enron and other failed companies. In a similar way, the proponents of the anti-tying rules argue that banks are using their credit resources to compete unfairly for securities and other business.

The Shadow Committee does not believe that there is any basis for re-imposing Glass-Steagall restrictions, or that their re-imposition would eliminate conflicts of interest involving bank lending. Nor does the Committee believe that the anti-tying rules should be tightened; indeed the special statutory prohibition applicable only to bank tying should be repealed.

Re-imposing Glass-Steagall restrictions on affiliation between banks and securities firms will not prevent the conflicts of interest that truly should be prevented—i.e. those that are harmful to banks, their parent holding companies, their shareholders or the deposit insurance fund. In general, harmful conflicts of interest arise for a banking organization when the interests of management are placed ahead of the interests of the organization's shareholders. A bank loan that is made as part of a combined transaction—in which the borrower also purchases the services of the bank's affiliated securities firm—is not inherently imprudent, even if it is made on terms that are more favorable than loans that would be made without the involvement of the securities affiliate. The combined services may reflect economies of scope or other efficiencies that justify the better loan terms, and are thus favorable from the standpoint of the borrower as well as its bank's holding company, its shareholders and the insurance fund. In addition, it is obvious that banks, like other businesses, may make loans on favorable terms in order to keep or develop business and customer relationships.

The broad language in the anti-tying provisions of the Federal Deposit Insurance Act purport to prohibit a bank from conditioning its furnishing of credit, or the terms on which the credit is supplied, upon a customer's use of the services of one or more of the bank's affiliates. The statutory language appears to apply even where the bank does not have market power in the anti-trust sense—i.e., the ability to force its customer to use its services or the services of an affiliate. The courts, however, have treated this prohibition as an effort to prevent banks' misuse of market power, and have generally not enforced the statutory language where market power was not present. Similarly, over many years of enforcing this statutory language, bank regulators have found very few cases of tying that violated the law.

In the highly competitive US financial markets, banks do not have any significant market power, and thus the broad statutory language prohibiting tying is largely a dead letter. However, its continued existence in the law gives rise to unnecessary litigation and controversy. For this reason, the Committee recommends that the prohibition be repealed. Banks still would continue to be subject to the provisions of the antitrust laws applicable to all other businesses.