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The erosion of the Glass–Steagall Act:: Winners and losers in the banking industry

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Abstract

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.

Keywords: Glass-Steagall Act; Section 20 subsidiaries

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.

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.

Section snippets

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] [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] [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…

Literature

Most prior research has focused on whether the Glass–Steagall Act is necessary due to conflicts of interest, or performance and diversification issues related to Glass–Steagall. In this section, I discuss the conflicts of interest literature in three different areas: the theoretical papers that formalize the issue, papers examining long term performance of commercial bank versus investment bank underwritten issues, and ex-ante pricing of commercial bank versus investment bank underwritten…

Methodology and data

Collectively, prior research indicates that commercial bank underwritten securities perform better, or at least no worse than, investment bank underwritten securities. Thus, the role of informed monitor for banks, as well as the possible synergies with investment banks, apparently outweighs the potential conflicts of interest. Banks act as an “inside investor” because banks not only audit a firm but invest in the firm in the form of a loan, or as an equity underwriter. Other research based on…

Empirical results

To test for abnormal performance around the Fed announcement of increased investment banking powers for all banks, the coefficient for each dummy variable indicates the share price reaction to particular announcements. Thus, under the null hypothesis of no abnormal performance or risk shifts around the announcement of increased investment banking power, each variable should have an insignificant coefficient.

Table 2 contains results of the abnormal returns for all banks around the announcements…

Cross sectional analysis

Given the findings of differential share price reaction among groups, a natural question is what makes these groups react differently? It is hypothesized that differential performance among banks around the announcements of increased investment banking is a function of being a Money Center bank, having prior Section 20 subsidiaries, and bank characteristics such as size, capital, and bank balance sheet composition. Banks with higher capital could also benefit because allowance of investment…

Summary and conclusions

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. Share price effects to announcements concerning the repeal of Glass–Steagall and the increase in the Section 20 loophole from 10% to 25% of affiliate activity are studied in a SUR model.

…

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> …The resulting list of banks is then merged with the CRSP daily stock file from December 1, 2009 through December 31, 2015 for a total of 1532 trading days.6 Consistent with Cornett and Tehranian (1990) and Cyree (2000) we keep only banks, which trade every day over the sample period, resulting in a total of 271 banks. We are concerned with how the Dodd-Frank Act might have affected market perceptions of banks considered TBTF.…

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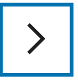
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