

Remarks  
By  
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Greetings. Thank you for having me here. It is a great honor to speak at The Clearing House's Annual Conference. There are so many industry leaders, regulators, and thoughtful presenters. I find myself in very good company. Today, I want to tackle a subject that has become taboo for banking regulators—the separation of banking and commerce in the United States. In discussing the topic, I offer an alternative to the popular narrative.

In my decades in the industry, few topics are more misunderstood and avoided than the separation of banking and commerce. I recall a meeting where I actually heard gasps when the topic came up for discussion. It is unfortunate that such reactions prevent a fulsome discussion of the issues associated with maintaining a wall of separation between banking and commerce. Such dogma props up bureaucracies that maintain the separation and serves the interest of the status quo without regard to why the separation exists in the first place or whether the separation has any usefulness for today's economy. The subject deserves a more open and contemplative discussion; so, I appreciate you indulging me while I take it on today.

An informed discussion about the separation of banking and commerce begins with asking a few basic questions. What interest does separating banking and commerce protect? Who benefits? Who suffers?

In the U.S. tradition, the argument is that the separation of banking and commerce is intended to protect banks from the corruptive power of commercial ownership and protect the market from banks consolidating and wielding too much commercial power.

Separating banking from commerce supposedly protects banking interests from the abuses and exploitative pressures of commerce and commercial incentives. The theory posits that banks are particularly vulnerable entities that need heightened restrictions and regulations to protect *them*.<sup>1</sup> This narrative suggests mingling banks with commercial firms or activities would corrupt the “pure banks,” put them at risk, and endanger the broader economic ecosystem dependent on banks for capital, credit, and banking services. It is also argued that banks should be kept out of commercial interests because their deposits are largely protected by the federal safety net. The suggestion is that allowing federally insured banks to become entangled with commercial enterprises would subsidize potentially risky commercial enterprises at public expense. Moreover, these subsidies would allow banks and their commercial affiliates to distort the marketplace in anticompetitive ways and, ultimately, concentrate power over commerce and the economy.

The narrative persists to keep commercial interests from owning or having controlling interests in banks, in part, because many view them as “public interests” rather than the “private businesses” they are. In more modern times, this line of reasoning was used to keep companies like Walmart from owning a state-chartered FDIC-insured industrial loan company, while allowing others like Target, to own a credit card bank.<sup>2</sup> The narrative also ignores the fact that

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<sup>1</sup> Mehrsa Baradaran, “Reconsidering the Separation of Banking and Commerce,” 80 Geo. Wash. L. Rev. 385 (2012) ([http://digitalcommons.law.uga.edu/fac\\_artchop/842](http://digitalcommons.law.uga.edu/fac_artchop/842)).

<sup>2</sup> Arthur E. Wilmarth Jr., “Wal-Mart and the Separation of Banking and Commerce,” 39 Conn. L. Rev. 1539 (2007) ([http://scholarship.law.gwu.edu/cgi/viewcontent.cgi?article=2166&context=faculty\\_publications](http://scholarship.law.gwu.edu/cgi/viewcontent.cgi?article=2166&context=faculty_publications)).

banks are subject to a robust regulatory regime to ensure their safety and soundness and compliance meant to protect both markets and consumers.

The *idea* that we should restrict the activities and powers of banks reaches back to the origins of banking in the United States. Patterned after the Bank of England,<sup>3</sup> charters of early U.S. banks left much to individual negotiations, and they typically prohibited banks from dealing in merchandise.<sup>4</sup> When Pennsylvania repealed the Bank of North America's charter in 1785, it did so in part because there were not enough limits on the bank's powers. When rechartered in 1787, the bank had clear limits on dealing in merchandise. New York did not define bank powers until 1825, after which the state placed strict limits on the power of banks.<sup>5</sup> Such restrictions may have made sense in the early years of our nation because so few banks and businesses existed, and each bank had the potential to have an outside effect on its community or region. As corporations became more plentiful and state and federal statutes affirmed corporate charters to conduct lawful businesses, banks continued to be treated as "entities of public interest" and have limits placed on their powers and activities.

In the 20<sup>th</sup> century, the Great Depression and two world wars further shaped the nation's experience and attitudes toward banking and commerce. The country's reaction to the Great Depression reflexively isolated banking from investment, commerce, and speculation. The separation of banking and commerce became more codified and less porous as a result. Congress enacted Glass-Steagall and the Banking Act of 1933<sup>6</sup> to further separate commercial and

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<sup>3</sup> Bernard Shull, "The Separation of Banking and Commerce in the United States: an Examination of Principal Issues." OCC Economics Working Paper 1999-1.

<sup>4</sup> Shull.

<sup>5</sup> See *The Legislative History of Banking in the State of New York*, 1855, pp. 19-20. Quoted in Shull.

<sup>6</sup> The Glass-Steagall Act was passed by the U.S. Congress in February 1932. It was amended by the Banking Act in 1933. The term Glass-Steagall more commonly refers to both of these statutes.

investment banking. But was previous intermingling the real problem, and was the depression the real reason for the new statute?

Popular history tells us Glass-Steagall was enacted to eliminate a persistent problem in banking that contributed to the Great Depression. Some more recent research shows, however, that the rhetoric used to pass Glass-Steagall does not stand up. Banks that combined deposit and investment banking performed better under stress during the depression than deposit banks without affiliates, and they issued higher quality securities than independent investment banks.<sup>7</sup>

If facts cannot explain why Congress took up Glass-Steagall, what does? Well, it may come down to the Rockefellers wanting to stick it to the Morgans.<sup>8</sup> After all, the origins of significant moments in history are often tales of powerful personal interests. As it turns out, the idea for sweeping reforms in the 1933 Banking Act that expanded reforms by the Glass-Steagall Act of 1932<sup>9</sup> came from Winthrop Aldrich of Chase Bank. Aldrich was John D. Rockefeller Jr.'s brother-in-law and the son of former Rhode Island Senator Nelson Aldrich. He was representing Rockefeller's interest when he threw his weight behind limiting commercial banks and their affiliates from underwriting or dealing in securities, as a means of making the Morgans' business more costly and difficult. He argued that Congress must regulate "private banks as heavily as commercial banks" and ensure "no interlocking directorates between any type of bank and securities firm." The reasons for his position were obvious to his contemporaries—attack the house of Morgan.<sup>10</sup>

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<sup>7</sup> Eugene Nelson White, "Before the Glass-Steagall Act: An Analysis of the Investment Banking Activities of National Banks." *Explorations in Economic History* 23. (1986). Pp. 33-55. See also Randall S. Kroszner and Raghuram G. Rajan, "Is the Glass-Steagall Act Justified?" *American Economic Review* 84, no. 4. (1994). Pp. 810-833, and George J. Bentson, *The Separation of Commercial and Investment Banking*. London: Macmillan Press. 1990.

<sup>8</sup> Alexander Tabarrok, "The Separation of Commercial and Investment Banking: The Morgans vs. The Rockefellers." *The Quarterly Journal of Austrian Economic* 1, no. 1. (1998). Pp. 1-18 ([https://mises.org/system/tdf/qjae1\\_1\\_1.pdf?file=1&type=document](https://mises.org/system/tdf/qjae1_1_1.pdf?file=1&type=document)).

<sup>9</sup> The Banking Act of 1933 is commonly referred to as the Glass-Steagall Act today, but financial reform occurred with the passage of the Glass-Steagall Act of 1932 on February 27, 1932.

<sup>10</sup> Tabarrok.

Until I explored this issue a little more, I was unaware of this anecdote about Winthrop Aldrich. But, it demonstrates that many things we accept as unassailable truths today have their roots in the circumstances and politics of their day. Rules and laws are enacted by people and affected by *their* personal interests at the time. They often persist long after the reasons that gave them life have ceased.<sup>11</sup> As Oliver Wendell Holmes suggested, rather than blindly “do as our fathers have done,” we have a responsibility to periodically ask, why?<sup>12</sup> And, we must question whether the reasons for decisions made decades ago continue to support the public interest today.

Let’s fast forward to more recent limits imposed to separate banking from commerce and investing. In 1956, the Bank Holding Company Act was enacted to enforce the separation of banking and commerce. It was not until the 1970s that the Bank Holding Company Act was extended to all bank holding companies, closing a loophole that had allowed holding companies that own a single bank to engage in commercial activities free of the Act’s limitations. While the loophole lasted, the number of one-bank holding companies grew from 117 in 1956 to 890 in 1969. By the time the hole was closed, one-bank holding companies held 43 percent of all deposits in insured commercial banks in the country. In 1999, Title IV of the Gramm-Leach-Bliley Act closed a similar loophole for holding companies that own a single thrift. Though structured differently, the laws, in both cases, allowed certain grandfathered companies to mix banking and commerce by permitting the affiliation of banks and commercial enterprises through a holding company structure. As a result, these laws continue to give grandfathered companies advantages not allowed to others.

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<sup>11</sup> Oliver Wendell Holmes, *The Common Law*, 8 (1881) (<http://www.general-intelligence.com/library/commonlaw.pdf>).

<sup>12</sup> Oliver Wendell Holmes, *The Path of the Law*, 10 Harvard Law Review. 457 (1897).

In addition, other provisions of federal law, such as section 4(o) of the Bank Holding Company Act, provide similar exceptions for some firms to mix banking and commerce more freely. The unfair advantage that these exceptions provide was recognized by the Federal Reserve in a report it submitted to Congress in 2016.<sup>13</sup> These special exemptions reflect a hard truth about the nature of regulation: well-lawyered and well-connected companies tend to gain and benefit from special exceptions, privileging them over the bulk of firms that must live under the weight of a general prohibition against mixing banking and commerce. In practice, then, a general prohibition on the mixing of banking and commerce has resulted in the very sort of things the prohibition was set up to prevent: advantaging and aggrandizing a few at the expense of the many. In sum, another win for the big guys.

Perhaps the answer to these special exceptions is to just get rid of them and strictly adhere to the prohibition on banking and commerce. A natural response, but in my view, not a very thoughtful one. The grandfathered companies that continued to commingle banking and commerce, and the companies that have accumulated exceptions present a natural experiment. Do these companies perform better or worse than their separated kin? The answer to this question would provide for a more informed decision on whether continuing to separate banking and commerce still makes sense.

One study by the Federal Reserve Bank of Cleveland looked at the performance of thrifts through the savings and loan crisis of the 1980s and '90s.<sup>14</sup> It concluded that unitary thrift holding companies—those owned by commercial companies and free to engage in certain commercial activities—tended to outperform the others and had more diversified revenue

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<sup>13</sup> Report to the Congress and the Financial Stability Oversight Council Pursuant to Section 620 of the Dodd-Frank Act, pp. 28-35 (September 2016) (<https://www.occ.gov/news-issuances/news-releases/2016/nr-ia-2016-107a.pdf>).

<sup>14</sup> James Thomson, "Unitary Thrifts: A Performance Analysis," *Economic Review* 37, no. 2. Federal Reserve Bank of Cleveland (June 15, 2001). Pp. 2-14.

streams, loan and asset portfolios, and funding sources compared with other thrifts. The study found no evidence suggesting that limited commingling of banking and commerce poses undue risks to the federal financial safety net.

A second test was provided by the financial crisis beginning in 2008. Many advocates for bank reform since the crisis claim that weakening Glass-Steagall through Gramm-Leach-Bliley and the mingling of banking and commerce allowed risk to build up in the system like tinder ready for a spark. But, these advocates treat the crisis as a “convenient” truth, and draw the wrong lessons from the experience.

The recent financial crisis actually demonstrated that there is nothing inherently safer about separating banking and commerce or traditional banking and investment banking. Even when separated, risk can build in one part of the system with less rigorous supervision and become a contagion spreading to infect the whole. Consider both Bear Stearns and Lehman. Neither of these companies were banks. They were not regulated as banks and functioned as commercial investment firms without the checks and balances of a prudential regulator and the strength of more diversified and stable sources of liquidity and capital. Conversely, look at IndyMac, WAMU, and Wachovia. Nothing about these banks was exotic. Still, they faltered, impacting millions of consumers, and played a significant role in the crisis.

Reinstating Glass-Steagall or continuing to look for ways to separate banking and commerce even more will not make the system any safer because mixing the two did not weaken the system in the first place. Even President Clinton acknowledged: “There’s not a single, solitary example that [ending Glass-Steagall] had anything to do with the financial crash. In fact, a study done afterward said that the unified banks were actually slightly less likely to fail than either the commercial banks that overloaded on subprime mortgages, or the investment banks,

like Bear Stearns, Lehman Brothers, and others.”<sup>15</sup> He goes on to say there should be a “serious look at the impact of Dodd-Frank on legitimate community banks,” but that’s a speech for another day.

Former Federal Reserve Vice Chairman Alan Blinder poses the question another way by asking, “What disasters would have been averted if Glass-Steagall was still on the books?” Would that have prevented poor work by ratings agencies, weak mortgage underwriting, or the bundling of mortgage-backed securities in ways that hid the underlying risk?

Advocates for keeping banking and commerce separate also point to size as a source of inherent risk and suggest current laws have allowed companies to become too big. As the argument goes, further mixing of banking and commerce would allow companies to get even bigger, at the expense of smaller community banks. Economists like Joseph Stiglitz point out that the biggest banks went from controlling 15 percent of banking assets before Gramm-Leach-Bliley to controlling 65 percent by 2008.<sup>16</sup> So, *of course*, that must be the cause of the crisis.

Well, hold on. Yes, critics point out that the law allowed mega mergers like J.P. Morgan and Chase Manhattan in 2000, but it also allowed Bank of America to help contain the economic meltdown by buying Countrywide and Merrill Lynch. Deals like those would not have been possible before 1999.

Besides, the danger is not the *size* of the banks; it’s the *concentration*. The solution to concentration is not further isolation and protectionism, but diversity and healthy competition. Laws that prevent companies with resources and means from becoming competitor banks only

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<sup>15</sup> James Ledbetter, “Bill Clinton on How Entrepreneurs Can Transform the Country.” *Inc.* September 2015 (<https://www.inc.com/magazine/201509/james-ledbetter/inc-interview-bill-clinton.html>).

<sup>16</sup> Jim Zarroli, “Fact Check: Did Glass-Steagall Cause the 2008 Financial Crisis?” National Public Radio. October 14, 2015 (<http://www.npr.org/sections/thetwo-way/2015/10/14/448685233/fact-check-did-glass-steagall-cause-the-2008-financial-crisis>).



serve to protect existing *big* banks from would-be rivals. It has the perverse effect of maintaining the concentration in the big banks that exists today.

In smaller communities, fewer restrictions against mixing banking and commerce could allow for greater use of local capital, and support growth and business activity locally. It could help smaller community banks grow and take advantage of benefits previously only available to grandfathered companies and banks that are big and sophisticated enough to convince the Federal Reserve to grant them an exception.

Meaningful competition could have a number of other positive effects besides tempering the risk concentrated in having just a few mega banks. It could make more U.S. banks globally competitive and promote economic opportunity and growth domestically. For banking customers, particularly those underserved by traditional banks, more competition could result in better banking services, greater availability, and better pricing. If a commercial company can deliver banking services better than existing banks, we hurt consumers by making it hard for them to do so. Don't take my word for it. A number of empirical studies tell the story.

One such study, introduced at the Federal Reserve Bank of Chicago's Conference on Bank Structure and Competition in 2007,<sup>17</sup> examined the effects of combining banks with companies from other commercial sectors by looking at returns and risk. The results suggest that the combined companies can achieve increased returns with minimum risk when combining banks with companies in either the construction, retail, or wholesale sectors.<sup>18</sup> The study also shows, both the banking and commerce sectors benefit from commingling. In an accompanying

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<sup>17</sup> Nisreen H. Darwish, "The Mixing of Banking and Commerce: A conference summary." *Chicago Fed Letter* 244a. November 2007.

<sup>18</sup> Larry D. Wall, Alan K. Reichert, and Hsin-Yu Liang, "The Final Frontier: The Integration of Banking and Finance – Part 2, Risk and Return Using Efficient Portfolio Analysis." *Economic Review* 93, no. 2. Federal Reserve Bank of Atlanta (2008). Pp. 1-14 ([https://www.frbatlanta.org/-/media/documents/research/publications/economic-review/2008/vol93no2\\_reichert\\_wall\\_liang.pdf](https://www.frbatlanta.org/-/media/documents/research/publications/economic-review/2008/vol93no2_reichert_wall_liang.pdf)).

paper, the authors observe that society could benefit from more mixing of banking and commerce in the form of economies of scale and scope, increased internal capital markets, and diversification.<sup>19</sup> At the same time, they see the rise of monopolistic conglomerates unlikely and note that other laws exist to mitigate that risk.

Another study introduced at that same conference looked at effects of mixing banking and commerce on the pricing of loans.<sup>20</sup> In 2009, the authors published findings that showed that as banking and commerce mix, customers benefit from improved pricing, up to a point. They cautioned, however, that when banking was overly concentrated and competition disappeared so did the benefit to customers.<sup>21</sup>

The takeaway from these studies is that mixing banking and commerce can generate efficiencies that deliver more value to customers and can improve bank and commercial company performance with little additional risk. Still, regulators should watch markets closely to avoid too much concentration and not enough competition. As prudential supervisors, regulators also would need to match any increased complexity in the institutions they oversee with added sophistication and capabilities.

Before closing, I want to make one more observation. In reviewing the literature out there, there appears to have been a rich dialogue leading up to the crisis about the benefits and risks of allowing banking and commerce to mix more freely. It was a healthy policy discussion and seemed to be inspiring significant research into the subject. Unfortunately, the crisis has been used as an excuse to silence that discussion, even though the evidence and data show that

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<sup>19</sup> Larry D. Wall, Alan K. Reichert, and Hsin-Yu Liang, "The Final Frontier: The Integration of Banking and Finance – Part 1, The Likely Outcome of Eliminating the Barrier." *Economic Review* 93, no. 1. Federal Reserve Bank of Atlanta (2008). Pp. 1-18. ([https://www.frbatlanta.org/-/media/documents/research/publications/economic-review/2008/vol93no1\\_wall\\_reichert\\_liang.pdf](https://www.frbatlanta.org/-/media/documents/research/publications/economic-review/2008/vol93no1_wall_reichert_liang.pdf)).

<sup>20</sup> Darwish.

<sup>21</sup> Li Hao, Dabarshi K. Nandy, and Gordon Roberts, "Effects of Bank Regulation and Lender Location on Loan Spreads." April 25, 2009 ([https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=775027](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=775027)).

combining banking and commerce had little to do with the cause of the crisis and the Great Recession that followed. We need to restart that dialogue. We need fresh research that looks at banking and commerce in a post-Dodd-Frank world. In having that conversation, we might find opportunities to do things a little differently, and we might start a powerful and beneficial economic engine.

I appreciate your attention and allowing me to share my thoughts on the debate over the separation of banking and commerce. I look forward to the discourse on this topic that may ensue because a regulator like me, even a temporary one, raises the question. I'm sure we'll hear passionate voices on both sides. I'd be happy to answer a few of your questions in the time we have left.