Insight

Reviving Glass-Steagall is Bad Policy

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Who says Democrats and Republicans can't agree on anything? This year both parties' platforms include language with regard to the Glass-Steagall Act (Glass-Steagall), the Depression-era law that prohibited commercial banks from participating in investment banking until it was repealed in 1999. Both parties now propose to reinstate Glass-Steagall – the Democrats call for "an updated and modernized version," while the Republicans call for a verbatim reinstatement of the 1933 law (strangely enough, placed right in the middle of a section entitled "Regulation: The Quiet Tyranny"). If any decency is to be gleaned from these proposals, at least the Democrats want to update the law before reinstating it. The problem is they're both wrong.

To understand these faulty platforms, recall that both parties have said that the repeal of Glass-Stegall in 1999 – and the resulting comingling of commercial and "risky" investment banking activities – caused the most recent financial crisis; hence their desire to do a policy u-turn. Unfortunately, that simply is not the case. In fact, the financial crisis wasn't caused at all by the fact that commercial banks were also participating in "risky" investment banking. As former Treasury Secretary Tim Geithner said, "If you look at the crisis, most of the losses that were material for the weak institutions – and the strong, relative to capital – did not come from those [proprietary trading] activities. They came overwhelmingly from what I think you can describe as classic extensions of credit."

Those that argue that Glass-Steagall's separation of commercial and investment banking would have prevented the financial crisis ignore both the realities of lending losses and the fact that commercial banks and investment banks were purposefully *merged* during the crisis (Barclays & Lehman Brothers; JP Morgan & Bear Stearns; Bank of America & Merrill Lynch, for example) in an attempt to strengthen the firms and stabilize the financial system.

Looking forward, a reinstatement of Glass-Steagall would hurt banks' stability, their shareholders, and their customers. In an earnings call early last year, JPMorgan CEO, Jamie Dimon, told investors that breaking up JPMorgan's commercial and investment activities would diminish earnings while increasing the bank's operating costs. He said that the ability to sell to the same customer base products across their various banking and wealth management sectors accounts for $15 billion (more than 15 percent) of the bank's annual revenue, and that it saves them over $3 billion per year in costs by being able to share employees, paperwork, and other logistics. Marianne Lake, JPMorgan's CFO, has explained that just losing that $3 billion in savings by breaking up the bank into separate entities would "materially offset" any "potential short-term" creation of value from the post-breakup freed capital.

A quick check on other large banks reveals similar situations. Last year Wells Fargo reported that its wealth and investment arm had an average "cross-sell" of 10.55 investment products per retail banking household. In the same year, Citigroup reported investment banking revenues of $4.5 billion, making up over a quarter of its total banking revenues ($16.9 billion). This month Bank of America reported that its earnings were down 17.5 percent , year over year, as a result of low interest rates on its commercial banking side – its investment banking side that Glass-Steagall seeks to sever is what's helping the bank remain profitable. Taking away the investment banking components of commercial banks means taking away, in many cases, the banks' most profitable segments. Doing so reduces the banks' overall profits, in turn increases costs to customers, and potentially means that many of the banks would fail as customers move to nonbanks for what would have been traditional banking services – as Vice Chairman of the Fed, Stanley Fischer has discussed.

While it might seem nice to have a policy that both sides can agree on, we should all agree that Glass-Steagall is not the law to do that. In this populist effort, the idea of breaking up big banks is good politics, but reviving Glass-Steagall is bad policy – and the two should not be confused.