Insight

Should Congress Reimpose Glass-Steagall?

MAY 21, 2010

Last night, the Senate passed its financial reform bill – "The Restoring American Financial Stability Act" – by a vote of 59 to 39, with two Democrats voting against the bill and four Republicans voting for it. The next step for the legislation as it makes its way to President Obama's desk is a conference committee, in which the freshly passed Senate bill will be reconciled with the House bill – the "Wall Street Reform and Consumer Protection Act" – passed on December 11th of last year.

In a May 13th interview with Bloomberg News, Rep. Barney Frank (D-MA), the chairman of the House Financial Services Committee, stated that the conference would likely "strengthen" the Senate bill, noting that public anger at financial institutions had only intensified since passage of the House bill. That same day, House Speaker Nancy Pelosi (D-CA) said that House Democrats were looking forward to Senate completion of the bill "so that we can go to conference and send a very clear message: never again will recklessness on Wall Street cause joblessness on Main Street."

Among the more draconian "reforms" debated by both the House and Senate in recent months, and perhaps again in the upcoming conference, is to repeal the Gramm-Leach-Bliley Financial Modernization Act of 1999 ("GLBA") as a means of reimposing Depression-era "Glass-Steagall" restrictions between commercial banking and non-bank financial activities. Such efforts are misguided and, if enacted as part of the final legislation, would severely undermine the effectiveness and competitiveness of American financial institutions, with very negative consequences for the stability of the U.S. financial system and, therefore, the productive capacity of the U.S. economy.

The Glass-Steagall provisions of the Banking Act of 1933 legally separated commercial banking and investment banking. As a result, "universal banks" engaged in both commercial lending and the underwriting of securities were forced to divest of one of those businesses. JP Morgan, for example, spun off its securities business, which became Morgan Stanley.

GLBA repealed Glass-Steagall by permitting well-managed and well-capitalized financial institutions to engage in a diversified range of financially related activities, including commercial banking, securities dealing and underwriting, insurance agency and underwriting activities, and merchant banking by way of separate subsidiaries affiliated under a structure called a "financial holding company" ("FHC"). Congress' intent in passing GLBA was to enable U.S. financial services firms competing in an increasingly global and competitive marketplace to organize themselves in ways more responsive to customer needs and shareholder priorities.

A proper policy response to the recent financial crisis requires an accurate diagnosis of the factors that actually contributed to the crisis. GLBA had nothing to do with the crisis. Proposals to repeal GLBA make the classic logical error of equating association with causation – simply because GLBA proceeded the financial crisis does not mean that GLBA caused the crisis.

More than 550 FHCs had been formed by the onset of the recent crisis. Only two – Wachovia and Citigroup – were nearly ruined by the crisis. Indeed, most of the notorious names of the crisis – Bear Stearns, Lehman Brothers, Merrill Lynch, Countrywide, Washington Mutual, IndyMac, and AIG – were not FHCs. Bear, Lehman, and Merrill were investment banks; Countrywide, WaMu, and IndyMac were thifts; AIG is an insurance company.

Of the five largest FHCs, three of them – Wells Fargo, Bank of America, and JPMorgan Chase – not only weathered the crisis, but served as instruments of stabilization and recovery by absorbing many of the failing institutions. JPMorgan Chase absorbed Bear Stearns and WaMu; Bank of America absorbed Countrywide and Merrill Lynch; Wells Fargo absorbed Wachovia.

Even Wachovia's near-failure was not due to errors in its principal activities or management, but entirely to its ill-timed purchase, in March of 2006, of Golden West Bancorp – an OTS-supervised thrift and the largest subprime mortgage underwriter in California.

In an October 2009 report, "Deregulation and the Financial Crisis," Peter Wallison of the American Enterprise Institute, concluded that "there is strong evidence that, despite heavy regulation, many of the banks that got into trouble did so by failing to act prudently in their investment or lending activities – in other words, in their capacity as banks – and not because they engaged in securities trading or were affiliated with investment banks that were underwriting and dealing in securities."

It should also be noted that had Glass-Steagall restrictions been in place during the recent crisis, the resolution of failing non-FHCs (Bear, Lehman, Merrill, etc.) by absorbing them into large FHCs would not have been legal. Reinstating Glass-Steagall would remove a major option for resolving failing institutions and, therefore, would leave the U.S. financial system more vulnerable, not less.

Moreover, contrary to the claims of those supporting reinstatement of Glass-Steagall, GLBA does not permit the mixing of insured deposits and "risky trading" in the securities subsidiary of an FHC. GLBA specifically mandates that the banking and non-banking activities of FHCs must be conducted in separate subsidiaries, and imposes significant restrictions on inter-affiliate transactions.

GLBA also did not spawn the era of "mega banks." Very large banks existed before GLBA – they were just less diversified and, therefore, more risky. By permitting the diversification of the activities and revenue streams of financial conglomerates, GLBA helps such entities become less risky and more stable.

Finally, repealing GLBA would severely undermine the competitiveness of internationally active U.S. institutions. Large corporate clients who depend on U.S. banks for the full range of financial products and services – loans, underwriting, trading, hedging of financial risks, private equity, and asset management – would likely turn to non-U.S. institutions if Congress bans banking companies from providing non-bank financial services.

The goal of financial reform should be to correct the deficiencies in the nation's framework of supervision that left our financial system so vulnerable to crisis and the financial authorities ill-equipped to combat the crisis. Repealing GLBA would target something that had nothing to do with creating the crisis, would undermine financial stability by restricting institutional diversification, and would remove an important weapon – the ability to merge troubled financial institutions – from the arsenal of financial authorities.

Simply stated, not very smart.