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Why Wall Street Loves Glass-Steagall

Reviving Depression-Era Banking Law Would Shatter Community Banks and Main Street Businesses

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Debates over financial regulation often refer to "Wall Street" and "Main Street" as shorthand for, respectively, 1) investment banking and the trading of financial instruments and 2) commercial banking, including taking deposits and making loans to local residents and businesses.

Politicians often like to claim they are championing the little guy by declaring their allegiance to Main Street. That pose is almost as old as American political rhetoric itself. Recently, however, it has taken a harmful form in calls to revive provisions of the Glass-Steagall Act, a New Deal-era financial law that mandated the separation of commercial and investment banking.

While restoring Glass-Steagall may appear like a slap at Wall Street, it would actually be a punch to Main Street. Re-imposing the barrier between commercial and investment banking would concentrate financial power in Wall Street, weaken local banks by denying them opportunities to diversify, and undercut the global competitiveness of U.S. financial institutions. In fact, Glass-Steagall hit Main Street hard the first time it came into play. In the decades before the Act was enacted, an investment banking industry was thriving in cities across the nation.

Were Glass-Steagall to return, the costs would fall most heavily not on big commercial banks, but on small banks across the U.S. Many regional banks, still recovering from the Great Recession, have stabilized themselves by expanding into investment banking and wealth management. A new Glass-Steagall would force smaller banks to curtail offering these services.

Glass-Steagall Repeal Was Long Overdue. Congress voted overwhelmingly to repeal the firewall between commercial and investment banking in the 1990s, for good reason. Under Glass-Steagall, commercial banks could not engage in underwriting or deal in non-government securities, while investment banks could not accept deposits.[1] That led to a wave of bank mergers that resulted in investment banking becoming concentrated on Wall Street. It also resulted in American banks losing business to banks in Europe and American businesses having fewer financing options than their European counterparts.

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Populist politicians argue that the repeal of Glass-Steagall, which occurred late in the Clinton administration, helped cause the 2008 financial crisis. It is not just Democrats. The Republican Party's 2016 election platform agreed with socialist presidential candidate Sen. Bernie Sanders (I-Vt.) in endorsing bringing back Glass-Steagall.[2] President Trump and some officials in his administration have said they are open to the idea.[3] However, the administration has recently indicated it may be backing away from that position.[4]

Some Republican politicians may see backing a new Glass-Steagall as political pro-Main Street cover as they seek to repeal the Dodd-Frank Wall Street Reform and Consumer Protection Act. Passed by a Democrat controlled Congress and signed by President Barack Obama in 2010, Dodd-Frank has restricted access to credit and forced community banks to devote considerable resources on regulatory compliance.[5] The Financial CHOICE Act—for Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs—which passed the U.S. House of Representatives in June, repeals and eases many provisions of Dodd-Frank and other laws, such as Sarbanes-Oxley, that impose heavy regulatory burdens on small banks and entrepreneurs.

Dodd-Frank entrenched big banks and worsened the problem of too-big-to-fail. Its many mandates have fallen hardest on small banks and credit unions, which cannot afford the large staffs maintained by big banks for complying with the rules.[6] A revised Glass-Steagall would have a similar effect. Glass-Steagall is sometimes wrongly described as a measure for "breaking up the banks." Yet, whatever the merits of that idea, Glass-Steagall did nothing to reduce the size of banks. Rather, it prohibited certain financial activities in a way that hurt smaller banks the most.

Several major Wall Street financial firms either have endorsed or are not opposing Glass-Steagall's possible return. Goldman Sachs CEO Lloyd Blankfein recently told CNBC: "We are probably the large bank best positioned for a return to Glass-Steagall." After the crisis hit in 2008, Goldman Sachs became a bank holding company, and its commercial operations are still small compared to the investment side.[7] Former Goldman Sachs President and Chief Operating Officer Gary Cohn, who is now director of the president's National Economic Council, endorses bringing back Glass-Steagall, according to a recent report by Bloomberg.[8]

Some left-leaning observers acknowledge that restoring Glass-Steagall would benefit firms like Goldman Sachs by blocking investment banking competition from commercial banks. Liberal journalist Nicholas Lehmann recently wrote in *The New Yorker* that "investment-banking firms like Goldman Sachs … always kind of liked Glass-Steagall." Lehmann noted that before its partial repeal in 1999, the Act "gave them an exclusive franchise in high-fee areas, like initial public offerings and mergers, which banks like Chase and Citicorp, as they were called at the time, couldn't enter."[9]

Dennis Kelleher, president and CEO of the pro-regulatory advocacy group Better Markets, favors restoring Glass-Steagall but still believes Goldman Sachs may disproportionately benefit from such action. "Most troubling about Mr. Cohn's possible embrace of Glass-Steagall is the potential benefits that would be uniquely enjoyed by his former firm, Goldman Sachs," he told the *Financial Times*. Goldman Sachs, he said, "would be king of the financial world where [universal] bank holding companies couldn't compete."[10]

Main Street Investment before Glass-Steagall. At the turn of the 20th century, with the growth of the telephone and automobile, more businesses sought to raise capital by issuing stocks and bonds to investors across state lines. Many of these companies "going public" would eventually list on the New York Stock Exchange. But when it came to underwriting the stock and selling to the first set of investors—the process today known as an initial public offering (IPO)—these firms would turn to their local banks or their affiliates. By the 1920s, many commercial banks in cities throughout the country would be active in securities underwriting and distribution, either through their affiliates or their bond departments.[11]

In Atlanta, for instance, the Trust Company of Georgia, a predecessor of SunTrust bank, took several local companies public starting in 1910, until the enactment of Glass-Steagall prohibited this activity in 1933. The companies were involved in various industries from coal to cotton—and the world's most famous brand.

In 1919, the Trust Company organized a stock offering and a friendly leveraged buyout of Coca-Cola. Trust Company President Ernest Woodruff—whose son Robert would later become Coca-Cola's longtime CEO—assembled a syndicate of wealthy investors to buy the majority of Coca-Cola's stock. The syndicate then made 500,000 shares of this stock available to the public, almost half of which were bought by residents of Atlanta. The front-page headline in the *Atlanta Constitution* on August 22 of that year blared, "COCA-COLA BOUGHT BY ATLANTANS," celebrating the fact that the company, which already had its soft drink in international markets, would not have to sell out to "New York interests."[12]

The Trust Company itself acquired stock in Coca-Cola that helped it, and successor SunTrust, weather economic storms and prosper over the next several decades. By the 1990s, this stock would be worth more than $1 billion.[13]

Similarly, in Pittsburgh, Mellon National Bank underwrote and distributed stock offerings for the local firms that would become Alcoa, U.S. Steel, and Gulf Oil (which merged with Chevron in 1984).[14] In Chicago, the local First Trust & Savings Bank handled the 1918 stock offering of meatpacking giant Swift & Co, now JBS USA.[15]

Investment banking appears to have thrived on Main Street by the late 1920s. It took a hit, as did everyone, from the Great Depression, but there was no sound business reason why it should not have come back after the economy recovered. Instead, Glass-Steagall simply barred Main Street commercial banks from pursuing investment banking, which became more concentrated around Wall Street.

Glass-Steagall Shatters Main Street Investment Banking. The Glass-Steagall Act, named after Rep. Henry Steagall (D-Ala.) and Sen. Carter Glass (D-Va.), was intended as a response to the Great Depression. Glass-Steagall generally refers to specific sections of the Banking Act of 1933 that established a firewall between commercial and investment banking. Under the legislation, investment banks could not accept deposits, while commercial banks could not be engaged principally—meaning they could devote no more than 10 percent of their income—to underwriting or dealing in securities.[16]

The legislation attempted to address two primary goals:

- Stop the unprecedented run on banks, which saw 5,795 U.S. banks fail between 1929 and 1932, and restore public confidence in the nation's banking system.
- Prevent bank depositors from additional exposure to risk associated with stock market volatilities by severing the link between commercial and investment banking, which the authors of the statute believed to have been responsible for the market crash of 1929.

The Act was also a pet project of Sen. Glass, who had long believed investment and commercial banking should be separate and securities investments were purely speculative.[17] He adamantly believed that restricting bank lending to short-term financing of commercial activity was essential for directing bank credit to what he considered more productive uses, such as industry, commerce, and agriculture.[18] Glass was not so much calling for reining in Wall Street, as making a moralistic call to protect Main Street banks from the supposedly corrupting influence of investment banking.

Banishing investment banking from commercial banks effectively restricted it to New York, which provided a windfall for specialized Wall Street investment banks like Goldman Sachs, Lehman Brothers, and other financial titans. As Columbia University visiting scholar Tian Kang Go concluded in his comprehensive study of the era:

> By the end of the 1930s, the regional financial-industrial groups that competed with the major New York powers in the 1920s had either been transformed into their subordinate allies or become increasingly dependent on them for the financing of their enterprises.[19]

Regional banks' selloff of their securities affiliates, combined with the economic stress of the Depression years, set off a wave of investment bank consolidations. Federal regulators' response to this government-induced series of mergers? More intervention.

In 1947, the U.S. Justice Department filed an antitrust suit against 17 New York-based financial firms, known as the "Wall Street 17," charging them with monopolizing the securities market. In his 1953 decision dismissing the suit (*United States v. Morgan*), U.S. District Judge Harold Medina wrote that the consolidation was not due to "conspiracy" by the firms, but in large part due to "certain statutory and regulatory provisions of great significance" that the government had promulgated. Chief among these, Medina wrote, was Glass-Steagall, "pursuant to the terms of which commercial banks … were required to go out of the investment banking business." As a result, Medina noted, "Thousands of employees of these institutions were forced to make new connections, and many joined the staffs of some of the 17 defendant investment banking houses."[20]

For example, one of the firms charged in the "Wall Street 17" suit was the product of a notable post-Glass-Steagall merger. It combined three securities firms from three different cities into one investment bank, which was later charged in the "Wall Street 17" antitrust suit. Fifteen years after passage of Glass-Steagall, the investment bank affiliates of Pittsburgh's Mellon Bank, the First National Bank of Boston, and Chase National Bank had merged into a single New York-based entity called First Boston Inc.[21]

Glass-Steagall Was Wrong then—and It Is Wrong now. Given the damage that Glass-Steagall did to capital formation on Main Street, could the supposed "safety" the Act brought to Main Street balance this out? The answer is "no." As history shows, a commercial bank dealing in securities, by itself, has never fomented a financial crisis.

Evidence for the necessity of a firewall between commercial and investment banking was largely drawn from a 1932 inquiry by the U.S. Senate Committee on Banking and Currency into the causes of the 1929 Crash.[22] The inquiry, named after the investigation's chief counsel, Ferdinand Pecora, is credited with exposing abusive practices in the financial industry and galvanizing support for stricter regulations.

While supporters of Glass-Steagall often cite these hearings to bolster their case, subsequent analyses have all but refuted the evidence on which the committee relied.[23] As *The Economist* argued in 1999, "Accusations of disreputable practices and dishonest dealings made against the banks, particularly during the Congressional 'Pecora Hearings', were not supported by any compelling evidence."[24]

The Pecora investigation failed to address the fundamental causes of the 1929 crisis. It was the structural fragility of the banking system due in part to government policy, not banks' securities speculation, which led to the widespread failures. As Emory University finance professor George Benston argued in his book, *The Separation of Commercial and Investment Banking*: "The evidence from the pre-Glass-Steagall period is totally inconsistent with the belief that banks' securities activities or investments caused them to fail or caused the financial system to collapse."[25]

The historical record on bank failures contradicts the conclusions of the Pecora Investigation. Between 1930 and 1933, banks that engaged in both commercial and investment banking had lower failure rates than others.[26] While 26.3 percent of all national banks failed during that period, only 6.5 percent of securities affiliated banks failed.[27] This is because banks engaged in both commercial and investment banking had greater diversification and economies of scale, and diversification generally reduces risk. Banks' securities activities were not a weakness, but a source of strength.

Furthermore, as former financial regulator and UK Treasury Minister Oonagh McDonald argues, the majority of the 9,096 banks that failed between 1930 and 1933 were small banks that were unable to diversify loan risk in struggling agricultural towns.[28] This was principally due to the structure of unit banking within states and the prohibition of nationwide branch banking.[29] This overarching financial regulation forced banks to be small, undiversified, and tied to their local economies. During the Depression, they failed along with their local economies.

That the regulation-driven structural fragility of the banking system, not commercial bank speculation, was to blame for the bank failures is further verified by the experience of Canada. Canada faced largely the same economic problems as the US, with GDP falling by 40 percent between 1929 and 1939, but only one Canadian bank failed during the period. This is because, as McDonald further argues: "[N]ationwide branching allowed banks to handle any local runs while still maintain only negligible excess reserves. They were in a structurally stronger position to survive any potential financial crises."[30]

The Glass-Steagall Act would not have prevented the 1929 financial crisis or the Great Depression. Interestingly, Sen. Glass himself may have recognized this. He was reported to be considering the repeal of the prohibition of commercial bank underwriting of some corporate securities, claiming that the total ban was an overreaction to the crisis that had unduly damaged securities markets.[31] However, this partial repeal failed to garner support and the Glass-Steagall Act remained in place for the next 66 years.

Glass-Steagall's Harm to U.S. Competitiveness Leads to Partial Repeal. In many ways, Glass-Steagall exacerbated underlying problems in the American banking system.[32] The banking crises of the 1930s were in large part due to fragmentation across regions and the associated lack of diversification. Preventing banks from diversifying through unified banking created further fragility. Just as during the Depression, there were widespread failures when local conditions turned sour. Notable examples include the impact of the 1986 oil collapse on Texan banks and the damage to New England financial institutions when the region's property markets went bust in the early 1990s.[33]

By the late 1990s, it was clear that the decades-long separation of commercial and investment banking had done little to remove the risk of bank failures, but rather limited consumer choice and harmed U.S. competitiveness. As *The Economist* wrote in 1998, Glass-Steagall "has long been recognized as a cause of inefficiency that prevents financial firms providing the full range of products wanted by their customers."[34]

For much of the 20th century, bank clients had to go through an investment firm for investing in assets like stocks and bonds, a separate commercial bank for checking services, and an insurance company for insurance services. According to 1997 testimony by former Secretary for Domestic Finance John D. Hawke Jr., removing these restrictions would save consumers around $15 billion a year, as customers could enjoy a wider range of services and lower prices as a result of the improved competition among previously distinct firms.[35]

International comparisons showed that all the separated services—commercial banking, investment banking, and insurance—could be provided under one roof. Financial powerhouses Germany and Switzerland had little issue with universal banking, long allowing the mix of underwriting and securities holding.[36]

By contrast, the United States and Japan—which, after the Second World War, was forced to adopt banking laws similar to the United States—were the only developed nations to have separated commercial and investment banking at the time.[37] This hindrance left U.S. banks relatively uncompetitive in international markets, which was reflected in the international rankings of bank size. For example, in 1960, six of the world's 10 largest banks were based in the United States, while by 1980 only two U.S. banks were in the top 10. By 1989, there was not a single U.S.-based bank in the global top 25. Given the globalization of financial markets, it was increasingly damaging to prohibit U.S. banks from engaging in activities performed by their global competitors.

Though Glass-Steagall restricted the securities activities of domestic banks, it did not apply to U.S. banks' activities outside the United States.[38] By 1988, Citicorp offered investment banking services in over 35 countries, something it could not do in the United States.[39] Supporters of Glass-Steagall repeal argued that eliminating the law's obsolete distinctions would enable American companies to engage more effectively in world markets and provide customers the greater service and better prices that they were already offering abroad.[40]

In 1999, Congress voted overwhelmingly to partially repeal Glass-Steagall through the Gramm-Leach-Bliley Act (GLBA), also known as the Financial Services Modernization Act. Passing the Senate 90-8 and the House 362-57 and signed into law by President Clinton in 1999, it left many Glass-Steagall provisions in place.[41] The so-called firewall between commercial and investment banking was implemented under four sections of Glass-Steagall, of which GLBA only repealed two—Sections 20 and 32.[42] These amendments primarily ended affiliation restrictions, which freed up holding companies to own both commercial and investment banks.

Under GLBA, banks could still not underwrite or deal in securities outside of certain carefully defined categories, such as marketable debt obligations that are not predominantly speculative in nature and obligations issued by a state, political subdivision, or agency of that state.[43] Post-GLBA banks and securities dealers remained legally separate from each other, even if a holding company was allowed to control both a bank and a securities dealer. As Heritage Foundation analyst Norbert Michel writes: "U.S. law—both before and after the GLBA—forbids insured depository institutions, commonly known as banks, from underwriting or dealing in securities. It also means that U.S. law prohibits securities dealers from taking demand deposits and making loans."[44]

Glass-Steagall Repeal Helped Mitigate the Financial Crisis. Had the Glass-Steagall Act not been partially repealed in 1999, the 2007-2008 financial crisis would have unfolded in largely the same way. The primary cause of the crisis had little to do with the Gramm–Leach–Bliley Act amendments, just as the original conception of the law failed to deal with the cause of the 1929 financial crisis. Bank losses occurred in mortgage lending and securitization, in part because of moral hazard engendered by government guarantees.[45] These were completely legal practices that had little to do with Glass-Steagall. Firewalling commercial from investment banking would have done little to stop the downfall. As Peter Wallison of the American Enterprise Institute notes:

> None of the investment banks that have gotten into trouble—Bear, Lehman, Merrill, Goldman or Morgan Stanley—were affiliated with commercial banks. And none of the banks that have major securities affiliates—Citibank, Bank of America, and J.P. Morgan Chase, to name a few—are among the banks that have thus far encountered serious financial problems. Indeed, the ability of these banks to diversify into nonbanking activities has been a source of their strength.
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> Most important, the banks that have succumbed to financial problems—Wachovia, Washington Mutual and IndyMac, among others—got into trouble by investing in bad mortgages or mortgage-backed securities, not because of the securities activities of an affiliated securities firm.[46]

In reality, it was poorly written mortgage loans, spurred on by the government-sponsored enterprises Fannie Mae and Freddie Mac, and low-income housing lending quotas imposed by the Community Reinvestment Act that were at the heart of the mortgage crisis.[47] Credit losses on real estate loans drove the bulk of commercial bank failures. Glass-Steagall would not have prevented this.

Advocates of reinstating Glass-Steagall often point to the supposed widespread deregulation in the financial industry leading up to the crisis. However, as discussed previously, GLBA merely repealed two sections of the Glass-Steagall act and actually added more levels of regulation. In fact, from 2000-2007 federal financial regulators issued almost 800 separate rules, only seven of which were deregulatory, totaling more than 7,000 pages.[48]

Not only would Glass-Steagall not have prevented the financial crisis, it would have increased its severity by limiting the options for helping securities firms in liquidity crunches.[49] The formal creation of financial holding companies allowed distressed investment banks, such as Bear Stearns and Merrill Lynch, to be acquired promptly by JPMorgan Chase and Bank of America rather than go bankrupt.

For example, when Goldman Sachs and Morgan Stanley were under stress to acquire adequate short-term funding, they were allowed to quickly reorganize into financial holding companies with commercial banking arms. Glass-Steagall's repeal was instrumental in addressing such a liquidity squeeze.[50]

Just Say No to 21st Century Glass-Steagall. The Glass-Steagall Act failed to address the fundamental causes of American financial instability. It did little to improve bank safety, while limiting consumer choice and harming U.S. competitiveness. Yet it is a bad idea that never seems to die—and now it appears to have spread beyond American shores.

Much like U.S. lawmakers have become fixated on reviving Glass-Steagall, the United Kingdom is looking to create a similar set of flawed rules—which have in turn influenced debate in the U.S. regarding Glass-Steagall's possible revival.

The UK's 2011 Independent Commission on Banking was established to address the fundamental weakness of the British banking sector after the 2007-2008 financial crisis. The commission's report, known as the Vickers Report, recommend "ring-fencing"—legally separating retail banking divisions from global trading, investment banking, and brokerage services. "Inside" the ring-fence would be all retail deposits and their overdrafts, while "outside" would be investment banking activities including derivatives, debt and equity underwriting, and investing and trading in securities. Banks would be free to place consumer and business lending as well as trade finance on either side of the fence.

Forecasts show that the cost of implementation and compliance will amount to billions of pounds.[51] There is little evidence that it will make U.K. banking any safer. Lehman Brothers, the U.S. financial firm whose collapse in September 2008 greatly accelerated the financial crisis, was an investment bank that never added a retail banking arm. Conversely, Northern Rock, the British bank that experienced a run on deposits at the beginning of the crisis in 2007, was a retail bank with no investment banking division. "Ring-fencing" would have had no effect on either," notes Mark Littlewood, general director of the London-based Institute for Economic Affairs.[52]

In discussions on both ring-fencing and Glass-Steagall, it has become common to label commercial banking as essentially safe, while characterizing investment banking as inherently risky. Yet both lending and trading involve risk, and investment banking—the raising of capital for others—is often the least risky of financial activity. As economist Robert Litan, a former fellow at the Brookings Institution and Kauffman Foundation, notes: "In a typical securities offering, the underwriter bears the risk of loss for only a few days, whereas a commercial bank bears the risk of a loan default until the loan is due."[53]

As noted, banks that engage in unified banking may be best able to diversify risk. For example, retail losses resulting from a collapsing property market can be balanced by gains in other asset classes. As Competitive Enterprise Institute Vice President Iain Murray points out, "to re-impose a firewall between commercial and investment banking now would be to *inject* risk into the financial system, not reduce it."[54]

The Real Solution Is to Expand Competition. Like its predecessor, a new Glass-Steagall would harm Main Street and enrich Wall Street. The banking regulation debate needs to focus not on limiting what existing banks should be allowed to do, but on finding ways to expand the competitive playing field.

Glass-Steagall's partial repeal allowed regional banks to expand their wealth management services, from deposits to investments and insurance. Even as the economy was still mired in effect of the financial crisis in the first quarter of 2010, most banks in the KBW Regional Banking Index, a stock market composite that measures the performance of regional banks, reported positive results from their wealth management services.[55] Investment need not be limited to Wall Street. Regional banks like KeyCorp and Fifth Third Bancorp in Cincinnati have recently added personnel for mergers and acquisitions and stock, bond, and loan offerings.[56] With greater freedom to expand operations, regional banks could further expand such offerings to their customers.

Bank regulators should also clear the path both for startup banks and for banks affiliated with America's best-run Main Street companies, such as Wal-Mart and Home Depot, which have indicated that they desire to have affiliated banks.[57]

The Financial CHOICE Act, which passed the U.S. House of Representatives in June 2017, also repeals provisions of Dodd-Frank that have frustrated community banks and credit unions and reduced services for entrepreneurs, investors, and consumers. If lawmakers pursue these pro-competition policies, Main Street banks across America can once again help build unique industries to make their hometowns great.

Notes

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