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The Repeal Of The Glass- Steagall Act And The Current Financial Crisis

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ABSTRACT

The Glass-Steagall Act was passed in 1933 in response to the failure of the banks following the Great Depression. One out of every five banks failed in the aftermath of the stock market crash. Legislators and regulators questioned the role the underwriting of securities played in the financial collapse. Many believed these investment banking activities caused a conflict of interest in that banks often suggested that their customers purchase securities the banks had underwritten. They believed that this conflict of interest contributed significantly to the stock market crash and the bank failures. The Glass-Steagall Act forced banks to choose between being a commercial bank or an investment bank, in effect constructing a wall between commercial banking and investing banking activities. The Glass- Steagall Act was the first law signed by President Franklin D. Roosevelt upon taking the oath of office. Almost immediately upon enactment, the financial community lobbied to have the Act repealed. Over the years, this persistent lobbying led to a continual reinterpretation and liberalization of the Glass-Steagall Act, until the Act was repealed in 1999. On the dawn of repeal, the late Senator Paul Wellstone made an impassioned plea on the Senate floor. He said the repeal of Glass-Steagall would enable the creation of financial conglomerates which would be too big to fail. Furthermore, he believed that the regulatory structure would not be able to monitor the activities of these financial conglomerates and they would eventually fail due to engaging in excessively risky financial transactions. Ultimately, he said, prophetically, that the taxpayers would be forced to bail out these too-big-to-fail financial institutions. Clearly, Senator Wellstone was in the minority as the legislation repealing the Glass-Steagall Act was passed in both the House and the Senate with large majorities. President Bill Clinton signed the legislation into law in late November, 1999. It has now been over ten years since the repeal of Glass-Steagall and the United States is in the grip of the largest financial crisis since the Great Depression. Legislators and regulators are again questioning the role that the investment banking activities of commercial banks have played in a financial crisis. Some believe the repeal of Glass-Steagall contributed significantly to the current financial crisis. Others believe that if Glass-Steagall had still been in place, the financial crisis would be much worse. This paper examines the role that the repeal of Glass-Steagall played in the current financial crisis.

Keywords: Repeal of Glass-Steagall Act; Financial Crisis of 2008

HISTORY OF THE GLASS-STEAGALL ACT

In the waning days of the Hoover Administration, the Senate Committee on Banking and Currency held hearings to investigate the causes of the Depression. During the first year, the hearings did not uncover any significant information. "The hearings had failed to penetrate Wall Street's shadowy landscape of margin selling, stock rigging and speculation because witnesses ducked questions and the committee's counsels were weak and changed frequently."[1]

The tenor of the hearings dramatically changed in January of 1933 after Ferdinand Pecora, a former Manhattan assistant district attorney, was appointed head counsel. Bill Moyers painted a vivid picture of Ferdinand Pecora in his 2009 PBS program on the Depression. He said, "Ferdinand Pecora was the savvy immigrant from Sicily who became a Manhattan prosecutor with a memory for facts and figures that proved the undoing of a Wall

Street banking world gone berserk with greed and fraud."[2]

The first witness to appear in front of Pecora was Charles Mitchell, the head of National City Bank. The bank, which was the second largest in the United States, was known for promoting new risky securities. Pecora grilled Mitchell on the bank's sales practices. Under examination, Mitchell admitted that National City Bank gave bonuses to traders based on sales figures; the riskier the security, the higher the bonus. During the hearings, Mitchell also disclosed that National City bank sold off bad loans to Latin American countries by securitizing them and selling them to unsuspecting investors. Six days after Pecora launched his investigation, Charles Mitchell resigned in disgrace. [3]

J. P. Morgan, Jr. was another bank executive who withered under Pecora's questioning. Morgan, a top executive at Chase bank, admitted that he enriched himself by shorting Chase stock during the Depression.[4]

So, one after another, the lions of Wall Street underwent Pecora's blistering examination. The public was shocked at the degree of greed and corruption the bank executives admitted to. Before the Pecora hearings, as they became known, the reputations of the country's bankers were unscathed. As a matter of fact, the banks were praised for their conduct during the nationwide banking failure that followed the stock market crash. The public was unaware that the banks' unscrupulous tactics contributed significantly to the financial system collapse.

Prior to the Pecora hearings, the banks had lobbied congress successfully to avoid new significant regulation, as the public was not demanding it. At the time, banks were allowed to trade freely in securities and wanted to continue this lucrative business. In his memoir, *Wall Street under Oath*, Ferdinand Pecora commented on bankers' resistance to regulation. "Bitterly hostile was Wall Street to the enactment of the regulatory legislation. Had there been full disclosure of what was being done in furtherance of these schemes, they could have not survived the fierce light of publicity and criticism. Legal chicanery and pitch darkness were the banker's stoutest allies." [5]

The disturbing banking practices and conflicts of interest revealed in the hearings caused the public to demand that the banks be reined in. The politicians had no choice but to acquiesce and enact the strict banking regulations that had been languishing in the halls of Congress for years.

In the middle of June 1933, Congress passed the historic Banking Act of 1933, which became known as the Glass-Steagall Act. The legislation bore the name of the two congressmen who drafted it - Senator Carter Glass and Representative Henry Steagall. The legislation banned commercial banks from underwriting securities. Banks were forced to choose between being commercial banks, that held deposits and made loans, and investment banks that conducted securities transactions.

The Glass-Steagall Act also created the Federal Deposit Insurance Corporation, the FDIC. The FDIC insured bank deposits of commercial banks. In return for this insurance protection, the Federal Reserve Bank's control over commercial banks was tightened.

The Glass-Steagall Act restored public trust in the American financial system. The think tank, Demos, in a position paper, stated, "Glass-Steagall's goal was to lay a new foundation of integrity and stability for America's banks. It worked. Financial panics had been regular and devastating occurrences since before the Civil War. No more. While individual banks continued to fail occasionally, depositors escaped largely unscathed. Trust in the stock and bond markets also grew. For investors around the world, the U. S. financial system seemed to set a high standard of transparency and reliability."[6]

THE CASE FOR AND AGAINST THE REPEAL OF THE GLASS-STEAGALL ACT

Practically from the day it was signed into law, banks lobbied for the repeal of the Glass-Steagall Act. However, the lobbying efforts to loosen the restrictions of Glass-Steagall increased significantly in the 1970's. In the 1980's, numerous congressional bills to repeal the Glass-Steagall Act were introduced.

In 1987, the Congressional Research Service prepared a study outlining the positives and negatives for preserving The Glass-Steagall Act. The following is an excerpt from the report:

The Case for Preserving the Glass-Steagall Act:

1. *Conflicts of interest characterize the granting of credit - lending - and the use of credit - investing - by the same entity, which led to abuses that originally produced the Act.*
2. *Depository institutions possess enormous financial power, by virtue of their control of other people's money. Its extent must be limited to ensure soundness and competition in the market for funds, whether loans or investments.*
3. *Securities activities can be risky, leading to enormous losses. Such losses could threaten the integrity of deposits. In turn, the Government insures deposits and could be required to pay large sums if depository institutions were to collapse as the result of securities losses.*
4. *Depository institutions are supposed to be managed to limit risk. Their managers, thus, may not be conditioned to operate prudently in more speculative securities businesses...*

The case against preserving the Glass-Steagall Act:

1. *Depository institutions will now operate in "deregulated" financial markets in which distinctions between loans, securities, and deposits are not well drawn. They are losing market shares to securities firms that are not so strictly regulated and to foreign financial institutions operating without much restriction from the Act.*
2. *Conflicts of interest can be prevented by enforcing legislation against them and by separating the lending and credit functions through forming distinctly separate subsidiaries of financial firms.*
3. *The securities activities that depository institutions are seeking are both low-risk, by their very nature, and would reduce the total risk of organizations offering them, by diversification.*
4. *In much of the rest of the world, depository institutions operate simultaneously and successfully in both banking and securities markets. Lessons learned from their experiences can be applied to our national financial structure and regulation.*[7]

Although Congress did not repeal the Glass-Steagall Act in the 1980's, the Federal Reserve Bank reinterpreted sections of the Glass-Steagall Act to allow banks to earn up to 5% of their revenue from securities transactions. By the end of the 1980's, the limitation was raised to 10% of revenues. Additionally, banks were permitted to do a small amount of underwriting.

In 1996, the limitation was increased again. Banks were now allowed to earn up to 25% of their revenues from securities transactions. This increase, in effect, repealed the Glass-Steagall Act. The merger of Citicorp and Travelers Insurance Company into Citigroup in April 1998 is seen as the impetus for the formal repeal of the Act. Professor Charles Geisst of Manhattan College, author of numerous books on the Depression and financial history, commented on Citigroup's lobbying efforts in an interview with PBS Frontline. He said, "They pushed so hard that the legislation . . . was referred to as the Citi-Travelers Act on Capitol Hill."[8]

The legislation that repealed the Glass-Steagall Act passed the House and the Senate with overwhelming majorities - 90 to 8 in the Senate and 362 to 57 in the House.[9] The legislation had a clear mandate; however, a heated debate preceded its passage.

In 1999, Senator Byron Dorgan warned that the repeal of the Glass-Steagall Act could threaten the integrity of the United States' financial system. He said, "I think we will look back in 10 years' time and say we shouldn't have done this, but we did because we forgot the lessons of the past and that what was true in the 1930's is true in 2010. I wasn't around during the 1930's or the debate over Glass-Steagall... We have now decided in the name of modernization to forget the lessons of the past of safety and soundness".[10]

On the eve of the vote on the legislation, the late Senator Paul Wellstone made an impassioned speech on the Senate floor pleading against repeal. Senator Wellstone implored, "I rise in strong opposition to S. 900, the

Financial Services Modernization Act of 1999. S. 900 would aggravate a trend toward economic concentration that endangers not only our economy, but also our democracy. S. 900 would make it easier for banks, securities firms and insurance companies to merge into gigantic new conglomerates that would dominate the U. S. financial industry and the U. S. economy... This is the wrong kind of modernization because it fails to put in place adequate regulatory safeguards for these new financial giants, the failure of which could jeopardize the entire economy. It's the wrong kind of modernization because taxpayers could be stuck with the bill if these conglomerates become *too big to fail*."[11]

In 1939, Ferdinand Pecora himself warned about the financial community's prospective attempts to repeal financial regulation. In his memoir, Pecora wrote, "As soon as business recovered, the titans of finance developed, once again, an arrogant self-confidence and a dogmatic assurance that any attempt to restrain their own activities must inevitably mean the ruin of the country".[12]

The supporters of the repeal of the Glass-Steagall Act were far more numerous and equally as impassioned as the opposition. Upon the passage of the legislation, Secretary of the Treasury, Lawrence Summers, said, "Today Congress voted to update the rules that have governed financial services since the Great Depression and replace them with a system for the 21st century. This historic legislation will better enable American companies to compete in the new economy".[13]

Senator Phil Gramm, one of the authors of the repeal legislation, said "The world changes and we have to change with it. We have a new century coming and we have an opportunity to dominate that century the same way we dominated this century. Glass-Steagall, in the midst of the Great Depression, came at a time when the thinking was that the government was the answer. In this era of economic prosperity, we have decided that freedom is the answer."[14]

Senator Bob Kerrey thought the fears that financial instability would result from the repeal were erroneous. He stated, "The concerns that we will have a meltdown like 1929 are dramatically overblown."[15] Senator Charles Schumer believed failure to repeal the Glass-Steagall Act might prevent the U. S. financial markets from maintaining a leadership position in the world. Senator Schumer said, "If we don't pass this bill, we could find London or Frankfurt, or years down the road, Shanghai, becoming the financial capital of the world. There are many reasons for this bill, but first and foremost is to ensure that the U. S. financial firms remain competitive."[16] Upon signing the legislation repealing the Glass-Steagall Act, President Bill Clinton said, "Glass-Steagall was no longer appropriate to the economy in which we live. It worked pretty well for the industrial economy...but the world is very different".[17]

THE REPEAL OF THE GLASS-STEAGALL ACT AND THE CURRENT FINANCIAL CRISIS

The causes of the Great Depression are still being debated today, more than 80 years after the stock market crash of 1929. Therefore, the causes of the current Great Recession will certainly be debated for many years to come. A key part of the present discussion has centered on the repeal of the Glass-Steagall Act. Some analysts and legislators view the repeal as one of the main causes of the financial collapse, while others believe the repeal blunted the effects of the collapse.

In November 2009, Senator Byron Dorgan said, "I thought reversing Glass-Steagall would set us up for dramatic failure and that is exactly what has happened. To fuse together the investment banking functions with the F.D.I.C. banking function has proven to be a profound mistake."[18]

Demos, a nonpartisan public policy and research organization, wrote a report entitled "A Brief History of Glass-Steagall" addressing the impact of the repeal on the current day crisis. The report concedes that much of the current financial damage was done by pure investment banks which would not have been constrained by the Glass-Steagall Act. However, Demos believes that commercial banks' securities activities may have made financial collapse worse and necessitated federal intervention. The report states, "...commercial banks played a crucial role as buyers and sellers of mortgage-backed securities and credit default swaps, and other explosive financial derivatives. Without the watering down and ultimate repeal of Glass-Steagall, the banks would have been barred from most of these activities. The market's appetite for derivatives would then have been far smaller and Washington might not

have felt the need to rescue the institutional victims."[19]

In a March 27, 2008 speech at Cooper Union, presidential candidate Barack Obama said, "A regulatory structure set up for banks in the 1930's needed to change. But by the time the Glass-Steagall Act was repealed in 1999, the $300 million lobbying effort that drove deregulation was more about facilitating mergers than creating an efficient regulatory framework. . . Unfortunately, instead of establishing a 21st century regulatory framework, we simply dismantled the old one., thereby encouraging a winner take all, anything goes environment that helped foster devastating dislocations in our economy."[20]

Professor Curtis C. Verschoor of DePaul University stated, in a 2009 article in *Strategic Finance,* "Freed from the restrictions of the Glass-Steagall Act, giant bank holding companies appeared to have been focused more on meeting the expectations of Wall Street analysts than on protecting depositors' funds from risk."[21]

In testimony before Congress in 2007, Robert Kutner said, "Since the repeal of Glass-Steagall in 1999, after more than a decade of de facto inroads, super-banks have been able to re-enact the same kinds of structural conflicts of interest that were endemic in the 1920's, lending to speculators, packaging and securitizing credits and then selling them off, wholesale or retail, and extracting fees at every step along the way... The repeal of Glass-Steagall coincided with low interest rates that put pressure on financial institutions to seek returns through more arcane financial instruments. Wall Street investment banks, with their appetite for risk, led the charge."[22]

Mark Tran, in the Guardian.co.uk, opined, "U.S. banks, particularly investment banks, are in difficulty because they were granted what they wished for. Left to their own devices, several managed to ruin themselves and create havoc in the international financial system. Wall street Bankers may be wishing that regulators had kept them on a shorter leach, not least, because fewer of them would be out of a job today."[23]

Several prominent bankers who were at the forefront of the repeal of Glass-Steagall have publicly expressed regret over their involvement. David Komansky, former Merrill Lynch & Co. Chief Executive Officer, stated in an interview with Bloomberg News, "Unfortunately, I was one of the people who led the charge to get Glass-Steagall repealed. I regret those activities and wish we hadn't done that."[24] John Reed, Chairman of Citicorp, during the Citicorp-Travelers merger, stated, "U.S. lawmakers were wrong to repeal Glass-Steagall."[25]

Perhaps Camden Fine, the president of a Washington trade group that represents 5,000 small banks, summed up the anti-appeal position best when he said, "We cruise along for 80 years without a major calamity infecting the entire financial system and then less than eight years after the repeal of Glass-Steagall, we have a financial meltdown in this country... That's no accident."[26]

Robert Pozen of *Forbes* believes, "The repeal of Glass-Steagall was, at most, a minor factor leading up to the financial crisis, and its repeal was instrumental in resolving the liquidity squeeze on Wall Street". Pozen opined that... "the wall between commercial and investment banking was long filled with holes." He argues that most of the securities transactions that the commercial banks engaged in would have been permissible without the repeal of Glass-Steagall. He believes that it was the underwriting of mortgage-backed securities that caused the crisis and that for the large banks, this was not a significant cause of losses. In fact, he said, "...the big banks held mortgage securities with the highest ratings, which they would have been permitted to hold under Glass-Steagall."[27] Pozen believes that "...the repeal facilitated the rescue of the four large investment banks and thereby reduced the severity of the financial crisis".[28]

Charles W. Calomiris of the Wall Street Journal agrees with Robert Pozen's position. In an October 2008 article, Calomiris stated, "Wasn't it the ability of commercial banks and investment banks to merge a major stabilizer of the financial system?"[29] He argues, "Subprime lending, securitization and dealing in swaps were all activities that banks and other financial institutions have had the ability to engage in all along. There is no connection between any of these and deregulation."[30] Calomiris believes that the major cause of the crisis was the inability to accurately measure risk on the part of the banks and the credit rating agencies. He believes this inability was caused by misaligned incentives, ". . . those that measured risk profited from underestimating it and earned large fees in doing so."[31] According to Calomiris, contributing factors to the financial crisis were loose monetary

policy from 2002-2005 and government subsidies for leverage in real estate.[32]

Although Professor Curtis C. Verschoor of DePaul University believes that the repeal of the Glass-Steagall Act was a major contributor to the current financial crisis, he also believes that flawed work by the credit rating agencies was a major contributor. When analyzing the failures at Citigroup, Verschoor stated, "Citi's risk efforts relied heavily on the flawed work of credit rating agencies. It believed that the possibility of troubles with collateralized debt obligations was so tiny (less than 1/100 of 1%) that it excluded them from their risk analysis, even after Bear-Stearns ran into serious subprime trouble in the summer of 2007."[33]

Professor Michael Perino of St. John's University thinks that the credit rating agencies played a crucial role in the current financial crisis, particularly their role in the creation of derivatives.[34]

Representative Jim Leach, one of the writers of the Gramm-Leach-Bliley Act, which repealed the Glass-Steagall Act, believes that the repeal made the current crisis much less severe as it allowed commercial banks to take over failing investment banks. In a Time Magazine article of September 17, 2008, he stated, "If you didn't have commercial banks ready to step in, you'd have a vastly bigger crisis today."[35]

Justin Fox of *Time* believes that transaction-oriented investment banking is the crux of the current financial crisis. Fox believes these transactions, which he refers to as the shadow banking system, "...began slithering its way out of the reach of banking regulators in the 1970's, more than two decades before the Gramm-Leach-Bliley Act put an end to the Glass-Steagall separation of banks and Wall Street. Some advocates (Jim Leach, in particular) actually saw their legislation as a way to rein in some of the shadow banking nonsense and bring it back under the control of banks and the watchful eye of bank regulators."[36]

CONCLUSION

The question of whether or not the repeal of the Glass-Steagall Act caused the current financial crisis cannot be answered definitively. The arguments on both sides are compelling and informative. Through continued debate, the financial community and legislators may determine the factors that contributed to the financial collapse. With this knowledge, they may be able to construct a regulatory reform structure that allows the U.S. financial market to remain a leader on the world stage while being shielded from financial turbulence.

Today, as the regulators implement the Dodd Frank Act, we can only hope that they analyze the current financial crisis carefully, listen to the arguments on all sides, and draft regulations that will uphold the integrity of the U.S. financial markets for decades to come.

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NOTES