The Heritage Foundation

ISSUE BRIEF

No. 4699 | MAY 3, 2017

Glass–Steagall Separation Did Not and Will Not Make Markets Safer

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In 2016, the Democratic and Republican Party platforms called for reinstating some version of the Glass–Steagall Act, the 1933 law that separated commercial and investment banking. This separation was a major policy mistake, rooted in the misguided belief that politicians and bureaucrats can appropriately design financial markets by dictating precisely who can take which financial risks. Reinstating anything similar to a Glass–Steagall separation would be an even greater misstep.

Such a policy would be completely inconsistent with the Trump Administration's stated goals of empowering individuals to make independent choices, fostering vibrant financial markets, and enabling American companies to be more competitive with foreign firms.[1] Such a misguided policy also would deprive the financial sector of the very competitive forces that strengthen markets by exposing weaknesses, inefficiencies, and inequities. In the name of bringing stability to financial markets, Glass–Steagall does the opposite by restricting firms' ability to diversify their investments—a basic principle in protecting against the ebb and flow of the economy.

The Critical Role of Financial Risk

Financial intermediaries—firms that pool individuals' funds and channel the money to others who need capital to operate—are a central reason why the economy of the United States is as productive as it is. Many different types of companies, including banks, investment banks, investment companies, credit unions, and venture capital funds, fulfill this role by taking financial risks.[2] The process of financial intermediation, whether carried out by banks, investment banks, or other intermediaries, is a vital component of economic growth because it facilitates capital formation and the efficient allocation of scarce capital resources.

Without this financial risk-taking, raising the capital necessary to launch or operate a business or borrowing to buy or build a home would be much more difficult and expensive, if not impossible. When people fail to take these financial risks, society suffers from fewer goods and services available and at higher prices.[3] Empirical research cautions against relying on excessive government supervision and regulation of this risk-taking—even in the banking sector—because doing so works against the development of a healthy financial system.[4] Restrictions like Glass–Steagall's are a classic example of excessive regulation that harms both the financial system and the broader economy.

Financial Diversification Lowers Risk

Sound financial practice dictates that investing in a diverse portfolio of assets rather than one single type of asset reduces an investor's financial risk. Holding a diversified portfolio of stocks and bonds, for example, is less risky than holding a single risky security or loan. The same principle applies to financial firms, whether they are buying securities or making loans.

This paper, in its entirety, can be found at
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A bank that lends only to one type of industrial customer in a local market is exposed to greater risk than one that lends to many different types of customers across several geographic locations. Similarly, a financial firm that diversifies by investing funds in many different types of assets—bonds, money market funds, equities, and various commercial loans—is exposed to less financial risk than a bank that makes only commercial loans.

These ideas are not merely theoretical. The U.S. has already had two major crises exacerbated by banks that lent in narrow markets: in one case, geographic markets and in the other, asset markets.[5] Banks that diversify are better protected against unique problems that arise in one sector of the economy, so it makes perfect sense that combined commercial–investment banking firms were stronger than their single-focused counterparts in the 1930s.[6] It makes little sense to return to a regulatory framework that legally forces financial firms into becoming narrowly focused entities that cannot adequately diversify their risks. The notion that doing so could improve the stability of the banking system is based on a flawed understanding of financial risk.

Commercial Lending Is About Taking Risk

Supporters of reinstating Glass–Steagall claim that the 1933 law "forbade commercial banks from engaging in risky speculative investments"[7] and that its repeal in 1999 led to the risky behavior that caused the financial crisis.[8] There are several problems with this story, not the least of which is that the 1999 Gramm–Leach–Bliley Act (GLBA) did not repeal the Glass–Steagall Act.[9] Perhaps most important, though, is that restrictions like those in Glass–Steagall did not—and would not—prevent banks from making so-called risky speculative investments. All investments, including commercial loans, are risky and speculative.

1. Norbert J. Michel, "Trump's Executive Orders on Financial Regulation Are a Great First Step," The Daily Signal, February 3, 2017, http://dailysignal.com/2017/02/03/trumps-executive-orders-on-financial-regulation-are-a-great-first-step/.
2. Norbert J. Michel and David R. Burton, "Financial Institutions: Necessary for Prosperity," Heritage Foundation *Backgrounder* No. 3108, April 14, 2016, http://www.heritage.org/markets-and-finance/report/financial-institutions-necessary-prosperity.
3. The distinction between these types of investments and "speculative" investments such as short selling is a false dichotomy. All investments are speculative because the outcome is uncertain, and even short selling benefits markets by, for example, improving liquidity and providing information that leads to more accurate prices.
4. James R. Barth, Gerard Caprio, Jr., and Ross Levine, "Bank Regulation and Supervision: What Works Best?" *Journal of Financial Intermediation*, Vol. 13 (2004), pp. 205–248, https://pdfs.semanticscholar.org/2cd1/36671433f39b314c1f3dfb59843ae8896ffd.pdf (accessed May 1, 2017).
5. Regulations created a "unit banking" structure that led to widespread bank failures during the Great Depression. See Eugene N. White, *The Regulation and Reform of the American Banking System, 1900–1929* (Princeton, NJ: Princeton University Press, 1983). In the late 1980s, the savings and loan crisis originated in specialized mortgage lending institutions. See "The Savings and Loan Crisis and Its Relationship to Banking," Chapter 4 in Federal Deposit Insurance Corporation, Division of Research and Statistics, *History of the Eighties–Lessons for the Future, Vol. 1, An Examination of the Banking Crises of the 1980s and Early 1990s*, December 1997, https://www.fdic.gov/bank/historical/history/167_188.pdf (accessed May 3, 2017).
6. Eugene White, "Before the Glass–Steagall Act: An Analysis of the Investment Banking Activities of National Banks," *Explorations in Economic History*, Vol. 23, No. 1 (January 1986), p. 40, https://campus.fsu.edu/bbcswebdav/users/jcalhoun/Courses/Growth_of_American_Economy/Chapter_Supplemental_Readings/Chapter_22/White-Before_the_Glass-Steagall_Act.pdf (accessed May 1, 2017). See also George Edwards, "The Myth of the Security Affiliate," *Journal of the American Statistical Association*, Vol. 37, No. 218 (June 1942), p. 232, and Terris Moore, "Security Affiliate Versus Private Investment Banker—A Study in Security Originations," *Harvard Business Review*, Vol. 12 (July 1934), pp. 480–482.
7. Justin Miller, "Gary Cohn's Glass–Steagall Support Is a Trickle-Down Trojan Horse," *The American Prospect*, April 13, 2017, http://prospect.org/article/gary-cohn-Glass-Steagall-support-trickle-down-trojan-horse (accessed April 14, 2017).
8. See, for example, Jim Zarroli, "Visiting New York City, Bernie Sanders Attacks Clinton, 'Greed' of Wall Street," *NPR Morning Edition*, January 6, 2016, http://www.npr.org/2016/01/06/462094414/visiting-new-york-city-bernie-sanders-attacks-clinton-greed-of-wall-street (accessed January 6, 2016); James Rickards, "Repeal of Glass–Steagall Caused the Financial Crisis," *U.S. News and World Report*, August 27, 2012, http://www.usnews.com/opinion/blogs/economic-intelligence/2012/08/27/repeal-of-Glass-Steagall-caused-the-financial-crisis (accessed December 21, 2015); and Joseph E. Stiglitz, "Capitalist Fools," *Vanity Fair*, December 31, 2008, http://www.vanityfair.com/news/2009/01/stiglitz200901-2 (accessed December 21, 2015).
9. The GLBA repealed only two sets of four Glass–Steagall restrictions so that commercial banks could legally affiliate with investment banks. See Norbert J. Michel, "The Glass–Steagall Act: Unraveling the Myth," Heritage Foundation *Backgrounder* No. 3104, April 28, 2016, http://www.heritage.org/markets-and-finance/report/the-glass-steagall-act-unraveling-the-myth#.

Banks are in the business of using customer deposits, many of which have to be returned to the customer on demand, to make long-term loans. These loans are, by definition, risky speculative investments because there is simply no way to know for certain whether a borrower will repay a loan. In fact, individual loans are generally riskier than individual publicly traded stocks and bonds. While an equity investment in any of the Standard & Poor's 500 stocks, for instance, can easily be liquidated (sold without a major loss in value), any single commercial loan is highly *illiquid*.

It is generally very easy to find a buyer for one of these stocks, even in the midst of a market downturn, but individual commercial loans typically have very few (if any) buyers. In fact, under the new Basel III *Liquidity Coverage Ratio* rules, commercial banks are allowed to count equities but not commercial loans toward their required amount of high-quality liquid assets.[10] The Glass–Steagall Act took a very narrow view of financial intermediation and did little to make markets safer. Policymakers should keep these facts, along with many lesser-known Glass–Steagall facts, in mind when crafting new financial market regulatory reforms.

The Real Impact of Glass–Steagall

Given the Glass–Steagall Act's reputation, it is difficult to comprehend how little supporting evidence Congress uncovered before passing the bill in 1933. While countless analysts have cited the many abusive and reckless investment practices that Congress supposedly uncovered before passing Glass–Steagall, most of these assertions are exaggerated or untrue.[11] The record shows that most of these references cite secondary sources rather than the original record, opinions and allegations rather than evidence of abuse, and practices such as tax avoidance and excessive salaries that had nothing to do with combining investment and commercial banking.

The definitive historical study of Glass–Steagall shows that "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."[12] In fact, the evidence suggests that Depression-era financial firms engaged in both commercial and investment banking were stronger than institutions engaged only in commercial banking.[13] This evidence is entirely consistent with the basic principle of financial diversification, which holds that investors should avoid depending too heavily on any single class of assets.

Additional Glass–Steagall Facts

President Trump has called for a "21st century" version of Glass–Steagall, though exactly what such a policy might entail remains unknown.[14] Given that the Depression-era law unnecessarily separated commercial and investment banking, policymakers should consider the following facts before reimplementing anything similar to that law:

- The earliest and most noteworthy failures of the 2008 crisis involved pure investment banks (Lehman, Bear Stearns, Merrill Lynch) and pure commercial banks (Washington Mutual, Wachovia).[15]

- Glass–Steagall-type restrictions would prevent banks from taking "risky bets" with insured deposits only if the restrictions prevent banks from making consumer and commercial loans. A

10. Equities count as level 2B high-quality liquid assets. See U.S. Department of the Treasury, Office of the Comptroller of the Currency; Federal Reserve System; and Federal Deposit Insurance Corporation,, "Liquidity Coverage Ratio: Liquidity Risk Measurement Standards," Final Rule, *Federal Register*, Vol. 79, No. 197 (October 10, 2014), pp. 61440–61541, https://www.gpo.gov/fdsys/pkg/FR-2014-10-10/pdf/2014-22520.pdf (accessed April 13, 2017).
11. Michel, "The Glass–Steagall Act: Unraveling the Myth."
12. George Benston, *The Separation of Commercial and Investment Banking* (New York: Oxford University Press, 1990), p. 41.
13. Michel, "The Glass–Steagall Act: Unraveling the Myth."
14. Emily Stephenson, "Trump Calls for '21st Century' Glass–Steagall Banking Law," Reuters, October 26, 2016, http://www.reuters.com/article/us-usa-election-trump-banks-idUSKCN12Q2WA (accessed April 13, 2017).
15. See Douglass J. Elliot, "Political Myths About Banking Make for Bad Policy," Brookings Institution, March 24, 2015, https://www.brookings.edu/opinions/political-myths-about-banking-make-for-bad-policy/ (accessed April 15, 2017), and Andrew Ross Sorkin, "Reinstating an Old Rule Is Not a Cure for Crisis," *The New York Times* DealBook, May 21, 2012, https://dealbook.nytimes.com/2012/05/21/reinstating-an-old-rule-is-not-a-cure-for-crisis/?_r=3 (accessed April 15, 2017).

better approach would be to reduce the coverage of federally backed deposit insurance.[16]

- The 1933 Glass–Steagall separation applied only to U.S. banks' *domestic* operations. Internationally, U.S. commercial banks regularly offered securities services. By the 1980s, the top 30 Eurobond underwriters were U.S. bank affiliates. Citicorp offered investment-banking services in over 35 countries, and Chase Manhattan had offices in almost twice as many countries as 10 major investment banks combined.[17]

- Senator Elizabeth Warren (D–MA), the consummate Wall Street critic who sponsored a new Glass–Steagall bill to separate commercial and investment banking, has admitted that those restrictions would not have prevented the 2008 crisis (or even the well-publicized JP Morgan "London whale" trading loss).[18]

- The mortgage-backed securities at the heart of the 2008 crisis were explicitly blessed as safe by federal regulators, with the express goal of funding more nontraditional mortgages.[19]

Conclusion

The 1933 Glass–Steagall Act is still admired by many who believe that its separation of commercial and investment banking banned the high-risk activities that caused the Great Depression. These Glass–Steagall proponents are wrong on several counts. Most important, the act did not ban high-risk activities in banking and likely helped weaken financial markets throughout the 20th century.

Implementing a new version of the Glass–Steagall separation between commercial and investment banking would not make markets safer, and the very notion that politicians and bureaucrats can design financial markets by dictating precisely who can take which financial risks is flawed. The most likely result from implementing a similar version of the Glass–Steagall separation, which clearly serves to protect firms from competition, is that consumers would suffer from higher prices, fewer choices, and less opportunity.

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16. Mark Calabria, "Deposit Insurance, Bank Resolution, and Market Discipline," in *Prosperity Unleashed: Smarter Financial Regulation*, ed. Norbert J. Michel (Washington: The Heritage Foundation, 2017), http://www.heritage.org/markets-and-finance/report/deposit-insurance-bank-resolution-and-market-discipline.
17. Michel, "The Glass–Steagall Act: Unraveling the Myth."
18. Sorkin, "Reinstating an Old Rule Is Not a Cure for Crisis."
19. The Federal Reserve, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency amended their risk-based capital rules in 2001 so that banks could hold even less capital for highly rated (privately issued) mortgage-backed securities. After the 2001 rule change, certain AA-rated and AAA-rated asset-backed securities were given the same low-risk weight (20 percent) as agency-issued mortgage-backed securities. For more on this change, known as the recourse rule, see Jeffrey Friedman and Wladimir Kraus, *Engineering the Financial Crisis: Systemic Risk and the Failure of Regulation* (Philadelphia: University of Pennsylvania Press, 2011), p. 69.