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The Rise and Fall of Glass-Steagall

BY WARREN C. GIBSON AND JEFFREY ROGERS HUMMEL

The ongoing financial crisis has pundits, bloggers, academics, and politicians scrambling for explanations. Deregulation gets a major share of their attention, specifically the 1999 repeal of the Glass-Steagall Act of 1933. Just what was Glass-Steagall and how did it come about?

Bank failures were among the most dramatic and devastating aspects of the Great Depression. A wave of failures swept the country in 1930. A second and stronger wave followed in 1933. In all some 9,000 banks failed, taking with them all or part of the savings of millions of individuals and businesses. Perhaps the most significant response to this crisis was the Glass-Steagall Act, officially known as the Banking Act of 1933. (Glass-Steagall originally referred to a measure enacted in 1931 that was concerned mainly with powers of the Federal Reserve System, but that name now generally refers to the 1933 act.)

Glass-Steagall was a far-reaching measure that established federal deposit insurance (see *The Freeman*, June 2010; www.tinyurl.com/2v5u9cf) as well as separation of investment banking from deposit, or commercial, banking. Although it is rightly classed as one of the New Deal reforms, the bill had been debated before Roosevelt's assumption of the presidency in March 1933 and the bank holiday the same month. In fact, Senator Carter Glass had long made known his opposition to "universal banking," in which single firms could conduct deposit banking, investment banking, and

other financial activities. Glass had been a sponsor of the Federal Reserve Act of 1913 and by 1933 was without doubt the most respected and powerful politician on matters related to banking.

The Glass-Steagall separation of investment and deposit banking was generally repealed by the Gramm-Leach-Bliley Act of 1999, during the administration of Bill Clinton. However, in response to the financial crisis of 2008, there has been much discussion of whether repeal was a mistake and whether some or all of its

restrictions should be reinstated. We can gain valuable perspective on the current situation and calls for reform if we know a little about Glass-Steagall. What problems was it supposed to solve? What political incentives were at work? What new problems might it have caused?

Investment banking seems quite different from commercial banking. We might even wonder why both are called banking. Deposit banks accept deposits and make loans.

They provide benefits to savers who couldn't reasonably find and assess borrowers on their own, and to borrowers who would have a hard time finding lenders. Investment banks underwrite securities, meaning they help companies issue new equity (shares of stock) or debt securities (bonds). They perform similar services for state and local governments that wish to issue bonds.



Roosevelt with, to his right and left, respectively, Glass and Steagall.

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They set an offering price, line up buyers, and sometimes guarantee to absorb the securities themselves should any remain unsold. Unless they keep some of the new securities on their books, their work is finished once the securities are sold.

Some of the skills and practices of investment bankers are quite similar to those of bank-lending officers. Lenders must investigate the creditworthiness of prospective borrowers. Investment bankers must perform the same sort of due diligence in deciding whether to underwrite a proposed security offering and if so, how to price it. Firms that combine commercial and investment banking under one roof thus tend to be more efficient, a situation that economists call “economies of scope.” If they successfully exploit economies of scope, combined firms provide lasting benefits to their corporate clients and indirectly to consumers, as well as higher profits to themselves—at least until competing firms bid away those profits.

Pecora Hearings

The main impetus for the separation aspect of Glass-Steagall was a series of congressional hearings known as the Pecora hearings, named for the chief counsel of the Senate Committee on Banking and Currency. The hearings took place in 1933 and 1934 and generated some 11,000 pages of testimony. Ever since that time the Pecora hearings have been cited as firmly establishing the abuses that can and did arise when a single firm is allowed to engage in both deposit banking and investment banking, and as justifying government intervention to curb those abuses. This belief, by now something of an urban legend in financial and regulatory circles, is summarized in the following congressional testimony given in 1986:

[The Pecora hearings] on the securities practices of banks disclosed that bank affiliates had underwritten and sold unsound and speculative securities, published deliberately misleading prospectuses, manipulated the price of particular securities, misap-

propriated corporate opportunities to bank officers, engaged in insider lending practices and unsound transactions with affiliates. Evidence also pointed to cases where banks had made unsound loans to assist their affiliates and to protect the securities underwritten by the affiliates. Confusion by the public as to whether they were dealing with a bank or its securities affiliate and loss of confidence were also cited as adverse consequences of the securities affiliate system.

Who said that? None other than Paul Volcker, former chairman of the Federal Reserve System, who was given credit (perhaps exaggerated) for stopping the inflation of the late 1970s and who has reentered public life as an adviser to President Obama. (More about Volcker and the proposed Volcker Rule below.)

For years Glass had been frustrated in his attempts to legislate separation of commercial and investment banking. Revelations of supposed abuses by National City Bank (NCB) of New York and its president, disclosed in the Pecora hearings, provided the spark to ignite the issue and give Glass his victory. Senator Burton Wheeler thundered, “The best way to

restore confidence in our banks, is to take these crooked presidents out of the banks and treat them the same as they treated Al Capone when Capone avoided payment of his tax.”

The Witch Hunt

The press got on board to the point where the *Literary Digest* reported that “Apologies, even resignations, do not satisfy listening editors.” Heywood Broun, a leading columnist and perhaps the Paul Krugman of his day, piled on with, “The only thing that some of our great financial institutions overlooked during the years of boom was the installation of a roulette-wheel for the convenience of depositors.” The hearings and their aftermath, it is fair to say, had become a witch hunt.

NCB was a leading New York bank, restrained by law to operate only within the city. Its subsidiary,

One senator said the government should “treat [bank presidents] the same as they treated Al Capone.”

National City Company (NCC), had become the largest and most prominent commercial-bank-related securities underwriter, with offices in many cities besides New York. National City and its president, Charles Mitchell, were charged with numerous misdeeds. Mitchell allegedly arranged his affairs so as to avoid income tax. It was also alleged that the bank paid high salaries and bonuses and made special lending facilities available to executives.

These are scarcely criminal offenses. But among the more serious charges, executives allegedly profited from the firm's own securities underwritings. For example, National City bought a large block of stock in the new Boeing Corporation. Rather than sell this stock to the public, Pecora charged that NCC "retained a large block for itself and allotted the remainder to Mr. Mitchell and a select list of officers, directors, key men, and special friends." But an internal NCC memorandum concerning this stock says, "[O]n account of the fact this industry is still somewhat unseasoned, even though we regard this particular company as sound and having a very bright future, we were not quite ready to make a general offering to our customers. It would have been next to impossible to avoid taking orders from the type of investor who should not buy this stock. Therefore, our own family and certain officers and employees of the Boeing Co. and affiliations have taken the entire issue."

Not only does this not sound improper, but in fact it sounds like just the sort prudent regard for customers' best interests that was supposed be lacking in combined firms such as NCB/NCC.

The committee produced a Mr. Brown, a witness who claimed to have lost \$100,000 as a result of an NCC salesman's bad advice. Bankrupt and in ill health, Mr. Brown was an ideally sympathetic witness, but it turned out that he had been a successful businessman and not a novice. NCB was forbidden to call rebuttal witnesses.

In his 1990 book, *The Separation of Investment and Commercial Banking*, Professor George Bentson investi-

gated numerous other charges against NCB and showed that none had any substantial basis in fact. Similar charges were brought against the Chase Bank, its president Alfred Wiggins, and the affiliated Chase Securities Corporation. Bentson also showed that these charges were mostly unsubstantiated—and added a thorough critique of the supposed theoretical problems of universal banks such as conflicts of interest.

Caveat Emptor

But what about conflict of interest? It is certainly possible that a banker in a combined firm might steer customers into ill-suited investments or insurance products. This is a hazard we face whenever we deal with professionals, such as physicians who advise treatments and also provide them, or lawyers who advise lawsuits and offer to file them. Such hazards are manageable: We can always get a second opinion or consult a fee-based financial planner or simply rely on the professional's incentive to maintain a reputation for ethical service.

Financial institutions have widened their offerings considerably in recent years without any apparent problems. At the website of Wells Fargo Bank, for example, one finds not only traditional deposit and savings accounts and loans of all sorts, but also stock brokerage, mutual funds, automobile insurance, homeowner's insurance, and even pet insurance. (But the Wells Fargo branch in a nearby Safeway store didn't catch on and was closed.) Similarly, Charles Schwab, which began as a discount broker, now offers a full range of investment products and advice as well as banking services through its affiliated bank. Customers enjoy expanded services and lower prices as a result of the widening of competition among traditionally distinct firms. There is no sign of significant or widespread problems arising from conflicts of interest in such firms.

Combined firms are not assured success. Sears, Roebuck, for example, once decided to get into financial services. Sears as such couldn't just start accepting deposits and making loans, nor could any commercial

The press got on board and the hearings ultimately leading to Glass-Steagall turned into a witch hunt.

bank start selling underwear. But it formed a holding company, and the combination was effected. For a brief time customers in a nearby Sears, clutching their underwear purchases, could wander across the aisle into an alcove where smiling agents offered banking services through Allstate Savings and Loan, insurance policies from Allstate Insurance, and securities from Dean Witter—Sears subsidiaries all. Customers, not regulators, showed that no economies of scope were to be found in the Sears approach: The alcoves were returned to retail use, and the subsidiaries were sold. By the time Sears recovered from this excursion, Walmart was riding high and Sears was headed for the ropes.

Another failed expansion of scope was Citicorp's acquisition of The Travelers, a major insurance firm that had previously acquired the Smith Barney brokerage. The resulting combination was christened Citigroup but the hoped-for synergies never appeared and Travelers was sold. This happened long before Citigroup was rescued by a federal bailout. Citigroup, incidentally, is the successor of the National City Bank of Glass-Steagall fame.

The End-Around

Sears and Citigroup aside, some firms achieved a substantial degree of financial integration in the 1980s and '90s. Banks had figured out how to dodge the Glass-Steagall prohibition on ownership of firms "engaged principally" in underwriting and securities dealings. They simply formed subsidiaries that conducted a large enough volume of other business that they could legitimately claim they escaped the "engaged principally" clause. This avenue was not available to smaller institutions that could not marshal the required volume of business to employ this dodge. Thus by the 1990s Glass-Steagall was fast becoming a dead letter. The Gramm-Leach-Bliley Act of 1999 acknowledged the situation and provided a straightforward path toward financial integration as opposed to the variety of side routes that had been taken.

Incidentally, no other developed country has ever seen fit to separate commercial banking from invest-

ment banking. Banks in Germany and Switzerland have always been free to engage in underwriting and securities holding to no obvious harm. British banks are slightly more regulated: They are not allowed to sell insurance.

Backed partly by the reputation and stature of Paul Volcker, the Dodd-Frank act is now law. A provision that at least echoes the Volcker rule prohibits "high risk" proprietary trading by banks (trading for their own account). However, the distinction between proprietary trading and similar but supposedly benign forms of trading is left to regulators. Thus the effects of this and the act's other loosely related provisions won't really be known until a passel of regulations are written and implemented. Very likely the full effects

of Dodd-Frank won't be apparent until the next financial crisis. It is disturbing that the urban myths that backed Glass-Steagall have survived like a dormant virus in the person of Mr. Volcker, as his quoted testimony suggests, and have re-emerged in Dodd-Frank.

Glass-Steagall tore investment banks out of the arms of their commercial banking parents. After that they stood alone, first as partnerships and then, starting with Merrill Lynch

in 1971, as corporations. More recently they began to convert themselves into bank-holding companies. In September 2008 the last two major stand-alone investment banks, Goldman Sachs and Morgan Stanley, took the plunge. At a stroke these institutions gained certain advantages such as borrowing privileges at the Fed's Discount Window, while subjecting themselves to stricter regulations on leverage and borrowing. Most important, their explicit status as banks gives them greater assurance of a future bailout should failure loom again.

Scapegoat

The timing of the repeal of Glass-Steagall makes this deregulatory move a convenient scapegoat for the financial crisis. But the crisis began with the housing collapse, a result of government encourage-

While the Volcker rule does not seem to be a return to Glass-Steagall, it is disturbing that Volcker has bought the urban myth supporting it.

ment of unsound lending practices. Financial firms took too much risk with mortgage-backed securities, in part because of moral hazard engendered by government guarantees and partly because bond rating firms were not as independent as was once thought. The limited liability that the investment banks gained when they became corporations may also have amplified moral hazard. There is no good reason to believe that Glass-Steagall, had it remained in effect, would have prevented any of these problems.

A panoply of myths grew up around the Great Depression, many of which are only now being debunked. Sadly, the current Great Recession may spawn a new set of myths, among them the supposed role of Glass-Steagall's repeal. We have seen how 1930s congressional hearings produced scapegoats that led to Glass-Steagall's separation of investment banking from

commercial banking. Is history repeating? Last April the Securities and Exchange Commission filed securities fraud charges against Goldman Sachs. The civil complaint, since settled for \$550 million, contended that the firm stacked the deck on billions of dollars worth of mortgage securities in favor of insiders and at the expense of outsiders. At this writing the Manhattan U.S. Attorney's office is conducting an investigation that could lead to criminal charges. And Goldman executives were subject to some 11 hours of intensive questioning in front of a Senate committee, during which they largely stood their ground.

We do not know whether the charges against Goldman Sachs have merit, but the parallels between that firm and the National City Bank of 1933 are eerie. We may well be seeing the manufacture of another scapegoat. **FEE**

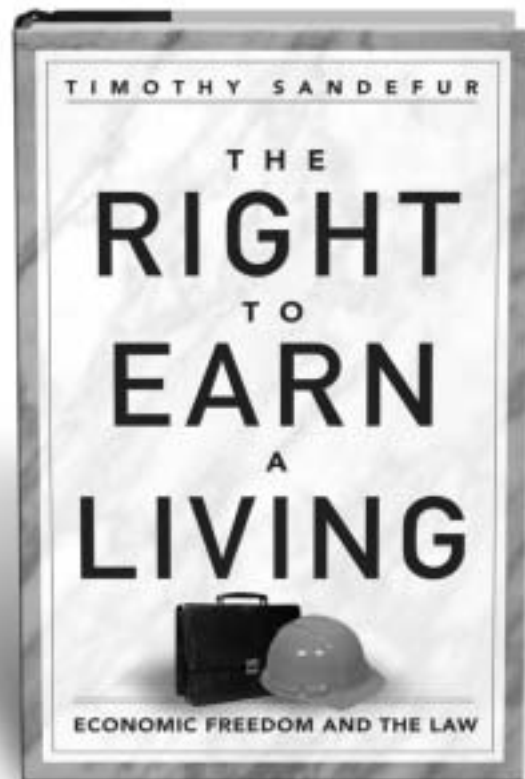
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