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Could the 1933 Glass-Steagall Act have prevented the financial crisis?

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Abstract

This paper explores the common argument according to which the repeal of the Glass-Steagall Act was at the origin of the 2008 financial crisis. By arguing successively that the Act would not have covered the failing banks and that it would not have solved the “Too-big-to-fail” problem, this paper concludes by the negative. Had the Glass-Steagall act still been in place, the Global Financial crisis would not have been prevented. Mortgage policies, low capital requirements and Basel II seem to be more convincing alternatives.

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1 Introduction

The Great Depression and the banking crises in the 1920s resulted in the legislative enforcement of the separation of investment and commercial banking through the enactment of the Glass-Steagall Act in 1933 (“the Act”). Still, after nearly 70 years of existence, the Gramm-Leach-Bliley Act repealed the 1933 legislation. The repeal of 1999, even if incremental changes, both legislative and judicial,¹ have taken place in the last decades, was the perfect scapegoat for the 2008 financial crisis.

Following this idea, the presidential campaign of 2016 saw both the republicans and the democrats arguing for a “21st century Glass-Steagall Act”.² The idea of the reinstatement is supported by a large political spectrum, especially with opinions according to which banks should not be involved in “casino banking” or that the FED should not provide a safety net to those risky operations gambling depositors money. However, this essay will argue that the Glass-Steagall Act could not and would not have prevented the financial crisis and, therefore, that the idea of its reinstatement is not supported.

¹ *Investment Co. Inst. v. Camp*, 401 U.S. 617 (1971)

² David Dayen. *The Republican Platform’s Surprise Revival of Glass-Steagall Legislation*. The Intercept. July 19, 2016; *What’s one thing Democrats and the GOP agree on? Restore Glass-Steagall*. the Guardian. July 21, 2016.

2 The Glass-Steagall Act would not have increased stability by prohibiting the underwriting of securities

Some may argue that the repeal of the 1933 Glass-Steagall-Act has created instability in the financial sector and caused the financial crisis of 2008; on the contrary, while the Glass-Steagall-Act was in place, it seemed to work quite well. However, this stability was possible under the condition that the government keeps the inflation steady by not increasing the deficit dramatically.³ This was not the case and, in the 1960s, the deficit was growing.⁴ In this scenario, the prohibition of interest on deposits established by the Glass-Steagall-Act encouraged depositors to take their funds out of the banks.⁵ Hence, the stability of the 1933 Banking Act was the result of other circumstances.

This part will argue that the Glass-Steagall Act could not have avoided the financial crisis because most of the failing banks at that time would not have been covered by the act (1.). Furthermore, the argument according to which the restriction of the underwriting of securities brings stability is not convincing (2.).

³ Charles W. Calomiris and Stephen H. Haber. *Fragile by design: the political origins of banking crises and scarce credit*. The Princeton economic history of the Western world. Princeton, New Jersey: Princeton University Press, 2014. 570 pp.

⁴ The Washington Post. *1960s deficit spending led to today's grief*. The Denver Post. July 7, 2012.

⁵ Calomiris and Haber, *Fragile by design*.

2.1 Failing banks were not covered by the Act

The main argument in favour of the Act is that the legislation boosted the need for banks to have strong risk management processes. Accordingly, as the riskiest banks failed during the crisis, the Act would have prevented, or at least seriously contained, the crisis by preventing in the first-place banks to engage in such risky endeavours. This argument suffers from two serious flaws.

First, there is very little evidence that the non-repeal of the Glass-Steagall Act would have changed anything. Indeed, it seems that the current debate on the reinstatement of such an Act is serving a political rationale rather than an economic one. Andrew Ross Sorkin goes on to say that “even if [it] wouldn’t have prevented the financial crisis [...] you can build public attention behind it”.⁶ Moreover, when investigating failing banks during the financial crisis, it certainly does not appear that the distinction between commercial and investment banks would have changed anything. Failures of Lehman Brothers, Bear Stearns, and Merrill Lynch, considered as the very illustrations of the crisis of the financial system, would not have been changed by the Glass-Steagall Act as they were not correlated with their links with commercial banks.⁷

Second, bank failures during the financial crisis were mainly due to poor

⁶ Andrew Ross Sorkin. “Reinstating an Old Rule Is Not a Cure for Crisis”. In: *DealBook, New York Times* (2012).

⁷ Randall Kroszner. *Interconnectedness, Fragility and the Financial Crisis*, p. 20; Oonagh McDonald. *Lehman Brothers: A Crisis of Value*. Bloomsbury Academic, 2015. 272 pp.

and bad choices. If it is commonly admitted that FED's safety net has increased a little the risk banks were ready to take in their risk-seeking operations,⁸ it is erroneous to argue that banks failed only due to this. For instance, small banks, representing the vast majority of FED-insured banks,⁹ failed mainly because of their poor choices concerning real estate loans – by essence a commercial activity. IndyMac, another symbol of the crisis, was acting with poor business strategy which would have been authorized under the Glass-Steagall Act.¹⁰ Lawrence White argues that the financial crisis “could have and would have proceeded in much the same fashion even if Glass-Steagall had not been repealed in 1999”.¹¹ On the same note, Martin Wolf considered that the essence of the interdictions of the Act was simply not “the core of what went wrong”.¹²

Therefore, with or without the Act, those failures would have been the same and would not have been prevented. The Glass-Steagall Act, alone, could not have increased the stability of the banking system enough to avoid the crisis.

⁸ H. Davies. *The financial crisis: who is to blame?* Cambridge, UK ; Malden, MA: Polity Press, 2010. 229 pp.

⁹ Oonagh McDonald. “The Repeal of the Glass-Steagall Act: Myth and Reality”. In: *Policy Analysis* (2016), p. 24.

¹⁰ Ibid.

¹¹ Lawrence J. White. “Lessons from the Debacle of '07-'08 for Financial Regulation and Its Overhaul”. In: *SSRN Journal* 09-01 (2008).

¹² Martin Wolf. *The shifts and the shocks: what we've learned - and have still to learn - from the financial crisis*. London: Lane, 2014. 465 pp.; Martin Wolf. *Volcker's axe is not enough to cut banks to size*. Jan. 26, 2010.

2.2 The prohibition of underwriting securities was unwise

The key argument of those in favour of the Act is to consider that it was, in the first place, a good idea. Hence commercial banks underwriting securities is necessarily a bad thing. But this argumentation is not supported by evidence.¹³

Indeed, it has been demonstrated that the cost for companies to raise funds for investment was increased due to the Glass-Steagall Act.¹⁴ Another study has argued that the relationship between J.P. Morgan and its clients resolved the asymmetric information issues.¹⁵ In this sense, clients can benefit from the involvement of their banks in the securities market. Other authors have focused their attention on the rationale of the prohibition of underwriting securities for commercial banks. Benston demonstrated that no evidence has been brought on the interest of such a restriction. He argued that there was very little concern on the FED's safety net.¹⁶

Of course, those studies have been performed before the 2008 financial crisis and those in favour of a return of the act say that the conclusions would certainly be different now. But in 2012, Neal and White have reached the

¹³ Calomiris and Haber, *Fragile by design*.

¹⁴ Carlos D. Ramirez. "Did Glass-Steagall Increase the Cost of External Finance for Corporate Investment?: Evidence From Bank and Insurance Company Affiliations". In: *The Journal of Economic History* 59.2 (1999), pp. 372–396.

¹⁵ Carlos D. Ramirez. "Did J. P. Morgan's Men Add Liquidity? Corporate Investment, Cash Flow, and Financial Structure at the Turn of the Twentieth Century". In: *The Journal of Finance* 50.2 (1995), pp. 661–678.

¹⁶ George J. Benston. *The Separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered*. New York: Oxford University Press, Jan. 1, 1990. 580 pp.

same conclusion and demonstrated that the securities underwriting was a basis for stability. They, therefore, argue against the Dood-Frank legislation and the Volcker's Rule, basing their argument on a historical view of the different banking acts in the United States and abroad.¹⁷

As such, it seems difficult to argue that the Glass-Steagall Act in 1933 was other than a political move and a quick reaction to the Great Depression.

3 The Glass-Steagall Act did not substantially affect the structure of the financial system

On the other hand, supporters of the reinstatement of the Act considers that if it was still in place in 2008 it would have avoided the financial crisis by preventing banks to become too big to fail (1.) or too interconnected to fail (2.). This part will argue the opposite.

3.1 The Glass-Steagall Act would not have solved the too big to fail problem

Those advocating for the reinstatement of the Glass-Steagall Act argued that it would have helped to contain, if not avoid, the 2008 financial crisis by preventing banks to become too big to fail.¹⁸ In this sense, because investment

¹⁷ Larry Neal and Eugene N. White. "The Glass-Steagall Act in historical perspective". In: *The Quarterly Review of Economics and Finance* 52.2 (May 1, 2012), pp. 104–113.

¹⁸ Wolf, *Volcker's axe is not enough to cut banks to size*; Wolf, *The shifts and the shocks*.

banks would not be saved if running into difficulties they would have to act more cautiously and, hence, would never become this big.¹⁹ This argument is flawed in several aspects.

First, it is very doubtful that, in the future, a government would let a big investment bank fail. Arguably, no one would like a “new Lehman”. Second, when studying banks that have failed during the crisis, one can easily remark that a lot of them were operating under the threshold of \$1 billion of assets.²⁰ Their failures are due to other circumstances, especially poor risk management. On the contrary, some very big banks survived the crisis. For example, J.P. Morgan has been one of the most stable institutions during the catastrophe because it was more diversified and, hence, much safer. More, the very rationale of the Glass-Steagall Act to react to the speculative actions of the banks in 1929 was wrong. The Great Depression was mainly due to small banks failing because dependent on their local conditions (at this time the agricultural well-being). The biggest banks would not have failed in the same manner. In 2008, small banks failed by a lot as well because driven by their credit losses.

As such, it appears unlikely that the too big to fail problem was at the origin of the financial crisis of 2008 or, at least, that this would have been avoidable with the Glass-Steagall Act still in place. Rather, regulatory failures to control the mortgage’s dilemma as well as the lack of enforceable minimum capital requirements seem more plausible. Stating that the Glass-

¹⁹ “The Turner Review: A regulatory response to the global banking crisis”. In: (2009), p. 126.

²⁰ McDonald, “The Repeal of the Glass-Steagall Act: Myth and Reality”.

Steagall Act would have solved the too big to fail problem on its own and, as such the financial crisis, would mean closing our eyes on the dramatic growth of the subprime market caused by very bad lending policies and risk assessment procedures.

3.2 The Glass-Steagall Act would have increased the interconnection problem

Another argument raised is the one considering that the Act would have tackled the interconnection problem in the financial sector.²¹ This argument has acquired some visibility in 2010 through the different testimonies of Paul Volcker, strongly advocating for the so-called “Volcker Rule”, a Glass-Steagall Act-like legislation. The basis of the argumentation exposed is to consider the financial system more fragile in its entirety than the sum of the fragility of the individual actors inside it. In other words, the system is risky because of the interconnection between risky operators. In this sense, the loss of one bank can result in the loss of others’ due to the interbank deposit and lending process.²² In an interconnected system, a crisis would spread like wildfire,²³ especially considering the fact that banks are interlocked with each other but also with other financial actors, such as insurance companies, investment funds, etc. The size of a few banks would not be the problem,

²¹ *Implications of the Volcker Rules for Financial Stability*. In collab. with Simon Johnson. Feb. 4, 2010; *Speech to Scottish Business Organizations*. In collab. with Mervyn King. Oct. 20, 2009; *Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies*. In collab. with Paul Volcker. Feb. 2, 2010.

²² Kroszner, *Interconnectedness, Fragility and the Financial Crisis*.

²³ Ben Bernanke. *Non-Monetary Effects of the Financial Crisis in the Propagation of the Great Depression*. NBER Working Paper 1054. Jan. 1983.

but the key is more the connection between financial actors.

However, when studying the 2008 crisis in the US it quickly appears that the interconnection issue did not arise from the mixing between commercial and investment banks.²⁴ More, if we force banks to divide their activities, it will by definition increase the number of actors in the financial market. This will be likely to increase even more the interconnection issue since we will multiply the risk of each individual actor. On this specific point, Lawrence White goes on to argue that the repeal of the Glass-Steagall Act had an effect to reduce the interconnection in the market and hence was part of the solution.²⁵

Therefore, either the reinstatement of the separation between commercial and investment activities or the limitation *per se* of the size of the banks will inevitably result in a deeper fragmentation of the financial market. As a result, risk will increase exponentially.

4 Conclusion

As a conclusion, it seems that the presence of the Glass-Steagall Act in 2008 would have changed very little things about the crisis. Neither the too big to fail and the too interconnected to fail problems nor the failures of the banks would have been tacked by such a piece of law. The reasons for the crisis therefore lie somewhere else. It is common to argue that the fragility of the system was not understood by the actors as well as by the

²⁴ Kroszner, *Interconnectedness, Fragility and the Financial Crisis*.

²⁵ White, "Lessons from the Debacle of '07-'08 for Financial Regulation and Its Overhaul".

regulators themselves. Also, Wall Street was so large and powerful that it gives the illusion of safety to many. Still, the division between investment and commercial operations does not seem to have anything to do with it.

However, solutions do exist. If another banking act is not necessary, it is widely recognized that the 2008 crisis has waived two questions: mortgages and capital requirements. First, 40% of the mortgages immediately preceding the crisis were granted at a down payment below 3%. Hence, the rapid growth of risky mortgages and the lack of regulations are ideal candidates. Second, capital requirements were the core of the problem. Calomiris goes on to argue that “if housing-finance policies were the fuel for the subprime crisis, then weak prudential regulation was a hot, dry wind that made that fuel extraordinarily flammable.”²⁶ Governments and politics decided that the risk was worth taking regarding the cost of mortgages which would have dramatically increased if it was not for this policy. Hence capital requirements were not applied, and banks failed. The US government is not the only one to blame though. The adoption of the Basel II system, enabling banks to use their models to decide which level of capital requirement was satisfactory, also played its part.²⁷ Therefore, neither the idea that the Act would have prevented the financial crisis nor the reinstatement of it seem convincing.

²⁶ Calomiris and Haber, *Fragile by design*.

²⁷ Joseph R. Mason and Josh Rosner. “How Resilient are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions?” In: *SSRN Electronic Journal* (2007); Joseph R. Mason and Josh Rosner. “Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions”. In: *SSRN Electronic Journal* (2007).

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