On My Mind

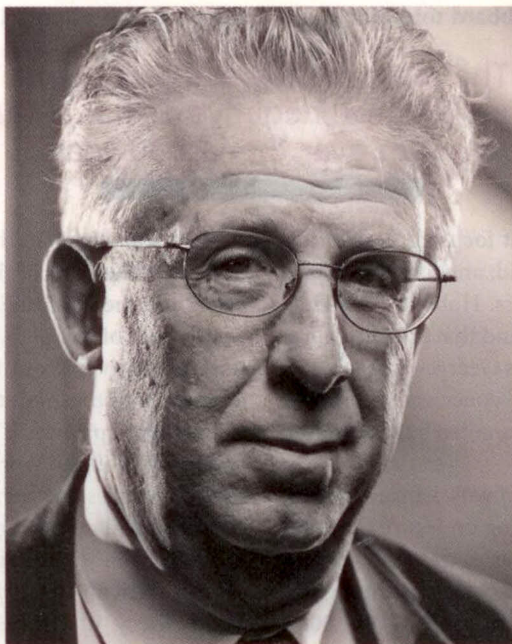
Stop Pining for Glass-Steagall

Thank goodness that statute was gone when it came time to rescue Merrill Lynch and Bear Stearns. By Robert Pozen

AT THE DEPTH OF THE DEPRESSION in 1933, Congress passed the Glass-Steagall Act to separate commercial banking from the securities business: JPMorgan here, Morgan Stanley there. In 1999 the banks persuaded Congress to tear down the wall. Glass-Steagall was repealed. Banks could merge with brokers.

Now there's a backlash against that repeal. Some commentators and some politicians blame the repeal for the 2008 financial crisis. They want to resurrect Glass-Steagall.

This is a bad idea. The repeal of Glass-Steagall was at most a minor factor in leading up to the financial crisis, and its repeal was instrumental in resolving the liquidity squeeze on Wall Street.



What killed banks last year? Old-fashioned commercial lending.

The wall between commercial and investment banking was long filled with holes: Even under Glass-Steagall commercial banks could invest in bonds, manage mutual funds, execute securities trades on the order of their customers and underwrite government-related securities. The main thing they couldn't do was underwrite corporate stocks and bonds. Even that prohibition was loosened, as regulators permitted bank holding companies to set up special subsidiaries devoted in part to underwriting corporate stocks and bonds. In other words, the main impact of repealing Glass-Steagall was to allow banking organizations to become more active in underwriting.

It was after the repeal that banks got deeply into underwriting mortgage-backed securities, and it was mortgage securities that triggered the crisis. But this doesn't mean that the expansion of underwriting was an important cause of losses at these banks. If this argument were true, we would expect to see the portfolios of big banks crammed with low-rated mortgage paper that they could not sell in their underwritings. In fact, big banks held primarily the mortgage securities with the highest ratings, which they would have been permitted to hold under Glass-Steagall.

It could also be argued that large banks would be tempted to make bad loans to companies in order to get their underwriting business. While such practices have periodically occurred, they have for years been prohibited by several federal statutes. Moreover, when the SEC looked at the banks that became insolvent during 2008, it found that the main cause of insolvency was losses on traditional bank loans unrelated to their securities underwritings.

At the same time, the repeal of Glass-Steagall facilitated the rescue of four large investment banks and thereby helped reduce the severity of the financial crisis. When Bear Stearns and Merrill Lynch got into serious trouble, they were promptly acquired with federal assistance by JPMorgan Chase and Bank of America, respectively. These rescues happened only because banks could own full-service broker-dealers. When Goldman Sachs and Morgan Stanley were challenged to find adequate short-term funding, they were allowed to quickly convert from broker-dealers into bank holding companies.

Banks have a significant advantage over broker-dealers in obtaining short-term financing in illiquid markets. A bank can rely on insured deposits and Fed loans as well as short-term financing in the form of commercial paper. Commercial paper buyers are a fickle bunch. Bank depositors are more stable retail customers.

Given the globalization of the financial markets, it would be foolhardy to prohibit U.S. banks from engaging in securities activities that are performed by their global competitors. And it would be almost impossible to obtain an international agreement that all countries would impose—many for the first time—the restrictions of Glass-Steagall on their local banking activities. Indeed, even when Glass-Steagall restricted the securities activities of U.S. banks, the law never extended to those activities conducted by those banks outside the U.S.

In short, reinstating the Glass-Steagall Act would not prevent another financial crisis. It would just increase the severity of any such crisis by limiting the options for helping securities firms in liquidity crunches. Moreover, imposing restrictions on the securities activities of U.S. banks would put them at a tremendous disadvantage relative to their foreign competitors. **F**

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