PROJECT SYNDICATE
AN ASSOCIATION OF NEWSPAPERS AROUND THE WORLD

August 2012

Spooked by Glass-Steagall's Ghost?

By Mark Roe

CAMBRIDGE – America's long-controversial Glass-Steagall Act of 1933, which separated deposit-taking commercial banks from securities-trading investment banks in the United States, is back in the news. This separation long symbolized America's unusual history of bank regulation – probably the most unusual in the developed world.

American banking regulation had long kept US banks small and local (unable to branch across state lines), unlike their European and Japanese equivalents, while limiting their operational capacity (by barring banks from mixing commercial and investment banking). These limits on American banking persisted until the 1990's, when Congress repealed most of this regulatory structure. Now the idea of a new Glass-Steagall is back, and not only in the US.

Sandy Weill, Citigroup's onetime CEO, said last month that allowing commercial and investment banks to merge was a mistake. This is the same Weill who had lobbied to gut Glass-Steagall in order to build today's Citigroup, which put insurance companies, securities dealers, and traditional deposit-taking banks all under one roof. In fact, he engineered an agreement to merge Citi with a large insurer – illegal at the time under Glass-Steagall – and *then* pushed for the law's repeal, so that the merger could proceed.

A similar debate has been underway in Britain. A commission headed by Sir John Vickers, the Oxford economist and former Bank of England chief economist, wants banks' retail operations to be "ring-fenced" from riskier trading and investment banking businesses. Ring-fencing is not exactly Glass-Steagall-style separation – Glass-Steagall forbade commercial banks from even affiliating with investment banks – but it is in the same spirit.

The impetus for the rethinking is, of course, the recent financial crisis. Are Weill and Vickers right now, people are asking, or was Weill right two decades ago, when he backed allowing investment and commercial banks to merge?

That is actually the wrong question to ask first. The first question is whether Glass-Steagall's repeal strongly contributed to the financial crisis in the US. If it did, Glass-Steagall's repeal should be revisited, and quickly. If it did not contribute much to the crisis, keeping risky trading away from commercial banks' deposit base may still be desirable, but not something that the financial crisis "proved" is necessary.

Those who say that the financial recent crisis tells us to re-enact Glass-Steagall overlook what failed and what did not: the largest failures in the 2008 crisis – Lehman Brothers,

AIG, and the Reserve Primary Fund – were not deposit-taking commercial banks on which Glass-Steagall's repeal had a major impact. AIG was a mega-insurer. Lehman was an investment bank. The Reserve Primary Fund – brought down by its purchases of IOU's from Lehman – was a money-market mutual fund, not a commercial bank.

True, major commercial banks, like Citibank and Bank of America, tottered, but they were not at risk because of their securities underwriting for corporate clients or their securities-trading divisions, but because of how they (mis)handled mortgage securities. Mortgage lending, however, is a long-standing activity for commercial and savings banks, mostly unaffected by Glass-Steagall or its repeal.

Some commercial-banking activities are closer to securities trading. The so-called "Volcker Rule," proposed by Paul Volcker, the former US Federal Reserve chairman, is a mini-Glass-Steagall, aiming to bar deposit-taking commercial banks from derivatives trading – now seen to be a dangerous activity for them. But, again, although derivatives trading played an important role in the crisis (AIG's inability, without a government bailout, to honor its risky credit-default swaps is the best example), Glass-Steagall's repeal did not unleash the riskiest trades in the institutions that failed. Reenacting it will do little, if anything, to remedy crisis-related ills, beyond what the Volcker Rule is supposed to do anyway.

The best case against Glass-Steagall's repeal is not that mixing investment and commercial banking caused the crisis. Rather, the best case arises from a general sense that financial institutions have become too complicated to regulate and too big to fail even when staying within their traditional businesses. Hence, we should simplify and strengthen them.

But even if those are the goals, the recent focus on repealing Glass-Steagall is not helpful, because it is not the most important way to simplify and strengthen America's banks. It thereby diverts policymakers' attention from the main issues. If the financial crisis reveals a structural problem in banking, it is more likely to come from insufficient capital to cushion a bank's fall, or from too many financial institutions having become too big to fail.

The US Dodd-Frank legislation, enacted in 2010, did (weakly) cap the size of future bank mergers. But, if size is still the problem, more could be done. If big banks have become too complex to regulate, then a workable Volcker Rule is the best way to start simplifying them. And, if the problem is systemically risky derivatives trading in banks and elsewhere, then the priority given to derivatives traders over nearly every creditor ought to be curtailed.

Ironically, Glass-Steagall itself arose in the 1930's from commercial bankers' efforts to divert regulators' attention from other remedies. Small-town bankers throughout the country wanted government-guaranteed deposit insurance, while stronger big-city banks feared that government deposit insurance would put them at a competitive disadvantage.

After all, deposits from the small-town banks were running off to big banks in money centers like New York, Chicago, and Los Angeles.

Two decades ago, Donald Langevoort, now a law professor at Georgetown, showed that major bankers – indeed, the leaders of First National City, the predecessor to Weill's Citibank – proposed Glass-Steagall in lieu of deposit insurance. No big bank was at risk from trading securities then, but the big banks' investment-banking affiliates were not making money trading and underwriting securities during the Depression, so the banks were willing to surrender that part of their business. The irony is that Congress took up the big banks' offer to separate commercial and investment banking, but then enacted deposit insurance anyway.

Glass-Steagall was a distraction then; it is a distraction now. If the goal is to shore up the weaknesses revealed by the global financial crisis, policymakers in the US and other countries should first look elsewhere.