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background paper

A Brief History of the Glass-Steagall Act

Ten years ago last November, a Republican-led Congress and a Democratic White House rolled out the red carpet for a new age of global, "full service," too-big-to-fail financial institutions. The move repealed the Glass-Steagall Act of 1933, a set of reforms responsible for the longest crisis-free period in U.S. financial history. At the time, industry lobbyists argued that this modern experiment in deregulation would bring greater stability and competitiveness to the financial services industry. Today, it is clear that they were wrong—and spectacularly so. Competition is suffering from high concentration and anti-competitive subsidies to the biggest institutions, and the system has been radically destabilized by unregulated activities, costing taxpayers nearly $19.3 trillion[1] in bailouts and subsidies. As Washington debates the best way to prevent future crises, it is helpful to understand how public policy helped bring about the current one.

What Glass-Steagall Was

Officially known as the Banking Act of 1933, it was one of the landmark pieces of legislation associated with Franklin Roosevelt's New Deal. The measure established the concept of deposit insurance and set up the Federal Deposit Insurance Corporation to provide it. Glass-Steagall[2] also erected a firewall between commercial banks, which take deposits and make loans, and investment banks, which organize the sale of bonds and stocks.

The Road to Glass-Steagall

Between 1929 and 1933, more than 4,000 U.S. banks had closed permanently, saddling depositors with close to $400 million in losses. In March 1933, President Roosevelt had been forced to shut down the entire banking system for four days.

The law at the time allowed banks to traffic freely in securities. A congressional investigation led by a firebrand prosecutor named Ferdinand Pecora unearthed massive evidence of recklessness, cronyism, and fraud both in the use of depositor funds and in the promotion of securities for sale to the public. A top executive of Chase National Bank (ancestor of today's JPMorgan Chase) had enriched himself by short-selling his company's shares during the stock market crash. National City Bank (now Citibank) had taken a heap of failed loans to Latin American governments, packaged them as securities, and unloaded them on unsuspecting investors.[3]

Banking and securities underwriting made for a poisonous combination, many people concluded. The Glass-Steagall Act accordingly gave banks a year to decide: they could get out of the securities business, and enjoy the benefits of deposit insurance and access to the low-interest credit of the Federal Reserve; or they could be investment banks and brokerage houses, and forego those privileges.

What The Law Wrought

Glass-Steagall's goal was to lay a new foundation of integrity and stability for America's banks. It worked. Financial panics had been regular and devastating occurrences since before the Civil War. No more. While individual banks continued to fail occasionally, their depositors escaped largely unscathed. Trust in the stock and bond markets also grew; for investors around the world, the U.S. financial system seemed to set a high standard of transparency and reliability.

Building on the apparent success of 1930s banking and securities regulation, Congress decided to establish a Glass-Steagall-style wall between banking and insurance. Under the Bank Holding Act of 1956, banks were permitted to sell insurance, but not to underwrite it. (Had that rule remained in force down to the present day, AIG would have been unable to weave banks into its web of toxic credit derivatives, which are structured as insurance contracts.)

How Quickly We Forget

By the early 1980s, anti-regulation advocates had won sway in Washington. With steady weakening of the financial regulatory structure came a new period of crisis and volatility that began with the Savings and Loan crisis[4] and has yet to end. In the spring of 1987, the Federal Reserve Board voted 3-2 to let banks engage in a range of securities underwriting activities. One of the dissenting votes was cast by Fed chairman Paul Volcker, who feared (among other things) that banks would again seek to profit from lucrative loan securitization opportunities.[5]

His successor, Alan Greenspan, had more faith in the self-correcting machinery of unfettered markets. During the presidency of George H.W. Bush, Greenspan and Treasury Secretary James Baker took steps that weakened Glass-Steagall by, for example, letting banks underwrite municipal bonds on the premise that they were safe by definition. In 1991, the administration called on Congress to repeal the law outright. Although a bill to that effect was voted down in the House of Representatives that year, the anti-Glass-Steagall movement was clearly gaining steam.[6]

The Final Shove

In the interim, financier Sanford Weil had taken advantage of various exemptions in the law to build an empire of insurance, commercial-banking, and investment-banking units. In early 1998, he proposed a merger to Citicorp's John Reed.

The idea was a brazen violation of Glass-Steagall. But by now, Greenspan had prevailed on the Fed to let bank holding companies own investment-bank affiliates with as much as 25 percent of their business in securities underwriting. (The previous ceiling had been 10 percent.) Meanwhile, the Clinton administration, with the ex-investment banker—and future Citigroup Chairman—Robert Rubin as Treasury Secretary, was sympathetic to the case for bigger and more diversified banks in the name of American global competitiveness.

After heads-up phone calls to Greenspan, Rubin, and Bill Clinton, Weil and Reed announced the biggest-ever corporate merger, resulting in the biggest-ever financial services company. For a brief time, it appeared that the Fed might require the new entity to sell off its insurance operations. Weil's solution was to crank up another Glass-Steagall repeal effort and wait out the result, assuming that no one in power would object. He had figured right. The final push took a year and a half, and entailed hundreds of millions of dollars in lobbying and campaign contributions. But on November 12, 1999, Clinton signed the Financial Modernization Act (commonly known as Gramm-Leach-Bliley) into law.[7]

Cries of Alarm

On Capitol Hill, only a few people resisted. One was North Dakota Senator Byron Dorgan, who, on May 11, 1999, made an impassioned floor speech "captured only by the cameras of CSPAN-2," according to one account. "I want to sound a warning call today about this legislation," Dorgan declared. "I think this legislation is just fundamentally terrible."[8]

Some House Democrats initially argued that the banks should not be given so much without delivering anything in return. Most of them relented, however, after the bill was sweetened with provisions that modestly expanded the Community Reinvestment Act. In the end, the vote in both chambers was overwhelming. Only eight Senators voted no: seven Democrats (Dorgan, Barbara Boxer, Barbara Mikulski, Tom Harkin, Richard Bryan, Russ Feingold, Paul Wellstone) and one Republican, Richard Shelby of Alabama.

"You've seen the roll call," Dorgan recalled. "We didn't really have to deal with push back because they had such a strong, strong body of support for what they call modernization that the vote was never in doubt... The title of the bill was 'The Financial Modernization Act…' [I]f you don't want to modernize, I guess you're considered hopelessly old fashioned."[9]

Where are They Now?

Some of the leading proponents of repeal were among its most conspicuous beneficiaries. Phil Gramm, after retiring in 2002, went to work for UBS AG, a Swiss commercial bank that moved into investment banking, with disastrous results.[10] Rubin, who had stepped down as Treasury Secretary shortly before the vote, resurfaced as chairman of Citigroup's executive committee, with a reported initial annual compensation in the $40 million neighborhood.[11] Citigroup lost $27.7 billion in 2008 and lives on as a ward of the federal government, second only to AIG in the huge sums of taxpayer money it has required to remain solvent.[12]

Another prominent advocate of repeal, Lawrence Summers, succeeded Rubin as Treasury Secretary and now heads President Obama's White House Council of Economic Advisors. "This historic legislation will better enable American companies to compete in the new economy," Summers said after Congress approved Gramm-Leach-Bliley.[13] The current Treasury Secretary, Timothy Geithner, is a devotee of the Rubin-Summers school of deregulation, and has offered systemic risk legislation that falls far short of restoring prudential size and activity limits on today's megabanks.

Looking Backward

Did the abandonment of Glass-Steagall contribute to the financial meltdown? Some commentators profess to see little connection, since, they say, most of the damage was sown by pure investment banks such as Morgan-Stanley, Bear Stearns, and Lehman Brothers and by the effectively unregulated, runaway insurance company, AIG.

But commercial banks played a crucial role as buyers and sellers of mortgage-backed securities, credit-default swaps, and other explosive financial derivatives. Without the watering down and ultimate repeal of Glass-Steagall, the banks would have been barred from most of these activities. The market and appetite for derivatives would then have been far smaller, and Washington might not have felt a need to rescue the institutional victims.

As a candidate for president, Barack Obama seemed to see the link. "A regulatory structure set up for banks in the 1930s needed to change," he said in his March 27, 2008, speech at New York City's Cooper Union. "But by the time the Glass-Steagall Act was repealed in 1999, the $300 million lobbying effort that drove deregulation was more about facilitating mergers than creating an efficient regulatory framework… Unfortunately," he went on to say, "instead of establishing a 21st century regulatory framework, we simply dismantled the old one," thereby encouraging "a winner take all, anything goes environment that helped foster devastating dislocations in our economy."[14]

Today, though, the Obama administration seems disposed to let giants be giants, while subjecting them to more regulation (and developing an emergency plan to unwind those that run amok in the future). By contrast, Paul Volcker would restore the basic principle of Glass-Steagall, with banks restricted to banking again. "The banks are there to serve the public," he said recently, "and that is what they should concentrate on. These other activities create conflicts of interest. They create risks, and if you try to control the risks with supervision, that just creates friction and difficulties… and ultimately fails."[15]

Former Citicorp CEO John Reed—co-architect of the great merger—recently voiced the same opinion.[16] And even Alan Greenspan, while not defending the precise regulatory architecture of Glass-Steagall, has come around to the view that if financial institutions are truly too big to fail, they just might be too big to exist.[17]

Endnotes

1. Nomi Prins, Krisztina Ugrin, "Bailout Subsidization and Type Report," at http://www.demos.org/pubs/prins_bailoutsubsidization.pdf.
2. Virginia Senator Carter Glass, the driving force behind the law, had been one of Woodrow Wilson's treasury secretaries. As a congressman in 1913, he had played a part in the creation of the Federal Reserve. Glass's chief partner on Capitol Hill, Henry Bascom Steagall, was the chairman of the House Banking and Currency Committee.
3. Ron Chernow, "Where Is Our Ferdinand Pecora?" *The New York Times*, Jan. 5, 2009.
4. FDIC, "The S&L Crisis: A Chrono-Bibliography," at http://www.fdic.gov/bank/Historical/s&l.
5. PBS Frontline, "The Long Demise of Glass-Steagall: A Chronology," at http://www.pbs.org/wgbh/pages/frontline/shows/wallstreet/weill/demise.html.
6. In 1995, the new chairman of the Senate Committee on Banking, Housing, and Urban Affairs, Phil Gramm of Texas, mounted a new campaign to undo the law. This time, repeal measures made it through the banking committees of both chambers. Although the House and Senate were unable to agree on a single measure, Glass-Steagall's days were numbered.
7. Frontline, "Long Demise of Glass-Steagall."
8. Sam Stein, "Glass-Steagall Act: The Senators and Economists Who Got It Right," Huffington Post, Oct. 29, 2009.
9. Stein, "Glass-Steagall Act: The Senators and Economists Who Got It Right".
10. Daniel Gross, "Phil Gramm's UBS Problem," *Slate*, July 7, 2008.
11. Robert Kuttner, "Friendly Takeover," *The American Prospect*, March 18, 2007.
12. Martin Crutsinger, :"Citigroup Reaches Aid Deal With Government," Associated Press, Feb. 27, 2009.
13. Sam Stein, "Glass-Steagall Act: The Senators and Economists Who Got It Right," *Huffington Post*, Oct. 29, 2009.
14. Barack Obama, "Renewing the American Economy," March 27, 2008, speech at Cooper Union.
15. Louis Uchitelle, "Volcker's Voice, Often Heeded, Fails to Sell a Bank Strategy," *The New York Times*, Oct. 21, 2009.
16. John Reed, letter to the editor, *The New York Times*, Oct. 23, 2009.
17. Michael McKee and Scott Lanman, "Greenspan Says U.S. Should Consider Breaking Up Large Banks," Bloomberg, Oct. 15, 2009.

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