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Bringing Back Glass-Steagall is a Bad Idea

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Introduction

There are some Republicans and Democrats in Congress who blame the Great Recession of 2008 on the dismantling of Glass-Steagall. The law, repealed in 1999 under President Clinton, had separated commercial and investment banking. This separation began with the passing of the US Banking Act of 1933 (insurance was also segregated). The legislation was a consequence of the stock market crash of 1929 and the subsequent Great Depression. However, the combination of commercial and investment banking had little to no effect on triggering the stock market crash or the Great Depression. Furthermore, subsequent problems within banking have not been prevented because of Glass-Steagall, nor have they been created because of its repeal. Consequently, the call for reinstatement of Glass-Steagall is misguided.

The Stock Market Crash of 1929 and the Great Depression

To protect the public, Congress enacted the Banking Act in 1933. Advocates asserted that separating investment and commercial banking would reduce conflicts of interest and increase bank safety; however, arguments supporting these claims have little merit.

With regard to conflict of interest, Galbraith (1954) alleges massive fraud as one of the causes for speculation and the ensuing crash; but Bierman (1991) found little evidence of insider trading or stock manipulation. In addition, the idea that broker loans added to the speculation is not supported by the data. Kindleberger (1978) argues that the rising supply of broker loans from non-banks fueled the market bubble. However, as White (1990) noted, the movement of the discount rate, the commercial paper rate, and the call and time rate for broker loans was highly correlated through 1926 and 1927, but the call and time rates in broker loans rose significantly in 1928 and 1929 while the discount and commercial rates rose only slightly. This evidence suggests that the demand for credit did not come from easy lending standards by the banks. The rise in interest rates instead suggests that bankers recognized the increase in risk and attempted to reduce speculation. This information

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agrees with the findings of Smiley and Keehn (1988) that margin requirements rose sharply in 1928.

Further refuting the conflict of interest claim is the evidence that universal banks offered higher quality securities than pure investment banks (Kroszner and Rajan, 1995). Benston (1990) corroborates these findings and asserts that the evidence of fraud and abuse was mostly fabricated.

With regard to the supposition that the combination of investment and commercial banking activities created undue risk, Benston (1990) found no confirmed evidence to support this argument. If the combination caused undue risk for commercial banks, failure rates for universal banks should be higher than banks without investment banking affiliates; however, White (1990) found just the reverse. During the period of 1930 to 1933, the failure rate for stand-alone commercial banks was four times greater.

Bank failures during the period were significant due mainly to loose regulation. There were no rules determining minimum capital requirements to open a bank. Also, there were no laws governing the amount of reserves that could be lent. As a result, from 1900 to 1920, the number of commercial banks nearly tripled to 30,000. On average 600 banks failed each year from 1921 to 1929. However, after the crash nearly 10,000 banks closed or were suspended from 1930 to 1933.

So, if the combination of commercial and investment banking was not the cause of the stock market crash nor the Great Depression that ensued, what was? While stock prices rose steadily during the 1920s, the economy grew steadily as well. The Republican government's laissez-faire approach supported business growth. While electricity developed slowly before 1920, expansion advanced rapidly during the next decade. Mass production of autos, radios, refrigerators, etc., enabled manufacturers to reduce cost and produce goods for a much wider market. In addition consumer credit grew allowing consumer spending to flourish.

As a result, economic growth in the "Roaring Twenties" was strong, despite the deep recession of 1920 to 1921. From 1922 to 1929 GNP grew at an average rate of 4.7% per year while wholesale prices remained steady. Production rose 64%. After 1921, unemployment had averaged 3.7% but fell to 2% in 1930. Wages increased 26% by the end of the decade.

Though stock prices climbed, the evidence of a "bubble" is debatable. While DeGrace (2011) states the average P/E ratio in 1929 was 60, Bierman (1991) determined the average to be only 15. According to Sirkin (1975), to justify the peak P/E ratio of 20.4, earnings would have to grow at an annual rate of 9% for the next 10 years. From 1925 to 1929 earnings had grown on average 9%. So, although stock prices were high, they were not out of line given recent growth and, at the time, some leading economists agreed. Irving Fisher of Yale was convinced that the stock market's rise was justified, even after the crash. Charles Dice of Ohio State argued that economic fundamentals justified the higher prices (Bierman, 1991).

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However, while the economy had been strong, data pointed to deterioration. The economy had softened during the two months prior to the crash. Also, the Federal Reserve's index of industrial production dropped in July. This weakening could have induced unease. Fueling this anxiety were a number of pronouncements from officials regarding Wall Street's "speculative orgy" as described by Philip Snowden, England's Chancellor of the Exchequer on October 3, 1929. President Hoover (1952) stated that he attacked speculation from a number of directions and asked publishers and editors to warn the country. And according to Hoover, many responded with strong editorials. Fed President Adolph Miller, concerned about over-speculation, began tightening the money supply in 1928. He described 1929 as "this period of optimism gone wild and cupidity gone drunk." In early 1929, the US Senate adopted a resolution declaring the Senate would support legislation "necessary to correct the evil complained of and prevent illegitimate and harmful speculation."

What actually triggered the crash in 1929 is open to debate. Utilities were being reviewed by the FTC, New York City, New York State, and Massachusetts. Electricity was a bourgeoning industry that was changing the world in the 1920s, and utilities were among the high flying stocks of 1929. On October 11, Massachusetts regulators refused Boston Edison's request to split its stock in an attempt to reduce speculation. They also wanted to discourage the expectation of future dividend increases and began a rate inquiry. While the utilities index dropped under 1% that day, the same percentage drop as industrials, the index lost a total of 55% from October through November. This compares to a decline in industrials of 44% and railroads of 32%. Up to that point, utilities had gained more than twice that of the other two groups for the year. Before the crash, utility stocks were trading above three times their book value even though, as a regulated industry, their value should not vary significantly from book value. With prices extended, the probability of a correction rose.

When trading volumes hit record levels, reporting of prices became delayed as much as an hour and a half. Margin calls increased, telephone lines were busy, and brokerage firms could not keep up with trading. Panic ensued.

Although the crash shook confidence and may have reduced consumer spending, it was not the primary cause of the depth or length of the Great Depression. Policy error was the main culprit. Tight monetary policy began in 1928 and continued after the crash, thereby reducing the supply of money. Banks, having gone through the panics that began in 1930, were loath to extend credit.

These sources have nothing to do with the combination of commercial and investment banking. Consequently, the argument for Glass-Steagall advanced by Tabarrok is compelling. Taborrak (1998) makes a convincing case that the real reason for its passage had more to do with the Rockefeller banking group seeking to weaken the House of Morgan, a banking rival. JP Morgan was much more involved in investment banking activities than Rockefeller's banks, notably National City (which later became Citibank). Winthrop Aldrich, Chairman of Chase, who, as the Times noted, "is a representative of the John D. Rockefeller interests," (his sister was married to John D. Rockefeller, Jr.), lobbied extensively for passage. The ratification of Glass-Steagall led to the break-up of JP Morgan and Company into JP Morgan and Morgan Stanley.

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Savings and Loan Crisis

Regardless of the motive behind Glass-Steagall, the more important question is whether it achieved its objective of increasing safety and reducing conflicts of interest. Unfortunately, it did not prevent the Savings and Loan crisis. The Federal Home Loan Bank Act of 1932 provided funding to offer long-term, amortized loans to buy homes. This preferential treatment enabled Savings and Loans Associations (S&Ls) to proliferate across the United States. In the early 1980s, Congress passed legislation that allowed S&Ls to act more like commercial banks. Also, to help profitability, Congress lowered the capital requirements which encouraged increased leverage in real estate. While legislation and market forces played a part, this new capability and mismanagement created unsound real estate lending and led to the demise of the industry. From 1986 through 1995, the number of S&Ls dropped almost in half. The fact that these institutions did not have investment banking activities did not prevent risky lending practices.

The Stock Market Crash of 1987

Another crisis in the 1980s, which Glass-Steagall was meant to address, was the stock market crash of 1987. On October 19, the Dow Jones Industrial Average plunged 508 points and the S&P 500 dropped 20.4%. The decline was the greatest single day loss on Wall Street. From its peak in August, the S&P 500 lost was over 35%. The crash of 1987 and 1929 share many similarities: the extent of the loss, a preceding strong rise in equity prices, brokerage houses being unable to keep up with orders and the inability to get current prices on the day of the crash, and hints of a slowing economy.

Similar to 1929, investors pushed P/E ratios above 20, but conflicts of interest between commercial and investment banking cannot be blamed for this "speculation"—Glass-Steagall was in effect and institutions could not engage in both pursuits. Luckily, policy decisions after the crash in 1987 were much different than in 1929. Unlike 1929, the Fed loosened monetary policy. Through open market purchases, the Fed added $2.2 billion in reserves. The Fed made the discount window available to commercial banks when they needed reserves. As a result, there was little impact on the economy outside of the financial industry and the market only needed two years to recoup the losses.

The Great Recession

The next banking crisis, the Great Recession of 2008, developed after Glass-Steagall was repealed, and many blame its repeal for the crisis. After the repeal, banks became heavily involved in mortgage-backed securities underwriting, and it was subprime mortgages that initiated the crisis. However, the underwriting of subprime loans was not a major cause for losses at big banks. "Liar" loans and home equity lines of credit—traditional lending—were bigger problems for banks. While the argument about making bad loans to get underwriting business has merit, it is prohibited by several federal statutes outside of Glass-Steagall. Additionally, the SEC found that losses on traditional bank loans, not securities underwritings, caused most banks to become insolvent.

The large investment banks—including the banks that triggered the crisis, Bear Stearns and Lehman Brothers—did not even enter commercial banking. Furthermore, traditional lenders like Washington Mutual and Countrywide Financial did not have investment

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banking operations. Additionally, AIG was technically an insurance company and did not act as a commercial or investment bank. Similarly, Glass-Steagall's repeal had no bearing on the risk-taking at Fannie Mae and Freddie Mac.

Banks have become larger since the repeal of Glass-Steagall. But the term "too big to fail" was actually coined long before. In 1984, Todd Conover, the Comptroller of the Currency, in testimony before the House Banking Committee, defended his decision to save Continental-Illinois because it was "too big to fail." More importantly, had Glass-Steagall been in force, the merger of Merrill and Bank of America would not have been allowed, neither would the conversion of Goldman Sachs or Morgan Stanley into bank holding companies. These transformations helped to limit the crisis.

Excessive risk taking in pursuit of profits led to the lack of prudence in both commercial and investment banking activities. Glass-Steagall would not have curtailed this drive. Fed Chairman, Alan Greenspan, noted for his laissez-faire attitude toward regulation, told the House Oversight Committee in 2008 that his belief that banks would be more prudent in their lending practices because of the need to protect shareholders had proven wrong. However, the Fed and other regulatory bodies had the authority to protect the financial system after Glass-Steagall's repeal. As the Financial Crisis Inquiry Report concluded: the SEC could have required more capital and halted risky practices, the Fed could have clamped down on bank excesses, and policy makers could have regulated mortgage securitization.

German Universal Banking

Finally, Fohlin (2000) studied the German universal banking system prior to World War I and found that universality did not influence concentration, levels of market power, or performance. While the study is limited to pre-World War I, it is important to note that Germany has not experienced any banking crisis as a result of universal banking.

Conclusion

The combination of commercial banking and investment banking has been blamed for the stock market crash of 1929 and the subsequent Great Depression, as well as the Great Recession of 2008; however, there is little evidence to support that claim. Furthermore, the separation did not prevent the Savings and Loan crisis nor the stock market crash of 1987. Imprudent risk taking, lack of oversight, and policy errors produced these crises. Glass-Steagall would not have prevented these and will not prevent a crisis in the future. Bringing it back will, however, reduce diversification within the banking industry and make the industry more vulnerable to shocks.

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