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The Case Against Restoring Glass-Steagall

By Donna Borak
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WASHINGTON — Former Citigroup chairman Sandy Weill's call to reinstate Glass-Stegall has sparked a growing counter-movement among those that argue restoring the Depression-era law would not make the system safer.

The naysayers are hoping to outmaneuver policy heavyweights like Tom Hoenig, a director at the Federal Deposit Insurance Corp. and former president of the Federal Reserve Bank of Kansas City, who say separating commercial from investment banking is the only way to prevent another financial crisis.

The list of skeptics includes former bank executives and regulators from both political parties, including Richard Kovacevich, the former chairman and chief executive of Wells Fargo, Steven Rattner, former counselor to Treasury Secretary Tim Geithner, and Rob Nichols, a former Treasury official in the Bush administration and now president of the Financial Services Forum.

"Glass-Steagall never solved any real problems," said Wayne Abernathy, the head of financial institutions policy and regulatory affairs at the American Bankers Association. "I haven't found anyone at all that has been coherent in outlining [the argument]. It's all been mystical. It will make the world better. It will make things less risky. They've never really hooked up cause and effect. The riskiest thing that a bank does … is loan money to somebody."

The allure of Glass-Stegall, the 1933 law that banned commercial banks from owning investment banks, has become so prominent that a recent episode of HBO's The Newsroom said its repeal was the cause of the 2008 financial crisis.

But many current and former industry and regulatory officials take issue with that idea, saying the crisis and the 400-plus bank failures that resulted had nothing to do with the mix of commercial and investment banking.

They point to Bear Stearns, Lehman Brothers and Merrill Lynch as proof, as all three investment firms were at the center of the crisis, but were not owned by commercial banks at the time (Bear was eventually bought by JPMorgan Chase, while Merrill was purchased by Bank of America). Had Glass-Stegall been in effect in 2008, they argue, Bear, Lehman and Merrill would still have collapsed. Nor would the law have prevented the fall of insurance giant AIG or real estate investment trust New Century Financial.

The primary cause of the crisis, they say, is the proliferation of exotic mortgage products that were securitized and sold off across the market. Nothing in Glass-Steagall would have prevented such loans from being originated, sold and securitized.

"Roughly 20 financial institutions were the major perpetrators of the recent financial crisis and the resulting great recession, primarily through the origination, securitization and distribution of exotic subprime mortgages with toxic features such as negative amortization and teaser rates, with stated incomes and reduced documentation," wrote Bill Issac, a former chairman of the Federal Deposit Insurance Corp. and Kovacevich in an editorial in the *American Banker*.

To be sure, Steven Pearlstein, a columnist for *The Washington Post*, notes that investment bank activities in the U.S. created a shadow banking system outside of regulators' jurisdiction, which helped encourage sloppy lending practices.

Still, Pearlstein is unconvinced Glass-Steagall would have stopped the crisis.

"Repeal of Glass Steagall has become for the Democratic left what Fannie Mae and Freddie Mac are for the Republican right — a simple and facially plausible conspiracy theory about the crisis that reinforces what they already believed about financial markets and economic policy," he wrote in a recent column.

Rattner, a former Obama administration official, said the crisis is regulators' fault, not the repeal of Glass-Steagall in 1999 in the Gramm-Leach-Bliley Act. He blames "old-fashioned poor management that expanded the banks' portfolios and activities too aggressively without sufficiently robust risk controls, enabled by lax (or nonexistent) oversight by regulators."

"Many of those excesses were concentrated in the housing sector, where a now a legendary bubble formed without regulators or industry leaders recognizing it," Rattner wrote in an op-ed in *The New York Times*.

Both Isaac and Kovacevich agree.

"Unfortunately, regulators failed to see or act on the problems until they escalated into a full-scale crisis," write Isaac and Kovacevich. "Rating agencies, unbelievably, rated significant tranches of these high-risk mortgage-backed securities AAA. By mid-2008 Fannie Mae, Freddie Mac and other government agencies owned or insured over 70% of these risky mortgages, according to research by Ed Pinto at the American Enterprise Institute."

A return to Glass-Steagall would be disastrous, many argue. They predict further consolidation, a reduction in lending and a smaller banking industry share of the economy.

"If you want a smaller, dwindling banking industry, which has been the most heavily regulated part of the financial services industry, then Glass-Steagall will give you that," said Abernathy. "But I think it's arguable whether that's good for the industry or for the industry's customers."

Others, like Tony Fratto, a former Treasury and White House official in the Bush administration, said that breaking up the banks will wind up raising the costs of U.S. businesses and reduce banks' competiveness globally.

In a recent blog post, he warned that the banking system must be able to grow larger to deal with an ever increasing global economy.

"While the banking system of the post-World War II era may have been sufficient for the economy of the immediate post-World War II era, that banking system is certainly not sufficient for today's economy," writes Fratto. "The volume, diversity, speed, and breadth of both trade and capital flows are breathtaking."

He is seconded by Mark Calabria, director of financial regulation at the Cato Institute and a former top Republican Senate aide, who said size and diversity is a critical part of a bank's competitiveness.

"You need to have American banks be big and diversified, if they are going to be internationally competitive," says Calabria. "If you want our banks to go up against UBS and Deutsche Bank or Mitsubishi, you need to be big and competitive and be in almost every business line."

If the U.S. were to return the old days of Glass-Steagall, Calabria said, American banks would be essentially leaving the global playing field, which also might impact how well clients are treated if they are unable to have a bank that serves to meet its "one-stop shopping" needs.

People are turning to Glass-Steagall because of a continuing string of financial mishaps, including MF Global's collapse, JPMorgan's trading loss, and the Libor scandal, Calabria said. He argues the only way to combat that problem is to essentially re-do Dodd-Frank, and take different steps to eliminate too big to fail.

"If there was a sense that we fixed the financial system, we wouldn't be having this debate at all," said Calabria. "Sometimes these things are driven as much by perception, whether those perceptions are reality or not, and I would say, the large part of the American public has the perception that we have done very little to fix the financial system."

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