Should we return to the Glass-Steagall Act[1] after this credit crunch?

In this period of the credit crunch it is inevitable, that there are a lot of comments on the phenomenon of the credit crunch. In this respect I would like to draw the attention to a comment, posed by Thomas Woods in a blog for the Mises Group.

"In 1999, in the Clinton administration, they repealed the Glass-Steagall Act. This was the Depression-era legislation that separated commercial from investment banking. In 2000, they deregulated all derivatives. And in 2004, Hank Paulson, the current Treasury Secretary, who at the time was chairman of Goldman Sachs, convinced the Securities and Exchange Commission to remove all capital requirements for investment banks, and thus they were able to drive up their profits by amazing leverage. For example, when Bear Stearns finally went under, it had $33 in debt for every dollar in equity. So this is an amazing leverage. And it's amazing that all reserves against debt would have been removed by the Securities and Exchange Commission. So, the whole thing is reckless beyond imagination." [2]

Financial events following the repeal

The repeal enabled commercial lenders such as Citigroup, which was in 1999 then the largest U.S. bank by assets, to underwrite and trade instruments such as mortgage-backed securities and collateralized debt obligations and establish so-called structured investment vehicles, or SIVs[3], that bought those securities. The year before the repeal, sub-prime loans were just 5% of all mortgage lending. By the time the credit crisis peaked in 2008, they were approaching 30%.

The history of the Act

The Glass-Steagal Act of 1933 established the Federal Deposit Insurance Corporation (FDIC) in the US and included banking reforms, some of which were designed to control speculation. Some provisions such as Regulation Q, which allowed the Federal Reserve to regulate interest rates in savings accounts, were repealed by the Depository Institutions

[1] See for information on the Glass-Steagall Act, Wickepedia

[2] Blog by Thomas Woods , January 29, 2009

[3] A structural investment vehicle (SIV) was a type of fund in the shadow banking system. Invented by Citigroup in 1988. SIV's were popular until the market crash of 2008. See Wickepedia

Deregulation and monetary Control Act of 1980. The initiative has been taken by Senator Carter Glass, a Democrat of Virginia, and by the co-sponsor of the bill that became the Glass-Steagall Act, and Senator Steagall.

Two separate United States laws are known as the Glass-Steagall Act. The first was passed in February 1932 in an effort to stop deflation and expanded the Federal Reserve's ability to offer rediscounts on more types of assets and issue government bonds as well as commercial paper. The second and best-known Glass-Steagall Act was passed in 1933 in reaction to the collapse of a large portion of the American commercial banking system in early 1933. While many economic historians attribute the collapse to the economic problems which followed the Stock Market Crash of 1929, some economists attribute the collapse to gold backed currency withdrawals by foreigners who had lost confidence in the dollar and by domestic depositors who feared that the United States would go off the gold standard. [4]

The Republican Hoover administration had lost the November 1932 election to Franklin Delano Roosevelt, but his administration did not take office until March 1933. The lame duck Hoover Administration and the incoming Roosevelt Administration could not, or would not, coordinate actions to stop the run on banks affiliated with the Henry Ford family that began in Detroit, Michigan, in January 1933. The Federal Reserve chair - man Eugene Meyer was equally ineffectual. Congressional Research Service Summary: In the nineteenth and early twentieth centuries, bankers and brokers were sometimes indistinguishable. Then, in the Great Depression after 1929, Congress examined the mixing of the “commercial” and “investment” banking industries that occurred in the 1920s. Hearings revealed conflicts of interest and fraud in some banking institutions’ securities activities. A formidable barrier to the mixing of these activities was then set up by the Glass Steagall Act.

The second Glass-Steagall Act, passed on June 16, 1933 and officially named the Banking Act of 1933, introduced the separation of bank types according to their business (commercial and investment banking), and it founded the Federal Deposit Insurance Corporation for insuring bank deposits. Literature in economics usually refers to this simply as the Glass-Steagall Act, since it had a stronger impact on US banking regulation.

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[4] The Gold Standard has one tremendous virtue according to von Mises “the quantity of the money supply, under the gold standard, is independent of the policies of governments and political parties. This is its advantage. It is a form of protection against spendthrift governments”, L. von Mises “Economic Policy: Thoughts for Today and Tomorrow”, Chicago, Ill: Regnery Gateway, 1979, p. 65
The Gold Standard is still abolished

Repeal of the Act

The bill that ultimately repealed the Act was introduced in the Senate by Phil Gramm (a Republican from Texas) and in the House of Representatives by Jim Leach(Republican from Iowa)in 1999.

Having majorities large enough to override any possible Presidential veto, the legislation was signed into law by President Bill Clinton on November 12, 1999.

The banking industry had been seeking the repeal of Glass-Steagall since at least the 1980s. In 1987 the Congressional Research Service prepared a report which explored the case for preserving Glass-Steagall and the case against preserving the act.

Perhaps it could be reconsidered to draft another act, that separates commercial from investment banking. Not the same on as the Glass-Steagall Act of 1933. That is already 76 years ago and obsolete. But to stop phenomena like the SIV's would not be bad.
The Gold Standard will not return anyway.

The argument for preserving Glass-Steagall (as written in 1987):

1. Conflicts of interest characterize the granting of credit – lending – and the use of credit – investing – by the same entity, which led to abuses that originally produced the Act

2. Depository institutions possess enormous financial power, by virtue of their control of other people's money; its extent must be limited to ensure soundness and competition in the market for funds, whether loans or investments.

3. Securities activities can be risky, leading to enormous losses. Such losses could threaten the integrity of deposits. In turn, the Government insures deposits and could be required to pay large sums if depository institutions were to collapse as the result of securities losses.

4. Depository institutions are supposed to be managed to limit risk. Their managers thus may not be conditioned to operate prudently in more speculative securities businesses. An example is the crash of real estate investment trusts, sponsored by bank holding companies (in the 1970s and 1980s).

The argument against preserving the Act (as written in 1987):

1. Depository institutions will now operate in "deregulated" financial markets in which distinctions between loans, securities, and deposits are not well drawn. They are losing market shares to securities firms that are not so strictly regulated, and to foreign financial institutions operating without much restriction from the Act.

2. Conflicts of interest can be prevented by enforcing legislation against them, and by separating the lending and credit functions through forming distinctly separate subsidiaries of financial firms.

3. The securities activities that depository institutions are seeking are both low-risk by their very nature, and would reduce the total risk of organizations offering them – by diversification.

4. In much of the rest of the world, depository institutions operate simultaneously and successfully in both banking and securities markets. Lessons learned from their experience can be applied to our national financial structure and regulation.[7]

Perhaps it could be reconsidered to draft another act, that separates commercial from investment banking. Not the same as the Glass-Steagall Act of 1933. That is already 76 years ago and obsolete. But to stop phenomena like the SIV's would not be bad. [5]

[5] This article has been published in the Newsletter of LVMI Europe February 2009