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A Return to Glass-Steagall? I Don't Think So

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Glass-Steagall was born in the Great Depression as a knee-jerk overreaction to the abuses of that era. Like Dodd-Frank in the current financial crisis, it was pandering to the popular perception, not necessarily the informed view. Returning to Glass-Steagall-like prohibitions may also be a knee-jerk reaction.

Before pining for the return of Glass-Steagall, let's reminisce a bit.

This famous piece of legislation, separating banking from investment banking, was born in the Great Depression as a knee-jerk overreaction to the abuses of that era. Like Dodd-Frank in the current financial crisis, it was pandering to the popular perception, not necessarily the informed view.

Returning to Glass-Steagall-like prohibitions may also be a knee-jerk reaction. Look at the history of changing needs and financial failures that led to innovations since Glass-Steagall was passed in 1933 and you can be your own judge of what we would be returning to if we would reestablish the old barriers.

The abuse of securities underwriting powers by banks was the populist theme that led to the passage of Glass-Steagall. However, such powers played little role in the financial disaster of 1929-33.

Martin Mayer, the historian and prolific writer of books and essays on the financial industry, said of that time that the banks' worst violation was manipulating the market prices of their own shares. This was a common unprincipled activity, legal at the time and practiced by nonfinancial corporations as well as financial institutions.

What has been accepted as the precipitating event of the start of the Great Depression was the stock market bubble that burst in October 1929, having risen fourfold during the decade. This rampant speculation was fueled by cheap loans from banks, where stock purchases were made with 10% margin. As banks saw the collateral underpinning their loans decline rapidly, they began to call in those loans made to speculators.

Many investors found it impossible to repay their debt and accelerated the rate of default which, in turn, eroded the confidence in the banking sector. Without bank deposit insurance, a bank failure meant depositors would lose all their money. As clients pulled their savings out, the speed at which banks collapsed accelerated.

Thereafter, as Milton Friedman and Anna J. Schwartz concluded in "**A Monetary History of the United States, 1867-1960**," the subsequent Great Depression was caused by the misguided reaction of the Federal Reserve in stepping back and allowing the money supply to dwindle. By 1933 the money supply fell to one-third of its peak in 1929.

Returning to Glass-Steagall would require us all to deny the history of innovation and change, all the generations of regulatory and legal interpretations, all the good that had been done, and for what purpose?

The idea of investment banks being the bad actors of finance that should be separated from deposit-taking banks does not hold up well when we look at the actions of other actors – regulators, financial innovators and traditional bankers – over the ensuing years.

Changes affected by technological advances and modern risk management techniques have evolved banking practices and banking institutions. Banking is not conducted locally. It is conducted globally, whether local branches serve a small rural community or operate in the City or on Wall Street.

Banking's traditional lending and deposit taking businesses are interrelated to global funding, syndication and intermediation. Banking must be placed in the context of a global financial industry of which it is but a part. Banking has evolved over a generation in which new technologies enabled the globalization of financial services and facilitated business consolidations through successive mergers and acquisitions.

Is returning to the prohibitions of Glass-Steagall a palliative just like the Volker Rule – simple to say, hard to do – or the Dodd-Frank regulations that targeted the wrong issues for the causes of the Great Recession, just like Glass-Steagall did for the Great Depression?

To think about separating investment banking from banking we should first recall what happened in the Great Recession. Bear-Stearns and Lehman Brothers, the first to succumb, were not banks – they were primarily dealers in commercial paper and government bonds; derivatives brokers and dealers; securities agents and market-makers; investment managers and investment fund aggregators; and capital raising and syndication agents. Countrywide, IndyMac, and Washington Mutual were Savings & Loans, primarily engaged in mortgage lending and syndication of these mortgages. When they all failed, regulators reached out to banks to acquire their investment banking pieces. Other financial institutions that failed were, likewise, not banks. AIG is an insurance company. Freddie Mac and Fannie Mae are Government Securities Entities (GSEs).

The cause of the Great Recession was loose credit standards for mortgages driven by a political climate that reinforced home ownership for everyone, whether they could afford it or not, as the definition of a healthy, prosperous society, not the elimination of Glass-Steagall.

The banker that James Stewart memorialized in "It's a Wonderful Life," the 1930's classic that depicted the small-town-lending and deposit-taking bank, is gone, never to be resurrected. However, regulators are still trying to put the genie back in the bottle and return to our earlier model of banking.

Are we out of ideas to modernize and adapt our financial system? Are we so attached to a lazy way, a politically safe way of solving our problems? Looking back rather than going forward?