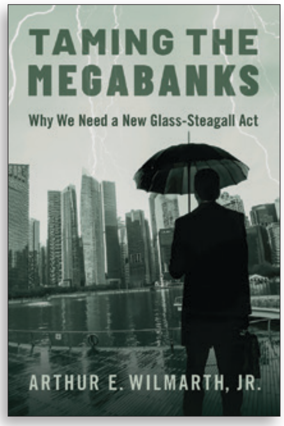
BookReview

A New Glass-Steagall — and Then Some



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TAMING THE MEGABANKS: WHY WE NEED A NEW GLASS-STEAGALL ACT
BY ARTHUR E. WILMARTH JR., NEW YORK: OXFORD UNIVERSITY PRESS, 2020, 589 PAGES

REVIEWED BY JOHN MULLIN

The Glass-Steagall Act was enacted in 1933 in response to the banking crises of the Great Depression. Drafted with an eye toward financial stability, one of the act's main provisions was to separate commercial banking from investment banking — to have commercial banks focus on accepting deposits and making loans and to have investment banks focus on securities underwriting and trading. But the law later gave way to industry resistance: Many of its restrictions were removed during the 1980s and 1990s, and its core provisions were repealed with the enactment of the Gramm-Leach-Bliley Act in 1999.

In *Taming the Megabanks*, Arthur Wilmarth Jr. of George Washington University Law School explores the implications of the gradual erosion and ultimate repeal of the Glass-Steagall Act's banking restrictions. Taking the reader on a deep dive into the history of U.S. banking and bank regulation since the late 1800s, Wilmarth concludes with a proposal for a new version of Glass-Steagall that would profoundly reshape the U.S. financial system.

Wilmarth argues that bank regulators made big mistakes in both the 1920s and the 2000s by allowing institutions to blur the lines between commercial banking activities and investment banking activities — thus becoming what are known as universal banks. In both cases, according to Wilmarth, universal banks made risky loans that they were able to package as securities and sell to poorly informed investors, contributing to unsustainable credit booms that ended with disastrous results.

The financial excesses of the Roaring '20s were closely tied to the expansion of banks' securities market activities, according to Wilmarth. Crucially, commercial banks aggressively competed with investment banks to increase their market share in the securities underwriting business. Incentivized by aggressive bonus plans, bankers all too frequently facilitated the distribution of securities by misleading clients about their riskiness. According to Sen. Frederic Walcott, R.-Conn., who sat on the committee that drafted the Glass-Steagall Act, the "dangerous use of the resources of bank depositors for the purpose of making speculative profits" fueled the boom-and-bust cycle that led to the Great Depression.

Glass-Steagall's "system of segmented financial sectors" helped to mitigate "perverse incentives for excessive risk-taking" and ushered in a prolonged period of U.S. financial stability, according to Wilmarth. The largest banks, however, fought a determined and ultimately successful campaign against restrictions on their securities market activities.

As important as this rollback may have been, however, Wilmarth's analysis suggests that its role in the 2007-2008 financial crisis may not have been as consequential as a more obscure development — the effective loosening of Glass-Steagall's Section 21, which prohibited securities firms from accepting deposits. Starting at least as far back as the 1970s, securities firms had increasingly been able to fund themselves using deposit substitutes — such as commercial paper and repo loans — that had most of the same economic characteristics as demand deposits but were legally allowable under Section 21. By exploiting this loophole, securities firms such as Bear Stearns and Lehman Brothers were able to act as "de facto universal banks as they relied on short-term deposit substitutes to fund a growing share of their activities."

The new Glass-Steagall Act proposed by Wilmarth would go further than the original law by barring nonbanks from funding themselves with deposit substitutes. Instead, they would be required to fund most of their operations by issuing some combination of equity securities and debt obligations with maturities greater than 90 days.

The potential implications of this proposal, if adopted, would be enormous. His new Glass-Steagall would not just, as a practical matter, require Citigroup to spin off its capital markets affiliates and require Goldman Sachs and Morgan Stanley to sell their modest deposit banking operations. His proposed changes would most likely upend the entire shadow banking sector — greatly shrinking the balance sheets of securities brokerage firms and money market mutual funds.

Deposits would shift back into the traditional banking sector, according to Wilmarth, with many benefits. He argues that such a shift would improve the ability of federal regulators to monitor the risks of short-term claims in the financial system and to prevent the runs on shadow banks that have become a "leading and recurrent cause of systemic financial crises." Moreover, he contends, such a reform would "expand the availability of bank credit to small and medium-sized businesses."

These are large claims, indeed. But large potential benefits would be needed to support such a far-reaching reform that would almost certainly present difficult transitional issues and prove highly disruptive to the businesses of many nonbank financial firms. **EF**

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