Chapter 2
Did the "Repeal" of Glass-Steagall Have Any Role in the Financial Crisis? Not Guilty. Not Even Close

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Introduction

The law that separates investment banking from commercial banking, popularly known as the Glass-Steagall Act, initially consisted of only four short statutory provisions. Section 16 generally prohibited banks from underwriting or dealing in securities,[1] and Section 21 prohibited securities firms from taking deposits.[2] The remaining two sections, 20[3] and 32,[4] prohibited banks from being affiliated with firms that are principally or primarily engaged in underwriting or dealing in securities. The Gramm-Leach-Bliley Act of 1999 (GLBA) repealed Sections 20 and 32, so that banks could thereafter be affiliated with securities firms; but Section 16 was left intact, so that whatever banks were forbidden or permitted to do by Glass-Steagall—before the enactment of the GLBA—remained in effect. The fact that Glass-Steagall, as it relates to banks, remains in full force and still governs the securities activities of banks is apparently not generally known. Those who blame the financial crisis—and specifically the weak financial condition of banks—on the "deregulation" of Glass-Steagall or the GLBA, seem to have only a fuzzy idea of what deregulation they are talking about. When challenged for specifics, they generally cite the "repeal" of Glass-Steagall. This chapter is intended to demonstrate that the significant elements

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[1] Section 16, as incorporated in 12 U.S.C 24 (Seventh), both prohibits banks from underwriting and dealing in securities and permits them to act as brokers, as follows: "The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock."

[2] 12 U.S.C. 378.

[3] 12 U.S.C. 377.

[4] 12 U.S.C 78.

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of Glass-Steagall—those that apply to banks—were never repealed, and thus that neither the financial problems of banks, nor the financial crisis itself, can be blamed on the GLBA's supposed "repeal" of Glass-Steagall.

The term "bank" is often misused, and it is important to clarify how the term will be used in this chapter. A bank is a very specific type of entity, chartered by the federal government or a state, to take deposits that are withdrawable on demand—the hallmark of a bank—and make loans. In the discussion that follows, I will use the term "bank" to refer to depository institutions chartered by national or state banking authorities and insured by the Federal Deposit Insurance Corporation (FDIC). Recently, it has become common—especially in the media—to refer to other kinds of financial institutions as "banks" or part of something called the "shadow banking system," even though these nonbank financial institutions—securities firms (also called investment banks), insurance companies, finance companies, hedge funds and others—do not take deposits, and their deposits are not insured by the FDIC. To be sure, these nonbank financial institutions make loans, but lending alone is not banking, and the consistent misuse of the term "bank" to describe nondepository institutions has sown a great deal of confusion about what real banks can and cannot do.

Since we are interested in the effect of Glass-Steagall's repeal on the financial condition of banks, and the possible role of repeal in the banking crisis, it is important to distinguish between banks and other nonbank financial institutions—particularly, bank holding companies (BHCs) and investment banks. As we will see, banks can engage in securities trading for only a very limited category of securities—primarily government securities or those backed by the government—but a BHC or an investment bank is not subject to these restrictions. A BHC is an ordinary business corporation that controls a bank; it is not specially chartered like a bank and not permitted to take deposits. Nor does a BHC have other attributes of a bank, which include automatic access to the Federal Reserve's (Fed) discount window, participation in the nation's payment system, and deposits insured by the FDIC. In addition, BHCs are regulated by the Fed, while most banks—and virtually all large ones—are regulated by the Office of the Comptroller of the Currency, a unit of the Treasury department that charters and supervises national banks. State chartered banks are regulated by their home state regulators and the FDIC at the federal level.

An investment bank is a securities firm—a firm specializing in the business of trading securities of all kinds. Investment banks are not backed by the government in any way and—unlike banks—are intended to be risk-takers. The Glass-Steagall Act was designed to separate commercial banks from investment banks; it did that simply by prohibiting affiliations between the two and by prohibiting commercial banks from engaging in the business of investment banks—that is, underwriting and dealing in securities. After 65 years, and many academic studies showing that this separation was unnecessary and misplaced,[5] the GLBA repealed the affiliation

[5] See, e.g., the work cited by Barth, Brumbaugh and Wilcox, "The repeal of Glass-Steagall and the advent of broad banking. J Econ Persp, May 2000.

prohibitions of Sections 20 and 32, but—as noted above—left the restrictions on bank securities activities intact.

A good example of the misuse of the term bank appears in a recent article by reporter Louis Uchitelle in the *New York Times*. The article notes that Paul Volcker "wants the nation's banks to be prohibited from . . . trading risky securities, the very practice that got the biggest ones into trouble in 2008."[6] After scanning this sentence, readers might be forgiven for believing that banks trade risky securities. But that would be incorrect. Because of the continuing applicability of Glass-Steagall, banks are still prohibited from trading securities—other than various government-issued or government-backed securities that are generally risk-free. Under these circumstances, it's not clear what institutions Uchitelle is referring to as banks; he could have meant the BHCs that control banks, or he could be referring to subsidiaries of these BHCs that trade securities, or even to subsidiaries of banks that are permitted to trade securities after the GLBA. But he could not have been referring to banks themselves. Imprecise use of language like this is one of the reasons that many people have the mistaken view that Glass-Steagall was repealed by the GLBA, and that banks can now trade risky securities. But as I will show, banks—the government insured entities that are permitted to take deposits—are still forbidden by Glass-Steagall to trade any but the safest kinds of securities.

Glass-Steagall in the Context of Banking Law

U.S. banking laws are designed to separate a bank from the risks that might be created by the activities of its affiliates—particularly, its holding company or any subsidiary or affiliate of the bank that is permitted to engage in securities trading. This separation is effected by severely restricting the transactions between banks and their affiliates. There are two principal reasons for these restrictions: (i) to ensure that the so-called bank "safety net"—deposit insurance and access to the discount window—is not extended beyond banks to their holding companies or their nonbank affiliates, and (ii) to protect the bank's financial position from exposure to the risks that are taken by its affiliates and securities subsidiaries. Insofar as possible, the idea is to allow a holding company—and even a bank securities affiliate—to fail without endangering the health of any related bank.

In order to reduce the range of bank risk taking, banking laws and regulations also limit the activities in which banks themselves can engage. That is the context in which the Glass-Steagall Act should be viewed. As noted above, Glass-Steagall continues to prohibit banks from "underwriting or dealing" in securities. "Underwriting" refers to the business of assuming the risk that an issue of securities will be fully sold to investors, while "dealing" refers to the business of holding an inventory of securities for trading purposes. Nevertheless, banks are in the business of making investments, and Glass-Steagall did not attempt to interfere with that

[6] Uchitelle, Op. cit., note 1.

activity. Thus, although Glass-Steagall prohibited underwriting and dealing, it did not interfere with the ability of banks to "purchase and sell" securities they acquired for investment. The difference between "purchasing and selling" and "underwriting and dealing" is crucially important. A bank may purchase a security—say, a bond—and then decide to sell it when the bank needs cash or believes that the bond is no longer a good investment. This activity is different from buying an inventory of bonds for the *purpose* of selling them, which would be considered dealing.

Nor did Glass Steagall ever prohibit banks from buying and selling whole loans, even though a loan could be seen as a security. When securitization was developed, banks were permitted—even under Glass-Steagall—to securitize their loan assets and sell their loans in securitized form. Similarly, banks were always permitted to purchase and sell securities based on assets, such as mortgages, that they could otherwise hold as whole loans. Glass-Steagall did not affect this authority, but the act was interpreted to make clear that they could not deal in or underwrite these or other securities. Under this interpretation, banks could not underwrite or deal in mortgage backed securities (MBS), but they were free to buy these securities as investment securities and sell them when they believed that would be appropriate. Again, these restrictions remained in force after GLBA; the only difference was that GLBA now permitted banks to be affiliated with firms that engaged in underwriting or dealing in securities, including MBS, and this affiliation could be through a subsidiary of the bank's holding company (both the bank and the securities firm would then be under common control) or through a subsidiary of the bank itself. In both cases—whether the securities firm is a holding company affiliate or a subsidiary—there are severe restrictions on transactions between the bank and the securities firm. These are outlined below.

Finally, Glass-Steagall permitted banks to underwrite and deal in government securities, or securities backed by a government, and this was unaffected by GLBA. For example, banks could, before and after Glass-Steagall and GLBA, underwrite and deal in U.S. government securities, the securities of Fannie Mae and Freddie Mac, and the general obligation bonds of states and municipalities. This exemption applies mostly to securities that are backed by the U.S. government or by a state or municipality, although it also applies in cases—such as Fannie Mae and Freddie Mac—where the issuer of the security is performing a government mission but not strictly backed or guaranteed by the federal government or a state or municipal government.

From this analysis, it should be clear that the GLBA's repeal solely of the affiliation provisions of the Glass-Steagall Act did not permit banks to do anything that they were previously prohibited from doing. Accordingly, it is incorrect to suggest that Glass-Steagall's repeal had any affect whatever on the ability of banks to engage directly in the risky business of underwriting and dealing in securities. Nevertheless, it is reasonable to ask whether the repeal of the affiliation provisions of Glass-Steagall could have caused banks to suffer the losses that were a prominent feature of the financial crisis, and whether the possibility of affiliation with banks could have caused the losses to the large securities firms—also known as investment banks—that drove one of them into bankruptcy (Lehman Brothers), two of them into becoming subsidiaries of banks (Merrill Lynch and Bear Stearns), and two more into recasting themselves as BHCs under the supervision of the Fed (Goldman Sachs and Morgan Stanley). The remaining portions of this chapter will review the specific restrictions that Glass-Steagall imposes on banks, the restrictions on transactions between banks and their securities affiliates and subsidiaries, and the possibility that affiliations with a bank—permissible after GLBA—might have caused the losses suffered by the large investment banks.

Regulation of the Securities Activities of National Banks

Almost all the big banks—Citibank, Wachovia, Bank of America, JP Morgan Chase, and Wells Fargo—are (or were in the case of Wachovia) national banks, chartered, regulated, and supervised by the Comptroller of the Currency, an official of the Treasury Department. National banks are creatures of the federal government and derive all their powers from federal law. State-chartered banks are subject to the different legal regimes of the chartering states, but if they are insured by the FDIC—and virtually all state-charted banks are federally insured—they are subject to substantially the same Glass-Steagall rules as those applicable to national banks. Since national banks are chartered under federal law, their powers as banks are outlined in 12 U.S.C. 24 (Seventh), the basic statute that enumerates the specific activities in which national banks are permitted to engage. If an activity is not listed in or implied by this statutory section, national banks cannot engage in it.

The Office of the Comptroller of the Currency (OCC) has issued extensive regulations outlining what national banks are authorized to do under 12 U.S.C 24 (Seventh), which is the statutory provision that incorporates Section 16 of the Glass-Steagall Act. Section 16, as outlined above, permits banks to act as agents or brokers for securities, but prohibits them from underwriting or dealing. Since GLBA made no change in the provisions of Glass-Steagall concerning bank securities activities, these regulations were not modified as a result of the GLBA. Under the OCC regulations, banks could underwrite or deal in only two categories of securities, called Type I and Type II.

Type I securities are as follows:

(1) Obligations of the United States;
(2) Obligations issued, insured, or guaranteed by a department or an agency of the U.S. government, if the obligation, insurance, or guarantee commits the full faith and credit of the United States for the repayment of the obligation;
(3) Obligations issued by a department or agency of the United States, or an agency or political subdivision of a State of the United States, that represent an interest in a loan or a pool of loans made to third parties, if the full faith and credit of the United States has been validly pledged for the full and timely payment of interest on, and principal of, the loans in the event of nonpayment by the third party obligor(s);

(4) General obligations of a State of the United States or any political subdivision thereof; and municipal bonds if the national bank is well capitalized as defined in 12 CFR 6.4(b)(1);
(5) Obligations authorized under 12 U.S.C. 24 (Seventh) as permissible for a national bank to deal in, underwrite, purchase, and sell for the bank's own account, including qualified Canadian government obligations; and
(6) Other securities the OCC determines to be eligible as Type I securities under 12 U.S.C. 24 (Seventh).

Type II securities are as follows:

(1) Obligations issued by a State, or a political subdivision or agency of a State, for housing, university, or dormitory purposes that would not satisfy the definition of Type I securities pursuant to paragraph (j) of §1.2;
(2) Obligations of international and multilateral development banks and organizations listed in 12 U.S.C. 24 (Seventh);
(3) Other obligations listed in 12 U.S.C. 24 (Seventh) as permissible for a bank to deal in, underwrite, purchase, and sell for the bank's own account, subject to a limitation per obligor of 10% of the bank's capital and surplus; and
(4) Other securities the OCC determines to be eligible as Type II securities under 12 U.S.C. 24 (Seventh).[7]

The regulations relating to Type III, IV, and V securities are detailed and technical, but generally these categories include corporate bonds, municipal bonds that are not general obligation securities, small business-related securities that are investment grade, and securities related to commercial or residential mortgages.[8] The OCC's regulations place limits on the size of bank holdings of securities in these categories, but banks are permitted to purchase and sell these securities in the same way that they can purchase and sell whole loans. However, banks are not permitted to underwrite and deal in Type III, IV, or V securities.

Accordingly, under the OCC's regulations, before and after GLBA, banks could not underwrite or deal in MBS or other nongovernmental securities. They could, of course, invest in MBS, but they could do this before and after the adoption of both Glass-Steagall and the GLBA, just as they were permitted to invest in the whole loans that the MBS represented. In other words, to the extent that banks suffered losses on MBS, collateralized debt obligations, or other instruments that were securitized versions of whole loans, their losses came from imprudent investments and not from trading—that is, underwriting or dealing—in these instruments. It would be correct to say, therefore, that banks suffered losses on these securities by acting as

[7] CFR Title 12: Banks and Banking, Part 1—Investment Securities, Sec 1.2 (a) and (b), available at http://www.occ.gov/fr/cfrparts/12CFR01.htm# § 1.02 Definitions.
[8] Ibid.

banks—as lenders—and not as the securities traders that some commentators seem to imagine.

Bank Affiliations with Securities Firms

Although banks themselves could not underwrite or deal in MBS or other non-governmental securities under Glass-Steagall, the GLBA permitted banks to be affiliated with securities firms. Did this newly permitted affiliation cause banks to take risks and suffer losses they would not have sustained if the GLBA had not repealed the affiliation prohibitions in the Glass-Steagall Act? The answer again is "no." Banking law and regulations prevent the activities of a bank securities affiliate or subsidiary from adversely affecting the financial condition of a related bank.

As noted above, banking laws and regulations are designed to separate banks as fully as possible from the risks that are taken by their holding companies, or by any affiliate that is a subsidiary of the holding company. Although it is possible after GLBA for a bank to hold a securities firm as a subsidiary, the OCC regulations require that this subsidiary be treated like a subsidiary of the holding company, rather than like a subsidiary of the bank. The principal statutory provisions that wall off the bank from its holding company and from its own securities subsidiary are sections 23A and 23B of the Federal Reserve Act,[9] which are applicable to all banks, whether federal or state chartered.

Section 23A limits the financial and other transactions between a bank and its holding company or any holding company subsidiary. For extensions of credit, the limit on a bank's exposure to its holding company or any holding company subsidiary is 10% of the bank's capital and surplus for any one holding company affiliate and 20% for all affiliates in the aggregate. All such lending or extensions of credit must be collateralized with U.S. government securities up to the value of the loan, and must be overcollateralized if other types of marketable securities are used as collateral.[10] All transactions between a bank and its affiliates must be on the same terms as the bank would offer to an unrelated party.[11] Other restrictions also apply, including prohibitions on the bank's purchase of a low quality asset from an affiliate,[12] or the bank's issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate.[13] All these restrictions are applied by the Comptroller of the Currency to a national bank's relationship with a securities subsidiary.[14]

[9] 12 U.S.C. 371c and 371c-1

[10] 12 U.S.C. 371c (c) (1)

[11] 12 U.S.C.-1(a) (1)

[12] 12 U.S.C. 371c (a) (3)

[13] 12 U.S.C. 371c (b) (7)

[14] CFR Title 12, Sec 5.39 (h) (5), available at http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr;sid=1362d767c96a0fe1dccee11e2b313524;rgn=div5;view=text;node=12%3A1.0.1.1.5;idno=12;cc=ecfr#12:1.0.1.1.5.3.4.8.

Of course, if the securities firm is a subsidiary of the bank rather than a holding company affiliate, the bank will have an investment in the subsidiary which could be lost if the subsidiary fails. However, the OCC's regulations require that the bank "must deduct the aggregate amount of its outstanding equity investment, including retained earnings, in its [securities subsidiary] from its total assets and tangible equity and deduct such investment from its risk-based capital . . . and . . . may not consolidate the assets and liabilities of [the securities subsidiary] with those of the bank."[15]

These restrictions substantially reduce any likelihood that the business of a securities affiliate or subsidiary will have an adverse effect on the bank. The bank's lending to a securities affiliate or subsidiary is severely limited, must be collateralized, and must be made on the same terms that the bank would offer to an unrelated third party. In addition, the bank's investment in a securities subsidiary is not recorded as an asset on its balance sheet. In other words, they are effectively written off at the time they are made. Thereafter, if the securities subsidiary should fail, there will be no impact on the bank's balance sheet. Under these circumstances, it is highly unlikely that any activity carried on in a securities affiliate or securities subsidiary of a bank could have an adverse effect on the financial condition of the bank.

It is very doubtful that the restrictions of Sections 23A and 23B would be ignored either by a bank as an institution or by any director, officer, or employee of a bank or its holding company. The law permits civil and criminal penalties for knowing violations of the 23A and 23B, or any other regulation, and the civil fines involved can be enormous. For example, banking regulators can impose a *personal* civil money penalty of up to $1 million per day on any bank director or officer, for every day that a violation continues, if the director or officer engaged in a knowing violation of an order or regulation, or a breach of fiduciary duty, that causes a substantial loss to a bank.[16]

Accordingly, it is reasonably clear that GLBA's repeal of the affiliation provisions of the Glass-Steagall Act did not have and could not have had any adverse effect on the financial condition of any parent or affiliated bank, and thus did not contribute and could not have contributed in any way to the financial crisis.

What Caused the Financial Instability and Possible Insolvency of the Largest Banks?

Since banks themselves could not engage in any securities activities after the enactment of the GLBA that they could not do before the act's adoption, one must look elsewhere for the causes of the financial weakness that many U.S. banks suffered.

[15]CFR Title 12, Sec 5.39(h)(1)(i) and (ii). Available at http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr;sid=1362d767c96a0fe1dccee11e2b313524;rgn=div5;view=text;node=12%3A1.0.1.1.5;idno=12;cc=ecfr#12:1.0.1.1.5.3.4.8.
[16]12 U.S.C. 1818(i).

As noted above, there is strong evidence that, despite heavy regulation, many of the banks that got into trouble did so by failing to act prudently in their investment or lending activities—in other words, in their capacity as banks—and not because they engaged in securities trading or were affiliated with securities firms that were underwriting and dealing in securities. If this is true, bank losses should show up in the types of assets that banks traditionally hold—mortgages, commercial and industrial loans, and investments—and not in their trading accounts. That, in fact, is what we see.

In the spring of 2009, at the request of the Treasury Department, the Fed and the Comptroller of the Currency supervised a special process of stress testing by the 19 largest U.S. financial institutions (most of which were banks). Table 2.1 is taken from a report by the Fed on the stress tests, and shows the projected aggregate losses for all 19 institutions in an adverse economic and financial scenario.[17] For purposes of this discussion, it is important to note that the projected losses that these 19 institutions were likely to suffer came from the usual assets that are found in banks—residential and commercial mortgages, commercial loans, credit card receivables, and the like. The relatively high level of trading and counterparty losses in the table—still a relatively small portion of the total—is probably attributable to including the holdings of the independent investment banks (Goldman Sachs and Morgan Stanley) among the 19 institutions, and the consolidation of the assets of the investment banks acquired in 2008 by JP Morgan Chase (Bear Stearns) and Bank of America (Merrill Lynch). Thus, the projected aggregate trading and counterparty losses for those four banks were over $80 billion, out of a total of $99 billion for all 19 institutions as a group.[18] Similar losses for all the other banks in the survey were negligible.

Table 2.1 Estimated losses for 2009 and 2010 for the more adverse scenario

Loan category	Estimated loss (in billions of dollars)	Percentage of losses within category
First lien mortgages	102.3	8.8
Second/junior lien mortgages	83.2	13.8
Commercial and industrial loans	60.1	6.1
Commercial real estate loans	53.0	8.5
Credit card loans	82.4	22.5
Securities (AFS and HTM)	35.2	N/A
Trading and counterparty	99.3	N/A
Other[a]	83.7	N/A
Total estimated losses (before purchase accounting adjustments)		$599.2 billion

[a]Includes other consumer and nonconsumer loans and miscellaneous commitments and obligations.

[17]Board of Governors of the Federal Reserve System, "The Supervisory Capital Assessment Program: Overview of Results," May 7, 2009, available at www.federalreserve.gov/newsevents/press/bcreg/bcreg20090507a1.pdf (accessed May 29, 2009).

[18]Ibid., Appendix.

Accordingly, it would be accurate to conclude that the enactment of GLBA—to the extent that it allowed banks to affiliate with securities firms—did not result in major losses at the banks as the result of their own securities activities or the securities activities of their subsidiaries or affiliates. On the contrary, it seems clear that the banks got into trouble, and precipitated the financial crisis and the recession, by doing exactly the things we expect them to do—make loans and hold normal and traditional financial assets. The absence of any major source of projected losses coming from securities trading activities shows that the repeal of the affiliation provisions of the Glass-Steagall Act did not induce the banks to take on unusual amounts of trading assets. Nor was trading a significant source of their projected financial losses.

Did the Securities Firms (Investment Banks) Get into Trouble Because of Their Affiliations with Banks?

There is still one other possibility—that GLBA's repeal of the affiliation provisions in Glass-Steagall enabled securities firms to establish relationships with banks and that these relationships caused the near-insolvency of Merrill Lynch, Goldman Sachs, and Morgan Stanley, and the bankruptcy of Lehman Brothers. However, this seems highly unlikely. Each of these investment banking firms had a subsidiary bank—something that would not have been possible before the repeal of the affiliation provisions of Glass-Steagall—but these bank affiliates were far too small to cause any serious losses to their massive parents.

The following table shows the relative size of the parent and the subsidiary bank for each of the four major securities firms (Table 2.2).

Table 2.2 Subsidiaries of investment banks are relatively small

Investment bank	Investment bank assets (2008)	Subsidiary bank's assets
Goldman Sachs	$800 billion	25 billion[19]
Morgan Stanley	660 billion	38.5 billion[20]
Merrill Lynch	670 billion	35 billion[21]
Lehman Brothers	600 billion	4.5 billion[22]

[19]Federal Reserve Board, "Order Approving Formation of Bank Holding Companies," The Goldman Sachs Group, Inc., September 21, 2009, p.1.

[20]Federal Reserve Board, "Order Approving Formation of Bank Holding Companies," Morgan Stanley, Inc., September 21, 2009, p.1.

[21]iBanknet, Merrill Lynch Bank & Trust Co, FSB, October 22, 2009; available at http://www.ibanknet.com/scripts/callreports/getbank.aspx?ibnid=usa_2577494.

[22]Investigative Reporting Workshop, Woodlands Commercial Bank, available at http://www.ibanknet.com/scripts/callreports/getbank.aspx?ibnid=usa_3376461.

In light of the huge disparities between the size of each major investment bank and the size of its depository institution subsidiary, it is highly unlikely that the insured bank subsidiary could cause any serious financial problem for the parent investment bank, or significantly enhance the financial problems that the parent company had created for itself through its own operations.

Conclusion

Accordingly, it seems clear that the banks that encountered financial problems got into trouble the old fashioned way—by making imprudent loans. There is no evidence of significant amounts of risky securities trading activities. Similarly, the investment banks got into trouble as traders and risk takers—their traditional business—and not because of their affiliations with the small banks they held as subsidiaries. Thus, it is possible to conclude without much question that GLBA's repeal of the affiliation provisions of the Glass-Steagall Act had no significant effect whatever on the financial crisis.

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