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Markets make best case for Glass-Steagall

By John Authers

One-stop shops knew that they were too big to fail, encouraging risk-taking

The brainchild of Carter Glass and Henry B. Steagall will not go away. It is 13 years since the key provisions of their banking act were repealed, and about 83 years since they were introduced.

When Glass-Steagall – which thwarted deposit-taking commercial banks from owning insurers and investment banks – was repealed, it seemed obsolete. Wall Streeters spent much energy finding legal ways around it. A cross-party consensus agreed with little debate that it must go.

Now, another cross-party Senate group, led by former Republican presidential candidate John McCain and Elizabeth Warren, the consumerist Democratic senator for Massachusetts, have introduced a bill to reinstate Glass-Steagall's split of commercial and investment banking.

It is not going to happen. But it should. With the benefit of the experience of the last 13 years, we can see that Glass-Steagall should never have been repealed.

The case for repeal went as follows. Financial services groups wanted to offer customers a one-stop shop. Companies could access both syndicated loans and equity; individuals could buy mortgages, insurance and stocks, all in one place. This would diversify revenue streams, reducing risk. Access to deposits, a cheap form of finance, would ease the costs for investment banks. The higher margins that come from pumping more sales through the same distribution system would lift returns for shareholders and cut prices for clients.

How did that work out? Let the market be the measure. On the eve of the agreement to repeal Glass-Steagall, on October 24 1999, the S&P 500 financial services index traded at almost 3 times book value. It now trades at 1.3 times book. Trailing 12-month earnings per share for the sector are lower now than they were in October 1999. The financials index as a whole has fallen 15 per cent – although with dividends included, it has made a positive return of 15.2 per cent, or about 1 per cent per year. Repealing Glass-Steagall was terrible for shareholders.

But what about clients? Did Glass-Steagall repeal really have much to do with the financial disaster of 2008?

Critics point out that it was specialist investment banks such as Bear Stearns and Lehman Brothers that brought the financial system to its knees, not financial supermarkets.

But this ignores the fact that no supermarket could possibly be allowed to fail. Both Citigroup and Bank of America, owners of Salomon Smith Barney and Merrill Lynch respectively, needed repeated injections of government aid to see them through. Both contributed in full to overblown credit markets.

It also ignores the impact that the presence of such institutions had on the securities industry. With new leviathans piling into subprime credit, and pressing regulators to allow them to take on far more leverage, specialist investment banks had to follow. Further, the behemoths proved unmanageable because of their sheer complexity. This contributed to awful errors of risk management.

Finally, there is moral hazard. The one-stop shops knew that they were too big to fail, encouraging risk-taking. Over the last decade, US banking has grown far more concentrated. In the mid-1990s, the biggest five banks accounted for about 13 per cent of assets. By 2009 this was 38 per cent.

This is still far less concentrated than most European markets. Indeed, Glass-Steagall, and other Depression-era measures such as the bar on interstate banking, helped the US avoid the over-concentration and over-banking that made the eurozone's banks too big for their governments to rescue. In 2010, US banks' assets accounted for 81 per cent of US gross domestic product. The figures for Germany, France, and Spain were 294, 416, and 325 per cent respectively.

Look also at the broader culture. In the US, retail financial products tend to be cheaper, and consumers tend to be better informed, than in Europe. This is in large part because in the US, investments are largely sold by stockbrokers with professional qualifications in finance; while in Europe and the UK, sales of investments are left to banks and insurers.

Finally, look at the Glass-Steagall era. Those seven decades look like an anomaly, a "quiet period", as Yale University economist Gary Gorton puts it, when there were hardly any bank runs (and economic growth was steady). For decades leading up to the Great Crash, bank runs had been endemic in the US. Deposit insurance, and a requirement that banks that took deposits could not also play at investment banking, vanquished that problem.

That was quite an achievement. It did not look that way in 1999. It does now.

Could it be improved? Almost certainly. But the idea of separating deposit-takers from investment banks needs to return to the debate. If this attempt to reinstate Glass-Steagall achieves that, it will at least be more than a political stunt.

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