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New Glass-Steagall would help to keep lenders in line

By John Authers

It’s a shame the Depression-era legislation was repealed

Two weeks ago, this column argued that Glass-Steagall, the Depression-era legislation that barred US commercial banks from investment banking and insurance, should not have been repealed, and that something like it should be reinstated. There was copious feedback, so let us return to the issue.

Rather than look at the 1999 repeal’s obvious failure to have the hoped-for positive consequences, let us to ask what Glass-Steagall was meant to achieve, and what the reimposition of Glass-Steagall, or something like it, could achieve now.

At the time, one aim dominated all others. Depositors’ money was to be sacrosanct. The US had suffered too many bank runs, when loss of confidence by depositors brought down otherwise healthy institutions. Glass-Steagall, by making it harder for banks to take risks with depositors’ funds, was an integral part of the measures to thwart bank runs.

There were other elements. Deposit insurance, backed by an aggressive regulator which ensured that banks behaved themselves, was critical. So were rules – which grew inconvenient as clients grew more mobile – to stop banks offering services in more than one state. This made them smaller and easier to police.

But a split between commercial and investment banking helps avoid bank runs. The 2008 crisis saw a famous run on the Northern Rock bank in the UK, and also saw a run on money market funds, seen by many as a direct alternative to bank deposits. Guarding against bank runs remains important. This justifies a separation of depositors’ funds from trading activities, albeit arguably without a full Glass-Steagall split.

A second benefit of Glass-Steagall, which probably seemed less important to its founders, was to inhibit the spread of capital markets to areas that had once been the purview of banks’ lending officers. Once the split was removed, it changed the behaviour of all players, and not only those who opted to become universal banks, combining deposit-taking and investment banking under one roof.

The oft-expressed objection that it was specialist investment banks, and specialist mortgage lenders, that crashed outright, rather than the newly created universal banks, is therefore a canard. The change in the rules

affected everyone.

Look at how investment banks responded. Chris Slingo, now of MHW Associates but at Morgan Stanley when Glass-Steagall was repealed, recounts the story. “The immediate concern that we, in common with the other investment banks, had was that the commercial banks that were then allowed to provide capital market services would offer loans when competing for M&A and other advisory fee business (the investment bank’s lunch).”

Commercial banks had already suffered the indignity of losing some of their core businesses to markets-driven alternatives. For example, the commercial paper market deprived them of their business making short-term loans to large companies, so may have felt this was only fair.

Investment banks lack the capacity to make big loans and hold them on their balance sheet. So Morgan Stanley set up a task force, which decided that “we needed to turn loan assets into marketable securities so that when we made loans in the course of competing for fee business we could distribute those assets and turn over the balance sheet.”

This was intended as a defensive manoeuvre, nothing more. Instead, according to Mr Slingo, “as with many things in the financial world we as an industry stumbled across a whole new market in the distribution of loans.” Soon the whole alphabet soup of CDOs, CDSs, CLOs and the rest was burgeoning, as banks on either side of the old Glass-Steagall split discovered a huge new business in credit trading.

The problem, as everyone discovered, is that there is a difference between the care a lending officer takes over making a loan that will stay on his or her bank’s balance sheet, and the indiscipline that arises when it can immediately be traded away.

Despite first appearances, then, Glass-Steagall had helped limit the emergence of such a trading culture for lending. It did not rule out such behaviour, as the securitisation of mortgages long predated 1999. But its repeal was a key element in allowing that culture to run rampant.

Would Glass-Steagall’s return put the genie back in the bottle? Probably not. The financial system works as it does. Hedge funds, unaffected by Glass-Steagall, are fast taking on the roles of banks.

But somehow, those who make loans or investments must be kept in touch with the consequences of their actions. It would have been better if Glass-Steagall had never been repealed. Bringing it back would not bring back the financial system as it existed in 1999, unfortunately, but it is most helpful that such an option is back in the debate.

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