Obama takes on America's banks with new Glass-Steagall act

President Obama targets Wall Street with reforms that echo classic Depression-era legislation that prevented commercial banks from making risky trades

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theguardian.com, Thursday 21 January 2010 12.57 EST

Traders crowd the sidewalks outside the New York Stock Exchange on the day of the 1929 market crash. The Glass-Steagall act that followed has now been taken up by President Obama. Photograph: Bettmann/CORBIS

Officially it was blandly named the Banking Act of 1933 but around the world it is better known as Glass-Steagall, the ground-breaking piece of legislation that prevented commercial banks which took deposits from embarking on risky trading activities.

Carter Glass and Henry Steagall were the revolutionaries of the time. The years after the Great Depression sparked a debate in the US about how to prevent such devastation hitting the economy again, after nearly 5,000 banks collapsed.

President Barack Obama, hurt by the historic loss of a Democratic seat in the Kennedy stalwart

state of Massachusetts, is now determined to earn his own place in the history books by again making banks pay the price for the taxpayer bailouts that were needed in October 2008 to stop the financial system collapsing.

His Glass-Steagall act for the 21st century will now be known as the "Volcker rule" named after former Federal Reserve chairman Paul Volcker – and is intended to stop banks which take deposits from running hedge funds, making private equity investments or using their money to take bets on markets. He will also stop big mergers between banks.

Glass-Steagall forced commercial and investment banks to separate. Commercial banks were not allowed to underwrite the sales of stocks and bonds, while investment banks could not take in deposits from customers.

It remained in place for half a century before it was repealed in 1999 through the Financial Services Modernisation Act, again better known by the names of the politicians who promoted the legislation – Gramm, Leach and Bliley.

These Republican politicians enabled allow banks to become retail and investment operations and combine with insurance companies. Their law has been blamed by many commentators for the financial crisis that enveloped the globe barely a decade later.

Without the changes to the law, Citigroup – which the US taxpayer has been forced to bail out – would not have been allowed to exist after banking group Citibank and insurer Travellers announced their intention to merge. Until the 2008 financial crisis, Citi was able to claim to be one of the biggest financial institutions in the world as a result of the takeovers it was permitted to make as a result of the legislative changes – including a move into investment banking by buying brokers Smith Barney and parts of Schroders.

In the UK, the debate about the need for a "new" Glass-Steagall has raged in the wake of the 2008 bank bailout. Liberal Democrat Treasury spokesman Vince Cable was one of the first to speak out in favour of "narrow banking" but the government has so far insisted that it does not believe that legislative change is needed to force a separation between investment banks and deposit-taking banks. Instead, Alistair Darling is pressing on with proposals for "living wills" which require firms to "establish clear contingency plans for action in times of failure".

"This may necessitate plans for revisions to corporate structures of some institutions, which may include establishing clear lines between deposit-taking and other banking operations," the treasury outlined in its reforming financial markets paper in July 2009.

Obama, though, is now going one step further, by promising to prohibit banks from engaging in activities which might cause a risk to customer deposits. It is his way of ending the mentality of

"too big to fail" in financial markets.

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