Reinstate the Glass Steagall Act?*

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It seems like every week brings another call to reinstate the Glass Steagall Act. This article provides some background on the Act, the amendments to the Act made by the Gramm Leach Bliley Act, and related provisions in the Dodd-Frank Act. This article suggests that the current reinstatement debate is disconnected from the facts. Yet, as a friend of mine recently stated, that is beside the point.

The Glass Steagall Act is named for its principal authors Senator Carter Glass and Congressman Henry Steagall. Carter Glass was a Senator from Virginia, who had a major hand in the enactment of the Federal Reserve Act in 1913 when he was a member of the House of Representatives. Glass also had been Secretary of the Treasury under President Wilson prior to his service in the Senate. Henry Steagall was a member of Congress from Alabama and Chairman of the House Committee on Banking and Currency in 1933 when the Glass Steagall Act was passed.

The Glass Steagall Act also is known as the Banking Act of 1933, and it included a number of provisions unrelated to the current reinstatement debate. For example, the Act established the Federal Deposit Insurance Corporation and the Federal Open Market Committee. It also prohibited the payment of interest on demand deposits. That prohibition was repealed in the Dodd-Frank Act.

The provisions of the Act that are the center of the current reinstatement debate are sections 20 and 32. Section 20 prohibited banks from affiliating with a securities firm. Section 32 prohibited bank officers and directors from serving as officers and directors of a securities firm. These provisions were repealed in the Gramm Leach Bliley Act in 1999, after section 20 had been interpreted by the Federal Reserve Board to permit a bank holding company to own a bank and a securities firm as long as the securities firm engaged in a limited amount of bank ineligible securities activities, and after Congress had amended the Federal Reserve Act to require that transactions with affiliates be conducted at "arm's length" (23B of the Federal Reserve Act).

The Gramm Leach Bliley Act did not repeal section 13, which amended the Federal Reserve Act to impose prohibitions and limitations on transactions between affiliates, including a provision that prohibits

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a bank from making loans to purchase securities from an affiliate (23A of the Federal Reserve Act); section 16, which prohibits banks from underwriting securities and from purchasing for their own account securities other than government obligations and other similar "investment securities;" or section 21, which prohibits securities firms from accepting deposits.

In sum, the Gramm Leach Bliley Act permitted banks to be affiliated with securities firms under a common corporate umbrella, but retained the restrictions in the original Glass Steagall Act on the securities activities of banks and the banking activities of securities firms. Congress also retained the restrictions on affiliate transactions contained in 23A and 23B of the Federal Reserve Act.

The affiliations between banks and securities firms permitted by the repeal of sections 20 and 32 were not responsible for the financial crisis. Lehman Brothers, Merrill Lynch, and Bear Sterns were not affiliated with banks. AIG and Washington Mutual were not affiliated with securities firms.

Other factors were at the heart of the crisis, most notably a failure of risk management, insufficient capital and liquidity, and poor mortgage underwriting standards. These problems were addressed effectively in the Dodd-Frank Act and the Federal Reserve Board's rules on capital planning. Dodd-Frank also added to the Glass Steagall framework by prohibiting banks and any firm affiliated with a bank from engaging in proprietary trading or operating a hedge fund, and expanding the restrictions of 23A. Yet, as my friend noted, that is beside the point.

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