A Brief History Lesson: How We Ended Glass Steagall

Posted By Barry Ritholtz On May 17, 2012 @ 8:00 am In Really, really bad calls,Regulation | 35 Comments

So I am researching the history of Glass Steagall for a new project, and I am continually amazed to learn the details how this law was slowly overturned. It is an informative lesson in tenacity of gradual erosion, how bank lobbyists can slowly sand away rules, with a healthy does of regulatory capture thrown in.

We know that Glass Steagall (aka The Banking Act of 1933) was a simple, effective, easy-to-follow regulatory rule that kept commercial (aka taxpayer-insured depository) banks separate from their more speculative Wall Street investment bank brethren.

So exactly how did we end up dismantling that, eventually overturning it in 1999?

To paraphrase Hemingway: *Slowly at first, then all at once.*

This extremely effective law was eroded gradually over time. Its history shows that numerous attempts were made to carve out exceptions for decades. Many of these were successful.

The project went in a different direction, but I am left with lots of notes about how Glass Steagall ended. Rather than toss them, they are worth posting. From about a dozen sources, here are my rough draft and notes:

> **1967** saw an attempt to permit banks to underwrite municipal revenue bonds; that died in the Senate. By 1974, following the passage of ERISA laws and the introduction of the 401(k), bank regulator OCC authorized national banks to provide "**automatic investment services**." This permitted pre-planned funding of investment accounts — cash in deposit accounts was allowed to be withdrawn "regularly and automatically" to purchase securities. The Federal Reserve determined that Glass-Steagall allowed banks to place commercial paper.
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> The proverbial "Camel's nose was in the tent." Once that occurred, bank lobbyists managed to carve out an increasingly large set of exceptions. Those gradual exceptions led to a few major changes in how the Glass-Steagall act was interpreted, and with greater exceptions to come.
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> The next seed was planted in 1977: The Federal Reserve Board staff argued bank holding companies should be able to establish **securities affiliates** that underwrote and dealt in government securities and other bank-eligible securities beyond mere commercial paper. OCC authorized in 1978 the selling of securitized mortgage backed paper.
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> **Nonbank Banks**: In 1982, there were a huge series of changes, including the rise of the "Nonbank Banks" These were non FDIC insured financial institutions that looked and felt like banks, but were technically deemed non banks.
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> But a huge shift intellectually occurred in 1982: FDIC chairm William Isaac issued a "policy statement" suggesting state chartered (non-Federal Reserve member) banks could establish "subsidiaries." These seperate companies wholly or partially owned by banks would be permitted to do what Glass Steagall disallowed banks to do: Underwrite and deal in securities.
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> Later in 1982, Comptroller C. Todd Conover of the OCC approved the mutual fund company Dreyfus and retailer Sears — both not banks — to establish "nonbank bank" subsidiaries. These were to be exempt from Glass Steagall. Note that Federal Reserve Chairman Paul Volcker opposed this, and asked Congress to overrule both the FDIC's and the OCC's actions.

> What began with Dreyfus and Sears, next moved on to a series of *non bank banks* including Merrill Lynch, J. & W. Seligman & Co. Prudential-Bach.
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> The International Banking Act of 1978 allowed foreign banks to establish or purchase US banks and security firms, leading US banks to complain to Congress that Glass-Steagall was interfering with their ability to compete internationally (sound familiar?).
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> **Enter Greenspan:** In 1987, newly appointed Federal Reserve chair pressed the FOMC Board for formal approval of "Section 20 affiliate exemptions." Fed Chair Paul Volcker had not supported these exemptions to allow bank holding companies to establish subsidiaries. Greenspan of course, never met a deregulatory act he didn't support. So despite the fact that these subsidiaries were divisions of FDIC insured depository banks, they were permitted to engage in iBank like underwriting of RMBS, Commercial paper, and Muni bonds — pretty much anything but equities. With Section 20 of Glass-Steagall's prohibition for banks underwriting and dealing in securities mostly neutered, the line between iBanks and depository institutions was blurred.
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> To the prior list of exemptions above, we can add the following: Bankers Trust, Citicorp, and J.P. Morgan & Co. 1987 was the year the Federal Reserve Board approved their subsidiaries to underwrite securities.
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> Also in 1987: **Competitive Equality Banking Act** (CEBA). In theory, this was a response to the Savings & Loan crisis, but it too carved out even more exemptions to Glass Steagall.
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> In 1988, Greenspan recommended that the FRB expand underwriting powers of Section 20 affiliates. He discussed eliminating the key that component separated commercial deposit banking and iBanking. In Congressional testimony and public statements, Greenspan pressed for the Federal Reserve Board to repeal Glass-Steagall.
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> The next major milestone: 1995. That was when Representative James A. Leach (R-IA) became chair of the House Banking Committee. One of his first acts was to introduce a Greenspan supported bill to repeal key provisions of Glass-Steagall (notably, Sections 20 and 32). Treasury Secretary Robert Rubin announced the Clinton Administration's support. Greenspan, Leach and Rubin believed that Glass-Steagall was "obsolete and outdated."
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> **Travelers and Citicorp Merger**:
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> The final straw for Glass Steagall came on April 6, 1998: That was when Travelers and Citicorp announced their merger.
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> The then existing rules allowed Citigroup to own the Travelers insurance underwriting business for two years before either divestment or FRB approval. Alternatively, the Bank Holding Company Act could be amended or overturned to "*permit affiliations between banks and underwriters of property, casualty, and life insurance.*" (Citigroup's Salomon Smith Barney was already kosher under the affiliate exemption rules).
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> And that is exactly what happened. The Gramm-Leach-Bliley Financial Modernization Act of 1999 was signed into law on November 12, 1999.

Here is Bill Moyers [1]:

> After 12 attempts in 25 years, Congress finally repeals Glass-Steagall, rewarding financial companies for more than 20 years and $300 million worth of lobbying efforts. Supporters hail the change as the long-overdue demise of a Depression-era relic.

It is quite a tortured history. Corporations can exist forever, and their lobbyists and paid advocates can slowly whittle away laws they don't like. It is nothing short of amazing to see how effective they can be when confronted with laws they don't like.

This points out why the regular generational crises that come along should provide the

opportunity to re-establish regulations, and reduce their influence in times of panic.

Greenspan, Rubin, Reagan and Clinton all contributed to its demise. But the missed opportunity here was President Obama's — – it may be his greatest failure. It may come to eventually define his presidency and could be the reason it may be a single term.

URLs in this post:

[1] Bill Moyers:
http://www.pbs.org/wgbh/pages/frontline/shows/wallstreet/weill/demise.html