

**REMARKS AT THE INDIANA LAW REVIEW SYMPOSIUM ON
“LAW AND THE FINANCIAL CRISIS”
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INTRODUCTION

In 1981, under Secretary Donald Regan, the Treasury Department proposed a radical approach to bank deregulation.¹ The Glass-Steagall Act was in full effect at the time, and it prohibited banks from engaging in underwriting or dealing in corporate securities and from being affiliated with any firm that engaged in these activities.

The reasons for the 1981 Treasury plan were relatively simple. It was becoming clear even then that banks were losing their role as the primary sources of finance for the real economy. Increasingly, companies that had registered their securities with the SEC were going to the securities markets for financing, issuing bonds, notes, and commercial paper for their long, medium, and short-term financial needs.

Once companies began to report regularly to the SEC on their financial condition, investors were able to decide for themselves the risks associated with fixed income securities. The intermediation of banks—with their special knowledge of the financial condition of their borrowers—was no longer necessary. It was much cheaper for issuers of securities to pay underwriting fees than to negotiate loan agreements with banks and pay the higher interest costs banks required.²

Since the 1980s that trend has continued. The banking industry has provided about \$1.5 trillion in financing to business borrowers, while the securities industry has provided about ten times as much, \$15 trillion.³ In 1965, bank lending to real estate was less than twenty-five percent; by 2008, over fifty-five percent of bank lending was to real estate, and continuing to rise. The reason, of

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1. Paul A. Samuelson, *Evaluating Reganomics*, 27 CHALLENGE 4, 8 (1984).

2. *Id.*

3. *Federal Reserve Statistical Release Z.1*, FINANCIAL ACCOUNTS OF THE UNITED STATES, <http://www.federalreserve.gov/Releases/z1/Current/data.htm>, archived at <http://perma.cc/4X3H-V2NV> (last updated Dec. 10, 2009).

course, is that real estate developers and small businesses seldom have access to securities market funding, so they have to borrow from banks. But lending to the volatile real estate business and the small business community is not going to sustain the U.S. banking system over the long term.

Under the Treasury plan, banks themselves would continue to be restricted by Glass-Steagall, but bank holding companies—ordinary corporations that control one or more banks—would be able to underwrite and deal in securities or control subsidiaries that did so. Then, as now, most banks, and all the large ones, were subsidiaries of holding companies.⁴ To permit this structure to work, the sections of Glass-Steagall that prohibited affiliations between banks and securities firms had to be repealed. In other words, the Treasury's idea was to free bank holding companies—but not banks—from restrictions on the kinds of financial activities in which they could engage, allowing them to offer a variety of financial services as the market for these services developed.⁵

The key elements of the original Treasury plan were finally adopted in the Gramm-Leach-Bliley Act ("GLBA") of 1999, which repealed a portion—but not all—of Glass-Steagall. Its policy purpose was to allow bank holding companies to engage in other financial activities, such as underwriting insurance as well as underwriting and dealing in securities, though it retained the portion of Glass-Steagall that prohibits banks themselves from doing so.

With this background, there are two questions I would like to address today:

1. Did the partial repeal of Glass-Steagall have a role in the financial crisis?
2. Should Glass-Steagall be restored?

I. GLASS-STEAGALL AND THE FINANCIAL CRISIS

I will clarify the term "bank" because it is often misused. In the context of these remarks, a bank is a very specific type of entity, chartered by the federal government or a state, to take deposits that are withdrawable on demand—the hallmark of a bank—and make loans.

Only banks as I have just defined them are insured by the Federal Deposit Insurance Corporation ("FDIC"), have access to the Federal Reserve's ("Fed") discount window, and participate in the U.S. payment system. It is the presence of government insurance and those other functions that account for the special restrictions on bank activities. The theory is that banks, because of their deposit insurance and unique functions in the financial system, must be kept from taking risks.

Bank holding companies, on the other hand, are not insured, do not have access to the Fed's discount window, and do not participate in the nation's payment system. Accordingly, there is no sound policy reason for restricting their activities, as long as the risks taken by holding companies cannot affect the

4. *Bank Holding Companies*, PARTNERSHIP FOR PROGRESS, <http://www.fedpartnership.gov/bank-life-cycle/manage-transition/bank-holding-companies.cfm> archived at <http://perma.cc/GPF7-5BSA> (last visited Feb. 12, 2014).

5. *Id.*

financial conditions of their subsidiary banks.

Part of the confusion about Glass-Steagall comes from the fact that there are entities called investment banks. These are firms that specialize in underwriting and dealing in securities. Investment banks are not banks in any strict sense; they are not long-term lenders, not backed by the government in any way, were never covered by Glass-Steagall, and—unlike true banks, generally called commercial banks—are intended to be risk-takers. In order to reduce the confusion caused by the similar use of the word “bank,” I will refer to investment banks as securities firms.

The Glass-Steagall Act was designed to separate commercial banks from securities firms, and it did that simply by prohibiting affiliations between the two and by prohibiting banks from engaging in the business of underwriting and dealing in securities.⁶ Much of U.S. banking law and regulation is designed to separate banks from the risks that might be created by the activities of their non-bank affiliates—particularly, its holding company or any holding company subsidiary. This separation is affected, as I’ll discuss shortly, by severely restricting the transactions between banks and their holding company affiliates.

There are two principal reasons for these restrictions: (i) to ensure that the so-called bank “safety net”—deposit insurance and access to the discount window—is not extended beyond banks to their holding companies or their nonbank affiliates, and (ii) to protect the bank’s financial position from exposure to the risks that are taken by its affiliates and securities subsidiaries. The idea is to allow a holding company—and even a bank securities affiliate—to fail without endangering the health of any related bank. That is the context in which the Glass-Steagall Act should be viewed.

Although Glass-Steagall prohibited banks from underwriting and dealing in securities, it did not prohibit banks from buying, selling, and holding loans and fixed income securities for investment, or trading the loans or securities in which they had invested. This is logical. Securities and loans are the stock in trade of banks, just as oil is the stock in trade of Exxon Mobil. So even under Glass-Steagall, banks could not only make loans, they could invest in loans and securities and buy and sell these assets as their businesses required.

Here, the difference between “buying and selling” and “underwriting and dealing” is crucial. As noted earlier, Glass-Steagall continues to prohibit banks from ‘underwriting or dealing’ in securities. “Underwriting” refers to the business of assuming the risk that an issue of securities will be fully sold to investors, while “dealing” refers to the business of holding an inventory of securities for the *purpose* of trading them.

Thus, a bank may purchase a security—say, a bond—and then decide to sell it when the bank needs cash or believes that the bond is no longer a good investment. Its *purpose* in buying the bond initially was not to trade it, so that activity would not be considered dealing in a security.

When securitization was developed, banks were permitted—even under Glass-Steagall—to securitize their loan assets and sell them in securitized form.

6. See 12 U.S.C. § 378 (2012); *id.* § 24.

This was seen by regulators as simply another way to buy and sell loans, which was always permitted under Glass-Steagall.

From this analysis, it should be clear that the GLBA's repeal solely of the affiliation provisions of the Glass-Steagall Act did not permit banks to do anything that they were previously prohibited from doing. It certainly did not authorize banks for the first time to use insured funds to buy and sell securities, as some commentators have alleged.⁷ As I've shown, banks were always able to do that under Glass-Steagall. It was simply part of the business of being a bank. To repeat, only underwriting and dealing in securities was forbidden to banks by Glass-Steagall. Accordingly, it is incorrect to suggest that Glass-Steagall's partial repeal had any affect whatsoever on the ability of banks to take any more risks than they had been taking while Glass-Steagall was fully in effect.

With this background, what banks did with mortgages and mortgage-backed securities ("MBS") before the financial crisis comes into focus. Before the GLBA, while Glass-Steagall was fully in effect, banks could invest in and buy and sell mortgages and mortgage-backed securities. These instruments were considered by bank regulators to be a securitized form of the whole mortgages that banks could always trade.

There is no evidence that trading—buying and selling—MBS caused any significant bank losses in the financial crisis. Those losses came almost entirely from investing in and holding privately-issued mortgage-backed securities, and to some extent whole mortgages. In other words, to the extent that banks suffered losses on MBS, collateralized debt obligations, or other instruments that were securitized versions of whole mortgages, their losses came from what turned out to be bad investments and not from trading—let alone underwriting and dealing—in these instruments.

It would be correct to say, therefore, that banks suffered losses on these securities by acting as banks—as lenders—and not as the securities traders that some commentators seem to imagine. Nevertheless, it is reasonable to ask whether the repeal of the affiliation provisions of Glass-Steagall could have caused banks to make these bad investments and thus suffer the losses that were a prominent feature of the financial crisis.

This could come about, for example, if the newly-permitted affiliations between banks and securities firms caused the banks to take greater risks. One way this might happen would be through banks making loans to their affiliated securities firms, or buying low quality MBS from their affiliates.

A. Bank Affiliations with Securities Firms

Banking law and regulations prevent the activities of a bank securities affiliate or subsidiary from adversely affecting the financial condition of a related bank. Sections 23A and 23B of the Federal Reserve Act, for example, limit the

7. Board of Governors of the Federal Reserve System U.S. Department of the Treasury, *Report to the Congress on Financial Holding Companies Under the Gramm-Leach-Bliley Act*, 28 (2003), www.federalreserve.gov/boarddocs/rptcongress/glbartptcongress.pdf.

financial and other transactions between a bank and its holding company or any holding company subsidiary.⁸ For extensions of credit, the limit on a bank’s exposure to its holding company or any such subsidiary is ten percent of the bank’s capital and surplus for any one holding company affiliate and twenty percent for all affiliates in the aggregate.⁹

To put this in perspective, most banks have risk-based capital of roughly ten percent.¹⁰ Thus, a loan to an affiliate cannot exceed one percent of the bank’s assets, and loans to all affiliates as a group cannot exceed two percent. Moreover, all such lending or extensions of credit must be collateralized with U.S. government securities up to the value of the loan, and must be over-collateralized if other types of marketable securities are used as collateral.¹¹

Under Section 371c of the Federal Reserve Act, all transactions between a bank and its affiliates are subject to the same standard of banking practices as the bank would offer to an unrelated party.¹² Other restrictions also apply, including prohibitions on the bank’s purchase of a low quality asset from an affiliate,¹³ or the bank’s issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate.¹⁴

All these restrictions are applied by bank regulators to a bank’s relationship with its holding company, the holding company’s subsidiaries, and in the rare case in which a bank itself—rather than its holding company—has a securities subsidiary.¹⁵ In that case, incidentally, the bank’s interest in its subsidiary must be subtracted from its assets when its capital position is computed.¹⁶

These restrictions effectively eliminate interconnections between a bank and its holding company affiliates and thus any substantial likelihood that the business of a securities affiliate or subsidiary will have an adverse effect on the bank. Accordingly, it is reasonably clear that GLBA’s repeal of the affiliation provisions of the Glass-Steagall Act did not have and could not have had any adverse effect on the financial condition of any affiliated bank, thus not contributing to the weakening of banks in what we call the financial crisis.

B. Did the Securities Firms (Investment Banks) Get into Trouble Because of Their Affiliations with Banks?

There is still one other possibility—that GLBA’s repeal of the affiliation provisions in Glass-Steagall enabled securities firms to establish relationships

8. Federal Reserve Act, 12 U.S.C. §§ 371c-371c-1 (2012).

9. *Id.* § 371c(a)(1).

10. FDIC, *FDIC Community Banking Study*, 6-1 (2012), www.fdic.gov/regulations/resources/cbi/report/CBSI-6.pdf [hereinafter *Banking Study*].

11. 12 U.S.C. § 371c(c)(1) (2012).

12. *Id.* § 371c(a)(4).

13. *Id.* § 371c(a)(3).

14. *Id.* § 371c(c)(1).

15. 12 C.F.R. § 5.39 (h)(5) (2013).

16. *Id.*

with banks and that these relationships [somehow] caused the near-insolvency of the five large securities firms—Merrill Lynch, Goldman Sachs, Bear Stearns, and Morgan Stanley, and the bankruptcy of Lehman Brothers during the financial crisis.

First, it is important to note that, although affiliations between banks and securities firms were permissible after the adoption of the GLBA, no such relationship existed between the big U.S. banks and the five large securities firms that also had financial difficulties during the crisis.¹⁷ Indeed, these large securities firms and the large Wall Street banks were fierce competitors.

To be sure, each of these securities firms had a subsidiary bank—something that would not have been possible before the repeal of the affiliation provisions of Glass-Steagall—but these bank subsidiaries were far too small to cause any serious losses to their massive parents. Merrill Lynch, for example, a securities firm with \$670 billion in assets, had an affiliated bank with assets of \$35 billion. Other large securities firms—Goldman, Sachs, Lehman Brothers, and Morgan Stanley had bank subsidiaries that were of roughly similar equivalent relative size.

Moreover, as in the case of the banks, the large securities firms got into trouble not from underwriting and dealing in securities—which they were permitted to do anyway because they were never subject to Glass-Steagall—but from buying and holding mortgage-backed securities for investment. When these securities declined in value during the financial crisis period, all of these firms were seriously weakened and Lehman Brothers failed.

In other words, the large securities firms and the large banks were both victims of the same activity—buying and holding for investment large amounts of mortgage-backed securities that fell significantly in value during what is known as the mortgage meltdown. Both were permitted to engage in this activity *before and after* the partial repeal of Glass-Steagall by the GLBA in 1999. Thus, it is possible to conclude without much question that GLBA's repeal of the affiliation provisions of the Glass-Steagall Act had no effect whatsoever on the financial crisis.

Indeed, if the GLBA had never been adopted, and Glass-Steagall had remained fully in effect, the financial crisis (except for the rescue of Bear Stearns) would have occurred exactly as it did. Let me correct that slightly. Without the amendment to Glass-Steagall, JP Morgan Chase could never have been able to acquire Bear Stearns in a Fed-finance, as the system was starting to unravel in March 2008. If you think that was a good thing, then you should be grateful for the repeal of the Glass-Steagall affiliation provisions. But if, as I do, you see that as the original sin—the reason for the chaos when Lehman was allowed to fail six months later—you might have a different view.

17. Peter J. Wallison, *Five Myths About Glass-Steagall*, AMERICAN, Aug. 16, 2012, www.american.com/archive/2012/august/five-myths-about-glass-steagall.

II. SHOULD GLASS-STEAGALL BE RESTORED?

Although the partial repeal of Glass-Steagall had no role in causing the losses that gave rise to the financial crisis, there still might be reasons to restore it. All the major securities firms—Goldman, Morgan Stanley, Merrill Lynch, Lehman Brothers and Bear Stearns are now either gone (like Lehman), are subsidiaries of banks (like Bear and Merrill), or are bank holding companies regulated by the Fed (like Goldman and Morgan Stanley).¹⁸ The likelihood is that they will no longer be the risk-takers they once were. Some may see this as good news, believing that risk-taking by large financial firms is what caused the financial crisis.

This, I think, is incorrect. The financial crisis was caused by U.S. government housing policy, implemented principally through the government-sponsored enterprises Fannie Mae and Freddie Mac, which forced the degrading of mortgage underwriting standards in order to spur home ownership by low and moderate income families.¹⁹ “[B]y 2008, half of all mortgages in the United States—28 million loans—were subprime or otherwise weak.”²⁰ Of this 28 million, “74 percent were on the books of government agencies” like Fannie and Freddie or Federal Housing Administration, showing incontrovertibly where the demand for these low quality loans originated.²¹ When these mortgages began to default in unprecedented numbers, it weakened all financial institutions that held them and caused the financial crisis.²²

Risk-taking is the father of innovation, competition, and change. That is as true in finance as it is in technology or pharmaceuticals. Bank holding companies, as regulated entities, are not risk-takers, so turning both securities and banking functions over to them—as has now happened—could slow economic growth. This is the most powerful argument for reinstating Glass-Steagall—not that it will prevent another crisis, but because separating securities firms from banks will encourage more risk-taking.

I don’t believe that this is the right way to look at the issue. Deposit banking as a business is in trouble over the long term. It cannot compete with the securities markets in financing business corporations.

18. Daniel Gross, *Morgan Stanley Retreats from Investment Banking and Trading*, DAILY BEAST (Jan. 11, 2013, 4:45 AM), <http://www.thedailybeast.com/articles/2013/01/11/morgan-stanley-retreats-from-investment-banking-and-trading.html>, archived at <http://perma.cc/C7XS-CZAX>.

19. See Peter J. Wallison, *Government Housing Policy and the Financial Crisis*, 30 CATO J. 397 (2010), object.cato.org/sites/cato.org/files/serials/files/cato-journal/2010/5/cj30n2-12.pdf.

20. Peter J. Wallison & Edward J. Pinto, *Wallison and Pinto: New Qualified Mortgage Rule Setting Us Up for Another Meltdown*, WASH. TIMES, Mar. 3, 2013, <http://www.washingtontimes.com/news/2013/mar/3/wallison-and-pinto-new-qualified-mortgage-rule-set/?page=all>, archived at <http://perma.cc/V6QL-4JHG>.

21. *Id.*

22. *Id.*

In 2012, JPMorgan Chase, the largest of the big Wall Street bank holding companies, earned only forty-six percent of its revenue from lending activities.²³ The balance, fifty-four percent, came from other businesses, including securities.²⁴ This disparity has been growing over time.²⁵

The right policy, then, is the one originated by the Treasury in 1981 and adopted in the GLBA in 1999, to open up the range of permissible activity to bank holding companies, so they can follow the changes in a constantly changing market for financial services. Cutting them off from securities activity would have the opposite effect—isolating these large institutions as white elephants, consigned to a fringe area of the market, and gradually losing profitability as competitors innovate around them.

The question is whether bank holding companies, now active in the securities business, will come to dominate all of finance, especially after most of their competition has been either eliminated or fallen under the dead hand of the Fed.²⁶ This is a matter of serious concern.

However, I believe that among the thousands of securities firms that operate in today's market there are many that will grow to take the place of the large independent securities firms that were decimated by the 2008 financial panic. After all, the pattern we see repeated in our economy is a constant turnover in the firms that dominate a market.²⁷ Microsoft, for example, was once so dominant that there were calls for breaking it up.²⁸ Now, it is struggling to hold its position against competition from Apple and Google, which in turn are struggling to fend off competition from Samsung and Facebook.²⁹ This is how it will always be as long as we allow a free rein to competition and there are independent sources of equity finance always looking for profit.

23. JPMORGAN CHASE & CO., ANNUAL REPORT 188-89 (2012).

24. *Id.*

25. *Id.*

26. See Donna Harris, *Ally's Chief Says Bank Holding Companies Will Dominate*, AUTOMOTIVE NEWS (Feb. 2, 2011, 12:23 PM), <http://www.autonews.com/article/20110202/BLOG14/110209946/ally%E2%80%99s-chief-says-bank-holding-companies-will-dominate#axzz2g31ADVhT>, archived at <http://perma.cc/GSP3-FZ9P>.

27. *Banking Study*, *supra* note 10, at 6-14.

28. Adam Hartung, *Microsoft Still Can't Find Its Future. Is It Too Late for the Company?*, FORBES (Jan. 20, 2013, 1:38 PM), <http://www.forbes.com/sites/adamhartung/2013/01/20/sell-microsoft-now-game-over-ballmer-loses/>, archived at <http://perma.cc/QTC6-TFCY>.

29. *Id.*