Glass–Steagall Legislation

This article is about four specific provisions of the Banking Act of 1933, which is also called the Glass-Steagall Act.

The term Glass–Steagall Act usually refers to four provisions of the U.S. Banking Act of 1933 that limited commercial bank securities activities and affiliations within commercial banks and securities firms. Congressional efforts to “repeal the Glass–Steagall Act” referred to those four provisions (and then usually to only the two provisions that restricted affiliations between commercial banks and securities firms). Those efforts culminated in the 1999 Gramm–Leach–Bliley Act (GLBA), which repealed the two provisions restricting affiliations between banks and securities firms.

The term Glass–Steagall Act is also often used to refer to the entire Banking Act of 1933, after its Congressional sponsors, Senator Carter Glass (D) of Virginia, and Representative Henry B. Steagall (D) of Alabama. This article deals with only the four provisions separating commercial and investment banking. The article 1933 Banking Act describes the entire law, including the legislative history of the Glass-Steagall provisions separating commercial and investment banking. A separate 1932 law also known as the Glass–Steagall Act is described in the article Glass–Steagall Act of 1932.

Starting in the early 1960s federal banking regulators interpreted provisions of the Glass–Steagall Act to permit commercial banks and especially commercial bank affiliates to engage in an expanding list and volume of securities activities. By the time the affiliation restrictions in the Glass–Steagall Act were repealed through the GLBA, many commentators argued Glass–Steagall was already “dead.” Most notably, Citibank’s 1998 affiliation with Salomon Smith Barney, one of the largest US securities firms, was permitted under the Federal Reserve Board’s then existing interpretation of the Glass–Steagall Act. President Bill Clinton publicly declared "the Glass–Steagall law is no longer appropriate."

Many commentators have stated that the GLBA’s repeal of the affiliation restrictions of the Glass–Steagall Act was an important cause of the late-2000s financial crisis. Some critics of that repeal argue it permitted Wall Street investment banking firms to gamble with their depositors’ money that was held in affiliated commercial banks. Others have argued that the activities linked to the financial crisis were not prohibited (or, in most cases, even regulated) by the Glass–Steagall Act. Commentators, including former President Clinton in 2008 and the American Bankers Association in January 2010, have also argued that the ability of commercial banking firms to acquire securities firms (and of securities firms to convert into bank holding companies) helped mitigate the financial crisis.

The sponsors

The sponsors of both the Banking Act of 1933 and the Glass-Steagall Act of 1932 were southern Democrats: Senator Carter Glass of Virginia (who in 1932 had been in the House, Secretary of
the Treasury, or in the Senate, for the preceding 30 years), and Representative Henry B. Steagall of Alabama (who had been in the House for the preceding 17 years).

Legislative history of the Glass–Steagall Act

The article on the 1933 Banking Act describes the legislative history of that Act, including the Glass–Steagall provisions separating commercial and investment banking. As described in that article, between 1930 and 1932 Senator Carter Glass (D-VA) introduced several versions of a bill (known in each version as the Glass bill) to regulate or prohibit the combination of commercial and investment banking and to establish other reforms (except deposit insurance) similar to the final provisions of the 1933 Banking Act. On June 16, 1933, President Roosevelt signed the bill into law. Glass originally introduced his banking reform bill in January 1932. It received extensive critiques and comments from bankers, economists, and the Federal Reserve Board. It passed the Senate in February 1932, but the House adjourned before coming to a decision. The Senate passed a version of the Glass bill that would have required commercial banks to eliminate their securities affiliates. The final Glass–Steagall provisions contained in the 1933 Banking Act reduced from five years to one year the period in which commercial banks were required to eliminate such affiliations. Although the deposit insurance provisions of the 1933 Banking Act were very controversial, and drew veto threats from President Franklin Delano Roosevelt, President Roosevelt supported the Glass–Steagall provisions separating commercial and investment banking, and Representative Steagall included those provisions in his House bill that differed from Senator Glass’s Senate bill primarily in its deposit insurance provisions. Steagall insisted on protecting small banks while Glass felt that small banks was the weakness to U.S. banking.

As described in the 1933 Banking Act article, many accounts of the Act identify the Pecora Investigation as important in leading to the Act, particularly its Glass–Steagall provisions, becoming law. While supporters of the Glass–Steagall separation of commercial and investment banking cite the Pecora Investigation as supporting that separation, Glass–Steagall critics have argued that the evidence from the Pecora Investigation did not support the separation of commercial and investment banking.

This source states that Senator Glass proposed many versions of his bill to Congress known as the Glass Bills in the two years prior to the Glass-Steagall Act being passed. It also includes how the deposit insurance provisions of the bill were very controversial at the time, which almost led to the rejection of the bill once again.

The previous Glass Bills before the final revision all had similar goals and brought up the same objectives which were to separate commercial from investment banking, bring more banking activities under Federal Reserve supervision and to allow branch banking. In May 1933 Steagall’s addition of allowing state chartered banks to receive federal deposit insurance and shortening the time in which banks needed to eliminate securities affiliates to one year was known as the driving force of what helped the Glass-Steagall act to be signed into law.
The Glass–Steagall provisions separating commercial and investment banking

The Glass–Steagall separation of commercial and investment banking was in four sections of the 1933 Banking Act (sections 16, 20, 21, and 32). The Banking Act of 1935 clarified the 1933 legislation and resolved inconsistencies in it. Together, they prevented commercial Federal Reserve member banks from:

- dealing in non-governmental securities for customers
- investing in non-investment grade securities for themselves
- underwriting or distributing non-governmental securities
- affiliating (or sharing employees) with companies involved in such activities

Conversely, Glass-Steagall prevented securities firms and investment banks from taking deposits.

The law gave banks one year after the law was passed on June 16, 1933 to decide whether they would be a commercial bank or an investment bank. Only 10 percent of a commercial bank's income could stem from securities. One exception to this rule was that commercial banks could underwrite government issued bonds.

There were several “loopholes” that regulators and financial firms were able to exploit during the lifetime of Glass-Steagall restrictions. Aside from the Section 21 prohibition on securities firms taking deposits, neither savings and loans nor state charted banks that did not belong to the Federal Reserve System were restricted by Glass-Steagall. Glass-Steagall also did not prevent securities firms from owning such institutions. S&Ls and securities firms took advantage of these loopholes starting in the 1960s to create products and affiliated companies that chipped away at commercial banks' deposit and lending businesses.

While permitting affiliations between securities firms and companies other than Federal Reserve member banks, Glass-Steagall distinguished between what a Federal Reserve member bank could do directly and what an affiliate could do. Whereas a Federal Reserve member bank could not buy, sell, underwrite, or deal in any security except as specifically permitted by Section 16, such a bank could affiliate with a company so long as that company was not “engaged principally” in such activities. Starting in 1987, the Federal Reserve Board interpreted this to mean a member bank could affiliate with a securities firm so long as that firm was not “engaged principally” in securities activities prohibited for a bank by Section 16. By the time the GLBA repealed the Glass-Steagall affiliation restrictions, the Federal Reserve Board had interpreted this “loophole” in those restrictions to mean a banking company (Citigroup, as owner of Citibank) could acquire one of the world’s largest securities firms (Salomon Smith Barney), as described in the article Glass–Steagall: decline.

By defining commercial banks as banks that take in deposits and make loans and investment banks as banks that underwrite and deal with securities the Glass Steagall act explained the
separation of banks by stating that commercial banks could not deal with securities and investment banks could not own commercial banks or have close connections with them. With the exception of commercial banks being allowed to underwrite government issued bonds, commercial banks could only have ten percent of their income come from securities.

The Glass Steagall Legislation page specifies that only Federal Reserve member banks were affected by the provisions which according to secondary sources the act “applied direct prohibitions to the activities of certain commercial banks

**Glass–Steagall decline & effective repeal**

It was not until during 1933 that the separation of commercial bank and investment bank was considered controversial. There was a belief that the separation would lead to a healthier financial system. Later on, over the years the separation became controversial. By 1935 Senator Glass himself attempted to “repeal” the prohibition on direct bank underwriting by permitting a limited amount of bank underwriting of corporate debt.

In the 1960s the Office of the Comptroller of the Currency issued aggressive interpretations of Glass–Steagall to permit national banks to engage in certain securities activities. Although most of these interpretations were overturned by court decisions, by the late 1970s bank regulators began issuing Glass–Steagall interpretations that were upheld by courts and that permitted banks and their affiliates to engage in an increasing variety and amount of securities activities. Starting in the 1960s banks and non-banks developed financial products that blurred the distinction between banking and securities products, as they increasingly competed with each other.

Separately, starting in the 1980s Congress debated bills to repeal Glass–Steagall’s affiliation provisions (Sections 20 and 32). In 1999 the Gramm–Leach–Bliley Act repealed those provisions.

These and other developments are described in detail in the main article, Glass–Steagall: decline, under the following topic headings:

- Glass–Steagall developments from 1935 to 1991
  - Senator Glass’s “repeal” effort
  - Comptroller Saxon’s Glass–Steagall interpretations
  - 1966 to 1980 developments
    - Increasing competitive pressures for commercial banks
    - Limited congressional and regulatory developments
  - Reagan Administration developments
    - State non-member bank and nonbank bank “loopholes”
    - Legislative response
    - International competitiveness debate
    - 1987 status of Glass–Steagall debate
  - Section 20 affiliates
  - Greenspan-led Federal Reserve Board
  - 1991 Congressional action and “firewalls”
• 1980s and 1990s bank product developments
  ▪ Securitization, CDOs, and “subprime” credit
  ▪ ABCP conduits and SIVs
  ▪ OTC derivatives, including credit default swaps

• Glass–Steagall development from 1995 to Gramm–Leach–Bliley Act
  o Leach and Rubin support for Glass–Steagall “repeal”; need to address “market realities”
  o Status of arguments from 1980s
  o Failed 1995 Leach bill; expansion of Section 20 affiliate activities; merger of Travelers and Citicorp
  o 1997-98 legislative developments: commercial affiliations and Community Reinvestment Act
  o 1999 Gramm–Leach–Bliley Act, eliminating legal barriers between commercial banks, investment banks, securities firms, and insurance companies

One of the most significant weaknesses of the act was the restrictions put on the separation of the investment and commercial banking, it prohibited the bank underwriting. Due to the restrictions put on banks for underwriting securities, some banks could not keep up with their competition, so a repeal for the act was put on. The repeal included many things but the most important was the repeal of separation of investment and commercial banking and the limited of underwriting securities.

That an appeal was necessary because banks were losing their competition, also by allowing banks to underwrite securities, it would allow to create a better relationship with customers and help maintain a customer loyalty to the bank. Also, by having investment and banking activities operate in the same institution, it would make the industry more credible because of diversification.

Aftermath of repeal

Because the Federal Reserve’s interpretations of Glass–Steagall Sections 20 and 32 had weakened those restrictions, commentators did not find much significance in the repeal of those sections. Instead, the five year anniversary of their repeal was marked by numerous sources explaining that the GLBA had not significantly changed the market structure of the banking and securities industries. More significant changes had occurred during the 1990s when commercial banking firms had gained a significant role in securities markets through “Section 20 affiliates.”

After the financial crisis of 2007–08, however, many commentators argued that the repeal of Sections 20 and 32 had played an important role in leading to the crisis. Other commentators argued that the repeal had helped end, or mitigate, the crisis.

The main article on this subject, Glass–Steagall: Aftermath of repeal, has sections on:

• Commentator response to Section 20 and 32 repeal
• Financial industry developments after repeal of Sections 20 and 32
Glass–Steagall “repeal” and the financial crisis

It also mentions that in the 1960’s the Office of the Comptroller of the Currency made the Glass Steagall Act allow national banks to engage in a variety amount of securities activities. In the essay by Neely, from the federal reserve history website, she also mentions the important information presented above but expanded with it more. For example, she expands on what banks can underwrite which includes commercial paper, mortgage-backed securities, equity and corporate debt as long as these contribute to a small percentage of their affiliate’s revenue. She also adds that the Office of the Comptroller of the Currency allows banks to engage in mutual fund related activities including discount brokerage services.

Glass Steagall in post-financial crisis reform debate

Following the financial crisis of 2007-08, legislators unsuccessfully tried to reinstate Glass–Steagall Sections 20 and 32 as part of the Dodd–Frank Wall Street Reform and Consumer Protection Act. Currently, bills are pending in United States Congress that would revise banking law regulation based on Glass–Steagall inspired principles. Both in the United States and elsewhere banking reforms have been proposed that also refer to Glass–Steagall principles. These proposals raise issues that were addressed during the long Glass–Steagall debate in the United States, including issues of “ring fencing” commercial banking operations and “narrow banking” proposals that would sharply reduce the permitted activities of commercial banks.

Please see the main article, Glass–Steagall in post-financial crisis reform debate, for information about the following topics:

- Failed 2009-10 efforts to restore Glass–Steagall Sections 20 and 32 as part of Dodd–Frank
- Post-2010 efforts to enact Glass–Steagall inspired financial reform legislation
- Volcker Rule ban on proprietary trading as Glass–Steagall lite
- Further financial reform proposals that refer to Glass–Steagall
  - UK and EU “ring fencing” proposals
    - Similar issues debated in connection with Glass–Steagall and “firewalls”
  - Limited purpose banking and narrow banking
    - Wholesale financial institutions in Glass–Steagall reform debate
  - Glass–Steagall references in reform proposal debate

Source: http://en.wikipedia.org/wiki/Glass–Steagall_Act
April, 2014