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Taming the Megabanks: Why We Need a New Glass-Steagall Act

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The FinReg Blog (Global Financial Markets Center, Duke University School of Law, Sept. 24, 2020), available at https://sites.law.duke.edu/thefinregblog/2020/09/24/taming-the-megabanks-why-we-need-a-new-glass-steagall-act/

Arthur E. Wilmarth, Jr.

Banks became major participants in U.S. securities markets twice in the past century – during the 1920s and after the mid-1990s. Both times, banks with "universal banking" powers originated risky loans and packaged them into securities that were sold to investors around the world. Both times, universal banks promoted unsustainable credit booms that led to destructive busts – the Great Depression of the early 1930s and the Great Recession of 2007-09. Both times, governments arranged costly bailouts of universal banks.

Congress passed the Glass-Steagall Act of 1933 in response to the Great Depression. The Glass-Steagall Act separated banks from the securities markets. It established a decentralized financial system consisting of three independent sectors: banking, securities, and insurance. That system was stable and successful for more than four decades. However, regulators opened loopholes in Glass-Steagall beginning in the 1980s, and Congress repealed the Act in 1999. The undermining and repeal of Glass-Steagall precipitated the subprime mortgage boom of the 2000s.

Congress did not adopt a new Glass-Steagall Act after the Great Recession. Instead of adopting fundamental structural reforms, Congress passed the Dodd-Frank Act. Dodd-Frank tried to make financial institutions safer by instituting a series of technical reforms. However, Dodd-Frank left in place a dangerously unstable financial system dominated by universal banks

and “shadow banks,” including private equity firms, hedge funds, and other large asset managers.

In my forthcoming book, *Taming the Megabanks: Why We Need a New Glass-Steagall Act* (Oxford University Press, 2020), I argue that universal banks are inherently dangerous because they promote destructive boom-and-bust cycles. Universal banks generate those toxic cycles for three reasons. First, universal banks use low-cost, government-protected deposits to fund risky loans. They bundle those loans into asset-backed securities, which they sell as supposedly “safe” investments. The ability of universal banks to earn lucrative fees from originating and securitizing loans encourages them to pursue reckless lending and securitization strategies.

Second, the wide-ranging activities of universal banks – including deposit-taking, lending, securities underwriting and trading – generate hazardous conflicts of interest. Universal banks have powerful financial incentives to sell and trade in the asset-backed securities and other financial instruments they underwrite through their capital markets units. Universal banks also have strong reasons to extend credit to support their underwriting and trading activities. Conflicts of interest destroy the ability of universal banks to act as prudent, objective lenders or as impartial investment advisers.

Third, universal banks adopt incentive compensation plans that encourage the pursuit of short-term profits. The bonus-heavy compensation plans of universal banks promote speculative lending, underwriting, and trading, which in turn produce dangerous credit booms. Credit booms frequently lead to severe busts and prolonged economic recessions. Governments must pay a very high price to counteract those busts.

Taming the Megabanks contends that we must adopt a new Glass-Steagall Act to separate banks from securities markets. A new Glass-Steagall Act would restore financial stability and ensure that our financial system serves Main Street business firms and consumers instead of Wall Street speculators. Universal banks would be broken up and would no longer dominate our financial system. Shadow banks would shrink substantially because they could no longer fund their activities by offering short-term financial instruments that function as substitutes for deposits. A more decentralized and competitive financial system would provide better services to commerce, industry, and society.

The rise of first-generation universal banks and their involvement in the Great Depression

Chapter 1 of the book describes how large U.S. commercial banks took advantage of regulatory loopholes and created universal banking organizations before World War I. Universal banks were very successful in selling war bonds during the Great War, and they greatly expanded their securities activities during the 1920s.

As discussed in Chapters 2 and 3, universal banks competed with private investment banks to underwrite risky domestic and foreign loans during the 1920s. Universal banks and investment banks packaged those loans into bonds, which were sold to investors in America and around the globe. Universal banks and investment banks also competed to sell speculative stocks to American and overseas investors. Competition between universal banks and investment banks produced an enormous credit boom, which fueled dangerous bubbles in real estate and securities markets.

Chapter 4 describes the collapse of U.S. securities and real estate markets after the Great Crash of October 1929. The collapse of both markets inflicted grievous losses on borrowers, investors, universal banks, and investment banks. Plummeting values of securities and real estate

triggered widespread loan defaults, as well as steep drops in household consumption and business investment. The resulting economic slump destroyed millions of jobs and paved the way for the Great Depression.

As explained in Chapter 5, financial upheavals in the U.S. spread to Europe and Latin America, where many governments and businesses depended on loans from American bankers. Universal banks and investment banks financed those loans by selling foreign bonds to American and overseas investors during the 1920s. The sudden shutdown of the foreign bond market in the early 1930s and the resulting disruption of international credit flows precipitated systemic banking crises in Austria, Germany, Italy, Belgium, and other European nations. Universal banks dominated the financial systems of most European countries, and widespread failures among those banks triggered severe economic downturns.

Similarly, a dozen leading American universal banks failed or were bailed out during U.S. banking crises that occurred between 1930 and 1933. Universal banks in the U.S. and Europe were highly vulnerable because problems in the securities markets and the general economy quickly spilled over into these banks' investment and loan portfolios. In contrast, Britain and Canada did not experience systemic banking crises during the Great Depression. The structural separation of commercial banks from securities markets in Britain and Canada was an important factor that provided greater resilience to their banking and financial systems during the 1930s.

The enactment and successful operation of the Glass-Steagall Act

As described in Chapter 6, Congress responded to the Great Depression by passing the Glass-Steagall Act of 1933. The Glass-Steagall Act broke up universal banks to prevent a recurrence of the boom-and-bust cycle that led to the Great Depression. Banks were compelled

to divest their securities operations, and nonbanks were prohibited from accepting deposits. The Glass-Steagall Act also established a federal deposit insurance program, which greatly reduced the threat of bank failures from depositor runs.

The Glass-Steagall Act made the U.S. financial system more stable and less vulnerable to contagion by dividing the financial system into independent sectors with clearly defined legal boundaries. The statute also eliminated the destructive conflicts of interest and excessive risk-taking that universal banks displayed during the 1920s. Glass-Steagall's supporters concluded that banks could not act as prudent, objective lenders or as impartial investment advisers if they were allowed to underwrite and trade in securities other than government bonds.

As discussed in Chapter 7, Glass-Steagall's decentralized system of independent financial sectors prospered from the end of World War II through the 1970s. During that period, no major financial crises occurred, even though the financial system faced significant challenges from rising inflation and volatile currency exchange rates. An important reason for that era's financial stability was that problems arising in one sector of the financial system were much less likely to spread to other sectors. Regulators could address financial disruptions with targeted responses that did not require massive bailouts of the entire financial system. In addition, regulators could encourage financial institutions in one sector to help troubled institutions in another sector.

The destruction of Glass-Steagall's prudential buffers and the subprime mortgage boom that led to the Great Recession

Despite Glass-Steagall's successful record, the largest U.S. banks waged a twenty-year campaign to undermine and repeal it. During the 1980s and 1990s, federal agencies and courts opened loopholes that allowed banks to conduct a widening array of securities and insurance activities. Meanwhile, the biggest U.S. securities firms became shadow banks as regulators allowed them to offer short-term financial instruments, including money market mutual funds

and securities repurchase agreements (repos). Those financial instruments functioned as deposit substitutes because they permitted holders to obtain repayment at par (100% of the amount invested) on demand.

As explained in Chapter 8, the big-bank lobby persuaded Congress to repeal Glass-Steagall's core provisions in 1999. The repeal of Glass-Steagall allowed banks to create universal banking organizations by affiliating with securities firms and insurance companies. The United Kingdom (U.K.) and the European Union (EU) also deregulated their financial sectors during the 1980s and 1990s. By the early 2000s, a group of large universal banks dominated financial markets on both sides of the Atlantic.

As described in Chapters 9 and 10, universal banks played leading roles in the subprime lending boom that led to the global financial crisis of 2007–09. Universal banks packaged trillions of dollars of high-risk mortgage loans into mortgage-backed securities, which were sold as "safe" securities to investors around the world. The five largest U.S. securities firms were also major participants in the subprime lending and securitization surge, and they became de facto universal banks by offering short-term deposit substitutes to fund a growing portion of their operations.

The subprime lending and securitization wave of the 2000s resembled the credit boom of the 1920s in many ways, including the presence of widespread conflicts of interest and excessive risk-taking. The "assembly line" that packaged subprime mortgages into mortgage-backed securities created conflicts of interest for loan brokers, lenders, loan servicers, securities underwriters, credit ratings agencies, and issuers of financial guarantees. All of those participants received lucrative fees that encouraged them to ignore the obvious risks posed by subprime mortgages and mortgage-backed securities. Universal banks had the most pervasive conflicts of

interest because they performed multiple roles, received multiple fees, and had the strongest incentives to disregard risks.

The subprime assembly line relied on a continuing stream of credit from lenders and investors to finance subprime mortgages. That flow of credit depended on the widely-shared assumption that U.S. housing prices would keep rising, thereby enabling subprime borrowers to avoid defaults by refinancing their mortgages or selling their homes.

In 2007, the flow of credit into subprime mortgages shut down after U.S. housing prices stopped rising and began to fall. As explained in Chapter 10, the collapse of the subprime mortgage market and declining home prices precipitated a wave of defaults by subprime borrowers. Those defaults inflicted huge losses on universal banks, securities firms, and other financial institutions with large exposures to subprime mortgages and mortgage-backed securities. Financial and economic crises ensued on both sides of the Atlantic. The boom-and-bust cycle of the 2000s bore a striking similarity to the destructive cycle of the 1920s and early 1930s. Universal banks played leading roles in both cycles and were at the center of the calamities that followed.

Responses by governments and central banks to the global financial crisis

Chapter 11 describes the enormous bailout programs that the U.S., U.K., and EU established to prevent the global financial crisis from causing a second Great Depression. Those programs provided over $12 trillion of capital infusions, guarantees, and emergency loans to financial institutions. The U.S., U.K., and EU bailed out troubled universal banks and large shadow banks, with the prominent exception of Lehman Brothers. They also rescued holders of short-term financial instruments issued by shadow banks, even though shadow banks were not regulated as banks and the deposit substitutes they issued were not protected by deposit

insurance. The U.S., U.K., and EU effectively wrapped their safety nets around their entire financial systems, going far beyond their traditional practice of protecting banks and bank depositors.

Governments on both sides of the Atlantic assumed very heavy debt burdens to rescue their financial sectors and implement fiscal stimulus programs that mitigated the economic and social fallout of the Great Recession. Despite those programs, many thousands of businesses failed, millions of workers lost their jobs, and millions of families lost their homes.

Central banks supported government rescue efforts by cutting short-term interest rates to zero and below. Central banks also adopted quantitative easing (QE) programs, which pushed down longer-term interest rates by purchasing huge amounts of government bonds, mortgage-backed bonds, and other debt securities. The central banks of the U.S., U.K., EU, and Japan expanded their balance sheets from $4 trillion to $15 trillion between 2007 and 2018. By reducing interest rates, QE programs provided relief to debtors and allowed governments to issue bonds with lower yields and lower costs. However, many observers warned that central banks were exceeding their mandates and risking their political independence.

Post-crisis reforms and the systemic dangers posed by universal banks and shadow banks

Unlike the Great Depression, the Great Recession did not result in fundamental changes to the financial systems of most developed nations. In 2009, as described in Chapter 12, the U.S. and other members of the Group of 20 (G20) nations agreed on a reform agenda that largely preserved the status quo. Instead of proposing structural changes to financial institutions and markets, the G20 recommended technical reforms to improve the effectiveness of financial regulation. Those reforms included higher capital and liquidity requirements for banks and better procedures for dealing with failures of systemically important financial institutions.

Congress adopted most of the G20's recommendations when it passed the Dodd-Frank Act. At the same time, the Obama administration and most members of Congress rejected fundamental structural reforms. They defeated proposals to break up the largest banks, and they did not seriously consider the possibility of adopting a new Glass-Steagall Act.

The impetus for financial reform weakened as memories of the financial crisis faded. The Obama administration failed to implement some of Dodd-Frank's important mandates before President Obama's second term ended in January 2017. The Trump administration repealed or undermined several of Dodd-Frank's key reforms. Reform efforts also lost much of their momentum in the U.K. and the EU after 2016.

Post-crisis reforms have left in place a "global doom loop," in which (1) governments and central banks ensure the stability of financial markets and provide "too-big-to-fail" guarantees to universal banks and large shadow banks, (2) universal banks and large shadow banks underwrite rising levels of public-sector and private-sector debts with support from the easy-money policies of central banks, and (3) investors and creditors take speculative risks because they expect that governments and central banks will intervene when necessary to stabilize financial markets and prevent failures of universal banks and large shadow banks. The global doom loop has created a hazardous web of mutual dependence among governments, central banks, universal banks, shadow banks, and financial markets.

Central banks have supported the global doom loop by maintaining ultra-low interest rates and injecting trillions of dollars of liquidity into financial markets. Central bank policies have enabled universal banks and shadow banks to underwrite record levels of debt for corporations, households, and governments. Worldwide private-sector and public-sector debts

increased by more than 50% between 2007 and 2020. In March 2020, the ratio of global debts to global GDP reached 331%, an all-time high.[1]

Taming the Megabanks was completed before the Covid-19 pandemic caused the world's current economic crisis. Governments have responded to that crisis by authorizing $11 trillion of fiscal stimulus programs. Those outlays will cause worldwide sovereign debt burdens to exceed 100% of global GDP by 2021, surpassing the record set during World War II. Central banks have expanded their balance sheets by purchasing $6 trillion of government bonds, corporate debt, and other assets during the pandemic.[2]

The pandemic-induced economic crisis confirms that governments and central banks remain hostages to the fate of universal banks and shadow banks. Government and central banks have responded to the pandemic by employing the same strategies they adopted during the global financial crisis of 2007–09, but at a faster pace and with an even broader scope. Central banks have again been forced to act as "market makers of last resort" by providing massive infusions of liquidity to ensure the stability of financial markets and the survival of financial giants. Indeed, governments and central banks have broken new ground by providing unprecedented support for corporate bond markets, thereby revealing the dangerous overhang of corporate debt that universal banks and shadow banks underwrote during the past decade.

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[1] International Institute of Finance, *Global Debt Monitor* (July 16, 2020) (reporting that total global debts reached $258 trillion in March 2020, amounting to 331% of global GDP), available at https://www.iif.com/Portals/0/Files/content/Research/Global%20Debt%20Monitor_July2020.pdf?; Satyajit Das, "The World Will Pay for Not Dealing with Debt," *Sydney Morning Herald* (Dec. 24, 2018) (reporting that total global debts were $167 trillion in 2007), available at https://www.smh.com.au/business/markets/the-world-will-pay-for-not-dealing-with-debt-20181224-p50o2m.html.

[2] International Monetary Fund, *Global Financial Stability Report Update* (June 2020), at 2-4, available at https://www.imf.org/en/Publications/GFSR/Issues/2020/06/25/global-financial-stability-report-june-2020-update; International Monetary Fund, *World Economic Outlook Update* (June 2020), at 16-17, available at https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020.

The urgent need for a new Glass-Steagall Act

Our current financial system has trapped the world in an infernal cycle of debt-fueled booms followed by painful busts, which governments and central banks must "contain" through extraordinary interventions. Each new intervention creates a greater sense of complacency among investors, thereby promoting an even larger and more threatening boom. Sooner or later, governments and central banks will fail in their efforts to "contain" the explosion after a future boom, and that failure could cause another Great Depression.

To break this destructive cycle and restore financial stability, we must adopt a new Glass-Steagall Act. As explained in the Conclusion of *Taming the Megabanks*, a new Glass-Steagall Act would prevent banks from using government-protected deposits to finance speculative trading in the capital markets. It would prohibit banks from underwriting securities other than government bonds. It would bar nonbanks from offering short-term financial instruments (like money market mutual funds and repos) that function as "deposits" but are not subject to the requirements of deposit insurance and other prudential banking regulations.

A new Glass-Steagall Act would greatly improve financial stability. It would reestablish risk buffers that prevent contagion across financial sectors. It would improve market discipline by stopping banks from transferring their public subsidies to affiliates engaged in capital market activities. Regulators would no longer be forced to prop up securities markets because of concerns about massive securities exposures held by banks. Shadow banks would shrink substantially, as they could no longer fund their operations with short-term financial instruments.

A new Glass-Steagall Act would create a more diverse and competitive banking system by breaking up universal banks. It would enable bank regulators to monitor and control levels of short-term claims in financial markets because those claims could be issued only by banks.

Banks would return to their traditional roles of providing deposit, credit, fiduciary, and payment services to businesses and consumers. Banks would have much stronger incentives to serve all segments of business and society, instead of focusing their attention on Wall Street speculators, multinational corporations, and wealthy investors.

Securities markets would again become true markets because they would no longer be linked to the fortunes of too-big-to-fail universal banks and shadow banks. Our political, regulatory, and monetary policies would no longer be held hostage by giant financial conglomerates. Banks and securities firms would return to their proper roles as servants – not masters – of commerce, industry, and society.

In 1914, Louis Brandeis warned the American public, "We must break the Money Trust or the Money Trust will break us."[3] Congress acted on his advice in 1933 by enacting the Glass-Steagall Act. Brandeis' warning is just as timely today as it was in 1914 and 1933.

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[3] Louis Brandeis, *Other People's Money: And How the Bankers Use It* (1914), p. 137.