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Statement of the Shadow Financial Regulatory Committee on

Glass-Steagall and the Volcker Rule

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Recently, several commentators, including some prominent former banking executives and regulators, have expressed the view that the banking activities limits in the original 1933 Glass-Steagall Act should be reinstated. These statements have provoked an avalanche of comment about the benefits of separating commercial banking from securities underwriting and dealing. In addition, the Volcker Rule—which, because it restricts proprietary trading by banks, is seen by many people as a return of Glass-Steagall—has turned out to be a controversial provision of the Dodd-Frank Act. The Committee does not believe that Glass-Steagall should be reinstated, and sees no persuasive rationale for the Volcker Rule.

The 1999 partial "repeal" of Glass-Steagall in the Gramm-Leach-Bliley Act (GLBA) eliminated some restrictions on the ability of bank holding companies (BHCs) —but not insured banks—to engage in underwriting and dealing in securities. Although this also can be seen by some as permitting BHCs to take greater risks through securities activities, it had little if any effect on the problems banks and BHCs encountered in the 2008 financial crisis.

The commercial banks and parent holding companies that got into trouble in 2008 did so principally by acquiring and holding large amounts of mortgage-backed securities (MBS) that had pooled subprime and other low quality mortgages. Insured banks were always permitted under Glass-Steagall to acquire, and to buy and sell, MBS because these instruments were regarded as loans in securitized form. Similarly, the five largest investment banks that got into financial trouble in 2008—Bear Stearns, Lehman Brothers, Goldman Sachs, Morgan Stanley and Merrill Lynch—were not affiliated with insured commercial banks. They also got into trouble by holding the same MBS backed by subprime or low quality loans. Accordingly, since the crisis was not related to anything that would have been prevented by Glass-Steagall, nothing about the financial crisis would have been different if the GLBA's Glass-Steagall repeal had not been adopted.

Reinstating Glass-Steagall would prevent bank holding companies (BHCs) from engaging in securities underwriting and dealing. Since there is no indication that the partial repeal of Glass-Steagall in the GLBA was a proximate cause of the financial crisis, reinstating the Act's restrictions would unnecessarily weaken BHCs by reducing their ability to diversify without in any way protecting the safety net.

Dodd-Frank's Volcker rule—which prohibits insured commercial banks and their affiliates from engaging in what the rule calls "proprietary trading"—bears some superficial resemblance to Glass-Steagall but in some respects it is more restrictive and in other respects less so. It goes further than Glass-Steagall because it prohibits proprietary trading of all securities, except U.S. government debt securities, by all "bank-related entities." This is a broader prohibition than Glass-Steagall, which (before its amendment by the GLBA) prohibited banks and BHCs from underwriting and dealing in corporate debt and most municipal revenue bonds, but permitted banks and BHCs to trade in these instruments. Generally, "dealing" in a security means holding an inventory of securities to buy and sell with third parties, while "trading" involves buying and selling for advantageous investment or profit purposes. Thus, the Volcker rule imposes a more restrictive regime on banks and BHCs by prohibiting proprietary trading of all securities—foreign sovereign bonds, state and local bonds, and revenue bonds—except U.S. government securities. This restriction is likely to reduce the liquidity in the markets for these securities and thus raise financing costs.

The Volcker Rule goes less far than Glass-Steagall because it contains exceptions for underwriting, hedging and market making. In other words, although insured banks could not underwrite or deal in fixed income securities under Glass-Steagall, they can engage in underwriting, making markets and hedging under the Volcker Rule. The difference between proprietary trading and making markets, hedging and underwriting is extremely difficult to define clearly, especially in regulatory language, which explains why the Volcker Rule's implementation by the regulators has been delayed. In effect, the Volcker rule restricts all securities trading by commercial banks, BHCs and their nonbank affiliates to trading only for the account of customers, market-making, and their own hedging transactions. Since there is no evidence that proprietary trading played any significant role in the 2008 financial crisis, the Committee sees no persuasive argument in favor of the Volcker Rule's prohibitions on all trading within bank holding companies.

Proponents of the Volcker Rule believe that proprietary trading is speculative and a risky use of insured deposits in ways that impose undesirable risks on taxpayers. But the Volcker Rule also applies to BHCs and their nonbank affiliates which have limited or no access to either federally insured deposits or the Federal Reserve's discount window. In addition, The Committee notes that banks have ample ways to take large risks as the recent financial crisis and the role played by banks investments in mortgages and mortgage-related securities demonstrate.