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The Glass-Steagall Act: A Legal and Policy Analysis

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Summary

The phrase "Glass-Steagall" generally refers to the separation of commercial banking from investment banking. Congress effected a separation of commercial and investment banking through four sections of the Banking Act of 1933—Sections 16, 20, 21, and 32. These four statutory provisions are commonly referred to as the Glass-Steagall Act.

Key Takeaways of This Report

- The Glass-Steagall debate is not centered on prohibiting risky financial services; rather, the debate is about whether to permit inherently risky commercial and investment banking activities to be conducted within a single firm—specifically within firms holding federally insured deposits.
- Over the course of the nearly 70-year-long Glass-Steagall era, the clear-cut separation of traditional commercial banking and securities activities gradually eroded. This erosion was the result of a confluence of matters, including market changes, statutory changes, and regulatory and judicial interpretations.
- The Glass-Steagall era formally ended in 1999 when the Gramm-Leach-Bliley Act (GLBA) repealed the Glass-Steagall Act's restrictions on affiliations between commercial and investment banks.
- Less than a decade after GLBA, the United States suffered its worst financial crisis since the Great Depression. Some have argued that the partial repeal either was a cause of the financial crisis that resulted in the so-called Great Recession or that it fueled and worsened the crisis's deleterious effect. On the other hand, some policymakers argue that Glass-Steagall issues were not significant causes of the crisis, and that the Glass-Steagall Act would have made responding to the crisis more difficult if it had remained in place.
- The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act; P.L. 111-203) was Congress's primary legislative prescription to prevent a similar financial crisis in the future.
- The Dodd-Frank Act neither reinstated the sections of the Glass-Steagall Act that were repealed by GLBA nor substantially modified the ability of banking firms to affiliate with securities firms. It did, however, include some arguably Glass-Steagall-like provisions, which were designed to promote financial stability going forward, reduce various speculative activities of commercial banks, and reduce the likelihood that the U.S. government would have to provide taxpayer support to avert or minimize a future financial crisis.
- Some believe that a more effective way of accomplishing these policy objectives would be to fully reinstate the Glass-Steagall Act. In fact, multiple bills have been introduced in the 114th Congress with that stated purpose. These bills include: S. 1709/H.R. 3054, The 21st Century Glass-Steagall Act of 2015, and H.R. 381, the Return to Prudent Banking Act of 2015. On the other side of the policy discussion, some argue that the Glass-Steagall Act is ill-suited for the current financial system and that the recent financial crisis would have occurred even if GLBA had never partially repealed the Glass-Steagall Act.
- Even if the Dodd-Frank Act had completely re-enacted the repealed provisions of the Glass-Steagall Act, the financial history of the Glass-Steagall era shows that regulatory walls could be difficult to maintain or enforce.

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Introduction

The phrase "Glass-Steagall" generally refers to the separation of commercial banking from investment banking.[1] In this context, commercial banking refers to the activities engaged in by depository institutions,[2] which this report also will refer to as "banks" or "commercial banks." In contrast, investment banking refers to activities engaged in by securities dealers and brokerage firms, which this report also refers to as "investment banks" or "securities firms." Congress effected a separation of commercial and investment banking through four sections of the Banking Act of 1933—Sections 16, 20, 21, and 32—that were designed "to prevent the undue diversion of funds into speculative operations...."[3] These four statutory provisions are commonly referred to as the Glass-Steagall Act. Specifically, Section 21 prohibited nonbanks from accepting deposits, while Sections 16, 20, and 32 prohibited depository institutions from affiliating with securities firms and from engaging in certain securities activities.[4]

Although there is general consensus as to what the Glass-Steagall Act *refers*, there is less consensus regarding what "Glass-Steagall" truly *means*. This lack of consensus is the result of the confluence of factors and events that occurred during the nearly 70 years from when the Glass-Steagall Act was enacted until its partial repeal by the Gramm-Leach-Bliley Act[5] (GLBA) in 1999. These factors include statutory changes to both the four Glass-Steagall Act provisions and other laws that indirectly impacted the permissible securities activities of commercial banks; evolving interpretations of the Glass-Steagall Act by both federal administrative agencies and the courts; and changes in financial markets and economic conditions.

The Glass-Steagall policy debate focuses on the permissible activities of financial firms in light of the risks associated with those financial activities. Commercial banking (e.g., deposit-taking and lending) is inherently risky because depositors have the right to withdraw their funds on short notice and external events can cause widespread loan defaults, even if the loans were prudent when approved. Regulatory policies, such as deposit insurance and prudential requirements, can help limit the riskiness of commercial banking. Securities markets are inherently risky because securities prices are volatile. However, the exposure of a securities firm to price volatility primarily depends on the degree to which the securities firm has traded for its own account (proprietary trading) or otherwise contractually committed to the securities, rather than merely serving as the middleman for customers (whether buyers or issuers of securities). The Glass-Steagall debate is not centered on prohibiting risky financial services; rather, the debate is about

[1] Multiple pieces of legislation were named for Senator Carter Glass and Representative Henry Steagall, who led banking committees in Congress during the Depression. In a different context, the term Glass-Steagall might refer to the range of eligible collateral to be discounted by banks with the Federal Reserve, which was broadened by the "Glass Steagall Amendment" in 1932. Anti-Depression Legislation, American Institute of Banking, New York, 1933, pp. 57-60.

[2] There are several different types of depository charters: banks, thrifts, and savings associations. A depository charter can be issued by either a state or federal chartering authority. This report uses the terms "commercial bank," "bank," "depository," and "depository institution" interchangeably to generally refer to all of these different financial institutions with a depository charter.

[3] Act of June 16, 1933, 48 Stat. 162. The legislation included amendments to various banking laws relating to national banks, Federal Reserve Banks, and member banks.

[4] The association of the term Glass-Steagall with limitations on the permissible activities of banks is longstanding. *See, e.g.*, GAO Report GGD-88-37, *Bank Powers: Issues Related to Repeal of the Glass-Steagall Act*, January 1988, available at http://www.gao.gov/assets/210/209907.pdf.

[5] P.L. 106-102.

whether to permit inherently risky commercial and investment banking activities to be conducted within a single firm—specifically within firms holding federally insured deposits.

The United States suffered its worst financial crisis since the Great Depression less than one decade after GLBA formally repealed part of the Glass-Steagall Act. Some have argued that the partial repeal either was a cause of the financial crisis that resulted in the so-called Great Recession[6] or that it fueled and worsened the crisis's deleterious effect.[7] On the other hand, some policymakers argue that Glass-Steagall issues were not significant causes of the crisis,[8] and that the Glass-Steagall Act would have made responding to the crisis more difficult if it had remained in place.[9]

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)[10] was Congress's primary legislative prescription to prevent a similar financial crisis in the future. The Dodd-Frank Act neither reinstated the sections of the Glass-Steagall Act that were repealed by GLBA nor substantially modified the ability of depository institutions to affiliate with securities firms. It did, however, include some arguably Glass-Steagall-like provisions, which were designed to, among other things, address perceived inadequacies of the financial regulatory system at the time of the Great Recession so as to promote financial stability going forward; reduce various speculative activities of banks; and reduce the likelihood that the U.S. government would have to provide taxpayer support to avert or minimize a future financial crisis.

Some believe that a more effective way of accomplishing these policy objectives would be to fully reinstate the Glass-Steagall Act. In fact, multiple bills have been introduced in the 114th Congress with that stated purpose. These bills include: S. 1709/H.R. 3054, The 21st Century Glass-Steagall Act of 2015, and H.R. 381, the Return to Prudent Banking Act of 2015. The bills would attempt to restore Glass-Steagall in different ways, although none of them would simply re-enact the original Glass-Steagall statutory text that was repealed by GLBA. The divergent approaches of these bills to reach the same policy objectives reinforce the lack of consensus on what it actually means to "restore Glass-Steagall." Others argue that the Glass-Steagall Act is ill-suited for the current financial system and that the recent financial crisis would have occurred even if GLBA had never partially repealed the Glass-Steagall Act.[11]

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[6] Thomas Hoenig, Vice Chairman Fed. Deposit Ins. Corp., *Lehman Brothers: Looking Five Years Back and Ten Years Ahead*, Speech Before the National Association of Corporate Directors, Texas Tricity Chapters Conference, September 2013, (arguing that the repeal of the Glass-Steagall Act caused the win-lose culture of broker-dealers to replace the more cautious traditional culture of commercial banks, which resulted in increased appetite for risk in the financial system, and resulted in increased leverage of financial firms within the federal safety net).

[7] James Lardner, *A Brief History of the Glass-Steagall Act*, Demos Background Paper, November 10, 2009, available at http://www.demos.org/publication/brief-history-glass-steagall-act (assigning considerable blame for the causes of the crisis on activities that were permitted under Glass-Steagall, but arguing that participation of commercial banks in certain swaps and derivatives markets made the crisis worse than it would have otherwise been).

[8] Keith Hennessy, Douglas Holtz-Eakin, and Bill Thomas, *Financial Crisis Commission Report*, Dissenting Op., p. 414, available at http://fcic.law.stanford.edu/report (emphasizing 10 contributing causes to the crisis, none of which are dependent upon the relation of commercial banks to broker dealers).

[9] Ben S. Bernanke, COURAGE TO ACT: A MEMOIR OF A CRISIS AND ITS AFTERMATH, p. 439, W. W. Norton & Co. (2015) (arguing that if the Glass-Steagall Act had remained in effect, some Federal Reserve crisis responses would not have been permitted, such as the acquisition of the investment bank Bear Stearns by the commercial bank JPMorgan).

[10] P.L. 111-203.

[11] *The Global Financial Crisis: A Plan for Regulatory Reform*, Committee on Capital Markets Regulation, p. ES-30, May 2009, available at http://www.europarl.europa.eu/meetdocs/2009_2014/documents/d-us/dv/d-us_tgfc-ccmr_executive_summa/d-us_tgfc-ccmr_executive_summary.pdf.

To inform this policy debate, this report provides background on the economic conditions in which the Glass-Steagall Act was enacted and provides an economic and legal analysis of the Glass-Steagall Act's enactment, erosion, and partial repeal by GLBA. The report concludes with an analysis of the Glass-Steagall Act's relationship with financial stability and the Glass-Steagall-like provisions of the Dodd-Frank Act.

Background: The Great Depression and Congressional Response

The Board of Governors of the Federal Reserve System (Fed) was established in 1913 in order to respond to problems in the banking system as a lender of last resort.[12] Yet, many components of the financial system collapsed in the years immediately following the stock market crash of 1929—a period commonly referred to as the Great Depression. Banks failed in waves from 1930 through 1933.[13] Many small and mid-sized banks found it difficult to turn to the Fed for assistance. Many of these banks were not members of the Federal Reserve System and, therefore, did not have access to the Fed's lending facilities. Even those that were Fed member banks often lacked assets that were eligible to be collateral for loans from the Fed.[14] Finding private alternatives to Fed loans, including attempts to issue debt securities, also was difficult for small and mid-sized banks, in part because securities markets were also disrupted during the Great Depression and because smaller institutions often had not tapped securities markets frequently enough or on a large enough scale prior to the Great Depression to establish sufficient reputations in the market.[15] Fearful of financial turmoil, bank depositors withdrew their funds *en masse*.[16] The 1929 crash also precipitated severe mark-downs in the value of securities held by a wide range of other financial institutions, causing many struggling financial firms to sell securities at distressed prices.[17] For these and other reasons, banks and securities markets spread and magnified economic losses in ways that current policymakers would describe using the terms "systemic risk" and "systemic event."

In response to the financial crisis that followed the stock market crash of 1929, the Senate passed a resolution that authorized the Senate Committee on Banking and Currency to conduct an investigation into the "abusive" banking and securities practices that might have fueled financial instability.[18] The investigation is referred to as "the Pecora Commission" after the committee's

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[12] Act of December 23, 1913, 38 Stat. 151, primarily codified at 12 U.S.C. §§221, *et. seq*.

[13] *A Brief History of Deposit Insurance*, p. 21, Fed. Deposit Ins. Corp., September 1998, available at https://www.fdic.gov/bank/historical/brief/brhist.pdf.

[14] Michael Bordo and David Wheelock, *The Promise and Performance of the Federal Reserve as Lender of Last Resort 1914- 1933*, p. 17, October 15, 2010, available at https://www.frbatlanta.org/documents/news/conferences/10jekyll_BordoWheelock.pdf.

[15] Jesse H Jones and Carl H. Pforzheimer, FIFTY BILLION DOLLARS: MY THIRTEEN YEARS WITH THE RFC, pp. 13-53, New York: MacMillan Company (1951).

[16] *A Brief History of Deposit Insurance*, Fed. Deposit Ins. Corp., September 1998, available at https://www.fdic.gov/bank/historical/brief/brhist.pdf.

[17] At the time, potential conflicts of interest for bankers offering securities for sale was a concern. Critics accused bank managers that had offered securities to the public of "banksterism," an allusion to organized crime and gangsterism of the time. For a discussion of the collapse of securities and bond markets and its relation to perceived conflicts of interest among banks, *see* Marc Flandreau, Norbert Gaillard, and Frank Packer, *Ratings Performance, Regulation and the Great Depression: Lessons from Foreign Government Securities*, May 2009, available at http://graduateinstitute.ch/files/live/sites/iheid/files/shared/publicationsNEW/publications_GCI/working_paper_ratings_gci.pdf.

[18] *Stock Exchange Practices*, Report of the Committee on Banking and Currency Pursuant to S.Res. 84 (72d Cong.), pp. (continued...)

chief counsel, Ferdinand Pecora.[19] The Pecora Commission identified a number of conflicts of interest and other "[a]buses arising out of the interrelationship of commercial and investment banking" that played a role in that crisis.[20] The Pecora Commission Report explained:

> A prolific source of evil has been the affiliated investment companies of large commercial banks. These affiliates have been employed as instrumentalities by commercial banks to speculate in their own stock, to participate in market operations designed to manipulate the price of securities, and to conduct other operations in which commercial banks are forbidden by law to engage.
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> Commercial banks did not hesitate to violate their fiduciary duty to depositors seeking disinterested investment counsel by referring such inquiries to their affiliates. The affiliates unloaded securities owned by them on unsuspecting investors and depositors. The activities of investment affiliates encouraged speculation by officers and directors of commercial banks and resulted in the payment of excessive compensation and profits to these officials.[21]

Congress attempted to address many of the causes of systemic risk, as well as the abuses identified by the Pecora Commission through a series of legislative enactments from 1932-1935.[22] These acts included the Banking Act of 1933,[23] as well as the Securities Act of 1933[24] and the Securities and Exchange Act of 1934.[25] The laws addressed a broad swath of banking and securities market issues, including (1) broadening the range of collateral eligible for loans from the Fed; (2) establishing the Federal Home Loan Bank (FHLB) system to enable smaller banks to access securities markets to fund mortgages on more favorable terms; (3) establishing the Federal Deposit Insurance Corporation (FDIC) to reduce fear among bank depositors; (4) imposing a cap on the interest rate that banks could pay depositors; and (5) prohibiting banks from participating in certain securities activities.[26] Some of these measures have been repealed (e.g., interest rate caps);[27] some have been altered (e.g., maximum FDIC deposit insurance coverage);[28] and some have been continued or expanded (e.g., range of eligible collateral for emergency Fed loans).[29]

Through these acts, Congress created distinct regulatory regimes for commercial banks and securities firms in the United States. Generally, these laws reinforced a regulatory system in

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113-114, 155-56, June 6, 1934, (*hereinafter* "*Pecora Commission Report*") available at http://www.senate.gov/artandhistory/history/common/investigations/pdf/Pecora_FinalReport.pdf.

[19] *Senate History: Subcommittee on Senate Resolutions 84 and 234*, U.S. Senate, available at http://www.senate.gov/http://www.senate.gov/artandhistory/history/common/investigations/Pecora.htm.

[20] *Pecora Commission Report* at 113.

[21] *Id*. at 113-14.

[22] Although the Pecora Commission's official report was not issued until 1934, Members of Congress were well aware of the ongoing hearings and investigations during deliberation on these laws. Several of these laws included "Glass-Steagall" in their titles due to the fact that Senator Carter Glass and Representative Henry Steagall led the Senate and House Banking Committees, respectively, at that time.

[23] 48 Stat. 162.

[24] 48 Stat. 74.

[25] 48 Stat. 881.

[26] ANTI-DEPRESSION LEGISLATION: A STUDY OF THE ACTS, CORPORATIONS, AND TRENDS GROWING OUT OF THE "BATTLE WITH DEPRESSION," Am. Inst. of Banking, pp. 57-60, New York (1933).

[27] *See, e.g.*, the Depository Institutions Deregulation and Monetary Control Act, P.L. 96-221; the Garn-St. Germain Depository Institutions Act, P.L. 97-320.

[28] *See, e.g.*, the Depository Institutions Deregulation and Monetary Control Act, P.L. 96-221.

[29] 12 U.S.C. §343(3).

which banks were subject to activity restrictions and prudential regulation, including on-site examination, while securities firms were subject to a regime based on preventing market manipulation and publicly disclosing information considered sufficiently detailed as to allow the investing public to make informed investment decisions.

The Glass-Steagall Act

The Banking Act of 1933 was intended "[t]o provide for the safer and more effective use of the assets of banks, to regulate interbank control, and to prevent the undue diversion of funds into speculative operations, and for other purposes."[30] It included four sections—Sections 16, 20, 21, and 32—collectively known as the Glass-Steagall Act, which were designed to prevent banking firms from engaging in speculative securities operations. The Glass-Steagall Act attempted to address some of the specific "[a]buses arising out of the interrelationship of commercial and investment banking" that were identified by the Pecora Commission, including the following:

- commercial banks using securities affiliates "to speculate in their own stock, to participate in market operations designed to manipulate the prices of securities, and to conduct other operations in which commercial banks are forbidden by law to engage";
- commercial banks "violating their fiduciary duty to depositors seeking disinterested investment counsel by referring such inquiries to their affiliates"; and
- bank-affiliated officers receiving "excessive compensation" for securities deals.[31]

Specifically, Glass-Steagall Act Section16, which, although it has been amended over the years, is still in effect,[32] preserves national banks as creatures of limited authority. Pursuant to Section 16, national banks generally are only authorized to engage in "the business of banking" and any "incidental power" thereto. Section 16 generally precludes banks from underwriting and dealing in securities;[33] however, it does authorize national banks to deal in, underwrite, and purchase

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[30] 48 Stat. 162. The legislation included amendments to various banking laws relating to national banks, Federal Reserve Banks, and member banks.

[31] *Pecora Commission Report* at 113-14.

[32] 12 U.S.C. §24 (Seventh). The seventh undesignated paragraph of §24 is commonly referred to as §24(Seventh). *See, e.g.*, Watters v. Wachovia Bank, N.A., 500 U.S. 1, 7 (2007).

[33] In pertinent part, §16 of the Banking Act of l933, as enacted, read:

> [t]he business of dealing in investment securities by the association shall be limited to purchasing and selling such securities without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities: *Provided*, That the association may purchase for its own account investment securities under such limitations as the Comptroller of the Currency may by regulation prescribe, but in no event (1) shall the total amount of any issue of investment securities of any one obligor or maker purchased after this section as amended takes effect and held by the association for its own account exceed at any time 10 per centum of the total amount of such issue outstanding, but this limitation shall not apply to any such issue the total amount of which does not exceed $100,000 and does not exceed 50 per centum of the amount of the capital stock of the association actually paid in and unimpaired and 25 per centum of its unimpaired surplus fund. As used in this section the term 'investment securities' shall mean marketable obligations evidencing indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes and/or debentures commonly known as investment securities under such further definition of the term 'investment securities' as may by regulation be prescribed by the Comptroller of the Currency. Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by

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certain enumerated securities without quantitative limitation.[34] These types of securities are referred to as "bank eligible securities," while all other securities are referred to as "bank ineligible securities."

Section 20 of the Glass-Steagall Act prohibited member banks (i.e., all national banks and state-chartered banks that are members of the Federal Reserve System) from affiliating with businesses that are "engaged principally" in securities activities.[35] Section 21, which is in force today in an amended form,[36] makes it illegal for a firm to engage in both deposit taking and investment banking, except the "bank eligible securities" allowed under Section 16.[37] Glass-Steagall Act Section 32 prohibited interlocking directorates between member banks and securities firms.[38]

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> the association of any shares of stock of any corporation. The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to obligations of the United States, or to general obligations of any State or of any political subdivision thereof, or obligations issued under authority of the Federal Farm Loan Act, as amended, or issued by the Federal Home Loan Banks or the Home Owners Loan Corporation: *Provided*: That in carrying on the business commonly known as the safe-deposit business the association shall not invest in the capital stock of a corporation organized under the law of any State to conduct a safe-deposit business in an amount in excess of 15 per centum of the capital stock of the association actually paid in and unimpaired and 15 per centum of its unimpaired surplus.

48 Stat 162, 184-185.

[34] Glass-Steagall §16 permitted commercial banks to invest, underwrite, and deal in "obligations of the United States, ... general obligations of any State or of any political subdivision thereof, or obligations issued under authority of the Federal Farm Loan Act, as amended, or issued by the Federal Home Loan Banks or the Home Owners Loan Corporation." 48 Stat. 162, 185. Subsequent legislative changes added types of securities to §16's original list. These are referred to as "bank eligible securities." Congress has expanded the list of permissible securities over time. The current list of bank eligible securities is found at 12 U.S.C. §24 (Seventh).

[35] In pertinent part, §20 of the Banking Act of 1933, as enacted, read: "no member bank shall be affiliated in any manner ... with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or at retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities." 48 Stat. 162, 188.

[36] 12 U.S.C. §378.

[37] In pertinent part, §21 of the Banking Act of 1933, as enacted, read:

> ... it shall be unlawful:
>
> (1) For any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor; or
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> (2) For any person, firm, corporation, association, business trust, or other similar organization, other than a financial institution or private banker subject to examination and regulation under State or Federal law, to engage to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor, unless such person, firm, corporation, association, business trust, or other similar organization shall submit to periodic examination by the Comptroller of the Currency or by the Federal reserve bank of the district and shall make and publish periodic reports of its condition, exhibiting in detail its resources and liabilities, such examination and reports to be made and published at the same times and in the same manner and with like effect and penalties as are now provided by law in respect of national banking associations transacting business in the same locality. 48 Stat. 162, 189.

[38] In pertinent part, §32 of the Banking Act of 1933, as enacted, read:

(continued...)

In the short term, the Glass-Steagall Act, in combination with complementary securities laws, erected a rigid wall separating commercial banks and securities firms. This wall of separation was exemplified by the evolution of one-specific firm—J.P. Morgan & Co. Prior to Glass-Steagall's enactment, J.P. Morgan was a prestigious financial conglomerate that successfully engaged in both commercial banking and securities activities. In response to the Glass-Steagall Act, J.P. Morgan & Co. was forced to split into two distinct firms with separate boards, directors, officers, and management. John Pierpont Morgan, Jr. headed the commercial banking business, which took his name, while other partners and employees from the old firm established a separate securities firm called Morgan Stanley. In lay language, the investment bank, Morgan Stanley, was separated from the commercial bank, JPMorgan.[39]

Equally important to this discussion is what the Glass-Steagall Act and complementary securities laws did not do. While the Glass-Steagall Act generally prohibited depository banks from competing in securities markets as broker-dealers and underwriters, the only activities-based restriction on securities firms and their employees contained in the Glass-Steagall Act and the complementary securities laws relevant to this discussion was the prohibition on accepting deposits. These laws did not prohibit securities market professionals from using securities markets to fund private debt in competition with, or even in conjunction with, commercial banks.[40]

Thus, for example, during the Glass-Steagall era, commercial entities and individual consumers were free to borrow through either securities markets or the commercial banking market. Commercial and consumer borrowers could get a loan:

1. exclusively through the commercial banking market, where the loan was originated and held for its full term by a depository bank (an originate-to-hold business model);
2. exclusively through the securities markets, where the loan was originated by a nonbank and then sold to a trust, insurance company, or some other nonbank firm (an originate-to-distribute model[41]); or

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> ... no officer or director of any member bank shall be an officer, director, or manager of any corporation, partnership, or unincorporated association engaged primarily in the business of purchasing, selling, or negotiating securities, and no member bank shall perform the functions of a correspondent for any member bank or hold on deposit any funds on behalf of any member bank, unless in any such case there is a permit therefor issued by the Federal Reserve Board; and the Board is authorized to issue such permit if in its judgment it is not incompatible with the public interest, and to revoke any such permit whenever it finds after reasonable notice and opportunity to be heard, that the public interest requires such revocation. 48 Stat. 162, 194.

[39] Ron Chernow, THE HOUSE OF MORGAN, pp. 384-391, Grove Press, New York (1990).

[40] For a comparison of bank and nonbank financial intermediation, see CRS Report R43345, *Shadow Banking: Background and Policy Issues*, by Edward V. Murphy.

[41] The originate-to-distribute model of mortgage finance involves lenders selling the loans they originate to entities that then convert them into securities for sale. Fannie Mae and Freddie Mac, which are statutorily prohibited from originating mortgages, utilize the originate-to-distribute model. Mortgage and mortgage-backed securities buyers in an originate-to-distribute model rely on market provided information (e.g., credit ratings) to judge the quality of prospective purchases because they do not participate in the mortgage underwriting and origination processes. When buyers and sellers have different information (asymmetries) about the quality of a product (are they "lemons" in the used-car sense?), economists have identified potential mispricing of the products. In response, market participants might try to rely on reputation, warranties, guarantees, and other contract devices to try to overcome pricing inefficiencies. If mortgage-backed securities purchasers "underpriced" the risk inherent in the securities, then the originate-to-distribute model could have contributed to too much (relative to the risk) investment in housing and helped (continued...)

3. through a combination of both, where the loan was originated by a depository institution and then sold to a nonbank (another originate-to-distribute model).[42]

In other words, while J.P. Morgan & Co. could not conduct all of the same activities after Glass-Steagall as before its enactment within a single, affiliated financial conglomerate, the Glass-Steagall Act did not prohibit all of the very same activities (in type and volume) from entering the marketplace through the combined efforts of the unaffiliated JPMorgan (commercial bank) and Morgan Stanley (investment bank).[43]

Although Glass-Steagall limited the scope of the activities of JPMorgan the commercial bank, it had much less to do with the size or scale of the bank going forward. For example, although the firm that Morgan built was broken in two in reaction to the Glass-Steagall Act, the act itself was not designed to cap the size of commercial or investment banks or to break up these banks with the intent of eliminating the risk that they would become "too-big-to-fail." It would not have been a violation of the four sections of the Glass-Steagall Act for either JPMorgan or Morgan Stanley to have grown significantly after the firms were separated.

Glass-Steagall's Erosion

Over the course of the nearly 70-year-long Glass-Steagall era, the separation of traditional commercial banking and securities activities gradually eroded. As previously mentioned, this erosion was the result of a confluence of matters, including market changes, statutory changes, and regulatory and judicial interpretations, which are addressed in turn.

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to inflate the housing bubble. George A. Akerlof, *The Market for 'Lemons': Quality Uncertainty and the Market Mechanism*, 84 Q. J. Econ. 488 (August 1970), available at http://socsci2.ucsd.edu/~aronatas/project/academic/Akerlof%20on%20Lemons.pdf.

[42] Saul Klaman, *The Postwar Rise of Mortgage Companies*, Nat'l Bureau of Econ. Research 0-87014-374-3 (1959), available at http://www.nber.org/chapters/c2553.pdf.

[43] As is discussed more fully below, GLBA repealed the Glass-Steagall Act's affiliation restrictions—Sections 20 and 32—which allowed depository institutions to affiliate with securities firms and insurance companies by authorizing the formation of financial holding companies owning both commercial and investment banking subsidiaries.

Financial holding companies are the parent heads of financial conglomerates that own at least one depository institution subsidiary, but that also are permitted to hold ownership stakes in certain nonbank financial institutions, such as broker-dealers and insurance firms, in accordance with 12 U.S.C. §1843(*l*)(1) and other provisions of the Bank Holding Company Act of 1956. Financial holding companies are sometimes referred to as "universal banks" because they are able to offer a wide-range of financial services among different affiliates within a single ownership structure.

However, GLBA preserved other laws that restrict and limit the relationships of and transactions entered between affiliates within a single conglomerate, such as Sections 23A (12 U.S.C. §371c) and 23B (12 U.S.C. §371c-1) of the Federal Reserve Act. For a fuller analysis of Federal Reserve Act §§23A and 23B, *see* the "Federal Reserve Act Sections 23A and 23B Restrictions on Interaffiliate Transactions Between Banks and Securities Subsidiaries of FHCs or Financial Subsidiaries of Banks" of CRS Report R41181, *Permissible Securities Activities of Commercial Banks Under the Glass-Steagall Act (GSA) and the Gramm-Leach-Bliley Act (GLBA)*, by David H. Carpenter and M. Maureen Murphy.

Additionally, post-GLBA, certain individual subsidiaries of a financial holding company remain subject to activity restrictions. For example, the depository institution subsidiaries of a financial holding company are subject to the securities restrictions of Glass-Stegall Act Section 16, and all nondepository subsidiaries are prohibited from offering insured deposits by Glass-Steagall Act Section 21.

Market Changes

After a period of relative calm following World War II, economic conditions during the Glass-Steagall era caused disruptions in banking and securities markets.[44] Some of these challenges included rising inflation beginning during the Vietnam War and energy price volatility in the 1970s. As a result of these challenging economic conditions, commercial banks, especially smaller institutions, had difficulty sustaining profitability. Although the economic challenges might not be attributed exclusively to the four Glass-Steagall Act provisions, they and other regulatory features of the Glass-Steagall era may have contributed to instability in banking and securities markets by, for instance, making it difficult for institutions to respond the challenges.[45]

For example, non-Glass-Steagall Act provisions of the Banking Act of 1933 imposed interest rate caps on deposits that could be offered by commercial banks.[46] Rising inflation was a policy concern during the 1960s, and market interest rates rose well beyond these statutory rate caps as a result of inflation in the 1970s.[47] This prompted a consumer movement to interest-bearing accounts and investment products offered by securities firms, such as money market funds.[48] Corporate consumers also began moving to securities firms for short-term lending, through the commercial paper market, for example, which for some was less expensive than borrowing directly from banks. As a result, depository banks found it difficult to compete with savings opportunities available through securities markets. This contributed to a decline of bank deposits as a share of the financial system and reduced the profitability of traditional bank products.[49]

Smaller commercial banks with high concentrations of long-term mortgages in their portfolios found it especially difficult to cope with persistent increases in interest rates.[50] In the late 1980s, oil price volatility also caused lenders with concentrations in commercial real estate in oil producing states to experience historically high loan default rates. By the end of the 1980s, the country faced a wave of depository institution failures, led by smaller regional banks and thrift institutions.[51] Securities markets were not entirely spared. The stock market crashed in 1987, for example, but it recovered relatively quickly.[52]

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[44] *The First Fifty Years*, Fed. Deposit Ins. Corp., available at https://www.fdic.gov/bank/analytical/firstfifty/chapter1.html.

[45] *Id*.

[46] R. Albert Gilbert, *Requiem for Regulation Q: What it Did and Why it Passed*, Fed. Reserve Bank of St. Louis, February 1986, available at https://research.stlouisfed.org/publications/review/86/02/Requiem_Feb1986.pdf.

[47] Although inflation during the 1960s might seem low by historical standards, economists often relate the effects of inflation (or deflation) to the difference between the actual inflation rate relative to the expected rate at the time people signed contracts or otherwise arranged their affairs. During the 1960s, Congress was legislating changes to financial services in response to rising debt, as well as rising inflation. *See, e.g.*, "Lowering Interest Rates, Fight Inflation, Help Housing, Small Business, and Employment," H. Rpt. 91-755, at 4-8 (1969) (discussing rising inflation and legislation designed to change the regulator's authority regarding interest rate caps and to help foster secondary markets in mortgages).

[48] Jerry W. Markham, *Banking Regulation: Its History and Future*, 4 N.C. Banking Inst. 221, 240-44 (2000).

[49] *Id*.

[50] *Id*. at 244-45.

[51] *Id*. at 246-47.

[52] Hayne Leland and Mark Rubenstein, *Comments on the Market Crash: Six Months After*, J. of Econ. Perspectives (Summer 1988).

The combination of financial stress among depositories and the declining importance of deposits as a share of the financial sector contributed to calls for regulatory and statutory changes to banking and securities policies.[53]

Statutory Changes and Judicial and Administrative Interpretations

As economic conditions evolved throughout the 1960s, 1970s, and 1980s, securities firms began developing lines of business providing financing vehicles for products like mortgages and automobile loans that competed with traditional commercial bank products, including deposit accounts.[54] In an attempt to keep pace, banks began seeking permission from their regulators to engage in a greater universe of securities-related activities. In some cases, laws were enacted to meet this end.[55]

Statutory Changes

For example, several laws added new classes of securities to the list of bank-eligible securities provided in Glass-Steagall Act Section 16.[56] Another major statutory change was the enactment of the Bank Holding Company Act of 1956 (BHC Act).[57] The BHC Act generally required companies holding a controlling interest in a bank to register with the Fed as bank holding companies. Bank holding companies were generally prohibited from owning companies engaged in nonbanking activities, except that the act expressly permitted bank holding companies to own companies engaged in activities that are "closely related" to banking activities.[58]

The Office of the Comptroller of the Currency (OCC) and the Fed were empowered to implement, enforce, and by extension, interpret (by regulation, guidance, or order) the subtleties and ambiguities of the Glass-Steagall Act[59] and the BHC Act.[60] The OCC and Fed, interpreting Glass-Steagall's prohibitory language and elaborating on activities permissible under the BHC Act's "closely-related" provision, gradually permitted commercial banks to engage in an increasing number of activities resembling traditional securities products and services.[61] In many cases, these decisions were approved by courts.

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[53] Jerry W. Markham, *Banking Regulation: Its History and Future*, 4 N.C. Banking Inst. 221, 253-61(2000).

[54] Charles K. Whitehead, *Reframing Financial Regulation*, 90 B.U. L. Rev. 1, 16 (2010).

[55] *Id*. at 210.

[56] 12 U.S.C. §24(Seventh), e.g., Federal Financing Bank Act of 1973, P.L. 93-224 (adding Fannie Mae-issued securities as bank eligible); Housing and Community Development Act of 1974, P.L. 93-383 (adding Freddie Mac-issued securities as bank eligible). As previously mentioned, the enumerated "bank eligible securities" are exempt from the general prohibition on banks' ability to deal in, underwrite, and hold securities.

[57] P.L. 84-511; BHC Act May 9, 1956, ch. 240, 70 Stat. 133, codified at 12 U.S.C. §§1841, *et seq*.

[58] Under the BHC Act, the Fed may authorize bank holding companies to hold shares of companies whose activities the Board finds "to be so closely related to banking or managing or controlling banks as to be a proper incident thereto." 12 U.S.C. §1843(c)(8).

[59] *See, e.g.*, Invest. Co. Inst. v. Camp, 401 U.S. 617, 626-27 (1971) ("It is settled that courts should give great weight to any reasonable construction of a regulatory statute adopted by the agency charged with the enforcement of that statute. The Comptroller of the Currency is charged with the enforcement of the banking laws to an extent that warrants the invocation of this principle with respect to his deliberative conclusions as to the meaning of these laws.").

[60] P.L. 84-511 §5(b); 70 Stat. 137 ("The Board is authorized to issue such regulations and orders as may be necessary to enable it to administer and carry out the purposes of this [BHC] Act and prevent evasions thereof.).

[61] *See infra* sections "OCC Administrative Interpretations" and "Federal Reserve Board Administrative Interpretations."

Judicial Interpretations

In 1971, the U.S. Supreme Court issued a seminal decision involving agency interpretation of the Glass-Steagall Act in *Investment Company Institute v. Camp*.[62] While ultimately holding against the OCC's specific interpretation of the Glass-Steagall Act, the case is important because it paved the way for a broad reading of the act, as well as a policy of granting judicial deference to agency interpretation of the act.[63]

Camp involved a challenge to the OCC's authority to authorize national banks to offer pooled investment funds. A pooled investment fund is the product of two traditional banking services—pooling trust funds and acting as a managing agent for bank customers. This combination of traditional banking services, however, resulted in a product that closely resembled a traditional securities product—an open-end mutual fund. The OCC had issued regulations authorizing banks to offer pooled investment funds, which was challenged by a securities industry group as exceeding the scope of bank authority provided by the Glass-Steagall Act.

The Supreme Court seemed inclined to give deference to any reasonable interpretation of the Glass-Stegall Act advanced by the Comptroller. The Court explained:

> It is settled that courts should give great weight to any reasonable construction of a regulatory statute adopted by the agency charged with the enforcement of that statute. The Comptroller of the Currency is charged with the enforcement of the banking laws to an extent that warrants the invocation of this principle with respect to his deliberative conclusions as to the meaning of these laws.[64]

In the case at hand, however, the Court concluded that the Comptroller had failed to provide "an administrative interpretation of §§16 and 21" because the challenged OCC-issued regulations did not cite or even allude to the Glass-Steagall Act.[65] Without an OCC interpretation to look to, the Court was forced to conduct its own interpretation of the Glass-Stegall Act and its legislative history to determine legislative intent. According to the Court,

> The Glass-Steagall Act reflected a determination that policies of competition, convenience, or expertise which might otherwise support the entry of commercial banks into the investment banking business were outweighed by the "hazards" and "financial dangers" that arise when commercial banks engage in the activities proscribed by the Act.[66]

The Court concluded that the operation of a pooled investment fund could involve the "subtle hazards" that Congress sought to prevent through the Glass-Steagall Act. Echoing the abuses identified by the Pecora Commission report, some of the subtle hazards cited by the Court were that the bank's reputation might be attached to the success of the fund; the bank might be pressured to rescue a failing fund; the bank could be tempted to extend credit, betray confidences, or give poor advice to customers for the sake of the fund; and the fund's activities could reflect poorly upon customer confidence in the bank.[67]

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[62] 401 U.S. 617 (1971).

[63] Although the *Camp* decision was limited to an OCC interpretation, the Court's reasoning applies equally to the Fed's interpretation of laws it is statutorily authorized to enforce.

[64] *Id*. at 626-27.

[65] *Id*. at 628.

[66] *Id*. at 630.

[67] *Id*. at 635-39.

While in the short term, the Court ruled against the OCC, the Court's opinion influenced subsequent decisional law by establishing a standard that deference would be paid to the OCC's (and, by extension, the Fed's) reasoned conclusions that certain activities are authorized under the Glass-Steagall Act and other relevant banking laws.[68]

In response to *Camp*, the OCC and Fed began providing extensive legal reasoning in their orders and regulations approving activities of requesting banks and bank holding companies. When these decisions were challenged as counter to the Glass-Steagall Act or BHC Act, courts looked to the reasonableness of the regulators' reasoning, rather than assessing whether that was the best interpretation or whether the court would have made the same decision.[69] By and large, courts held that the OCC's and Fed's decisions approving activity requests were valid and reasonable interpretations of the banking laws.[70]

OCC Administrative Interpretations

After *Camp*, the OCC responded to numerous requests from banks regarding whether certain activities were permissible as part of (or incidental to) the "business of banking" under Glass-Steagall Act Section 16. The OCC adopted an increasingly broad interpretation of bank powers authorized under Section 16.[71] The agency provided extensive legal opinions explaining how and why it came to legal conclusions as to whether particular activities were permissible under Section 16.[72] Ultimately, the OCC approved banks' and their operating subsidiaries' ability to engage in a wide-range of activities that shared characteristics with traditional securities and insurance products and services.[73]

The OCC's approval orders and the legal tests utilized in those orders were largely validated by the Supreme Court in a 1995 decision, *NationsBank of North Carolina v. Variable Annuity Life Insurance Co. (VALIC)*. The *VALIC* Court stated:

> We expressly hold that the "business of banking" is not limited to the enumerated powers in § 24 Seventh and that the Comptroller therefore has discretion to authorize activities beyond those specifically enumerated. The exercise of the Comptroller's discretion, however, must be kept within reasonable bounds. Ventures distant from dealing in financial investments—for example, operating a general travel agency—may exceed those bounds.[74]

The OCC interpreted the *VALIC* decision and the case law upon which *VALIC* was grounded as an affirmation of the OCC's broad reading of Section 16 of the Glass-Steagall Act and the scope

[68] Deference towards agency interpretation generally was further spurred by the landmark 1984 Supreme Court decision in *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.* in which the Court held that reviewing courts, in the absence of clear legislative language to the contrary, shall uphold agency interpretations that are reasonable. 467 U.S. 837 (1984).

[69] *See, e.g.*, NationsBank of North Carolina v. Variable Annuity Life Ins. Co., 513 U.S. 251, 254 (1993).

[70] *See, e.g., id.* (holding that OCC's determination that sale of annuities is "incidental" to "the business of banking" is a reasonable interpretation of Glass-Steagall Act §16, as amended); M&M Leasing Corp. v. Seattle First Nat'l Bank, 563 F.2d 1377, 1380 (9th Cir. 1977) (holding that leasing cars and other personal property is "within the scope of the business of banking"). *But see, e.g.*, Nat'l Retailers Corp. of Arizona v. Valley Nat'l Bank, 411 F. Supp. 308 (D. Ariz. 1976) (holding that the provision of certain data processing services is not "incidental" to "the business of banking").

[71] Saule T. Omarova, *The Quiet Metamorphosis: How Derivatives Changed the "Business of Banking,"* 63 U. Miami L. Rev. 1041, 1051 (2009).

[72] *Id*. at 1051-54.

[73] *See infra* n. 76-84.

[74] 513 U.S. 251, 258, n. 2 (1995).

of permissible authorities of national banks. Shortly after the Supreme Court's ruling, the OCC synthesized its understanding of the law by stating:

> Judicial cases affirming OCC interpretations establish that an activity is within the scope of this authority [i.e., Glass-Steagall Act §16 (as amended)] if the activity: (1) is functionally equivalent to or a logical outgrowth of a traditional banking activity; (2) would respond to customer needs or otherwise benefit the bank or its customers; and (3) involves [*sic.*] risks similar to those already assumed by banks.[75]

Specifically, the OCC approved of the ability of banks and their operating subsidiaries to become members of security exchanges[76] and commodity exchanges,[77] as well as to engage in discount brokerage;[78] investment company advising;[79] securities lending;[80] individual retirement account (IRA) management;[81] private placement of securities;[82] brokering and dealing in options and futures on foreign currency and other financial products;[83] and general obligation municipal bond underwriting, dealing, and holding[84] among other activities. The OCC also approved brokering and dealing in derivative contracts even where banks were explicitly prohibited from directly investing in the asset underlying the contract, such as equity derivative swap contracts that are derived from equity securities.[85]

Additionally, the OCC approved banks' ability to buy and take physical possession of certain equity securities for the purpose of hedging customer-driven equity derivative transactions, subject to certain additional safeguards.[86]

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[75] OCC Interpretive Letter No. 684 (August 4, 1995).

[76] OCC Interpretative Letter No. 380 (December 29, 1986), *reprinted* in Banking L. Rep. CCH ¶ 85, 604 (considered an "incidental" power).

[77] OCC Interpretative Letter No. 380 (December 29, 1986) (citing an "unpublished letter from J.T. Watson, Deputy Comptroller of the Currency, July 11, 1975 (membership on commodities exchange permitted for bank operating subsidiary executing transactions for bank's own account)," among other unpublished letters).

[78] Sec. Ind. Assoc. v. Comptroller of the Currency, 577 F. Supp. 252 (D.C. Cir. 1985). The court described discount brokerage this way:

> [The bank subsidiaries will be] "discount" brokerages, which will buy and sell securities solely as agent, on the order and for the account of customers. Neither will purchase or sell securities for its own account, nor engage in underwriting, nor give investment advice. "Discount" brokers are so characterized because their commissions are significantly lower than those charged by full-service brokers who, in addition to trading on behalf of customers, offer investment advice.

Id. at 253.

[79] OCC Interpretative Letter No. 386 (June 10, 1987), *reprinted* in Banking L. Rep. CCH ¶ 85,610.

[80] OCC Interpretative Letter No. 380 (December 29, 1986) (stating: "It is an established practice for national banks to lend either their own investment or trading account securities, or their customers' securities held in custody, safekeeping, trust, or pension accounts.").

[81] Invest. Co. Inst. v. Clarke, 630 F.Supp. 593 (D.Conn. 1986).

[82] 73 Fed. Res. Bull. 2, fn. 43 (1987) (citing OCC, FDIC, Fed, *Commercial Bank Private Placement Activities* (1978)).

[83] OCC Interpretative Letter No. 380 (December 29, 1986), *reprinted* in Banking L. Rep. CCH ¶ 85, 604.

[84] *Eligibility of Securities for Purchase, Dealing In Underwriting and Holding by National Banks; Rulings Issued by the Comptroller*, OCC, 47 *Federal Register* 18,323 (April 29, 1982).

[85] OCC Interpretive Letter No. 652 (September 13, 1994).

[86] OCC Interpretive Letter No. 892 (September 13, 2000), available at http://www.occ.gov/interp/sep00/int892.pdf.

Federal Reserve Board Administrative Interpretations

Similarly, the Fed, often at the request of bank holding companies, provided guidance regarding (1) when a company would be considered "engaged principally" in the securities business for the purpose of Glass-Steagall Act Section 20, as well as (2) what activities are "closely related" to the business of banking for the purposes of the BHC Act. Much like the OCC's reading of Section 16, the Fed adopted increasingly broad interpretations of these provisions. The Fed's interpretations also were largely approved by the courts.[87]

Under Fed rulings, bank holding companies generally were only permitted to engage in investment banking activities through separately capitalized subsidiaries, which became known as "§20 subsidiaries." These subsidiaries would not be considered "engaged principally" in the securities business as long as their bank-ineligible securities activities did not exceed a certain percentage of their gross revenue. Initially, the Fed set a 5%-10% limit on the amount of revenue from bank-ineligible securities in relation to the gross revenue of the company.[88] However, in regulations prescribed in 1996,[89] the Fed increased the gross revenue threshold limit to 25%.[90]

By the time GLBA was enacted, the Fed had approved applications involving at least 41 "§20 subsidiaries."[91] The Fed authorized these companies to underwrite and deal in bank-ineligible securities,[92] including municipal bonds; commercial paper; mortgage-backed securities and other consumer-related securities; corporate debt securities; and corporate equity securities.[93] In

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[87] *See, e.g.,* Sec. Indus. Assoc. v. Bd. of Governors, 839 F.2d 47 (2nd Cir. 1988); Sec. Indus. Assoc. v. Bd. of Governors, 900 F.2d 360 (D.C. Cir. 1990).

[88] *Orders Issued Under Section 4 of the Bank Holding Company Act, Citicorp, J.P. Morgan & Co. Incorporated, and Bankers Trust New York Corporation, Order Approving Applications to Engage in Limited Underwriting and Dealing in Certain Securities*, 73 Fed. Res. Bull. 473 (1987). The Fed "concluded that subsidiaries would not be engaged substantially in bank ineligible activities if no more than five to ten percent of their total gross revenues was derived from such activities over a two-year period, and if the activities in connection with *each* type of bank ineligible security did not constitute more than five to ten percent of the market for that particular security." Securities Industry Assoc. v. Board of Governors, 839 F.2d 47, 51 (2nd Cir. 1988) [emphasis original], *citing Bankers Trust New York Corp.*, 73 Fed. Reserve Bull. 138, 485-86 (1987).

[89] Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 *Federal Register* 68,750, 68,752 (December 30, 1996).

[90] 61 *Federal Register* 68,750 (December 30, 1996). Some comments to the Fed's proposed regulations, which were largely adopted as part of the final regulations, argued that increasing the gross revenue threshold to 25% would allow commercial banks "to affiliate with the nation's largest investment banks, contrary to the express purpose of section 20 of the Glass-Steagall Act." The Fed responded by stating:

> although not relevant to the statutory interpretation, the Board is not convinced that a 25 percent revenue limit would allow unlimited affiliation between banks and investment banks for purposes of section 20. Adverse commenters provided no data to support their assertion that it would. The Board has reviewed the publicly available financial information for a sample of the largest investment banks, and it is not apparent that they would be in compliance with a 25 percent revenue limit. ... Determining the ineligible revenue of independent investment banks is difficult because they do not segregate ineligible revenue from eligible revenue in their annual reports or the FOCUS reports that they file with the Securities Exchange Commission.

61 *Federal Register* 68,755 and 68,755, fn. 32 (December 30, 1996).

[91] 61 *Federal Register* 68,751 (December 30, 1996).

[92] 61 *Federal Register* 68,750, 68,754-55 (December 30, 1996).

[93] 61 *Federal Register* 68,750, 68,750-51 (December 30, 1996), *citing Citicorp, J.P. Morgan & Co., and Bankers Trust New York Corp.*, 73 Fed. Res. Bull. 473 (1987), *aff'd*, Sec. Indus. Assoc. v. Bd. of Governors, 839 F.2d 47, 66 (2d Cir.); *Chemical New York Corp., Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp, Manufacturers Hanover Corp., and Security Pacific Corp.*, 73 Fed. Res. Bull. 731 (1987); *J.P. Morgan & Co., The Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp, and Security Pacific Corp*., 75 Fed. Res. Bull. 192 (1989), *aff'd*, Sec.
(continued...)

addition to underwriting and dealing activities, the Fed also approved the provision of investment advice[94] and the brokering of securities.[95]

The Fed also approved an increasing number of activities as "closely related" to the business of banking for the purposes of the BHC Act. The Fed ultimately promulgated the full list of these permissible nonbanking activities at 12 C.F.R. §225.28(b).[96] With respect to securities-related activities, the regulation established conditions and limitations on permissible activities and distinguished between two distinct categories of activities: (1) agency functions for customers and (2) transactions as principal (i.e., for the company's own account, often referred to as "proprietary trading").[97] This distinction is relevant because, as previously discussed in the "Introduction" section of this report, customer-driven securities activities, such as acting as a market-maker or broker, do not expose firms to as much of the price-volatility risk as proprietary trading.

Glass-Steagall's Partial Repeal by the Gramm-Leach-Bliley Act

After statutory changes and administrative and judicial decisions of the 1970s, 1980s, and 1990s discussed above had increasingly eroded the strict separation between banking and securities dealing envisioned by the Glass-Steagall Act, it was left to GLBA to eliminate the remaining state and federal barriers to affiliation among banks and securities firms.

GLBA repealed Sections 20 and 32 of the Glass-Steagall Act, which essentially had prohibited affiliations and management interlocks between banking firms and securities firms.[98] GLBA eliminated the language in the BHC Act that had prevented bank holding companies from taking controlling interests in securities firms.[99] It also authorized bank holding companies to expand into "financial holding companies," after which the holding company (through its affiliated subsidiaries) could conduct a broad spectrum of financial activities and own a greater variety of

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Indus. Assoc. v. Bd. of Governors, 900 F.2d 360 (D.C. Cir. 1990).

94 Bd. of Governors of the Fed. Reserve Sys. v. Inv. Co. Inst., 450 U.S. 46 (1981).

95 Sec. Indus. Assoc. v. Bd. of Governors of the Fed. Reserve Sys., 468 U.S. 207 (1984).

96 The list includes activities related to extending credit; real estate appraising; check-guaranty services; collection agency services; credit bureau services; asset management, real estate settlement services; operating industrial loan companies and savings associations; management consulting; employee benefits consulting; career counseling; courier services; various limited insurance services; community development activities; issuing money orders; and data processing. 12 C.F.R. §225.28.

97 *Id*. The proprietary trading category included "[u]nderwriting and dealing in government obligations and money market instruments"; "[i]nvesting and trading activities" in certain swaps, futures, options, foreign exchange, and other derivative contracts; and "buying and selling bullion, and related activities." *Id*.

98 P.L. 106-102, §101, 113 Stat. 1338, 1341. The act also permitted the expansion of national bank securities powers, subject to the requirement that they be conducted in separate operating subsidiaries. P.L. 106-102, Tit. I, §§101-161, 113 Stat. 1338, 1341. GLBA also significantly modified the overall focus of federal regulation of the financial services industry by moving away from regulation by organization to functional regulation. Dating back to 1933, federal regulation of the financial services industry focused on organizational structure, i.e., all activities in banks were subject to bank regulators, while activities in securities firms were subject to securities regulators. GLBA placed a greater emphasis on functional regulation, transferring authority for regulating certain securities products and services engaged in by banks to the SEC, for example. P.L. 106-102, Tit. II, §§201-241, 113 Stat. 1339, 1385-1407.

99 P.L. 106-102, §§102-103, 113 Stat. 1338, 1341-1359.

nonbanking companies, including securities and insurance firms.[100] In short, universal banking services could be offered through a single ownership structure.

Although GLBA authorized financial holding companies with securities and banking subsidiaries, it left unaltered various laws that imposed activity restrictions on certain types of financial institutions that could be affiliated within a single financial holding company ownership structure. For example, GLBA left standing Sections 16 and 21 of the Glass-Steagall Act. It, thus, continued Section 16's general prohibition on the ability of depository institutions (including depositories that are affiliated with securities broker-dealers through a financial holding company structure) to underwrite and deal securities and to engage in proprietary trading activities with respect to most debt and equity securities.[101] It also continued Section 21's prohibition on the acceptance of deposits by broker-dealers and other nonbanks.[102] Thus, while a wide range of financial services could be offered through a single affiliated financial holding company, individual subsidiaries within the conglomerate are not permitted to offer universal banking services. Finally, GLBA also preserved laws, such as Sections 23A[103] and 23B[104] of the Federal Reserve Act, that restrict and limit the relationships of and transactions entered between affiliates within a single financial holding company conglomerate.[105]

Policy Implications of Reinstituting a Glass-Steagall Regime

Less than a decade after GLBA's repeal of the Glass-Steagall Act's affiliation restrictions, the United States suffered its worst financial crisis since the Great Depression. As previously mentioned, this has led some to argue that the repeal of the Glass-Steagall Act either caused or exacerbated the negative impact of the recent crisis. What follows is an analysis of the role that the Glass-Steagall affiliation restrictions played in financial stability, generally, as well as the likely impact that the repeal of those affiliation restrictions had on the recent financial crisis, with a specific focus on the bursting of the housing bubble, which many economists believe was a primary contributor to the crisis.

Potential Trade-Offs When Addressing Sources of Financial Instability

Financial policy decisions often involve trade-offs. The Glass-Steagall approach could reduce potential conflicts of interest when a financial firm has a client interested in more than one type of financial product (in this case, deposits and securities) by removing the incentive for banks to

[100] Approval of a bank holding company's application to become a financial holding company is not automatic; under GLBA, the Fed may not approve such an application unless it finds that all of the bank holding company's subsidiary commercial banks are well-capitalized and well-managed. 12 U.S.C. §1843(*l*)(1).

[101] 12 U.S.C. §24 (Seventh).

[102] 12 U.S.C. §378(a)(1).

[103] 12 U.S.C. §371c.

[104] 12 U.S.C. §371c-1.

[105] For a fuller analysis of Federal Reserve Act §§23A and 23B, *see* the "Federal Reserve Act Sections 23A and 23B Restrictions on Interaffiliate Transactions Between Banks and Securities Subsidiaries of FHCs or Financial Subsidiaries of Banks" of CRS Report R41181, *Permissible Securities Activities of Commercial Banks Under the Glass-Steagall Act (GSA) and the Gramm-Leach-Bliley Act (GLBA)*, by David H. Carpenter and M. Maureen Murphy.

refer depository customers to their own securities dealers. It also could help protect the payment system by preventing losses in securities markets from causing depository banks to fail. However, these potential advantages may come at the cost of reduced financial institution diversification and reduced prudential oversight of securities-funded debt because, in general, securities regulation is disclosure based, not prudential.[106]

Reinstituting a rigid separation between commercial and investment banking would not eliminate every potential risk to the financial system. For example, commercial banks generally are subject to regulatory caps on any single asset class exceeding a certain percentage of the bank's portfolio.[107] These caps on asset class are intended to diversify bank portfolios so that losses in any one industry or one geographic area do not destabilize the banking system as a whole. However, under Glass-Steagall Act Section 16, commercial banks are allowed to invest, deal in, and to hold certain bank-eligible securities, such as U.S. Treasury securities, without limitation. To the extent that banks hold significant amounts of Treasury securities or other exempt assets, a substantial devaluation of those assets for any reason would impose significant losses on the banking system and potentially trigger a financial crisis.

Other potential sources of financial crises include "irrational exuberance" for a traditional bank product, capital flight in anticipation of a sharp currency devaluation, and settlement failures for products used as collateral for securities trades.[108] The Glass-Steagall Act was not designed to prevent these other sources of financial instability.

Evidence of the Effectiveness of the Glass-Steagall Act in Enhancing Financial Stability

There is a cost to restricting the range of activities for banks, such as the Glass-Steagall Act's restriction on securities activities. Activity restrictions reduce the risk that losses from the prohibited activity will destabilize the banking market, but at the cost of reducing diversification. Under a Glass-Steagall-like regime, commercial banks would be less likely to suffer losses from securities offerings, but they also would be less likely to be able to offset losses from core lending activities during periods in which securities markets continue to operate profitably. Evaluating this tradeoff can be difficult because it requires either cross-country comparisons or reference to distant U.S. history.

Proponents of a return to Glass-Steagall may argue that financial stability in the United States appears to have improved in the period after Glass-Steagall was passed. The United States suffered repeated banking crises prior to the enactment of the Glass-Steagall Act. During a typical 19th century banking panic in the United States, depositors would discover that their bank was in trouble or might hear similar rumors of other banks, then rush to withdraw their deposits.[109]

[106] Under Title I of Dodd-Frank Act, investment banks that are designated as systemically significant by the Financial Stability Oversight Council (FSOC) are subject to prudential regulation by the Fed.

[107] 12 U.S.C. §24 (Seventh). Regulatory limits on asset concentration by country or industry may serve as an illustration. *See, e.g.*, *Common Practices for Country Risk Management in U.S. Banks*, Bd. of Governors of the Fed. Reserve Sys., November 1998, available at http://www.federalreserve.gov/boarddocs/staffreports/country.pdf.

[108] For a nonexhaustive list of 26 potential causes of the recent financial crisis, *see* CRS Report R40173, *Causes of the Financial Crisis*, by Mark Jickling. This report addresses, in more general terms, the majority of the 26 potential causes specified in CRS Report R40173, *Causes of the Financial Crisis*, with a focus on the potential causes that are most relevant to the Glass-Steagall Act's affiliation restrictions.

[109] *See* Charles W. Calomiris, *Banking Crises and the Rules of the Game*, Nat'l Bureau of Econ. Research, October 2009.

Fractional reserve banking systems are not designed to withstand these bank runs. Even the establishment of the Fed as a lender of last resort in 1913 did not end bank runs in the United States. It might be argued that the reduction in depositor bank runs following the enactment of the Banking Act of 1933 is evidence that the four Glass-Steagall provisions shored up confidence among depositors that their banks would not lose money in securities activities, making them less likely to withdraw deposits during an economic downturn.

There is an alternative interpretation of the effect of the enactment of the Banking Act of 1933 on the reduction in the number of bank runs. In addition to erecting the Glass-Steagall affiliation restrictions, the Banking Act of 1933 also established the FDIC as a government-backed guarantor of certain commercial bank deposits. There arguably is a more direct connection between deposit insurance and the likelihood of bank runs by depositors than restrictions on the securities activities of commercial banks because FDIC insurance insulates depositors from bank losses.[110] However, because both policy changes were enacted in the same legislation, it is difficult to appeal to U.S. history to evaluate the tradeoff between activity limitation and diversification.

Evidence of financial stability or instability may also be seen by comparing the historical record of different countries. Such comparisons are mixed. Many developed economies do not separate commercial banking from investment banking. For example, many countries allow their banks to provide the full range of financial services. On the one hand, these countries generally experienced fewer bank runs than did the United States in the 19th century and experienced similar stability following World War II.[111] For example, Canada did not suffer the intensity of bank runs that the United States did during the Great Depression, nor did Canada's financial system suffer the degree of instability that the United States did during the recent mortgage crisis, even though Canada and the United States are both developed economies with many similar activities.[112] Yet, Canada's banks are not restricted the way that U.S. banks were by the Glass-Steagall Act. The relative stability of Canada's financial system, however, did not prevent severe economic hardship during the Great Depression or other bouts of economic instability.[113] Similarly, many European countries with universal banking enjoyed relative financial stability during the same time that Glass-Steagall was in effect in the United States.[114] However, financial crises and banking panics struck several European and emerging market economies with very different regulatory and institutional approaches during the 1990s.[115] Historical and international comparisons, thus, are inconclusive.

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[110] M. Keeley, *Deposit Insurance, Risk, and Market Power in Banking*, 80 Amer. Econ. Rev. 1183 (1990).

[111] Report of the National Monetary Commission, pp. 23, 38-39, January 9, 1912, available at http://www.federalreservehistory.org/Media/Material/Event/60-238 (discussing relative financial stability in Great Britain, France, and Germany).

[112] Hugh Thomas and Ingo Walter, *The Introduction of Universal Banking in Canada: An Event Study*, 2 J. Int'l Fin. Mgmt. & Acct. 110 (1991).

[113] Pedro S. Amaral and James C. MacGee, *The Great Depression in Canada and the United States: A Neoclassical Perspective*, 5 Rev. of Econ. Dynamics 45 (2002), available at http://publish.http://publish.uwo.ca/~jmacgee/RED_depresion.pdf.

[114] *See, e.g.*, Theodor Baums and Michael Gruson, *The German Banking System – System of the Future?*, 19 Brooklyn J. of Int'l L. 101 (1993).

[115] *See, e.g.*, Paul Krugman, *Currency Crisis* (Ch. 8.1 of INTERNATIONAL CAPITAL FLOWS issued by the Nat'l Bur. of Econ. Research), pp. 431-434, January 1999, available at http://www.nber.org/chapters/c9803.pdf (discussing the European Exchange Rate Mechanism Crisis of 1992-93).

How Might the Absence of Glass-Steagall Have Affected Financial Instability During the 2000s?

The financial crisis of 2007-2008 consisted of several elements, including the following:

- the expansion of mortgage-related debt and rapidly rising house prices prior to financial turmoil;
- the bursting of this housing bubble in 2007, and the accompanying illiquidity in financial markets tied to housing and mortgages; and
- financial panics[116] in September and October of 2008, during which
    - several major financial institutions, including broker-dealers and an insurance firm, filed for bankruptcy, were provided emergency financial assistance by policymakers, or were sold under distress, largely as a result of losses on mortgage-related assets; and
    - various securities markets suffered severe disruptions, such as when the money market mutual fund industry suffered rapid withdrawals resembling a bank run.

Analyzing these events requires not only taking into account the permissible activities and regulation of banks, but also the permissible activities of securities firms and other nonbanks.

Housing Boom and Bust

Some have argued that the housing bubble and mortgage crisis would not have occurred had the Glass-Steagall Act not been eroded (as described above) and partially repealed by GLBA.[117] An evaluation of this argument requires identifying the banking and securities activities that caused significant losses in the mortgage market and an analysis of whether or not those activities would

[116] The term "financial panic" is used in this context as a term of art. Economists have diagnosed financial panics as a special application of Charles Mackay's 1841 classic, EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS. The term is used to describe sudden self-reinforcing plunges in asset prices, races to withdraw funds from brokerage and depository accounts, and refusals to renew extensions of credit to longstanding counterparties. For examples of the variety of financial arrangements that can be associated with financial panics, *see* CRASHES AND PANICS: LESSONS FROM HISTORY, Eugene White ed., Irwin Professional Pub, Homewood, Ill. (1990). Often, but not always, financial services panics involve a timing conflict between a firm's assets and liabilities, i.e., a maturity mismatch. Former Fed Chairman Ben S. Bernanke, for example, has defined "financial panic" in a maturity mismatch context as "a generalized run by providers of short-term funding to a set of financial institutions, possibly resulting in the failure of one or more of those institutions ... [that] is possible in any situation in which longer-term, illiquid assets are financed by short-term, liquid liabilities, and in which suppliers of short-term funding either lose confidence in the borrower or become worried that other short-term lenders may lose confidence." Federal Reserve Board of Governors Chairman Ben S. Bernanke, Reflections on a Year in Crisis, Speech delivered at the Federal Reserve Bank of Kansas City's Annual Economic Symposium, Jackson Hole, Wyoming, August 21, 2009, available at http://www.federalreserve.gov/newsevents/speech/bernanke20090821a.htm. In addition to those associated with maturity-mismatch, financial panics can occur in other contexts where lenders or investors lose confidence in their borrowers' ability to make a return on loans or investments, such as in a classic bank run by depositors.

[117] *See, e.g.,* Thomas Hoenig, Vice Chairman Fed. Deposit Ins. Corp., *Lehman Brothers: Looking Five Years Back and Ten Years Ahead,* Speech Before the National Association of Corporate Directors, Texas Tricity Chapters Conference, September 2013, (arguing that the repeal of the Glass-Steagall Act caused the win-lose culture of broker-dealers to replace the more cautious traditional culture of commercial banks, which resulted in increased appetite for risk in the financial system, such as through mortgages, and resulted in increased leverage of financial firms within the federal safety net); James Rickards, *Repeal of Glass-Steagall Caused the Financial Crisis*, U.S. News & World Report, August 27, 2012, available at http://www.usnews.com/opinion/blogs/economic-intelligence/2012/08/27/repeal-of-glass-steagall-caused-the-financial-crisis.

have been prohibited or curtailed under a Glass-Steagall regime. Put another way, this section analyzes whether the mortgage crisis of the mid- to late-2000s could have happened even in the absence of the erosion, or outright repeal by GLBA, of Glass-Steagall's separation of commercial and investment banking *within a single financial conglomerate*.[118]

During 2007-2009, the historically large increase in the default rates of residential mortgages caused losses that depleted bank capital and contributed to financial instability.[119] Many analysts also have identified losses on securitized mortgages as a significant contributor to financial instability during the recent crisis.[120] These losses caused the government-sponsored enterprises, Fannie Mae and Freddie Mac, to require significant taxpayer support in order to maintain solvency.[121] Thus, the capital of the banking system was at risk whether the mortgages were held outright or in the form of securities, even if the mortgage-backed securities were guaranteed.

Offering mortgages and holding mortgages in portfolio are part of the core business of commercial banks, although banks generally are encouraged to diversify their activities. The Glass-Steagall Act did not prohibit banks from holding whole mortgages on their balance sheets, regardless of whether or not they originated them. The Glass-Steagall Act also did not prohibit banks from holding mortgages in the form of securities backed by the Federal Home Owners Loan Corporation (under the original language of the Glass-Steagall Act) or by Fannie Mae or Freddie Mac (under Glass-Steagall Act Section 16 as amended after the establishment of these two government-sponsored enterprises).[122]

Prudential regulators of banks have generally sought to limit banks's exposure to mortgage-related assets because of maturity mismatch.[123] Even prior to GLBA, bank regulators encouraged securitization in part to remove mortgages and mortgage-related assets from the banking system under this same policy rationale.[124] But Glass-Steagall Act Section 16 goes farther than encouragement or discouragement, by limiting bank acquisition of private-label mortgage-backed securities (i.e., mortgage-backed securities that are not guaranteed by Fannie Mae or Freddie Mac). This Section 16 limitation was in force both before and after GLBA because GLBA did not

[118] For a general discussion of what the Glass-Steagall Act did not do, *see "The Glass-Steagall Act"* section of this report.

[119] *Financial Crisis Inquiry Report*, Fin Crisis Inquiry Comm'n, p. xvi (2011), available at https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

[120] *Id.*

[121] See CRS Report RL34661, *Fannie Mae's and Freddie Mac's Financial Problems*, by N. Eric Weiss, available upon request.

[122] Functionally, Glass-Steagall attempted to prevent banks from speculating on securities for their own account (proprietary trading). Because there is little economic difference between a bank holding 100 mortgages in its portfolio compared to a bank holding a security entirely backed by the same 100 mortgages, regulators must attempt to interpret the statute as financial products evolve, or there must be additional statutory guidance. One of the benefits that the government-sponsored enterprises received as part of their charters was that banks had fewer restrictions on their ability to hold GSE-related mortgage securities. *See* CRS Report RL33756, *Fannie Mae and Freddie Mac: A Legal and Policy Overview*, by N. Eric Weiss and Michael V. Seitzinger, available upon request.

[123] The prudential regulators encouraged the securitization of mortgages in part to better manage asset concentration risks. *See, e.g.*, Asset Securitization Comptroller's Handbook, Office of the Comptroller of the Currency, p. 2, November 1997, available at http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/assetsec.pdf (describing asset securitization as enhancing a lender's ability to "... manage potential asset-liability mismatches and credit concentrations.").

[124] *See* David C. Wheelock, *Government Policy and Banking Market Structure in the 1920s*, 53 J. of Econ. Hist. 857, 857-59 (December 1993). Prudential regulation of mortgage-related assets predates Glass-Steagall. That is, banking regulators have traditionally had other sources of authority to use to limit mortgage-related assets, and in practice they exercised it.

repeal Section 16. Yet, the mortgage crisis of the 2000s happened in spite of Section 16's limitations and the other policies to encourage removal of mortgage-related assets from depositories. Therefore, the erosion and repeal of the Glass-Steagall Act's affiliation restrictions was probably not the primary cause of the growth of private label securitization or the rise and fall in real estate prices.

Underwriting Standards and Losses on Mortgage-Related Securities

The potential effects of the Glass-Steagall Act on mortgage underwriting standards and eventual firm losses involve trade-offs that could mitigate or exacerbate problems that emerged during the crisis. As is explained below, the four provisions of the Glass-Stegall Act do not directly address loan qualification standards; however, they could affect the incentives of mortgage originators. On the one hand, the separation of commercial banking from securities issuance can foster an originate-to-distribute model if securities markets help fund debt. On the other hand, bank lenders that also issue securities backed by loans might self-deal or otherwise favor their own interests over the interests of their customers. Both adopting an originate-to-distribute model and engaging in self-dealing could entice mortgage originators to imprudently loosen underwriting standards.

The Glass-Steagall Act did not directly address prudent lending standards. It was not designed to prevent the erosion of mortgage underwriting standards of primary lenders or to anticipate all future contingencies that might increase mortgage defaults for commercial banks. Because the capital of the banking system was directly exposed to a rise in defaults for a core business of commercial banking—residential mortgages—a stronger separation of commercial and investment banking probably would not have prevented losses among commercial banks or prevented a contraction in credit made available to the wider economy when the banking system became undercapitalized.

Some might argue that the Glass-Steagall Act could have prevented the decline in underwriting standards that is often attributed to securitization, notably in mortgages originated by nonbank lenders.[125] However, the Glass-Steagall Act limited the investment activities of commercial banks; it did not prevent nondepositories from extending mortgages that compete with commercial banks. It did not prevent these nondepositories from then selling the mortgages to investment banks. It did not prevent investment banks from transforming the mortgages into securities to sell to pension funds, insurance companies, or other investment pools. The Glass-Steagall Act also did not directly address the financial incentives of the institutions that originated mortgages, sold mortgage-related securities, or held mortgage assets. Therefore, the Glass-Steagall Act would have been unlikely to prevent the decline in underwriting standards that is attributed to nondepositories through securitization.

On the other hand, the Glass-Steagall provisions were directed at the conflicts of interest and other potential abuses of commercial banks that also issued securities.[126] The repeal of the Glass-Steagall Act's affiliation restrictions could have placed downward pressure on mortgage underwriting standards as a result of the incentives associated with universal banks' (i.e., financial holding companies with both depository bank and broker-dealer subsidiaries) attempts to establish initial market share in securities markets after GLBA's enactment.

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[125] *See Subprime Lending and Securitization and Government-Sponsored Enterprises (GSEs), Hearing Before the Fin. Crisis Inquiry Comm'n*, 111th Cong. (2010) (written testimony of John C. Dugan, Comptroller of the Currency), available at http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0408-Dugan.pdf.

[126] For a discussion of the policy aims of the Glass-Steagall Act as originally enacted, *see* the "Background" and "The Glass-Steagall Act" sections above.

One European Central Bank (ECB) study tried to assess the relative default rates contained in securities issued through the broker-dealer channel (e.g., Morgan Stanley) to securities issued through large universal banks (e.g., JPMorgan).[127] This study found that the securities issued through the universal bank channel had "a significantly higher default rate" than those issued through broker-dealers that were unaffiliated with commercial banks.[128] The authors found no evidence that these universal banks had engaged in the types of self-dealing the Pecora Commission had identified and that the Glass-Steagall Act was specifically designed to address.[129] However, they did find evidence consistent with these universal banks lowering prices (i.e., "underestimating default risk") as a way to try to increase their market share.[130] "In other words, banks had to be initially more aggressive than investment banks [*sic*] houses in order to gain market share, and in pursuing this objective they might have loosened their credit standards excessively."[131] The resulting heightened default rates might have exacerbated the effects of the recent mortgage and housing crises. If the Glass-Steagall Act's affiliation restrictions had been strictly enforced, these bank-affiliated participants (which ultimately had higher default rates after GLBA) would not have entered the market, although it would not have prevented new, nonbank-affiliated entrants that also might have desired to expand their market share.

Securities Market Disruption

In addition to broker-dealers and other nonbank financial firms suffering losses on mortgage-related assets, the financial crisis also saw several securities markets crash in ways that the Glass-Steagall Act's affiliation restrictions likely would not have prevented.[132]

Financial markets can become unstable, for instance, if the value of assets used as collateral becomes uncertain or falls quickly. In addition, financial markets are inherently vulnerable because the business of finance frequently involves maturity mismatch (i.e., "a situation in which longer-term, illiquid assets are financed by short-term, liquid liabilities, and in which suppliers of short-term funding either lose confidence in the borrower or become worried that other short-term lenders may lose confidence").[133] The U.S. securities markets suffered from both types of vulnerabilities in 2007-2008.[134] The four Glass-Steagall provisions (or even the

[127] Dario Focarelli, David Marques-Ibanez, and Alberto Franco Pozzolo, *Are Universal Banks Better Underwriters? Evidence from the Last Days of the Glass-Stegall Act*, European Central Bank Working Paper Series No. 1287, January 2011, available at https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1287.pdf?09b2c4eba47768c81d6bb53a500f6761.

[128] *Id*. at 22.

[129] *Id*. at 23.

[130] *Id*.

[131] *Id*.

[132] Securities market turmoil also occurred during the Glass-Steagall Era, such as the "Black Monday" crash of 1987. *See* Federal Reserve Board Governor Susan M. Phillips, *Black Monday: 10 Years Later*, Speech at Bentley College, Waltham, Mass., October 15, 1997, available at http://www.federalreserve.gov/boarddocs/speeches/1997/19971015.htm.

[133] *See* Federal Reserve Board of Governors Chairman Ben S. Bernanke, *Reflections on a Year in Crisis*, Speech delivered at the Federal Reserve Bank of Kansas City's Annual Economic Symposium, Jackson Hole, Wyoming, August 21, 2009, available at http://www.federalreserve.gov/newsevents/speech/bernanke20090821a.htm.

[134] *See* Federal Reserve Board Governor Daniel K. Tarullo, Shadow Banking After the Financial Crisis, Speech delivered at the Federal Reserve Bank of San Francisco Conference on Challenges in Global Finance: The Role of Asia, San Francisco, California, June 12, 2012, available at http://www.federalreserve.gov/newsevents/speech/tarullo20120612a.htm (outlining financial panics in the money market industry, as well as the tri-party repo (repurchase agreement) and securities lending markets in 2008, some of which involved maturity mismatch and some involving price volatility).

contemporaneously enacted securities acts) did not address maturity mismatch or the vulnerability of the system to a sharp decline in collateral values (in this case, home prices).

For example, a money market fund, The Reserve Primary Fund, suffered losses on debt issued by a broker-dealer, which ultimately led the value of its shares to "break-the-buck" (i.e., fall below par of $1.00 per share) in 2008.[135] Although not legally obligated to do so, money market fund sponsors in such situations historically have stepped in to absorb losses necessary to avoid breaking-the-buck. The Reserve Primary Fund, however, did not provide this informal relief in 2008.[136]

After news spread that The Reserve Primary Fund's shares broke-the-buck, investors began withdrawing money from other money market funds, creating a panic in the money market fund industry that was analogous to a classic bank run. Policymakers confronted the possibility that industries that depended upon money market funds for short-term financing would also experience stress.[137] In response, the Department of the Treasury created a temporary program to insure money market funds.[138] This episode is instructive because anything that could cause a firm whose debt is held by money market funds[139] to default could have sparked such a run. Yet, the Glass-Steagall Act's affiliation restrictions would not prevent these types of runs.[140]

How the Dodd-Frank Act Addressed the Relationship Between Commercial and Investment Banking

Although the Dodd-Frank Act neither reinstated the sections of the Glass-Steagall Act repealed by GLBA nor eliminated the ability of banking firms to affiliate with securities firms, it included various provisions designed to meet some of the same policy objectives of the Glass-Steagall Act. These policy objectives include reducing speculative securities-related activities of commercial banks and eliminating sources of financial instability, including some sources that the Glass-Steagall Act was never intended to address, such as the potential for securities markets to cause a crisis.

One illustration is Section 619 of the Dodd-Frank Act, commonly referred to as the Volcker Rule.[141] As mentioned in the introduction, trading securities for one's own account (proprietary

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[135] *See* Federal Reserve Board Governor Daniel K. Tarullo, *Shadow Banking After the Financial Crisis*, Speech delivered at the Federal Reserve Bank of San Francisco Conference on Challenges in Global Finance: The Role of Asia, San Francisco, California, June 12, 2012, available at http://www.federalreserve.gov/newsevents/speech/tarullo20120612a.htm.

[136] *Id*.

[137] *See* the "Money Market Mutual Fund Guarantee Program" section of CRS Report R43413, *Costs of Government Interventions in Response to the Financial Crisis: A Retrospective*, by Baird Webel and Marc Labonte.

[138] *Id*.

[139] Money market funds hold a variety of highly liquid and relatively low-risk assets. Typically, these include government securities, certificates of deposit, commercial paper of companies, or other similar securities. Losses in any of these markets could cause a money market fund to break-the-buck, not just a default by a securities broker-dealer. *See Fast Answers: Money Market Funds*, Securities and Exchange Commission, available at http://www.sec.gov/answers/mfmmkt.htm.

[140] The Glass-Steagall Act, for instance, did not provide a guarantee that money market or other investment funds would not lose money.

[141] P.L. 111-203 §619, codified at 12 U.S.C. §1851. *See also* CRS Report R43440, *The Volcker Rule: A Legal Analysis*, (continued...)

trading) is riskier than mere brokering on behalf of customers. When trading on behalf of customers, the firm derives a fee no matter which direction the security's price moves. The Volcker Rule generally prohibits "banking entities" (i.e., commercial banks and their affiliates) from engaging in the proprietary trading of securities, but permits customer-driven securities transactions. The Dodd-Frank Act arguably restricts proprietary trading even more than the Glass-Steagall Act did because the Volcker Rule applies not just to depository institutions, but also to all a depository's affiliates and subsidiaries, including broker-dealers. The Volcker Rule also restricts banking entities' ability to make investments in or have relationships with hedge funds and similar "covered funds" that are exempt from registering with the SEC or Commodity Futures Trading Commission (CFTC).[142]

The Dodd-Frank Act also includes multiple titles focused on promoting financial stability, many of which are not limited to depository institutions. Some of the examples include heightened prudential regulations under Title I, which are applied not only to large banks, but also to systemic nonbank financial institutions.[143] Some examples of heightened prudential regulations include emergency divestiture authority[144] and floors for permissible regulatory standards set by regulators.[145] In addition, Title I of the Dodd-Frank Act established the Financial Stability Oversight Council (FSOC) to monitor systemic risks to the U.S. financial system and provided the Fed enhanced prudential regulatory powers over systemically important bank and nonbank financial firms.

In addition, the Dodd-Frank Act strengthens mortgage underwriting, origination, and securitization standards for both depository and nondepository institutions in an attempt to address the mortgage-related issues that seemed to play such a significant role in the recent financial crisis.[146]

Moreover, the Dodd-Frank Act has left untouched Sections 16 and 21 of the Glass-Steagall Act, limiting the types of investments that banks may undertake and precluding securities firms from engaging in deposit taking.

The policy tools incorporated in the Dodd-Frank Act can potentially address several sources of financial instability that the Glass-Steagall regime alone could not. For example, not only were commercial banks kept separate from investment banks under the Glass-Steagall Act, but some policy tools for addressing causes of financial instability were limited to the commercial banking sector. In contrast, the Dodd-Frank Act includes policy tools to provide prudential regulation for large systemic financial firms even if they are not commercial banks, and an administrative alternative to bankruptcy for nondepository financial institutions.

(...continued)

by David H. Carpenter and M. Maureen Murphy.

[142] *Id*.

[143] P.L. 111-203, Title I, codified at 12 U.S.C. §§5311, *et. seq. See also* CRS Report R41384, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Systemic Risk and the Federal Reserve*, by Marc Labonte.

[144] P.L. 11-203 §121, codified at 12 U.S.C. §5331.

[145] P.L. 111-203 §115, codified at 12 U.S.C. §5325.

[146] P.L. 111-203, Title XIV and §941, primarily codified through amendments of the Truth in Lending Act, 15 U.S.C. §§1601, *et seq*., and the Real Estate Settlement Procedures Act, 12 U.S.C. §§2601, *et seq*. *See, also,* CRS Report R43081, *The Ability-to-Repay Rule: Possible Effects of the Qualified Mortgage Definition on Credit Availability and Other Selected Issues*, by Sean M. Hoskins and CRS In Focus IF10204, *QRM: Risk Retention and the Mortgage Market*, by Sean M. Hoskins.

Conclusion

The separation of commercial and investment banking can help insulate insured depositories from volatility in securities markets. It can also insulate investment decisions by depositors from conflicts of interest if depository bankers refer clients to their own affiliates. This insulation comes at the cost of reducing the diversification of revenue sources for the banking system. The separation, by itself, does not address how investment banks are regulated within securities markets or the ways in which nonbanks can use securities activities to fund consumer and commercial debt in competition with depository banks. That is, the securities laws governing the treatment of debts funded through securities markets can be heightened or eased whether or not commercial banks may affiliate with securities broker-dealers. Separation of commercial and investment banking may help reduce the complexity of examining depositories, although it does not necessarily reduce the complexity of how securities markets fund debt.

Over the 70 or so years of the Glass-Steagall era, economic conditions, regulatory interpretations, and legislative changes eroded the rigid wall it established between commercial and investment banking. GLBA was the final step in this process. The Dodd-Frank Act attempts to promote financial stability and to limit some of the potential speculative activities of commercial banks in various ways, such as through the Volcker Rule, but it does not completely restore the Glass-Steagall Act. Even if the Dodd-Frank Act had completely re-enacted the repealed provisions of the Glass-Steagall Act, the financial history of the 1970s, 1980s, and 1990s shows that regulatory walls could be difficult to maintain or enforce.

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