Will Trump Reimpose Glass-Steagall?

Mark Kolakowski

November 16, 2016

It was arguably the biggest deal era ever in the U.S. banking industry.

Trump Reforms

The 1999 repeal of part of the Glass-Steagall Act spawned the birth of a new breed of megabanks that transformed American business and finance.

JPMorgan Chase & Co. was forged from a breathtaking series of deals, including the purchase of Bear Stearns. Bank of America Corp. become dominant through a series of banking and brokerage takeovers, including Merrill Lynch. Citigroup Inc., created in 1998 from a giant merger, signaled Glass Steagall's demise.

Breaking Up Wall Street

President-Elect Donald Trump pledged during his election campaign to reverse that trend by reimposing a key element of Glass-Steagall to create a smaller banking sector that will no longer pose a threat to the U.S. or global economy as it did during the 2008 financial crisis.

A strict reimposition of the law would force bank holding companies to divest any Wall Street subsidiaries, including their brokerage and investment banking arms, in a significant reshaping of the industry.

Mark A. Calabria, director of Financial Regulation Studies at the Cato Institute, predicts that the big losers would include JPMorgan Chase (JPM) and Citigroup (C). Bank of America (BAC) and Wells Fargo (WFC) would also be hurt, but "not to the same extent." Nonetheless, the new rule could even force Bank of America to divest its giant Merrill Lynch unit.

While smaller banks may be unscathed, the super regional banks also may be vulnerable, says Calabria. "Most smaller banks do little investment banking. The more important question is really the mega-regionals," he says. "Would banks like PNC Financial Services Group (PNC), SunTrust Banks Inc. (STI) and Regions Financial Corp. (RF) be carved out (i.e., exempted)? Maybe."

Foreign Bank Losers

Calabria notes that big foreign banks such as UBS Group AG (UBS), Credit Suisse Group AG (CS) and Deutsche Bank AG (DB) also would be affected, but they already have separate U.S. operations to some extent. Anyway, he says, the U.S. market is becoming "ever less attractive to foreign banks for lots of reasons. Ultimately U.S. consumers, mostly corporate but also household, will be hurt from reduced competition."

Trump's Winners

Winners would include Morgan Stanley (MS) and Goldman Sachs Group Inc. (GS). They would enjoy less competition from big commercial banks, in return for giving up a small presence in traditional commercial banking.

A rising number of voices have called for the reimpositon of something resembling the key section of the Glass-Steagall Act of 1933 barring commercial banks from underwriting or dealing in securities. During the 1930s, the logic was simple and compelling: to reduce risk to the financial system after massive failures of banks and securities firms that followed the 1929 stock market crash and the onset of the Great Depression.

Glass Steagall's Logic

"Many on Wall Street actually supported the original Glass-Steagall as an avenue to reduce competition, and Wall Street had sued on several occasions to protect Glass-Steagall from being watered down," notes Calabria. "The issue is more complex than conventional wisdom presents it as." He points out that the 1933 bill had many exceptions. For example, commercial banks were allowed to underwrite bonds issued by governments and their agencies at the federal, state and local levels.

Repeal in 1999

Peter Wallison, co-director of Financial Policy Studies at the American Enterprise Institute, points out that Glass-Steagall was not repealed entirely in 1999, just the section that excluded commercial banks from investment banking and broker-dealer activities. The bill, pushed by the banking industry, allowed bank holding companies to enter these fields through separately incorporated affiliates.

For decades, banks had lost ground to securities firms as sources of financing for major corporations, and Glass-Steagall thus had become "a very outdated restriction on the financial system," he says. The 1999 bill "saved banks from being isolated from (large sectors of) the economy," given that demand for commercial loans largely was confined to startups and small companies by then. (See also: *America's Startups Crisis: It's Hurting the Economy*.)

Bank Breakups a "Serious Mistake"

The financial crisis of 2007-08 increased the concentration of the financial services industry and concerns about "too big to fail" and "systemically important" institutions. Long before Trump's election as president, enthusiasm for restoring the old Glass-Steagall had started to grow, partly as a means to break up big bank holding companies.

Wallison says that making bank holding companies divest profitable securities underwriting and broker-dealer affiliates would be "a serious mistake." It would create weak banking institutions and require bailouts, he says. In his view, “the dangerous institutions are the (traditional) banks themselves, especially the trillion dollar banks." Moreover, the divestiture process would be a complex undertaking, certain to “cause tremendous market turbulence” for years.

Reform Compromise

The post-election rally in bank stocks seems to indicate that banks aren't concerned about a return of Glass Steagall under Trump. Wallison argues that a Republican Congress would never consider, let alone pass, the necessary legislation. Such a move would be contrary to Trump's deregulatory, pro-growth economic agenda.

Trump and Congress could find a middle road. Calabria, for one, is confident that a new Glass-Steagall Act, like the original and the more recent Volcker Rule, would have many exceptions. Like anything out of Congress, "the final product would resemble Swiss cheese." He estimates that passage by Congress has "maybe a 25% chance and only if included as part of a larger package. Zero chance it would pass as a standalone measure."

Bank CEOs, no doubt, will watch those odds carefully. Trump, after all, initially was seen as having far less than a 25% chance of becoming president. That means anything can happen, especially on Wall Street.