# Glass-Steagall Act: Nostalgia For An Old Law Won't Help the Economy

By: Brian Jencunas – July 12, 2013

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If Sen. Elizabeth Warren (D-Mass.) has her way, banks will have to party like it's 1999. Warren, along with three other senators, has filed the 21st Century Glass-Steagall Act, a bill that would prevent deposit-holding banks from also being investment banks or insurers. This law was originally passed in 1933 and remained in effect until 1999, when the Gramm-Leach-Billey Act repealed certain aspects of it. Warren made banking regulation a central part of her Senate campaign, using the phrase "banking should be boring" and reminding voters of Wall Street's role in the 2008 financial crisis.

Hating Wall Street has always been great politics — both Franklin and Teddy Roosevelt referred to bankers and political opponents as "malefactors of great wealth" and more recently President Obama pilloried Mitt Romney's private equity background during the 2012 election. However, as public policy, the 21st Century Glass-Steagall Act is a disaster. It makes risk management more difficult for American banks while also preventing them from being competitive on a global scale.

Wall Street's risk management leading up the 2008 financial crisis was abysmal, but as Warren admitted in an interview with Andrew Ross-Sorkin, the 21st Century Glass-Steagall Act wouldn't have prevented the crisis. Keeping banking "boring" won't actually reduce the risk of bank failures, as lending money is not inherently less risky than investment banking.

Some of the most egregious examples of banks failing to manage risk have come from the commercial sector. Commercial banks like Countrywide, Wachovia, and IndyMac collapsed and helped cause the 2008 financial crisis by giving mortgages to borrowers who had neither the income nor the assets to pay back the loans, while only one of the banks that failed in 2008 had investment banking operations. Had the 21st Century Glass-Steagall Act been in place, the crisis would have been worse, since investment banks like Goldman Sachs and JPMorgan could not have purchased the failing banks.

One of the ways banks manage risks is diversification — being involved in a variety of sectors means losses in one can be offset by gains in another. Warren's bill would prevent this kind of diversification and make banks more vulnerable to the boom-and-bust cycle.

During her appearance on MSNBC's *Morning Joe*, Warren claimed her bill wouldn't change how customers interact with their banks, but many Americans would actually end up paying more for banking if her bill becomes law. When commercial banks can also offer insurance, it encourages them to offer lower rates to people who use the bank

for both their insurance and banking needs. That would be illegal under Warren's bill, and consumers would pay more because of it.

Most harmfully however, the 21st Century Glass-Steagall Act would make American banks less competitive internationally. That might sound good to many Americans, who are angry at Wall Street's excesses, but since the financial sector is a major part of America's overall GDP, unreasonable handicaps would have dire ramifications for the rest of the economy.

As Cato Institute fellow Louise Bennett wrote, "The U.S. is the only country that has ever pursued a fragmented banking industry and .... There has been little momentum on the part of most overseas regulators to restructure or restrict global banks (except in the case of imposing higher capital requirements)."

This means that American banks would have a harder time competing with their European and Chinese counterparts if Warren's bill passes. That could lead to American companies choosing foreign investment banks, and American banks moving operations overseas. Both of these would take money out of the American economy, harming an already sclerotic economic recovery.

Banks absolutely need better risk management, and since their deposits are insured by the government, regulations should have a part to play in forcing changes. But this bill is a terrible way to go about it. The Basel III summit has already produced a global agreement to raise capital requirements for banks, and that would lower banks' risk exposure without making it harder for American banks to diversify or compete with foreign ones.