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Glass-Steagall Revival a Tough Fit for Modern Banking, Analysts Say

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New banking regulation discussions in Washington are dredging up a Depression-era ghost that analysts say would fit poorly in the modern financial industry.

Suggestions of reviving and revamping the Glass-Steagall Act, a 1933 law that separated commercial and investment banking, reignited after Bloomberg News reported on April 5 that National Economic Council Director Gary Cohn expressed support for such a separation during a private meeting with senators. The next day, Sen. Elizabeth Warren (D-Mass.) introduced her "21st Century Glass-Steagall Act of 2017," with Sens. John McCain (R-Ariz.) and Angus King (I-Maine) as co-sponsors.

Glass-Steagall has been off the books since 1999, when President Bill Clinton signed its repeal. Banking industry critics have pointed to the law's demise as a culprit in the 2008 financial crisis. The 2016 GOP and Democratic party platforms espoused some version of a Glass-Steagall revival, a nod to populist sentiments among the electorate.

But breaking up big banks would be applying old wisdom to a new financial system, said Aaron Klein, a Brookings Institution fellow in economic studies. The principle may be solid, he said, but the exact rule is not a good fit. Glass-Steagall also wouldn't have addressed the entities and activities behind the last decade's financial crisis, he added in an interview Tuesday.

“The craziness that occurred was unrelated to aspects of Glass-Steagall that people want to bring back,” said Klein, who’s also policy director of the Center on Regulation and Markets at Brookings.

But a more limited version of the old law is getting fresh consideration, and not just from lawmakers and Cohn.

A plan from Federal Deposit Insurance Corp. Vice Chairman Thomas Hoenig would allow investment and commercial banking activities to exist within the same bank holding company umbrella, but split into separately capitalized subsidiaries. Hoenig on Wednesday said policymakers should turn their efforts to structural banking changes rather than a purely regulatory approach.

Speaking at the Hyman P. Minsky economic conference, Hoenig said he’s not sure where the discussions of reinstating Glass-Steagall will lead.

“There are other alternatives, including greater separation of activities” within holding companies, he said.

Amanda Critchfield, a spokeswoman for Senate Banking Committee Chairman Mike Crapo (R-Idaho), declined to comment Wednesday on any Glass-Steagall proposals. Warren’s bill, which has four co-sponsors, was referred to the banking panel, which has taken no action on the measure.

The objective of any structural wall between banking activities is to protect insured deposits from risky trading activity, analysts say. But such plans would face challenges in an increasingly interconnected financial system.

It’s not clear what path President Donald Trump would choose. The White House on Wednesday did not provide a requested update on any Glass-Steagall policy plans, though spokeswoman Natalie Strom pointed to Trump’s campaign support for “simplification of the banking system.”

The Hoenig plan looks most feasible among the paths to a modern-day wall between banking activities, said Lawrence Baxter, a Duke University law professor and director of its Global Financial Markets Center. “I think that is the shortest way to get there,” he said in a Tuesday interview.

The U.K.’s banking separation regime, known as “ringfencing,” could also come into play as a model for U.S. banking regulation. But a key counterargument could limit its potential: that the separation between activities would be too flimsy to weather a crisis.

Serious changes to banking regulation would probably require broad bipartisanship on Capitol Hill, a scenario that isn’t likely in the 115th Congress.

It’s also worth considering what led to Glass-Steagall’s repeal, said Klein. Commingled activities from investment and commercial banking chipped away at its marrow, but the law’s final death knell resonated from a banking and insurance merger. And, because the Volcker Rule under the

2010 Dodd-Frank law already prohibits banks from proprietary trading activities, some Glass-Steagall nostalgics might be focusing more on size than activities, Klein said.

"What remains in a Volcker Rule world that requires Glass-Steagall unless your real objection is size?" he said.

Either Glass-Steagall or Hoenig's plan depend on federal banking guarantees, said George Selgin, director of the Cato Institute's Center for Monetary and Financial Alternatives.

"I sympathize and think there is a rationale for Hoenig's proposal and others like it," Selgin said in an interview Wednesday. But he said the banking system would be better served "by attacking the problem at its roots" by ruling out taxpayer bailouts.