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Should Glass-Steagall Be Reinstated?

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ABSTRACT

This paper will focus on the difference between commercial and investment banking and the efforts to reinstate the Glass-Steagall act. Many believe the repeal of Glass-Steagall was the primary cause of the Global Financial Crisis.

This paper argues that the Glass-Steagall act was not is not a universal Band-Aid for the United States banking system, and that other regulative actions need to be taken beyond the separating of commercial and investment banks.

Regulative methods include: ring-fencing, capital and liquidity requirements, stricter oversight of credit ratings agencies and more.

Word length

The text of this paper (excluding abstract, table of contents, footnotes and bibliography) comprises approximately 9588 words including substantive footnotes.

Subjects and Topics

Glass-Steagall Act 1933

Ring-Fencing

Commercial and Investment Banking

INTRODUCTION

In November 2015 during a Democratic Presidential debate against Hillary Clinton, Bernie Sanders[1] stated that he believed that the best way to regulate "too big to fail banks" and tackle Wall Street Reform, was to reinstate the Glass-Steagall Act.[2] Echoing Senator Sanders's sentiment former Labour Secretary to President Bill Clinton and economist Robert Reich[3] claimed that the overlap of commercial and investment banking was the driving factor behind the Global Financial Crisis (GFC) of 2008.[4]

This is not the first time cries of "reinstate Glass-Steagall" have echoed through debate halls and political speeches. Since the onset of the GFC, and in some cases years before, economists and politicians alike have claimed that reinstating or creating a "New Glass-Steagall"[5] was the only way to move forward and prevent another financial crisis. What will reinstating Glass-Steagall, specifically the part of the act that separates commercial and investment banking really do to prevent fraud, corruption, and another financial crisis from happening? How will bringing or recreating this archaic legislation back into existence help reign in the terror of a poorly regulated Wall Street?

This paper will discuss reasons for and against reinstatement of the Glass-Steagall Act. If it is reinstated will there be changes to its original language and inclusivity and how does it need to be revised to better work with current legislation? To better understand the reasons for and against reinstatement, this essay will explore why Glass-Steagall was created and what its successes and failures were as legislation as well as what reversed Glass-Steagall and why it was reversed. Additionally this essay will explore the questions: What does separation of commercial and investment banking have to do with preventing a crisis? Why does no other country have legislation separating commercial and investment banks? Based on the findings what legislative suggestions may better prevent another financial crisis.

I DIFFERENCE BETWEEN COMMERCIAL AND INVESTMENT BANKING

For the purposes of this paper the difference between commercial and investment banks and banking is defined in order to further clarify the concerns and reasoning behind reinstating Glass-Steagall and the alternate options available to prevent another crisis. As described above, the main purpose of the Glass-Steagall act was to separate commercial and investment banking shortly after the 1929 stock market crash. Before the stock market crashed in 1929, there were

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[1] Bernie Sanders, a modern socialist, is an activist and Senator from Vermont, who ran for President in the Democratic Primaries. Previously a member of the American Independent Party, he has inspired a more progressive platform for the Democratic Party and encouraged a younger, poorer, and more cynical generation to join politics.
[2] Richard Eskow "5 Reasons Glass-Steagall Matters" (16 November 2015) Bernie Sanders <https://berniesanders.com/yes-glass-steagall-matters-here-are-5-reasons-why/>
[3] Robert Reich is an Economist and author. He served as Secretary of Labor under President Bill Clinton during his first term from 1990-1994. He is the author of 14 books on capitalism and America's economic system.
[4] Richard Eskow "5 Reasons Glass-Steagall Matters" (16 November 2015) Bernie Sanders <https://berniesanders.com/yes-glass-steagall-matters-here-are-5-reasons-why/>
[5] See 21st century Glass-Steagall on page 16

two major Universal Banks[6] which in the analysis of the aftermath of the crash were found to have not only received bailouts from Reconstruction Finance Corporation[7] but also to have "used deceptive and manipulative techniques to sell massive volumes of foreign bonds and other high-risk securities"[8] which "triggered widespread public outrage and generated public support for enactment of the Glass-Steagall Act as well as the Securities Act of 1933[9] and the Securities Exchange Act of 1934[10]."[11] To understand why the public and legislators, in 1933 and currently, viewed a commercial bank's ability to sell investments and underwrite securities as an issue it must first be understood that there are fundamental differences between commercial and investment banks.

A Commercial Banks

A commercial bank is a bank whose main activities are operating accounts, taking in deposits, taking in and paying out cash and making loans.[12] Additionally they can supply and trade foreign currency and often provide credit card services.[13] This is not to be confused with commercial banking which is a subsection of banking that provides bank accounts or other service for businesses rather individuals.[14] The opposite of this would be retail banking where the customers are individuals and small businesses, who usually partake in current and savings accounts, loans and mortgages, credit cards and some insurance.[15] The term commercial bank is used to describe this type of banking, because short term loans were a product created for businesses.[16] This product and service was then extended to individual customers as well as governments and other non-business entities.[17]

Commercial banks are only required to keep a small percentage of deposits as a reserve, it can use the rest to extend or make loans.[18] Then when another party borrows from the bank

[6] Universal Bank: A bank provides all financial products, including commercial and investment. They also sometimes own other entities like insurance companies or anything else deemed related to finance.

[7] The Reconstruction Finance Corporation or (RFC) was a U.S. government agency originally created to provide loans to banks and other financial institutions, as well as railroads and businesses in the after math of the great Depression. This was then expanded by the Emergency Relief Act to include public or government works, as well as farms and war time plants and some foreign aid. It was supposed to act as a non-political government based loans system, however there was much corruption and the agency was disestablished between 1953-7. Gale Encyclopedia of U.S. Economic History (2 ed, 2015, online ed) Reconstruction Finance Corporation (RFC).

[8] Arthur Wilmarth "Prelude to Glass-Steagall: Abusive Securities Practices by National City Bank and Chase National Bank During the 'Roaring Twenties'" (25 August 2016) <www.ssrn.com> at Abstract and 1294-1306

[9] Securities Act 1933 (United States)

[10] Securities Exchange Act of 1934 (United States)

[11] Arthur Wilmarth "Prelude to Glass-Steagall: Abusive Securities Practices by National City Bank and Chase National Bank During the 'Roaring Twenties'" (25 August 2016) <www.ssrn.com> at 1289-1291

[12] *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Commercial Bank

[13] *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Commercial Bank

[14] *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Commercial Banking

[15] *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Retail banking

[16] *Britannica Academic* (reissue, 2016, online ed) Commercial Bank

[17] *Britannica Academic* (reissue, 2016, online ed) Commercial Bank

[18] *Britannica Academic* (reissue, 2016, online ed) Commercial Bank

that sum borrowed is put into the borrower's checking account.[19] The demand deposit[20] is then increased until the full amount borrowed is repaid.[21] This enables commercial banks to increase or decrease their monetary supply by creating more demand deposits.[22] However, assets at commercial banks are far more liquid[23] and less risky than that of investment banks.[24] Before 1999 when Glass-Steagall was reversed, they were strictly limited to the above activities and were not allowed to underwrite, sell, or deal in insurance or securities like they do today.

B Investment Banks

Investment banks are similar to merchant banks[25] in the United Kingdom, in that they provide advice on mergers and acquisitions and finance for corporations by buying and selling shares in those corporations for investors.[26] Some of the products offered by investment banks, also known as investment banking, are hedge funds and unit trusts.[27] Products like these are short term (as opposed to share buying and selling) and involve a high amount of risk, this is often referred to as casino banking[28].[29] Most laws preventing commercial banks from selling securities were relaxed in the 1980s and fully reversed in 1999.[30]

Investment banks do not take deposits but rather provide ancillary services[31] like trading of derivatives[32], equity securities, fixed income instruments, currencies, and commodities.[33] There are two main sides to investment banking, the sell side which involves trading in securities both the underwriting and the research, and the buy side which includes giving advise concerning the buying and selling of investments like: private equity funds,

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[19] *Britannica Academic* (reissue, 2016, online ed) Commercial Bank
[20] A Demand Deposit is a current account. *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Demand Deposit
[21] *Britannica Academic* (reissue, 2016, online ed) Commercial Bank
[22] *Britannica Academic* (reissue, 2016, online ed) Commercial Bank
[23] Liquid means assets that are cash based or easily turned into cash without significant loss. These include current account, trade debts, and marketable investments. *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Liquid
[24] *Britannica Academic* (reissue, 2016, online ed) Commercial Bank
[25] Merchant Banks are the equivalent of an Investment Bank in the United States. These banks focus on international trade and currency, long term loans, unit trusts, and multi-national corporations. *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Merchant Banks
[26] *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Investment Bank
[27] *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Investment Banking
[28] Casino Banking is a pejorative term for investment banking *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Casino Banking
[29] *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Investment Banking
[30] *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Investment Bank
[31] Ancillary Services are credit brokerages, debt adjusting, debt counselling, debt collecting, debt administration, or the operation of a credit-reference agency *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Ancillary Services
[32] Derivatives are a financial instrument. Its cost is directly related to its underlying value. Derivatives include: futures contracts, forwards, swaps, and options. They are traded on derivatives markets or over the counter. The boom in trade of this type of financial product in the 1990s through the 2000s is seen as a major cause of the GFC. *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Derivative
[33] Anonymous "What is Investment Banking" *Enterprise Magazine* (United States, 30 June 2015) at 16-17

mutual funds, life insurance, unit trusts, and hedge funds.[34] These can be split into private (information that has not been publicly disclosed) and public (stocks and public information) function with "Chinese walls" [35] separating the two to prevent insider trading.[36] Advisors who provide investment banking in the United States must be licensed are regulated by the SEC[37] and FINRA[38].[39] Investment banks have 3 core activities:[40]

- Front office: which generates revenue through 1) the investment banking division (IBD) which maintains relationships with corporations within different industries to bring in business for the bank and 2) the markets which includes sales and trading for the bank and any clients with the goal of making money on each trade.
- Middle office: which maintains management of internal controls, treasury, and strategy.
- Back office Operations: which involves data checking the trades made to ensure they are correct and then carrying out the necessary actions to complete the trade.

It is clear that both commercial and investment banks offer very different products and services, and the potential for conflict of interest is high for any institution that offers both types of banking services.

II GLASS-STEAGALL ACT

Almost 80 years prior to the start of the GFC in 2008, the stock market crashed on Black Thursday the 24th of October 1929[41]. In the chaos that followed, fear that banks and the Stock Market failed due to lack of regulations spurred members of congress to seek a regulatory solution to prevent future financial failures and protect the fragile and recovering economy. In 1933 President Franklin D Roosevelt signed "emergency legislation"[42] known as the Banking Act of 1933 or Glass-Steagall named for the two House Representatives who wrote the bill.[43] Senator Glass was the original issuer of the bill and wrote it after studying the banking system, Senator Steagall sponsored the bill when deposit insurance was added in.[44] The primary

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[34] Anonymous "What is Investment Banking" *Enterprise Magazine* (United States, 30 June 2015) at 16-17
[35] Chinese walls are an information wall that separates the broking part of a firm from the marketing side to prevent conflict of interest. *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Chinese Walls
[36] Anonymous "What is Investment Banking" *Enterprise Magazine* (United States, 30 June 2015) at 16-17
[37] Securities and Exchange Commission is a government agency tasked with regulating the securities market. A *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Securities and Exchange Commission
[38] Financial Industry Regulatory Authority is a United States non-governmental self-regulating group that is made up of the National Association of Securities Dealers (NASD) and the regulatory arm of the New York Stock Exchange (NYSE). *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Financial Industry Regulatory Authority
[39] Anonymous "What is Investment Banking" *Enterprise Magazine* (United States, 30 June 2015) at 16-17
[40] Anonymous "What is Investment Banking" *Enterprise Magazine* (United States, 30 June 2015) at 16-17
[41] Harold Bierman *The causes of the 1929 stock market crash: a speculative orgy or a new era?* (Greenwood Press Westport, Connecticut, 1998) at 1
[42] Julia Maues "Banking Act of 1933, commonly called Glass-Steagall" (22 November 2013) Federal Reserve History < http://www.federalreservehistory.org/Events/DetailView/25>
[43] Maues "Banking Act of 1933, commonly called Glass-Steagall", above
[44] Howard H. Preston "The Banking Act of 1933" (1933) 23 Am Ec Rev 585 at 585

motivation was to prevent commercial banks from using client's investments for speculative means, hence the main focus of the bill was to separate commercial and investment banking.[45]

By separating the commercial and investment banking, Glass and his colleague sought to ensure that the banks had rules in place to "prevent the undue diversion of funds into speculative operations"[46]. There are many similarities between the stock market crash in 1929 and the GFC in 2008, both were record breaking boom and bust, and both had commercial banks dealing in securities.[47] Much like the current concern of banks being "Too Big to Fail" (TBTF)[48] the first generation Universal Banks, National City Bank and Chase National Bank were not only selling and underwriting securities but were amassing huge earnings and significant losses.[49] Mirroring the GFC, both banks received bailouts from the Reconstruction Finance Corporation in 1933.[50] An investigation by the Pecora Committee[51] found that both banks were guilty of using "manipulative techniques"[52] to sell large amounts of foreign bonds and other risky securities to unknowing personal investors and small institutions.[53] At the end the committee found both banks had committed the following: insider trading, dealing sub-prime loans to support securities, and advertising prices and stocks of favoured clients as more expensive and lucrative than they were.[54] These "abuses" caused so much public outrage that most of congress provided overwhelming support for the Glass-Steagall Act.[55]

Following the signing of the act, commercial banks were no longer allowed to underwrite or deal in securities, and investment banks were no longer allowed to have "overlapping

[45] Howard H. Preston "The Banking Act of 1933" (1933) 23 Am Ec Rev 585 at 585
[46] Glass-Steagall Act 1933 (United States)
[47] Arthur Wilmarth "Prelude to Glass-Steagall: Abusive Securities Practices by National City Bank and Chase National Bank During the 'Roaring Twenties'" (25 August 2016) <www.ssrn.com> at Abstract and 1286-1287
[48] TBTF is the idea that certain financial institutions, due to their large size and economic impact, will always be supported in a crisis, because their failure would have a devastating effect on the stability the economy. The government would therefore always be inclined to bail them out. Financial institutions would then be less inclined to avoid risky behaviour, knowing the business would suffer no consequence. *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Too Big to Fail
[49] Arthur Wilmarth "Prelude to Glass-Steagall: Abusive Securities Practices by National City Bank and Chase National Bank During the 'Roaring Twenties'" (25 August 2016) <www.ssrn.com> at 1297
[50] Arthur Wilmarth "Prelude to Glass-Steagall: Abusive Securities Practices by National City Bank and Chase National Bank During the 'Roaring Twenties'" (25 August 2016) <www.ssrn.com> at 1289
[51] Pecora Committee was the United States Senate Committee on Banking and Currency tasked with investigating the causes of the 1929 stock market crash. Arthur Wilmarth "Prelude to Glass-Steagall: Abusive Securities Practices by National City Bank and Chase National Bank During the 'Roaring Twenties'" (25 August 2016) <www.ssrn.com> at 1301
[52] Arthur Wilmarth "Prelude to Glass-Steagall: Abusive Securities Practices by National City Bank and Chase National Bank During the 'Roaring Twenties'" (25 August 2016) <www.ssrn.com> at 1303
[53] Arthur Wilmarth "Prelude to Glass-Steagall: Abusive Securities Practices by National City Bank and Chase National Bank During the 'Roaring Twenties'" (25 August 2016) <www.ssrn.com> at 1303
[54] Arthur Wilmarth "Prelude to Glass-Steagall: Abusive Securities Practices by National City Bank and Chase National Bank During the 'Roaring Twenties'" (25 August 2016) <www.ssrn.com> at 1303
[55] Arthur Wilmarth "Prelude to Glass-Steagall: Abusive Securities Practices by National City Bank and Chase National Bank During the 'Roaring Twenties'" (25 August 2016) <www.ssrn.com> at 1306

directorships or common ownership."[56]-[57] Later that same year the Securities Act of 1933 and the Securities Exchange Act of 1934 were established creating further regulation for investment banks and the stock exchange.[58] This was to not only help the public have much needed faith in the banking system again, but also to prevent competition and overlap of duties that could lead to another potential stock market crash. In addition to the separation of commercial and investment banking and the restricted use of bank credit for speculation, the Glass-Steagall Act also enforced the following provisions: [59]-[60]-[61]

- Stricter regulation of national banks through the Federal Reserve System[62]
- Modified Double Liability
- Made banking the social responsibility of the federal government
- Regulated interest on deposits
- Required holding companies and affiliates to report three times annually to both the Federal Reserve Bank[63] and the Federal Reserve Board
- Any bank holding companies that owned majority shares of the Federal Reserve had to register with the Fed and register for a permit to vote their shares
- Created the Federal Deposit Insurance Corporation (FDIC)[64] one of the more controversial features in the law.

Many believe that government regulation between 1933 and 1999, when the Glass-Steagall act was in place, oversaw the financial markets with growing financial prosperity[65]. In some ways that is true. The financial boom of the 1980's and 1990's was greater than that of the 1920's. The Glass-Steagall Act's role as sole provider of that prosperity is highly questionable, and one of the many reasons economists and bank lobbyist[66] argue that reinstating Glass-Steagall would not prevent a future crisis. While the FDIC can easily be claimed as one of its more risk averting rules, the claim that separation of commercial and investment banks, it most prominent purpose, was what solely prevented a crisis between 1933 and 1999 is incorrect. In fact, in 1956 the Bank Holding Company Act[67] (which was substantially amended in 1966 and 1970) was created first for the purpose of defining what a Bank Holding Company was and

[56] Julia Maues "Banking Act of 1933, commonly called Glass-Steagall" (22 November 2013) Federal Reserve History < http://www.federalreservehistory.org/Events/DetailView/25>
[57] Howard H. Preston "The Banking Act of 1933" (1933) 23 Am Ec Rev 585 at 590
[58] Arthur Wilmarth "Prelude to Glass-Steagall: Abusive Securities Practices by National City Bank and Chase National Bank During the 'Roaring Twenties'" (25 August 2016) <www.ssrn.com> at 1290
[59] Maues "Banking Act of 1933, commonly called Glass-Steagall", above
[60] Federal Reserve Bank of New York "Banking Act of 1933" (1933) 1248 Circular at 2
[61] Howard H. Preston "The Banking Act of 1933" (1933) 23 Am Ec Rev 585 at 590-591
[62] Federal Reserve System is the organization, created by the Federal Reserve Act 1913, made up of 12 Federal Reserve Banks. *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Federal Reserve System
[63] Federal Reserve Bank are the 12 banks throughout the United States that along with the Federal Reserve Board of Govenors develop and enact financial policy. *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Federal Reserve Bank
[64] Federal Deposit Insurance Corporation is a United States government corporation providing deposit insurance for US banks through the Bank Insurance Fund (which all Federal and some State Banks pay into.) *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Federal Deposit Insurance Corporation
[65] Robert Reich "Hillary Clinton's Glass-Steagall" (14 July 2015) Robert Reich.org <http://robertreich.org/post/124114229225>
[66] Bank Lobbyist is a person who tries to influence legislation on behalf of a bank or other financial institution.
[67] Bank Holding Company Act 1956 (United States)

what it could and could not do.[68] An aspect that was sorely lacking in the Glass-Steagall Act.[69]-[70] So much so that Banks were finding effective ways of skirting around state branching restrictions by creating chain or group banks, which were seen as independent banks with in each state instead of branches.[71]-[72] This loophole in definition worried legislators who like today were afraid of big conglomerate banks from amassing too much power.[73]-[74] Other abilities that bank holding companies had that were cause for concern were: "they could own non-bank firms, such as manufacturing, transportation, or retail businesses, in addition to banks".[75]

Concerned legislators were worried that these banks could use the deposits from their customers to make loans to their non-bank subsidiaries or unfairly coerce those borrowing from the bank to purchase from their business.[76] It would be the equivalent of Bank of America[77] creating a car loan for a borrower and then insisting that the borrower purchase their car from a Bank of America owned car dealership an act that closely resembles the subprime mortgage crisis and OTC[78] derivative market. While it took a while, bank holding companies were officially defined and regulated in 1956.[79] Legislative loopholes, such as only defining a bank holding company as a company that owns two or more banks and did not include their non-bank subsidiaries, in this act were further fixed in amendments in 1966 and 1970.[80]

Clearly the Glass-Steagall Act was not the only necessary legislation to prevent abusive commercial banking practices. If this is the case then why would reinstating Glass-Steagall prevent another crisis when the GFC was a perfect storm of abusive commercial and investment

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[68] Joe Mahon "Bank Holding Company Act of 1956" (22 November 2013) Federal Reserve History <http://www.federalreservehistory.org/Events/DetailView/31>

[69] Joe Mahon "Bank Holding Company Act of 1956" (22 November 2013) Federal Reserve History <http://www.federalreservehistory.org/Events/DetailView/31>

[70] Committee on Banking and Currency *Bank Holding Company Act 1956* (February 10, 1958) at 2

[71] Joe Mahon "Bank Holding Company Act of 1956" (22 November 2013) Federal Reserve History <http://www.federalreservehistory.org/Events/DetailView/31>

[72] United States Congress House Committee on Banking and Currency *Bank Holding Company Act 1956* (February 10, 1958) at 3

[73] Joe Mahon "Bank Holding Company Act of 1956" (22 November 2013) Federal Reserve History <http://www.federalreservehistory.org/Events/DetailView/31>

[74] United States Congress House Committee on Banking and Currency *Bank Holding Company Act 1956* (February 10, 1958) at 3

[75] Joe Mahon "Bank Holding Company Act of 1956" (22 November 2013) Federal Reserve History <http://www.federalreservehistory.org/Events/DetailView/31>

[76] United States Congress House Committee on Banking and Currency *Bank Holding Company Act 1956* (February 10, 1958) at 4-5

[77] Bank of America is one of the four largest banks in the United States, and is the second largest Bank Holding Company. It acquired Meryll Lynch in September 2008.

[78] Over the Counter Market is a market where financial products are bought and sold outside the jurisdiction of the normal financial market. These transactions are difficult to track. *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Over the Counter Market

[79] Joe Mahon "Bank Holding Company Act of 1956" (22 November 2013) Federal Reserve History <http://www.federalreservehistory.org/Events/DetailView/31>

[80] Joe Mahon "Bank Holding Company Act of 1956" (22 November 2013) Federal Reserve History <http://www.federalreservehistory.org/Events/DetailView/31>

banking practices using financial products that did not exist (see derivatives) when the act was created? By 1999 the Financial Services Modernization Act[81], commonly called Gramm-Leach-Bliley[82] , effectively repealed the aspect of Glass-Steagall that prevented commercial banks and investment banks from affiliating.[83] The United States financial boom of the 1980's and 1990's led policy makers and financial leaders to the hubristic opinion that the markets and the players could regulate themselves. Nine years after the repeal, the United States and the world saw predatory lending and backdoor hedging ruin the once stable economy. But by that point in time commercial and investment banks had already found new and creative ways of repealing or avoiding the rules in Glass-Steagall. What role did the Financial Services Modernization Act of 1999 play in the GFC?

III REVERSING GLASS-STEAGALL OR THE GRAMM-LEACH-BLILEY ACT

A Changes instituted Gramm-Leach-Bliley Act

In response to the rapidly changing products and financial institutions lobbying for freer markets the Gramm-Leach-Bliley Act was born. This act is what the majority of those in favour of reinstating the Glass-Steagall act believe is the cause of the GFC. As Joe Mahon advises in *Financial Services Modernization Act of 1999, commonly called Gramm-Leach-Bliley*, the major change the act instituted was a new type of financial institution known as a Financial Holding Company or FHC[84]-[85] An FHC is similar to the Bank Holding Company, in that it is an umbrella organisation, however this umbrella organisation could own and operate subsidiaries involved in various financial products and activities deemed complimentary to financial activities by the Board of Governors[86] of the Federal Reserve System.[87] The FHC is what effectively repealed Glass-Steagall, as now these umbrella organisations were allowed to own both commercial and investment banks. This is the key bone of contention between those in favour of separation and those opposed to it. This is also the bedrock of the campaign to bring back the Glass-Steagall act. However, like most new legislation, there is not only one change that occurred when the Gramm-Leach-Bliley act was signed. Other key changes the Gramm-Leach-Bliley act brought about that are worth investigating are the changes to who oversees FHCs and how they would be regulated.

[81] Financial Services Modernization Act of 1999 (United States), commonly called Gramm-Leach-Bliley
[82] Named after the Senator and two House Representatives who sponsored the Bill
[83] Joe Mahon "Financial Services Modernization Act of 1999, commonly called Gramm-Leach-Bliley" 22 November 2013) Federal Reserve History <http://www.federalreservehistory.org/Events/DetailView/53>
[84] Joe Mahon "Financial Services Modernization Act of 1999, commonly called Gramm-Leach-Bliley" 22 November 2013) Federal Reserve History <http://www.federalreservehistory.org/Events/DetailView/53>
[85] Financial Services Modernization Act 1999 (United States) sec 103
[86] The Federal Reserve Board
[87] Financial Services Modernization Act 1999 (United States) sec 103

Mahon advises that the Fed[88] would oversee the new FHCs by "relying" on reports and prudential supervision and regulations[89] from state and federal authorities.[90] Mahon's example is that the Securities and Exchange Commission regulates the registered securities brokers, dealers, and investment advisers; state insurance commissioners would oversee licensed insurance companies state to state; while commercial bank entities and thrifts would be regulated by state and federal banking agencies.[91] Each separate state, federal, and government branches (or reporting entity) would then individually report to the Fed. These prudential regulations made it hard to actively oversee and regulate the newly legal FHCs. What the Fed failed to do was ensure that these reporting entities were correctly regulating and overseeing the financial institutions. With rapid innovation in the financial markets and the prudential regulation model the reporting entities failed to correctly monitor the FHCs for reckless and fraudulent behaviour.[92]

B How the Gramm-Leach-Bliley Act Failed

In the 1970's derivatives entered the financial market as a popular form of hedging risk and making money.[93-94] The regulations set out in the Glass-Steagall Act in 1933 could not begin to regulate this new financial option that was not wholly an investment, insurance, or a loan. It was therefore necessary to update regulation into the new era in conjunction with innovations in banking and finance, however the Gramm-Leach-Bliley act, much like the Glass-Steagall act failed to provide the necessary oversight and flexibility to grow with innovation in the constantly growing financial markets.

This is evidenced clearly in *Subprime Mortgage Default and Credit Default Swaps,* a study published at the University of Texas in 2015.[95] In the study the authors found a distinct increase in defaults on residential mortgage loans and the over the counter (OTC) credit default swaps were the main cause of the GFC.[96] The study found that the originate to distribute[97] loan model encouraged mortgage lenders to create risky mortgage loans in order to ensure their financial gain on unregulated credit default swaps.[98] This model encouraged risky lending behaviour and manipulative lending practices similar to the actions unearthed by the Pecora Committee.[99] What this means is that those mortgages that had a credit default swap placed on

[88] The Fed is an abbreviation that can mean both the Federal Reserve System or the Federal Reserve Board *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) The Fed
[89] Prudential regulations: Audits, inspections, rule development, sanctions etc.
[90] Mahon "Financial Services Modernization Act of 1999, commonly called Gramm-Leach-Bliley" above
[91] Mahon "Financial Services Modernization Act of 1999, commonly called Gramm-Leach-Bliley" above
[92] Keith Goodwin "Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010" (22 November 2013) Federal Reserve History < http://www.federalreservehistory.org/Events/DetailView/59>
[93] William S. Mathers "A Brief History of Derivatives" (2013) RealMarkits <http://www.realmarkits.com/derivatives/3.0history.php>
[94] Rangarajan K. Sundaram "Derivatives in Financial Market Development"(13 September 2012) IGC <http://people.stern.nyu.edu/rsundara/papers/RangarajanSundaramFinal.pdf> at 27 and 1-38
[95] Eric Arentsen, David C. Mauer, Brian Rosenlund, Harold H. Zhang, Feng Zhao "Subprime Mortgage Defaults and Credit Default Swaps" (2015) Vol 70 (2) The Journal of the American Finance Association at 689–731
[96] Arentsen et all "Subprime Mortgage Defaults and Credit Default Swaps" above at 689
[97] Loans made by Banks to sell off rather that to see through to the maturity date.
[98] Arentsen et all "Subprime Mortgage Defaults and Credit Default Swaps" above at 689
[99] Arentsen et all "Subprime Mortgage Defaults and Credit Default Swaps" above at 691

them no later than 180 days after the closing date for the mortgages had a significantly higher probability of defaulting or loan delinquency. Another relevant point the study revealed is that Commercial and Investment banks were equally guilty of subprime lending in order to fulfil risky CDS[100] which originated before the loan.[101]

With unregulated financial products being purchased over the counter and prudential supervision essentially missing the dangerous and risky behaviour of both investment and commercial banks, the GFC was inevitable. These details make it clear that the real danger in the Gramm-Leach-Bliley act was twofold: first the inability of the Fed to properly regulate the financial institutions, and second, much like the Glass-Steagall act, the legislations poorly written coverage of new and existing financial products. This demonstrates that the failure in the Gramm-Leach-Bliley act had little to do with the reversal of Glass-Steagall, and more to do with its inability to regulate financial institutions and products. Some continue to claim that had Glass-Steagall not been reversed, then commercial banks would have been unable to own investment banks and vice versa.

The issue with subprime mortgages and the GFC had less to do with financial institutions cross pollinating their products, and more to do with the lack of regulations for the product (OTC CDS) and banks legally being able to create risky financial products in order to feed their own hedging. In short if banks had not been able to take out CDSs on their own loans, perhaps the GFC would not have been so devastating for average borrower. It is worth noting that almost no other major country in the world has had any problems arise from the lack of separation of commercial and investment banking. Why then would reinstating Glass-Steagall thus separating commercial and investment banks prevent another crisis? Especially when the real threat lays in conflict of interest, an issue tackled by the Volcker Rule[102] in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010[103].

IV DODD-FRANK ACT

Between 1999, when the Banking Act of 1933[104]-[105] was repealed by the signing of Financial Services Modernization Act of 1999[106]-[107], and 2008, when the global financial crisis began, Commercial and Investment banks previously separated by legislation took full advantage of their new found freedom and negligent government oversight to draw up predatory loans and make billions of dollars in the unregulated OTC market from credit derivatives. In reaction to the GFC the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010[108] was signed by President Obama to create stricter regulation and oversight which was lacking in

[100] Credit Default Swaps
[101] Arentsen et all “Subprime Mortgage Defaults and Credit Default Swaps” above at 725
[102] Volcker Rule see Dodd-Frank act 2010 (United States) sec 619
[103] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (United States)
[104] Banking Act 1933 (United States)
[105] Commonly called Glass-Steagall Act
[106] Financial Services Modernization Act 1999 (United States)
[107] Commonly called Gramm-Leach-Bliley
[108] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (United States)

former regulations. The legislation instituted the following changes to oversight and banking restrictions:

- It established the Financial Stability Oversight Council[109] and Orderly Liquidation Authority.[110] These two entities are in charge of overseeing and monitoring companies which are TBTF, the Orderly Liquidation Authority has the ability to provide monetary assistance towards liquidations of financial institutions, while the Financial Stability Oversight Council can dismantle any banks that are TBTF and liquidate banks that are deemed to financially weak.[111]-[112]
- It instituted the Federal Insurance Office which oversees insurance companies monitoring for potential risk. [113]
- Established the Consumer Financial Protection Bureau (CFPB) which replaced the Office of Thrift Supervision. This Bureau provides a single government agency tasked with overseeing and ensuring consumers protection under any federal consumer protection laws.[114]-[115]
- Created SEC Office of Credit Ratings improves the accuracy of ratings provided by agencies to help ensure the financial strength of the businesses. These NRSROs[116] are now required to have effective procedures and methods for determining ratings, as well as effective internal governance controls to prevent fraud.[117]
- Most importantly to the purpose of this paper, and the question of whether or not reinstating Glass-Steagall is necessary, is the Dodd-Frank act instituted the Volcker Rule.[118-119]

These prudential oversights are different from those instituted in Gramm-Leach-Bliley, as there are specific federal government councils to oversee and report on different financial products and institutions, versus relying on a combination of state based and federal authorities to report on a variety of institutions depending on the location and state based authorities. The supervisions in Dodd-Frank offer a more comprehensive and clear line of authority for stability and oversight.[120]

[109] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (United States) s 111
[110] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (United States) s 201-204
[111] "Dodd-Frank Wall Street Reform and Consumer Protection Act" (2016) Investopedia <http://www.investopedia.com/terms/d/dodd-frank-financial-regulatory-reform-bill.asp#ixzz4JqX9lESE>
[112] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (United States) s 111, 201-204, 622
[113] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (United States) s 502
[114] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (United States) s 335 and 1091
[115] "CFPB: Consumer Finance Protection Bureau" Consumer Finance <www.consumerfinance.gov>
[116] Nationally Recognized Statistical Rating Organization
[117] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (United States) s 932
[118] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (United States) s 619
[119] Keith Goodwin "Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010" (22 November 2013) Federal Reserve History < http://www.federalreservehistory.org/Events/DetailView/59>
[120] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (United States) s 620

A The Volcker Rule

The Volcker Rule is named for former Federal Reserve Chairman Paul Volcker[121].The purpose of the rule is to prevent banks from making specific speculative investments (e.g. CDS on subprime mortgages).[122] More specifically it prevents banks from interacting in investments with their own accounts, and puts limitations on ownership and relationships with hedge and private equity funds.[123]-[124] This rule prohibits trading of: securities, derivatives, futures and options on any of the banks own accounts or products, as these actions present a conflict of interest as they only benefit the bank and are not in the best interest of the customer.[125] It essentially prevents what banks were doing in the subprime mortgage crisis that led to the GFC.

The banks are however allowed to continue market making, underwriting, hedging, trading of government securities, selling insurance, selling hedge and private equity funds, and acting as agents, brokers and custodians.[126] While banks can still derive profit from these investment products and activities, they are prohibited from transacting in them if it will expose the market or their customers to undue risk or instability or if it will present the bank with a conflict of interest.[127] Furthermore each bank must meet their reporting requirements (which vary in levels based on the size of the institution) and disclose their trading activity to the government.[128]-[129] Additional rules require larger financial institutions to be subject to independent audit and analysis, though smaller institutions do not have as rigorous reporting requirements.[130]-[131]

Some of the heaviest criticisms of the Volcker Rule came before it was even added to the Dodd- Frank Act. Often called "Glass-Steagall Lite" many claimed the rule is "too subtle", full of loopholes, overly complex, not adequate enough to prevent the disaster caused by the sub-prime mortgage crisis in the GFC.[132] The final regulations were approved by five federal agencies in December 2013. These rules make up section 619 of the Dodd-Frank Act and went into effect on 1st of April 2014, with American banks fully compliant by 21st of July 2015.[133] This means the Volcker Rule has only been in full effect for a little over a year. Which is not a

[121] *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Volcker Rule
[122] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (United States) s 619
[123] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (United States) s 619
[124] "Volcker Rule" (2016) Investopedia <http://www.investopedia.com/terms/v/volcker-rule.asp#ixzz4JqUd17p6>
[125] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (United States) s 619
[126] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (United States) s 619
[127] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (United States) s 620-2
[128] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (United States) s 619
[129] "Volcker Rule" (2016) Investopedia <http://www.investopedia.com/terms/v/volcker-rule.asp#ixzz4JqUd17p6>
[130] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (United States) s 619
[131] "Volcker Rule" (2016) Investopedia <http://www.investopedia.com/terms/v/volcker-rule.asp#ixzz4JqUd17p6>
[132] Philip Wallach "Moving Beyond Calls for a 'New Glass-Steagall'" (2012) 51 Brookings Issues in Governance Studies at 4
[133] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (United States) s 619

sufficient amount of time to judge the rules effectiveness at harnessing, what President Obama referred to as, unscrupulous lenders.[134]

V WHY SEPARATE COMMERCIAL AND INVESTMENT BANKING?

A Why and Why not?

One of the many people who are calling for the reinstatement of the Glass-Steagall act is Robert Reich. He, along with Senators Elizabeth Warren and Bernie Sanders, believe that the Volcker Rule is a poor substitute for the Glass-Steagall act. Their focus is on the fact that Glass-Stegall fully prohibits commercial and investments banks for collaborating and trading in each other's products. To Reich and others the Volcker Rule does fully separate commercial and investment banks and is therefore unsuitable. In *Hillary Clinton's Glass-Steagall* Reich argues that investment banks are the not the real culprits as the "Wall Street apologists" claim.[135] Reich claims that these nonbanks were funded by loans from commercial banks who financed their troublesome activity, all because Glass-Steagall was reversed.[136]

Reich seems to see commercial banks as the all-powerful evil puppet master encouraging and financing other financial institutions in fraudulent and unscrupulous activity.[137] Reich points out that those against regulation claim that no big banks failed and therefore Glass-Steagall does not need to be resurrected, Reich equates this to claiming that no one drowning at a beach means life guards are not necessary.[138] While the sentiment is understandable if we were discussing deregulation of the banking industry as a whole, it is a bit over the top in regards to discussion of legally separating commercial banks from investment banks. As previously stated the failure of both the Glass-Steagall act and the Gramm-Leach-Bliley act was not the overlap of commercial and investment banks, but rather the lack of effective oversight by the Fed. The argument fails further when he claimed that mortgage lenders would not have been able to lend and underwrite in derivatives if not for commercial banks providing funding.[139] Banks have always practiced lending, and Glass-Steagall had no direct effect over the derivatives market,[140] so resurrecting this act would do little to prevent looser lending practices. And as pointed out earlier in this paper it was not just commercial banks that caused the GFC, funding or not, and Glass-Steagall was not solely responsible for regulating commercial banks.

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[134] Keith Goodwin "Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010" (22 November 2013) Federal Reserve History < http://www.federalreservehistory.org/Events/DetailView/59>

[135] Robert Reich "Hillary Clinton's Glass-Steagall" (14 July 2015) Robert Reich.org <http://robertreich.org/post/124114229225>

[136] Robert Reich "Hillary Clinton's Glass-Steagall" (14 July 2015) Robert Reich.org <http://robertreich.org/post/124114229225>

[137] Robert Reich "Hillary Clinton's Glass-Steagall" (14 July 2015) Robert Reich.org <http://robertreich.org/post/124114229225>

[138] Robert Reich "Hillary Clinton's Glass-Steagall" (14 July 2015) Robert Reich.org <http://robertreich.org/post/124114229225>

[139] Robert Reich "Hillary Clinton's Glass-Steagall" (14 July 2015) Robert Reich.org <http://robertreich.org/post/124114229225>

[140] Which were largely unregulated until the Dodd-Frank Act

Edward Morris echoed Reich's sentiments earlier this year. Like Reich he claims that without a Glass-Steagall like legislation another financial crisis in some form or another will happen again.[141] Morris goes on to state that Sandy Weill[142], one of the greatest champions for reversing Glass-Steagall, has changed his mind about the separation of the two types of financial institutions.[143] If the issues are banks (all banks) becoming too big to fail and banks partaking in risky trades to the detriment of their clients then the Volcker Rule should fit the regulative criteria. There is no evidence that separating commercial and investment banking will cause fraudulent behaviour, as no other country has legislation prohibiting such financial activities. The real cause of the crisis was the conflict of interest and the lack oversight, not the overlapping financial activities and ownership of commercial and investment banks. Though Morris admits that the more substantial regulatory environment created by Dodd-Frank has for the time being ensured that banks have better behaviour.[144] With the Volcker Rule newly instituted this could be the common ground between separation and deregulation.

Philip Wallach however has a different point of view to Reich and Warren. He believes that the call to reinstate Glass-Steagall is more political posturing than anything else.[145] Wallach points to Elizabeth Warren's campaign to reinstate Glass-Steagall summarizing her point of view into three parts: Commercial banking should be boring, Glass-Steagall made commercial banking boring from 1933-1999, therefore Glass-Steagall needs to be reinvented.[146] He points out that Warren's call to make banking boring effectively splits banking into two functional categories; utility and casino.[147] As Wallach states, by that logic anything that is not commercial banking is risky and glamorous and should remain so, and commercial banking should be safe and was safe and boring during the Glass-Steagall era. Similar approaches are found in narrow banking[148] and utility model of banking[149]. However, Wallach continues, this is flawed logic as there is no safety in lending.[150] Lending, a core product of commercial banking, is inherently full of risk and always has been. If we follow the

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[141] Edward Morris "Why Bernie's Right About Glass-Steagall" (4 April 2016) Bill Moyers.com <http://billmoyers.com/story/why-bernies-right-about-glass-steagall/>

[142] Sandy Weill former Chief Executive Officer and Chairman of CitiGroup.

[143] Edward Morris "Why Bernie's Right About Glass-Steagall" (4 April 2016) Bill Moyers.com <http://billmoyers.com/story/why-bernies-right-about-glass-steagall/>

[144] Edward Morris "Why Bernie's Right About Glass-Steagall" (4 April 2016) Bill Moyers.com <http://billmoyers.com/story/why-bernies-right-about-glass-steagall/>

[145] Philip Wallach "Moving Beyond Calls for a 'New Glass-Steagall'" (2012) 51 Brookings Issues in Governance Studies at 2

[146] Philip Wallach "Moving Beyond Calls for a 'New Glass-Steagall'" (2012) 51 Brookings Issues in Governance Studies at 3

[147] Philip Wallach "Moving Beyond Calls for a 'New Glass-Steagall'" (2012) 51 Brookings Issues in Governance Studies at 3-4

[148] Narrow Banking is a model of banking where retail banks stick to their traditional role of leading and deposit taking and would separate from speculation and securities. They would also have higher capital requirements. This idea was developed and proposed as a way of reinforcing ring-fencing. *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Narrow Banking

[149] Like Narrow Banking Utility model of banking would focus on banks providing basic financial services. In this model banks are seen as the equivalent of public utilities, and should therefore be similarly regulated *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Utility Model Banking

[150] Philip Wallach "Moving Beyond Calls for a 'New Glass-Steagall'" (2012) 51 Brookings Issues in Governance Studies at 3

"boring bank" method then lending should be done by investment banks, which is the opposite of what most people want after the GFC.

Another prominent concern, Wallach advises, is the fear that legislation as it is currently written will make government bailouts a guarantee.[151] That TBTF banks will take undue risk knowing that Uncle Sam will always be there to bail them out of jail. Wallach points out that had the separation of Glass-Steagall still be current or governments unable to intervene then the GFC could have been more disastrous, as Glass-Steagall would have prevent some of the larger corporations from absorbing the failing smaller ones (e.g. Bank of America and Merril Lynch) and the government would have been unable to save larger businesses from going bankrupt which would have had larger economic issues.[152] No one wants to see banks using the government as a meal ticket when they gamble away their own wages, but the GFC could have been much worse had the bailout not occurred.

Vice Chairman of the Federal Deposit Insurance Corporation Thomas Hoenig, a long-time fan of keeping banks small, simple, and risk averse helped support a 2013 bipartisan bill to rewrite Glass-Steagall.[153] The bill brought to the house in 2013 by Senators Elizabeth Warren and John McCain was known as the 21st Century Glass-Steagall Act.[154] Hoenig embraced the act claiming it would be healthy for the economy.[155] The bill looked to restrict large bank activity through high capital requirements, capital requirements similar to the Basel III[156] standards.[157] Capital requirements, as Wallach points out, that the Dodd-Frank act has in sections 165, 171, 606, 616.[158] Most recently this July, Republican Presidential Nominee Donald Trump made the surprising move of adding the reinstatement of Glass-Steagall act to his platform.[159] While it could be a reaction to Hilary Clinton's refusal to do the same, it is none the less a surprising move for the Republican Platform and an odd bedfellow for the likes of Warren and Sanders, which does nothing to add merit to their cause

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[151] Philip Wallach "Moving Beyond Calls for a 'New Glass-Steagall'" (2012) 51 Brookings Issues in Governance Studies at 5

[152] Philip Wallach "Moving Beyond Calls for a 'New Glass-Steagall'" (2012) 51 Brookings Issues in Governance Studies at 5

[153] Maria Aspan "Glass-Steagall Bill 'Deserves Healthy Debate: FDIC's Hoenig." *American Banker Regulation & Reform* (United States, 22 July 2013) at 3

[154] Maria Aspan "Glass-Steagall Bill 'Deserves Healthy Debate: FDIC's Hoenig." *American Banker Regulation & Reform* (United States, 22 July 2013) at 3

[155] Maria Aspan "Glass-Steagall Bill 'Deserves Healthy Debate: FDIC's Hoenig." *American Banker Regulation & Reform* (United States, 22 July 2013) at 3

[156] Basel III accords developed by the Basle Committee on Banking Supervision in 2011 after the global banking crisis of 2007–08; requires banks to hold capital worth of 8.5% and Liquidity Coverage Ratio of enough cash to cover a 30 day crisis. See also fourth capital requirements directive. "Details of the Basle III accord from the Bank for International Settlements" <http://www.bis.org/bcbs/basel3.htm>

[157] Maria Aspan "Glass-Steagall Bill 'Deserves Healthy Debate: FDIC's Hoenig." *American Banker Regulation & Reform* (United States 22 July 2013) at 3

[158] Philip Wallach "Moving Beyond Calls for a 'New Glass-Steagall'" (2012) 51 Brookings Issues in Governance Studies at 11

[159] Ian McKendry "GOP Lawmakers Blindsided by Trump's Embrace of Glass-Steagall" *American Banker Law and Regulation* (online ed, United States, 19 July 2016)

B 21st Century Glass-Stegall Act and Ring-Fencing Discussions Abroad

Warren and McCain's 21st Century Glass-Steagall Act of 2015 is an alternate option to reinstating the original Glass-Steagall Act of 1933. The act proposes the following changes:[160]

- Like the original act it will separate commercial banks that offer checking and savings products and are insured by the FDIC, from investment banks, hedge funds, swaps market, and private equity. This is almost a carbon copy of the original except in the fact that it will include wording to separate commercial banks from "products that did not exist when Glass-Steagall was originally passed" like derivatives and swaps. This would essentially prevent and undo and current financial holding companies.
- It would define what banking is in more specific terms to prevent any activities that are considered non-banking activities from being a part of bank holding companies.
- It promises to take on TBTF, but admits it is only the first step and cannot solely on its own end large corporate banks. The bill will do this by separating commercial and investment banks which will force many financial holding companies to break down into smaller separate entities. This will supposedly prevent bail outs as the small institutions will not have a government guarantee of a bailout.
- There would be a 5 year transition period and heavy penalties for violating the law.

The bill was introduced first to the Senate on the 7th of July 2015[161] by Senator Warren, followed by an introduction to the House of Representative a week later on the 14th of July[162]. They bill was referred to Committee on Banking, Housing, and Urban Affairs and the Subcommittee on Regulatory Reform, Commercial and Antitrust Law respectively.[163]-[164] In 2009 H.R4375 called the Glass-Steagall Restoration Act was presented to the 111th Congress, this bill never made it past being introduced to the House of Representatives and then referred to the House Committee on Financial Services.[165] And yet again in 2011 Glass-Steagall Restoration Act of 2011 was introduced to the 112th Congress and received the same fate.[166] In fact the 21st Century Glass-Steagall Act of 2015 was a second generation attempt which started with the 21st Century Glass-Steagall Act of 2013.[167]-[168] This is not the first time a bill either restoring or reinventing the Glass-Steagall act has been presented to congress. See also Return to Prudent Banking Act of 2009[169], 2011[170], 2013[171]-[172], and 2015[173], Banking Integrity Act of 2009[174] and 2010[175]. What these failed bills have in common, despite the difference in title, is the goal of reinstituting the language in Glass-Steagall that separates commercial and

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[160] Elizabeth Warren "Elizabeth Warrens 21st Century Glass-Steagall Act Fact Sheet" Warren.Senate.Gov <www.warren.senate.gov>
[161] 21st Century Glass-Steagall Act of 2015 S.1709 (United States)
[162] 21st Century Glass-Steagall Act of 2015 H.R.3054 (United States)
[163] 21st Century Glass-Steagall Act of 2015 H.R.3054 (United States)
[164] 21st Century Glass-Steagall Act of 2015 S.1709 (United States)
[165] Glass-Steagall Restoration Act H.R4375 (United States)
[166] Glass-Steagall Restoration Act of 2011 H.R.2451(United States)
[167] 21st Century Glass-Steagall Act of 2013 S.1282 (United States)
[168] 21st Century Glass-Steagall Act of 2013 H.R.3711 (United States)
[169] Return to Prudent Banking Act of 2009 H.R.4377 (United States)
[170] Return to Prudent Banking Act of 2011 H.R.1489 (United States)
[171] Return to Prudent Banking Act of 2013 S.985 (United States)
[172] Return to Prudent Banking Act of 2013 H.R.129 (United States)
[173] Return to Prudent Banking Act of 2015 H.R.381 (United States)
[174] Banking Integrity Act of 2009 S.2886 (United States)
[175] Banking Integrity Act of 2010 H.R.4461 (United States)

investment banking, either by reinstating Glass-Steagall or amending existing legislation to include the same regulations as the act.

There is still no evidence that separating commercial and investment banking functions will prevent fraudulent and risky behaviour. The Volcker Rule covers the majority of the concerns over risk by preventing commercial banks engaging in securities on their own products, and TBTF can easily be fixed by ensuring financial institutions meet more stringent capital requirements. Currently no other country legally separates commercial and investment banks.[176] Though in the aftermath of the GFC and the battle cries from Warren and others in the United States for a new Glass-Steagall have encouraged other countries to consider the same.[177] Thomas Clarke a Professor at the Centre for Corporate Governance at the University of Technology Sydney notes that John Vickers chair of the Independent Commission on Banking in the UK after the GFC, suggested United Kingdom banks should also divide or ring-fence[178]-[179] their retail and investment banks, while other European countries like France consider similar actions.[180] The European Commission's Liikanen Report[181] proposes[182] ring fencing as regulatory requirement for the European Union as well, and as of June 2015 the Council drafted regulation in accordance with the Liikanen Report and advised its official position that there were two options for mitigating "excessive risk" in trading activities: Ring-Fencing retail banks or "through measures imposed by competent authorities in accordance with the regulation."[183] To date the regulation has not been voted into effect. Similarly the Independent Banking Commission[184] recommended in the Vickers Report that retail banks should be ring fenced to separate the retail banking activities from that of wholesale and investment banks being done by the same financial institution with banks needing to be

[176] Anonymous "What is Investment Banking" *Enterprise Magazine* (United States, 30 June 2015)
[177] Thomas Clarke "Should we follow the US and UK and separate our banks?" (7 August 2014) *The Conversation* <http://theconversation.com>
[178] *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Ring-Fence
[179] Ring-Fence or Ring- Fencing would allow one part of a company to go into receivership or bankruptcy without affecting the rest of the company. Allows money to be allocated to a specific purpose so that it does not become part of the general resources of an organization. Separates different parts of a business from eachother for regulatory purposes. To separate one part of a business from another for regulatory reasons. *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Ring-Fence
[180] Thomas Clarke "Should we follow the US and UK and separate our banks?" (7 August 2014) *The Conversation* <http://theconversation.com>
[181] A Report commissioned by the European Union in 2012, it created a "High-level Expert Group to examine possible reforms to the structure of the EU's banking sector." The President and Commissioner appointed Erkki Liikanen, Governor of the Bank of Finland, as the chairman. They were tasked with determining "whether, in addition to ongoing regulatory reforms, structural reforms of EU banks would strengthen financial stability and improve efficiency and consumer protection, and, if so, to make proposals as appropriate." See: <http://ec.europa.eu/finance/bank/structural-reform/index_en.htm>
[182] Thomas Clarke "Should we follow the US and UK and separate our banks?" (7 August 2014) *The Conversation* <http://theconversation.com>
[183] European Council: Council of the European Union "Restructuring risky banks: Council agrees its negotiating stance" (press release, 19 June 2015)
[184] Set up in 2010 and Chaired by Sir John Vickers an economist and professor.

compliant by 2019.[185]-[186] A number of recommendations made in the report have been adopted by the government including higher capital requirements[187].[188]

Clarke in agreement writes "In Australia we need to dispel the notion we live in the best of all possible banking worlds, and begin the process of separating retail from investment banking, to prepare for the shocks of the future that the international financial system is no doubt gearing up to provide."[189] Despite the echoing of similar separatist calls to Warren and company no actual legislation or regulations have been voted into effect in any other first world country. Other countries, much like the United States, are slow to officially separate their commercial and investment banking. This could be because there are other options to prevent another GFC besides ring-fencing or separating the commercial and investment banking, however the United Kingdom will follow through with the Vickers Report recommendation to ring fence their retail banks by 2019.[190]-[191]

VI OTHER OPTIONS

It has been 8 years since the GFC wreaked havoc and the world economies are still slowly rebuilding and rewriting their regulations to prevent another crisis. Most first world countries are still recovering and in the aftermath are creating and discussing options for regulating financial institutions.

A Turner Review and Fourth Capital Requirements Directive

Adair Turner's[192] review of the financial crisis advises what must happen at a legislative and regulatory level to prevent a future crisis. Turner was commissioned by the Chancellor of the Exchequer[193] to review the GFC shortly after it started in October 2008 and make recommendations of regulatory changes needed to prevent another crisis.[194] These recommendations are focused on the United Kingdom but would also be useful in the United States. Turner has many suggestions for how to prevent another crisis a few of which are:[195]

-Increase the quality not the quantity of the capital
-Liquidity and capital regulations should be of equal importance
-Greater supervision and higher standards for individual banks
-Supervision and restrictions for credit ratings agencies
-Sustainable Funding

[185] *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Vickers Report
[186] Independent Banking Commission *Final Report Recommendations* (United Kingdom 2011) at 35-77
[187] Independent Banking Commission *Final Report Recommendations* (United Kingdom 2011) at 83-99, 151
[188] *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Vickers Report
[189] Thomas Clarke "Should we follow the US and UK and separate our banks?" (7 August 2014) *The Conversation* <http://theconversation.com>
[190] Anonymous "How will the UK bank ring-fence work?: Recent concessions on transfers from retail banks and cross-selling have been welcomed by the sector" *The Week* (online ed, United Kingdom, 26 October 2015)
[191] Caroline Binham "BoE pushes on with bank ring fencing rules: Central bank rejects claims it has watered down plans for insulating retail activity" *The Financial Times* (online ed, United States, 27 May 2016)
[192] Adair Turner "The Turner Review" (2009)
[193] Chancellor of the Exchequer is the head of Her Majesty's Treasury.
[194] Adair Turner "The Turner Review" (2009) at 7
[195] Adair Turner "The Turner Review" (2009) at 7-9

-Better communication with investors regarding risk
-Remuneration policies that avoid incentives to take unfavourable risks
-A clearing house and counterparty system for CDS
-A supervisory enhancement programme with increased supervision and resources to larger and complex institutions, focus on risks and outcomes "rather than just systems and processes"
-"New capital and liquidity requirements should be designed to constrain commercial banks' role in risky proprietary trading activities"
-International cooperation for bank supervision

Another change Turner urged was stricter liquidity and capital requirements in the Basel model.[196] This was put into place in the United Kingdom in 2011 with Basel III requirements.[197] Basel III capital standards was considered by the FDIC as an interim measure, but was heavily criticised by many American legislators like Thomas Hoenig, who finds the standard inadequate as banks make their own risk assessments regarding the assets they hold.[198] Hoenig voted against FDIC's Basel III rule, but has actively supported a similar plan that would require larger banks to increase the percentage of their assets held as capital.[199] This regulation would require bank holding companies to increase to a 5% leverage ratio with insured subsidiaries holding 6%.[200] The European Union has embraced the Basel III model with their Fourth Capital Requirements Directive.[201]-[202] The European Union council agreed on the 26th of June 2013 to make the Basel III model a legislative requirement for any member of the European Union.[203] Inspired by the de Larosière[204]group report in February of 2009, the Fourth Capital Requirements Directive seeks to have a stricter set of financial regulations for all member states with a "minimum core standard".[205] Parts 4 through 6 and 8 of the agreed legislation cover the basic minimum capital requirements that all banks within member states must follow with a required compliance date of 1st of January 2014.[206]-[207] The Dodd-Frank act

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[196] Adair Turner "The Turner Review" (2009) at 53
[197] *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Basel III
[198] Maria Aspan "Glass-Steagall Bill 'Deserves Healthy Debate: FDIC's Hoenig." *American Banker Regulation & Reform* (United States 22 July 2013) at 3
[199] Maria Aspan "Glass-Steagall Bill 'Deserves Healthy Debate: FDIC's Hoenig." *American Banker Regulation & Reform* (United States 22 July 2013) at 3
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[201] *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Basel III
[202] "Corrigendum to Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation" (2013) 648/2012 Official Journal of the European Union at 1
[203] "Corrigendum to Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation" (2013) 648/2012 Official Journal of the European Union at 1
[204] Chaired by Jacques de Larosière
[205]"Corrigendum to Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation" (2013) 648/2012 Official Journal of the European Union at 1
[206] "Corrigendum to Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation" (2013) 648/2012 Official Journal of the European Union at 1
[207] *Oxford A Dictionary of Finance and Banking* (5 ed, reissue, 2015, online ed) Fourth Capital Requirements Directive

meets some of the prudent suggestions that Turner has made. Including increased capital liquidity requirements,[208] stricter supervision of credit rating agencies[209], and increased supervision and high prudential oversight for financial institutions, and better protection for consumers[210].

B Financial Markets Conduct Act 2013

New Zealand, like many other countries, has no definitive regulation separating their commercial and investment banking. Yet there has been no major issues with the supervision and overlap of financial products. This is because their legislation post GFC is well written and inclusive.

This act was put into place five years after the financial crisis, and has sound and logical regulations regarding financial markets. Particularly in its purpose to ensure confidence for both businesses and consumers: [211]

> The main purposes of this Act are to—
> (a) promote the confident and informed participation of businesses, investors, and consumers in the financial markets; and
> (b) promote and facilitate the development of fair, efficient, and transparent financial markets.
> 4Additional purposes
> This Act has the following additional purposes:
> (a) to provide for timely, accurate, and understandable information to be provided to persons to assist those persons to make decisions relating to financial products or the provision of financial services:
> (b) to ensure that appropriate governance arrangements apply to financial products and certain financial services that allow for effective monitoring and reduce governance risks:
> (c) to avoid unnecessary compliance costs:
> (d) to promote innovation and flexibility in the financial markets.

The Financial Markets Authority[212] states that "The FMC Act provides for fair dealing in relation to financial products and services by prohibiting: misleading or deceptive conduct; false or misleading representations; unsubstantiated representations; offers of financial products in the course of unsolicited meetings." [213]

Furthermore this act provides a specific, yet wide definition of derivative, which leaves room for the legislation to grow with developing financial products. It defines a derivative as: [214]

[208] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (United States) s 165, 171
[209] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (United States) s 932
[210] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (United States) s 335
[211] Financial Markets Conduct Act 2013 (New Zealand) s3
[212] The Financial Markets Authority (FMA) is the New Zealand government agency who oversees and enforces financial regulations.
[213] Financial Markets Authority "Fair Dealing" <https://fma.govt.nz/compliance/fair-dealing/>
[214] Financial Markets Conduct Act 2013 (New Zealand) s 4

> (4) In this Act, subject to subsection (5) (a) and (b) and section 10, derivative—…
> (A) an asset:
> (B) a rate (including an interest rate or exchange rate):
> (C) an index:
> (D) a commodity; and
> (b) includes a transaction that is recurrently entered into in the financial markets in New Zealand or overseas and is commonly referred to in those markets as—
> (i) a futures contract or forward; or
> (ii) an option (other than an option to acquire by way of issue an equity security, a debt security, or a managed investment product); or
> (iii) a swap agreement; or
> (iv) a contract for difference, margin contract, or rolling spot contract; or
> (v) a cap, collar, floor, or spread;

This is a success, as one of the main failings to the Glass-Stegall act was its inability to cover the ever growing financial products. The Financial Markets Conduct Act also goes on to clarify what is not included under its definition of derivatives. It also provides a clear and concise example of what a regulated offer means and clarifies in which instances a license is required.[215] While the legislation is protective of consumers in financial institutions one cannot help but wonder what the housing bubble in Auckland will do to New Zealand's economy and whether the United States sub-prime mortgage crisis should be a warning. As Philip Stork points out in *Contagion Risk in the Australian Banking and Property Sectors,* regarding Australia's seeming unscathed reaction to the GFC, that Australia has some of the top safest banks in the world as of 2009 most likely due to their stringent approach to supervision including stress-tests and increased capital requirements for low documentation loans[216] (which have remained less than 1% of their total outstanding loan value)[217] The decrease of first time home owners and the over-all housing prices could lead to less back ground and more risk in the lending sector of New Zealand's financial. As it stands both the Financial Markets Conduct act and the Dodd-Frank act have similar inclusive language regarding financial products, regulations and government oversight, and consumer protection.

C What Should the United States Do?

The onset of Ring-Fencing in the United Kingdom (and the great potential for the European Union to do the same) brings a stronger case for the reinstatement of the separation of commercial and investment banks as found in the Glass-Steagall act. However the Dodd-Frank act (the United States legislative answer to the GFC) has only been in effect for 6 years with very many of its rules enforced very recently, most notably the Volcker Rule which has only been in effect for 1 year. The Volcker Rule as stated earlier is a partial reinstatement of some of the rules found in Glass-Steagall separating commercial and investment banks. The focus in the Volcker Rule is to cut down and eliminate the conflict of interest inherent in BHCs

[215] Financial Markets Conduct Act 2013 (New Zealand) s 6
[216] A loan for self-employed/sole trader or small business owners that requires less financial history or proof that the borrower can pay back the lender.
[217] Philip A. Stork, Amelia Pais "Contagion Risk in the Australian Banking and Property Sectors (2010) 35 JBFLP 681 at 681-697

and FHCs by restricting the use and sale of securities by commercial banks. While it does not prevent commercial banks from underwriting and selling securities, it does prevent them from doing so on their own clients or products thus eliminating the originate to distribute model. This could perhaps be the common ground between total separation or ring-fencing and none at all. The truth is though it is too early to tell. 1 year of oversight is not enough to claim it will be or is ineffectual, and given the year of effort and time spent to reinstate Glass-Steagall only to have it be turned down time and again is evidence enough that smaller steps are in order. What is clear is that prevention of another financial crisis cannot solely be met by separation alone. Turner, de Larosière, and Liikanen are correct in their assessment that higher capital requirement and liquidity are part of the answer. And as pointed out earlier in this paper Turner, de Larosière, and Liikanen have not recommended just one way of preventing another GFC. Though two of them do encourage ring-fencing, much like the calls to reinstate Glass-Steagall, they also point to: increased oversight, capital requirements, higher penalties for non-compliant banks, greater consumer protection, increased quality and quantity of liquidity, better remuneration policies for employees, higher standards and oversight for credit ratings agencies, and increased cooperation internationally. Separation in and of itself just would not be enough. A measured and balanced approach is the answer and the Dodd-Frank act is an excellent start, though not wholly enough.

As to whether ring-fencing will work, we should leave it to the United Kingdom to try it out in 3 years' time. Maybe their success or failure will be the encouragement of discouragement needed to increase or decrease the Volcker Rule. Wallach suggests that instead of tearing down the Dodd-Frank act and starting fresh, that we instead use it as a building block for future reform to fix what is missing, ineffective, or not wholly working.[218] He goes on to state that "Proponents of 'breaking up the banks' or using Glass-Steagall-like measures to limit bank size should also start with the provisions that already exist in law. Little-discussed is the fact that banks exceeding 10% of the nation's deposits were already statutorily barred from making interstate acquisitions of other banks under the Riegle-Neal Act of 1994[219]-[220], though there were exceptions for absorbing failing banks."[221] Wallach also suggests that the previously discussed TBTF argument, many state will be fixed by reinstating Glass-Steagall, could be fixed in conjunction with Dodd-Frank by the SAFE Banking Act of 2012[222]-[223], which would require the largest banks in America to shrink themselves to a more manageable and less risky

[218] Philip Wallach "Moving Beyond Calls for a 'New Glass-Steagall'" (2012) 51 Brookings Issues in Governance Studies at 10
[219] Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (United States)
[220] The main provision of the Riegle-Neal Act of 1994 was that it allowed the Federal Reserve Board of Governors to authorize Bank Holding companies that were well capitalized to own or operate out of state banks. This amended the Bank Holding Company Act of 1956 (United States). Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (United States)
[221] Philip Wallach "Moving Beyond Calls for a 'New Glass-Steagall'" (2012) 51 Brookings Issues in Governance Studies at 10
[222] SAFE Banking Act of 2012 (United States) S. 3048 and H.R. 5715
[223] Safe, Accountable, Fair, and Efficient Banking Act of 2012 or SAFE Banking Act of 2012 – Aimed to amend the Bank Holding Company Act of 1956 to prevent BHC's from owning over 10% of the deposits of insured depository institutions in the United States. Institute prescribed leverage ratio requirements for BHC and FHC.

size.[224] As Wallach finishes "The surge of interest in bringing back Glass-Steagall speaks to the understandable persistence of concerns about the safety and soundness of our banking system. There are ample reasons for these concerns, but I have argued that the focus on Glass-Steagall is largely misguided. Reformers should turn their energies elsewhere."[225] Perhaps call for evidence model, much like the European bank regulators, where they often re-evaluate banking legislation to ascertain if the law is working like it is supposed to. [226] Much like a doctor will reassess the medication his patient is taking, looking for changes, improvements, unwanted and unmanageable side-effects, weighing the pros and cons of the treatment, making changes where required. A common sense approach to reform and amendments is what is required.

VII CONCLUSION

There is evidence banks were bad. Statistical analysis of credit default swaps and the subprime mortgage crisis prove that. We know they need regulation, but Glass-Steagall is not the right regulation. It was great in its heyday, however the length of that heyday is debatable given the other banking acts that either introduced loopholes, but it failed to grow with the ever changing financial products and markets. It only effectively regulated commercial banks (for a short period of time), and did very little to rein in and mitigate the economic risks investment banks posed to the nation. It is clear that regulation is necessary and that commercial and investment banks need to be equally held accountable to their clients and the government. Instituting outdate regulations that have proven to only be a political rally call[227] to end the fraud and greed in the banking industry is not only misleading but a grave waste of time, money, energy, and resources. We are better served by actively addressing the effectiveness of current banking and finance legislation and building reasonable, inclusive, and cohesive amendments to better regulate and protect the economy and consumers.

- Expect more from our ratings agencies, by regulating them, the Dodd-Frank act makes an excellent start with this, but could be further amended by with stricter oversight and greater fines credit ratings agencies for misconduct. Create regulation, monitor, find the loopholes, amend, and continue the cycle.
- A top priority as evidenced by the recent experiences of customers at Wells Fargo[228], the Dodd-Frank act should be amended to prevent remuneration policies that encourage employees with incentives or unrealistic goals to take risks that are not in the best interest of their customers.

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[224] Philip Wallach "Moving Beyond Calls for a 'New Glass-Steagall'" (2012) 51 Brookings Issues in Governance Studies at 11
[225] Philip Wallach "Moving Beyond Calls for a 'New Glass-Steagall'" (2012) 51 Brookings Issues in Governance Studies at 12
[226] Ian McKendry "GOP Lawmakers Blindsided by Trump's Embrace of Glass-Steagall" American Banker Law and Regulation (online ed, United States, 19 July 2016)
[227] Philip Wallach "Moving Beyond Calls for a 'New Glass-Steagall'" (2012) 51 Brookings Issues in Governance Studies at 2
[228] Wells Fargo is currently under investigation for fraudulent accounts created in customer's names without their consent by employees in order to make their target goals. Jon Marino "Wells Fargo under investigation by US House of Representatives Congressional leaders step up the heat on the San Francisco bank in the wake of fake account revelations." *CNBC* (online ed, United States, 16 September 2016)

- While not a popular idea raising the capital and liquidity requirements further to be in line with what is required in the European Union and the United Kingdom.
- The restrictions on commercial banks selling and underwriting securities should be revisited often to see how well it is working at preventing risk and financial fraud in commercial banking.

Much like bacteria evolves to circumvent antibiotics, criminals (banking or otherwise) will find a way around the law. It is the laws job to grow and change with society. Criminals will always try and find a way to commit a crime and there is no one banking law that will end fraudulent behaviour and greed. Regulations must evolve over time in conjunction with that which they regulate. Reinstating Glass-Steagall is a bit of a dead horse, though the spirit of the attempts to reinstate it are not without merit. Since the Dodd-Frank act was signed there have been over 14 bills introduced to congress to amend or repeal different aspects of the law put in places to protect consumers.[229] Clearly there are still banks and legislators who care more about enlarging their own salary than their consumers or the economy. However changing minds takes time, and harkening back to the good old days of Great Depression financial reform will not win over banks and the legislators in their pockets.

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[229] See the congressional website <https://www.congress.gov/>

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