FACT SHEET

Repealing Glass-Steagall Contributed to the 2008 Financial Crash; Properly Reinstating it Can be an Important Protection to Prevent Future Crashes and Taxpayer Bailouts

As President Trump and his Chairman of the National Economic Council, Gary Cohn, join Senators Elizabeth Warren (D-MA), John McCain (R-AZ), Angus King (I-ME) and Maria Cantwell (D-WA) in talking about "breaking up the too-big-to-fail banks" and bringing back "a Glass Steagall-type law," we thought it would be useful to address the following questions:

What is Glass-Steagall?
What happened to the Glass-Steagall law?
What happened when Glass-Stegall was repealed?
What did all this have to do with the financial crash in 2008?
Who is against the reinstatement of Glass-Steagall-like protections?
What are the arguments against doing that?

First, what is Glass-Steagall? After the Great Crash of 1929 and the Great Depression of the 1930s, several laws were passed to create layers of protections between the high risk, dangerous financial activities on Wall Street and the hardworking American families on Main Street. Importantly, these layers of protections were of different types: structural, regulatory and supervisory.

The Glass-Steagall Act was the key structural legal protection enacted: It prohibited the same bank from engaging in both relatively low-risk traditional commercial banking (using FDIC-insured and Fed-backed savings accounts to make mortgage and business loans) and higher-risk trading, insurance and investment banking operations. For more than 60 years, the Glass-Steagall Act kept those activities separate and, during that time, the U.S. created the largest middle class and had the highest rate of economic growth in its history while the financial system thrived and avoided catastrophic crashes.

Because Glass-Steagall prohibited banks from engaging in both commercial and residential banking and investment banking, securities trading and insurance at the same time, it prevented Wall Street's highest-risk activities from endangering the bank that engaged in socially useful traditional banking. As University of Chicago economist Luigi Zingales explains:

> "While Glass-Steagall may not be the most efficient form of regulation, **it worked for more than sixty years** . . . The beauty of Glass-Steagall, after all, was its simplicity: banks should not gamble with government-insured money. Even a six-year-old can understand that."

Second, what happened to the Glass-Steagall law? It was effectively repealed with the passage of the Gramm-Leach-Bliley Act in 1999, which was part of a larger successful push by Wall Street's biggest banks and its allies to dismantle many of the safeguards put in place to protect the American people following the Great Depression.[1]

In one of history's great ironies, Citibank spearheaded the efforts to repeal the Glass-Steagall Act, even though it was

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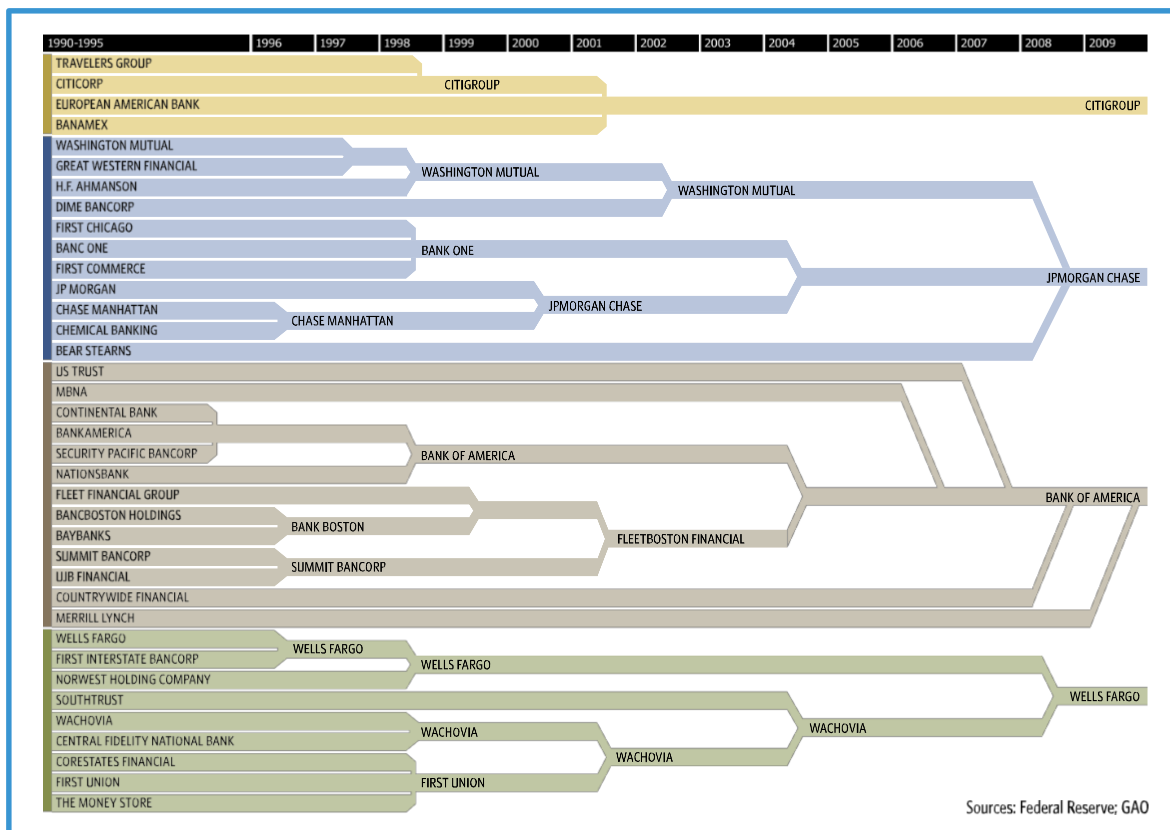
[1] A recent study reported for the first time the political campaign finance motives behind the early efforts to repeal Glass Steagall. See "Fifty Shades of Green: High Finance, Political Money and the U.S. Congress," Tom Ferguson, Paul Jorgensen and Jie Chen, Roosevelt Institute, May 2017 at 4, accessible here: http://rooseveltinstitute.org/wp-content/uploads/2017/05/FiftyShadesofGreen_0517.pdf .

one of the most reckless banks whose behavior helped cause the Great Crash of 1929 and the Great Depression of the 1930s. In fact, Senator Carter Glass (who became the co-author of the Glass-Steagall Act) singled out the CEO of National City Bank (Citibank's predecessor) as one of the men most responsible for the 1929 Crash. (This terrific article by Andrew Cockburn in Harper's Magazine spells out the details.) Once it succeeded in repealing Glass-Steagall, Citibank super-sized itself and ended up being at the center of the 2008 financial crisis, requiring numerous bailouts, as detailed by George Washington University Law School Professor Art Wilmarth. (As one observer noted, apparently "all you need for a financial crisis are excess optimism and Citibank.")

This dangerous deregulatory push, including the repeal of Glass Steagall, brought on the 2008 financial crash, which will cost the country more than $20 trillion dollars and has cost tens of millions of America's middle-class families their jobs, homes and savings.

Third, what happened when Glass-Steagall was repealed? Large financial institutions were able to acquire other financial institutions and combine lower-risk traditional banking and higher-risk Wall Street trading, securities and insurance activities. These mergers and acquisitions created gigantic, sprawling, interconnected, global financial institutions that threatened taxpayers and risked massive bailouts if they ever failed. That was because, if the uninsured investment banking activities of a megabank got into trouble and threatened to take down the FDIC-insured part of the bank, then the government would inevitably have to save both parts to save the insured part.

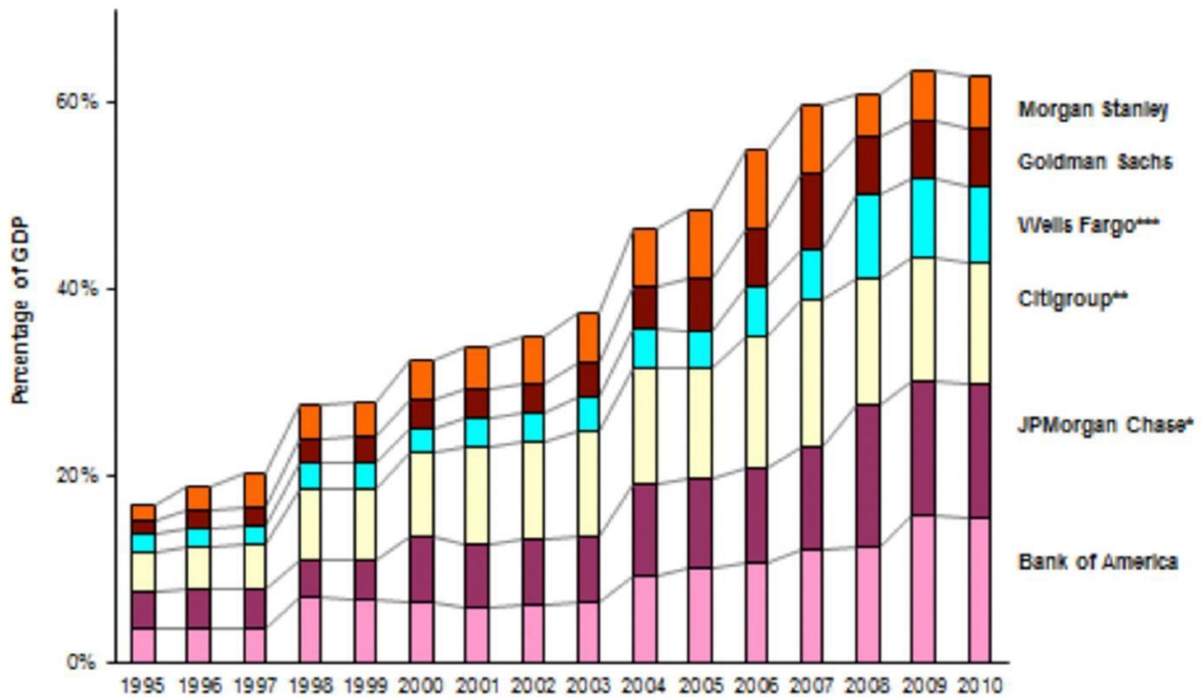
Repealing Glass-Stegall not only took down that critical separation; it also unleashed an acquisition spree that made the biggest banks bigger and bigger as this chart shows:



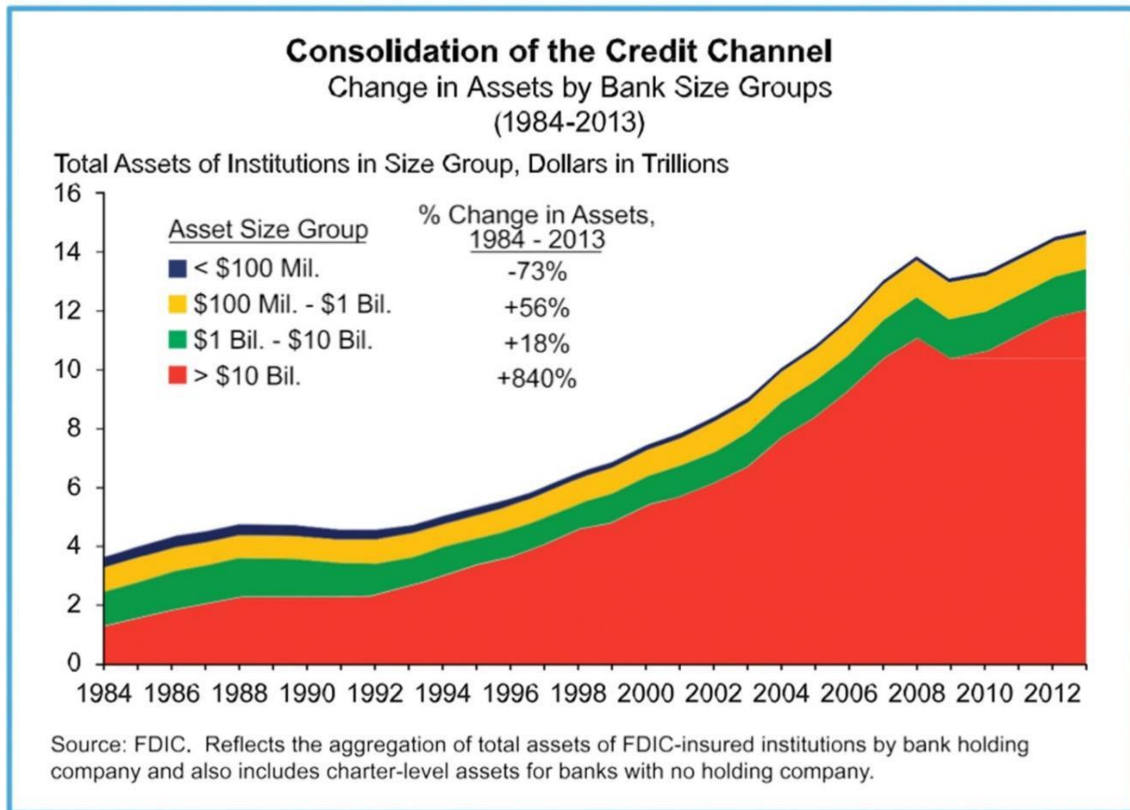
To see a larger version of this chart, click here.

This chart shows that, starting in the mid-1990s when the repeal zeal over Glass-Steagall reached its zenith, the merger and acquisition of almost 40 financial institutions resulted in just four sprawling financial conglomerates. Three of those spanned the globe with trillions of dollars in assets and derivatives, hundreds of thousands of employees, operating through thousands of subsidiaries in 50 or so countries.

In addition to adding interconnectedness, complexity and massive, global management stress from combining so many different financial institutions, these consolidations resulted in many fewer banks of much larger size. In fact, the top 6 banks grew their assets from about 20% of GDP in 1997 to more than 60% of GDP in 2008, as shown on this chart:



As those banks grew to colossal proportions, they accounted for an even larger share of the banking assets in this country. Note again what happened after Glass-Steagall was repealed in 1999:



As these banks got larger and larger, they also had less equity (called "capital" for banks) to absorb any potential losses they might incur. In fact, some of these banks were leveraged more than 33 to 1 on borrowed money, meaning that they would be effectively bankrupt if their assets values declined a mere 3%. Making those banks even more fragile, many funded themselves with inordinate amounts of short-term, often overnight, funding, making them highly vulnerable to runs.

All of this was a direct result of the repeal of Glass Steagall.

Fourth, what did all this have to do with the financial crash in 2008? Individually or in combination, by 2007-2008 these banks had become so large, complex and interconnected that if they failed, they would endanger the entire banking and financial system, and ultimately, the entire economy. And because they exposed socially useful traditional banking system to losses from high-risk trading and investments, government and taxpayers would end up on the hook for all of it. That's what happened in 2008.

For example, Citigroup, a bank holding company that was supposed to be supervised by the Federal Reserve Board of New York, is Exhibit A proving this: it was one of the biggest, most reckless failures of the 2008 crash and received the biggest bailout of any single institution: $476.2 billion in bailouts from a series of rescue programs. (It is also the only Wall Street bank that didn't repay the money it received from the TARP program – the government sold its stake to investors.)

Once Citibank succeeded in getting Glass-Stegall repealed and merged itself with the Travelers Group into a gargantuan bank known as Citigroup, and combined commercial lending with securities and insurance activities, it went

on a binge of reckless and illegal activities, fueled with massive amounts of FDIC insured deposits. In addition to placing huge proprietary bets, by 2007, Citigroup was the number one worldwide placement agent of high-risk collateralized debt obligations (CDOs), which it sliced and diced into various derivatives that it not only sold, but itself shorted in immense quantities. As this court filing shows, Citigroup engaged in shockingly irresponsible high-risk CDO trading and investments.

In a gross miscarriage of justice, only one of the CDOs that Citigroup put together and shorted resulted in an SEC enforcement action.

Moreover, Citigroup also engaged in the fiction of creating entities that were supposedly entirely independent and unrelated. For example, it sponsored several Cayman Island-incorporated structured investment vehicles (SIVs), essentially small banks funded with commercial paper and with no capital requirements. These entities were supposed to be "bankruptcy remote," meaning that their creditors had no legal recourse to Citigroup, and Citigroup was not liable for their debts. However, as is often if not always the case (as Stanford University professor Darrell Duffie pointed out in his book "How Big Banks Fail"), the purchasers of the SIVs' commercial paper believed that there was an implicit guarantee from Citigroup given that it created the SIVs and sold the paper, which was widely held by money market funds. In late 2007, when the markets began to experience turmoil, Citigroup took more than $59 billion in assets for which it had zero legal liability back onto its balance sheet, in part from seven SIVs it created, to avoid asset fire sales and reputational damage. Citigroup had to then take substantial write downs on these assets, which impaired what little capital it had and triggered the long-term run on and ultimate collapse of the bank.

Confirming the irresponsible recklessness that was at the core of Citigroup, its CEO said in 2007, "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."

But as everyone knew by then (and Goldman Sachs knew long before as revealed by Bill Cohan), it was only a matter of time before the music stopped. When it did, liquidity predictably dried up, and Citigroup began its insolvency death spiral. Unlike other businesses that fail and go bankrupt, Citigroup avoided the consequences of its recklessness, poor judgments and illegal behavior only when the government and taxpayers stepped in and provided massive bailouts. (Doesn't seem like much has changed in the Citigroup CEO suite: in May 2015, when Citigroup had to pay more than $1 billion and plead guilty to a criminal charge for rigging the foreign exchange markets, its current CEO referred to this as a mere "embarrassment," i.e., no big deal. Not exactly a comforting tone-at-the-top for a too-big-to-fail bank copping a criminal plea and paying an historically large fine, shortly after being bailed out by U.S. taxpayers for crashing the U.S. financial system.)

As if all this isn't enough to prove that Citigroup was an out-of-control recidivist, it knowingly continued its fraudulent mortgage practices, the very activities that inflated the housing bubble and precipitated the 2008 financial crash, for four years **after** the 2008 financial crash, into 2012.

The moral of the story is this: Citigroup would not have existed in the form it did and would not likely have been too-big-to-fail, too-complicated-to-manage, too-big-to-jail, engaged in those repeated reckless and illegal activities, posed that incredible danger, and required almost $500 billion bailouts if Glass-Steagall had been left in place.

Almost unbelievably, the biggest banks in the U.S. today are bigger than Citigroup was in 2008 when it collapsed and had to be bailed out. While they may be better managed, engaging in less reckless and illegal activities, and are significantly better regulated, these handful of biggest banks remain too-big-to-fail without damaging if not destroying the U.S. and global financial system.

That's a primary reason many are proposing to put Glass-Steagall-like protections back into place: to separate traditional socially useful banking from the higher-risk trading, investment and insurance activities of banks.

Fifth, who is against reinstating Glass-Stegall like protections? The arguments against reinstating Glass Steagall are self-serving, weak or correctable.

First, Wall Street's too-big-to-fail banks hate the idea of restoring Glass-Steagall. The most important thing to understand is that Wall Street's megabanks want to remain too-big-to-fail because that means they get big bonuses in good times and get taxpayers to bail them out in bad times. In addition, they want to keep the subsidy from using low-cost and sticky government backed depositors' money to fund their higher-risk trading and investment businesses. That's why they are doing whatever they can to make sure Glass-Steagall-like protections aren't put back into place.

Second, some from the Federal Reserve are against restoring a Glass Steagall-like law. They fear it would limit the Fed's ability to respond to the next crash and, thereby, make that crash much worse. Former Fed Chairman Ben Bernanke has recently restated this view, observing that 2008 Fed-brokered shotgun mergers of JP Morgan Chase with Bear Stearns and Bank of America with Merrill Lynch would not have been possible. However, he completely ignores the fact that those emergency measures would likely not have been necessary if Glass Steagall was still in place and that the crash, if it happened at all, would have been substantially less severe and required much less Fed intervention. If the threat from too-big-to-fail is ended or greatly reduced, then the need for the Fed to act is greatly reduced.

Third, there are those, like Better Markets, that fear a new Glass Steagall law would not be done right and could increase the likelihood of future crashes. For example, if done wrong, it could re-create the dangerous two-tiered system of regulation that caused the unregulated shadow banking system to expand dramatically. That is to say, if a Glass Steagall like law were passed, then both types of systemically significant financial institutions would have to be similarly regulated to ensure that risk doesn't again migrate from a highly regulated banking system to a lightly regulated shadow banking system. A new law could also create more risk if a Glass Steagall-like law were passed, but other critical financial protection rules on capital, liquidity, resolution plans, stress tests and others were weakened or eliminated.

Sixth, what are the arguments against reinstating a Glass-Steagall-like law? Some say that the repeal of Glass-Steagall had nothing to do with the 2008 crash. They say Bear Stearns, Lehman Brothers and AIG (i.e., the so-called "shadow banking system") were not subject to Glass-Steagall and, voilà, it is therefore irrelevant. However, those seemingly sensible claims are little more than incomplete, revisionist history that, first and foremost, ignores the facts detailed above regarding the supersizing of the largest banks, which became overly complex, leveraged and interconnected. Without the repeal of Glass Steagall, these incredibly fragile, dangerous institutions would not have existed. There might have been other changes to the law and financial system, but the crash, if it happened anyway, would certainly have been less severe and less costly.

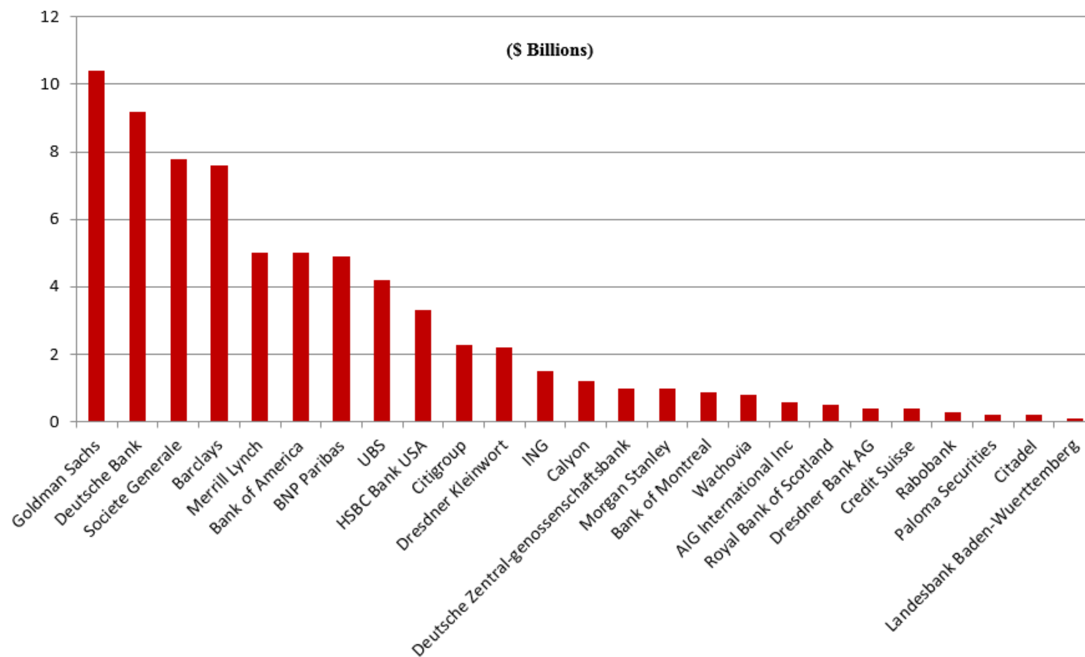
There are also other numerous reasons that the argument Glass Steagall was irrelevant to the 2008 crash is baseless. For example, the so-called shadow banking system -- which prominently included the investment banks Goldman Sachs, Morgan Stanley, Bear Stearns, Lehman Brothers and Merrill Lynch -- was funded, directly or indirectly, by FDIC-insured and Fed backed bank holding companies like JPMorgan Chase, Bank of America, and Citigroup. These banks funded the shadow banking system directly through lines of credit as well as repurchase agreements (so-called "repos") and in many of other ways.

Moreover, JPMorgan's acquisition of Bear Stearns only happened because its CEO, Jamie Dimon, insisted that U.S. taxpayers assume 100% of the risk of $30 billion of Bear Stearns' most toxic derivatives. The U.S. government assumed this multi-billion-dollar risk because Bear Stearns was the counterparty to and interconnected with the gigantic too-big-to-fail bank holding companies made possible by Glass-Steagall's repeal. The same is true for Lehman Brothers, which precipitated the financial crash because of that very same interconnectedness.

The bailout of global insurance conglomerate AIG is probably the clearest example of the nexus between too-big-to-fail banks and the shadow banking system. While the bailouts ultimately totaled a little less than $185 billion, it is important to remember that the bailout amount was actually unlimited, as the government committed to doing "whatever it takes" to prevent AIG's failure and what was believed to be the inevitable collapse of the entire financial system. AIG's

imminent bankruptcy was only prevented by massive government bailouts because its counterparties were interconnected global too-big-to-fail banks:

Payments to AIG's Counterparties after being Bailed Out

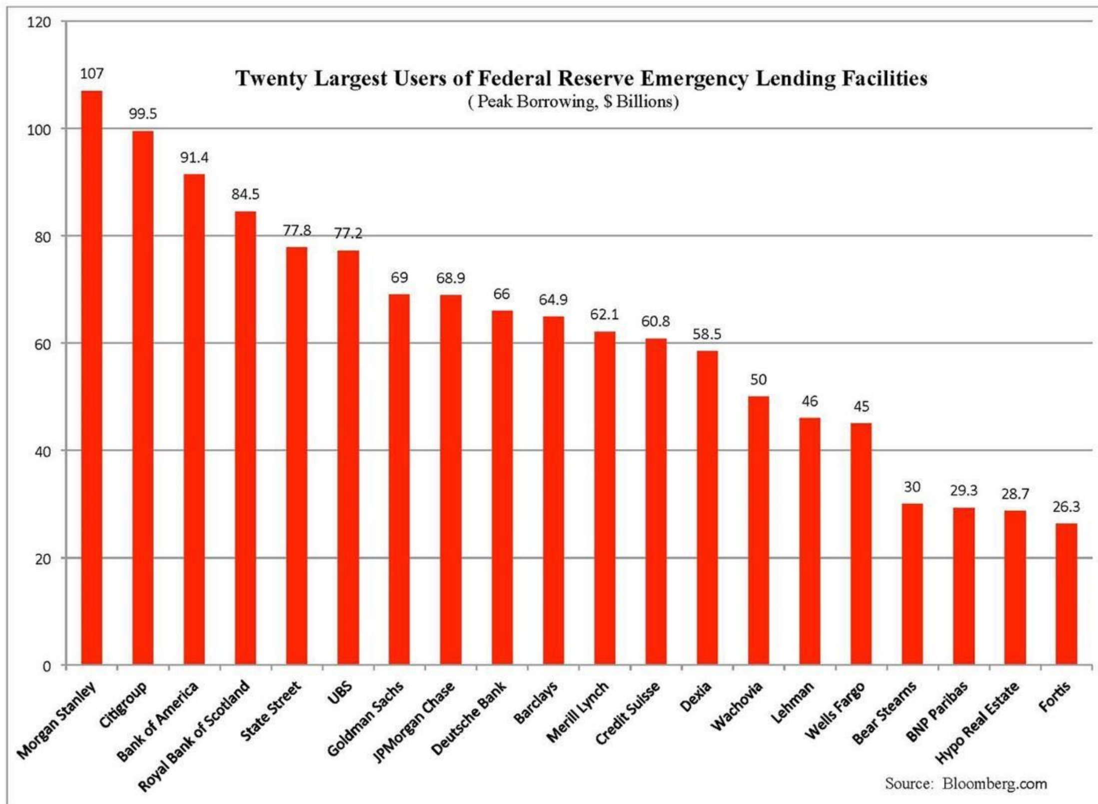


The financial crisis made clear the dangerous interconnectedness that existed between the too-big-to-fail banks, made possible by the repeal of the Glass-Stegall Act, and the investment banks that populated the shadow banking system. Remember the week of September 15, 2008, in which Lehman's failure nearly brought down the financial system: Lehman failed on Monday, AIG was bailed out on Tuesday, the Reserve Fund broke the buck on Wednesday, the equity markets continued to crash and the wholesale funding markets dried up on Thursday (which caused the Treasury to guarantee the $3.7 trillion money market industry), and by Friday Morgan Stanley didn't believe it would be able to open the following Monday, September 22, 2008, which meant that Goldman Sachs was "toast."

It is undeniable that all these events were inextricably interconnected with the too-big-to-fail bank holding companies, which were directly threatened with failure due to their own irresponsible conduct and the cascading crash of the financial system.

The truth is that the repeal of Glass-Steagall enabled the creation of the too-big-to-fail banks, which all had to be bailed out by the U.S. government and taxpayers, as proved by the following chart (which actually significantly understates the scope and breadth of the bailouts each received because it only shows peak borrowings from the Fed's emergency lending facilities and not all the other rescue programs and bailouts or even cumulative lending):

Banks Needing Bailouts



Some have made other arguments or claims against reinstating Glass-Steagall, but they are not serious.[2] For example, some have said that "this is a much more complicated issue than pointing to any one piece of legislation and saying if we just pass that everything would be fine." Others have said there "is no one answer to the too-big-to-fail problem" or claim that "proponents of ending too-big-to-fail love to point to the repeal of Glass Steagall as the culprit." No serious person is claiming that "the repeal of Glass Steagall [w]as **the** culprit"; however, the facts detailed above show that it undeniably was **a** "culprit."

While most would agree that preventing financial crashes is a "complicated issue," no one serious is "pointing to [Glass-Steagall] and saying, if we just pass [that one bill], everything will be fine." And, no one is "just saying there is one answer to the too-big-to-fail problem." Everyone knows that there are no magic bullets, single solutions or simple answers to the massive threat posed by the too-big-to-fail firms and activities. Indeed, everyone recognizes that even the description of the problem ("too-big-to-fail") is inaccurate because size is just one of the many issues that need to be addressed (along with complexity, interconnectedness, funding, leverage, resolution, cross-border, etc.).

[2] Although these arguments are often made by serious people, they too often have conflicts of interest that taint their views. For example, the architects and cheerleaders for repealing Glass Steagall in the 1990s are some of the strongest deniers that it had any role in contributing to the 2008 crash. While this may be a good way to avoid personal responsibility or the need for rigorous reflection and analysis of ones' actions, it is not the position of someone who has thought deeply about the issues or substantively addressed the facts detailed above regarding the undeniable post-repeal changes in the financial industry.

That's why serious people discuss comprehensive plans that have different types of protections (structural, regulatory, supervisory, etc.) that will effectively rein in Wall Street's riskiest activities and protect Main Street families once again, not just today, but throughout the business cycle and, indeed, for decades. That's what political leaders did after the Great Crash of 1929 and the Great Depression of the 1930s and that's what political leaders of today must do.

Conclusion. The point of restoring a structural barrier between taxpayer-supported traditional commercial, socially-useful lending and Wall Street's high-risk securities, investment and insurance activities (i.e., a Glass-Steagall like law) isn't to prevent the last crisis or to be so foolish to think the next crisis can be predicted and prevented with clarity and certainty. As far-sighted legislators and policy makers saw after the Great Crash of 1929, what a safe, sound, durable, non-threatening, socially-useful financial system needs are multiple layers of protection of different types between Wall Street and Main Street. Restoring the separation between commercial and investment banking is one of the most sensible layers of protection because it takes away the taxpayer subsidy of insured deposits while at the same time forcing the biggest banks to absorb their own costs and, therefore, become less dangerous to taxpayers and the economy. Plus, as noted above, creating a barrier between commercial banking and investing banking is clear and simple: "even a six-year-old can understand" it.

Reinstating Glass-Steagall is not the only solution and it won't solve too-big-to-fail by itself. It can, however, be an important part of an overall plan to reduce the risk on Wall Street while increasing the protections for Main Street.

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Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street and make our financial system work for all Americans again. Better Markets works with allies – including many in finance – to promote pro-market, pro-business and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements and more. To learn more, visit www.bettermarkets.com.