

**Taming the Megabanks: Why We  
Need a New Glass-Steagall Act**  
(Oxford University Press, 2020)

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## Key Points

- 1. Banks become major participants in the securities markets twice in the past century – during the 1920s and since the late 1990s. Both times, banks with “universal banking powers” promoted unsustainable credit booms that led to destructive busts – the Great Depression of 1929-1933 and the Great Recession of 2007-09. Both times, governments arranged costly bailouts of universal banks on both sides of the Atlantic.**
- 2. Congress responded to the Great Depression with the Glass-Steagall Act of 1933. Glass-Steagall created a federal deposit insurance program and separated banks from the securities markets. It also prohibited nonbanks from accepting deposits.**
- 3. Glass-Steagall created a decentralized financial system in the U.S., consisting of banks, securities firms, and insurance companies. That system was stable until the late 1980s. The structural buffers separating the three financial sectors prevented financial contagion (e.g., the stock market crash of October 1987 did not undermine the U.S. banking system).**
- 4. Regulators opened numerous loopholes in Glass-Steagall beginning in the late 1980s, and Congress repealed it in 1999.**

## Key Points (contd.)

5. **Universal banks create dangerous boom-and-bust cycles for five reasons:**
  - a) **Banks use low-cost, government-insured deposits to fund risky loans.**
  - b) **Banks move risky loans off their balance sheets by packaging them into asset-backed securities, which are sold as purportedly “safe” investments to poorly-informed investors.**
  - c) **The combination of deposit-taking, lending, securities underwriting, and trading creates toxic conflicts of interest. Those conflicts of interest prevent universal banks from acting either as objective lenders or as impartial investment advisors.**
  - d) **A bonus-driven culture encourages insiders to pursue risky deals that produce up-front fees and short-term profits, while ignoring longer-term risks.**
  - e) **Universal banks create giant financial conglomerates, which are too big to fail, manage, or regulate effectively, and are largely insulated from market discipline.**

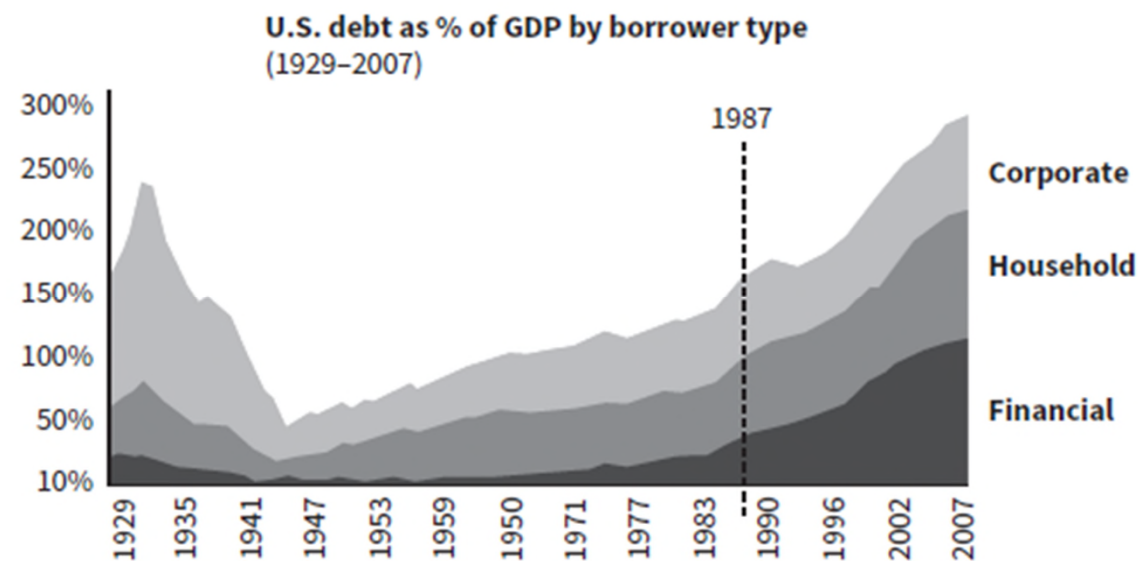
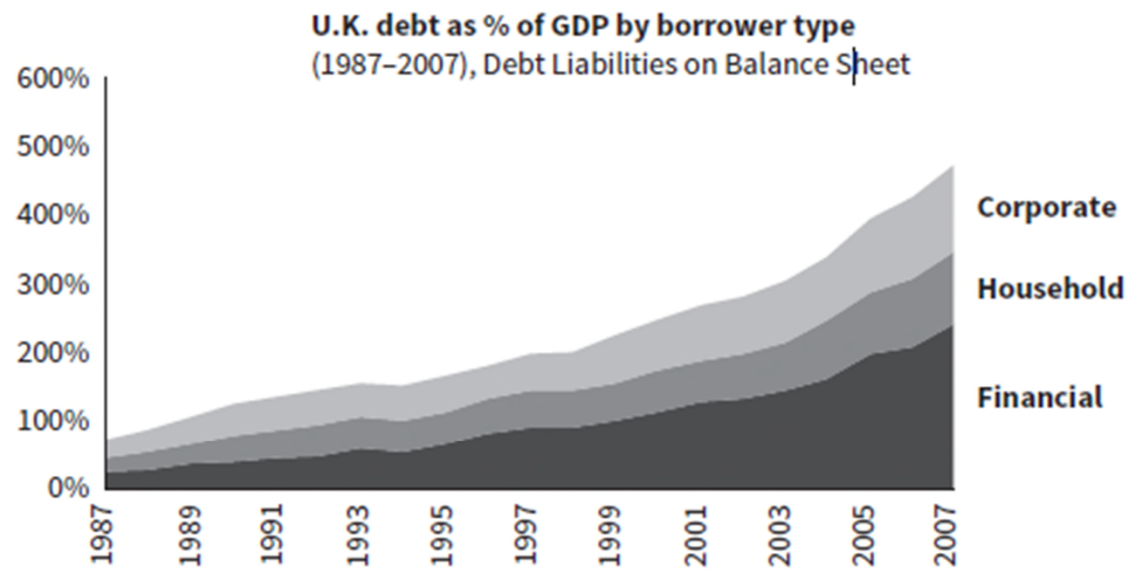
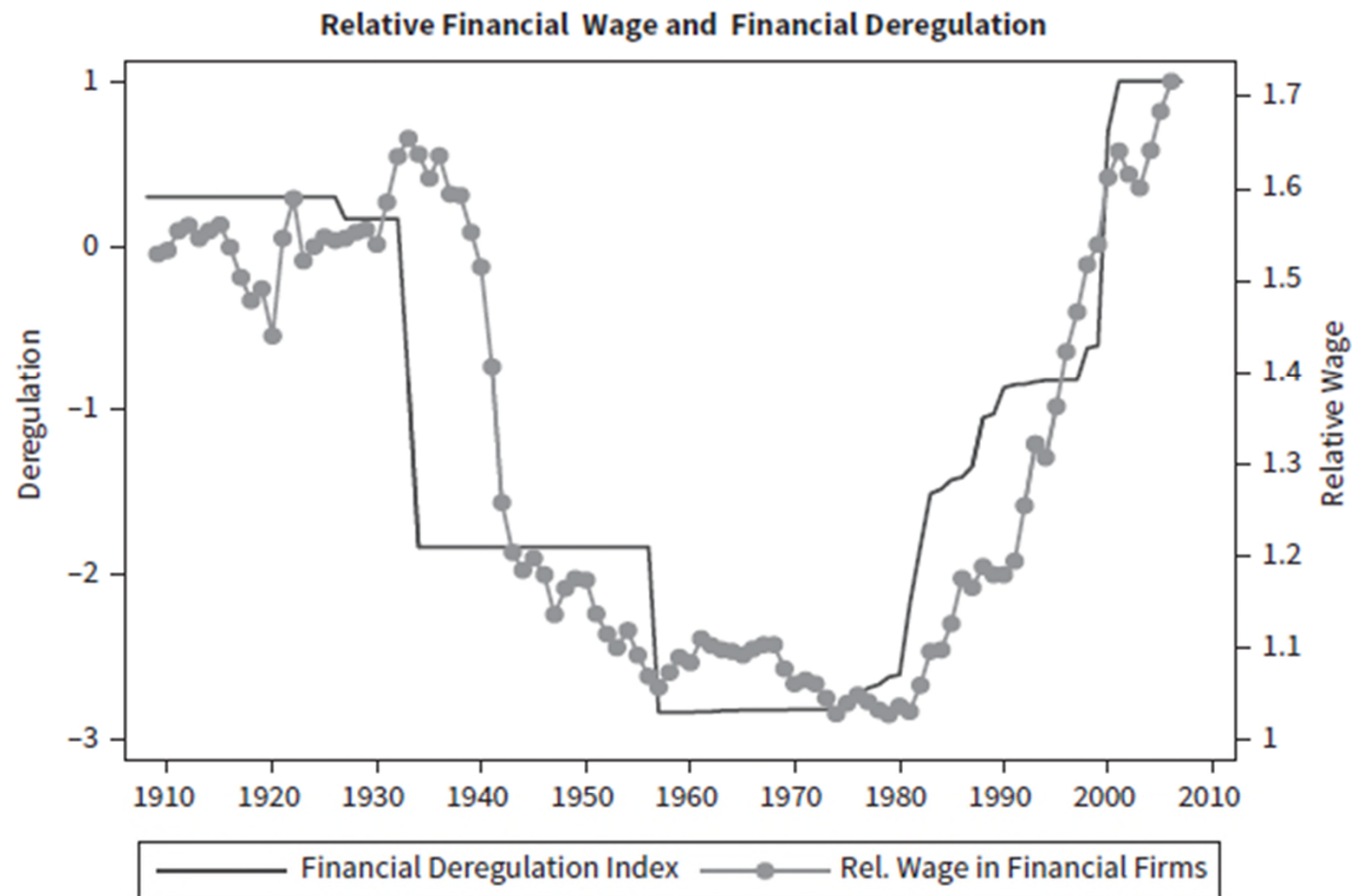


Figure 0.3 Changes in U.S. and U.K. Ratios of Total Debt to GDP During the Credit Booms Leading to the Great Depression and Great Recession

Source: FSA (2009: 18) (exhibit 1.10)



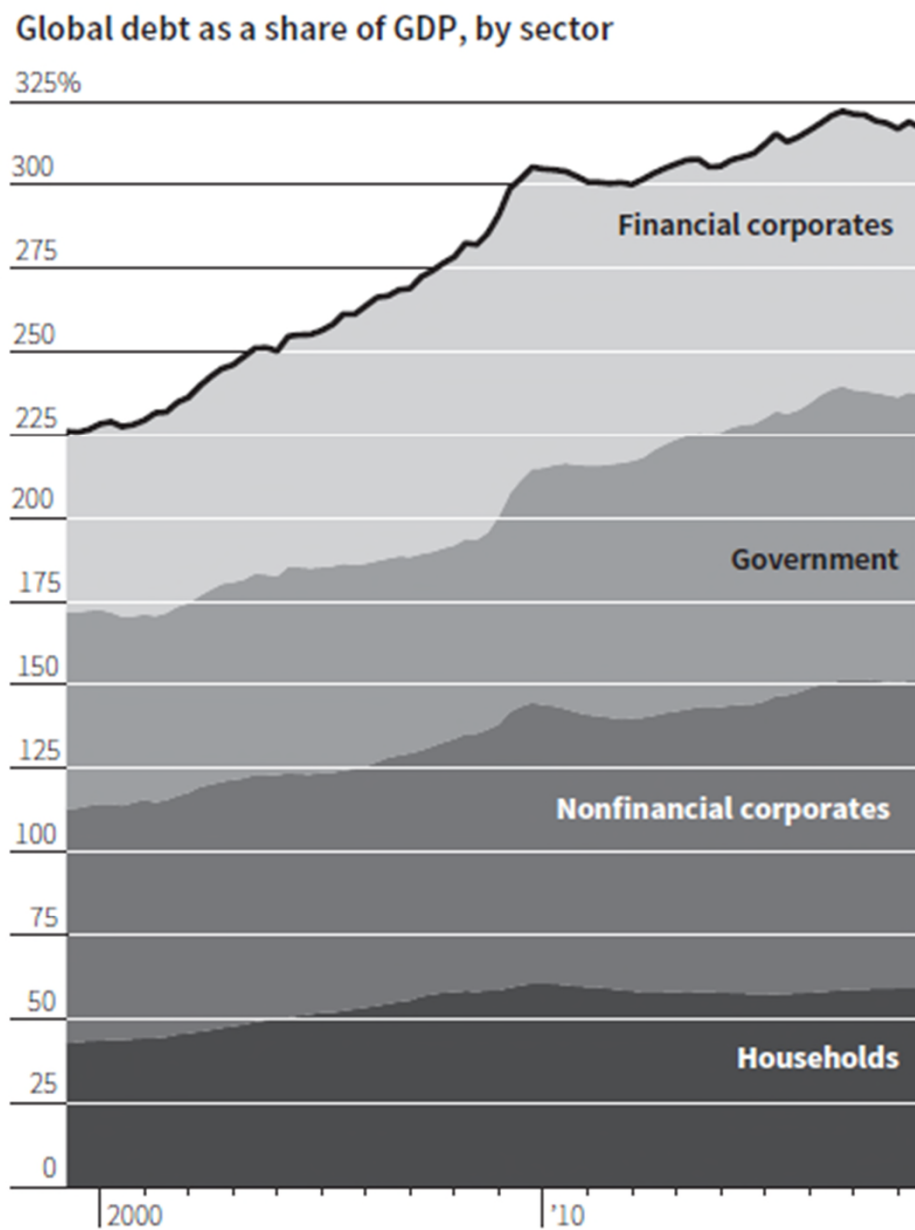
**Figure 0.4** The Impact of Financial Deregulation on Compensation in the Financial Industry Compared with Other U.S. Industries, 1910–2008

*Note:* The “relative wage” is the ratio of the average wage in finance to the average wage in the nonfarm private sector (excluding finance).

*Source:* Philippon & Reshef (2012: 1578) (figure VIII C)

## Key Points (contd.)

6. Congress passed the Dodd-Frank Act after the Great Recession. Dodd-Frank adopted a series of highly technical reforms, including stronger capital and liquidity requirements and a new framework for resolving failures of systemically important financial institutions (SIFIs).
7. Dodd-Frank did NOT change the basic structure of our financial system. It left in place a dangerously unstable system dominated by universal banks and large “shadow banks,” including private equity firms and hedge funds. Shadow banks are not regulated as banks but provide substitutes for banking services (e.g., deposits, payments services, and loans).
8. Post-crisis reforms have perpetuated a “global doom loop,” in which:
  - Governments and central banks provide too-big-to-fail guarantees to universal banks and large shadow banks and intervene as necessary to stabilize financial markets.
  - Universal banks and large shadow banks finance rising levels of private sector and public sector debts with support from accommodating monetary policies of central banks.
  - Investors and creditors take excessive risks because they expect that governments and central banks will protect SIFIs and backstop financial markets (e.g., 2008-09, 2019-20).
  - Total global debt has grown from \$84 trillion (225% of global GDP) in 2000 to \$167T (282%) in 2007, \$257T (322%) in 2019, and \$281T (356%) in 2020. Total U.S. debt has increased from \$27T in 1999 (212% of U.S. GDP) to \$54T (288%) in 2007, \$75T (346%) in 2019, and \$82T (381%) in 2020. See next slide for rise in global debt (Figure 12.1).



**Figure 12.1** Increases in the Ratio of Global Debt to Global GDP, by Sector, 2000–2017

Source: Wall Street Journal (2019)



## **Key Points (contd.)**

- 9. A new Glass-Steagall Act would prohibit banks from using government-protected deposits to finance speculative investments in the capital markets. It would prevent banks from packaging risky loans into asset-backed securities. It would stop nonbanks from offering short-term financial instruments (e.g., money market mutual funds and securities repurchase agreements) that function as deposit substitutes. It would require nonbanks to fund themselves with medium-term and longer-term debt, thereby forcing shadow banks to shrink significantly.**
- 10. A new Glass-Steagall Act would improve financial stability by reestablishing risk buffers that prevent contagion across financial sectors. It would improve market discipline by preventing banks from transferring their public subsidies to affiliates engaged in capital market activities. Regulators would no longer feel compelled to bail out securities markets to prevent failures of large banks with significant securities exposures.**
- 11. A new Glass-Steagall Act would end the dominance of universal banks and create a more diverse and competitive banking system. Our political, regulatory, and monetary policies would no longer be held hostage by giant financial conglomerates. Banks and securities firms would return to their proper roles as servants – not masters – of commerce, industry and society.**



# **New Issues Posed by Entry of Technology Firms into the Banking Industry**

- **The FDIC and OCC are inviting technology companies to enter the U.S. banking industry through acquisitions of (1) FDIC-insured industrial banks, and (2) uninsured national banks. Both approaches allow technology firms to acquire banks without complying with the Bank Holding Company Act (BHCA). The BHCA prohibits ownership of banks by commercial firms, and it gives the Fed consolidated supervisory authority over companies that control banks and affiliates of those companies.**
- **Unless the FDIC's and OCC's efforts are blocked by Congress or the courts, they will inevitably lead to mergers between major banks and Big Tech firms, thereby destroying the U.S. policy of separating banking and commerce.**
- **Ownership of banks by commercial firms prevents banks from acting as impartial lenders because commercially-owned banks have powerful incentives to extend preferential loans to their owners or their owners' customers (especially when their owners are under financial stress). Such ownership also creates a strong likelihood that the federal "safety net" for banks (including deposit insurance, the Fed's support as lender of last resort, and the Fed's guarantees for the payments system) and "too-big-to-fail" bailouts will be provided to large commercial owners of banks (e.g., GE, General Motors, and GMAC during 2008-09).**

# **New Issues Posed by Entry of Technology Firms into the Banking Industry (contd.)**

- **The repeal of Glass-Steagall “bankified” our capital markets by allowing banks to enter the securities markets and by extending the federal “safety net” to protect those markets. A large-scale entry by technology firms into the banking industry would “bankify” our entire economy, producing an even broader decline in market discipline.**
- **The recent failures of Wirecard Bank and Greensill Bank provide strong warnings about the risks of (1) allowing commercial firms to control banks, and (2) permitting banking authorities to regulate ONLY banks without possessing consolidated supervisory authority over their parent companies and affiliates. Both failures were caused by unsound and abusive loans provided by Wirecard Bank and Greensill Bank to their affiliates and customers of affiliates. Germany’s BaFin failed to detect clear evidence of fraud affecting both banks, due to its lack of oversight over their parent companies and affiliates. Similar regulatory failures occurred in other countries (e.g., UK, Australia).**
- **The ongoing struggles between Chinese authorities and Ant Group (Alibaba, Ant Financial) and Tencent (WeBank, WeChat) provide further warnings about the difficulty of supervising technology giants that establish large banking operations. Each company has allegedly channeled unsound consumer loans into “partner” banks and engaged in anticompetitive conduct (e.g., obstructing customers who use its platform from buying goods or services through its competitor’s platform).**