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Cracked Rear View: The Uses and Abuses of Financial History in the 2008 Crisis

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The financial markets crashed. The American economy tanked. Many blamed financial institutions, arguing that banks made risky, irresponsible investments with depositors' money.

This description applies to two American economic crises: one in 1933, and, over 80 years later, the meltdown of 2007-08. Outwardly, they have much in common: so much, in fact, that some have argued that the regulations created in the wake of the earlier meltdown could have prevented the second. Others have stated that New Deal financial regulations can fix the current problems with the financial system.

Historical analogies are often used by decision makers to understand new and unknown situations in terms of what has already been learned from the past. For example, in 2008 John Thain, the former CEO of Merrill Lynch, said: "This is not like 1987 or 1998 or 2001. We will in fact look back to the 1929 period to see the kind of slowdown we are seeing now." Similarly, a 2009 report by the Congressional Oversight Panel states that the real estate bubble in the second half of the 1920s - which was a major contributing factor to the stock market crash of 1929, the collapse of banks, and the Great Depression - has very real parallels with the subprime mortgage crisis that acted as a catalyst for the 2007-08 financial crisis.

However, historical analogies are also often oversimplified so that decisions are justified by glossing over the subtle differences between the past and the present. Many regulatory decisions based on historical lessons are unsuccessful. They either fail to consider the past in all of its complexity or incorrectly apply past lessons onto altogether different situations in the present.

A prime example of the abuse of financial history is the now infamous Glass-Steagall Act. Glass-Steagall was enacted as part of the Banking Act of 1933, and repealed in 1999 under then-Treasury Secretary Robert Rubin. Critics from Senator Elizabeth Warren to Nobel-Prize winning economist Joseph Stiglitz have argued that the law's repeal played a major role in creating the most recent crisis.

But the repeal of Glass-Steagall was not responsible for the most recent meltdown, and reinstating it will not reproduce the decades of financial stability that came to pass after the Great Depression. Times have changed. The problem now is not how to separate commercial banks from investment banks. The real problem is how to promote good management in a financial system where banks are happy to take more risks because the taxpayer bears the burden of those risks – a problem commonly referred to as 'moral hazard' in economics.

The Glass-Steagall Act separated commercial and investment banking in order to insulate commercial banks from the vagaries of the stock market. Banks that accepted deposits could make commercial loans and invest in short-term trading, but they could not buy corporate securities; banks that underwrote securities or engaged in the securities markets could not accept deposits. This was intended to reassure the public that their deposits were not subject to speculation in the wake of the severe bank runs and bank failures of the early 1930s.

But it is unclear whether universal banks—which participate in both commercial and investment banking activities—actually made riskier decisions in the years before the banking crisis of 1933. Before Glass-Steagall was instated, numerous academic studies conclude, universal banks in fact acted much more cautiously than investment banks in the years before the bank failures. Of the bonds underwritten between 1925 and 1929, only 12 percent of the value of those underwritten by the security affiliates of commercial banks had defaulted by 1940, according to a 1994 study by Kroszner and Rajan in *The American Economic Review*. By contrast, the same study found that 32 percent of bonds underwritten by investment banks defaulted by 1940.

The expected returns at the time of issue were lower for commercial bank affiliates, while the actual returns were higher, as Ang and Richardson wrote in *The Journal of Banking and Finance* in 1994. This indicates that commercial bank affiliates did not misrepresent the quality of their securities and their performance was not inferior to the securities issued by investment banks.

Historical evidence also suggests that national banks that engaged in both commercial and investment banking actually weathered the banking crisis of 1933 better than other national banks. The failure rate was four times less for national universal banks compared to that of all national banks between 1930 and 1933, according to White's 1986 article in *Explorations in Economic History*.

But even if the underlying problem of 1933 was the union of commercial and investment banking, Glass-Steagall still would not have prevented the 2008 meltdown. For one thing, Glass-Steagall's requirements were irrelevant to many of the key players in the financial meltdown. Bear Stearns, Lehman Brothers, and Merrill Lynch were all investment banks without commercial banking business, so their troubles had nothing to do with the repeal of Glass-Steagall. AIG is an insurance company, while Fannie Mae and Freddie Mac are government enterprises that finance mortgages.

Of course, some of the major players in the financial crisis actually were commercial banks that engaged in investment banking. But their failures were primarily related to lending money held on deposit, which is permitted under Glass-Steagall as a commercial banking activity. Citigroup's underwriting of bad loans was just as risky as its collateralized debt obligations under its investment banking arm. Bank of America's acquisition of subprime lender Countrywide Financial produced plenty of bad loans itself. Wachovia was hampered by bad loans after it acquired the mortgage lender Golden West. JP Morgan's $2 billion trading loss was because the bank was trying to offset its potential losses – or hedge - against the risk of its commercial banking portfolio, not because of its investment banking activities.

Banks like Citigroup used their bad loans - a commercial banking activity - to create securities, the sale of which funded their investment portfolios. Glass-Steagall would not have prevented Citigroup, Bank of America, or Wachovia from making these bad loans. Rather, it would have cut the commercial banks off from funding their loans by direct sales of mortgage-backed securities. But the bad loans still could have been packaged and sold to other investment banking firms (albeit, possibly for a lower profit), which means that Glass-Steagall would not have prevented the securitization of mortgage loans. Nor would Glass-Steagall have stopped JP Morgan from insuring its lending portfolio. The bank's trading loss was not a speculative bet, but was rather a hedge gone wrong.

Furthermore, Glass-Steagall would not have helped prevent the crisis because financial firms had been finding ways to circumvent the law at least ten years prior to the meltdown. Commercial banks today often are owned by holding companies, which also own a number of other businesses. Among these other businesses are brokerage houses, investment banking firms, and real estate companies. The structure of holding companies would therefore subvert any re-implementation of Glass-Steagall. Even without a direct chain of ownership, investment banking firms would not be isolated from commercial banks. To prevent the assets of one of these enterprises from being endangered by another, the Fed sought to implement legal barriers – or "firewalls" - between them. But the proposed firewalls were thought to be too rigid because they would eliminate the benefits of combining both activities under a holding company. The result was the implementation of a more lax system of firewalls that did not isolate the assets of investment banking firms and commercial banks in practice as the Federal Reserve gradually cut back on active banking supervision throughout the 1990s. Thus, even if Glass Steagall was re-implemented, it would not make much difference today, as banks have already found a way around it.

In fact, the evolution of federal deposit insurance - another component of the Banking Act of 1933 - plays a far greater role in the problems of 2008 than the repeal of Glass-Steagall. The Federal Deposit Insurance Corporation (FDIC), which still exists today, was created as a second means of protecting bank deposits. While Glass-Steagall was intended to protect bank deposits from speculative investment activities, deposit

insurance was meant to protect deposits if a bank could not pay its debts. But banks' knowledge that they can count on the government — and taxpayer dollars — to bail them out has made them reckless.

Federal deposit insurance did not start out that way. In 1933, small, local unit banks were particularly susceptible to liquidity constraints when a large number of depositors would withdraw their money at the same time - a situation referred to as a bank run. Lawmakers wanted federal deposit insurance to create a financial system wherein the larger, more stable banks subsidized the smaller, more unstable ones. The FDIC was to be privately funded by the banks, so that the burden of financial stability was not placed on taxpayers.

But that changed decades later. In 1987, at the height of the savings and loan crisis, the viability of the FDIC's financial backing came into question. In a non-binding joint resolution, Congress affirmed that the resources of the U.S. government - in other words, taxpayer dollars—stood behind the FDIC-insured depositors. Since the banks could count on the government to bail them out, they could take bigger risks. This would lead to practices such as subprime and predatory lending. For example, Countrywide Financial made high-cost adjustable rate mortgages that allowed homeowners with weak credit to make interest-only payments. Similarly, Wachovia's "pick-a-payment" mortgages did not even require that minimum payments cover the interest of a loan, where the outstanding amount was simply added to the mortgage balance.

Banks are now left shockingly unaccountable for the risks they take. After 1933, regulators had two options for resolving bank insolvency: liquidation or the purchase of assets and assumption of liabilities by another firm. After 1950, an insolvent institution could also be supported by the FDIC through loans or the acquisition of assets if it were deemed to be essential to the banking system. However, this last option was rarely used because regulators thought a market distortion would be created if a bank were thought to be too important to let collapse. This market distortion came to pass after 1987. Large institutions coupled the knowledge that they were essential to the banking system with the knowledge that they would not be allowed to fail. Any risks taken would therefore not be incurred by the bank itself; resulting in significant moral hazard. Since banks did not have to bear the costs, they were compelled to take greater risks. Such a situation results in financial instability and lies at the heart of what regulators must tackle to address the faultlines in the banking system

Attaching investment banking activities to commercial banks in today's financial system does produce more risk. But this is because investment banking firms are securitizing the loans of commercial banks in a financial system that is characterized by moral hazard. Some believe that universal banking is tantamount to insuring investment banks' securities, mutual funds, or other investments. But the larger issue is that banks operate in a financial system that does not hold them accountable for the irresponsible risks they take. Unless this changes, the separation of commercial

and investment banking will do little to improve the soundness of the American financial system.

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