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Kurt Winiecki founded Winiecki Wealth Management in 2011 after careers as a tax accountant and attorney. He is experienced in investment strategies, financial planning, taxes, and estate planning. He holds degrees in finance, accounting, and law and uses his background to recognize and reduce risks in all aspects of peoples' lives. Winiecki can be contacted at 312-961-1266 or kurt@winieckiwealth.com.

Lending, Investing Can Be a Risky Combo

Was Repeal of Glass-Steagall Misguided?

BY KURT WINIECKI, FOUNDER, WINIECKI WEALTH MANAGEMENT LLC

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Was Repeal of Glass-Steagall Misguided?

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To keep federal spending under control, Warren Buffet suggests that in any year the U.S. government deficit exceeds 3 percent of the nation's gross domestic product (GDP), no sitting member of Congress should be allowed to run for reelection. While the quip may have been tongue-in-cheek, tying the success of Congressional careers to the economic success of the country might not be such a bad idea.

A more serious proposal for addressing problems in the U.S. economy would be the reinstatement of the Glass-Steagall Act. Enacted by Congress in 1933 in response to the financial mayhem that caused the Great Depression, the law mandated the separation of commercial banking and investment activities. It was repealed in 1999 amid complaints that the law put banks at a competitive disadvantage with domestic investment houses and overseas banking and investing institutions in the market for lending-type products.

But as the recent financial crisis demonstrated, the combination of lending and risky investing that accelerated after repeal of the law continues to create the potential for economic catastrophe. This article discusses the history of Glass-Steagall and how its reinstatement would likely affect lending today.

When Glass-Steagall was enacted, its advocates cited several arguments in favor separating commercial banking and investment activities. Lending institutions wield enormous financial power because they maintain control of customers' demand deposits. The U.S. government insures those deposits to a large degree and could suffer enormous losses if large lending institutions failed. For these and other reasons, including the need to ensure continued access to capital, it is important to maintain the integrity of lending institutions.

At odds with the relative conservatism that one would expect from institutions that control demand deposits, however, investing was and remains a risky activity. Huge amounts of money can be lost on bad investment decisions, which can threaten the integrity of the lending system. Combining lending and investing can create conflicts of interests between the need to ensure the safety of deposits and the allure of the potential to achieve big investment returns. Preventing such problems was the driving force behind the original law.

Glass-Steagall maintained a separation between lending and investing for decades. But as time passed, the memory of the Great Depression and its causes seemingly faded, and the financial world changed dramatically.

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Slowly, boundaries between the lending and investment industries began to fade. Banks began to offer products that resembled securities, and investment banks began to offer products that resembled loans.

As depository institutions lost market share to less-regulated investment firms, calls for the repeal of the Glass-Steagall Act grew louder and gained traction. Supporters maintained that repeal of the act could be coupled with regulations requiring banks to limit themselves to relatively low-risk investments to prevent potential conflicts. Supporters argued that repeal was necessary to allow U.S. banks to remain competitive. Following numerous failed attempts to repeal the law over a number of years, the law was finally abolished in 1999 by a Republican-controlled Congress in legislation signed by Democratic President Bill Clinton.

Continued deregulation following the act's repeal created new relationships between depository banks and investment banks that eventually led to poorer quality loans, massive securitization of mortgages, and a

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housing bubble. Banks and newly formed institutions began combining lending and risk-taking investment operations, initially making huge profits selling securitized mortgages. In *The Two Trillion Dollar Meltdown*, Charles R. Morris explained what happened next:

"[L]ike most booms, it inevitably veered into destructive excess. By 2003 or so, mortgage lenders were running out of people they could plausibly lend to. Instead of curtailing lending, they spread their nets to vacuum up prospects with little hope of repaying their loans. Subprime lending jumped from an annual volume of $145 billion in 2001 to $625 billion in 2005, more than 20 percent of total issuances. More than a third of subprime loans were for 100 percent of the loan value—even more when the fees were added in. Light-documentation mortgages transmuted into 'ninja' loans—no income, no job, no assets."

Former Federal Reserve Chairman Alan Greenspan, testifying before Congress in October 2008, said, "I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms...."

Fallout from the Crisis

With less regulation, some financial institutions grew to be "too big to fail"—their demise would be disastrous for the U.S. economy. As a result, the U.S. government was forced to intervene to keep these giants afloat. At different points during the recession, the government stepped in to insure additional deposits and provided several bailout programs to prevent a financial meltdown.

Another important development in lending after the repeal of Glass-Steagall was the emergence of a separate, unregulated "shadow banking system," which boomed between 2000 and 2008. Its participants do not accept deposits and therefore are not regulated as depository banks.

The shadow banking system includes hedge funds, special investment vehicles, money market funds, and other entities that provide lending services between investors and borrowers, earning service fees and the spread on the interest rates. Because they are not subject to the strict regulations depository banks face, shadow banking entities can use more leverage and are less transparent than regulated banks, and they provide astounding amounts of credit to the system—more than $10 trillion in 2007, although that figure fell to $6 trillion by 2009.

Congress responded to the Great Recession of 2007-2009 by passing the Dodd-Frank Act, which addressed many issues that contributed to the financial crisis. Included in the legislation was the Volcker Rule, the goal of which was to limit the risks banks are allowed to take on their investments. Banks argue that the law's complexities make it difficult to follow, while detractors complain that Dodd-Frank contains so many loopholes as to be ineffective.

A reinstated Glass-Steagall should address several key issues. Most pressing among them would be regulation of the shadow banking system to reign in inappropriate risks (that is, any risks that put the banking system at risk). One common proposal is a bright line test that would require that any institution that lends money or would require rescuing in a crisis should be regulated as a bank. While this would certainly restrict the massive amounts of credit now provided by the shadow banking system, the result would be increased stability, fairness in lending standards, and safer loans over the long term.

Additionally, Congress should address the securities-type products created and sold by banks, such as mutual funds, in any new Glass-Steagall law, as well as competition from foreign institutions. Reinstatement of Glass-Steagall would not likely stimulate lending in the short term, but the trickle-down effect of strengthening the economy would eventually lead to more credit for better loans.

Establishing Balance

Today's economy has reversed its free fall, but the U.S. still struggles with high unemployment and low growth. Although lending is picking up, it remains slow. Many believe, given that financial institutions are blamed for causing the Great Recession to a large extent, these institutions should loan more now to speed the recovery.

The sentiment that lenders should be making more loans to make up for

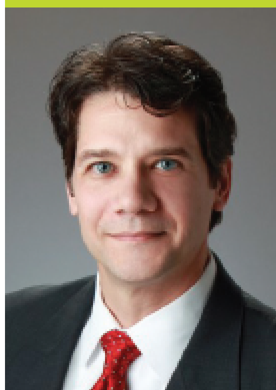
past sins is irrelevant, as is whether the government's responses to the financial crisis to this point have been prudent. Lending is, and must remain, market-driven. The availability of credit and the prudence of loans must be determined by competitive market factors. Banks claim that they are making prudent loans, which are increasing as the economy improves.

There is little doubt that bank lending standards were much too loose during the lead-up to the recession. But it is also likely that in response to their problems, banks overreacted and tightened lending standards too much. However, they make those decisions based on the current economy, current balance sheets, current sentiment, and other factors. No one should expect, much less force, banks to base their lending practices on any other criteria.

That said, reinstatement of Glass-Steagall would have positive effects on the economy that should provide, over time, a much better backdrop against which to lend. Reducing the risks related to deposits would decrease volatility in lending standards. Less volatility in lending standards would likely lead to a steadier stream of credit—a welcome change from the spigot being nearly completely open or completely closed. Beyond that, the obvious conflicts of interest that helped push the U.S. into a housing crisis and recession would be greatly reduced, if not eliminated entirely.

One of the biggest hurdles to long-term U.S. growth and prosperity are institutions that are too big to fail and the instability in the financial system created by legally permissible conflicts of interest. Allowing banks charged with safeguarding demand deposits to risk their survival in equity markets rather than focusing on making sound loans adds unnecessary risks to an exceedingly complex financial system.

While reinstating the Glass-Steagall Act would go a long way in addressing conflict of interest and too big to fail problems, it would not likely have an immediate significant effect on lending. Arguably, and depending on how the shadow banking system was regulated, such a move might restrict credit in the shorter term. But in the longer term, a healthier economic environment would result.



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