Our Perspectives:
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The Reasons for the Gramm-Leach-Bliley Act*

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One of the most repeated allegations about the financial crisis is that the passage of the Gramm-Leach-Bliley Act (GLBA) that repealed two sections of the Glass-Steagall Act in 1999 was a significant contributing factor in the subprime mortgage meltdown. However, these allegations never specify the exact link between GLBA and the crisis. The reason is that there is no readily apparent link between the two events. Simply put, the provisions of the Glass-Steagall Act that were repealed by GLBA had nothing to do with subprime mortgage lending, the origination of mortgage-related securities, or with the authority of banks to purchase mortgage-backed securities. And it was the purchase of these securities that resulted in the large losses that banks and other investors suffered when the housing bubble finally burst.

The Glass-Steagall Act

The Glass-Steagall Act refers to four sections of the Banking Act of 1933 that deal with the securities activities of banks. Of these four sections, two were repealed by GLBA, and the other two remain on the books and are enforced. The two sections that were repealed prohibited banks from having an affiliated company that engaged principally in the business of underwriting securities. The two sections that remain in place generally prohibit a bank from directly engaging in the business of issuing, underwriting, selling or distributing securities. The Glass-Steagall Act includes an exception that permits a bank to continue to engage in securities underwriting, and issuing and dealing in certain limited types of debt instruments and Government securities.

Thus, following passage of GLBA, the provisions limiting the securities activities of banks remained, but the two provisions prohibiting affiliations were repealed. In their place, the GLBA instituted a procedure to allow securities firms, insurance companies, and banks to form affiliations through a bank holding company structure. Companies seeking to form such affiliations had to be approved by the Federal Reserve Board.[1] The banks involved had to be well-capitalized and well-managed under Board standards, and had to have at least satisfactory Community Reinvestment Act ratings.

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[1] National banks were also given the option to form "financial subsidiaries" to engage in these activities, but the restrictions on the use of these subsidiaries made the holding company structure the more efficient choice, especially for the larger banks that already were organized as part of a bank holding company.

Glass-Steagall Act and the Financial Crisis

The financial crisis relates to subprime mortgages and mortgage-backed securities. However, the Glass-Steagall Act has nothing to do with mortgage loan originations, and since at least 1976, has not been viewed as restricting the ability of a bank to purchase mortgage-backed securities or even to securitize mortgage loans that the bank originates.[2] Thus, long before 1999, GLBA banks have been originating mortgages, purchasing mortgage-backed securities and securitizing mortgage loans. It is generally understood that these activities were conducted in a safe and sound manner until the large bubble in housing prices created incentives to lower underwriting standards and to ignore warnings that the increase in housing prices was unsustainable.

There is one criticism of GLBA that has substance. The legislation adopted an approach called "functional regulation," in which the Federal Reserve Board supervises the holding company, the banking agencies supervise the bank entities, the SEC supervises the insurance entities, and the States supervise the insurance entities. In retrospect, this may have left gaps in the supervisory structure. But it was the approach recommended by the Federal Reserve, the SEC and the state insurance agencies, and Congress was assured at the time, and even thereafter, that it provided for "umbrella supervision" of the entire organization. Nevertheless, even if more comprehensive supervision by the Federal Reserve had been authorized in 1999, it is not clear how this would have affected the outcome of the 20072008 collapse.

Repeal of Glass-Steagall Had a Long History

Despite today's conventional wisdom to the contrary, the repeal of two provisions of the Glass-Steagall Act in 1999 was not the product of a political deregulatory philosophy, but instead the product of years of bi-partisan consideration of the issue.

The Gramm-Leach-Bliley Act is closely modeled on the Proxmire Financial Modernization Act of 1988.[3] The Proxmire bill, which was co-sponsored by Senator Jake Garn, passed the Senate by a vote of 94-2. The bill was authored by Senator Proxmire, and was supported by such liberal members of the Banking Committee as Senators Dodd and Sarbanes. The Proxmire bill was the result of recommendations to amend the Glass-Steagall Act that were advocated by both liberal and conservative members of Congress going back to at least 1981. The repeal of the Glass-Steagall Act was strongly supported by both Republican and Democratic Presidents, academic experts, economic experts, and *all* of the banking agencies. A review of the hearings and committee reports indicate that Congress was motivated by legitimate public policy concerns, including the fact that larger and the most credit worthy businesses were by-passing banks for their credit needs and raising funds directly through the securities markets, leaving banks with a riskier customer base.

In 1999, the Gramm-Leach-Bliley Act was strongly advocated for the Clinton Administration, which lobbied for its adoption. Both liberal and more conservative members of the Senate Banking Committee supported the repeal of the Glass-Steagall Act. Even the dissenting report of the Senate Banking Committee stated that there was agreement on the need to repeal the Glass-Steagall Act. The final version of the bill passed the Senate by a bipartisan vote of 90-8, and passed the House with a vote of 362-5.

[2] Letter of Robert Bloom First Deputy Comptroller for Policy (June 1, 1976). See also, Securities Industry Association v. Clarke, 885 F.2d 1034 (2ndCir. 1989).

[3] S. 1886, 100th Cong. 2d Sess. (1988).

Conclusion

In order to make the necessary reforms to prevent a recurrence of the financial meltdown, it is important to objectively analyze the causes of the disaster. The financial crisis caused serious and substantial harm to the United States and its citizens, and it is critically important to make reforms that will deal with the actual causes of the crisis. The allegation that the partial repeal of the Glass-Steagall Act is an underlying cause has been taken up by the popular press and talk show hosts, but the facts do not appear to support this view.

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