Deregulation and the Financial Crisis*

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The recent pronouncement by Sandy Weill, the former Chairman and CEO of Citigroup, that the separation between commercial banking and securities underwriting should be reinstituted has reignited the debate about the role of bank deregulation as a cause of the subprime crisis. In particular, Mr. Weill's comments have been taken as evidence that the 1999 repeal of the Glass-Steagall Act, contained in legislation known as the Gramm-Leach-Bliley Act (GLBA), which Mr. Weill enthusiastically supported at the time, was a significant cause of the financial meltdown that began in 2007. These views have been espoused repeatedly by newspaper columnists, talk show pundits, and even some respected think tanks since the financial meltdown began.

As a result, it has become conventional wisdom that deregulation, in general, and GLBA, in particular, was a major cause of the financial meltdown. However, Mr. Weill never asserted that the repeal of Glass-Steagall was a cause of the financial crisis, and an objective review of the banking legislation over the past 30 years makes it clear that GLBA and other federal deregulatory legislation had nothing to do with the subprime failures and resulting market panics. This article will explore some of the common myths about GLBA and other federal legislation commonly viewed as deregulatory in nature.

Myth: Safety and soundness standards were lowered through deregulation.

Fact: Federal legislation did not reduce safety and soundness standards. The federal laws commonly viewed as deregulatory relate to permissible activities and geographic areas in which banks can operate, but did not lower supervisory standards or the powers of bank regulators. In the 1980s, the federal agencies were consistently given new and enhanced enforcement powers over depository institutions. In 1991, Congress authorized the agencies

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to take “prompt corrective actions” to sanction banks whose capital levels fell below certain thresholds, and the discretionary authority to deem a bank “undercapitalized” when its activities appeared risky. In the Gramm-Leach-Bliley Act, adopted in 1999, additional emphasis was placed on capital, and only “well capitalized” and “well managed” institutions were allowed to use the benefits of that legislation.

During this period, laws were also adopted to strengthen restrictions on insider lending and to restrict further bank transactions with affiliated companies. The federal banking agencies were authorized to impose civil fines against banks and bank insiders of up to $1 million per day. New criminal penalties were adopted for violating banking laws and money laundering regulations. Consumer privacy protections were adopted. Numerous consumer protection provisions were added, including limitations on high cost mortgage loans, truth-in-savings disclosures, and limits on how long a bank could hold a deposit before making the funds available for withdrawal. There is no instance in the past 30 years in which deregulatory legislation reduced safety and soundness standards for depository institutions or hampered the enforcement powers of the federal banking agencies.

Myth: Until passage of federal bank deregulation legislation, the banking industry was healthy and relatively failure free since the Great Depression.

Fact: The banking industry suffered repeated periods of major losses and widespread failures in the past 30 years. To a large extent, these financial problems were caused by Depression-era laws that simply did not work in a more modern economy. For example, prior to deregulation, institutions were subject to stringent limits on the amount of interest they could pay depositors. When competing investments were developed paying higher rates, such as money market mutual funds, deposit outflows crippled depository institutions. Another example is the laws that essentially required savings associations to hold large portfolios of fixed-rate, 30-year mortgages. When interest rates spiked, these mortgages became money losing assets, and the savings and loan industry lost billions. Yet another example is the law that limited banks to operating in a single state. As our communications and transportation system developed, the need for interstate banking became clear, and Congress responded by deregulating these geographic limits.

Myth: The Glass-Steagall Act prevented the mixing of banking and securities activities.

Fact: The Glass-Steagall Act of 1933 required the separation of commercial banking and securities underwriting. Even under Glass-Steagall, banks were allowed to affiliate with securities brokers and with mutual funds, and could engage in derivative activities including credit derivatives and various types of swaps. They could also offer investment advice. Beginning in the 1980s, banks were also permitted to affiliate with firms underwriting securities, as long as the underwriting business was not the firm's primary activity. Many large banks had these so-called "securities affiliates" for close to 15 years prior to the repeal of Glass-Steagall, with no ill effects on the economy or safety and soundness.

Myth: The Gramm-Leach-Bliley Act weakened supervision of banking conglomerates.

Fact: The Gramm-Leach-Bliley Act repealed the last remnants of the Glass-Steagall Act that were still in place following years and years of regulatory actions that created many exceptions to allow banks to engage in securities activities. GLBA put in place a new structure to permit the affiliation of banks and securities firms under the close supervision of the Federal Reserve Board, and subject to rules limiting the permissible transactions between the bank and the securities affiliate. GLBA made the Federal Reserve the "umbrella" supervisor for the combined company, but also provided that the SEC would be the primary regulator for the securities entity, and the appropriate state insurance agency would be the primary regulator for any insurance entity in the combined company. This system was called "functional supervision" by the supporters of the bill.

In 1999, functional supervision was thought to be the best approach, since the SEC and the state insurance regulator would have the most expertise in their respective areas, and the Federal Reserve would maintain an overall view on the entire entity. GLBA was not intended to weaken supervision, but to strengthen it. However, the enhanced supervision framework requires the respective agencies to work cooperatively and share information. To the extent that supervisory gaps developed, it relates to the lack of appropriate follow through by the regulatory agencies, and was not the intent or expectation of Congress when it adopted the legislation.

Myth: The Gramm-Leach-Bliley Act is a significant cause of the subprime crisis.

Fact: Allowing securities firms and banking firms to affiliate had nothing to do with the subprime crisis. Mortgage lending has been a permissible banking activity long before the Glass-Steagall Act was finally repealed in 1999. The securitizing of mortgage loans has also been a permissible banking practice since the development of mortgage-backed securities in the 1970s. There is no connection between the repeal of Glass-Steagall and subprime lending or the securitization of subprime loans.

Myth: The repeal of Glass-Steagall made companies too big to fail.

Fact: Repeal of Glass-Steagall led to the growth of some very large financial firms into even larger and more complex conglomerates. Whether or not this is a healthy development for our financial system is currently a topic of debate in Congress and in the press. But whatever one's views on that issue, it should also be understood that GLBA did not institute the "too big to fail" problem. It existed long before 1999.

Prior to GLBA, the largest financial institutions in the country would no doubt have been thought of as "too big to fail," and the actions of the government during the crisis demonstrate that companies that did not take advantage of the GLBA provisions were clearly thought of as "too big to fail." For example, the government took steps to protect the creditors of Bear Stearns, Fannie Mae, Freddie Mac, and AIG. Creditors of Long-Term Capital were also protected through government intervention in 1998. Going as far back as 1984, the government provided assistance to protect the creditors of Continental Illinois National Bank. These actions were motivated by concerns that these companies presented systemic risks to the financial stability of the United States, even though they did not use any of the GLBA merger authority. There is no support for the contention that but for the repeal of Glass-Steagall companies would not be considered too big to fail.

Myth: GLBA reduced required capital levels.

Fact: The Gramm-Leach-Bliley Act did not affect required capital levels. These levels are set by the federal banking agencies for banks, and by the SEC for securities firms. In 2004, an international agreement was reached in Basel, Switzerland to move to a new capital methodology that would have reduced required capital for certain assets, including mortgages, and raised capital for other assets thought to be riskier. These capital rules were never fully implemented for U.S. depository institutions, and no bank or bank holding company was allowed to use the new rules. However, the SEC adopted these new rules for large securities firms, and they began to use the new standards soon after the international agreement was reached.

Myth: Banking deregulation was motivated by devotees of free market economics whose aim was to remove all government controls over our banking system

Fact: Federal legislation liberalizing banking powers was almost always a reaction to changing circumstances in which it became obvious that the Depression era rules were not working. They were not partisan measures. The goals of modernizing our banking regulatory structure was strongly advocated by both Democratic and Republican Administrations, and these bills were adopted with large bi-partisan majorities.

Myth: The large banks were responsible for the repeal of the Glass-Steagall Act.

Fact: The repeal of the Glass-Steagall Act can be traced back to the Proxmire Financial Modernization bill, which passed the Senate in 1988. This bill was the model that the Clinton Administration used when it introduced its version of financial modernization in 1997. This bill was adopted on an overwhelming bi-partisan basis in 1999 as GLBA. Support for repealing Glass-Steagall was widespread among economists, academics, federal regulators, and other public policy experts, not just large banks. Opposition came primarily from the insurance and securities industry. The breakthrough that allowed GLBA to be enacted related to a change in position by these industry groups. While it is true that many large banks supported repeal of Glass-Steagall, it is also true that this position was held by a diverse array of experts and opinion leaders, as evidenced by the fact that people such as Senator Proxmire supported repeal.

Myth: Even if Gramm-Leach-Bliley did not cause the subprime crisis, it made the problems worse.

Fact: This assertion is not supportable. The fact that the Glass-Steagall barrier had been removed by GBLA actually helped resolve the problems caused by the financial crisis. The repeal of Glass-Steagall made possible the combinations that helped save such companies as Merrill Lynch and

Bear Stearns that were merged into large bank holding companies. It also permitted other securities firms suffering financial distress to acquire a bank and thereby become bank holding companies under Federal Reserve Board supervision. These actions helped ameliorate the financial turmoil, and would not have been permissible if Glass-Steagall was in effect.

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