

Based on the delineation of the nature of the financial regulation in the US between the 1930s and 1980's, analysing why such regulation was though necessary, how successful it was and why and how that structure of regulation was dismantled

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Abstract

Between 1929 and 1933 nearly 40 percent of the nation's banks disappeared. In their wake, Roosevelt's New Deal government put in place an extensive system of financial regulations. The inflation of 1970s made the deregulation the only possible solution in order to protect the failing banks and shift in savings away from banks. This led cumulatively to the final dismantling of Glass-Steagall in 1986. Although, the final nail in the coffin came in 1999 when President Clinton signed the Financial Services Modernization Act. In this paper I will only look at the period between 1930s and 1980s.

Keywords: regulation, roosevelt's, financial, modernization

Introduction

The most severe crash of a financial market, the 1929 Wall Street crash, produced an economic calamity, which led in turn to a collapse of the U.S. banking system. Between 1929 and 1933 nearly 40 percent of the nation's banks disappeared. In their wake, Roosevelt's New Deal government put in place an extensive system of financial regulations. The most important initiative was the 1933 Glass-Steagall Act or as it is officially known, the Banking Act. Commercial banks were limited to the prosy tasks of accepting deposits, managing checking accounts, and making business loans. Commercial banks would also be monitored by the newly formed Federal Deposit Insurance Corporation (FDIC), which provided government-sponsored deposit insurance for the banks in exchange for close government scrutiny of their activities. Investment banks, by contrast, could freely invest their clients' money and undertake other high-risk activities, but they had to steer clear of the commercial banks.

Similar regulations were imposed on Savings & Loans (S&Ls) in 1932, and continued to operate through the 1970s. In particular, under the old regulatory regime, mortgage loans in the United States could be issued only by S&Ls and related institutions. The government regulated the rates S&Ls could charge on mortgages, and the S&Ls were prohibited from holding highly speculative assets in their portfolios.

But even during the New Deal years themselves, financial-market titans were already fighting to eliminate or at least defang the regulations. The inflation of 1970s made the deregulation the only possible solution in order to protect the failing banks and shift in savings away from banks. This led cumulatively to the final dismantling of Glass-Steagall in 1986. Although, the final nail in the coffin came in 1999 when President Clinton signed the Financial Services Modernization Act. In this paper I will only look at the period between 1930s and 1980s.

The new deal ERA

During the 1930s, the U.S. and the rest of the world experienced a severe economic contraction, the Great Depression. Bank runs were common because there wasn't insurance on deposits at banks, banks kept only a fraction

of deposits in reserve and customers ran the risk of losing the money if their bank failed. In response to these conditions the US financial structure saw a complete change.

In 1993, Congress created the Federal Deposit Insurance Corporation (FDIC), and insured deposits in commercial banks. President Franklin D. Roosevelt signed the Banking Act of 1933 and a year later Federal Savings and Loan Insurance Corporation (FSLIC) was created as part of the National Housing Act of 1934 in order to insure deposits in savings and loans. Similarly regulations were also established in securities markets under the Securities Act of 1933. The Glass-Steagall Act was a reaction to the fact that banks, before the Great Depression, had mixed the commercial and investing activities and regulators felt that this had caused banks to take too much risk with depositors' money.

In the economic conditions of the time, these regulations were "based upon two principles: (1) restriction of competition among financial institutions and (2) government protection, including federal insurance of deposits and a federal commitment to prevent financial panics^[1]."

Under the Glass-Steagall Act, regulation Q placed the limits on the interest rates bank could offer on deposits; this reduced the competition among banks and put an end to interest rate wars. Creation of insurance corporations retained the investor's faith in banking system.

The act created a Chinese wall between commercial banks and other financial activities. After the enactment of Glass-Steagall, commercial banks could accept depositor's money and make loans but could not become involved in selling or trading securities or underwriting. They certainly could not trade in risky or speculative financial instruments. Investment banks could underwrite securities and sell securities, but they could not accept bank deposits or make loans to customers. This prevented banks from investments in riskier activities and banks had high quality loan portfolios.

Such dissociation assigned made different agencies focus on different activities without causing any competition among them. Also, low interest rates on loans fostered investment and as a result more employment and income.

Bank failures were reduced significantly. “For example, from 1930 to 1933 more than 9000 commercial banks failed, causing devastating effects upon the public’s confidence in the entire system of monetary payments. In contrast, from 1934 to 1973 only 641 U.S. banks were closed, an average of less than seventeen a year ^[2].” In such a stable environment profits could be made simply by financing long term mortgages loans with short term deposits by savings and loans industry. Therefore, housing industry saw a growth in terms of increased ownership of houses.

Threats to the regulatory regime

For the next three decades the regulatory framework was well in place. This was the conservative period of “3-6-3” business. Interest rates were kept at regulated levels by the “pegging” policy of the government, where the yields on government securities were kept at levels below the Regulation Q ceilings. This discouraged the shift of savings away from banks. During this period government sustained huge national debt and federal deficit in order to protect Regulation Q from proliferation of “money substitutes”. A shift in power from public democratic control to private commercial bankers occurred in Federal Reserve with the 1935 Banking Act. Soon after the end of World War II, motivated by little price escalation, The Federal reserve-Treasury accord of 1951 freed the Fed from its pegging policy. This was a cornerstone in the process of Financial Deregulation that started in US step by step. As market interest rate started to rise, the banking industry developed pressure to raise Regulation Q.

In response to the rising rate of interest, Fed allowed banks to offer certificate of deposit which could attract funds away from securities market. “Thus the initial steps toward interest rate deregulation appear to have been at least partially inspired by banks’ attempts to avoid regulatory restrictions as well as by their attempts to accommodate commercial customers’ desire for market rates of interest ^[3]”

This was the time when Financial Institutions started to exploit the regulatory regime through “financial innovations” such as commercial papers and short term treasury bonds. Creation of “nonbank bank” was the result of such exploitation where corporations acquired a bank and then took it out of commercial loan business.

However, these new products were not widely popular till 1970s. These innovations blurred the line between deposits and securities and hence, banking industry complained that Glass Steagall has become obsolete. Also the threat from unregulated off-shore markets led to the advocacy for the repeal of glass Stegall.

Throughout 1970s inflation and interest rates kept rising. Two oil shocks during this period lead to a rise in primary commodity prices and a cost push inflation. By this time it was clear that it is difficult to maintain high growth and low inflation. With high inflation and regulated interest rates, savers lose money as they receive lesser returns. On the top of it the austerity policy followed by U.S. raised interest rates even higher. Therefore, consumer demanded some other instruments where they could put their money. “By the end of 1980, tight money had proven largely fatal to the Carter administration. More importantly, the monetary experiment had made financial deregulation inevitable. Double digit interest rate imperiled the entire structure of regulated interest rate ^[4].” Money was pulled out of commercial banks and put in innovative instruments.

Money market mutual funds introduced by securities dealers thus became popular.

U.S Response

By the end of 1970s the competition for commercial banks and thrift institutions became intense and there was a need to take strong actions by the policy makers. Due to inflation, ceilings set by usury laws became a constraint. The use of credit cards was popular in late 60s and 70s ^[5]. In the case of *Marquette National Bank vs. First of Omaha Service Corp*, Supreme Court’s decision in state usury law applied to nationally-chartered banks’ lending across state lines allowed these banks relocate to states with most deregulated usury ceilings. This was the first step towards the era of dismantling of regulations in U.S.

In order to make banks and savings and loans associations competitive to the mutual funds, President Carter signed into law the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980. Depository institutes were allowed to offer negotiable order of withdrawal (NOW) accounts with competitive rates of return in the market. Also the federal deposit insurance was increased from \$40,000 to \$100,000. It also required all banks to maintain reports and hold reserves at the Federal Reserve.

When Regan became the president, the system of deregulation continued. In 1982, Congress passed the Garn-St. Germain Act of 1982. The legislation authorized thrifts to engage in commercial loans up to 10 percent of assets and offer a new money market deposit account (MMDA) to compete directly with money market mutual funds. The new expanded powers allowed thrifts to act more like a bank and less like a specialized mortgage lending institution. Realizing the possibility of industry problems in the future, the Garn-St. Germain Act also provided direct capital assistance to distressed institutions and expanded federal regulators’ ability to deal with institutional failures in the future ^[6]. A time table was set under which all depository interest rates by 1986. This Act made the thrift institutions to enter unto new domains of market. Asset liability mismatch, inadequate deposit insurance and poor supervision a huge savings and loan crises persisted in U.S. throughout 1980s.

In 1986, the wall between investment banks and commercial banks was finally dropped by allowing banks to derive 5% of their revenues from investment banking business. By 1987, banks were allowed to deal in debt and equity securities within 10% limit. They now handle commercial paper, municipal bonds and mortgage-backed securities. Thus, the most important pillar of Glass Steagall was dropped and Alan Greenspan, the fed chairman appointed in 1987 was behind the massive deregulation.

Whole of the Regan period was referred as an atomistic behavior period where every individual was involved in speculative activities focusing on increasing his wealth. The income thus derived was “rentier income”- income derived in the form of interest from the ownership of money. With competition becoming intense, credit standards did slip in banking system. Loan default was rising and lending in oil gas was rising as interest rates rose banks had to cover the cost of funding. The collapse of Oklahoma Bank, Penn Square Bank was such consequences.

ConcuSSION

The regulatory framework that was put in place in post the Great depression separated the commercial banks activities

from other Wall Street banks. There was no growth and diversification in financial industry during the Glass Steagall period till 1950s. But it was successful in reducing fragility among banks, the very purpose it was introduced for. We saw financial deregulation occurred in phases, sometimes by Federal Reserve decision making and sometimes by market pressures. Time to time, adjustments were made through passing Acts in order to make commercial banks competitive to the financial innovations. To put the whole events between 1930 to 1980 under some theoretical framework, I can say that the innovations of Nonbank-Banks and mutual funds was simply the byproducts of the endogenous emergence of the financial system. On the other hand the inflation of 1970s was nothing but a result of external intervention. Lastly, loophole in legal framework of glass Steagall and the ideology and political powers affected the way whole system emerged.

Finally, during this period, there was a shift in the role Fed plays in the system. From effective policies to reduce competition it became a protectionist. Federal Reserve's role as a lender of last resort was no more to simply lend but to stabilize the system as a whole. The coverage of depository institutes was increased and Fed now bailout the failing banks and savings and loans associations.

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